



# Legal Study on the Microfinance Sector in SRI LANKA

2010



Ministry of  
Finance and  
Planning

gtz



Lanka Microfinance  
Practitioners' Association

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## **i. About GTZ**

### **Our Organisation**

The Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) is a federally owned organisation. We work worldwide in the field of international cooperation for sustainable development. Our mandate is to support the German Government in achieving its development objectives. We provide viable, forward-looking solutions for political, economic, ecological and social development in a globalised world. Sometimes working under difficult conditions, we promote complex reforms and change processes. Our corporate objective is to improve people's lives on a sustainable basis.

### **Who We Work For**

GTZ is based in Eschborn near Frankfurt am Main. It was founded in 1975 as a company under private law. Most of our activities are commissioned by the German Federal Ministry for Economic Cooperation and Development (BMZ). We also operate on behalf of other German ministries, the governments of other countries and international clients – such as the European Commission, the United Nations and the World Bank – as well as for private companies. We act on a public-benefit basis, channelling all surpluses back into our own international cooperation projects for sustainable development.

### **Worldwide Operations**

GTZ has operations in 128 countries in Africa, Asia, Latin America, the Mediterranean and Middle East regions, as well as in Europe, Caucasus and Central Asia. We have our own offices in 88 countries. We employ almost 15,000 staff worldwide, more than 11,000 of whom are national personnel. About 1,800 people work at Head Office in Eschborn and elsewhere in Germany.

Promotion of the Microfinance Sector (ProMiS) is a comprehensive programme implemented by the Sri Lankan Ministry of Finance and Planning in partnership with GTZ on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ).

## ii. Foreword

### LEGAL STUDY ON THE MICRO FINANCE SECTOR IN SRI LANKA

I take great pride in writing a foreword for the Legal Study initiated by Lanka Micro Finance Practitioners' Association (LMFPA) with the support of GTZ ProMiS Project.

We have observed that in the absence of a separate legislation for the Micro Finance sector, Micro Finance Institutions and their activities are governed by different legislations which are currently in force in the country. This has been identified as one of the major challenges faced by the Micro Finance Institutions as well as all stakeholders for the future development of the sector. In the mean time we also appreciate the initiatives taken by the Government of Sri Lanka to date to streamline the Microfinance Sector in order to accelerate the poverty alleviation process. It is important to note that the policy document of "Mahinda Chintanaya" has given significant emphasis on the promotion of micro finance. We understand that currently efforts are being made by the Ministry of Finance and the Central Bank of Sri Lanka, to bring a suitable legislation for the micro finance sector.

The above Legal Study has been initiated to assist stakeholders, particularly our member Micro Finance Institutions to understand the existing legal status related to their governance and activities. We also believe that this study will be helpful and shed light to the policy makers and other opinion leaders in the process of developing appropriate policies and legislations for this sector.

I take this opportunity to thank our members and the Board of Management for providing valuable input. I also extend my heartfelt gratitude to the GTZ ProMiS Project for providing financial assistance and specially Mr. Hasitha Wijesundara, Microfinance Specialist for Co-ordinating this activity with utmost care and dedication. I thank M/S F. J. & G De Sarams, Attorneys-at-Law for compiling this comprehensive legal study, which is unique in this kind.

**Shakila Wijewardena**

*President*

Lanka Micro Finance Practitioners' Association



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## 01. Summary of existing laws and legislative proposals related to microfinance.

Currently, there is no one law in Sri Lanka which deals specifically with microfinance or the regulation of entities carrying out microfinancing. The laws applicable to this area are contained in various laws having varying degrees of applicability depending on the entity carrying out microfinancing and the type of microfinancing being provided.

The Ministry of Finance in conjunction with the Central Bank of Sri Lanka had proposed the introduction of a bill on the regulation of microfinance institutions. However, our research reveals that this proposal has been suspended.

In the analysis given below, we have reviewed various laws that impact microfinance institutions ("MFIs") in Sri Lanka.

We have, for ease of reference, set out below the issues raised by you in the terms of reference provided and stated our views thereon immediately below each such question.

## 02. A brief analysis of the law/s in Companies Act, Money Lending Ordinance, Banking Act (Commercial Banks, Licensed Specialized Banks & Foreign Banks), Finance Companies Act, Exchange Control Act, Pawnbrokers Ordinance, Finance Leasing Act, Societies Ordinance, Co-operative Societies Law, Samurdhi Authority Act, National Housing Act, Regulation of Insurance Industry Act, Debt Recovery (Special Provisions) Act, Mortgage Act, Monetary Law Act, CRIB related Laws, Inland Revenue Act and VAT Act etc with relation to the MicroFinance Industry in Sri Lanka.

The laws referred to above have varying degrees of applicability to entities carrying out microfinance in Sri Lanka. We have given a brief summary of the salient features of each of the said laws below and discussed the applicability of the said laws to MFIs.

### Companies Act

The Companies Act No.7 of 2007 ("Companies Act") governs all Companies in Sri Lanka and provides for the incorporation of Companies and related matters, specific

provisions applicable to private Companies and Companies limited by guarantee, issue of shares and debentures by a Company, shareholders' rights and obligations, charges created by a Company, management and administration of Companies (including preparation of financial statements, meetings and proceedings, directors duties, appointment and removal of directors etc), amalgamation of Companies and winding up of Companies etc.

The Companies Act also regulates overseas Companies which have established a place of business in Sri Lanka and off-shore Companies.

A Company set up under the Companies Act may be either

(A) A limited liability Company - i.e. a Company that issues shares, the holders of which have the liability to contribute to the assets of the Company, if any, specified in the Company's articles as attaching to those shares);

A Company that issues shares may be a private Company (i.e. a Company, the articles of association of which prohibit it from issuing shares/ other securities to the public and limit the number of shareholders to 50 excluding employee and ex-employee shareholders) or a limited Company other than a listed Company or a listed Company, the shares of which are quoted on the stock exchange.

The name of every limited Company (other than a listed Company) must end in the word "Limited" or the abbreviation "Ltd". The name of a private Company must end in the words "Private Limited" or "(Pvt) Ltd". The name of a limited Company that is listed must end in the words "Public Limited Company" or "PLC".

(B) An unlimited Company - i.e. a Company that issues shares but the holders of such shares have unlimited liability to contribute to the assets of the Company under its articles; or

(C) A Company limited by guarantee - i.e. a Company that does not issue shares, the members of which have undertaken to contribute to the assets of the Company in an amount specified in its articles in the event of a liquidation.

Such Companies may apply to the Registrar General of Companies for a license to dispense with the word 'Limited' in its name if the objects of such Company are restricted to the promotion of commerce, art,



science, religion, charity, sport or any other useful object and intends to apply its profits or other income to promoting its objects and prohibits (in terms of its articles) the payment of any dividend to its members. After incorporation, the articles of such a Company cannot be amended or altered without the prior written approval of the Registrar.

The provisions of the Companies Act referred to in the Third Schedule thereto shall not apply to a Company limited by guarantee.

### Applicability of the Companies Act to MFIs:

Any person wishing to setup a microfinance institution as an incorporated Company should follow the provisions of the Companies Act to do so. Such incorporation would provide (other than in the case of an unlimited Company as discussed above) the benefit of “limited liability” for the ‘investor’.

### **Money Lending Ordinance**

The Money Lending Ordinance No. 2 of 1918 (as amended by Act Nos. 9 of 1954 and 11 of 1963) (“Money Lending Ordinance”) states that no person shall carry on the business of money lending if such person is

- (i) An individual who is not a citizen of Sri Lanka,
- (ii) A foreign Company,
- (iii) A foreign firm,

Unless such foreign Company or firm is approved for such purposes by the Minister of Finance by Order published in Gazette.

The term “money lending” is not defined in the Money Lending Ordinance.

A “foreign Company” is defined as a Company to which Part XI of the Companies Ordinance (now Part XVIII of the Companies Act No. 07 of 2007) applies other than any commercial Bank within the meaning of the Monetary Law Act or any life insurance Company.

A “foreign firm” is defined as a firm (i) consisting of two partners one of whom is not a citizen of Sri Lanka or both of whom are not such citizens or (ii) consisting of more than two partners at least one of whom is not a citizen of Sri Lanka.

The Money Lending Ordinance further provides for the regulation of money-lending transactions by way of requiring the compliance with its provisions by persons, firms or Companies carrying out such money lending transactions. These include provision of rules for determining “unreasonable” rates of interest, the requirements for maintaining accounts, rules regarding “undue influence” in money lending transactions etc.

The Money Lending Ordinance further empowers a court where proceedings are taken for the recovery of money lent or the enforcement of any agreement/security, to re-open the transaction and take an account between the lender and the person sued if there is evidence that the return to be received by the lender over and above what was Actually lent is excessive or the transaction was harsh and unconscionable or unfair between the parties thereto. [Section 2]

The above provision however does not apply to transactions in the course of business by

- (a) Mutual provident/specially authorized society under the Societies Ordinance
- (b) Any society incorporated under the National Housing Act
- (c) Any society registered/deemed to be registered under the Co-operative Societies Law

[Please note that consequent to the Thirteenth Amendment to the Constitution being passed by Parliament, ‘co-operative societies’ is a devolved subject contained in the Provincial Council List as well as the Concurrent List of the ninth schedule to the Thirteenth Amendment.

This means that the provincial councils now possess the power to make statutes relating to the registration and supervision of Co-operative societies in consultation with Parliament. Where a provincial council has made a statute pertaining to the registration and supervision of co-operative societies within its province, co-operative societies to be formed within such province are required to register under such provincial statute and existing co-operative societies within such province are deemed to be so registered.

Such societies are then governed by the provisions set out in the provincial statutes and not the Co-operative Societies Law No. 5 of 1972. To date Western, Central and Sabaragamuwa provinces have promulgated statutes relating to registration and supervision of co-operative societies

In the absence of specific provision either in the Money Lending Ordinance or in the respective provincial statute as to the applicability of the aforesaid section 2 to co-operative societies within such provinces registered or deemed to be registered under such provincial statutes, it may be contended that such exemption is available to such co-operative societies as well as it may be assumed that with the devolution of this subject, it is intended that co-operative societies shall in future be registered at provincial level. This aspect is discussed further in our discussion of the Co-operative Societies Law in this report.]

- (d) Any corporate/unincorporated body empowered by any special enactment to lend money
- (e) Registered Bank
- (f) Person carrying on *bona fide* the business of insurance
- (g) Licensed pawnbroker.

#### Applicability of the Money Lending Ordinance to MFIs:

The Money Lending Ordinance will apply to microfinance institutions in relation to the money lending aspect of their business.

Section 2 of the Money Lending Ordinance will not apply to a MFI if it falls within the list of entities referred to under (a) to (g) above.

#### **Banking Act**

The Banking Act of Sri Lanka No. 30 of 1988 (as amended by Act Nos. 39 of 1990, 33 of 1995, 02 of 2005, 15 of 2006 and 46 of 2006) ("Banking Act") provides *inter alia*, for

- Licensing of persons carrying on Banking business and the business of accepting deposits and investing such money;
- Supervision and regulation of such licensed entities by the Central Bank of Sri Lanka;
- Capital requirements, reserve funds and maintenance of liquid assets applicable to licensed Banks;
- Regulation of off-shore Banking business;
- Preparation of accounts, audit, furnishing of information and inspection;

- Directors and secretaries of licensed Banks;
- Control over Banks;
- Vesting the Banking business of a licensed Bank, liquidation of Banks incorporated in Sri Lanka and closure of local branches of Banks incorporated outside Sri Lanka; and
- The issue of directions by the Monetary Board of Central Bank to licensed Banks on aspects such as advances to be made/not made by Banks, maintenance of margins, maximum accommodation to be given to connected parties, maximum share holding percentage in a Bank.

#### **(i) Licensed Commercial Banks**

The Banking Act provides that no *Banking business* shall be carried on except by a public Company under the authority of a license issued by the Monetary Board of the Central Bank of Sri Lanka ("the Monetary Board") with the approval of the Minister of Finance.

'Banking business' is defined under the Banking Act as the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part for advances, investments or any other operation either authorised by law or by customary Banking practices.

#### **Activities**

The Activities that can be carried out by a licensed commercial Bank ("LCB") set up under the Banking Act shall be specified in its license and include the forms of business listed in the second schedule of the Banking Act. These include, *inter alia*, (i) opening, maintaining and managing deposits, savings and other similar accounts (including current accounts) (ii) the borrowing, raising or taking up of money, (iii) the negotiating of loan and advances and (iv) the lending or advancing of money either upon or without security etc.

#### **Share ownership**

The Banking (Amendment) Act No. 05 of 2005 states, *inter alia*, that an individual, partnership or corporate body shall not either directly or indirectly or through a nominee or Acting in concert (defined as Acting pursuant to an understanding

(formal or informal) to actively co-operate in acquiring a material interest in a LCB to obtain or consolidate control of that Bank) with any other individual, partnership or corporate body acquire a “material interest”(defined as *the holding of over ten percentum of the issued capital of a licensed commercial Bank carrying voting rights*) in a LCB incorporated or established in Sri Lanka without prior approval of the Monetary Board given with the concurrence of the Minister of Finance. However the Monetary Board, may on a case by case basis, grant permission to specified categories of shareholders to acquire a material interest not exceeding 15% of the issued capital in a LCB carrying voting rights.

Foreign participation in the share capital of a licensed commercial Bank upto 100% of the share capital is permitted subject to the limitations above.

### Minimum Capital

It must be noted that the Banking Act specifies that every LCB shall at all times maintain a minimum equity capital as stated from time to time by the Monetary Board. Currently the amount prescribed is Rupees Two Thousand Five Hundred Million (Rs. 2,500,000,000/=).

### Supervision

The regulatory and supervisory function relating to Banks is carried out by the Bank Supervision Department of the Central Bank. The supervision of Banks is based on the internationally accepted standards for Bank supervision set out by the Basel Committee for Banking Supervision.

### (ii) Licensed Specialised Banks

The Banking Act stipulates that the business of accepting deposits of money and investing and lending such money shall not be carried on except by a Company which has an equity capital in an amount not less than fifty million rupees and under the authority of a license issued by the Monetary Board for such purpose under Part IXA of the Banking Act i.e. license as a licensed specialized Bank

This requirement does not apply to registered Finance Companies under the Finance Companies Act, a co-operative society under the Co-operative Societies Law, a building society incorporated under the National Housing Act and any organization established or registered under

any written law, not being an organization established primarily for the purpose of making profit, which accepts deposits only from its registered members and has obtained permission in writing from the Monetary Board to accept such deposits and to invest or lend the monies so accepted.

### Activities

Licensed specialised Banks (“LSBs”) differ from LCBs in that they are prohibited from opening and maintaining current (or “checking”) accounts for its customers. The ability to deal in gold and foreign currency available to LCBs (all of which have been appointed by Central Bank as authorized dealers in foreign currency) is also not available to LSBs.

The main activities LSBs are allowed to carry out are contained in the Fourth Schedule of the Banking Act, and include, *inter alia*, (i) accepting time and savings deposits and opening, maintaining and managing deposits, savings and other similar accounts, excluding however the carrying out of “Banking business” as defined in the Banking Act (see above), (ii) the granting of loans and advances or participating with other financial institutions in granting loans or advances to any enterprise. However as in the case of a LCB, the forms of business which a LSB may carry out are subject to any restrictions set out thereon in its license as well as any other written law.

The licensing requirements are similar to that of a LCB.

### Share ownership

There are no restrictions imposed by law on foreign investment in the share capital of a LSB other than the general limits on share ownership in Banks as set out under the Banking Act and directions issued from time to time thereunder. In general, no person (including a corporate body) may acquire more than 15% of the share capital of a LSB without the prior written approval of the Monetary Board.

### Minimum Capital

LSBs are required to at all times maintain an equity capital of Rupees One Thousand Five Hundred Million (Rs. 1,500,000,000/=).

## Supervision

LSB's are subject to regulatory control by the Central Bank as with LCBs (see above).

### (iii) Foreign Banks

Foreign Banks may carry on Banking business in Sri Lanka by complying with the requirements of the Companies Act applicable to registered overseas Companies and obtaining a license from the Monetary Board.

The requirements applicable under the Companies Act are as follows -

Within one month of establishing its business in Sri Lanka, the foreign entity must deliver to the Registrar General of Companies the documents set out below.

- (a) A certified copy of the charter, statutes or memorandum and articles of the Company, or other instrument constituting or defining the constitution of the Company, and where that instrument is not in an official language of Sri Lanka or in English, a translation of that instrument in such language as may be specified by the Registrar.
- (b) A list of the directors of the Company, containing such particulars with respect to the directors as are by the Companies Act required to be contained with respect to directors, in the register of the directors of a Company.
- (c) The names and addresses of one or more persons resident in Sri Lanka authorized to accept on behalf of the Company, service of documents and of any notices required to be served on the Company.
- (d) A statement containing the full address of:
  - (i) The registered or principal office of the Company;
  - (ii) The principal place of business of the Company within Sri Lanka.
- (e) A certified copy certified of recent date, of any document effecting or evidencing the incorporation of the Company.

On receipt of the documents referred to above, the Registrar may, on being satisfied that the requirements of the Act have been complied with, issue a certificate of registration

to such entity having a place of business in Sri Lanka, upon which such Company will have the status of a registered overseas Company in Sri Lanka.

The Banking Act provides that the Central Bank may require such Company to undertake to remit to Sri Lanka, prior to the commencement of business in Sri Lanka, a sum of money to be determined with the approval of the Minister of Finance in United States Dollars or its equivalent in a designated foreign currency. The amount to be remitted forms the assigned capital of the Company and shall be kept as a deposit with the Central Bank or in such other manner as determined by the Central Bank.

A foreign Bank which intends to set up Banking operations in Sri Lanka by establishing a place of business in Sri Lanka is subject to the licensing requirements and other provisions as applicable under the Banking Act including regulation and supervision by Central Bank.

### Applicability of the Banking Act to MFIs:

If an entity wishes to carry out microfinance business in Sri Lanka by establishing either a licensed commercial Bank or a licensed specialized Bank, the provisions of the Banking Act will apply to such entity and it should obtain the relevant license from the Central Bank.

In the event an MFI is already carrying out activities which fall within all the elements of the definition of "Banking business" (as contained in the Banking Act and discussed above) in Sri Lanka, it should obtain a license to operate as a LCB in Sri Lanka.

In the event an MFI is already carrying out the business of accepting deposits of money and investing and lending such money in Sri Lanka, it should obtain a license to operate as a LSB in Sri Lanka, unless it is a registered Finance Company, a registered co-operative society, a building society or a LCB or an organization fulfilling the stipulated criteria (as discussed above) which has the permission of the Monetary Board to accept such deposits.

### **Finance Companies Act**

The Finance Companies Act No. 78 of 1988 (as amended by Act No. 23 of 1991) ("Finance Companies Act") provides, *inter alia*, for registration and licensing of Finance Companies, regulation and supervisory control of such Companies by the Monetary Board including aspects such as capital and

statutory reserves to be maintained by Finance Companies, conduct of business, preparation of accounts and financial statements, winding up and vesting of business of Finance Companies, and the issue of directions by the Monetary Board regarding the manner in which the business of Finance Companies are to be conducted.

The Finance Companies Act defines “Finance business” as the business of accepting money by way of deposit, the payment of interest thereon and

- a) The lending of money on interest; or
- b) The investment of money in any manner whatsoever; or
- c) The lending of money on interest and the investment of money in any manner whatsoever.

In terms of the Finance Companies Act, no Finance business shall be carried on except by a public Company which -

- Is registered under the Companies Act;
- Has a minimum issued and paid up capital of not less than five million Rupees; and
- Is registered under the provisions of the Finance Companies Act.

Furthermore, a Finance Company is required by the Monetary Board of Sri Lanka to have an unimpaired core capital of not less than Rupees Two Hundred Million (Rs. 200,000,000/=) (core capital represents the permanent shareholders equity (paid up shares/common stock) and reserves created or increased by appropriations of retained earnings or other surpluses (i.e. share premia, retained profits and other earnings)

It must also be noted that the provisions of the Finance Companies Act do not apply to the business of any Banking institution as defined in the Monetary Law Act.

There are no restrictions on foreign entities investing in the shares of a Company carrying on business as a Finance Company. It is not possible, however for a foreign entity to do business in Sri Lanka as a Finance Company by registering a place of business in Sri Lanka as a registered overseas Company as the Finance Companies Act requires a Finance Company to be a public Company incorporated under the Companies Act.

### Applicability of the Finance Companies Act to MFIs:

If the business of a MFI falls within the scope of “Finance business” as defined in the Finance Companies Act, then such entity should be registered and licensed as a “Finance Company” under the Finance Companies Act.

Please note however, that such business should fulfill at least 2 of the stipulated criteria i.e. business of accepting money by way of deposit, the payment of interest thereon and the lending of money on interest or the investment of money in any manner whatsoever, to fall within the definition of “Finance business”.

Please note also that the provisions of the Finance Companies Act do not apply to the business of any Banking institution as defined in the Monetary Law Act or to a co-operative Society registered under the Co-operative Societies Law. [Although no specific reference is made to co-operative societies registered at provincial level, it may be assumed for the reasons more fully discussed in this report that such exemption is available for such co-operative societies as well.]

Therefore, in the event a MFI is in possession of a Banking license issued by Monetary Board or is a registered co-operative society, it is not subject to the requirements of the Finance Companies Act.

### **Finance Leasing Act**

The Finance Leasing Act No. 56 of 2000 (as amended by Act Nos. 24 of 2005 and 33 of 2007) (“Finance Leasing Act”) provides, *inter alia*, for the registration, regulation and monitoring of Finance leasing businesses and the rights and duties of lessors, lessees and suppliers of equipment.

The Finance Leasing Act stipulates that no person shall carry on Finance leasing business except under the authority of a certificate of registration issued in that behalf under the Finance Leasing Act. “Finance leasing business” is defined in the Finance Leasing Act as the business of investing money for the provision of equipment under a Finance lease.

The Finance Leasing Act defines “Finance lease” as an agreement between a lessor and a lessee-

- i. For the possession and use by the lessee for an initial period of not less than one year from the date of the agreement, of an equipment specified by the lessee and either provided by the lessor or a supplier selected by the lessee;
- ii. For the payment by the lessee to the lessor for possession and use of such equipment of such sums to be calculated so as to take into account in particular the amortization of the whole or substantial part of the cost of the equipment;
- iii. Which, after the acceptance of the equipment by the lessee, is not terminable by the lessee during the initial period set out in (a) above; and
- iv. Which, though not a hire purchase agreement within the meaning of the Consumer Credit Act No. 29 of 1982, (which is an Act that defines and regulates the duties of parties to hire-purchase agreements), may or may not provide for the extension of the initial period set out in paragraph (a) or for the purchase by the lessee of the equipment after the expiration of the initial period set out in paragraph (a) or the period extended under this paragraph.

“Equipment” is defined in the said Act as, any tangible asset which has an economically useful life of more than one year and does not include land, any improvements made to land other than fixtures or immovable property attached to land which can be removed from the land without substantial destruction to such fixture or immovable property.

There are no restrictions imposed on foreign investment in the shares of a Company carrying on the business of Finance leasing. It is not possible however, as in the case of a Finance Company, for a foreign entity to engage in Finance leasing business in Sri Lanka by registering a place of business as a registered overseas Company, as the Finance Leasing Act requires an applicant which is not a LCB or a LSB to be a public Company incorporated under the Companies Act.

#### Applicability of the Finance Leasing Act to MFIs:

If it is intended that the scope of the Microfinance activities to be carried out by a MFI includes or is limited to, “Finance leasing business” as defined in the Finance Leasing Act, then such MFI must be a registered Finance leasing establishment under the Finance Leasing Act, and have obtained a certificate of registration as such (please see further details on licensing procedures in our answer relating to Finance leasing businesses in question 4).

#### **Pawnbrokers Ordinance**

In terms of the 13<sup>th</sup> amendment to the Constitution, the subject of the ‘Pawnbrokers’, (except the pawnbroking business carried out by Banks), is set out in the List I - ‘the Provincial Council List’. Therefore, the business of pawnbroking is now a devolved subject and provincial councils may pass statutes on the subject of pawnbrokers.

In terms of the Article 154G (8) (of 13<sup>th</sup> amendment) to the Constitution, where there is a law in force on any subject in the Provincial Council List on the date the 13<sup>th</sup> amendment comes into force and subsequently a provincial council passes a statute on the same subject which in its long title states that such statute is inconsistent with the law on the same subject, the law will be suspended and inoperative within that province so long as that statute remains in force.

However, except the Western Province of Sri Lanka no other province has passed any statute on the subject of pawnbroking. Hence, we set out below a brief analysis of the Pawnbrokers Ordinance No. 13 of 1942 followed by a brief analysis of Pawnbrokers Statute No 03 of 2001 (as amended) of the Western Province.

#### **Pawnbrokers Ordinance**

The Pawnbrokers Ordinance No. 13 of 1942 (as amended by Act Nos. 2 of 1953, 55 of 1956, 11 of 1963 and 23 of 1973) (“Pawnbrokers Ordinance”) provides for the issue of licenses to pawnbrokers and regulation of the business of pawnbroking.

A pawnbroker is defined in the Pawnbrokers Ordinance to include “every person who carries on the business of taking goods in pawn”.

Even though a definition for pawning is not given in the Pawnbrokers Ordinance, some guidance on the meaning of “pawning” can be had from a direction issued by the Monetary Board of the Central Bank under the Banking Act which defines ‘pawning’ for the purposes of the conditions set out in the said direction as “*lending of money on the security of personal articles made of gold.....accepted as a pledge for a period not exceeding an initial period of twelve months*”. However, the business regulated by the Pawnbrokers Ordinance is probably not confined to lending against pledges of gold items for a period less than 12 months. The concise Oxford Dictionary defines a

“pawnbroker” as “a person who lends money at interest on the security of personal property pawned”

In terms of the Pawnbrokers Ordinance, any person carrying on the business of a pawnbroker must obtain a license on that behalf issued by the Divisional Secretary.

The Pawnbrokers Ordinance provides for the regulation and governance of persons carrying on pawn broking activity. These include the requirement of maintenance of certain books of accounts, procedures and provisions governing the “pawning”, redemption of goods pledged, maximum rates of interest to be charged, the rights of persons owning a pledge (defined in the Pawnbrokers Ordinance as a pawned article) and other such related matters.

As under the Money Lending Ordinance, the Pawnbrokers Ordinance too prohibits a person who is -

- (i) An individual who is not a citizen of Sri Lanka; or
- (ii) A foreign Company; or
- (iii) A foreign firm

from carrying out the business of a pawnbroker.

Regulations issued under the Exchange Control Act provides that a non resident shall not be entitled to invest in the shares of a Company carrying on the business of pawnbroking.

Licensed commercial Banks are exempt from the application of the Pawnbrokers Ordinance as section 83A of the Banking Act provides that “*the provisions of the Pawnbrokers Ordinance...shall not apply to a licensed commercial Bank and such Bank may carry on the business of pawn brokers subject to such conditions as may be determined by the Monetary Board*”.

Thus, whilst a foreign entity cannot engage in pawnbroking directly through a registered overseas Company in Sri Lanka or by investing in a Company incorporated locally, in the event it obtains a license to operate as a LCB under the Banking Act, it may offer pawnbroking services as part of its Banking services, unless prohibited to do so by a condition to such effect in the Banking licence.

### Applicability of the Pawnbrokers Ordinance to MFIs:

In the event an MFI intends to carry out pawnbroking Activity in Sri Lanka, it should have a license issued by the Divisional Secretary in terms of the Pawnbrokers Ordinance unless it is in possession of a Banking license issued by Monetary Board.

### **Pawnbrokers Statute No 03 of 2001 of the Western Province**

The provisions of the Pawnbrokers Statute No 03 of 2001 are almost identical to the provisions of the Pawnbrokers Ordinance. However, certain deviations are apparent in the areas relating to licensing, fees and charges payable thereto and with respect to amounts of fines in the event of violation of provisions of the said Statute.

The Pawnbrokers Ordinance requires a license to be obtained by the person who is desirous of carrying on the business of the pawnbroker whereas the said Statute requires a license to be obtained and maintained by each and every branch or shop which carries out the business of pawnbroker within the boundaries of the Western Province.

In terms of the Pawnbrokers Statute the supervisory authority is now vested with the Western Province Provincial Council. Thus the minister in charge of the subject is the minister in charge of the subject in the Western Province Provincial Council.

As previously discussed, where there is a law in force on any subject in the Provincial Council List on the date the 13<sup>th</sup> Amendment comes into force and subsequently a provincial council passes a statute on the same subject which in its long title states that such statute is inconsistent with the law on the same subject, the law will be suspended and inoperative within that province so long as that statute remains in force.

The Pawnbrokers Statute in its long title sets out that, the same is in accordance with the Pawnbrokers Ordinance of No 13 of 1942.

The question therefore arises as to the validity of the provisions in the Pawnbrokers Statute which are inconsistent with the Pawnbrokers Ordinance. In the absence of a statement in the long title of the Statute to the effect that it is inconsistent with the Pawnbrokers Ordinance, we are

of the view that the validity of such inconsistent provisions in the Western Province statute may be challenged as it does not fall within the scope of Article 154G (8) (of the 13<sup>th</sup> amendment) to the Constitution.

## Exchange Control Act

The Exchange Control Act No. 24 of 1953 (as amended by Act Nos. 35 of 1956, 47 of 1957, 17 of 1971, 17 of 1972, 39 of 1973, 04 of 1977 and 13 of 1977) (“the Exchange Control Act”) vests the Central Bank of Sri Lanka as the agent of the Government, with responsibility for carrying out the provisions of the Act. It *inter alia* regulates dealing in gold and foreign currency, provides for control of foreign assets, restricts payments to or for the credit of persons resident outside Sri Lanka, the issue of securities and the import and export of currency, gold and securities etc.

We summarise below the main provisions of the Exchange Control Act -

### Gold and Foreign Currency

The Exchange Control Act prohibits any person, other than an authorised dealer i.e. a LCB from buying, borrowing or accepting any gold or foreign currency, or selling or lending any gold or foreign currency to, or exchanging any foreign currency with, any other person other than an authorised dealer. This prohibition applied to all persons within Sri Lanka and to persons resident in Sri Lanka who do so outside of Sri Lanka. [Section 5]

A person obtaining gold or specified foreign exchange from an authorised dealer is entitled to be treated under the Exchange Control Act as if the Central Bank had consented to the retention and use by him of that gold or foreign exchange [Section 6(4)].

However, subject to the aforesaid exception, without the permission of the Central Bank no person is allowed to have in their possession any foreign currency [Section 6A].

### Control of foreign assets-

The Exchange Control Act also prohibits persons in, or resident in, Sri Lanka from

- (i) Opening an account with any Bank or institution doing any kind of Banking business outside Sri Lanka; or
- (ii) Continuing to maintain or operate such an account; or
- (iii) Closing such an account without the permission of the Central Bank [Section 6AA].

With respect to opening of foreign currency accounts in Sri Lanka, authorized dealers have been granted permission, subject to the terms and conditions stipulated by Central Bank, to open the certain restricted categories of foreign currency accounts in Sri Lanka.

### Payments

The Exchange Control Act further prohibits a person in Sri Lanka from

- (i) Making any payment to or for the credit of a person resident outside Sri Lanka, or
- (ii) Making any payment to or for the credit of a person resident in Sri Lanka by order or on behalf of a person resident outside Sri Lanka, or
- (iii) Placing or holding any sum to the credit of any person resident outside Sri Lanka

except with the permission of Central Bank.

[Section 7]

A further restriction has been placed on persons resident in Sri Lanka from making any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka with the permission of Central Bank [Section 8].

### Securities

Section 10 of the Exchange Control Act prohibits the issue and transfer of securities registered in Sri Lanka to any person resident outside Sri Lanka except with the permission of Central Bank.

Section 17 of the Exchange Control Act prohibits any person in Sri Lanka or a resident of Sri Lanka Acting outside Sri Lanka, from acquiring, holding or transferring any prescribed security except with the permission of the Minister of Finance.



## Import and export of gold and currency

The Exchange Control Act also prohibits the importing (without the permission of the Central Bank) of any notes of a class which are or have been legal tender in Sri Lanka, or any such other notes issued by a Bank or notes of a class which are or have been at any time legal tender in any territory or any gold. Furthermore it also prohibits (without the permission of the Central Bank) the export from Sri Lanka any currency, Treasury Bills, gold, savings certificate expressed in Sri Lanka or any foreign currency, or any of the following (including any such documents which have been cancelled) - (i) certificate of title to a security and any coupon, (ii) any policy of insurance, (iii) or any document certifying the destruction loss or cancellation of any of the aforesaid documents, or any such article exported on the person of a traveller or in a traveller's baggage as maybe prescribed.

The Exchange Control Act also empowers the Central Bank to give Bankers and any other persons who are concerned with the keeping of any register in Sri Lanka or are entrusted with the payment of capital moneys, dividends or interest in Sri Lanka, directions as respects the exercise of functions exercisable by them by virtue of, or by virtue of anything done under, the provisions of the ECA. These include directions to authorised dealer specifically with regards to the terms on which they are to accept gold or foreign currency, and requiring them to offer their gold or specified foreign exchange for sale to the Central Bank on the terms set out therein.

Furthermore the Exchange Control Act empowers the Central Bank to give directions requiring any person in (including resident in) Sri Lanka to furnish the Bank with any information (in the manner and within the time period set out therein) for the purpose of securing compliance with, or detecting evasion of, the provisions of the Exchange Control Act. This includes attending in person before any officer specified in such directions at such date and time as prescribed, for examination on any such matter or matters as specified in the said directions, or furnishing any such books or accounts or documents in his possession or control for the purposes of furnishing such information.

## Appointment of agents and technical advisers

In terms of section 29C of the Exchange Control Act, a Company (other than a Banking Company) which is not incorporated in Sri Lanka or which is controlled directly/

indirectly by persons resident outside Sri Lanka or any branch/ office of such Company in Sri Lanka or a firm consisting wholly/in part of persons resident outside Sri Lanka shall not accept appointment as -

- (i) Agent in Sri Lanka of any person, Company or firm in the trading or commercial transactions thereof; or
- (ii) Technical or management adviser in Sri Lanka of any person, Company or firm

except with the general or special permission of the Central Bank.

## Lending to or guaranteeing a non resident

Section 30(6) and (7) of the Exchange Control Act stipulate that except with the general or special permission of Central Bank, no person resident in Sri Lanka shall

- Give a guarantee in respect of any debt/obligation/ liability of any person resident outside Sri Lanka
- Lend any money either to any firm or Company (other than a Banking Company) which is controlled directly/indirectly by persons resident outside Sri Lanka.

## Applicability of the Exchange Control Act to MFIs:

A microfinance institution carrying on business in Sri Lanka either by incorporating a Company in Sri Lanka or through the establishment of a place of business would be subject to the provisions of the Exchange Control Act including the restrictions discussed above. For purposes of exchange control, it would be considered as a resident of Sri Lanka as offices and branches in Sri Lanka of Companies, firms, Banks or any other organizations whether owned by citizens of Sri Lanka or foreigners fall within the definition of "resident in Sri Lanka" in terms of directions issued under the Act.

The only exemption from application of the Exchange Control Act is in respect of entities that have entered into an agreement with the Board of Investment of Sri Lanka under Section 17 of the Board of Investment of Sri Lanka Law (please refer the discussion below on the Board of Investment of Sri Lanka Law) which exempts such entity from the application of the Act.

With respect to the prohibition on any person resident outside Sri Lanka from acquiring shares in a local Company except with the permission of the Controller of Exchange [vide Section 10 of the Exchange Control Act], this permission may be special (on a case by case basis) or general in nature. By regulation issued under the Exchange Control Act, the Controller of Exchange has given general permission to approved country funds, approved regional funds, corporate bodies incorporated outside Sri Lanka and individuals resident outside Sri Lanka for the acquisition of shares in local Companies, subject to certain exclusions, limitations and conditions specified in the said regulation including the requirement to channel such investment through a special account referred to as a Share Investment External Rupee Account known as SIERA.

The aforesaid regulation prohibits a person (individual or corporate) resident outside Sri Lanka from acquiring the shares of a Company incorporated in Sri Lanka and carrying out or proposing to carry out *inter alia*, the business of money lending or pawn broking;

Therefore, a foreign entity is prohibited from acquiring the shares of a Company incorporated in Sri Lanka carrying on or proposing to carry on the business of microfinance if such microfinance Activities include the business of money lending or pawn broking and as such a foreign entity intending to carry out microfinance Activities which include money lending or pawn broking may not incorporate a Company for such purpose or acquire shares in an incorporated Company already carrying out microfinance Activities unless it is a Banking Company under the Banking Act or a Finance Company registered under the Finance Companies Act.

Whilst Banks and Finance Companies are, *inter alia*, engaged in the business of money lending, there is no restriction on foreign ownership of shares in such entities (other than the single shareholder thresholds applicable in general) at present. It is noteworthy that earlier foreign ownership of Banks and Finance Companies was limited to the percentage of the issued capital of the Company as approved by the Government of Sri Lanka or any legal or administrative authority set up for the purpose. Such restrictions pertaining to Banks and Finance Companies were removed in 2002.

Legal and regulatory position on equity investments in local Companies is discussed further in our response to question # 11 below.

## The Debt Recovery (Special Provisions) Act

The Debt Recovery (Special Provisions) Act No. 2 of 1990 (as amended by Act No. 09 of 1994) ("Debt Recovery Act") provides for an expedited form of debt recovery for "lending institutions" in terms of the Debt Recovery Act.

The term "lending institution" is defined in the Debt Recovery Act as follows

- (a) A licensed commercial Bank within the meaning of the Banking Act No. 30 of 1988;
- (b) The State Mortgage and Investment Bank established by the State Mortgage and Investment Bank Act No. 13 of 1975;
- (c) The National Development Bank established by the National Development Bank of Sri Lanka Act No. 2 of 1979;
- (d) The National Savings Bank established by the National Savings Bank Act No. 30 of 1971;
- (e) The Development Finance Corporation of Ceylon established by the Development Finance Corporation of Ceylon Act; and
- (f) A Company registered under the Finance Companies Act No. 78 of 1988 to carry on Finance business,

And includes a liquidator appointed under the Companies Act No. 17 of 1982 or any authority duly appointed, to carry on, or wind up the business of any Bank, corporation or Company referred to above.

Further, in terms of the Debt Recovery Act the value of the principal amount lent or advanced must not be less than One Hundred and Fifty Thousand Rupees (Rs. 150,000/-) in order to follow the debt recovery procedure laid down in the Debt Recovery Act.

The Debt Recovery Act provides for lending institutions to file a plaint supported by an affidavit stating that a certain sum is due to it. The Act further provides that if any agreement or document is produced to court and it appears to be properly stamped (if required) and not to be open to suspicion by reason of any alteration etc and is not barred by prescription and the court is satisfied of the contents of the affidavit, the court shall issue a decree *nisi* in the sum prayed for in the plaint together with interest and other relief prayed for by the institution.

The defendant is not entitled to appear or show cause against the decree *nisi* (which is a form of an interim order), unless he obtains leave of court. The court shall grant such leave:

- (1) Upon the defendant paying into court the sum mentioned in the decree *nisi*; or
- (2) Upon the defendant furnishing such security as may appear to the court to be reasonable and sufficient for satisfying the sum mentioned in the decree *nisi*, in the event of it being made absolute; or
- (3) Upon the court being satisfied with the contents of the affidavit filed, that they disclose a defence which is prima facie sustainable and on such terms as to security, framing and recording of issues, or otherwise as the court thinks fit.

If the defendant either fails to appear and show cause or if having appeared his application to show cause is refused, the court shall make the decree *nisi* absolute.

If court makes an order making the decree *nisi* absolute, it will be considered as a writ of execution and it will be executed against the defendant.

The Debt Recovery Act provides that a defendant in an Action under the Debt Recovery Act or his representative in interest shall not alienate any movable or immovable property or otherwise dispose of same in any manner whatsoever after being served with the decree *nisi* unless the defendant has paid into court the sum mentioned in the decree *nisi*, the Action/decree *nisi* is dismissed, the decree absolute is satisfied with other property or with the approval of the court.

Any alienation/disposal of property in contravention of the above provision is null and void and of no force or effect in law and such property is open to seizure in whosoever's hands such property maybe except bona fide purchasers for value without notice of the decree *nisi*.

#### Applicability of the Debt Recovery (Special Provisions) Act to MFIs:

To utilise the debt recovery procedure laid down in the Debt Recovery (Special Provisions) Act, a MFI should fall within the definition of a "lending institution" as set out in the Debt Recovery (Special Provisions) Act i.e. it should be a LCB, a registered Finance Company or one of the Banks the names of which are set out in the said definition.

## **The Debt Conciliation Ordinance**

The Debt Conciliation Ordinance No. 39 of 1941 (as amended by Act Nos. 5 of 1959, 24 of 1964, 41 of 1973, 19 of 1978, 20 of 1983 and 29 of 1999) ("Debt Conciliation Ordinance") was enacted to establish the Debt Conciliation Board of Sri Lanka ("the Board"). The Board was empowered, *inter alia*, to provide a mediation forum between debtors and secured creditors for the settlement of debts which are owed by or to them.

The Debt Conciliation Ordinance defines a debtor as a person who has created a mortgage or charge over any immovable property and whose debts in respect of such property exceeds a prescribed sum.

A "secured creditor" is defined as a creditor holding a mortgage or charge on the immovable or movable property of the debtor or any part thereof created by a notarial instrument as a security for a debt due to him from the debtor.

The procedure, in general, is as follows -

A debtor may make an application to the Board to effect a settlement of the debts owed by him to all his secured creditors or to any one or more of them. Similarly any secured creditor of any debtor may make an application to the Board for the settlement of debts owed to him by that debtor. The Debt Conciliation Ordinance provides that every application shall be in writing, signed by the applicant and forwarded to the Board in the prescribed manner with such affidavits to furnish prima facie proof of the material facts set out/alleged in the application. The Debt Conciliation Ordinance also prescribes the particulars to be contained in the debtor's and creditor's respective applications.

The Board may, in consideration of the factors, and in line with the procedures, as outlined in the provisions of the Debt Conciliation Ordinance, have a preliminary hearing whereby the debtor and/or creditor (if the applicant is the creditor) are examined. If the Board, after such examination is of the opinion that it is desirable to effect a settlement between a debtor and all his secured creditors or any one or more of them or between the debtor and all his creditors (whether secured or unsecured), shall cause notice to be provided to secured (and if deemed applicable by the Board, the unsecured) creditors requiring them to submit to the Board on or before a specified date all particulars of debts owed to them by the relevant debtor (in the form

and manner prescribed) and shall publish a notice in the gazette that the Board is attempting to effect a settlement under the Debt Conciliation Ordinance between the debtor and his secured creditors or any one or more of them or between the debtor and all his creditors (whether secured or unsecured) (as the case maybe).

Thereafter the Board shall arrange for a hearing between the parties. At such hearing the Board shall call upon the debtor and each creditor to explain their case regarding each debt.

Where the parties come to an amicable settlement as regards the debt, the settlement (if approved by the Board) is to be reduced into form of a document (in duplicate), signed by both parties, and the Chairman of the Board. The Board shall not sign the settlement unless the Board is satisfied that a notice setting out the terms of the settlement has been served on each person appearing to the Board to be a secured creditor.

Where creditors whether secured or unsecured to whom more than fifty percent (50%) of the debts owed by the debtor arrive at an amicable settlement with such debtor, the settlement shall be reduced to writing, if it is considered equitable by the Board and shall set out the amounts payable to each of such creditors and the manner in which, the assets from which and the times at which such amounts are payable.

The Debt Conciliation Ordinance provides that it may be a term of a settlement that for the purpose of giving effect to the settlement the debtor shall execute a deed or instrument appointing a specified person as manager or trustee for administering any property dealt with in any settlement and such deed may be approved by the Board, and signed by the Chairman thereof.

Such settlement (when countersigned by the Chairman of the Board and subject to any order of the Board in that respect) shall be final between the parties and the contract in respect of any debt dealt with in the settlement shall become merged in the settlement.

Where the settlement deals with a debt secured by any charge, lien or mortgage over any movable/immovable property, the rights of such creditor, shall be deemed to subsist under the settlement (unless the settlement provides otherwise) until the amount payable has been paid or such property sold for the satisfaction of the debt.

In terms of the Debt Conciliation Ordinance, it is possible to for a settlement to provide for the creation of any charge/ mortgage over any property which upon registration of the settlement, shall be valid and effectual as if it is a charge created by the debtor on the date of the countersigning of the settlement.

The duplicate of such document must thereafter be delivered to the secretary to the Registrar of Lands for registration (as an instrument relating to each land dealt with in the settlement, and if the settlement deals with any moveable property, as a bill of sale affecting such movable property).

Furthermore where a debtor fails to comply with the terms of any such settlement, a creditor may (subject to the limitations set out in the Debt Conciliation Ordinance) apply to a court of competent jurisdiction that a certified copy of the settlement be filed in court and a decree be entered in his favour in terms of the settlement. If the court is satisfied, after such inquiry it deems necessary, that the petitioner (i.e. the creditor) is entitled to a decree in his favour, the court shall issue a decree nisi in his favour, and appoint a date for the hearing (notice of which shall be served on the debtor). On such date if the debtor fails to prove to the satisfaction of the court that there has been no default on his part in complying with the terms of the settlement the court shall make the decree *nisi* absolute. Furthermore the Debt Conciliation Ordinance states that such decision shall be final and no appeal from such order (or revision thereto) lie with the Court of Appeal.

The Debt Conciliation Ordinance empowers the Board to dismiss any application at any stage of the proceedings.

Where no amicable settlement is reached, the Board may, if it is of the opinion that the debtor has made the creditor a fair offer which the creditor ought reasonably to have accepted, grant the debtor a certificate in the prescribed form in respect of debts owed him to that creditor.

#### Applicability of the Debt Conciliation Ordinance to MFIs:

It appears that the debt settlement procedures under the Debt Conciliation Ordinance may only be initiated where the debt is secured although in the course of such a proceeding, a settlement may be arrived at in relation to debts of unsecured creditors as well. Hence, in order for a MFI to initiate debt conciliation proceedings at the Debt Conciliation Board, it should be a secured creditor within the meaning of the Debt Conciliation Ordinance.

Please note, however that the Debt Recovery (Special Provisions) Act (discussed above) provides that nothing in the Debt Conciliation Ordinance and the Money Lending Ordinance shall apply to or in relation to, “a lending institution” within the meaning of the Debt Recovery (Special Provisions) Act. Thus, if the microfinance entity is “a lending institution” within the meaning of the Debt Recovery (Special Provisions) Act, it cannot avail of or be subject to the provisions of the Debt Conciliation Ordinance.

### **The Inland Revenue Act**

Please see the response in relation to section 10.

### **Value Added Tax Act**

Please see the response in relation to section 10.

### **Mortgage Act**

Please see the response in relation to section 14.

### **Samurdhi Authority Act**

The Samurdhi Authority of Sri Lanka Act No.30 of 1995 (as amended by Act No. 02 of 1997) (“Samurdhi Authority Act”) was a governmental initiative for the provision of welfare services through the state. The Samurdhi Authority Act provided for the setting up of a Samurdhi Authority (as a body corporate with perpetual succession and the right to sue and be sued etc) which was to implement a Samurdhi National Programme (“Samurdhi Programme”) for the “improvement of the economic and social conditions of youth, women and disadvantaged groups of society”. This was to be achieved specifically through such initiatives such as the following -

- (a) Broadening their opportunities for income enhancement and employment;
- (b) Integrating them into economic and social development Activities;
- (c) Linking family level economic Activities with community development projects at village, district, divisional and provincial levels;
- (d) Mobilizing their participation in the planning and management of projects and schemes for their upliftment;

- (e) Fostering co-operation among them, promoting savings amongst them and assisting them to obtain credit facilities;
- (f) Facilitating the delivery of inputs and services of Government departments, public corporations, local authorities, private sector organizations and non-governmental organizations to beneficiaries of the programme
- (g) The implementation of such and other programmed formulated by the Government for poverty alleviation.

The Samurdhi Authority was empowered under the said Samurdhi Authority Act to *inter alia*, create a decentralized system of division level and district level Samurdhi committees and village and village cluster level Samurdhi centres and Samurdhi Balakayas (Samurdhi youth ‘force’) for the practical implementation of the Samurdhi Programme and to establish, manage and operate savings and credit schemes for the beneficiaries under the Samurdhi Programme. Functions of the Samurdhi centres and Balakayas include setting up ground level credit and Banking facilities (in conjunction with Banks and other lending institutions) and deposit mobilization for the constituents of their respective Grama Niladhari divisions, and planning and implementing infrastructure facilities for the development of their villages etc.

The Activities of the Samurdhi Authority are to be Financed by a fund set up for such purposes under the Samurdhi Authority Act, and all and any sums of money allocated by Parliament for the use of the Samurdhi Authority, and received by way of gifts, grants, donations etc to the fund, or as income from any property owned or administered by the Authority or any other sums of money received by the authority in the exercise of its it’s powers of discharge of its function shall be paid into the said fund.

### **Applicability of the Samurdhi Authority Act to MFIs:**

Whilst the Samurdhi Authority Act does not apply to MFIs directly, since the objectives of both MFIs and the Samurdhi Programme are compatible it is possible for MFIs to collaborate with the Samurdhi Authority and Samurdhi Centres in their respective programmes so as to make the best use of their respective synergies.

## Co-operative Societies Law

As previously mentioned, co-operative societies is a subject included in List I ("Provincial Council List") and List III ("Concurrent List") of the Ninth Schedule to the 13<sup>th</sup> Amendment to the Constitution which means that Provincial Councils for the nine provinces are entitled to enact their own statutes to provide for the following -

1. "Co-operative undertakings and the organization, registration, supervision and audit of co-operative societies within the Province;
2. Co-operative development within the Province including co-operative education and propaganda;
3. Provincial Co-operative Employees Commission;
4. Matters connected with employment, promotion, retirement and other connected matters of employees of co-operative societies within the Province"

We understand that provincial statutes on this subject have been enacted by the provincial councils for the Western province, Central province and Sabaragamuwa province.

Once a provincial statute is enacted by a province (on a subject included in the Concurrent List) which is inconsistent with an existing law on such subject passed by Parliament, the law passed by Parliament shall be suspended and be inoperative within that Province so long as the statute remains in force, unless Parliament, by resolution decides to the contrary.

In the following discussion, we have summarized the Co-operative Societies Law (which apply in the provinces excluding Western province, Central province and Sabaragamuwa province) followed by a summary of the provisions of the Western Province statute (the statutes of the other provinces being substantially similar to that of the Western province).

### The Co-operative Societies Law No. 5 of 1972

The Co-operative Societies Law No. 5 of 1972 (as amended by Act Nos. 5 of 1972, 37 of 1974, 11 of 1980, 32 of 1983 and 11 of 1992) ("Co-operative Societies Law") was enacted to provide for the development of co-operative societies and to consolidate and amend the law relating to the constitution and administration of co-operative societies.

The Co-operative Societies Law allows for the registration of societies which have the objectives of, in accordance with Co-operative principles, the provision of specified services contributing to the economic, social, educational and cultural welfare of its members, or of a society consisting only of registered societies established with the object of facilitating the operation of such societies, with or without limited liability.

In addition to providing for registration of co-operative societies, the Co-operative Societies Law also contains provisions dealing with members of registered societies and their rights and liabilities, rights, obligations and privileges of registered societies, general provisions relating to by-laws, property and funds of registered societies, audit, inquiry and inspection/investigation of registered societies, suspension, interdiction and removal of officers and dissolution of a committee, dissolution of a registered society, disputes and debts due to Government.

Such societies once registered (hereinafter referred to as a "registered co-operative society") are bodies corporate, with *inter alia*, perpetual succession, the power to hold property, enter into contracts, institute and defend legal proceedings, and to do all things necessary for the purpose of its constitution.

A co-operative society to become registered under the Co-operative Societies Law must either -

- (i) If consisting only of members, have a minimum membership of 10 natural persons over 18 years of age and residing or employed or owning immoveable property within the area of operation of the society seeking registration; or
- (ii) If consisting only of registered societies, have a minimum of three members.

[Please see our response to question # 4 below for the procedural aspects of registration of a co-operative society.]

Membership is to be under the provisions of the by-laws of the respective registered co-operative society, and each member, if provided for under the by-laws of the registered co-operative society may subscribe to its share capital subject to a maximum of one fifth of the said capital (unless the member is another registered society). However, a registered co-operative society may admit any individual as an associate member, subject to the limitation that such an associate member may not be entitled to "any share, in any form whatsoever, in the assets or profits of the society, or any

*vote in the conduct of the affairs of a society*". Each member is to be entitled to no more than one vote in the conduct of the affairs of the registered co-operative society.

The Co-operative Societies Law also states that a registered co-operative society is only entitled to make loans to members (or another registered co-operative society with the approval of the Registrar of Co-operative Societies) and may only receive loans or deposits from persons who are not members to such extent and under such conditions as set out by any rules issued under the said Law or the by-laws of the registered co-operative society.

Except as provided above, transactions with non-members are subject to the prohibition and restrictions prescribed in the rules issued under the said Law.

The Co-operative Societies Law further states that a registered society may deposit or invest its funds in any of the securities other than a first mortgage of immoveable property specified in section 20 of the Trusts Ordinance or with any Banker or in the shares or on the security of any other registered society or in any other mode permitted by the rules. A registered co-operative society may, with the prior approval of the Registrar of Co-operative Societies, invest in any public or private institution that has specific provision to enable such investment.

A registered co-operative society is required to make by-laws in respect of the following matters -

- (i) Name of society
- (ii) Registered address of the society
- (iii) Objects for which the society was established
- (iv) Purposes to which the funds of the society maybe applied
- (v) Qualifications for membership in the society, the conditions of admission of members and the mode of their admission.
- (vi) The nature and the extent of the liability of the members of the society.
- (vii) The withdrawal and expulsion of the members of the society and the payments, if any, to be made to them
- (viii) The transfer of the share or the interests of the members of the society
- (ix) The manner of raising funds, including the maximum rate of interest on deposits

(x) The general meetings of the society and the procedure at and the powers to be exercised by such meetings

(xi) The appointment, suspension and removal of the members of the committee and other officers of the society, and the powers and duties of the committee and other officers

(xii) The authorization of an officer of the society to sign documents on behalf of the society:

Where the objects of any registered co-operative society include the creation of funds to be lent to its members that society shall make by-laws in respect of the following additional matters -

(xiii) The occupation and residence of the members

(xiv) The conditions on which loans maybe made to members: -

(a) The rate of interest

(b) The maximum amount which maybe lent to a member

(c) Extension of the term, and renewal of loans

(d) The purpose for loans

(e) Security for repayment

(xv) The consequences if any of default in payment of any sum due on account of shares or loans

(xvi) The disposal of the profits

Furthermore registered co-operative societies are required, out of their net profits in any financial year, transfer not less than twenty-five percent (25%) of such net profits to a reserve fund, and contribute such amount as is prescribed by rules issued under the Co-operative Societies Law, to the Co-operative Fund. They may thereafter apply any remainder to (and within the limit set out in the Co-operative Societies Law) to the payment of dividends to members, payment of bonuses to employees, contributions to funds etc.

### **Co-operative Societies Statute No. 3 of 1998 of the Western Province Provincial Council**

The above statute is, to a great extent, almost identical to the Co-operative Societies Law in wording and format, and therefore our analysis of the said Co-operative Societies Law (above) is broadly applicable to the Co-operative Societies statute of the Western Province referred to above and that of the Central and Sabaragamuwa provinces.

However it must be noted that the registration, supervision and auditing of co-operative societies is done at a provincial level by the Registrar of Co-operative Societies appointed for such province.

There are also certain further differences between the Co-operative Societies Law and the provincial statutes, mainly of a procedural and/or administrative nature, some of which we highlight for your benefit. Please note that the following are only indicative, and are not to be taken as exhaustive.

- The Co-operative Societies Statute for the Central Province does not refer to educational welfare as a permitted objective for a co-operative society to apply for registration .
- The Co-operative Societies statutes for the Western and Sabaragamuwa provinces require a co-operative society to have a minimum of *twenty* persons over the age of eighteen years or residing, employed, or owning immovable property in the area of operation of the said co-operative society, as a condition of registration.
- The matters for which a co-operative society may or shall make by-laws are to be prescribed through rules made by the Minister in charge of the subject of Co-operatives for that province.
- The provision in the Co-operative Societies law providing for an exemption from stamp duty for co-operative societies registered thereunder does not appear to have been repeated in the Co-operative Societies statutes in the Western, Sabaragamuwa or Central provinces.
- The Co-operative Societies statute for the Sabaragamuwa province states that a registered society may not dispose of any profit without the permission of the Registrar.

### Applicability of the Co-operative Societies Law to MFIs:

A society of persons carrying on microfinance business on co-operative principles may register as a co-operative society under the Co-operative Societies Law or the Co-operative Societies statute applicable to that province (as the case maybe).

Benefits of such registration would be the acquisition thereby of legal status as an independent corporate body with limited liability (although it is possible to register without the benefit of limited liability in which case the liability of the members would be unlimited), perpetual succession, the

power to hold property, enter into contracts, institute and defend legal proceedings and to do all things necessary for the purpose of its constitution. Other benefits are exemption from the application of the Value Added Tax Act. Section 2 of the Money Lending Ordinance too does not apply to registered co-operative societies under the Co-operative Societies Law. [Whilst this exemption has not been amended to include co-operative societies registered in each province we are of the view that it could be argued that such exemption is also available to such co-operatives as well!]. A registered co-operative society is also entitled to set off the debts owed by a member of the society against deposits of such member held by the society which is the only right of set off (other than the Bankers' right of set off) conferred by law.

### **Societies Ordinance**

The Societies Ordinance No. 16 of 1891 (as amended by Act Nos. 17 of 1926, 14 of 1932, 55 of 1949, 16 of 1981 and 11 of 2005) ("Societies Ordinance") makes provision for the registration of mutual, provident and other societies.

The Societies Ordinance provides that the following societies may be registered under Societies Ordinance -

- (a) Societies established with the object of promoting thrift, giving relief to members in times of sickness and distress, of aiding them when in pecuniary difficulties and for making provision for their widows and orphans;
- (b) Societies for any purpose which the Minister, by notification in Gazette, has authorised as a purpose for which the powers and facilities of the Ordinance ought to be extended etc) ("specially authorized societies").

Once a society is registered under the said Ordinance (in the form and manner prescribed and in terms of the provisions of the said Ordinance) it has the legal status of a body corporate by the name registered, it may sue and be sued, have perpetual succession, a common seal and limited liability. Further all property for the time being vested in any person in trust for the society vests in the society.

A society to become registered must have atleast seven members, and a subscribed capital of atleast ten thousand rupees. Once registered the societies are under the purview of the Registrar of Companies.

1. Please see further discussion of this aspect in our note on the Money Lending Ordinance in question



Registered societies are required to comply with the provisions of the Societies Ordinance including maintenance of a registered office, publication of its name, auditing of accounts, filing of an annual return with the Registrar of Companies, maintaining a register of members, holding an annual general meeting etc.

The privileges of registered societies, as provided for in the said Ordinance, include:

- (i) The ability to (if its rules do not direct otherwise), *inter alia*, hold, purchase or take on lease on its own name any land, and to sell, exchange, mortgage, lease or build upon same.
- (ii) The advancing of money to its members on the security of movable or immovable property.
- (iii) The application of its profits for any lawful purpose.
- (iv) If the rules of the society allows it, investing (in its own name) any portion of its funds, not immediately required for its purposes, upon real or leasehold securities, in the shares or the security of any other registered society or of any limited liability Company, in public funds, Government Stock or securities.

#### Applicability of the Societies Ordinance to MFIs:

Turning to the applicability of the Societies Ordinance to MFIs, it is possible for a MFI to operate as a registered society in terms of this Ordinance if its objects fall within those set out above or with the special authorization of the relevant Minister.

Benefits of such registration would be the acquisition thereby of legal status as an independent corporate body with limited liability, perpetual succession, the power to hold property, enter into contracts, sue and be sued in the name of the society.

Other benefits would be inapplicability of section 2 of the Money Lending Ordinance and the ability to mobilize deposits of its members after obtaining the permission of the Monetary Board as more fully discussed in our response to question # 6 below.

#### **Voluntary Social Service Organisations (Registration and Supervision) Act**

The Voluntary Social Service Organizations (Registration and Supervision) Act No. 31 of 1980 (as amended by Act No. 8 of 1988) ("the VSSO Act") was enacted to provide for the registration of voluntary social service organizations with the Government, their inspection and supervision, facilitate the co-ordination of the Activities of such organizations, give governmental recognition to properly constituted organizations, enforce the accountability of such organizations on financial and policy management aspects to the members, general public and the Government, prevent malpractices by persons purporting to be such organizations and regularise the constitution of voluntary social service groups which have not been legally recognized.

In terms of the VSSO Act, every voluntary social service organization ("VSSO"), defined in the VSSO Act as an organization formed by a group of persons on a voluntary basis and which -

- (i) Is of a non-Governmental nature;
- (ii) Is dependent on public contributions, charities, grants payable by the Government or donations local and foreign, in carrying out its functions;
- (iii) Has as its main objectives, the provision of reliefs and services as are necessary for the mentally retarded or physically disabled, the poor, the sick, the orphans and the destitutes, and the provision of relief to the needy in times of disaster; and includes a community hostel, must become a registered organization under the VSSO Act.

Such registered VSSOs are thereafter subject to the governance and regulatory provisions in the VSSO Act, and must comply with all requirements therein. In our responses to questions bearing number 7 and 8 below, we have discussed VSSOs in more detail.

#### Applicability of the VSSO Act to MFIs:

The VSSO Act will apply to MFIs only if any MFI falls within the ambit of the definition of a VSSO in which case it should obtain registration under the VSSO Act with the Registrar of Voluntary Social Service Organisations.

## Securities and Exchange Commission of Sri Lanka Act

The Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 (as amended by Act Nos. 26 of 1991 and 18 of 2003) ("the SEC Act") provides for, *inter alia*, the establishment of the Securities and Exchange Commission of Sri Lanka for the purpose of regulating the securities market of Sri Lanka, the grant of licenses to stock exchanges, managing Companies in respect of unit trusts, stock brokers and stock dealers who engage in the business of trading in securities and the registration of market intermediaries etc.

The Securities and Exchange Commission of Sri Lanka Rules, 2001, issued under the SEC Act, sets out the general rules governing the listing and delisting of Companies listed on any stock exchange. Furthermore any person (legal or natural) intending a take-over or merger of a listed public Company must follow the rules (which deal with, *inter alia*, the procedural formalities to be followed in such a take-over or merger) set out under the Company Takeovers and Mergers Code of 1995 (as amended) also issued under the SEC Act.

### Applicability of the SEC Act to MFIs:

The SEC Act will apply only to a MFI which is a public listed Company in Sri Lanka.

## Monetary Law Act

The Monetary Law Act No. 58 of 1949 (as amended Act Nos. 33 of 1954, 11 of 1963, 18 of 1965, 16 of 1967, 05 of 1968, 21 of 1968, 02 of 1969, 30 of 1971, 37 of 1974, 16 of 1977, 10 of 1978, 62 of 1980, 52 of 1985, 07 of 1988, 26 of 1995, 32 of 2002 and 09 of 2006) ("Monetary Law Act") was enacted to establish the monetary system of Sri Lanka and the Central Bank of Sri Lanka to administer and regulate the monetary system and to confer and impose upon the Monetary Board of the Central Bank powers, functions and responsibilities necessary for the purposes of such administration and regulation.

Central Bank is the apex financial institution in Sri Lanka, and is governed by the five member (currently) Monetary Board (a body corporate, set up under the Monetary Law Act) with the Governor of the Central Bank (as appointed by the President of Sri Lanka on the recommendation of the Minister of Finance) as its Chairman.

Central Bank's broad ranging monetary and fiscal policy management duties (as set out in the Monetary Law Act, and under regulations etc issued thereunder) include, *inter alia*, the administration and regulation of the monetary and Banking system of Sri Lanka, the securing of economic, price and financial stability in Sri Lanka, currency issue and management, Acting as Banker to the Government of Sri Lanka, management of the public debt of Sri Lanka, administration of the provisions of the Exchange Control Act, and administration of foreign and government funded credit schemes for regional development.

Central Bank carries out its Activities mainly through the various departments set up thereunder (presently there are 26 such departments) including -

- (i) Department of Banking Supervision-Responsible for the regulation and supervision of licensed Banks.
- (ii) Department of Non-Bank Financial Institutions Supervision - Responsible for the regulation and supervision of non-Bank financial institutions such as registered Finance Companies and registered Finance leasing Companies.
- (iii) Department of Exchange Control - Responsible for foreign exchange management under the Exchange Control Act.
- (iv) Department of Rural Development - Responsible for promoting regional development through government and donor assisted rural credit delivery programs.
- (v) Department of Domestic Operations - Responsible for implementing monetary policy measures, mainly through the conduct of open market operations and the enforcement of the reserve requirement for commercial Banks. Operates current account facilities for the Government, commercial Banks and primary dealers.
- (vi) Financial Intelligence Unit - Responsible for implementation and administration of the provisions of the Prevention of Money Laundering Act No. 5 of 2006, the Financial Transactions Reporting Act No 6 of 2006 to facilitate the prevention, detection, investigation and prosecution of the offences of money laundering, the financing of terrorism and other unlawful Activities as defined in the said Acts.

### Applicability of the Monetary Law Act to MFIs:

MFIs would be subject to the regulation and supervision of the Department of Banking Supervision in the case of MFIs with Banking licenses, the Department of Non-Bank Financial Institutions Supervision in the case of MFIs which are non-Bank financial institutions, the Department of Exchange Control in relation to dealing in gold, foreign currency, payments to non-residents, opening of accounts and investments abroad etc. and the Financial Intelligence Unit in relation to reporting and other requirements under the Prevention of Money Laundering Act No. 5 of 2006 and the Financial Transactions Reporting Act No 6 of 2006.

### **Regulation of Insurance Industry Act**

The Regulation of Insurance Industry Act No. 43 of 2000 (as amended by Act No. 27 of 2007) (“the Regulation of Insurance Industry Act”) provided for *inter alia*, the establishment of an Insurance Board of Sri Lanka responsible for the development, supervision and regulation of the insurance industry, as well as the registration and supervision of the carrying on of insurance business, by any person, in Sri Lanka.

Under the Regulation of Insurance Industry Act, any person carrying on insurance business (defined in the Regulation of Insurance Industry Act as long term insurance business such as life insurance, linked long term insurance, annuities, contracts for granting of disability and multiple indemnity, accident and sickness benefits, permanent health, capital redemption contracts, pension policies, and general insurance business (all insurance business not falling within the former class) must become registered (in the form and manner prescribed in the Regulation of Insurance Industry Act, and in regulations or rules issued thereunder), and obtain a license thereafter specifying the class (and sub-class, if applicable) of the insurance business that the insurer is authorized to carry on.

A person so registered under the Regulation of Insurance Industry Act is not entitled to carry on any other form of business *unless* it is any financial services business with is ancillary or associated with the insurance business for which registration is obtained under the Act, and prior written approval from the Insurance Board for carrying out such business is obtained.

In order to obtain registration to carry on insurance business (in terms of the Regulation of Insurance Industry Act) a person should:

- (i) Be a public Company incorporated in Sri Lanka and registered under the Companies Act No. 7 of 2007;
- (ii) Have a paid up share capital not less than the prescribed amount;
- (iii) Pay as deposit to the Treasury such amount as maybe determined by the Insurance Board, by rules made in that behalf;
- (iv) Pay the prescribed fee; and
- (v) Fulfill any other requirements laid down by the Board.

Every insurer is required to pay to the Board as an annual fee, such sum of money as maybe prescribed.

The Regulation of Insurance Industry Act in addition to the procedure for registration of insurers provides for such matters as general provisions applicable to insurers, long term insurance business, accounts, inspection and investigation, publicity, management by administration and winding up, registration of brokers and insurance agents, offences etc.

All applicable requirements in the Regulation of Insurance Industry Act must be complied with by the insurer.

### Applicability of the Regulation of Insurance Industry Act to MFIs:

A MFI intending to engage in insurance business as defined in the Regulation of Insurance Industry Act should obtain a registration as an insurer from the Insurance Board of Sri Lanka. However, to obtain such registration as an insurer such entity should fulfill the stringent criteria discussed above. On registration, such entity would be subject to the requirements of the Regulation of Insurance Industry Act and the directions issued by the Insurance Board thereunder.

## Credit Information Bureau of Sri Lanka Act

The Credit Information Bureau of Sri Lanka Act No. 18 of 1990 (as amended by Act No. 08 of 1995) ("the CRIB Act") established the Credit Information Bureau ("CRIB") of Sri Lanka, as a body corporate, for the purpose of, *inter alia*, collecting credit information relating to borrowers from lending institutions (as defined in the CRIB Act) and for the provision of such information to the shareholders of the bureau (as defined in the CRIB Act) for the attainment of the objective of "facilitating the distribution of credit to all sectors of the economy and to the informal sector, in particular".

The CRIB's functions are -

- (i) To collect and collate, trade, credit and financial information on borrowers and prospective borrowers of lending institutions;
- (ii) To provide credit information, on request, to lending institutions who are shareholders of the CRIB and simultaneously to borrowers and prospective borrowers to whom such information relates;
- (iii) To establish a credit rating system in Sri Lanka and to sell such credit ratings to any foreign and local agencies or to any person making a request for such ratings; and
- (iv) To undertake research projects for lending institutions who are shareholders of CRIB;

with a view to facilitating the distribution of credit to all sectors of the economy and to the informal sector in particular.

Lending institutions are defined in the CRIB Act as including licensed commercial Banks, Finance Companies and *inter alia*, other institutions engaged in providing credit, declared by the Minister of Finance, having regard to the financial stability of that institution, by order published in the Gazette, to be a lending institution for the purposes of the CRIB Act.

Only the Monetary Board of Sri Lanka and lending institutions (as defined in the CRIB Act) can be shareholders of the CRIB.

The CRIB may, by notice in writing, require any lending institution to furnish it (within the period specified in the said notice) all such returns and information relating to borrowers from such lending institutions as is specified in the said notice. Such a lending institution will be under a

duty under the CRIB Act to comply with the requirements of such notice within the time frame specified, notwithstanding any provision of any law or agreement, to the contrary.

Failure (without reasonable cause) to comply with any notice given to a lending institution to furnish information as above, within the time frame given, or knowingly making false or incorrect statement in any return or information furnished as such etc., will be an offense under the CRIB Act, and liable upon conviction to the penalties specified therein.

### Applicability of the CRIB Act to MFIs:

From a review of the provisions of the Act it is apparent that the duty to furnish information on request by CRIB is applicable to all entities falling within the definition of a 'lending institution'. However, the right to receive credit information on a borrower is available only to a lending institution which is a shareholder of CRIB. To be eligible for membership in CRIB a particular MFI would have to be especially declared to be a lending institution by the relevant Minister by order published in the Gazette, unless it is a licensed commercial Bank or a Finance Company.

## National Housing Act

The National Housing Act No. 37 of 1954 (as amended by Act Nos. 37 of 1954, 22 of 1955, 30 of 1955, 42 of 1958, 36 of 1966, 09 of 1978 and 49 of 1981) ("National Housing Act") was enacted to provide for the establishment of a National Housing Fund, for the promotion of housing and building development by the establishment of building societies and by the declaration of bodies of persons as housing bodies and housing Companies and for the grant of assistance by the government for such development.

### Building Societies

Building societies as described by the National Housing Act are societies established by two or more persons associated for the raising by subscription from members a common fund for making advances to members for the carrying out of any of the housing objects referred to in the National Housing Act, being:

- (a) The construction of buildings for residential purposes or any other purpose connected with or incidental to any of the other objects specified hereinafter;

- (b) The manufacture, importation or supply of materials required for the construction of such buildings;
- (c) The provision of roads, water, electricity, gas and sewerage;
- (d) The administration, management or control of buildings and building schemes;
- (e) The provision of amenities for the inhabitants of any area in which any housing scheme has been carried out including transport and other services;
- (f) Any other prescribed object;
- (g) Any object ancillary or reasonably connected to the objects stated above;
- (h) The development of land for the carrying out of any of the objects stated herein;
- (i) The granting of assistance for the purpose of enabling the carrying out any of the objects stated herein;

[The granting of assistance referred to in (i) above includes lending of money in any manner whatsoever, the undertaking of guarantees, promoting, effecting, insuring, guaranteeing, underwriting, participating in the managing and carrying out of any issue (public or private) of Government or other loans or of shares, stock, debentures or debenture stock of any body corporate and by the lending of money for the purpose of any such issue.]

Such building societies by subscribing their names to an instrument of association approved by the Commissioner of National Housing and by registering such instrument with the Commissioner may form an incorporated building society with limited liability.

From the date of incorporation, a building society shall be a body corporate by the name contained in the instrument of association, capable of suing and being sued, and exercising, discharging and performing all the powers, functions and duties assigned to or imposed on the society by the instrument or by the National Housing Act, having perpetual succession (unless otherwise provided in the instrument) and a common seal.

The powers of a building society as stated in the instrument of association may include the power to hold land and mortgages over land, to make advances to members out of the stock or fund of the society and to borrow money and such other powers as may be necessary for the purpose of carrying out its object.

## Housing Bodies

The National Housing Act also contains provision for declaring bodies of persons as housing bodies which have the power, for the purpose of constructing houses and providing amenities and services for its members or employees, to carry out any of the objects described above and to exercise the following powers -

- (i) The power to acquire or to receive by way of gift or otherwise, any immovable or movable property (and to deal with such property in the manner set out in the said Act),
- (ii) The power to borrow money for the purposes of the objects,
- (iii) The power to charge rent or fees for any buildings or any services provided by carrying out of any of the objects stated above, and
- (iv) The power to enter into such contracts and to make such arrangements or to do all such Acts and things as maybe necessary or expedient for the carrying out of the objects stated above.

### Applicability of the National Housing Act to MFIs:

For a MFI to come within the purview of the National Housing Act, it should be either a building society or a housing body as described in the National Housing Act.

## Board of Investment of Sri Lanka Law No. 04 of 1978

Persons intending to setup a microfinance institution in Sri Lanka may also consider obtaining Board of Investment of Sri Lanka ("BOI") approval for their 'enterprise'.

The BOI is the statutory authority set up by the Government of Sri Lanka through an Act of Parliament to encourage investment in Sri Lanka, both local and foreign.

The Board of Investment of Sri Lanka Law No.04 of 1978 (as amended by Act Nos. 35 of 198, 43 of 1980, 21 of 1983, 49 of 1992 and 9 of 2002) (hereinafter 'the BOI Law') provides for two types of investment approvals.

1. Under Section 17 of the BOI Law

The BOI is empowered to grant special incentives to Companies satisfying specific eligibility criteria (which are designed to meet strategic economic

objectives of the Government of Sri Lanka). The mechanism through which such concessions (such as tax holidays) are granted is an agreement, between the BOI and the Company, which modifies, exempts and waives identified laws, in keeping with the BOI Regulations, from applicability to the Company. These laws include Inland Revenue, Customs, Exchange Control and Import Control.

2. Under Section 16 of the BOI Law

The above permits foreign investment entity to operate only under the normal laws of the country; that is, for such enterprises the provisions of *inter alia* the Inland Revenue, Customs and Exchange Control Laws shall apply.

The only advantage in obtaining approval under section 16 is that a foreign investor who wishes to reside in the country to manage his business or wishes to send an expatriate to reside in the country to manage the Company, could easily obtain a resident visa with permission to work in Sri Lanka due to the fact that the BOI will make a recommendation to the Controller of Immigration and Emigration. The issue of such a visa will be granted provided that the foreign investment in the Company is at least Two Hundred and Fifty Thousand US Dollars (US \$250,000).

Applicability of the BOI Law to MFIs:

The BOI Law is currently of limited application to MFIs as microfinance is not an area of investment which receives concessions by way of an agreement with the Board of Investment of Sri Lanka under section 17 of the BOI Act. Typical industries which receive such concessions are manufacture of non traditional goods, export oriented services, small scale infrastructure projects, regional operating headquarters, research and development, large scale projects, industrial estates etc. There is however an open category where special projects approved by the Cabinet sub committee on investment facilitation or the Cabinet of Ministers may receive such concessions. Whether microfinance is an area which would receive such special approval is, however, debatable, considering that foreign investment in the microfinance sector is prohibited due to the prohibition on foreign direct investment in money lending businesses.

**03. Narrative of the legal status of various Institutions who carry out Microfinance Activities in Sri Lanka including a brief description of the respective laws governing each type of institution**

The legal framework that would govern the operations of a MFI will differ according to the specific Activities that such an institution carries out (or intends to carry out). As such, the following is a broad overview of the general laws that maybe applicable to MFI's based on the law under which such institution is established/incorporated and/or the law under which such institution is licensed/registered (as provided by you).

Based on the information submitted to us, we have clustered the various institutions into seven categories, namely

- I. Institutions incorporated under the Companies Act;
- II. Institutions falling within the Societies Ordinance;
- III. Institutions falling within the Co-operative Societies Act;
- IV. Institutions falling within the Voluntary Social Service Organisations Act;
- V. Institutions incorporated by Acts of Parliament; and
- VI. Microfinance Activities carried out by individual persons.

It must be noted that the information provided below about the governing laws as well as (where possible) other relevant legislative enactments, are provided in brief outline for your convenience. Further information regarding the provisions of each individual legislative enactment can be found in our response to question 2 above and as regards their supervisory, governance and accountability structures, in our responses to questions 7 and 8 below.

**Companies registered under the Companies Act**

The Companies Act No. 17 of 1982 (referred to in the list submitted to us) was repealed by the Companies Act No. 7 of 2007 ("the Companies Act"). All Companies registered under the repealed Act are to be governed under the provisions of the new Companies Act.

The Companies Act provides for such matters as the following -

- Procedures in relation to incorporation of Companies;
- Special provisions applicable to private Companies and Companies limited by guarantee;
- Shares and debentures (including prospectus, allotment, nature and type of shares, issue of shares, calls on shares, distributions to shareholders, repurchase/ redemption of shares, financial assistance in connection with purchase of shares, cross holdings and transfer of shares/debentures);
- Shareholders and their rights and obligations (including liability of shareholders, powers of shareholders & minority buy-out rights);
- Registration of charges created by a Company and creation of floating charges;
- Management and administration of Companies (including meetings and proceedings, financial statements etc)
- Provisions applicable to Directors
- Prevention of oppression and mismanagement
- Amalgamation
- Off shore Companies and registered overseas Companies
- Winding up of Companies (including voluntary winding up, winding up by court and under supervision of court, appointment of administrators, receivers and managers)

A MFI carrying out microfinance Activities as a Company incorporated under the Companies Act (whether as a limited liability, unlimited liability or a Company limited by guarantee) would be subject to the provisions of the Companies Act. A Company so incorporated is a separate legal entity with all ensuing powers.

The Companies Act provides that a Company shall have, both within and outside Sri Lanka-

- Subject to the provisions in its Articles of Association, the capacity to carry on or undertake any business or Activity, do any Act or enter into any transaction;

- subject to the provisions of any written law of Sri Lanka or of any other country, all the rights, powers and privileges necessary for the purposes of paragraph (a) above.

In view of the foregoing, it is evident that a Company incorporated in Sri Lanka has the capacity and the power to carry on any business, undertaking or Activity subject to any restrictions contained in its Articles of Association or in written law. Whilst it is not required for a Company to state the objects for which such Company was incorporated in its Articles of Association, if it chooses to do so, such objects will be deemed to be a restriction placed by the Articles on carrying out any business or Activity not within those objects unless the Articles expressly provide otherwise.

Depending on the Activities being carried out by the MFI the following (non-exhaustive) Acts may in addition apply to it and the provisions therein require compliance by the MFI -

- (a) Banking Act No. 30 of 1988 (as amended)- if carrying on (or intending to carry on "Banking business" as a LCB or the Activities provided for in the Fourth Schedule as a LSB.
- (b) Finance Companies Act No. 78 of 1988 - if carrying on (or intending to carry on) "Finance business" as defined therein.
- (c) Finance Leasing Companies Act No. 56 of 2000 - if carrying on (or intending to carry on) "Finance leasing business" as defined therein.
- (d) Money Lending Ordinance - if carrying on money lending Activities, such person (legal or natural) will be required to comply with the provisions therein, including adherence to the limitations on foreign persons (legal or natural) carrying out such Activities.
- (e) Exchange Control Act - applicable in respect of dealing in gold and foreign currency, payments to or for the credit of non residents, maintenance of accounts abroad, control of foreign assets, issue of securities etc.
- (f) Debt Recovery Act No. 2 of 1990 (as amended) - provides for an expedited process of debt recovery for lending institutions (LCB's, Finance Companies etc) as defined therein.
- (g) Regulation of Insurance Industry Act No. 43 of 2000 - if carrying on (or intending to carry on) "insurance business" as defined therein.

- (h) Pawnbrokers Ordinance - if a Company wishes to carry out business as a "pawnbroker" as defined in the Act then
- (i) Inland Revenue Act 10 of 2006- provides for, inter alia, the imposition of income tax on such Companies as are provided for in the Act (e.g. resident Companies).
- (j) CRIB Act No. 18 of 1990 - provides for the collection of borrower information from lending institutions (as defined in the said Act) and the provision of such information to lending institutions who are shareholders of the CRIB.
- (k) Mortgage Act - applies to Approved Credit Agencies (as defined in the said Act) and governs the enforceability of mortgages thereby.
- (l) Securities and Exchange Commission Act No. 36 of 1987 (as amended) - if relating to the listing or delisting of a public limited Company or a takeover or merger relating to such a Company.

**Organisations registered under the Voluntary Social Service Organisations (Registration and Supervision) Act ("the VSSO Act")**

Organisations registered under the VSSO Act are governed, and supervised, under the provisions therein. Please see our answers in relation to the VSSO Act and VSSO in questions 2, 7 and 8 for further information in this regard).

**Organisations registered under the Co-operative Societies Law (and under the Co-operative Societies Statute of each respective province (where applicable))**

Such registered Co-operative societies are bodies corporate, with perpetual succession and a common seal, with the power to hold property, to enter into contracts, to defend and institute suits and other legal proceedings, and to do all things necessary for the purpose of its constitution.

Please see our answers in relation to the Co-operative Societies Law and registered Co-operative societies in questions 2, 7 and 8 for further information in this regard).

**Organisations registered under the Societies Ordinance**

Societies registered under the Societies Ordinance are bodies corporate, with perpetual succession and a common seal, and with power to hold property, to enter into contracts, to institute and defend suits and other legal proceedings, and to do all things necessary for the purpose of its constitution.

Please see our answers in relation to Societies Ordinance and registered societies in questions 2, 7 and 8 for further information in this regard).

**Institutions established by Act of Parliament**

Such institutions are statutory creatures, the rights, duties, powers and privileges of which are all dependant on the specific provisions of the establishing enactment.

**Microfinance Activities carried on by individual persons**

The specific laws that will govern the Activities of such persons will be dependent on the nature of the said Activities. Typically applicable laws, given the general Activities carried out as microfinance, include the Money Lending Ordinance, Pawnbrokers Ordinance, Inland Revenue Act, Value Added Tax Act.



**04. Analysis of the provisions under the Companies Act, Co-operative Societies Law, Voluntary Social Service Organisations (Registration and Supervision) Act etc, and other laws, to form and register a MicroFinance Institute with a brief outline of each process**

### Companies Act

As stated in relation to question 2, the Companies Act No. 7 of 2007 contains the law governing Companies in Sri Lanka.

A Company incorporated under the Companies Act may be either

- A limited Company i.e. a Company that issues shares, the holders of which have the liability to contribute to the assets of the Company, if any, specified in the Company's articles as attaching to those shares
- An unlimited Company i.e. a Company that issues shares, the holders of which have an unlimited liability to contribute to the assets of the Company under its articles
- A Company limited by guarantee i.e. a Company that does not issue shares, the members of which undertake to contribute to the assets of the Company in the event of its being put into liquidation, in an amount specified in the Company's articles.

In terms of the Companies Act, any persons or persons may incorporate a Company by making an application to the Registrar General of Companies, in the prescribed form signed by each of the initial shareholders, together with the following documents -

- (i) A declaration stating that to the best of such person or person's knowledge, the name of the Company is not identical or similar to that of an existing Company;
- (ii) The articles of association of the Company, if different from the articles set out in the First Schedule of the Act which specifies the model articles, and signed by each of the initial shareholders;
- (iii) Consent from each of the initial directors to Act as a director of the Company;

- (iv) Consent from the initial secretary to Act as secretary of the Company.

Upon the receipt of the application for incorporation in the prescribed form, the Registrar shall -

- Enter the particulars of the Company on the Register;
- Assign a unique number to that Company as its Company number;
- Issue a certificate of incorporation in the prescribed form to the applicant Company, specifying the following details -
  - a) The name and number of the Company;
  - b) The date on which the Company was incorporated;
  - c) Whether the Company is a limited Company, an unlimited Company or a Company limited by guarantee;
  - d) Whether the Company is a private Company;
  - e) Whether the Company is an off-shore Company.

Such certificate of incorporation in respect of any Company is conclusive evidence of the fact that, all the requirements under the Companies Act relating to the incorporation of a Company have been complied with by the entity which seeks to incorporate the Company.

A Company is also required within thirty working days from its incorporation to give public notice of its incorporation specifying the name and number of the Company and the address of its registered office.

### Microfinance through a Finance Company under the Finance Companies Act

If a MFI incorporated as a Company (as above) wishes to carry out "Finance business" as defined in the Finance Companies Act (see also our response in relation to question 2 above), then it must meet the requirements in the said Finance Companies Act regarding registration and minimum capital requirements.

Application for registration as a Finance Company must be made to the Monetary Board in the prescribed form, and

contain a declaration by the applicant that the particulars in the application, to the best of his knowledge and belief, are true and accurate. The Monetary Board can thereafter call for and examine (or cause to be examined) the books, records, and documents of the applicant, and on being satisfied that all requirements have been complied with, and that on the information available to it the registration would not be detrimental to the interests of the applicant's depositors and creditors, register the Company as a registered Finance Company.

### **Microfinance through a LCB/LSB under the Banking Act**

If a microfinance institution incorporated as a Company wishes to carry out "Banking business" as defined in the Banking Act ( please see also our response in relation to LCBs in question 2 above) or the Activities permitted to be carried out by a LSB (please see also our response in relation to LSBs in question 2 above), then prior to carrying out such Activities such an institution will have to obtain a Banking license issued by the Monetary Board of the Central Bank of Sri Lanka with the approval of the Minister of Finance. Application shall be made to the aforesaid Monetary Board for the granting of a Banking license in the form and manner prescribed in the Banking Act and in regulations issued thereunder.

An application to the Monetary Board for a Banking license should contain the prescribed documents and particulars set out below:

- (i) A copy of the Articles of Association of such Company or the constitution or any other document associated with the formation of such Company, together with the proposed amendments, if any, to such documents;
- (ii) A statement containing the names, addresses, occupations and qualifications of the Directors of the Company and any Directors proposed to be nominated or appointed and of the Chief Executive Officer of such Company;
- (iii) A copy of the audited balance sheet and profit and loss account of the Company for the preceding three years (in the case of an existing Company);
- (iv) If the applicant is a foreign Company:

- a) A written undertaking supported by a resolution of the Board of Directors of such Company or body corporate, stating that such Company or body corporate, as the case may be, shall on demand by the Central Bank, provide such funds as may be necessary to meet all obligations incurred in or in connection with, its business in Sri Lanka; and
- b) A report containing such information as may be determined by the Monetary Board, from the regulatory authority of the country in which such Company or body corporate is incorporated.

On receipt of an application by the Monetary Board along with the prescribed documents and particulars stated above, the Director of Bank Supervision of the Central Bank ("Director of Bank Supervision") may call for any other documents and particulars he considers necessary to determine whether a licence should be issued or not to the applicant.

On consideration of the documents stated above, if the Monetary Board is satisfied that the application may be approved in principle, it may issue a Letter of Provisional Approval pursuant to which the applicant is required to take all preliminary measures stipulated in such Provisional Letter. Where the Monetary Board is satisfied, that a license may be issued to the applicant, it may with the approval of the Minister of Finance, issue a license to the applicant to carry on either Banking business or the business of accepting deposits (as the case maybe) in Sri Lanka, subject to such terms and conditions as may be imposed by the Monetary Board.

### **Microfinance through a Finance Leasing Company under the Finance Leasing Act**

If the MFI incorporated as a Company intends to carry out Finance leasing (please see also our answer in relation to Finance leasing Companies in question 2) it must also be a registered Finance leasing establishment under the Finance Leasing Act.

Registration shall be through an application made to the Director of Non-Bank Financial Institutions Supervision of the Central Bank in the form and manner prescribed in the Finance Leasing Act. Thereafter, if the Director on the information contained in the application and any other documents, information or particulars obtained, and after

such investigation as the Director deems necessary, is satisfied that the applicant is fit and competent to carry out Finance leasing business, the Director may, having regard to the interests of the national economy, register the applicant, and issue a certificate of registration to the applicant.

### **Microfinance through registered societies under the Societies Ordinance**

An application to register a society under the Societies Ordinance (please see also our answer in relation to Registered Societies in question 2) must be made to the Registrar of Companies, signed by seven members and the secretary, and accompanied by two written or printed copies of the rules. The name of the society must be unique from any other registered society and shall contain the words "Society Limited" at its end. The Registrar shall, if satisfied that all requirements under the Societies Ordinance have been met (including those issued under regulations) shall register the society, and acknowledge such registry to the society. Such a registered society shall be a body corporate with a separate legal existence and limited liability.

### **Microfinance through Building Societies under the National Housing Act**

Persons may incorporate a building society, as provided for under the National Housing Act (please see also our answer in relation to question 2), by firstly subscribing their names to an instrument of association in the form and manner prescribed by the Commissioner of Co-operative Development.

Such instrument of association should state -

- i. The name of the society with "Limited" as the last word of the name.
- ii. The objects of the society
- iii. The powers of the society for carrying out its objects.
- iv. That the liability of its members is limited
- v. The extent to which the liability is so limited
- vi. The manner in which, and terms upon which, the stock or fund of the society is to be raised.
- vii. The address of the principal office of the society.

The instrument of association shall also make provision in respect of all matters for which provision has to be made under regulations made under the National Housing Act and all such other matters deemed necessary or expedient by the Commissioner for the purpose of enabling it to function as a building society and to carry out its objects and to exercise its powers. The instrument shall also make provision for management of the business of the society by a board of directors.

The instrument of association shall thereafter be submitted for approval and registration to the Commissioner and if so approved shall, upon payment of the prescribed fee, be registered and the society issued a certificate of incorporation.

### **Microfinance through Co-operative Societies under the Co-operative Societies Law**

Persons may incorporate a co-operative society (for further information please see our answer in relation to question 2) by submitting an application for registration to the Registrar of Co-operative Societies in line with the provisions of, and in the form and manner prescribed in the Co-operative Societies Law. Such application shall be accompanied by two copies of the proposed by-laws of the society. The persons by whom or on whose behalf such application is made shall furnish such other information as is required by the Registrar.

Thereafter the Registrar of Co-operative Societies may register such a society (and its by-laws) by issuing a certificate of registration if he is satisfied that

- A society has complied with the provisions of the Co-operative Societies Law and the rules issued thereunder,
- The Activity in which the society proposes to engage is economically feasible; and
- Its proposed by-laws and rules are not contrary to the Co-operative Societies Law and the rules thereunder.

Such a registered co-operative society shall be a body corporate under the name it is registered, with perpetual succession and a common seal, and with power to hold property, enter into contracts, to institute and defend suits and other legal proceedings and do all things necessary for the purpose of its constitution.

The above procedure applies, *mutatis mutandis*, in relation to the Western, Sabaragamuwa and Central Provinces as well. Application for registration must be made to the Registrar of Co-operative Societies for the relevant province.

### **Microfinance through Voluntary Social Service Organisations under the Voluntary Social Service Organisations (Registration and Supervision) Act**

Persons belonging to a voluntary social services organization, as defined in the Voluntary Social Service Organisations (Registration and Supervision) Act (“VSSO Act”) (Please see also our answer in relation to Voluntary Social Service Organisations in question 2 above) are required to register the organization under the VSSO Act.

Application for registration shall be in the prescribed form accompanied by prescribed documents and made to the Registrar of Voluntary Social Service organizations and shall be signed by the secretary of the organization.

If the Director is satisfied that the organization complies with the provisions of the said VSSO Act, he shall register such organization under the VSSO Act, and issue a certificate of registration thereunder.

### **Microfinance including Pawnbroking**

Any person carrying on pawnbroker Activities, as defined in the Pawnbrokers Ordinance (please see also our answer in relation to Pawnbroking in question 2 above), shall obtain a license issued in that behalf by the Divisional Secretary of the divisional secretary’s division by making an application in that behalf. No person shall be entitled to a license for carrying on the business of a pawnbroker unless he produces to the Divisional Secretary satisfactory evidence of good character and furnishes security in cash in the prescribed amount. Such a license shall be valid from the day issued until the 31<sup>st</sup> day of July next ensuing.

Please note that in terms of regulations issued under the Exchange Control Act, a non resident person may not invest in the shares of a Company carrying on pawnbroking business. In terms of the Pawnbrokers Ordinance, a foreign Company or a foreign firm may also not carry out the business of pawnbroking in Sri Lanka.

### **Microfinance through a statutory body**

It is possible for an entity established by an Act of parliament to carry out microfinance Activities provided that such Act empowers it to do so and it is not prohibited from engaging in microfinance in terms of any other enactment which is overriding in effect. Here, the particular entity will be formed in the manner provided by the relevant enactment.

### **05. Address the deposit mobilization issue faced by each type of institution governed under each law/Act mentioned in point 3.**

In terms of section 76A (1) of the Banking Act, the business of accepting deposits of money and investing and lending such money shall not be carried out except by a Company which has the prescribed equity capital and under the authority of a license issued by the Monetary Board for such purpose under Part IX A of the Banking Act i.e. such entity should have been issued a license to operate as a licensed specialized Bank.

The said section defines “a Company” as a Company formed and registered under the Companies Act and includes a Company duly incorporated outside Sri Lanka, a body corporate formed in pursuance of any statute of any foreign country, Royal Charter or letters patent and a body corporate established by or under written law excluding private Company incorporated outside Sri Lanka.

The term “**equity capital**” is defined as

- (a) Paid up capital if it is a licensed specialized Bank incorporated or established in Sri Lanka by or under any written law
- (b) The amount assigned to such Bank by the head office, if it is a licensed specialized Bank incorporated or established outside Sri Lanka

However, the Banking Act provides for exceptions to the above restriction. Thus, the requirement to obtain a licence as aforesaid will not apply in respect of the following categories of entities -

- (a) A Company registered under Finance Companies Act, No. 78 of 1988;
- (b) A Co-operative Society registered under the Co-operative Societies Law, No. 5 of 1972;

[Whilst this exemption has not been amended to include co-operative societies registered in each

province we are of the view that it could be argued that such exemption is also available to such co-operatives as well for the reasons morefully discussed in this report].

- (c) A building society incorporated under the National Housing Act;
- (d) Company licensed as a Licensed Commercial Bank under the provisions of the Banking Act
- (e) Any organization established or registered under any written law, not being an organization established primarily for the purpose of making profit, which accepts deposits only from its registered members and has obtained permission in writing from the Monetary Board to accept such deposits and to invest or lend the monies so accepted.

Therefore, to accept deposits from people, an MFI should fall within one of the permitted institutions referred to above. Thereafter, such MFI may mobilize deposits, invest and lend monies from such deposits.

When responding to question no. 3 above, we categorised the entities carrying out microfinance Activities in Sri Lanka (as informed to us) as follows depending on the law under which such entities were incorporated or registered.

- i. Institutions incorporated under the Companies Act;
- ii. Institutions falling within the Societies Ordinance;
- iii. Institutions falling within the Co-operative Societies Law;
- iv. Institutions falling within the Voluntary Social Service Organisations Act;
- v. Institutions incorporated by Acts of Parliament; and
- vi. Microfinance Activities carried out by individual persons.

We will now discuss the deposit mobilization ability of each of the aforesaid types of entities.

### **Institutions incorporated under the Companies Act**

As previously discussed, the Companies Act deals mainly with the formation of Companies in Sri Lanka (including registration of Companies incorporated outside Sri Lanka and having a place of business in Sri Lanka) and the regulation of such Companies in general.

Companies incorporated/registered under the Companies Act do not merely by virtue of such incorporation/registration have the ability (in the sense of legal capacity) to accept deposits.

In view of the restriction contained in the Banking Act on accepting deposits (discussed above), a Company incorporated/registered under the Companies Act would have to either

- Possess a license issued by the Central Bank i.e. either a commercial or specialized Banking license or a Finance Company license; or
- Be a non profit making entity accepting deposits from its registered members with the special permission of the Monetary Board

in order to accept deposits.

### **Deposit taking by a Licensed Commercial Bank or a Licensed Specialised Bank**

#### Licensed Commercial Banks (LCBs)

Upon being issued with a license to operate as a licensed commercial Bank, a LCB may carry out “Banking business” which is defined in the Banking Act as “the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part for advances, investments or any other operation either authorized by law or by customary Banking practices”.

In addition to the above, a LCB may also carry out any of the Activities listed in Schedule II to the Banking Act which is annexed hereto marked “ANNEXURE A”. The broad range of Activities which a LCB may undertake (as set out in the aforesaid Schedule II) includes “opening, maintaining and managing deposit, savings and other similar accounts.

It is therefore, evident from the foregoing that a LCB may accept deposits from the public.

However, in order to be eligible for a license to operate as a LCB, an entity should fulfill certain criteria stipulated in the Banking Act and in directions issued by the Monetary Board of Central Bank thereunder.

The main requirements set out by the Monetary Board in respect of LCB's are:

a) Maintenance of Capital.

The Banking Act stipulates that every LCB shall at all times maintain a minimum equity capital specified from time to time by the Monetary Board. "Equity capital" has been defined in the Banking Act as:

- i. Paid up capital if it is a LCB incorporated or established in Sri Lanka;
- ii. The amount assigned to such Bank by the head office, if it is a LCB incorporated or established outside Sri Lanka.

In the light of the above, every LCB is required, in terms of a direction issued by Central Bank on 12<sup>th</sup> April 2005, to have and maintain a capital of Rupees Two Thousand Five Hundred Million (Rs. 2,500,000,000/=). For this purpose, "capital" has been defined by the direction dated 22<sup>nd</sup> August 1997 issued by the Central Bank as "Tier 1-core capital: representing permanent shareholders' equity (paid-up shares / common stock / assigned capital) and reserves created or increased by appropriations of retained earnings or other surpluses, e.g.: share premium, retained profits and other reserves".

In terms of a direction issued by the Central Bank on the 29<sup>th</sup> of July 2005, LCBs incorporated abroad who desire to maintain capital in foreign currency and request the same from the Central Bank, will be permitted by the Central Bank, to maintain a maximum amount of fifty per cent (50%) of the new capital that is brought into Sri Lanka in foreign currency. The balance fifty per cent (50%) should be converted to Rupees and maintained in the Domestic Banking Unit of such LCB.

Out of the fifty per cent (50%) of the capital that will be maintained by the said LCB in foreign currency, twenty five per cent (25%) is required to be maintained as a non-interest bearing reserve with the Central Bank in US Dollars, Pounds Sterling or Euros, and the remaining twenty five per cent (25%) of the new capital is required to be retained in the Off-Shore Banking Unit of such LCB to be utilised only for lending to Companies approved by the Board of Investment of Sri Lanka.

b) Reserve Fund.

- A LCB is required to maintain a reserve fund and transfer to such fund, out of the net profits after payment of tax of each year, and before any dividend is declared or profits being transferred to Head Office or elsewhere,
- A sum equivalent to not less than five per centum (5%) of such profits until the amount of the reserve fund is equal to fifty per centum of the paid up or assigned capital of such Bank, and
- A further sum equivalent to not less than two per centum (2%) of such profits until the amount of the said reserve fund is equal to the paid up or assigned capital of such Bank.

c) Maintenance of Liquid Assets

Every LCB is required to maintain liquid assets of an amount stipulated by Central Bank (which shall not be less than 20% and not more than 30% of the total of its liabilities less its liabilities to Central Bank, to the shareholders, to the holders of non redeemable debt instruments and its liabilities under repurchase agreements relating to treasury bills, government issued/guaranteed securities and such other assets determined by Central Bank).

d) Maintenance of a Capital Adequacy Ratio

The Monetary Board, in a determination dated the 2nd of January 2004, has stipulated that every LCB must maintain, at all times, a minimum capital adequacy ratio of ten per centum (10%) in relation to risk weighted assets with core capital constituting not less than five per centum (5%) both on a Bank only/solo basis considering the domestic and off shore Banking units and on a consolidated basis i.e. including the Bank and all subsidiaries (in the case of foreign Banks this is confined to subsidiaries in Sri Lanka).

e) Single Borrower Limit for a LCB.

The Monetary Board, in a determination dated the 20th of February 2007, has determined that a LCB shall not -

- (1) Grant accommodation, exceeding thirty per centum (30%) of the capital funds of such Bank as at the end of its preceding financial year, to any single Company, public corporation, firm, association of persons or an individual, or
- (2) In the aggregate, grant accommodation exceeding thirty three per centum (33%) of the capital funds of such Bank, to any of the following -
- An individual, his close relations or to a Company or firm in which he has a substantial interest; or
  - A Company and one or more of the following,
    - a) Its subsidiaries;
    - b) Its holding Company;
    - c) Its associate Company;
    - d) A subsidiary of its holding Company; or
    - e) A Company in which such Company or its subsidiary, or its holding Company, or a subsidiary of its holding Company has a substantial interest;

Provided that a LCB may grant accommodation in excess of thirty three *per centum* (33%) of the capital funds of such Bank, to the category of customers as listed in (2) above, on the basis of a sum of scores assigned to it by the Monetary Board based on the Bank's credit rating, capital adequacy ratio and the customer's credit rating.

A LCB may grant accommodation in excess of the limits specified above, with the prior approval of the Monetary Board which is granted on a case by case basis and subject to such terms and conditions as may be prescribed by the Monetary Board.

The Monetary Board has also stipulated that the sum total of the accommodation granted at any time to the categories of customers referred to above, each of whose accommodation exceeds fifteen *per centum* (15%) of the capital base of a LCB, shall not exceed fifty five *per centum* (55%) of the total outstanding accommodation granted

by the LCB as at the end of the immediately preceding quarter.

Certain types of accommodation (those secured by specified security and those granted to specified entities, such as the Government of Sri Lanka) are excluded from the scope of the restriction discussed here.

#### f) Permitted Share Capital Ownership in a LCB

The Banking (Amendment) Act No. 05 of 2005 provides that an individual, partnership or corporate body shall not either directly or indirectly or through a nominee or Acting in concert with any other individual, partnership or corporate body acquire "*a material interest*" in a LCB incorporated or established in Sri Lanka by or under any written law without the prior written approval of the Monetary Board given with the concurrence of the Minister of Finance.

The Monetary Board is empowered to grant such approval subject to terms and conditions it may deem fit.

The said direction defines "*a material interest*" as "the holding of over ten per centum of the issued capital of a licensed commercial Bank carrying voting rights".

The term "Acting in concert" has been defined as "*Acting pursuant to an understanding (whether formal or informal) to actively cooperate in acquiring a material interest in a licensed commercial Bank so as to obtain or consolidate, control of that Bank*".

By a direction issued on 19<sup>th</sup> January 2007, it is also provided that the Monetary Board may on a case by case basis grant permission to specified categories of shareholders to acquire a material interest not exceeding 15 per cent of the issued capital carrying voting rights in a LCB.

Monetary Board may, in the case of a LCB requiring restructuring to avoid inadequacy of capital, insolvency or potential failure, on a temporary basis, permit the exceeding of the limit of fifteen *per centum* (15%).

We have not discussed such requirements as the entities referred to in the list given do not include any LCBs.

## Licensed Specialized Banks (LSBs)

Upon being issued with a license as a licensed specialized Bank, a LSB may carry out any of the Activities listed in Schedule IV to the Banking Act which is annexed hereto marked "ANNEXURE B". The broad range of Activities which a LSB may undertake (as set out in the aforesaid Schedule IV) includes "accepting time and savings deposits and opening, maintaining and managing deposit, savings and other similar accounts excluding however the carrying on of Banking business as defined in the Act"

However, in order to be eligible for a license to operate as a LSB, an entity should fulfill certain criteria stipulated in the Banking Act and in directions issued by the Monetary of Board of Central Bank thereunder.

The main requirements imposed by Monetary Board in this respect are set out below.

### a) Maintenance of capital.

In terms of a direction issued to all LSBs on 12<sup>th</sup> April 2005, a LSB is required at all times to maintain an equity capital (Tier 1 Core Capital) in an amount not less than one thousand five hundred million rupees (Rs. 1,500,000,000).

### b) Reserve Fund.

The Monetary Board, in a determination made dated the 21<sup>st</sup> of November 1997, has stipulated that a LSB is required to maintain a reserve fund and transfer to such fund, out of the net profits after payment of tax of each year, and before any dividend is declared,

- A sum equivalent to not less than five *per centum* (5%) of such net profits until the amount of the said reserve fund is equal to fifty per centum (50%) of the equity capital of such LSB, and after such percentage is reached;
- A sum equivalent to not less than two *per centum* (2%) of such net profits until the amount of the said reserve fund is equal to the equity capital of such LSB.

### c) Maintenance of Liquid Assets.

In a determination made on the 21<sup>st</sup> of November 1997 by the Monetary Board, every LSB is required to maintain liquid assets of an amount not less than twenty *per centum* (20%) of its total monthly deposit liabilities.

### d) Maintenance of a Capital Adequacy Ratio.

The Monetary Board, in a determination dated 27<sup>th</sup> of December 2001, has stipulated that every LSB must maintain, at all times, a minimum capital adequacy ratio of nine *per centum* (9%) in relation to risk weighted assets with core capital constituting not less than four decimal five *per centum* (4.5%).

### e) Single Borrower Limit for a LSB.

The Monetary Board, in a direction dated the 20<sup>th</sup> of February 2007, has stipulated that a LSB shall not-

- (1) Grant accommodation, exceeding thirty *per centum* (30%) of the capital funds of such Bank as at the end of its preceding financial year, to any single Company, public corporation, firm, association of persons or an individual, or
- (2) In the aggregate, grant accommodation exceeding thirty three *per centum* (33%) of the capital funds of such Bank, to any of the following -
  - An individual, his close relations or to a Company or firm in which he has a substantial interest; or
  - A Company and one or more of the following,
    - i. Its subsidiaries;
    - ii. Its holding Company;
    - iii. Its associate Company;
    - iv. A subsidiary of its holding Company; or
    - v. A Company in which such Company or its subsidiary, or its holding Company, or a subsidiary of its holding Company has a substantial interest;

Provided that a LSB may grant accommodation in excess of thirty three *per centum* (33%) of the capital funds of such Bank, to the category of customers as listed in (2) above, on the basis of a sum of scores assigned to it by the Monetary Board, based on the Bank's credit rating, capital adequacy ratio and the customer's credit rating.



A LSB may grant accommodation in excess of the limits specified above with the prior approval of the Monetary Board which is granted on a case by case basis and subject to such terms and conditions as may be prescribed by the Monetary Board.

The Monetary Board has also stipulated that a LSB may, for the purpose of direct funding of infrastructure projects, grant accommodation to the categories of customers referred to above, upto a limit of fifty *per centum* (50%) of the capital base of the LSB.

The sum total of the accommodation granted at any time to the categories of customers referred to above, each of whose accommodation exceeds fifteen *per centum* (15%) of the capital base of a LCB, shall not exceed fifty five *per centum* (55%) of the total outstanding accommodation granted by the LCB as at the end of the immediately preceding quarter.

### **Deposit taking by a Finance Company**

A Finance Company licensed under the Finance Companies Act No. 78 of 1988 is permitted to mobilize deposits from the public as the “Finance business” which such a Company is permitted to carry out is the “business of acceptance of money by way of deposit....”.

Although, we note that the entities referred to in the list given do not include any Finance Companies, we have set out below the minimum registration and regulatory requirements applicable to Finance Companies.

The minimum requirements for registration as a Finance Company are -

- (i) The applicant should be a public Company registered under the Companies Act;
- (ii) It should have a minimum issued and paid up capital of not less than Rs. 5,000,000/-

The Monetary Board may register an applicant Company as a Finance Company if it is satisfied that the above requirements are complied with and on the information available to the Monetary Board, that the registration would not be detrimental to the interests of its depositors and creditors.

Once the registration as a Finance Company is obtained, the main regulatory requirements applicable to it at present are, *interalia* -

#### (i) Minimum Core Capital Requirement

Every Finance Company is required to maintain at all times, an unimpaired core capital of not less than Rs. 200,000,000/-.

Here, Core Capital refers to permanent shareholders' equity (paid up shares/common stock) and reserves created or increased by appropriations of retained earnings or other surpluses i.e. share premia, retained profits and other reserves.

#### (ii) Capital Adequacy Ratio

Finance Companies are required to maintain its capital (adjusted for the items specified by the Central Bank) at a level not less than 10 percent of its risk weighted assets with core capital constituting not less than 5% of its risk weighted assets.

#### (iii) Liquid Assets

Every Finance Company is required to maintain a minimum holding of liquid assets (as specified) of not less than 15% of the total outstanding value of its time deposits and the face value of deposit certificates issued by the Company and not less than 20% of the outstanding value of savings deposits accepted by the Company.

### **Institutions within the purview of Societies Ordinance**

The Societies Ordinance contains no express provision either permitting or prohibiting 'deposit taking' by a registered society. Only contribution by members of the society to the funds of the society, as authorized by the Societies Ordinance and the rules of the society, are recognized.

In view of the restriction in section 76A (1) of the Banking Act, discussed above, which provides that the business of accepting deposits of money and investing and lending such money should not be carried out except as permitted in terms of the Banking Act, it would appear that, a society cannot accept deposits of money and invest and lend such money so accepted without the permission of the Monetary Board of Sri Lanka.

A society may be in a position to apply for the permission of Monetary Board for such purpose on the basis of such society being an organization established or registered under a written law, not being an organization established primarily for the purpose of making profit, which accepts deposits only from its registered members (as provided for in the last exception to the aforesaid restriction).

## **Institutions within the purview of Co-operative Societies Law**

### **Taking deposits**

The Banking Act recognizes a Co-operative Society as an entity entitled to accept money on deposit and invest or lend such monies without the requirement to obtain permission from the Central Bank. However the Banking Act has not been amended to include Co-operative societies registered under the respective co-operative societies statutes enacted by the provincial councils of the various provinces. Nevertheless, we are of the view that it could be argued that such an exemption is available to such entities as well on the basis that co-operative societies is now a devolved subject and it is likely that all co-operative societies will in future be registered at provincial level.

Whilst a co-operative society may accept deposits from its members, lend and enter into any other transactions with its members, a co-operative society may receive deposits and loans from persons who are not members only to the extent and under such conditions as may be prescribed by the rules made under the Co-operative Societies Law or under the respective Co-operative Societies statute of the relevant province (where applicable,) and the by-laws of the respective co-operative society.

The rules issued under the said Co-operative Societies Law provide that the Registrar of Co-operative Societies may by general or special order direct that any registered society shall so long as it receives loans, deposits or other credit facilities from any non-member other than a Bank, (1) not pay any dividend to its members or (2) pay dividends at such reduced rate as the Registrar of Co-operative Societies may determine.

The rules further require a registered co-operative society to fix, from time to time, at a general meeting of the society, the maximum amount it may receive as loans, deposits or otherwise from persons who are not members.

Where the Registrar of Co-operative Societies is of opinion that the fixing of a maximum amount as provided above shall create hardship to any particular registered society, the Registrar of Co-operative Societies may fix such maximum amount for such society for such term as he may consider necessary.

The rules further provide that "the manner of raising funds, including the maximum rate of interest on deposits" is a matter which must be compulsorily dealt with by the by-laws of the registered society.

We are not in a position to comment on the rules promulgated by the Western, Sabaragamuwa and Central provinces as they are not available for perusal.

### **Investing funds**

The Co-operative Societies Law permits registered co-operative societies to deposit or invest its funds in any of the securities (other than a first mortgage of immovable property) specified in section 20 of the Trusts Ordinance, or with any Banker or person Acting as a Banker, or in the shares or on the security of any other registered society or in any other mode permitted by the rules issued under the Co-operative Societies Law.

The rules permit a registered society to, with the prior approval of Registrar of Co-operative Societies, invest its funds in any public or private institution provided that specific provision has been made in such public or private institution to enable such investment.

Similar provisions for the investment of funds are available in the Co-operative Societies statutes for the Western, Sabaragamuwa and Central Provinces.

### **Granting loans**

A registered society should not grant any loans to any person other than a member provided that with the approval of the general body of the registered society and on such condition as may be imposed by it, a registered society may lend to another registered society or supply goods on credit to an associate member.

Similar provisions for the granting of loans are available in the Co-operative Societies statutes for the Western, Sabaragamuwa and Central Provinces.

### **Institutions within the purview of Voluntary Social Service Organization (Registration and Supervision) Act 31 of 1980 (the “VSSO Act”)**

The VSSO Act does not deal with any aspect of taking of deposits by a Voluntary Social Service Organization (“a VSSO”).

Hence, in view of the restriction contained in section 76A (1) of the Banking Act, a VSSO would require the special permission of the Monetary Board in order to accept deposits.

However, in terms of the VSSO Act a VSSO is defined as any organization formed by a group of persons on a voluntary basis and,

- a) Is of a non-Governmental nature;
- b) Is dependent on public contributions, charities, grants payable by the Government or donations local or foreign, in carrying out its functions;
- c) Has as its main objectives, the provision of such reliefs and services as are necessary for the mentally retarded or physically disabled, the poor, the sick, the orphans and the destitute, and the provision of relief to the needy in times of disaster;

and includes a community hostel.

Since a VSSO is dependant on donations, grants and contributions from various sources, for the provision of reliefs and services to people who are in need for such services, deposit taking does not appear to be an Activity which a VSSO could carry out in terms of the said Act as it may then fall outside scope/ambit of the definition.

### **A natural person**

In view of the restriction in section 76 A (1) of the Banking Act, it is not possible for a natural person to take or accept deposits.

**06. Based on point 5 provide recommendations & guidance to MFIs to tackle the deposit mobilization issue.**

### **Institutions within the purview of Banking Act No 30 of 1988**

As stated in our response to question 5 above, there is no restriction on deposit mobilization by Banks licensed under the Banking Act.

However, as noted in our responses to questions 5 and 7, Banks are highly regulated entities. Thus, LCBs and LSBs should comply with applicable statutory and regulatory requirements at any given time even if such LCBs and LSBs are primarily engaged in microfinance Activities.

Even Banks such as SANASA Development Bank (SADB), Uva Development Bank (UDB) and Sabaragamuwa Development Bank (SDB) which have been incorporated for the purpose of helping and facilitating the Finance needs of the poor and the underprivileged are subject to those requirements.

Therefore, for entities using either the LCB or LSB model for the provision of micro Finance services in Sri Lanka, it may be advantageous to lobby for a less stringent regulatory approach towards such entities in order to facilitate the growth of the MFI sector in Sri Lanka. A possibility may be to consider whether an additional category of Banking entities should be recognized by law which is subject to less stringent regulation in terms of capital adequacy etc than LCBs and LSBs. In the case of existing Banks, it may be possible to request that the microfinance aspect of its business be separately evaluated/regulated for instance as in the case of off shore Banking which has its own set of rules, regulations and requirements.

### **Institutions within the purview of Societies Ordinance**

A society cannot accept deposits of money and invest and lend such money without the permission of the Monetary Board of Sri Lanka (please see 5 (II) above).

However, the option available to a VSSO, as stated in 6 (IV) below, is available to societies as well.

Nevertheless, unlike in the case of a VSSO, certain societies which are registered under the Societies Ordinance have used the option stated in 6 (IV) below and have obtained the permission of the Monetary Board of Sri Lanka<sup>2</sup> to accept deposits from their members and to invest and lend the money so accepted. Therefore, registered societies may use this option and tackle the deposit mobilization issue successfully.

### **Institutions within the purview of Co-operative Societies Law**

The ability of a registered co-operative society to mobilize deposits both under the co-operative Societies Law and the provincial statutes for the Western, Central and Sabaragamuwa provinces is generally restricted to deposits from its members only. Deposit taking from non-members is subject to the rules issued under the Co-operative Societies Law/ respective provincial statutes (as the case maybe) and the by-laws of the respective co-operative societies. (please see discussion under 5 (III) above)

Though it may be seen that such restrictions are not micro Finance friendly, considering the objective of co-operative societies as set out in the Co-operative Societies Law or the relevant Co-operative Societies statute (as applicable), the restrictions on deposit mobilization are reasonable and justifiable due to the following reasons.

- The co-operative societies were formed to develop the rural area in which such society is functioning. Therefore, the restrictions on deposit mobilization limiting the mobilization of the deposits (to the people of such area who are members of the co-operative society) for the development thereof is rational.
- Since co-operative societies are managed by ordinary people with no real expertise on Finance, restriction on deposit taking is justifiable as imprudent investments may jeopardize vulnerable rural economies.

<sup>2</sup> Certain number of SARVODAYA SAMITHIs in Sri Lanka have been granted permission by the Monetary Board of Sri Lanka to accept deposits and invest and lend such money so accepted. However, no permission is granted to extend such acceptance of deposits beyond the membership of such organizations.

- VAT Act as well as certain provisions of the Inland Revenue Act are not applicable to co-operative societies. Therefore, if co-operative societies are freely allowed to mobilize deposits at large and invest the same in any field, that may have serious implications on the application of tax law as well.

### **Institutions within the purview of Voluntary Social Services Organisations (Registration and Supervision) Act 31 of 1980 (the “VSSO Act”)**

As discussed in our response to question 5 above, under the existing legal framework, a VSSO should obtain the written permission of the Monetary Board to accept deposits, invest and lend such money so accepted.

In order to obtain such permission, a VSSO should fulfill the following requirements,

- It should be duly registered under the VSSO Act.
- It should not be an organization established primarily for the purpose of making profit.
- It should accept deposits only from its registered members.

Thus, this option of engaging in micro Finance business will only be viable for a VSSO which provides microfinance services either on a non profit basis or primarily on non-profit basis and it has a registered membership from which it can mobilize such deposits.

Please note however, that in view of the definition of “Voluntary Social Service Organisations” in the VSSO Act which provides that in order for an organization to be considered as a “Voluntary Social Service Organisation” it should be “dependant on public contributions, charities, grants payable by the Government or donations local or foreign, in carrying out its functions”.

Hence, such deposits as taken in by a VSSO should not be utilized in “carrying out its functions”. Rather, it may only take/accept such deposits as part of the services it renders to the poor and the needy for instance by safeguarding the savings of such people on their behalf.

The Monetary Board may consider the grant if the required permission on a case-by-case basis depending upon the merits of each case and its policy on this issue at any given time.

However, in the current economic scenario affecting the world in general and Sri Lanka in particular (with the failure of several deposit taking institutions such as Finance Companies) and the strict regulatory approach being adopted towards VSSO operating in Sri Lanka, it is unlikely that Central Bank will take a very positive approach towards such an application at the current time.

**07. Comparative analysis of the various supervision structures (currently existing) and their relative legal powers in enforcing the law**

Supervisory structures vary from entity to entity based on the law under which such entity is incorporated, registered and/or licensed, as the case may be. Each law is equipped with its own supervisory structure built for the purposes of that law. Further an entity may be subject to more than one supervisory structure. For example, if a Company is incorporated under the Companies Act No 07 of 2007 and if such Company wishes to engage in Finance business within the meaning of the Finance Companies Act, such Company will not only be subject to the scrutiny of the supervisory mechanism under Companies Act but also the mechanism under Finance Companies Act and its regulations.

The following brief outline of the existing supervisory structures is based on the types of institutions and the umbrella legislations which establish such supervisory structures in relation to such institutions. However, it should be noted that some supervisory authorities entertain powers over various types of institutions. Thus, the subjection of an institution to the scrutiny of a particular authority substantially depends upon the business Activities of such institute.

**Institutions within the purview of Voluntary Social Service Organisations (Registration and Supervision) Act 31 of 1980 (the “VSSO Act”)**

Please refer to our response in relation to question 2 for a brief analysis of the VSSO Act.

The VSSO Act provides for two supervisory bodies viz,

- The Registrar of Voluntary Social Service Organizations (“RVSO”) including Assistant and Deputy Registrars Acting under directions of the RVSO.

- The Minister in charge of the subject of Voluntary Social Service (the “Minister”)

RVSO is vested with the following supervisory powers in terms of the VSSO Act, viz,

- a) To register/refuse to register a VSSO in terms of the VSSO Act
- b) To enter and inspect at all reasonable hours of the day, the premises of a voluntary organization registered under the VSSO Act for the purpose of ascertaining whether satisfactory standards of service are maintained in such organization;
- c) To bring to the notice of the Minister any allegation of fraud or misappropriation of funds committed by such organization; and
- d) To attend any meeting of the executive committee of such organization or a general meeting of the members of such organization, upon the written request of all or a majority of the members of the executive committee of such organization, or with the concurrence of the office bearers of such organization or the Minister. (The Registrar or the officer so attending will not have the right to vote at such meeting).

The Minister is authorized in terms of the VSSO Act to exercise any of the following powers, as the case may be.

- a) To make regulations in respect of any matter required by the Act to be prescribed or in respect of which regulations are authorized by the Act to be made;
- b) To refer any allegation of fraud or misappropriation made by any person against a registered VSSO, to a Board of Inquiry (Powers of appointing and nominating the members of Board of Inquiry are vested with the Minister.)

The Board of Inquiry is vested the powers to summon and compel the attendance of witnesses, to compel the production of documents and to administer any oath or affirmation to any person.

- c) To appoint an Interim Board of Management subject to the requisites set out in the VSSO Act, where a Board of Inquiry constituted as aforesaid reports to the Minister that there is evidence to support any allegation of fraud or misappropriation made against a voluntary organization and the Minister is satisfied

that the fraud or misappropriation is of such nature as would affect the financial management of the organization and that public interest will suffer if such organization is continued to be carried on by its existing executive committee.

- d) To refer the report of the Board of Inquiry to the appropriate authority for steps to be taken according to law.

### **Institutions within the purview of Companies Act No 07 of 2007 -**

Companies Act No 07 of 2007 is the primary legislation which deals with the Companies that are incorporated/registered under its provisions. Registrar-General of Companies at the Department of Registrar General of Companies is vested with general supervisory powers in respect of bodies incorporated/registered under the Companies Act.

Please refer to our response under questions 2 and 4 for the procedure in respect of incorporation and registration in terms of the Companies Act.

In terms of the Companies Act, incorporated bodies are obliged to record Company affairs and file such documents and notices with the Registrar-General of Companies as and when such is mandated by the Companies Act. This recording procedure and observation of legal formalities continue from the time of incorporation/registration up to winding up of a Company. In terms of the Companies Act, if those formalities and procedure are not adhered to in the manner set out therein, the Company and every responsible officer of the Company will be guilty of an offence and will be liable upon conviction to the penalty set out in the Companies Act.

Registrar-General of Companies is vested with powers both,

- A. Administrative and investigatory, and
- B. Quasi judicial

in nature in respect of the corporate bodies incorporated under the Companies Act.

Thus, the Registrar-General of Companies,

- Should maintain all the documents which will be filed with or sent to Registrar-General of Companies as required in the Companies Act in order that the public or any interested party may inspect those documents after paying the prescribed fee.
- May require a Company to furnish or produce such information as he may need to discharge his duties under the Companies Act
- May institute proceeding at court against Companies that have defaulted under the Companies Act to convict such Companies for the offences committed.
- May, with the permission from court, take steps to order the Company or officers responsible to produce such books or records of the Company where there is reasonable cause to believe that any person has while an officer of a Company, committed an offence in connection with the management of the Company's affairs, and evidence of the commission of the offence is to be found in any books or papers of or under the control of the Company.

Moreover, although a conviction for an offence set out in the Companies Act may only be imposed by court, the Registrar-General of Companies may, if he thinks fit, instead of instituting proceedings in court or where such proceedings have already been instituted, instead of continuing such proceedings against the Company or any officer of the Company in respect of such offence, accept from the Company or the officer, such sum of money as the Registrar may think proper in composition of the offence.

### **Public Limited Companies**

Every Company that is a public limited Company is either incorporated or registered under the Companies Act. In terms the Companies Act, a public limited Company is a limited liability Company. Once a Company issues shares to public in accordance with the Listing Rules of the Colombo Stock Exchange ("CSE"), such Company is a public limited Company in the eyes of the law. Thereafter, such Company, in addition to complying with the requirements of the Companies Act, should comply with the requirements under the Listing Rules of the CSE. Thus, if an MFI wishes to raise money by way of a public offer, understanding the Listing Rules and the supervisory structure thereunder is necessary.

The CSE is a licensed stock exchange licensed under the Securities and Exchange Commission of Sri Lanka Act No 36 of 1987 ("SEC Act") (Please see our response to question 2 for a brief analysis of the SEC Act). Currently, it is the only licensed stock exchange in Sri Lanka. Thus, a public offer of shares of a Company can be executed only through the CSE. The CSE has promulgated Listing Rules with the permission of the Securities and Exchange Commission of Sri Lanka ("SEC") established under the SEC Act. Thus, under the authority vested with the CSE by the SEC, the CSE is the main supervisory body/the monitoring mechanism of all the public limited Companies in Sri Lanka.

The Listing Rules regulates public limited Companies in all aspects - rules in relation to public issue of shares including contents of prospectus/introductory document, further issue of securities, contents of articles of association, corporate governance (please refer to our response to question number 8 for details on this respect), continuing listing requirements and corporate disclosure. An enforcement mechanism is also integrated to the Listing Rules. The CSE as the appointed regulator ensures that public limited Companies observe the requirements set out in the Listing Rules. Moreover, an enforcement mechanism is also integrated to the Rules to ensure compliance.

The SEC exercises certain number of direct powers over certain matters set out in the Rules.

### **Institutions within the purview of the Banking Act No 30 of 1988**

The Banking Act governs and controls both LCBs and LSBs in Sri Lanka.

The regulatory and supervisory function relating to Banks is carried out by the Bank Supervision Department of the Central Bank. The supervision of Banks is based on the internationally accepted standards for Bank supervision set out by the Basel Committee for Banking Supervision.

Under the off-site surveillance system, the financial condition of a LCB/LSB is monitored on the basis of periodic information provided by Banks on their operations. The periodic information includes weekly interest rates on deposits and advances, monthly returns on selected financial information, assets and liabilities, statutory liquid assets, quarterly returns on income and expenditure, capital adequacy, non-performing loans/advances, classified advances and provisioning for bad and doubtful advances, investments in shares, accommodation granted to Bank directors, their close relations and concerns in which a director has a substantial interest, interest spreads, half-yearly return on share ownership of the Banks and quarterly financial statements and annual audited financial statements.

In terms of the provisions of the Banking Act and the Monetary Law Act, a LCB/LSB is subject to statutory examinations once in every two years.

On-site supervision, including the risk based examination process, which focuses on identification of Banking risks, the management of these risks and the assessment of adequacy of resources to mitigate these risks, is supplemented by examination based on the internationally accepted CAMEL model (Capital Adequacy, Asset Quality, Management, Earnings and Liquidity).

Furthermore, a Bank's compliance with statutory requirements, applicable laws and regulations, internal controls and the standards of corporate governance are also assessed.

Matters relating to non-compliance with prudential requirements and any weaknesses and deficiencies in the financial condition, controls and systems of a Bank are brought to the notice of its Board of Directors, by the Central Bank to ensure that the necessary corrective Action is undertaken.

A LCB/LSB is also required to publish their quarterly and annual audited financial statements, including key performance indicators, in the newspapers, in all three languages, being Sinhala, Tamil and English, within two months from the end of each period.

#### **a) Powers of the Director of Bank Supervision.**

In terms of Section 45 of the Banking Act, where the head of the Department of Bank Supervision of the Central Bank of Sri Lanka ("Director of Bank Supervision") is of the opinion that a LCB/LSB

- Is engaging in unsafe or unsound practices in the carrying on of its business, which is likely to jeopardise its obligations to its depositors or is likely to result in such Bank being unable to meet its obligations; or
- Has contravened or failed to comply with the provisions of the Banking Act or of any regulation, direction, order or other requirement made or given under the Banking Act or has contravened or failed to comply with any other written law which in the opinion of the Director of Bank Supervision relates to Banking or Finance,

he may issue order directing such LCB/LSB -

- To cease and desist from any such practice, contravention or failure ; or
- To comply with the provisions of the Banking Act or of any regulation, direction, order or other requirement made or given under the Banking Act; or
- To take necessary Action to correct the conditions resulting from such practice, contravention or failure,

within such period as may be specified in the order.

#### b) Directions of the Monetary Board

In order to ensure the soundness of the Banking system, the Monetary Board of Central Bank may from time to time issue directions in respect of management of Banks and other financial institutions dealing with issues such as maintenance of capital, reserve funds, liquid assets, capital adequacy ratio, the class/es of advances which may/may not be made by any such Bank, the margins to be maintained in respect of secured advances, maximum amount of advance that may be made to a single borrower/group of Companies, maximum shareholding in a Bank etc.

The Monetary Board also has the power to require both general and specific provisions relating to bad and doubtful debts to be made by LCBs and LSBs.

### **Institutions within the purview of the Finance Companies Act No 78 of 1988**

The Monetary Board of the Central Bank of Sri Lanka is the authority which registers Finance Companies under the provisions of the Finance Companies Act, and issues Directions under the said Act.

The Director of the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka discharges the supervisory function over the operations of licensed Finance Companies.

#### a) Powers of the Director of Non-Bank Financial Institution Supervision

The Director may at any time examine the books and accounts of any Finance Company and furnish the report on any such examination to the Governor of the Central Bank of Sri Lanka.

The Director/any authorized officer may

- Administer any oath/affirmation to a director, manager, secretary, employee or auditor of a Finance Company;
- Require such person to furnish information relating to the affairs of the Finance Company and produce for inspection books, records or documents relating to the affairs of the Company in his possession/ custody;
- And where there is evidence of mismanagement by a Finance Company, to require such person to submit the accounts of the Finance Company to an auditor authorized by the Director.

In addition to the above, the Director may where he considers it necessary to ascertain the true condition of the affairs of a Finance Company,

- Require any person having information relating to such Company, to furnish such information or to attend in person for examination; and/or
- Examine the business of a Company which is or has at any relevant time been a holding Company/ subsidiary Company of the Finance Company or a subsidiary of the Finance Company's holding Company or an associate Company of the Finance Company.

#### b) Directions of the Monetary Board

The Monetary Board of the Central Bank of Sri Lanka may give directions under the Finance Companies Act to Finance Companies regarding the manner in which any aspect of the business of such Companies are to be conducted such as -



- (i) The terms and conditions under which deposits may be accepted by such Companies, the maximum rates of interest payable on such deposits, the maximum periods for which deposits may be accepted, the maximum amount that may be deposited with a Company in the name of one person in one or more accounts;
  - (ii) The terms and conditions under which any loan, credit facility or any type of financial accommodation may be granted by such Companies, the maximum rates of interest that may be charged on such loans etc., the maximum periods for which any such loan may be granted;
  - (iii) Maximum rates which may be paid to or charged by such Companies by way of commissions, discounts, fees or other receipts or payments whatsoever;
  - (iv) Minimum initial payment a prospective hirer should make on any hire purchase agreement; and
  - (v) Terms and conditions under which investments may be made by Finance Companies.
- c) Other powers of the Monetary Board

In addition to the above, the Monetary Board may

- Make rules on any matter in respect of which rules are authorized to be made under the Act or which is stated/required to be prescribed including rules relating to registration of Finance Companies, annual license fees, relevant forms to be used under the Act and relating to advertisements by a Finance Company;
- Review any agreement entered into by a depositor with a Finance Company the management and administration of which was taken over by the Board and vary the terms of such contract; and
- Review any agreement entered into by such Finance Company with any other person/s and vary the same where such agreement has been entered into without due regard to the interest of the depositors and creditors or to prudent commercial practice.

### **Institutions falling within the purview of the Finance Leasing Act No 56 of 2000**

Every registered Finance leasing establishment operates under the supervision of the Director, Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka.

#### a) Powers of the Director of Non-Bank Financial Institution Supervision

The Director of the Department of Supervision of Non-Bank Financial Institutions has the power to suspend or cancel the registration of any registered Finance leasing establishment on the following grounds -

- i) Failure to commence business within 12 months of registration
- ii) Ceasing to carry on Finance leasing business
- iii) Composition with creditors, liquidation or being wound up
- iv) Carrying on business in a manner detrimental to the interests of the lessees
- v) Inability to meet it's obligations to it's lessees, creditors or suppliers
- vi) Acting in contravention of any provision of the Act/ any regulation or direction given thereunder.

The Director has also the power to issue general directions under the Act to ensure that registered Finance leasing establishments maintain efficient standards in carrying out their duties, including directions on the following matters -

- i) Maximum rate of payments to be levied by the registered Finance leasing establishments;
- ii) Matters concerning the method of collecting payments;
- iii) Form and manner in which the books of accounts or other records or documents are to be maintained;
- iv) Terms and conditions of Finance leases;
- v) Minimum paid up capital and the reserves a registered Finance leasing establishment shall have, having regard to the value of its Finance leases;

- vi) Having regard to the paid up capital and reserves of a registered establishment, the maximum value of Finance leases that may be granted to any one person, group of persons, or category or persons as may be specified by the said Director;
- vii) Capital and reserves of the registered Finance leasing establishments;
- viii) Minimum initial payment required to be made by a lessee for any equipment or different categories of equipment, such minimum to be expressed as a percentage of the value of the equipment; or
- ix) Provisions for bad and doubtful debts.
- b) Powers of the Minister

The Act empowers the Minister to make regulations in respect of any matter required by the Act to be prescribed or in respect of which regulations are authorized by the Act to be made.

### **Institutions within the purview of the Societies Ordinance**

- a) Powers of the Registrar General of Companies

The supervisory structure in respect of registered societies is somewhat similar to the one in relation to Companies incorporated/ registered under the Companies Act. The Registrar General of Companies is the registrar for the purposes of the Societies Ordinance. As in the case of Companies incorporated/registered under the Companies Act, the Registrar General of Companies is vested with powers both,

- i) Administrative and investigatory, and
- ii) Quasi judicial

in nature in respect of the bodies incorporated under the Societies Ordinance.

The Registrar's powers include the power to, with the consent of the Minister

- At the request of a specified number of members, appoint an inspector to examine into the affairs of the society and to report thereon; and
- Call a special meeting of the society and direct what matters are to be discussed at such meeting.

The Registrar General of Companies is also vested with additional powers in respect of societies such as cancellation of registration of a society if he thinks fit at the request of a society or with the approval of the Minister in charge of the subject, on proof to his satisfaction that an acknowledgement of registry has been obtained by fraud or mistake or a society exists for an illegal purpose or has willfully, after notice from the Registrar violated any provision of the Ordinance or has ceased to exist and suspension of registration with the approval of the Minister.

The Registrar General of Companies also has the power to hear and determine any dispute between a member/person claiming through a member and the society.

- b) Powers of the Minister

The Minister has the power, *inter alia*, to make regulations in respect of registry and procedure under the Societies Ordinance, the forms to be used, the duties and functions of the Registrar General of Companies, inspection of documents kept with the Registrar General of Companies and in general for giving effect to the Societies Ordinance.

### **Institutions within the purview of Co-operative Societies Law**

The Co-operative Societies Law No. 5 of 1972 (as amended), which requires the registration thereunder of any society carrying on business with the word "Co-operative" in any part of its name, provides for a stringent and comprehensive supervisory structure for the regulation of such societies once registered. The following is a broad overview of the most relevant aspects of its supervisory structure.

The Co-operative Societies Law provides for two general supervisory bodies:

- i) The Minister for the time being of Co-operative Societies ("the Minister").
- ii) The Registrar of Co-operative Societies (including any deputy, senior assistant or assistant registrars as are appointed and as empowered by the Minister)

The supervisory powers under the Co-operative Societies Law can loosely be divided into "Administrative & Regulatory" powers and "Quasi-Judicial" powers.

## Administrative & Regulatory

Chapter VIII and IX of the Co-operative Societies Law deals with administrative & regulatory duties and powers of the Registrar of Co-operative Societies. These include:

- Nominating persons to the committee of management of the registered co-operative society, and nominate its president and/or vice-president;
- Receiving annual statement of accounts and a copy of their annual budget from every registered co-operative society;
- Auditing (or causing an audit of) the accounts of every registered co-operative society annually (including the powers to summon any past or present officer, agent, member etc of the society to give material information about the transactions of the society or the management of its affairs, and requiring therefrom, the production of any book or document relating to the affairs of the society, or any cash, security or other property belonging to the society in such person's custody or possession);
- The right to at all times have access to, and examine all books, documents, accounts and papers, securities and cash in hand of a registered co-operative society;
- The right to, if found in the course (or conclusion) of an audit, disallow any payments or use of funds of the registered co-operative society contrary to rules under the Co-operative Societies Law, or any other law, rules or regulations relating to Co-operative Societies etc, and to charge against any person the amount of any deficiency or loss caused by the negligence or misconduct of that person to the registered co-operative society;
- The right to, on his own motion or application of not less than one-third of the members of the registered co-operative society, hold an inquiry or inspection into the constitution, working and financial condition, or an inspection into the books of the said registered co-operative society;
- The power (if deemed necessary by the Registrar after an inquiry as above) to require the general body of a registered co-operative society to remove members of the committee of the registered co-operative society, or dissolve the committee and elect new committee members or a new committee in line with the by-laws of the registered co-operative society;

- The power to (if deemed necessary by the Registrar after an inquiry as set out above) cancel its registered status and dissolve a registered co-operative society;
- Appoint one or more persons to be the liquidator or liquidators of the society post cancellation of the registered status of the registered co-operative society. Such liquidator(s) will operate under the direct control and management of the Registrar.

## Quasi Judicial

- Carry out hearings into administrative decisions taken with regards to removal of committee members, dissolution of a committee, or the dissolution of the registered co-operative society;
- Refer any disputes relating to the registered co-operative society (as set out in the Co-operative Societies Law) to arbitration or decide the dispute(s) himself. Appeal from any outcome of arbitration shall be made to the Registrar, and the such decision is final (there is no recourse to civil courts under the Co-operative Societies Law);
- Adjudicate, and provide a final and conclusive decision, in any dispute as to the interpretation of the by-laws of a registered co-operative society.

## The powers of the Minister -

The Minister is empowered by the Co-operative Societies Law:

- To make such rules as maybe necessary for carrying out or giving effect to the principles and provisions of the Co-operative Societies Law;
- Exempt any society from any of the requirements of the Co-operative Societies Law as to registration;
- Exempt, by way of general or special order, any registered society or class of societies from any of the provisions of the Co-operative Societies Law or modify the applicability or date of applicability of such provisions thereto.

The abovementioned supervisory structure and powers are similarly provided for in the Co-operative Societies statutes for the Western, Sabaragamuwa and Central Provinces, with the Minister and Registrar of Co-operatives being the Minister in charge of Co-operatives and Registrar of Co-operatives for that respective province.

## 08. Review of existing laws relation to Governance and Accountability Issues (in Financial Institutions) and their applicability in managing MFIs.

Applicability of governance and accountability issues arising under a particular law to a particular entity depends upon whether such entity comes within the purview of such law.

For instance, governance and accountability issues under the rules of Corporate Governance set out in Listing Rules of Colombo Stock Exchange are applicable to public limited Companies only. Whether such are applicable to a Finance Company within the meaning of the Finance Companies Act will depend upon whether such Company is a listed entity in terms of the Listing Rules of Colombo Stock Exchange.

### Institutions within the purview of Voluntary Social Service Organisations (Registration and Supervision) Act 31 of 1980 (the “VSSO Act”)

Please refer to the discussion under section 7.

### Institutions within the purview of Companies Act No 07 of 2007

The Companies Act contains many provisions aimed at securing good governance and accountability in the management of corporate bodies. Some of the significant aspects are set out below -

- Board of directors of a Company is vested with the power of management of the Company. All such duties imposed by the Companies Act or otherwise should be discharged and performed by the board in a *bona fide* manner and in the best interest of the Company. Moreover, a director cannot Act or agree to the Company Acting in a manner that contravenes any provisions of the Companies Act or the articles of association of the Company. A director performing his duties should not Act in a manner which is reckless or grossly negligent. He or she should exercise the degree of skill and care that may reasonably be expected of a person of his knowledge and experience.
- Directors are bound to disclose their interests in the contracts that are to be entered or already entered by the Company and in shares issued by the Company.

- A director in possession of information in his capacity as a director/employee of the Company should not disclose that information to any person or make use of or Act on the information except for the purposes of the Company, as required by law, if he is authorized by the Board of Directors or the Articles of Association to do so.
- The board of the Company should always make sure that the solvency level (i.e. the assets of the Company are greater than the liabilities and stated capital of the Company) of the Company is maintained at any given time.
- The board of a Company should summon a annual general meeting of its shareholders within six months from the balance sheet date of the Company and a copy of the annual report on the affairs of the Company should be circulated to the shareholders not less than 15 working days before the date of the annual general meeting.
- Pre-incorporation contracts are enforceable against the Company after its incorporation.
- Company cannot enter into major transactions which are affecting the assets of the Company substantially without the approval of the shareholders by special resolution.
- Companies (except private Companies) should file its financial statements at the Registrar General of Companies.
- Companies are required to maintain an ‘interests register’ where the directors’ interests in contracts and shares of the Company are recorded.

Certain duties and obligations set out above may, in the case of private Companies, be waived with unanimous consent of the shareholders of the Company.

### Public Limited Companies

In addition to the above and as discussed under question 07, the Listing Rules of the CSE requires public listed Companies to observe, inter alia, the provisions in the Listing Rules on corporate governance. These rules mainly deal with the composition of the Board of Directors, appointment of independent directors, audit committees and remuneration committees.

## **Institutions within the purview of the Banking Act No 30 of 1988**

Monetary Board of the Central Bank of Sri Lanka issued directions, under section 46 (1) and 76 J (1) of the Banking Act No 30 of 1988, imposing mandatory requirements relating to corporate governance for LCBs/LSBs in Sri Lanka. The following is a brief analysis of the same.

Banking Act Direction No 11 of 2007 and 1 of 2008 on Corporate Governance for Licensed Commercial Banks and Banking Act Direction No 12 of 2007 and 2 of 2008 on Corporate Governance for Licensed Specialized Banks

The above directions impose rules on the following aspects of governance of LCB/LSBs in order to enhance the transparency, accountability and soundness of the Banking system.

- Responsibilities of the board
- The composition of the board
- Criteria to assess the fitness and propriety of directors
- Management functions delegated by the board
- The chairman and chief executive officer
- Board appointed committees such as audit committee and remuneration committee
- Related party transactions
- Disclosures

## **Institutions within the purview of Finance Companies Act**

Monetary Board of Central Bank of Sri Lanka issued directions, under section 9 of the Finance Companies Act No 78 of 1988, imposing mandatory requirements relating to corporate governance for Finance Companies in Sri Lanka.

Finance Companies (Corporate Governance) Direction No 03 of 2008:

The aspects of governance in relation to which the rules are imposed for Finance Companies are identical to the aspects in relation to which the rules of Corporate Governance are imposed upon LCBs/LSBs set out above.

## **Institutions within the purview of Societies Ordinance**

Other than the following, there are no significant governance or accountability requirements imposed by the Societies Ordinance on societies registered thereunder.

The relevant provisions are as follows -

- Registered societies are required once every year to submit its accounts for audit by a public auditor appointed in terms of the Societies Ordinance.
- A society shall send to the Registrar a general statement ("a return") of the receipts and expenditure, funds and effects of the society as audited which shall show separately the expenditure in respect of the several objects of the society
- Any member/person interested in the funds of the society may inspect the books and names of the members of the society (other than a loan or deposit account of a member which requires approval by a special resolution or the consent of the member)
- A society shall hold a general meeting of its members once a year
- The Ordinance sets out an inviolable upper limit on distribution of benefits in respect of a particular financial year among members of a society.

Further, the rules of the society should provide for the matters set out in the Schedule of the Societies Ordinance. These items include *inter alia* the objects of the society and the purposes for which the funds may be applicable, appointment and removal of management committee, the composition of a central body, annual return to the Registrar of the receipts and expenditure, funds and effects of the society, the investment of funds and the keeping of accounts and audit of the same etc.

## **Institutions within the purview of Co-operative Societies Law**

The Co-operative Societies Law together with the rules made thereunder as the general law governing co-operative societies in Sri Lanka provides for an extensive framework of governance and accountability requirements applicable to registered co-operative societies.

The following are some of the more salient features of the framework -

- Every registered co-operative society is required to have a committee of management to manage the Activities of the society, including compliance with all requirements under the Co-operative Societies Law, the rules issued thereunder, the by-laws of the society, and any general directions issued by the Registrar pertaining to the affairs of the society. Such committee will be subject to any powers etc of the Registrar (or any person entitled to exercise such powers) under the Law.
- Every co-operative society shall have by-laws and such by-laws shall be binding upon the society and the members thereof.
- The committee is required to maintain proper accounts of the income and expenditure, assets and liabilities and of all other transactions of the society, prepare annual statements of accounts, and an annual budget, and provide copies of said accounts and budget to the Registrar.
- The committee to maintain a register of members.
- The Registrar to audit, or cause an audit of, the accounts of every co-operative society annually.
- The Chairman and every member of the committee of a co-operative society to make an annual declaration of their assets (including of their immediate family members) in the prescribed form.
- The Registrar, or any person authorized by the Registrar may conduct inquiries, inspections or investigations into the Activities of a co-operative society in line with the provisions of the Co-operative Societies Law, and are empowered to take such Action as is provided for therein, including the removal of committee members, imposition of charges for misappropriation of funds etc, and the dissolution of the co-operative society (Please see also our response with regard to co-operative societies under question 7 above for further information).

Similar provisions relating to governance and accountability are provided for in the Co-operative Societies statutes for the Western, Sabaragamuwa and Central Provinces.

## 09. Review of the applicability of the provisions of the Value Added Tax Act for MFIs

Applicability of Value Added Tax Act No. 14 of 2002 (as amended by Act Nos. 07 of 2003 and 13 of 2004, 06 of 2005, 08 of 2006, 14 of 2007 and 15 of 2008) (“VAT Act”) to Financial Services Provided by MFIs

Please see question 10 (I) for a review of the Value Added Tax (“VAT”) in respect of businesses of MFIs.

Financial VAT is imposed upon the total value addition made by any “...**specified Institution or person carries on the business of supplying such financial services**”. Therefore, it should be considered whether MFIs carry on the business of supplying such financial services.

A business entity such as MFI may carry on number of business Activities while provision of financial services specified in the Act being one of them. In such context can the supply of specified financial services by an MFI in a small scale manner be construed to mean a business of supplying the financial services for the purposes of VAT, irrespective of its scale?

For the purpose of taxation, the word “business” has generally been construed to have a wider meaning in order to include any Activity which is continuously carried on in an organized manner to be within the scope of the word “business”.

Therefore, we are of the view that irrespective of the scale of the supply of financial services by an MFI, if an MFI supplies specified financial services as a usual part of Activity of carrying on the business of supplying other services, such MFI is subject to financial VAT.

### MFIs and Profits

The mere assertion that some of MFIs are not for profits is not adequate for any MFI to relieve itself from VAT liability. Because profits or loss is not a criteria for the calculation of the financial VAT. Thus, section 25C of the VAT Act sets out that

*“Every registered specified institution (**including any person-emphasis added**) under this Chapter shall be liable to tax for each taxable period on its total value addition of such institution which includes the net profits or loss, as the case may be...”*

Therefore, be there any value addition by any person by engaging in the business of the supply of financial services such person is subject to VAT.

#### Statutory Exemptions from Financial VAT.

In terms of 25A (iii) of the Act, the only body which is exempted from the application of the Chapter IIIA of the Act is a Co-operative Society registered under the Co-operative Societies Law. Hence, if the supply of micro Finance services is channeled through a Co-operative Society, total value addition taken place at the Co-operative Society level will be exempted from VAT due to the non-existence of taxable person.

Please see our response to question 10 below as to the applicability of this exemption to co-operative societies registered under the provincial statutes. For the reasons stated therein, we are of the opinion that the aforesaid exemption from financial VAT is available to such co-operative societies as well.

### 10. Review Tax and Revenue provisions with relations to MFLs

#### Value Added Tax (“VAT”)

Imposition of VAT is governed by Value Added Tax Act .

By the amendment No 07 of 2003 to the VAT, the business of supplying these financial services were recognized as a taxable Activity. In terms thereof, “financial services” were defined to mean -

- a) The operation of any current, deposit or savings account;
- b) He exchange of currency;
- c) The issue, payment. Collection or transfer of ownership of any note, order for payment, cheque or letter of credit;
- d) The issue, allotment, transfer of ownership, drawing, acceptance or endorsement of any debt, security, being’ any interest in or right to be paid money owing by any person;
- e) The issue, allotment, transfer of ownership of any equity security or a participatory security;

- f) Underwriting or sub-underwriting the issue of any equity security, debt security or participatory security; and
- g) The provision of any loan, advance or credit.

Until 2004, the taxable person had been restricted to “specified institutions” such as licensed commercial Banks and registered Finance Companies that carry on the business of supplying financial services in Sri Lanka. However, by the amendment No 13 of 2004, it was extended to apply “any person” who carries on the business of supplying financial services in Sri Lanka. “Person” is defined in the Interpretation Ordinance No 21 of 1901 to **include** “any body of persons corporate or unincorporate”.

It is stated that MFIs offer various financial services such as provision of loans and credits and operation of deposits and saving accounts during the course of their business of supplying financial services to the poor and under privileged sector of community.

Therefore, we are of the view that such MFIs engage in the business of supplying financial services set out above are subject to Value Added Tax.

With the extension of the application of the Act to “any person”, the distinction in respect of the application of financial VAT between the specified institutions and other persons ceased to be applied. In terms of section 25G of the Act, *“where any person carries on the business of supplying financial services, the preceding provisions of this Chapter (Chapter IIIA- emphasis added), shall mutatis mutandis apply, to and in relation to the supply of such services made by such person on or after July 1. 2003.”*

Thus, all the provisions in respect of specified institutions is applicable to MFIs alike.

#### Calculation of the value addition made by a person carrying on the business of the supply of financial services

The Act has provided two methods of calculating the value addition made by a business of supplying financial services in Sri Lanka. They are,

- a) The total value addition in respect of specified institution/person which/who carries on the business of supplying financial services (tax credit method)

- b) The value addition attributable to any person who carries on the business of supplying financial services (attributable method)

All persons engaged in the business of supplying financial services including the specified institutions is entitled to choose between any of the aforesaid alternative methods to calculate the value addition made by them. Accordingly, the person or specified institution may inform in writing to Commissioner General of Inland Revenue of his intention to calculate the value addition under tax credit method or attributable method in respect of any month commencing on or after 01<sup>st</sup> of July 2003. The selection of the method may depend upon the extent of the business of supplying financial services carried out by such person. However, the option once exercised is not revocable. Moreover, it should be noted that the value addition calculated under both of the two alternative methods is in respect of the total value addition made by the person who carries on the business of supplying financial services. (Please see item No 09 for more information).

### Registration

Every specified institution or person carrying on the business of supplying any financial service in Sri Lanka, is required to be registered under the Act where the value of such supply for a period of three months exceeds five hundred thousand rupees or for a period of twelve months one million eight hundred thousand rupees, as the case may be. Notwithstanding the above, no tax is charged from any person liable to such tax, if the value addition calculated in accordance with the provisions of the Act does not in respect of any calendar month exceed seventy five thousand rupees.

### Taxable period

The taxable period of a person who carries on the business of supplying financial services in Sri Lanka is one month. The rate of tax as applicable to any taxable period commencing on or after 01<sup>st</sup> of January 2006.

## **Inland Revenue Act No 10 of 2006 (as amended by Act Nos. 10 of 2007, 09 of 2008 and 19 of 2009)**

### Income from interest

The primary income of an MFI is the interest income generated from the business of money lending. In addition to that, interest income can arise from certain investments which a MFI may make. Both types of interest income are assessable under the Inland Revenue Act as income from interest.

### Assessment of Tax

In terms of the Inland Revenue Act, income arising from interest shall be the full amount of interest falling due, whether received or not, without any deduction for outgoing or expenses. Therefore, the tax payable for the income from interest in respect of a particular year of assessment will be the full amount of interest accruing to any MFI during that year of assessment, whether such interest has received or not.

However, the aforesaid calculation of income from interest on the accrual basis is allowed to be adjusted in the following circumstances.

- i) Where it appears to an Assessor that any interest is unpaid and cannot be recovered, any assessment which includes such interest should, notwithstanding the fact that assessment is final and conclusive, be reduced by the amount of the interest included which has been shown to be unpaid and irrecoverable or, if income tax has been paid in respect of such interest, such tax may be refunded on a claim in writing made within three years of the end of the year of assessment in respect of which such tax was paid.
- ii) Where any interest falling due in any year of assessment in respect of a loan has not been received and is likely to be irrecoverable, the person to whom such interest is due may exclude such interest from the profits and income chargeable with income tax for that year of assessment.
- iii) Where it appears to an Assessor that any interest which has been excluded from an assessment under paragraph (b) above, has subsequently been received and that income tax has not been paid in respect of such interest, he will make an assessment or additional assessment including such interest.



The phrase "interest falling due" means interest accruing for a particular year of assessment.

### **Exemptions from Income tax for registered Co-operative Societies:**

The Inland Revenue Act provides exemptions from income tax of certain persons (other than individuals) on the whole or any part of their profits and income. These include, *inter alia*, co-operative societies registered under the Co-operative Societies Law No. 5 of 1972 (as amended). In terms of the relevant exemption, a co-operative society is exempted from tax on its profits and income, other than profits and income from dividends or interests, up to any year of assessment on or before 31<sup>st</sup> March 2008 and for any year of assessment on or after 1<sup>st</sup> April 2013 and tax on profits or income for every year of assessment within a period of 5 years from 1<sup>st</sup> April 2008 to 31<sup>st</sup> March 2013.

As we have mentioned in our answer in relation to Co-operative Societies in question 2 above, the 13<sup>th</sup> Amendment to the Constitution devolved legislative powers on certain specified subjects to Provincial Councils. These included, *inter alia*, the power to make provincial statutes relating to the registration and supervision of Co-operative Societies. In short, where a provincial council has made a statute pertaining to the registration and supervision of Co-operative Societies within its province, co-operative societies are required to register thereunder, and are governed by the provisions set out therein, and not the Co-operative Societies Law No. 5 of 1972. To date several provinces have promulgated statutes relating to co-operative societies.

We note that the exemption above referred to in the Inland Revenue Act is in respect of co-operative societies registered under the Co-operative Societies Law. There is no reference in that exemption to co-operative societies registered under the relevant Co-operative Societies statutes of the various provinces. Therefore the question arises whether the said exemption would extend to co-operative societies registered under the various provincial statutes. Given that the subject of income tax is not a devolved subject under the 13<sup>th</sup> Amendment, the provincial statutes do not provide for matters relating to taxation of income. Therefore the provisions of the Inland Revenue Act must apply to those co-operative societies registered under the provincial statutes as well (even though there appears to be an omission in the Inland Revenue Act to specifically include in the exemption co-operative societies registered under the various provincial statutes). The intention of the

legislature appears to be to provide an exemption from income tax to "registered" co-operative societies. Therefore we are of the view that co-operative societies registered under the various provincial statutes would be able to successfully argue that they too should also be entitled to avail themselves of the said exemption.

**11. Detailed analysis of the laws and regulations relating to equity investments with special reference to MFI's and possible suggestions & recommendations for practitioners and regulators to handle this matter in a way benefiting to the sector.**

### **Restrictions on Investment in Shares**

There are no general restrictions on equity investments in Sri Lanka, including in MFIs, by persons resident in Sri Lanka.

However, the Exchange Control Act prohibits any person resident *outside* Sri Lanka from acquiring shares in a local Company except with the permission of the Controller of Exchange. This permission may be special (on a case by case basis) or general in nature.

By a regulation promulgated under the Exchange Control Act, the Controller of Exchange has given general permission for the acquisition of shares in local Companies by approved country funds, approved regional funds, corporate bodies incorporated outside Sri Lanka and individuals resident outside Sri Lanka subject to certain exclusions, limitations and conditions set out therein.

### **Exclusions**

A person (individual or corporate) resident outside Sri Lanka is prohibited from acquiring the shares of a Company incorporated in Sri Lanka and carrying out or proposing to carry out the following businesses -

- i) Money lending;
- ii) Pawn broking;
- iii) Retail trade with a capital of less than one million U.S. Dollars;
- iv) Coastal fishing.

## Limitations

Foreign ownership in shares in a Company carrying on or proposing to carry on any of the following businesses cannot exceed 40% of the issued capital of such Company, or if approval has been granted by the Board of Investment of Sri Lanka for a higher percentage of foreign investment in any Company, such higher percentage.

- i) Production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions;
- ii) Growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices;
- iii) Mining and primary processing of non renewable national resources;
- iv) Timber based industries using local timber;
- v) Fishing (deep sea fishing)
- vi) Mass communications
- vii) Education;
- viii) Freight forwarding;
- ix) Travel agencies
- x) Shipping agencies

Investing in the shares of a Company carrying on or proposing to carry on any of the following businesses requires the permission of the Government of Sri Lanka or any legal administrative authority set up for the approval of foreign investment in such businesses -

- i) Air transportation;
- ii) Coastal shipping;
- iii) Industrial Undertakings in the second schedule of the Industrial Promotion Act No. 46 of 1990, namely-  
Any industry manufacturing arms, ammunitions, explosives, military vehicles and equipment, aircraft and other military hardware;  
Any industry manufacturing poisons, narcotics, alcohols, dangerous drugs and toxic, hazardous, or carcinogenic materials;  
Any industry producing currency, coins or security documents;
- iv) Large scale mechanized mining of gems;
- v) Lotteries.

## Conditions

The permission granted above is subject to the following conditions,

- Person resident outside Sri Lanka who is a party to a share related transaction to make a declaration to the effect that such person is resident outside Sri Lanka on the share transfer form or share application form as applicable;
- Payment for shares in any share issue/transfer shall be made only out of or into a Share Investment External Rupee Account opened in a commercial Bank in Sri Lanka in accordance with directions given by the Controller of Exchange in that behalf to commercial Banks.

Other than the above, there are no restrictions on the foreign ownership of shares of local Companies carrying on the business of providing financial services except with regard to money lending services and pawnbroking.

The prohibition on foreign investments in Companies carrying on the business of money lending and pawnbroking does not apply Companies carrying on the business of Banking under a license issued by the Central Bank, Finance Companies registered under the Finance Companies Act or Finance leasing Companies registered under the Finance Leasing Act. There is no restriction on foreign investment in such Companies.

Due to the prohibition placed on foreign direct investment in Companies carrying on money lending, it is not possible for a foreign entity to invest in a Company carrying on microfinance business in Sri Lanka unless the local Company operates under a Banking license or a Finance Company license. Whilst there is no restriction on foreign investment in the shares of a local Company which then invests in a local microfinance institution, Sri Lankan regulatory authorities have since of late, sought to exclude such arrangements as well on the basis that such indirect foreign investment in the microfinance sector is an evasion of the intent of the exchange control regulations.

In view of the special nature of microfinance and the need to develop it in an economy like Sri Lanka, we see no real justification in excluding foreign investment in this area as to do so would be to deprive the country of much needed access to resources of foreign countries and bodies with the necessary funds and expertise to develop this sector.

To achieve this end, one would have to obtain an exclusion in respect of investment in Companies engaged in microfinance from the prohibition applicable to money lending in general under existing exchange control regulations. However, it is unlikely that such an exemption would be given until there is a legal and regulatory framework for the microfinance sector in Sri Lanka.

## 12. Analysis of law/s relating to obtaining a loan from foreign sources

### What are the limitations? And how to address them?

There are no restrictions on borrowing money from foreign sources unless such transaction involves foreign currency or a payment being made to or to the credit of a person out of Sri Lanka.

The Exchange Control Act No.24 of 1953 (as amended) ("the Exchange Control Act") provide the following -

#### Section 5

Except with the permission of Central Bank, no person (other than an authorized dealer), shall, in Sri Lanka, and no person resident in Sri Lanka (other than an authorized dealer) shall, outside Sri Lanka buy, borrow or accept gold or foreign currency from or sell or lend any gold or foreign currency to any person other than an authorized dealer;

[The term "authorized dealer" refers to licensed commercial Banks in Sri Lanka all of which have been appointed by the Central Bank of Sri Lanka as authorized dealers in gold and foreign currency.]

#### Section 6A

Except with the permission of Central Bank, no person shall have in his possession any foreign currency.

#### Section 7

Except with the permission of the Central Bank, no person shall, in Sri Lanka,

- a) Make any payment to or for the credit of a person resident outside Sri Lanka;

- b) Make any payment to or for the credit of a person resident in Sri Lanka by order of or on behalf of a person resident outside Sri Lanka;
- c) Place or hold any sums to the credit of any person resident outside Sri Lanka;

#### Section 8

No person resident in Sri Lanka shall make any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka except with the permission of the Central Bank.

For the purposes of the Exchange Control Act, a Company incorporated outside Sri Lanka (which does not have a branch in Sri Lanka), would be a person resident outside Sri Lanka.

Thus, approval of the Controller of Exchange is required for -

- A person in Sri Lanka
  - To borrow any sum in foreign currency from any person (other than a licensed commercial Bank);
  - To have foreign currency in his possession;
  - To make any payment to or to the credit of a non- resident;
- Any person (other than a licensed commercial Bank) to lend foreign currency to any person in Sri Lanka

LCBs have been appointed as "authorized dealers" by the Central Bank. Whilst LCBs as "authorized dealers" in foreign currency are permitted to deal in the same, they are entitled to lend or make payments in foreign currency only in respect of specified instances - such as lending to a Company exempt from the operation of the Exchange Control Act, by virtue of an agreement with the Board of Investment of Sri Lanka.

It is relevant to note that general permission has been granted in respect of payments in foreign currency in respect of transactions in the nature of "current transactions" (as opposed to capital transactions). Current transactions have been described as transactions relating to "payments or receipts which involve trade in goods and services" and

“capital transactions” have been described as transactions involving “payments or receipts which involve the transfer of real or financial assets by purchase or sale”. It is likely that payment of capital and interest under a loan would amount to a capital transaction for which special permission of the Controller of Exchange is required.

Please note also that the exchange control restrictions discussed above do not apply to any entity which has entered into an agreement with the Board of Investment of Sri Lanka under section 17 of the Board of Investment of Sri Lanka Law which exempts such entity from the application of the Exchange Control Act in relation to its business.

In the absence of an exchange control exemption by way of a Board of Investment approval as referred to above, the exchange control restrictions on obtaining loans from foreign sources apply to microfinance entities.

Whilst exchange control restriction on obtaining and repaying loans in foreign currency to non residents may be averted by channeling such by way of an investment in preference shares issued by the local Company with the repayment taking place through a redemption of such shares, two objections apply to such a scheme -

- (1) Such an arrangement is not possible in the case of microfinance entities due to the exchange control restriction on foreign direct investment in money lending which will also apply to an investment in preference shares issued by a MFI as the Exchange Control regulations do not make a distinction between ordinary shares and preference shares and the Companies Act definition of shares includes shares carrying preferential rights on distribution.
- (2) An investment in preference shares (as opposed to the grant of a loan) carries certain drawbacks for the investor, in that, the return on the investment may only be by way of a preferential dividend which has to be paid out of the profits of the Company and on satisfaction of the solvency test and in the case of a liquidation the investor would rank after secured and unsecured creditor.

### 13. Applicability of Debt Recovery Laws to MFIs.

#### Prevention of Frauds Ordinance No. 7 of 1840 (as amended)

The following provisions of the Prevention of Frauds Ordinance No. 7 of 1840 (“the Prevention of Frauds Ordinance”) are applicable in relation to an Action for the recovery of a debt and the enforcement of a mortgage or pledge.

In terms of the Prevention of Frauds Ordinance, no promise, contract, bargain, or agreement, should be of force or avail in law for

- The purpose of charging any person with the debt, default, or miscarriage of another; or
- For pledging movable property, unless the same shall have been Actually delivered to the person to who it is alleged to have been pledged

unless it be in writing and signed by the party making the same, or by some person thereto lawfully authorized by him or her.

In the event security over immovable property is being obtained, section 2 of the Prevention of Frauds Ordinance is relevant.

Section 2 stipulates that no sale, purchase, transfer, assignment or mortgage of land or other immovable property and no promise, bargain, contract, or agreement for effecting any such object or for establishing any security, interest or incumbrance affecting land or other immovable property, shall be of force or avail in law unless the same shall be in writing and signed by the party making the same or by some person lawfully authorized by him or her in the presence of a licensed notary public and two or more witnesses present at the same time, and unless the execution of such writing, deed or instrument be duly attested by such notary and witnesses.

In effect, section 2 provides that no transaction affecting immovable property or an interest in immovable property shall be valid unless it is effected by a written instrument signed by the relevant party/ his lawful representative in the presence of a licensed notary public and two or more witnesses who shall attest such execution.

## Money Lending Ordinance

Please refer our response to question 2 for a brief analysis of the Money Lending Ordinance.

The Money Lending Ordinance is significant in the process of debt recovery by a MFI as it contains provisions which confer certain level of protection towards the borrower. Some of them are as follows.

- In the proceedings taken in a court for the recovery of money lent or the enforcement of any agreement or a security, a court may at its discretion re-open the transaction and take an account between the lender and the person sued, and may notwithstanding any statement or settlement of account or any agreement purporting to close previous dealings and create a new obligation, re-open any account already taken between them, and relieve the person sued from payment of any sum in excess of the sum adjudged by the court to be fairly due in respect of such principal, interest, and charges as the court may adjudge to be reasonable having regard to the risk and all the circumstances.

This discretion of the court is exercisable when there is evidence which satisfies the court that the

- Return to be received by the creditor over and above what was lent, is excessive and that the transaction was harsh and unconscionable or as between the parties thereto, substantially unfair; or
- Transaction was induced by undue influence or is otherwise tainted;
- Transaction is secured by a promissory note for a fictitious sum with the knowledge of the lender or for an unspecified amount.

[Section 2 of the Money Lending Ordinance]

- In considering whether in any case the return to be received by the creditor, is excessive, the court shall have regard (amongst other things) to the reasonableness of the rate of interest to be charged. For example where the loan value is over Rupees two thousand five hundred (Rs. 2500/=), an interest rate exceeding 15% per annum is deemed to be unreasonable unless the creditor satisfies the court that the rate charged is in fact reasonable in all circumstances of the case.

- No interest should at any time be recoverable to an amount in excess of the sum then due as principal.
- If the return is excessive the court may order the borrower to pay such reasonable amount as may be determined by the court.

However, the provisions of section 2 of the Money Lending Ordinance is not applicable to transactions in the ordinary course of business by-

- a) Any mutual provident or specially authorized society registered under the Societies Ordinance;
- b) Any society incorporated under the National Housing Act;
- c) Any society registered under the Co-operative Societies Law;
- d) Any body corporate or incorporated empowered by a special enactment to lend money in accordance with such special enactment;
- e) Any duly incorporated and registered Bank or Banking Company;
- f) Any person or Company bona fide carrying on the business of insurance; and
- g) Any pawnbroker licensed under the Pawnbrokers Ordinance.

Thus, the protection conferred on a borrower by section 2 of the Money Lending Ordinance (discussed above) is not applicable to many of the micro Finance service providers such as co-operative societies, registered societies, Banks and Finance Companies.

In view of the foregoing, it would appear that the application of the main provisions of the Money Lending Ordinance is limited to the informal sector money lenders such as natural persons who engage in the business of money lending and incorporated bodies engaged in the business of money lending and owned by residents of Sri Lanka which do not fall within the exempted types of institutions in terms of the Money Lending Ordinance.

Such natural and legal persons who engage in the provision of micro Finance services may encounter some difficulties in recovering the debts due to such persons owing to the protections given to the borrower under the Money Lending Ordinance for instance in the event the interest rate charged by the MFI is high in comparison to regular Banking channels.

## **Debt Recovery (Special Provisions) Act No 02 of 1990**

As discussed in our response to question 02 above, the Debt Recovery (Special Provisions) Act No. 2 of 1990 (as amended) provides for an expedited form of debt recovery for “lending institutions” in terms of the said Act.

The applicability of the Debt Recovery (Special Provisions) Act is limited to the lending institutions identified in the said Act and is therefore of limited significance to most MFIs. The term “lending institution” is defined to mean-

- a) A licensed commercial Bank within the meaning of the Banking Act No. 30 of 1988;
- b) The State Mortgage and Investment Bank established by the State Mortgage and Investment Bank Act No. 13 of 1975 ;
- c) The National Development Bank established by the National Development Bank of Sri Lanka Act No. 2 of 1979;
- d) The National Savings Bank established by the National Savings Bank Act No. 30 of 1971;
- e) The Development Finance Corporation of Ceylon established by the Development Finance Corporation of Ceylon Act (Chapter 165) (now DFCC Bank); and
- f) A Company registered under the Finance Companies Act, No. 78 of 1988, to carry on Finance business;

and includes a liquidator or any authority duly appointed to carry on or wind up the business of any Bank, corporation or Company referred to above.

## **Recovery of Loans by Banks (Special Provisions) Act No.4 of 1990 (as amended by Act No. 24 of 1995)**

By the Recovery of Loans by Banks (Special Provisions) Act, provision was made for the recovery of a “loan” (which term has been defined to mean a “loan of money and includes any overdraft or advance or any other monetary accommodation by whatever name or designation called”) granted by ‘a Bank’ on the mortgage of property, whether movable or immovable, without such a mortgagee having to enforce such mortgage by the institution of an Action in the appropriate court. This special statutory right of a Bank is referred to as “Parate execution”.

In this Act, the term “Bank” is defined to mean a licensed commercial Bank within the meaning of the Banking Act, other than the Bank of Ceylon established by the Bank of Ceylon Ordinance, the People’s Bank established by the People’s Bank Act and any Bank established under the provisions of the Regional Rural Development Bank Act No.15 of 1985.It is also provided that the term ‘Bank’ is also deemed to include DFCC Bank and the HDFC Bank established by their respective statutes.

(Bank of Ceylon, People’s Bank and the State Mortgage and Investment Bank possess Parate execution rights by virtue of their respective statutes.)

The Recovery of Loans by Banks (Special Provisions) Act sets out the procedure to be followed by the lending institution in the exercise of the statutory right of sale of the mortgaged property (i.e. passing of a board resolution, due publication, publication of notices of sale, taking of possession, sale by public auction etc.)

The rights conferred by the Recovery of Loans by Banks (Special Provisions) Act will be available to a MFI only if such MFI falls within the definition of “Bank” as set out therein or is otherwise vested with such rights by its establishing enactment.

## **Debt Conciliation Ordinance No. 39 of 1941**

In terms of the above Ordinance, a Debt Conciliation Board is established for the purpose of facilitating the settlement of debts between debtors and creditors.

An application may be made to the Debt Conciliation Board by

- i) A debtor to effect a settlement of the debts owed by him to all his secured creditors or any one or more of them; or
- ii) Any secured creditor of any debtor to effect a settlement of the debts owed to him by that debtor.

The Debt Conciliation Ordinance defines the term “debtor” as a person -

- i) Who has created a mortgage or charge over any immovable property or any part thereof and whose debts in respect of such property exceed the prescribed amount; or

- ii) Who is a transferee of a right of redemption on a conditional transfer,

and includes the heirs, executors and administrators of such person.

The Debt Conciliation Ordinance defines the term “creditor” as a person to whom a debt is owing and includes the heirs, executors and administrators of that person and, in the case of a debt secured by a transfer or conditional transfer of immovable property as is a mortgage within the meaning of the Ordinance, the transferee of that property and the heirs, executors and administrators of the transferee but does not include the State or any person or body prescribed by regulation under section 61(2).

It appears that the debt settlement procedures under the Debt Conciliation Ordinance may only be initiated where the debt is secured although in the course of such a proceeding, a settlement may be arrived at in relation to debts of unsecured creditors as well. Hence, in order for a MFI to initiate debt conciliation proceedings at the Debt Conciliation Board, it should be a secured creditor within the meaning of the Debt Conciliation Ordinance.

Please note, however that the Debt Recovery (Special Provisions) Act (discussed above) provides that nothing in the Debt Conciliation Ordinance and the Money Lending Ordinance shall apply to or in relation to, “a lending institution” within the meaning of the Debt Recovery (Special Provisions) Act. Thus, if the microfinance entity is “a lending institution” within the meaning of the Debt Recovery (Special Provisions) Act, it cannot avail of or be subject to the provisions of the Debt Conciliation Ordinance.

### **Mortgage Act No. 6 of 1949**

Please see response to question # 14 below.

## **14. Review the applicability of the Mortgage Act to MFI's.**

The law of mortgage in Sri Lanka is governed by the common law (i.e. the Roman Dutch Law) and the Mortgage Act No. 6 of 1949 (as amended by Act Nos. 53 of 1949, 11 of 1953, 24 of 1969, 27 of 1987 and 03 of 1990) (“the Mortgage Act”).

The Mortgage Act generally deals with the procedural aspects in the creation as well as enforcement of mortgages. It provides for matters such as the following -

- Issue of notice of hypothecary Action, manner of issuing such notice and manner of serving process on persons joined as defendants in a hypothecary Action and who are entitled to notice thereof,
- Rights of persons to whom notice of the Action is issued to be joined as a party to the Action,
- Effect of decree in a hypothecary Action on persons noticed or added,
- Intervention by and rights of persons interested who are not entitled to notice
- Effect of sale in execution of decree upon puisine/ subsequent mortgage
- Provisions applicable on death, insolvency or disability of mortgagor or person entitled to notice of hypothecary Action
- Power of plaintiff to join claimants adverse to the mortgagor or to apply for declaration as to possession of land in the event of a sale
- Appointment of receiver of mortgaged land
- Sale under hypothecary decree including property liable to sale in execution of decree, renunciation of the rights afforded by section 46
- Special provisions for recovery where parate execution of immovable property is empowered
- Special mortgage of land accompanied by deposit of title deeds

Whilst the Mortgage Act would be generally applicable to MFIs in their capacity as mortgagees, it is noteworthy that, certain sections of the Mortgage Act contain aspects exclusively applicable to ‘approved credit agencies’ as the mortgagee.

## Definition of approved credit agencies

The Act defines an “approved credit agency” as -

- (a) Any Banking Company as defined in section 333 of the Companies Ordinance, which is declared by the Director of Commerce, by Notification published in the Gazette, to be an approved credit agency for the purposes of this Act;
- (b) The State Mortgage and Investment Bank, the Agricultural and Industrial Credit Corporation, the Loan Board, the National Savings Bank, and the Local Loans and Development Commissioners;
- (c) Any other Company, firm, institution, or individual for the time being declared by the Director of Commerce, by Notification published in the Gazette, to be an approved credit agency for the purposes of this Act

In order to benefit from the special provisions in the Mortgage Act which are applicable to approved credit agencies, a MFI would have to be declared as an approved credit agency by the Director of Commerce unless it is an entity falling within (a) or (b) above.

Please note that the provisions in the Companies Act on “Banking Companies” have been repealed and the law governing “Banking Companies” is found in the Banking Act. The Banking Act provides that a licensed commercial Bank which is granted a license under the Banking Act shall be deemed to be an approved credit agency for purposes of the Mortgage Act.

## Relevant aspects applicable to approved credit agencies under the Mortgage Act

The main advantage to a MFI which falls within the definition of an approved credit agency in the Mortgage Act would be that as mortgagee, an approved credit agency would benefit from certain procedural advantages not available to other mortgagees. This is mainly due to the fact that an approved credit agency, in the course of its day-to-day business, would regularly enter into mortgages as security for financial assistance granted to its customers.

For instance, the Mortgage Act sets out expedient procedures for the creation of a mortgage in favour of an approved credit agency as mortgagee. A further advantage would be that the rights of an approved credit agency under

a mortgage are better protected, provided that the proper procedure is followed.

### 1) Mortgages of Land

Under the Mortgage Act, an owner of land can create a mortgage in favour of an approved credit agency by the execution of an instrument as set out in the Mortgage Act accompanied by the deposit of title deeds with the approved credit agency.

Whilst such instrument is not required to be notarially attested (as section 2 of the Prevention of Frauds Ordinance does not apply to such instruments), a copy of such instrument should be forwarded by the approved credit agency to the Registrar of Lands of the district in which the approved credit agency carries on its business and to the Registrar of Lands of the district in which the land mortgaged by such instrument is situated.

With respect to the availability of parate execution, whilst there is no legal preclusion barring an approved credit agency which is entitled to exercise the statutory right of parate execution in terms of the Recovery of Loans by Banks (Special Provisions) Act, from using such mode of enforcement in relation to a mortgage created as aforesaid, it is arguable whether this could in fact be done, as the Mortgage Act seems to contemplate proceeding in court to enforce such a mortgage.

### 2) Mortgages of movables

Under the Mortgage Act an owner of shares is also allowed to create a mortgage on such movable assets in favour of an approved credit agency by the execution of an instrument as set out in the Mortgage Act accompanied by the deposit of the relevant share certificates and executed share transfer forms ‘in blank’. In such a case, the approved credit agency would have the right, on default by the mortgagor, to sell the shares in discharge of the debt. For the purposes of this section of the Mortgage Act, “sell” would also include the right of the approved credit agency to purchase the shares at the current market value.

The Mortgage Act also provides for the creation of a mortgage by the owner of a life insurance policy by the execution of a similar instrument in favour of an approved credit agency accompanied by the assignment to and deposit of the policy with the approved credit agency. In the event of the mortgagor



failing to repay his debt the approved credit agency would, under the Mortgage Act, be able to surrender such policy to the insurance Company and claim the full surrender value of the policy in order to set off against the mortgagor's debt.

In the case of a mortgage of any corporeal movables in favour of an approved credit agency, the right of sale of such corporeal movable is also given to the approved credit agency, and can be exercised in the event of default by the mortgagor, in settlement of the mortgagor's debts towards the approved credit agency resulting from such default. This would be subject however, to the parties making reference to the relevant section in the Mortgage Act in the instrument by which the mortgage is created. A further requirement is that such sale be by public auction, among others.

A mortgage can also be made of a book debt, which (as defined in the Mortgage Act) is a debt owed to the mortgagor by another person and is "shown in the books kept by such person in the ordinary course of the business". In such an event, the approved credit agency would have a right to demand payment of the debt from such third party, in order to set off the debt incurred by the mortgagor due to default of the mortgage. However, such a mortgage must be duly registered under the Registration of Documents Ordinance.

## 15. Review how setoff policies are applicable to MFIs? - Whether MFIs have the right to set off credit balances and debt balances of clients in the case of default by them?

### General Law

Under the laws of Sri Lanka, the right to set off is available only to Bankers. Banking law of Sri Lanka is derived from the English law of Banking. Under the English law of Banking where there is no agreement express or implied to the contrary, and only when the money owed to him is certain, which is due, the Banker is entitled to exercise the right to set off<sup>3</sup>. However, under the English law this right is available only to Bankers, but no other financial service providing institution. Therefore, unless the MFI is a Bank within the meaning of the Banking Act of Sri Lanka no right to set off is available to such a MFI, unless such right is expressly/impliedly provided for in the contract.

### Co-operative Societies

According to the Co-operative Societies Law and the Co-operative Societies statutes for the Western, Central and Sabaragamuwa provinces, a registered society will have a charge upon the deposits of a member or past member or deceased member in respect of any debt due to the society.

## 16. Review what are the ways that a MFI can do pawning and leasing under Sri Lankan Law? If MFI wants to do this, what are the provisions? What are the guidelines?

### Business of Pawnbroking.

A pawnbroker is defined in the Pawnbrokers Ordinance to include "every person who carries on the business of taking goods in pawn".

Even though a comprehensive definition for pawning is not given in the Pawnbrokers Ordinance, a direction issued by the Monetary Board of the Central Bank under the Banking Act defines 'pawning' for the purposes of the conditions set out therein as "lending of money on the security of personal

3 Fidler P J M, Sheldon and Fidler's Practice and Law of Banking [Macdonalds and Evans, Eleventh Edition, Page 31].

*articles made of gold.....accepted as a pledge for a period not exceeding an initial period of twelve months”.*

[It may be noted that the aforesaid definition is restrictive as pawning is not limited to the pledging of articles made of gold and may include any item of value.]

The Pawnbrokers Ordinance stipulates that no person shall carry on the business of a pawnbroker unless he is the holder of a license issued by the Divisional Secretary (who is a government official appointed for a particular administrative district having powers and duties in respect of such district).

Section 2A of the Ordinance provides that a license to carry out a pawnbroking business would not be granted to following persons/entities -

- a) An individual who is not a citizen of Sri Lanka;
- b) A foreign Company - defined in the Ordinance as “a Company to which Part XI of the of the Companies Ordinance applies” (which has now been replaced by the Companies Act No. 07 of 2007 and the relevant part being Part XVIII which deals with the registration of overseas Companies.);
- c) A foreign firm defined in the Ordinance as a firm consisting of “two partners one of whom is not a citizen of Sri Lanka, or both of whom are not such citizens or consisting of more than two partners at least one of whom is not a citizen of Sri Lanka”.

[You may also note that as previously discussed, with the passing of the 13<sup>th</sup> Amendment to the Constitution, pawnbroking being now a devolved subject, the provinces are empowered to enact their own laws on the subject. However, only the Western Province provincial council has enacted such a statute and any pawnbroker carrying on business within the Western Province is bound to follow the provisions of the Western Province statute on the subject. (Please see also our discussion of this aspect in our response to question 2 above.)]

From the above it is evident that a Company incorporated or established abroad would not be permitted to carry on the business of pawnbroking by establishing a place of business in Sri Lanka for such purpose.

Regulations issued under the Exchange Control Act provide that individuals resident outside Sri Lanka and corporate entities incorporated abroad shall not be entitled to invest in the shares of a Company carrying on the business of pawnbroking.

Licensed Commercial Banks are exempt from the application of the Pawnbroking Ordinance as section 83A of the Banking Act provides that “*the provisions of the Pawnbrokers Ordinance...shall not apply to a Licensed Commercial Bank and such Bank may carry on the business of pawn brokers subject to such conditions as may be determined by the Monetary Board*”.

Thus, whilst a foreign entity cannot engage in pawnbroking through a branch office in Sri Lanka or by incorporating a Company locally, in the event it obtains a license to operate as a Licensed Commercial Bank under the Banking Act, it may offer pawnbroking services as part of its Banking services, unless prohibited to do so by a stipulation to such effect in the Banking license.

To summaries the aforesaid provisions in law, the business of Pawnbroking may be carried only by licensed pawn brokers and licensed commercial Banks.

As to restrictions applicable to licensed pawnbrokers, the Pawnbrokers Ordinance provides inter alia, that

- No pawnbroker shall carry on business as an auctioneer; and that
- Pawnbrokers cannot charge interest at a rate exceeding the specified rates.

Please refer also our response to question # 2 on further aspects of the Pawnbroker’s Ordinance.

## **Finance Leasing business**

The carrying on of the business of Finance leasing is governed by the Finance Leasing Companies Act No. 56 of 2000 (“Finance Leasing Act”). Please refer to question 2 for a brief analysis of the Act.

In terms of the Finance Leasing Act, no person can carry on Finance leasing business, except under the authority of a certificate of registration issued in that behalf under the provisions of the said Act, by the Director of the Department of Supervision of Non-Bank Financial Institutions, of

the Central Bank of Sri Lanka. A Company with such a license is referred to as a "registered Finance leasing establishment".

A person will not be eligible to be registered under the above Act unless such person is:

- a) A Licensed Commercial Bank or a Licensed Specialized Bank within the meaning of the Banking Act;
- b) A Finance Company within the meaning of the Finance Companies Act;
- c) A public Company incorporated in Sri Lanka other than those referred to above, having a minimum issued and paid up capital as may be prescribed. The Minister of Finance has by Gazette Extraordinary No. 1196/27 dated 10<sup>th</sup> August, 2001 prescribed the minimum issued and paid up capital to be LKR 75 million.

An application for registration under the Finance Leasing Act must be made to the Director, Department of Supervision of Non-Bank Financial Institutions in the prescribed form, and be accompanied by -

- a) In the case of a Licensed Commercial Bank or a Licensed Specialized Bank, a certified copy of the license issued to such Bank by the Monetary Board under the Banking Act, and in force on the date of making the application;
- b) In the case of a Finance Company, a certified copy of the license issued by the Monetary Board under the Finance Companies Act, and in force on the date of making the application;
- c) In the case of a public Company-
  - (i) A certified copy of the Articles of Association of the Company; and
  - (ii) A certified copy of the Certificate of Incorporation of the Company;
- d) A certified copy of the operating manual containing the following particulars:
  - (i) The period of duration of a Finance Lease;
  - (ii) The method of recovery of the payments due on the Finance Lease;
  - (iii) The protection by the lessor of the right of the lessee against claims in respect of the equipment provided under the Finance lease;

- (iv) The disposal of such equipment after the expiration of the Finance Lease; and
- (v) Such other particulars as may be prescribed.

- e) The application fee as prescribed; and
- f) Certified copies of such other documents as may be prescribed.

In terms of Gazette Extraordinary No. 1196/27 dated 10<sup>th</sup> August, 2001 issued under the Finance Leasing Act, the application fee for registration in respect of a Licensed Commercial Bank or licensed specialized Bank or a Finance Company is prescribed as Rs. 1,000/- and for any other public Company as Rs. 5,000/-.

Where the Director, Department of Supervision of Non-Bank Financial Institutions, is satisfied that the applicant is fit and competent to carry on Finance leasing business, the Director may having regard to the interests of the national economy-

- a) Register the applicant; and
- b) Issue a certificate of registration to the applicant.

Every registered establishment is required under the Finance Leasing Act to exhibit the certificate of registration issued to it in a conspicuous place at the principal place of business of such registered Finance leasing establishment.

### Restrictions on Activities

Possession of a license under the Finance Leasing Act, enables the registered establishment to carry on Finance Leasing business which is defined as "the business of investing money for the provision of equipment under a Finance Lease".

A Finance leasing Company may, subject to any restrictions contained in its Articles of Association carry on any other type of Activity as well, provided that it is not a restricted activity such as Banking, Finance Business, Insurance and Pawn broking which may only be carried out after obtaining the relevant licenses.

A Finance leasing Company may lend money subject to the exchange control restrictions discussed under question 12 above (for instance relating to lending in foreign currency) and such other restrictions as may be contained in its Articles of Association or in its license to carry out "Finance leasing business".

The Act restricts a registered Finance Leasing establishment from altering or deviating from the particulars contained in the operating manual submitted to the Director or altering its Articles of Association without the prior written approval of the Director.

### Restrictions on investors

There are no restrictions imposed on foreign investment in the shares of a Company carrying on the business of Finance Leasing. It is not possible however, as in the case of a Finance Company, for a foreign entity to engage in Finance leasing business in Sri Lanka through the establishment of a branch office or a place of business in Sri Lanka, as the Finance Leasing Act requires an applicant for a license which is not a Licensed Commercial Bank or a Licensed Specialized Bank to be a public Company incorporated under the Companies Act.

### 17. Review on Micro Insurance - Lot of MFIs provides this service. What is the legitimacy of this? Can MFI doing lending provide insurance services? What are the guidelines?

#### The legitimacy of MFIs providing insurance services

In Sri Lanka, the law which regulates the insurance industry is the Regulation of Insurance Industry Act No 43 of 2000 ("the Regulation of Insurance Industry Act").

Please refer to our response to question 2 for a brief analysis of the Regulation of Insurance Industry Act.

The Regulation of Insurance Industry Act specifically sets out that no person should carry on insurance business in Sri Lanka unless such person is for the time being registered or deemed to be registered under the said Act to carry on such business.

Moreover, in terms of the Regulation of Insurance Industry Act no person will be allowed to register to carry on insurance business in Sri Lanka, unless such person is a public Company incorporated in Sri Lanka and registered under the Companies Act, having paid up share capital of no less than the current prescribed amount of Rupees One Hundred Million (Rs.100,000,000/=) per each class of insurance business it carries on. Such person should fulfill such other requirements as may be laid down by the

Insurance Board of Sri Lanka by rules made in that behalf, for the purpose of ensuring the proper conduct of insurers to safeguard the interests of the insured public and for the development of the insurance industry.

Other laws which apply to and regulates the provision of insurance services in Sri Lanka are of limited application as they are confined to certain identified areas e.g. the Agricultural and Agrarian Insurance Act, No. 20 of 1999 which established the Agricultural and Agrarian insurance Board, the Sri Lanka Export Credit Insurance Corporation Act No. 15 of 1978 which established the Sri Lanka Export Credit Insurance Corporation and the Social Security Board Act. No. 17 of 1990 which established the Social Security Board.

Therefore, any person who engages in insurance business without obtaining a license from the Insurance Board of Sri Lanka is committing an offence under the Regulation of Insurance Industry Act.

The Regulation of Insurance Industry Act also provides that no person shall in Sri Lanka without the prior written approval of the Insurance Board, directly or indirectly place any insurance business with an insurer not registered under the Act, except in relation to reinsurance business.

The Insurance Board may grant written approval for the above purpose only upon taking into consideration the policy of the Government in respect of the insurance industry and the national interest.

#### Can MFI doing money lending provide insurance services?

In terms of the Regulation of Insurance Industry Act, a person registered thereunder should not carry on any form of business other than insurance business. However, such person may with the prior written approval of the Board, carry on any financial services business which is ancillary or associated with the insurance business for which a registration is obtained under the Regulation of Insurance Industry Act.

Therefore, in the event an MFI wishes to provide financial services in addition to the supply of insurance services, such an MFI should first obtain a license to carry on the insurance business. Thereafter, such MFI may apply for the permission of the Insurance Board to carry on other financial services if and only if such financial service is ancillary or associated with the insurance business.

## 18. Study of the legal status of National Development Trust Fund<sup>4</sup>

### Legal Status

The legal status of the National Development Trust Fund (“NDTF”) has evolved over the years and three stages of its development can be identified, which had a significant impact upon its current legal status.

### First stage

The NDTF formerly known as the Janasaviya Trust Fund is a non profit organization established in 1991 by trust deed No. 365 and incorporated under section 114 of Trust Ordinance by Order of the Minister published in Gazette Extraordinary No. 665/31 dated 07<sup>th</sup> June 1991. The Trust was a result of a tri-partite loan agreement between Government of Sri Lanka, the World Bank and Federal Republic of Germany.

Under this loan agreement, LKR 52.8 Mn was granted to Sri Lanka on highly concessionary rate to implement poverty alleviation programs in Sri Lanka.

Through the Janasaviya Trust Fund, a poverty alleviation project was implemented and the project consisted of four sub-projects to address selected aspects of poverty. They are,

- a) A Rural Works Program aimed at increasing wage employment;
- b) Credit and Micro Enterprises Program targeted to groups interested in micro-enterprises;
- c) Nutrition Program to intervene in improving nutritional status of women and children; and
- d) A Human Resource Development Program to meet training and educational needs of poverty groups.

<sup>4</sup> Some of the information contained in our response to this question has been obtained from interviews we had with the officials of NDTF and from access to the following internet source- [www.treasury.gov.lk/NDTF/Brief%20History%20NDTF.doc](http://www.treasury.gov.lk/NDTF/Brief%20History%20NDTF.doc)

### Second stage

In 1997 the project was concluded as the donors had agreed to fund the project up to that point only. However, the Government of Sri Lanka decided to continue the project limiting it to the Credit and Micro Enterprises Program aspect which includes *inter alia* loan disbursements, loan recovery and repayment to the Treasury. The continuation of these Activities was also a requirement of the donors in terms of the tri-partite agreement. The Board of Trustees continued to function supervising these aspects.

The objective of the Credit and Micro Enterprises Program was to “improve and expand credit and other supporting services to facilitate self-employment and micro-enterprises through group-based lending while developing entrepreneurship.”

### Third stage

Subsequently, as the Government of Sri Lanka needed funds to continue the Credit and Micro Enterprises Program, the Asian Development Bank (ADB) agreed to fund the project upon the condition that a Company should be incorporated for this purpose. Accordingly, on 10<sup>th</sup> November 2003 NDTF formed a guarantee Company under the Companies Act No 17 of 1982 (repealed and replaced by the Companies Act No 07 of 2007) in the name of ‘National Development Trust Fund’ (bearing Company no. GA 130).

Currently, the task of the trustees is basically limited to recovering the loans granted under the Trust Fund. The Company with the aid of ADB continues the project of Credit and Micro Enterprises Program.

### Activities and borrowers of the Company.

The Company as a non-profit making entity operating under the Ministry of Finance and Planning provides credit facilities through a network of partner organizations. Thus, the Company does not supply credit facilities directly to individuals but only to identified partner organizations. The partner organizations in turn supply credit facilities to the poor and underprivileged of the community.

### Legal Status of Partner Organisations.

The partner organizations of the National Development Trust Fund fall within the following categories.

- a) Commercial Banks (licensed commercial Banks)
- b) Development Banks (licensed specialized Banks)
- c) Community based organizations (Societies or Voluntary Social Service Organizations)
- d) Multi-Purpose Co-operative Societies, SANASA Co-operative Societies, Fisheries Co-operative Societies (Co-operative Societies)

*(Please note that we have discussed the legal status of Licensed Commercial Banks, Licensed Specialized Banks, Societies, Voluntary Social Service Organizations and Co-operative Societies in our responses to the previous questions of this report.)*

**19. Series of recommendations on how MF practitioners can overcome barriers to investments in the sector both foreign currency loans & foreign equity... etc. (reference to points 11 & 12)**

Considering the restrictions applicable to foreign investment in the Micro Finance sector (i.e. prohibition on foreign direct investment in the shares of money lending Companies and the general exchange control restriction on borrowing in foreign currency & making capital payments to non residents), the best course of Action for the MFI sector in Sri Lanka would, in our view, be to advocate for a separate legal framework for the MFI sector which will take into account the special need for developing the sector as well as the special needs of the sector.

Such a legal framework could address the funding requirements of MFIs in Sri Lanka in a proper manner by recognising that, in order to achieve the required level of development MFIs need to have access to sources of funding other than the traditional sources such as donations (which may be subject to onerous conditions) and borrowing from Banks (which may be subject high rates of interest) as the limitations of such traditional sources may defeat the very purpose for which MFIs are established.

Until such time that a legal framework can be implemented as suggested above, it may be possible to advocate for specific amendments to the laws that restrict investment in the MFI sector. As no general exemptions are available in respect of the restriction on borrowing from non residents even for highly regulated entities such as Banks, it is unlikely that such restriction would be relaxed in the near future in relation to MFIs. It may however be possible to

move for an amendment of the regulation issued under the Exchange Control Act which restricts foreign investment in the shares of money lending Companies. In such a case however, the necessary amendments should be made to the Money Lending Ordinance as well.

**20. Upon reviewing the legal environment, provide a comprehensive set of recommendations to LMFPA in advocating for supportive government policy and legislation on Microfinance.**

The absence of a proper legal framework is, in our view the largest obstacle to the development of the MFI sector in Sri Lanka.

By formulating a law which recognizes Microfinance Institutions, provides for their registration/licensing with a central authority and their regulation thereafter, microfinance could be a formal sector in the financial services sector of the country.

Such a law would have to provide for the following -

- a) Establishment of a body to regulate “Microfinance Business” in Sri Lanka or vesting an existing body or an appointed officer of an existing body such as the Central Bank of Sri Lanka with the authority to regulate such business (hereinafter “the relevant authority”)
- b) A comprehensive definition of “Microfinance Business”  
  
(This could include not only lending but also the provision of various types of financial services such as insurance, pawnbroking, Finance leasing, deposit taking etc.)
- c) A prohibition of carrying on “Microfinance Business” in Sri Lanka without registering with the relevant authority or obtaining a license from the relevant authority
- d) Criteria to be fulfilled to obtain such license/ registration

(Here, it is vital that the criteria is not too restrictive as it should be recognized that microfinance can be effectively carried out by various entities such as limited liability Companies, Companies limited by guarantee, societies, co-operative societies and voluntary social service organizations. We see no

real reason for limiting such licensing/registration only to a certain type of entity.

Please note however, that it would be reasonable to draw a distinction between MFIs taking deposits from the public and MFIs which do not take such deposits. This could be achieved by having two different types of licenses/registrations. In such a case a deposit taking MFI could be subject to more stringent screening prior to the issue of a license.)

- e) Control and supervision of MFIs
  - Preparation of financial statements
  - Appointment of external auditors
  - Furnishing of audited financial statements, periodic reports and information to the relevant authority
  - Provision for examination of books, documents and persons by the relevant authority
  - Suspension/cancellation of license/registration
- f) Conduct of business by a MFI
- g) Winding up/closure of business by a MFI
- h) Power to issue directions to MFIs
- i) Exemptions from applicable laws

In the event the definition of "Microfinance Business" includes provision of financial services in addition to money lending such as pawnbroking, insurance, taking of deposits and Finance leasing necessary exemptions would have to be granted from the application of the Banking Act, the Money Lending Ordinance, Pawnbroking Ordinance, Regulation of Insurance Industry Act, the Finance Companies Act and the Finance Leasing Act.

Once a legal and regulatory framework is established as proposed above, it may be possible to advocate for a relaxation of the restrictions currently applicable to MFIs in Sri Lanka.

For instance, exchange control regulations exempting licensed/registered microfinance businesses from the prohibition imposed on foreign investment in money lending Companies may be sought. Depending on government policy, it may be possible to provide for such an exemption in the microfinance legislation itself. However, it is likely that the government would be more prepared to consider granting such an exemption by way of subsidiary legislation

such as a regulation under the Exchange Control Act (rather than providing it in the microfinance law itself) as a regulation/direction may be modified/cancelled/rescinded by an order made by the Minister far more easily than an amendment of an Act of Parliament.

With respect to the restriction on borrowing in foreign currency and making capital payments to a non-resident, it is unlikely that a general exemption from such restrictions would be given in *total* for even licensed/registered MFIs as currently no such general exemptions are available for any one sector including Banking, Finance Companies or insurance.

Such an exemption may also be sought from the Central Bank of Sri Lanka by way of a regulation issued under the Exchange Control Act. For instance, there are special regulations issued in respect of foreign currency loans to exporters, foreign currency accounts for hoteliers etc.



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