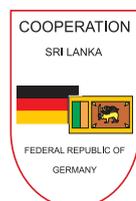




## Report on Savings Mobilization by Microfinance Institutions in SRI LANKA

2009

gtz



Ministry of  
Finance and  
Planning



Lanka Microfinance  
Practitioners  
Association

*This report contains the professional opinion of F J & G De Saram, Attorneys-at-Law on legal position of current deposit taking practice of Microfinance Institutions.*



## *About GTZ*

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

## Background & Introduction

GTZ ProMiS has commissioned F J & G de Saram, Attorneys-at-Law to produce a written report which covers the following aspects as set out in the terms of reference :-

- (1) To state the legal position of current **deposit taking practices of microfinance institutions** particularly in relation to past government directives and current government funded programmes
- (2) To make recommendations to the Lanka Micro Finance Practitioners Association (LMFPA) on its possible legal position in the event that deposit taking rights of microfinance institutions, non-governmental organisations and community based organisations are deprived of
  - whether infringements of equal rights of such institutions have occurred in the face of the Government funded microfinance programs, namely Samurdhi and Gamidiriya etc.
- (3) To make recommendations to the regulators, policy makers and the LMFPA on the possible practical solutions and legal measures that need to be taken to rectify this issue; and
- (4) Specific recommendations on the forthcoming amendments of the Finance Companies Act and the Banking Act.

Our report which is set out below is based on an examination of the local laws and regulations relating to savings mobilization including the Banking Act No. 30 of 1988 as amended ("the Banking Act"), the Finance Companies Act No.78 of 1988 as amended ("the Finance Companies Act"), the Co-operative Societies Law No.05 of 1972 as amended ("Co-operative Societies Law"), the Constitution of the Democratic Socialist Republic of Sri Lanka ("the Constitution"), interviews with relevant persons and the documents evidencing government policy on this aspect as provided by the LMFPA and the interviewees as set out below.

1. Interviews held

- Mr. E. A. Hettiarachchi (Director) – Regional Development Department, Central Bank
- Mr. Piyadasa (Director – Credit) – National Development Trust Fund (NDTF)
- Mr. J. Charitha Ratwatte (Former Managing Director) – Janasaviya Trust Fund (JTF)
- Mr. S.K.B. Tanayamwatta (Director – Banking & Finance)) – Samurdhi Authority of Sri Lanka
- Mr. Shakila Wijeywardena (Chief Executive Officer) – Sarvodaya Economic Enterprises Development Services (Guarantee) Limited (“SEEDS”) and President of the Sri Lanka Microfinance Practitioners Association (LMFPA)
- Mr. Sathis de Mel (Executive Director) - Arthacharya Foundation & Director of the Sri Lanka Microfinance Practitioners Association (LMFPA)
- Mr. Bisowela Gunasekera (Managing Director) – Sustainable Appropriate Projects (SAPCO) & the Manager of the Sri Lanka Microfinance Practitioners Association (LMFPA)

2. Documentation reviewed

- Operating Instructions – Poverty Alleviation Microfinance Project (PAMP) – Issued by Rural Credit Department – Central Bank of Sri Lanka (January 2001) (Sinhala & English versions).
- Draft operating instructions – Poverty Alleviation Microfinance Project II (PAMP II) – Eligibility Criteria for Participating Financial Institutions (PFIs).
- Trust Deed No. 365 of 3<sup>rd</sup> January 1991, establishing the Janasaviya Trust Fund.
- “*Credit Fund in Operation*” – Operating Instructions – Janasaviya Trust Fund (April 1993 (English version)/February 1993 (Sinhalese version)).

- Copy of standard agreement to be entered into between aspirant PO and NDTF for admittance to the NDTF program, titled *“Participatory Credit Agreement between National Development Trust Fund (A company limited by guarantee) (NDTF) and .....”*.
- Draft revised operating instructions for the National Development Trust Fund – Chapter II (Credit Fund).
- Letter dated 3<sup>rd</sup> November 1993 titled *“Terms of Reference – Area Coordinator”* to Arthacharya Foundation from Head of Division, Human Resource Development, Janasaviya Trust Fund.
- Letter dated 4<sup>th</sup> November 1993 titled *“Socially Mobilised Groups”* to Chief Executive-Arthacharya Foundation from Director (Credit) Janasaviya Trust Fund.
- Letter dated 7<sup>th</sup> January 1994 titled *“Socially Mobilised Groups”* from Director (Credit) Janasaviya Trust Fund.
- Compilation titled *“Poverty Alleviation through the Janasaviya Trust Fund and its Partners – A Preliminary Assesment”* comprising of:
  - *Review of the performance of the Janasaviya Trust Fund: Interim Reports* by
    - Sumanasiri Liyanage
    - M. Navaratna Banda
    - N. L. A. Karunaratne
  - *Present forms of Non – Governmental Self-Help promotion: Experience and Learning*  
by J. Charitha Ratwatte.
  - *An Elephant Loose in the Jungle: The World Bank and NGOs in Sri Lanka*  
by Roland Hodson.
- Letter dated 19<sup>th</sup> October 2000 titled *“Sarvodaya Village Development Banking Units”* to Managing Director Sarvodaya Economic Enterprises Development Services (Guarantee) Limited from Director – Bank Supervisor, Central Bank of Sri Lanka.

- “Study on TSL Project Design” by Mr. M. U. A. Tennakoon.
- “Report on the Impact Assessment Survey of the Small Farmers and the Landless Credit Project – 2005” issued by the Regional Development Department, Central Bank of Sri Lanka.

**(1) What is the legal position of current deposit taking practices of microfinance institutions particularly in relation to previous government directives and current government funded programmes?**

The current legal framework on the aspect of “deposit taking” is governed by and under the provisions of the Banking Act and of the Finance Companies Act.

**Position under the Banking Act**

The Banking Act [Section 2(1)] 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. The license referred to herein is the license to operate as a licensed commercial bank.

‘*Banking business*’ 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 authorised by law or by customary banking practices.

Thus, in order to carry on ‘*banking business*’, the primary characteristic of which is the ability take deposits payable on demand by cheque, draft, order etc. i.e. to open current accounts for customers, a license to operate as a licensed commercial bank is required (which also permits such entities to carry out the businesses set out in Schedule II to the Banking Act).

In this report, we will only be considering deposit taking in the form of savings deposits as we understand that the legal position on taking deposits payable on demand by cheque, draft, order etc. as contemplated by Section 2(1) of the Banking Act is not in issue.

Deposits, which are payable otherwise than as aforesaid are dealt with by Section 76A (1) of the Banking Act and Section 2(1) of the Finance Companies Act.

In terms of Section 76A (1) of the Banking Act, the business of accepting deposits of money and investing and lending such money ("deposit taking") 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.

A "deposit" is defined in the Banking Act as including *"a sum of money accepted from any person as a business on terms under which it will be repaid with or without interest or a premium, and either on demand or at a future time or in circumstances agreed to by or on behalf of the person making the payment and the person accepting it, provided that the person accepting the money is a person who in the usual course of business, lends money or makes available the use or the benefit of the money so accepted to third parties..."*

Section 76A of the Banking Act 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;
- (b) A Co-operative Society registered under the Co-operative Societies Law;
- (c) A building society incorporated under the National Housing Act;
- (d) A 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<sup>1</sup>.

Therefore, unless an entity carrying out deposit taking activities is one of the establishments specified in Section 76A (1) of the Banking Act, its deposit taking activities are *prima facie* unlawful.

**On an in-depth analysis of Section 76A (1), are the 'deposit taking' activities of microfinance institutions violate the restriction therein?**

The business for which a license is required in terms of Section 76A (1) of the Banking Act is the *'business of accepting deposits (emphasis added) of money and investing and lending such money*. The key element of the regulated activity being the acceptance of 'deposits', if acceptance of money by microfinance institutions can be interpreted not to mean accepting 'deposits' within the meaning of the Banking Act, that type of acceptance of money and investing and lending such money will not come within the purview of section 76A (1) of the Banking Act.

In terms of interpretation section [i.e. Section 86] of the Banking Act, *"deposits includes (emphasis added) a sum of money accepted from any person as a business on terms under which it will be repaid with or without interest or a premium, and either on demand or at a future time or in circumstances agreed to by or on behalf of the person making the payment and the person accepting it, provided that the persons accepting the money is a person who in the usual course of*

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<sup>1</sup> We have been informed by the Central Bank that, as of date, no organizations have been permitted to accept deposits under this specific sub-section.

*business, lends money or makes available the use or the benefit of the money so accepted to third parties..."*

The proviso to the above section consists of the following elements:-

*"Provided that,*

- *the persons accepting the money is a person*
- *who in the usual course of business,*
- *lends money or makes available the use or the benefit of the money so accepted*
- *to third parties"*

Therefore, it may be argued that in order to be considered as "a deposit" within the meaning of the Banking Act, monies accepted by a microfinance institution from an individual or a group of individuals should be lent to or its use or benefit made available to a third party. Accordingly the license or the permission of Monetary Board in terms section 76A (1) is required, if and only if, deposits so accepted are made available to 'third parties' by way of loans, investments etc. .

Most legal dictionaries define the phrase 'third party' (which is not defined in the Banking Act) as a person other than principals of a transaction or agreement.

Thus, where a group of individuals enter into a contractual arrangement with a microfinance institution to deposit their money with such institution in order to build up a pool of deposits which such institution may lend to the group, such type of 'deposit' taking may not amount to deposit taking within the meaning of section 76A (1) of the Banking Act provided it is not lent or its use or benefit is not made available to any person other than the group of persons from whom it was accepted.

However, a microfinance institution cannot deposit the monies that it accepted under such an arrangement with any bank or financial institution in the name of the institution as it will amount to a investment of money so accepted with a third party, the bank not being a party to the initial agreement between the institution and the group of individuals.

Moreover, monies accepted by the institution from a group of persons may not be lent to a person not belonging to such group. Lending of monies accepted from a group to a person within the group should also be structured and provided for as a lending to the group itself. In other words, where group savings are involved, lending should also be made to the group itself. If the institution proposes to lend to a group which has no savings or in excess of the group's own savings, such lending should be made out of funds which does not constitute savings of another group i.e. it should be from a different source of funding such as a grant/donation/bank loan etc..

Please note however that the above argument is based only an interpretation and it is possible that the impact of the definition of "deposits" in the Banking Act on Section 76A (1) thereof may be construed differently. Our suggested interpretation is also subject to the following qualifications:-

- (1) The definition of "deposits" is an inclusive definition which means that it is not exhaustive and is capable of including other meanings as well;
- (2) It is not certain that the reference to lending money is to be read as a reference to lending monies to a third party;
- (3) If such interpretation is followed, it may mean a severe curtailment in the activities of the microfinance institutions as they have to keep the savings of the various groups separate and not mix funds or lend from the savings of one group to another;
- (4) It does not exclude the application of the Finance Companies Act which (discussed below) also regulates deposit taking as being part of finance business.

### **Position under the Finance Companies Act**

The Finance Companies Act in Section 2 provides that *"no finance business shall be carried on except by a public company which –*

- (a) is registered under the Companies Act, No. 17 Of 1982;*
- (b) has a minimum issued and paid up capital of not less than five million rupees; and*
- (c) is registered under the provisions of this Act."*

[Please note that whilst Rs. 5 million is the minimum capital required to apply for registration as a finance company, the Finance Companies (Minimum Core Capital) Direction No. 1 of 2006 stipulates that every finance company shall at all times maintain an unimpaired core capital of not less than Rs. 200 million which applies to all registered finance companies.]

"Finance business" according to the Finance Companies Act means *"the business of acceptance of 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."*

The term "deposit" is not defined in the Finance Companies Act.

The substantial difference between 'deposit' taking in terms of section 76A (1) of the Banking Act and the definition of 'finance business' in the Finance Companies Act is that there is no reference to third parties in the latter. Therefore, it may be argued that lending monies deposited by a group to such group itself constitutes a 'finance business' under the Finance Companies Act. Thus, definition of 'finance business' is broad enough to encompass all aspects of deposit taking activities practiced by MFIs.

The proviso to section 76A (1) exempts, *inter alia*, a "finance company" registered under the Finance Companies Act from the licensing requirement of that section. The Finance Companies Act exempts, *inter alia*, any banking institution as defined in the Monetary Law Act from its purview. Thus, a licensed banking institution does not need a further license under the Finance Companies Act to carry out deposit taking and a registered finance company does need a license under section 76A (1) of the Banking Act to carry out deposit taking.

Therefore, unless an entity carrying out deposit taking activities is one of the establishments set out in section 76A (1) of the Banking Act, its deposit taking activities are unlawful.

In view of the aforesaid restrictions on deposit taking, the question arises as to the legal position of microfinance institutions (other than permitted entities i.e. licensed banks, finance companies, registered co-operative societies and building societies) such as unincorporated bodies like voluntary social services organisations (“MFIs”) and their mobilisation of savings of the poor. We are instructed that these activities, part of the poverty alleviation programs undertaken by these organisations, are mainly for the purpose of inculcating thrift and savings habits amongst the poorest segments of Sri Lankan society and that some of these organisations have been carrying out such activities on a formal scale for well over a decade.

So what, if there be one at all, is the legal premise, authority or basis on which such deposit taking activities are being carried out?

### **A government initiative?**

A claim, both by MFIs and external observers, is that such deposit taking activities commenced on initiatives undertaken by the government of the early 1990’s (and carried on to the present day), whereby MFIs were encouraged (it is alleged by some stakeholders that this was a requirement) to carry out savings mobilisation as part and parcel of greater micro-credit based poverty alleviation programs undertaken by the government and implemented through financial institutions and aforementioned MFIs. We shall examine these claims more fully in relation to two such government funded programs/projects: the National Development Trust Fund (“NDTF”) and the Poverty Alleviation Microfinance Project of the Central Bank of Sri Lanka (“Central Bank”).

We will also examine the workings of the Samurdhi scheme for purpose of comparison.

#### **1. The National Development Trust Fund (formerly the Janasaviya Trust Fund)**

The Janasaviya Trust Fund (“JTF”) was established in January 1991 under the trust deed No. 365 dated 03<sup>rd</sup> January 1991 and incorporated by way of gazette notification No. 665/31 of June 1991.

It was established by way of a loan agreement between the World Bank, the Federal Republic of Germany and the Government of Sri Lanka, whereby US Dollars 52.8 Million was provided on concessionary terms for the implementation of a poverty alleviation program in Sri Lanka.

In terms of the aforementioned trust deed, the general aim of the JTF was to *"identify, develop, promote, catalyse and support sustainable income generating opportunities and a higher quality of life for the poor through a range of activities including productive self employment, micro-enterprises and rural works."* This was to be achieved by, *inter alia*, *"providing lines of credit and support services to the poor generally through partner organisations such as People's Organisations, Non Governmental Organisations, Cooperatives, Savings institutions, Banks"* etc., and *"by promoting thrift, savings and an asset base among the poor leading to self reliant development."*

In essence, the JTF was to operate as an apex organisation working through Partner Financial Institutions (commonly referred to as "PFIs"), Partner Organisations (commonly referred to as "POs") and Community Based Organisations (known as "CBOs"), channelling the funds made available under the aforementioned loan to, *inter alia*, appropriate self employment ventures of the intended beneficiaries, as determined by the Partner Organisations in line with the sub-borrower criteria of the JTF.

The poverty alleviation project conducted by the JTF, though most noted for its credit and microfinance program, initially consisted of four sub-projects:

- a Rural Works Program aimed at increasing wage employment;
- a Nutrition Program to intervene in improving nutritional status of women and children;
- a Human Resource Development Program to meet training and educational needs of poverty groups; and
- Credit and Micro Enterprises Program targeted to groups interested in micro-enterprises.

In 1997, the initial project under the tri-partite loan was concluded. However, the Government of Sri Lanka decided to continue with the project limiting it to the fourth sub-project (i.e. Credit and Micro

Enterprises Program) only, which includes, *inter alia*, loan disbursements, loan recovery and repayment to the Treasury<sup>2</sup>. Subsequently with infusion of additional funds for the project by the Asian Development Bank (“ADB”), a guarantee company was incorporated under the Companies Act No. 17 of 1982<sup>3</sup> under the name “National Development Trust Fund” (bearing company no. GA 130) (“NDTF”) to take over and carry on the Credit and Micro Enterprise Program of the JTF. However the JTF continues in operation for the sole purpose of recovering loans that had been granted thereunder. The NDTF operates under the Ministry of Finance and Planning.

One of the strongest claims made is that it is the JTF itself which initially started MFIs on the path of deposit taking. Indeed, some even claim that Partner Organisations, which were to be implementation vehicles, were almost mandated by the JTF to mobilise savings (and in this context it is understood that savings mobilisation is to be synonymous with deposit taking) under the program.

One of the most noted proponents of this view is Mr. Sathis de Mel, the Executive Director of the Arthacharya Foundation, a prominent and well established MFI in Sri Lanka and, *inter alia*, a Partner Organisation of the NDTF.

In his draft paper titled “Microfinance and Government’s Responsibility” he makes several assertions, that

- the JTF credit programme which is based on the principles of refinancing, disbursed funds to the MFIs for credit mainly on the basis of savings mobilised by them;
- numerous circulars, guidelines, information and educational material and training programmes conducted by the JTF to the MFIs focused on the significance of savings mobilisation;
- it was the government which encouraged MFIs to go into the field of savings and credit, where they (i.e. MFIs) had no previous experience;

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<sup>2</sup> It should be noted that the continuation of this activity was also a stipulation of the initial tri-partite loan agreement.

<sup>3</sup> Repealed and replaced by the Companies Act No. 7 of 2007.

- savings were used as a form of informal collateral as well as an indicator of financial discipline (in the JTF program) and the JTF guided MFIs to mobilise compulsory savings as part of the recovery mechanism; and
- the NDTF had never informed any of its MFI partners that savings mobilisation is illegal.

Mr. De Mel hypothesises that, as a result, the microfinance operations of the MFIs (and it is assumed that he is referring specifically to the deposit taking activities thereof) “is the legitimate child” of the government itself.

As stated above, the objectives of the JTF *do* include promoting savings among the poor. Moreover the April 1993 policy and operational procedures brochure of the credit fund component of the JTF<sup>4</sup> (“JTF operations manual”) states, in its introduction, that mobilisation of beneficiaries’ savings is a high priority and that both Partner Organisations and beneficiaries have key roles to play in the generation and management of savings deposits<sup>5</sup>. However these principles and general statements require and merit further examination in light of the specific procedures, policies and guidelines set out in the JTF operations manual and other documentation issued thereby.

The eligibility criteria for becoming a Partner Organisation under the JTF<sup>6</sup>, were<sup>7</sup> as follows –

- At least two years experience in lending to the poor and a loan recovery rate for such period of at least 70% per cent; or
- One years’ experience in lending to the poor, with a 90% recovery rate; or

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<sup>4</sup> “Credit FUND in operation”, issued by the Janasaviya Trust Fund, April 1993

<sup>5</sup> We have noted a strong emphasis on this specific theme of the JTF in several circulars/letters issued thereby.

<sup>6</sup> The eligibility criteria to become a PO under the NDTF have been amended slightly, however the provisions/requirements therein are not overtly dissimilar to those under the JTF.

<sup>7</sup> See in general “A Review of the Performance of the Janasaviya Trust Fund, An Interim Report - Sumanasiri Liyanage (Department of Economics, University of Peradeniya), 2<sup>nd</sup> May 1995”, “Review of the Performance of the Janasaviya Trust Fund, An Interim Report – Dr. A. M. Navaratna Bandara (Senior Lecturer, Department of Political Science, University of Peradeniya), 2<sup>nd</sup> May 1995” and “Review of the Performance of Janasaviya Trust Fund, Interim Report on Zone 3 – Dr. N.L.A Karunaratne”.

- One years' experience in lending to the poor, with 70% recovery rate and a bank guarantee equivalent to the funds it disburses in JTF loans.

In addition, a Partner Organisation must have met the following criteria:

- Demonstrate financial viability or the potential for viability;
- Have a well developed and active savings mobilisation component (emphasis added);
- Demonstrate sound well organised management and acceptable accounting systems and credit-monitoring facilities;
- Have the capacity to implement the credit fund's lending policy which involves making small, short term loans at commercial rates of interest, relies of character references rather than collateral, and uses a group lending approach; and
- Demonstrate that it can successfully mobilize beneficiaries for training, credit, decision-making, utilisation of resources and other community and participatory processes or it must demonstrate an established working relationship with a community based organisation/CBO which has the capacity to undertake these tasks.

It is noteworthy that the ability to mobilise deposits is a criterion to be selected as a Partner Organisation.

The JTF operations manual envisages two forms of savings mobilization to be carried out:

- (i) compulsory mobilisation - through a deduction of a percentage of each loan granted which is thereafter credited to a savings account owned and managed by a group of sub-borrowers, called a "Group Contingency Fund"; and
- (ii) general savings mobilisation - whereby beneficiaries are required to participate in individuals savings programs.

In both forms, Partner Organisations are required to provide facilities for supporting such savings mobilisation efforts. The scope of these "facilities" is set out in Part 4 of the JTF operations manual;

in particular, paragraph 1 of section 4.1 states that savings mobilised must be deposited on behalf of the beneficiaries in interest-earning accounts in approved financial institutions.

However the following provisions are also noteworthy:-

- The JTF operations manual adds that *“POs may design their own savings programs within the spirit of the Credit Fund guidelines. The program should require beneficiaries to enter a contract with the PO to deposit a specific amount into a savings account on a regular basis along with each loan instalment”.*
- There is a reference to the ability of Partner Organisations to develop guidelines for limited withdrawal privileges for depositors and retaining a minimum of 35% of total deposits in reserve at all times for depositors’ demand.
- Paragraph 2 of section 4.3 states that when savings funds are used for lending, Partner Organisations may want to impose a relationship between loan size and savings; for example limiting the loan size to twice the amount in the individual’s savings account.

The ambiguity of the above provisions and their apparent conflict with the statement in paragraph 1 of section 4.1 set out above, raise questions whether the JTF required Partner Organisations to act as intermediaries in channelling the savings to an authorised financial institution (i.e. those envisaged in the Banking Act- see above) or to act as *de-facto* deposit accepting institutions themselves. Moreover it appears that Partner Organisations are **expected** to utilise deposits for lending purposes, at least in relation to the individual savings programs.

The instructions/guidelines in the JTF operations manual in relation to the aforementioned Group Contingency Fund (“GCF”) are, however, somewhat clearer on this matter. The GCF is required to be “owned and managed by a group of sub-borrowers”, decisions on the management thereof are to be made independent of the Partner Organisations and whilst loans may be provided therefrom (upto 50% of the GCF), it is to be done by the *group members* and for purposes approved by the *group*. The role of the Partner Organisation in relation to the GCF is purely to assist and facilitate the members of the group in, *inter alia*, depositing the GCF in an “interest-earning savings account” at an “appropriate bank” and withhold 5% from every loan granted to group members and credit it

to the said account<sup>8</sup>. This position is further supported by Clause 1 of Exhibit 1 of the standard form loan agreement to be entered into by a Partner Organisation seeking refinance from NDTF which provides that the *“Borrower/(PO) should establish a G.C.F. by deducting 5% from each loan obtained by the sub borrower. The funds should be invested in an interest bearing account and should be managed and operated by the sub-borrowers”*.

In our interviews with officials of NDTF, we were informed that the savings mobilisation aspect of the JTF was intended to be mobilisation at a grassroots level by social groups themselves. Partner Organisations were intended to act as facilitators providing the necessary impetus and know-how etc., enabling the beneficiaries to mobilise into groups, collect and manage the savings on their own. However, as they admitted, whilst theoretically sound, practical implementation of the aforesaid “intention” was not as easy.

When questioned on the specific issue of whether the JTF/NDTF may have implicitly encouraged or at the very least tolerated and accepted the deposit taking activities by Partner Organisations themselves under the program, the response was in the affirmative. As they pointed out, practical implementation required “practical solutions” and at an implementation level, the various stakeholders may have tacitly arrived at the “practical solution” of allowing the Partner Organisations to carry out the savings mobilisation through accepting deposits themselves. Thus, in reality, Partner Organisations may have collected the savings of the various groups and deposited the same in an account in the name of the Partner Organisations. The individuals who actually gave money to the group by way of a saving are issued with passbooks by the Partner Organisation which records their various debits and credits.

However it was emphatically stated that the official documentation of the JTF/NDTF was not at any point intended to mirror or support such an informal position. They reiterated that in terms of such documentation, the Partner Organisations were required only to act as facilitators in the saving mobilisation process.

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<sup>8</sup> This is reiterated in the “Participatory Credit Agreement” to be entered into between the NDTF and NGO, prior to admittance into the NDTF scheme.

We shall now consider the second of the aforementioned government programs: the Poverty Alleviation Microfinance Program (“PAMP”) of the Central Bank.

## 2. PAMP

PAMP was a poverty alleviation program that ran for a period of seven years from 1<sup>st</sup> December 1999 to 1<sup>st</sup> December 2006. It was initiated on the basis of a loan agreement between the Japan Bank for International Cooperation (“JBIC”) and the Government of Sri Lanka.

It was a scheme similar to the JTF in that the objectives included, *inter alia*, the establishing of a cost effective and sustainable micro credit delivery system for the poor and the inculcation of savings habits and thrift thereamong.

The PAMP was to consist of four main components, namely Credit, Training, Technical Assistance and Project Administration.

The credit component was to provide short and medium term credit to eligible individuals (i.e. the intended beneficiaries) for agricultural and non-agricultural micro-enterprises. The project was initially to be implemented in six selected administrative districts<sup>9</sup> and was implemented through the Regional Development Department (“RDD”) of the Central Bank. With the conclusion of the project in December 2006, the JBIC and the Government of Sri Lanka commenced negotiations on a second poverty alleviation programs on the same lines as the PAMP (titled “PAMP II”). The PAMP II commenced in 2009 and will continue till 2013.

As aforementioned, the scheme works similarly to that of the JTF: short and medium term credit was to be channelled from the RDD of the Central Bank for income generating activities of the beneficiary class through Participating Financial Institutions (commonly referred to as “PFIs”) and

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<sup>9</sup> Kurunegala, Nuwara Eliya, Badulla, Matale, Kalutara and Hambantota. However it was extended in 2005 to include the Northern and Eastern Provinces.

Participating Agencies (commonly referred to as “PAs”), with the concurrence of Project District Offices (“PDOs”) <sup>10</sup>.

In terms of the Operating Instructions of PAMP I<sup>11</sup> the role and responsibilities of Participating Agencies included *inter alia*, providing credit to income generating activities undertaken by the beneficiary class *and* mobilising savings.

The said operating instructions further state that there are two savings operations promoted under the project, both of which are obligatory for beneficiaries to participate in, in order to obtain loans thereunder i.e. called the Group Savings Fund (also known as “GSF”) and the Emergency Savings Fund (also known as “ESF”). So far this remains uncontroversial and somewhat similar to the provisions under the JTF operations manual referred to above.

However a striking dissimilarity is apparent when examining the provisions relating to the Group Savings Fund in the said operating instructions:

- Section 14.1(iv) states that Participating Financial Institutions or Participating Agencies, where the Group Savings Account (“GSA”) is maintained, will be required to give an interest at the prevailing market rates.
- Section 14.1(vii) states that the leader or secretary of a group will be responsible for maintaining the group account at the closest Participating Financial Institution’s or Participating Agency’s branch offices.
- Section 14.3(ii) mirrors the same provision on maintenance of account at the nearest Participating Financial Institution or Participating Agency in relation to the Emergency Savings Fund.

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<sup>10</sup> PDOs were responsible for coordinating activities between inter alia the RDD, the PFIs and the PAs at district level. They were responsible to the Project Central Committee (“PCC”), which was the overall coordination body of the program and consisted of representatives from the various stakeholders.

<sup>11</sup> Titled “Poverty Alleviation Microfinance Project (PAMP) funded by Japan Bank for International Cooperation (JBIC) OPERATING INSTRUCTIONS” issued by the Rural Credit Department of the Central Bank of Sri Lanka, January 2001.

Whilst these do not amount to directives or mandatory requirements imposed on the beneficiaries and/or, more importantly, Participating Agencies it is clear that the Central Bank envisages that Participating Agencies would function as deposit taking entities (albeit from the beneficiaries only and strictly within the PAMP scheme) and indeed, by the references and acknowledgments, implicitly assents thereto.

Furthermore on examination of the terms and conditions for becoming a Participating Agency<sup>12</sup> which are given below:

- be organisations registered under the Societies Ordinance or the Companies Act;
- have a minimum of two years experience in micro-credit and be active in small group formation, savings and micro credit in the relevant districts;
- have “on-time repayment” record of over 85% in the last two years of operations;
- not be defaulters of other lending agencies or such as the NDTF;
- have maintained audited accounts for the previous years and contain unqualified opinion;
- maintain at least one staff member responsible full time for lending operations;
- be able to keep separate records, accounts and bank accounts for the Project; and
- furnish the Project with a three year operational plan with appropriate strategy.

As such, there does not appear any requirement for the applicant entity to be licensed or permitted under the Banking Act or the Finance Companies Act to accept deposits.

In terms of its operating instructions, the PAMP scheme envisages that Participating Agencies would mobilise “eligible persons” into groups (of around 4-10 persons), which are thereafter registered with the relevant Project District Office. These groups will be the primary focal point for loans and savings.

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<sup>12</sup> In terms of section 6 of the Operating Instructions of the PAMP (vide footnote 8), it is the PCC which determines the rules and conditions for admission of NGOs as PAs. We were unable to obtain a direct copy of such rules and conditions and what is reproduced herein is from a secondary source (i.e. report titled “Study on TSL Project Design” by M.U.A Tennakoon) and the accuracy thereof has not been verified.

For instance, loans are only to be granted to groups which have demonstrated their viability through savings operations for a period of at least three months. Savings are to be compulsory, with each person in the group contributing a minimum amount weekly towards the Group Savings Account (which is to be managed by the group as a whole and operated by its “leader” and “secretary”). The Participating Agencies are also required to deduct and credit 5% of every loan granted to a group member to the relevant Group Savings Fund. Loans may be granted to a group member from the Group Savings Fund in excess of the balance lying to his credit (i.e. his savings), subject to the unanimous approval of the group and a restriction on such loans not exceeding 50% of the total balance in the Group Savings Account.

The Emergency Savings Fund, on the other hand, is to be an insurance fund for the group members, established and maintained by the Participating Financial Institutions/Participating Agencies contributing a percentage of the interest charged on every loan made to a group member to the Emergency Savings Fund. Similar to the Group Savings Fund, the Emergency Savings Fund is also to be managed by the group themselves. Therefore whilst the PAMP scheme entitles Participating Agencies to “carry out” deposit taking, loans from such deposits (i.e. the Group Savings Fund) are intended to be granted to group members by the group itself.

Similar to the savings schemes under the JTF, the role of the Participating Agency is only as a facilitator. However unlike the JTF operating instructions, the operating instructions under the PAMP 1 scheme clearly intends the facilitator role to be *inclusive* of acting as a depository institution (again limited to savings of the beneficiaries and within the confines of the PAMP scheme).

It may be pertinent at this juncture to provide (for purposes of comparison) an overview of another well-known poverty alleviation scheme undertaken by the Government, this time without any private sector/voluntary social service organisation participation: the “Samurdhi program”.

### **3. The Samurdhi Authority**

The Samurdhi Authority of Sri Lanka Act No.30 of 1995 (as amended) (“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 specific initiatives including, *inter alia*, mobilizing their participation in the planning and management of projects and schemes for their upliftment, fostering co-operation among them, promoting savings amongst them and assisting them to obtain credit facilities

The Samurdhi Authority was empowered under the 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 powers of discharge of its function shall be paid into the said fund.

Therefore the Samurdhi Authority is empowered under the provisions of the Samurdhi Authority Act itself to *inter alia* establish manage and operate savings schemes for its beneficiaries. It is however possible that establishing, managing and operating 'savings schemes' does not mean 'deposit taking' per se. Given that Section 76A(1) of the Banking Act regulates such 'deposit taking' , in our view Monetary Board approval (or a statutory exemption from such approval requirement) is

required in terms thereof if such establishing, managing and operating 'savings schemes' were to include the taking of deposits.

This is supported also by the fact that the Samurdhi Authority Act provides for an exemption from the application of Section 2 of the Finance Companies Act (discussed above) for the savings schemes established, managed and operated by the Samurdhi Centres.

As for the legality of this provision, whilst the Samurdhi Authority Act is itself a legislative enactment, it cannot lawfully permit a separate legal framework enabling savings mobilization/deposit outside the scope of the provisions of the Banking Act which does not exempt Samurdhi Authority or the Samurdhi Centres from the requirements of Section 76A. Therefore regardless of the aforementioned provisions of the Samurdhi Authority Act, the activities of the Samurdhi Authority and the Samurdhi Centres establishing, managing and operating savings schemes for their beneficiaries (if it entails deposit taking activity) requires in our view either permission from the Monetary Board under Section 76A(1) or an exemption therefrom.

## **Conclusion**

On examination of the aforementioned poverty alleviation programs several conclusions can be drawn.

Firstly, the claim that deposit taking by MFIs under the said schemes is causally at least *partly* attributable to the actions of their respective administering bodies (i.e. JTF/NDTF and the RDD (PAMP)) is not without merit. Whilst the documentation in the schemes is at best ambiguous, such ambiguities coupled with the approach of the said administering bodies to implementation (as we have gathered from our interviews, and as morefully described above, the approach had been more on a "practical" and "commonsense" basis as opposed to one based on "compliance") have to bear part of the responsibility for the current predicament of the implementing MFIs. Secondly it appears that until recently the poverty alleviation programs were seen as effective and successful and the general approach by the regulators seems to have been one of quiet acquiescence.

However with the recent events in the financial markets (i.e. the collapse of the Golden Key Credit Card Company, the "*sakvithi*" and "*danduwana mudalali*" fiascos etc) there has been immense pressure on the government to intervene in the case of deposit taking activities by what are technically "unlicensed financial institutions" (regardless of whether they are involved in microfinance or not). The question is whether such acquiescence or encouragement is sufficient to give legality to the deposit taking activities of microfinance institutions.

Any government program in Sri Lanka necessarily operates within the legal framework of Sri Lanka. Even where such a program is supported by its own legislative enactment (i.e. Samurdhi), it is exempt from the provisions of the other laws of the country only to the extent, *inter alia*, that the enactment expressly provides as such. Therefore even if it *was* established, beyond any doubt, that the aforesaid programs clearly required MFIs in their capacity as Partner Organisations or Participating Agencies to carry out deposit taking activities, such requirement would be ultra vires the law. The Banking Act states that deposit taking can only be carried out if the relevant entity obtains a license thereunder, or is permitted under section 76(A) and this applies to microfinance institutions engaged in government programs as well.

**(2) Recommendations to the Lanka Micro Finance Practitioners Association ("LMFPA") on its possible legal position in the event that deposit taking rights of microfinance institutions, non-governmental organisations and community based organisations are deprived of**

In our response to question 1 above, which analyzed section 76A (1) of the Banking Act, we arrived at the premise that unless an entity carrying out deposit taking is one of the establishments specified in Section 76A (1) of the Banking Act, its deposit taking activities are unlawful.

We now set out below the possible courses of action that may be adopted by a MFI in this situation:-

**(a) Obtaining license to operate as licensed specialised bank under the Banking Act or as a finance company under the Finance Companies Act**

Since deposit taking activities are regulated by both the Banking Act and the Finance Companies Act, and both exempt each other from their respective purview, an MFI is left with no option but to become an entity either regulated under the Banking Act or the Finance Companies Act.

It is due to the above reason that Central Bank has directed MFIs to restructure their business model to a finance company model.

It is undisputed that conversion of deposit taking business of a MFI to a finance company is much more convenient than the conversion of the same to a licensed specialized bank. However, it is also undisputed that neither the banking model nor the finance company model suits the microfinance business model.

**(b) Obtaining permission of Monetary Board to take deposits from members under Section 76A (1) of the Banking Act**

We are of the view that, the only model under the existing law, which may suit the needs of the micro finance sector, is set out in proviso to section 76A (1) of the Banking Act which provides that any organization, established or registered under any written law, not being an organization primarily for the purposes of making profits, which accepts deposits only from its registered members, and has obtained permission in writing from the Monetary Board to accept and to invest or lend the monies so accepted, may carry out deposit taking.

Thus, MFIs may apply for permission of Monetary Board to carry out their deposit taking activities under this structure.

The question then arises whether a permission granted by Monetary Board under Section 76A (1) of the Banking Act may exempt such entity from the requirements of the Finance Companies Act which requires persons carrying on 'finance business' to obtain a license in terms thereof.

Section 30 of the Finance Companies Act which excludes the application of the Act to certain entities specified therein does not expressly exempt an entity permitted by Monetary Board under Section 76A (1) from its statutory purview. The said section 30 sets out that,

*“Notwithstanding the provisions of subsection (1) of section 2, the provisions of this Act shall not apply to the business of any banking institution as defined in the Monetary Law Act (Chapter 422), or to a co-operative society registered under the Co-operative Societies Law, No. 5 of 1972, or the business of the National Development Bank established under the National Development Bank Act, No 2 of 1979, or to the Development Finance Corporation of Ceylon established under the Development Finance Corporation of Ceylon Act (Chapter 165)”*

However, it is unequivocal from language of section 76A (1) of the Banking Act viz. *“any organization established or registered under any written law”*, the organizations contemplated under the above model may or may not be incorporated bodies, whereas 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, No. 17 Of 1982, has a minimum issued and paid up capital of not less than five million rupees; and is registered under the provisions of this Finance Companies Act”*.

Therefore, there is a definite inconsistency between the two enactments. Section 82A of the Banking Act provides that the Banking Act must prevail over any other written law in the event of inconsistency between the Banking Act and such other written law.

Therefore, it is our view that MFIs permitted by Monetary Board under the aforesaid Section 76A (1) do not require a license in terms of the Finance Companies Act to carry out deposit taking.

The likelihood of obtaining such permission has been morefully discussed in our response to question 4 below.

### **(c) Dialogue with policy makers on the proposed Finance Business Act**

As more fully discussed in our response to question 5 below, the draft Finance Business Act which is intended to repeal and replace the Finance Companies Act is in its drafting stage at present.

The LMFPA may use this opportunity to strongly lobby with policy makers to obtain specific exemptions/provisions to be included in the proposed Finance Business Act. The type of exemptions/provisions that may be so included have been fully set out in our response to question 5 below.

In our view, this is the best course of action available to the microfinance sector at the current time.

### **(d) Challenging the Finance Business bill**

In the event, the LMFPA/microfinance sector is unsuccessful in obtaining specific exemptions/provisions into the Finance Business bill, the sector could consider by virtue of the provisions contained in Article 121 of the Constitution, by a petition in writing to the Supreme Court challenging the bill within one week from the bill being placed on the Order Paper of Parliament.

The said Article can be invoked in order for the Supreme Court to determine whether the bill or any provision thereof is inconsistent with the Constitution.

In order to be successful under this option the sector will have to be able to satisfy the Supreme Court that the provisions in the Finance Business bill violates, *inter alia*, the freedom of a person to engage in a lawful occupation, trade, business or enterprise.

Though the deposit taking currently carried on by MFIs is unlawful, the sector will have to present a case to the Supreme Court that the sector was developed with Government sanction, with the expectation that appropriate laws will be duly promulgated to legitimise microfinance business and in the interim various government agencies tacitly approved/permitted MFIs to continue their business. Having so permitted the microfinance sector to develop, passing a law that will deprive all the MFIs from engaging in that occupation as well as deprive thousands of village communities

depending on the sector and therefore is a violation of the fundamental rights guaranteed under the Constitution.

You should note however that the success of this application will be dependent on the sector providing strong irrefutable evidence evidencing government sanction/ encouragement in relation to deposit taking. We are of the view that the documentation provided to us for this report is insufficient to be the basis of such an application for the reasons we have morefully set out in our answer to question 1 above and therefore this course of action should only be followed if there is other overwhelming evidence to support the application.

**(e) Lobby for enactment of a separate law on microfinance**

As you know for some time, the Central Bank has been drafting a separate law to govern the microfinance sector. Therefore, the LMFPFA could also consider steps to expedite this process especially in the event exemptions/provisions for the microfinance sector are not included in the Finance Business Act. Our views on the separate microfinance legislation are contained in our response to question 4 below.

**(3) Whether an infringement of equal rights of such institutions have occurred in the face of the Government funded microfinance programs, namely Samurdhi and Gamidiriya etc.**

It is alleged that while non governmental institutions which engage in the business of micro finance have been precluded/are to be precluded from deposit taking and investing and/or lending such money so accepted ("deposit taking") except with a license/permission issued by the Monetary Board of Central Bank ("Monetary Board"), their counterparts appointed, established or controlled by the Government of Sri Lanka ("Government Sponsored Entities") carry out deposit taking without obtaining any such license/permission. The question has been raised, therefore, whether this constitutes a violation of right to equal treatment enshrined in the Constitution of Democratic Socialist Republic of Sri Lanka (the "Constitution").

## Invoking Fundamental Rights Jurisdiction of Supreme Court

By Article 126 of the Constitution, the Supreme Court is vested with the sole and exclusive right to determine any infringement or imminent infringement of fundamental rights including right to equal treatment set out in Article 12 by executive or administrative action.

It should be noted that, in terms of the said Article 126, the fundamental rights jurisdiction of the Supreme Court can be invoked only in respect of violations of fundamental rights by 'executive and administrative action'. 'Executive and administrative action' has unequivocally been construed by the Supreme Court to mean actions by the Government of Sri Lanka ("the Government") or any of its instrumentalities, thus:-

*"Fundamental rights operate only between individuals and the State. In the context of fundamental rights, the 'State' includes every repository of State power. The expression "executive or administrative action" embraces executive action for the State or its agencies or instrumentalities exercising governmental functions. It refers to exertion of State power in all its forms."*<sup>13</sup>

This position bears no difference in respect of the fundamental right, right to equality as well.

*"The right to equality pervades all spheres of State action, including administrative action of all kinds by all Government bodies. The Constitutional provision therefore means that no agency of the State or the officers or agents by whom its powers are exerted shall deny to any person the equal protection of the law."*<sup>14</sup>

The Banking Act and the Finance Companies Act set out the legislative will in respect of 'banking business' and 'finance business' and which entities should be permitted to carry out such businesses within the territory of Sri Lanka. Monetary Board is the administrative body, which is incorporated by the Monetary Law Act No 58 of 1949 as amended ("Monetary Law Act"), primarily

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<sup>13</sup> Rienzie Perera and Another vs. University Grants Commission and Another- 1978-79-80 1 (SLR) Page 128, at page 138.

<sup>14</sup> *Ibid.*

responsible for implementing the said legislative will within the statutory parameters applicable thereto.

Moreover, in terms of the Monetary Law Act, the Monetary Board is vested with the power of the management operations and administration of the Central Bank which in turn is the fiscal agent and banker of the Government.

Further, the Monetary Board is the apex governmental body functioning under Ministry of Finance, which implements the fiscal policy of the Government. Hence, the Monetary Board is an instrumentality of the Government and therefore the former's actions will fall within the ambit of 'executive and administrative action' set out in Article 126 of the Constitution.

### **Right to Equal Treatment/Equal Protection of Law.**

As previously mentioned, the Right to Equality is enshrined in the Article 12 of the Constitution.

Article 12 sets out that,

*"(1) All persons are equal before the law and are entitled to the equal protection of the law.*

*1) No citizen shall be discriminated against on the grounds of race, religion, language, caste, sex, political opinion, place of birth or any one of such grounds..."*

The right to Equality as embodied in Article 12 of the Constitution has, over the time, been interpreted to mean that the law must treat equals equally. Thus, the conception of equality as it stands today mandates that the State and all its instrumentalities should treat all people equally who are alike and who are placed in the same circumstances.

*"What is meant by equality in this Article is equality among equals. It does not provide that what is aimed at is an absolute equality of treatment to all persons in utter disregard in*

*every conceivable circumstance of differences such as age, sex, education, and so on and so forth and as may be found among people in general*<sup>15</sup>

It is perhaps on this ground that it is argued that MFIs are subject to discriminatory treatment through the preclusion from taking deposits except with a license/permission issued by the Monetary Board whilst the Government Sponsored Entities continue to carry out such deposit taking without any similar requirement to obtain license/permission from the Monetary Board.

However, the credibility of the above argument depends upon whether right to equality stipulated in Article 12 covers inequality in the matter of illegal treatment (equal violation), which has been discussed in detail below.

### **Does equality cover inequality in the matter of illegal treatment?**

As we explained more fully in our response to question 1, deposit taking is an activity regulated by law. Therefore, continuing such business without obtaining necessary approvals under the Banking Act or Finance Companies Act, as the case may be, is unlawful.

It is true that entities registered or established under the government funded/sponsored programs such as NDTF, PAMP and Samurdhi may be carrying on deposit taking activities. However, the said laws in respect of deposit taking does not permit any person to carry out deposit taking without obtaining necessary approvals purely on the basis that such persons are operating under Government funded/sponsored programs, nor do the said laws impliedly recognize such dichotomy as to its application.

In fact, although divisional centers established under Samurdhi Program have been impliedly authorized by the Samurdhi Authority Act No 30 of 1995 to carry out deposit taking activities, such entities are not recognised by Section 76A(1) of the Banking Act as being exempted from the requirements thereof. The amendment to the Banking Act by way of Banking Act (Amendment) No

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<sup>15</sup> Sharvananda J endorsed the view expressed in the Indian case - *Devadasan v. Union of India* in his judgment in *Rienzie Perera and Another vs. University Grants Commission and Another - 1978-79-80 1 (SLR) Page 128, at page 139.*

33 of 1995 *inter alia* sets out that in the event of inconsistency between the Banking Act and any other written law the Banking Act will prevail. Therefore, in the absence of express provisions excluding the application of provisions of the Banking Act (Samurdhi Authority Act does not contain such provisions), any entity/ies established or authorized under a written law cannot carry out deposit taking activities except with a license/permission issued by Monetary Board under the Banking Act or the Finance Companies Act.

Therefore, it can be concluded that deposit taking activities carried out/being carried out by government funded/sponsored programs without obtaining license/permission from Monetary Board are also unlawful.

Hence, any application made to the Supreme Court alleging that any order made/to be made by the relevant authority requiring MFIs to obtain such approvals as required by law is arbitrary and discriminatory on the ground that no such order has been made against Government Sponsored Entities and therefore violates Article 12 of the Constitution, inevitably results in a request made to the Court to nullify the order made against MFIs thereby sanctioning an unlawful and illegal act to compensate another illegal act committed by the relevant authority.

However, the Supreme Court in exercising its fundamental rights jurisdiction has vehemently refused to sanction any such act.

*"Article 14 (corresponding to our Article 12) cannot be understood as requiring the authorities to act illegally in one case, because they have acted illegally in other cases."<sup>16</sup> "...The equal treatment guaranteed by Article 12 is equal treatment in the performance of a lawful act. Via Article 12, one cannot seek the execution of any illegal or invalid act. Fundamental to this postulate of equal*

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<sup>16</sup> Sharvananda, C.J. endorsed the view expressed in the Indian case of *Venkata Subbiah Setty v. Bangalore Municipality* in his judgment in *C.W. Mackie & Co., Ltd v. Hugh Molagoda, Commissioner-General of Inland Revenue and Others*, 1986 1 (SLR) Page 300, at page 309.

*treatment is that it should be referable to the exercise of a valid right, founded in law in contradistinction to an illegal right which is invalid in law.*"<sup>17</sup>

Moreover, it was decided that *"the courts cannot condone any attempt at frustration of the law by the executive. It is basic to the Constitution that the Executive should carry out the mandate of the Legislature."*<sup>18</sup>

Therefore, any application alleging a violation of the right to equality on the above basis will necessarily fail due to the reasons set out above.

As explained in our response to question 1 above, section 76A (1) of the Banking Act prohibits any person from carrying out 'deposit taking' except with a license issued thereunder by the Monetary Board. However, the proviso to section 76A (1) sets out certain exclusions and exceptions to the main provision. The said proviso to section 76A, *inter alia*, sets out that,

any organization,

- (i) established or registered under any written law,
- (ii) not being an organization primarily for the purposes of making profits,
- (iii) which accepts deposits only from its registered members, and
- (iv) has obtained permission in writing from the Monetary Board to accept and to invest or lend the monies so accepted,

may carry out deposit taking.

However, in the event authorities decides to grant approvals only to Government Sponsored Entities or to adopt different guidelines/procedure which are more favorable to such Government Sponsored Entities enabling them to obtain necessary approvals without much difficulty compared

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<sup>17</sup> C.W. Mackie & Co., Ltd v. Hugh Molagoda, Commissioner-General of Inland Revenue and Others - 1986 1( SLR) Page 300, at page 309; Farook v. Dharmaratne, Chairman, Provincial Public Service Commission,Uva and Other- 2005 1 (SLR) Page 133, at page 141.

<sup>18</sup> C.W. Mackie & Co., Ltd v. Hugh Molagoda, Commissioner-General of Inland Revenue and Others - 1986 1( SLR) Page 300, at page 313.

to MFIs, whether such treatment will result in violation of Article 12 will depend upon whether such Government Sponsored Entities and MFIs can be considered equals.

### **Are Government sponsored entities and MFIs equals?**

The requirement to treat equals equally necessarily entails a determination as to who can be considered as equals. Identification of equals inevitably results in a classification of persons.

*“Reasonable classification is inherent in the concept of ‘equality’, because all persons are not similarly situate”<sup>19</sup>*

However, right to equality requires such classification should be on reasonable and on conceivable grounds.

*“Indeed every classification discriminates between persons and things. The very concept of classification is that of inequality. Yet, unless classification is permitted, injustice is bound to take place, for it would result in unequals being treated equally.”<sup>20</sup>*

*“The equal protection clause ceases to assure either equality or protection if it is avoided by any conceivable difference that can be pointed out between those bound and those left free.”<sup>21</sup>*

Therefore, in order for MFIs to assert any claim of discrimination, MFIs must be able prove that there is no conceivable difference between MFIs and Government Sponsored Entities thereby showing that any such classification is irrational and unreasonable.

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<sup>19</sup> Rienzie Perera and Another vs. University Grants Commission and Another- 1978-79-80 1 (SLR) Page 128, at page 139.

<sup>20</sup> Weligodapola v. Secretary, Ministry of Women's Affairs and Teaching Hospitals and Others- 1989 2 (SLR) Page 63, at page 74.

<sup>21</sup> Rienzie Perera and Another vs. University Grants Commission and Another- 1978-79-80 1 (SLR) Page 128, at page 140.

## Conceivable difference

In certain decided cases<sup>22</sup>, Supreme Court of Sri Lanka has adopted the following test in order to determine whether the difference postulated by the State is conceivable and reasonable.

- i. The classification must be founded on an intelligible differentia which distinguishes persons or things that are grouped together from others left out of the group; and
- ii. The differentia in question must have a reasonable relation or nexus to the objects sought to be achieved. In other words, there must be some rational nexus between the basis of classification and the objects intended to be achieved by such classification.

In terms of the said decided cases, the following rules should also be taken into consideration when applying the above test.

- i. The State has a right to make classifications and *prima facie* presumption is drawn that the State will not draw classifications which are unreasonable.
- ii. With regard to "*any permissible classification-mathematical nicety or perfect equality is not expected*"<sup>23</sup>
- iii. Burden of proof is on the petitioner to prove that the classification is founded on no intelligible differentia.

PAMP and NDTF are international fund based special schemes designed by the State with the help and assistance of such international donors in order to distribute the funds so obtained among the poor and underprivileged of the society thereby facilitating the attainment of the goal of social and economic equality among its citizens by the State.

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<sup>22</sup> Rienzie Perera and Another vs. University Grants Commission and Another- 1978-79-80 1 (SLR) Page 128; Palihawadana v. Attorney-General and Two Other- 1978-79-80 1 (SLR) Page 65; Ramuppillai v. Festus Perera, Minister of Public Administration, Provincial Councils and Home Affairs and Other- 1991 1 (SLR) Page 11, Gunaratna v. People's Bank and Others - 2001 1 (SLR) Page 381.

<sup>23</sup> Ramuppillai v. Festus Perera, Minister of Public Administration, Provincial Councils and Home Affairs and Other- 1991 1 (SLR) Page 11, at page 20.

The Samurdhi Program is a legislative initiative designed to attain the goal of social and economic equality in the society. Section 4 of the Samurdhi Authority of Sri Lanka Act, No. 30 of 1995 provides that,

*“The functions of the Authority shall be to formulate a program called the Samurdhi National Program (hereinafter referred to as “the program”) for the improvement of the economic and social conditions of youth, women and disadvantaged groups of society”*

Therefore, all schemes such as Samurdhi, PAMP and NDTF are undisputedly tied up with one of the State’s primary objects i.e. improving the standard of life of all people who constitute its subjects. Specially, one of its obligations thereunder is to endeavor its best to eliminate social and economic disparities and attain the goal of social and economic equality. This is unequivocally set out in many principles of the Directive Principles of State Policy of the Constitution. Thus, Article 27 of the Constitution, *inter alia* sets out that,

*The State is pledged to establish in Sri Lanka a democratic socialist society, the objectives of which include,<sup>24</sup>*

- *the promotion of the welfare of the People by securing and protecting as effectively as it may, a social order in which justice (social, economic and political) shall guide all the institutions of the national life;<sup>25</sup>*
- *the equitable distribution among all citizens of the material resources of the community and the social product, so as best to subserve the common good;<sup>26</sup>*
- *the establishment of a just social order in which the means of production, distribution and exchange are not concentrated and centralised in the State, State agencies or in the hands of a privileged few, but are dispersed among, and owned by, all the People of Sri Lanka.<sup>27</sup>*

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<sup>24</sup> Article 27 (2)

<sup>25</sup> Article 27 (2) (b)

<sup>26</sup> Article 27 (2) (e)

<sup>27</sup> Article 27 (2) (f)

*The State shall eliminate economic and social privilege and disparity, and the exploitation of man by man or by the State.<sup>28</sup>*

Although the directive principles of State Policy are not binding upon the three organs of State, any act of an organ of the State may be rationalized based on the positive duties imposed therein. Thus, Supreme Court in its judgment of *Seneviratne and Another v. University Grants Commission and Another* decided that, *"it is a settled principle of construction that when construing a legal document the whole of the document must be considered. Accordingly, all relevant provisions of the Constitution must be given effect to when a constitutional provision is under consideration and, when relevant; this must necessarily include the Directive Principles. It has been said that the Directive Principles are in the nature of an instrument of instructions which both the Legislature and executive must respect and follow. The expressive language in the above citations is intended to emphasize the fact that these provisions are part and parcel of the Constitution and that the courts must take due recognition of them and make proper allowance for their operation and function."<sup>29</sup>*

Therefore, there is no doubt that PAMP, NDTF and Samurdhi are welfare programs designed by the State to achieve one of its primary goals and obligations of achieving social and economic equality by eliminating social and economic disparities prevailing among its subject citizens.

The State in implementing the aforesaid programs has decided to engage services of certain selected MFIs based upon such guidelines drawn by such respective programs/schemes, for the obvious reason being that of unavailability of adequate State owned institutional network which is properly equipped and specialized to carry out such micro finance activities. On the other hand, with the limited resources available to the State, the cost of establishing such institutional network may be more than the ultimate benefits which are expected to be delivered to its subjects, citizens.

Therefore, engagement of services of such selected MFIs can be justified by the State.

On the other hand, the Government is compelled to implement such schemes within the existing statutory framework of the country.

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<sup>28</sup> Article 27 (7)

<sup>29</sup> 1978-79-80 1 (SLR) Page 182, at page 216.

*"It is basic to the Constitution that the Executive should carry out the mandate of the Legislature."*<sup>30</sup>

Therefore, if the Government is to implement such schemes with the assistance of such selected MFIs, the latter requires license/permission issued by the Monetary Board in order to carry out deposit taking activities under the government scheme. In the aforesaid circumstances the Monetary Board may exercising its discretion in terms of proviso to section 76A (1) may grant permission to such selected MFIs in order to facilitate the State achieving its goals. Such permission will result in two "classes" of MFIs, one being MFIs which receives the permission as aforesaid, namely Government Sponsored Entities while the other being MFIs which did not receive such permission from the Monetary Board to carry out deposit taking independently of such schemes as PAMP and NDTF.

It may be argued that in light of the aforesaid goal of the State to eliminate the social and economic disparities and its lack of resources to implement programs drawn to achieve the said goal ultimately lead to the engagement of selected MFIs to facilitate its goal. Thus, in the aforesaid circumstances constitutes an intelligible differentia between Government Sponsored Entities and MFIs could exist.

However, the law of the country mandated such MFIs to act within the existing parameters of the law thereby mandating permission for deposit taking form the relevant authority. Therefore, it may be argued that there is a rational nexus between the basis of classification and the objects intended to be achieved by such classification. Therefore, the prima facie presumption that,

*"In exercising its right to make distinctions between persons, I do not think that the State wastes its precious and limited energies in making them without a purpose. When the State makes distinctions, I therefore take it that it does so correctly appreciating the needs of our people and having regard to its experience, with a view to achieving something desirable because it is good for our people."*<sup>31</sup>.

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<sup>30</sup> *Supra* note 18.

<sup>31</sup> *Weligodapola v. Secretary, Ministry of Women's Affairs and Teaching Hospitals and Others -1989 2 (SLR) Page 63, at page 75.*

may be found to be un rebutted since in any case the “*Court will not insist that the classification is scientifically perfect and logically complete*”<sup>32</sup>

Therefore, MFIs application in this regard may fail on the ground that classification is reasonable.

*“A person relying on a plea of unlawful discrimination must set out with sufficient particulars his plea showing how, between persons similarly circumstanced, discrimination has been made, which discrimination is founded on no intelligible differentia. If the petitioner establishes similarity between persons who are subjected to differential treatment, it is for the State to establish that the differentia is based on a rational object sought to be achieved by it. But where similarity is not shown, the plea as to infringement of Article 12 must fail.”*<sup>33</sup>

However, in the event that a non- governmental MFI is granted approval under Section 76A (1) and another similarly circumstanced non- governmental MFI is not, then there may be *prima facie* case of a violation of equal rights and equal protection of the law.

**(4) Recommendations to the regulators, policy makers and the LMFPA on the possible practical solutions and legal measures that need to be taken to rectify this issue;**

For the reasons we have outlined in our response to question 1, “deposit taking” by MFIs is, in the current context and regardless of any government programs to the contrary, a restricted activity. However as we have theorized in our response to question 2, any alleged illegality is necessarily dependant on establishing whether MFIs are in fact engaged in the business of accepting “deposits” within the meaning of and contrary to the Banking Act and/or engaged in “finance business” within the meaning of and contrary to the Finance Companies Act.

Regardless of any such interpretative approaches, which by their very nature are contentious, there are several other possible options available to MFIs if they wish to carry out deposit taking activities:

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<sup>32</sup> *Ibid* at page 83.

<sup>33</sup> Rienzie Perera and Another vs. University Grants Commission and Another- 1978-79-80 1 (SLR) Page 128, at page 140.

## 1. Permission under section 76(A) (1) of the Banking Act

As we have mentioned above in relation to question 2, under section 76(A)(1) of the Banking Act any non-profit organisation, established or incorporated under any law may obtain permission from the Monetary Board to take deposits from its registered members and to invest or lend such monies. Whilst, as the provision reads, the exemption is limited to *non-profit organisations* which would necessarily have to be registered or established under a particular legislative enactment (i.e. societies ordinance, a company limited by guarantee under the Companies Act No. 7 of 2007, an un-incorporated body registered under the Voluntary Social Service Organisation Act etc), obtaining permission thereunder would provide respite to a great number of NGOs who are being requested by the Central Bank to register under the Finance Companies Act for their deposit taking activities.

Having carried out enquiries in this regard however, we are of the view that there appears to be a stance taken by the Monetary Board against providing permission under the aforementioned section, based on the "current context" (presumably the recent turbulence in the financial markets particularly in relation to unlicensed deposit taking activities). This hesitancy or opposition to the provision of permission under the aforementioned section could also be attributable to the lack of a supervisory framework to regulate such organisations *subsequent* to the granting of any such permission.

It is also however entirely possible that where a large number of MFIs (who meet the eligibility criteria) submit applications for permission under the aforementioned provision of the Banking Act, the authorities would be compelled to at the very least to expedite endeavours to create the necessary legal framework (i.e. through the proposed Microfinance Act). Moreover any attempts to give permission to certain MFIs and deny others may very well raise questions relating to the right to equality as guaranteed by Article 12 of the Constitution.

## **2. Enactment of a Microfinance Act**

One of the greatest needs in the current context, accepted on a general level by almost all the stakeholders in the microfinance industry, is a single legislative enactment providing for a supervisory and regulatory framework within which microfinance activity can lawfully be carried out.

As we have been informed, such an enactment is currently in the draft stage at the Central Bank, although we have not been provided with/able to obtain a copy thereof.

Any such enactment on microfinance should necessarily contain provisions relating to, *inter alia*, the setup of a supervisory authority (i.e. a separate department of the Central Bank with district level offices etc for ground level supervision and regulation or supervision and regulation through some other body or authority), a comprehensive definition of “microfinance business”, the prohibition of carrying out microfinance business without licensing or registration thereunder, the criteria for obtaining such licensing/ registration (with reasonable capital adequacy requirements etc., and an acceptance of the various organisational structures within which MFIs operate (i.e. guarantee companies, societies, voluntary social service organisations), control and supervision (i.e. accounting and auditing requirements, financial statements, provision for examination of books etc), winding up/closure of business by MFIs and the supervisory authority’s power to issue directives. Moreover there should be clear provision exempting such registered/licensed MFIs from the provisions of other conflicting laws, such as the Banking Act and the Finance Companies Act.

Therefore, at this present juncture, the legislative process pertaining to the anticipated “Microfinance Act” should be expedited and it is our view that the LMFPA is ideally placed to play a pivotal role in the lobbying therefor.

## **3. A self-regulatory body**

An alternative option is to pursue dialogue with the various stakeholders to set up a self regulatory authority for the licensing, supervision and regulation of MFIs in Sri Lanka.

For instance a structure similar to the following may be adopted:

- a. An independent microfinance self regulatory authority (“the Authority”) is set up (possibly incorporated by Act of Parliament or as a guarantee company etc) under the management of an elected “council” or board of directors consisting of representatives from the various stakeholders (i.e. Central Bank, LMFPFA etc).
- b. The Authority creates a “code of conduct” or several “codes of conduct” (if distinction is to be drawn between different classes of members – those who take deposits and those who don’t for example) by way of rules for its members, providing for the various aspects we have outlined above as requiring inclusion in any intended “microfinance” legislation.
- c. Membership should be offered to MFIs based on objective criteria that takes into consideration the various organisational structures that may be utilised and an agreement to abide by the code of conduct/the rules. Once registered, a MFI should be bound by the supervisory and regulatory structure under the aforementioned “codes of conduct”. The relationship between the MFI and the Authority would be contractual. In short, the MFI would obtain legitimacy for their “microfinance” activities, subject to, *inter alia*, complying with the provisions of the “codes of conduct” and being subject to the supervision of the Authority. The Authority should even, where necessary, be able to take over the management and control of such MFIs based on the aforementioned contract of membership. However the ability of the Authority to provide such legitimacy is dependent on it being provided by law. For example, in relation to deposit taking, obtaining an amendment to section 76(A) (1) Banking Act and to the Finance Companies Act providing, *inter alia*, that any MFI who is a registered member of the Authority would be exempted from the licensing requirements thereunder, would satisfy the legitimacy requirement.

The effectiveness of such an Authority is primarily dependent on government recognition and support for the same. Therefore, if such an option is to be pursued, discussions with the Ministry of Finance & Planning, the Central Bank, and any other relevant government ministry/department etc., must be commenced. The rationale behind the Authority must be explained to these entities: the providing of an effective and practical supervisory and regulatory framework with government involvement *without* government expenditure. It should be impressed upon these entities that if they are unwilling to consider such an option, viable and tangible alternatives (i.e. a Microfinance Act and supervisory body etc), on their part, should be forthcoming.

#### 4. Formal discussions between the LMFPFA and the Central Bank

In any scenario it is advisable for the LMFPFA to immediately commence formal discussions with the Central Bank in relation to the issue of “deposit taking” by its members. As the sole representative body of MFIs in Sri Lanka, the LMFPFA is ideally placed to do so and the points that could be raised for discussion could include the following:

- a) The need for a distinction between deposit taking activities on the promise of high returns and as investments (i.e. regular finance business carried on by finance companies etc.) and deposit taking as a form of savings mobilisation and social empowerment among the poor by non-profit entities, particularly in consideration of the capacity limitations of licensed commercial banks, licensed specialised banks and other licensed financial institutions etc., in operating in rural areas.
- b) The possibility of reaching an understanding with the Central Bank that the registered members of the LMFPFA would not be required to register under the Finance Companies Act for their deposit taking activities until the anticipated legal framework has been arrived at. However it should be impressed upon the Central Bank that not only is such registration unfeasible given the capital adequacy requirements etc., it is also impractical given the various legal structures of the MFIs as the Finance Companies Act recognises only companies having an equity capital and registered under the Finance Companies Act. The LMFPFA can instead offer to provide the Central Bank with a complete list of its members who are carrying out deposit taking activities with information on the specific nature of the activities etc., and any other details that the Central Bank requests, on the understanding that such organisations would not be specifically required to register as aforementioned, at least until a legal solution has been achieved that is reasonable for all the parties concerned.
- c) The practical difficulties faced by MFIs in simply “ceasing” their deposit taking activities, particularly instances where such MFIs have responsibilities imposed on them under the various government sponsored poverty alleviation programs (e.g. NDTF). Moreover it should be explained that such cessation would cause immeasurable damage to the trust and goodwill that the MFIs have built up among the rural masses within which they operate and setbacks it would cause to the MFIs carrying out their other activities (i.e. micro-credit).

(5) Specific recommendations on the forthcoming amendments to the Finance Companies Act and the Banking Act

1. The amendments to the Banking Act

The draft amendments to the Banking Act are mainly in relation to provisions applicable to licensed commercial banks (“LCB”) and licensed specialised banks (“LSB”). These include, *inter alia*, provisions (i.e. applicable to LCBs/LSBs) on such aspects as acquisition of businesses, management, numbered accounts, audits, information and examination, matters on which Monetary Board may issue directions and supervision of banking business.

The relevant provision of the Banking Act that is applicable to a majority of the MFIs (which we are instructed are not licensed banks in Sri Lanka) is however section 76(A), which we have examined morefully in our response to question 1. To recapitulate, in terms thereof, the business of accepting deposits of money and investing and lending such money is a restricted activity and a license must be obtained therefor; however, *inter alia*, any non profit organisation which accepts deposits from its registered members only and which has obtained written permission from the Monetary Board to accept such deposits and to invest or lend such monies would be exempt from such a licensing requirement.

It is our view that the aforesaid provision, as it stands, is not per se objectionable. Any MFI which is not-for-profit and which carries out deposit taking activities only in relation to its registered members would be entitled to apply for such permission from the Monetary Board. However, we have been informed that the Monetary Board, as a matter of policy, does not approve such applications in the present context<sup>34</sup>. Therefore it is a question of firstly facilitating the establishment of an enabling environment for the Monetary Board to *provide* such permission, by way of a microfinance regulatory and supervisory framework that meets those, arguably, legitimate concerns that currently inhibit the exercise of Monetary Board’s discretion to provide such permission.

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<sup>34</sup> Please see also our response to question 4.

## 2. The draft Finance Business Act

The draft Finance Business Act, which will repeal and replace the current Finance Companies Act is intended to be an extremely detailed and far-reaching legislative enactment.

It provides that “No person other than a company licensed under this Act shall carry on finance business” [vide Section 2(1)]. ‘Finance business’ is defined similarly as in the existing Finance Companies Act.

The draft Act then goes on to provide that “No person other than a person licensed to carry on finance business under this Act or a person exempted from the application of the provisions of this Act shall accept deposits”[vide Section 2(2)]. This provision is not found in the existing Finance Companies Act.

Licensing is subject to, *inter alia*, the person being a company registered under the Companies Act No. 7 of 2007 (and does not include a company limited by guarantee, a private company or an offshore company), having a core capital of not less than two hundred million rupees and being able to comply with the directions and rules applicable to finance companies.

These requirements are however not very different from those under those imposed for becoming a registered finance company under the Finance Companies Act. They are onerous and inflexible and in effect do nothing to provide any respite to microfinance institutions.

Given, however, that the intended enactment is still in its draft stages, there is now an opportunity to attempt to mitigate the stringent nature of some requirements of the proposed Finance Business Act on MFIs. The draft enactment has the capacity and general framework to regulate MFIs if adequate provision was made therein for such regulation.

In the first instance, the proposed Finance Business Act should recognise microfinance business as a specific and distinct type of finance business. It is envisaged that a comprehensive definition of “microfinance business” would be included. Once this is done, the provisions of the draft enactment which are onerous when applied to MFIs should be modified in an appropriate manner.

For instance the eligibility criteria should be amended to include the various different organisational structures (e.g. entities registered under the Societies Ordinance or the Voluntary Social Services Organisation Act, companies limited by guarantee etc.) adopted by MFIs at present. Such entities should be able to obtain licensing as “microfinance institutions” carrying on “microfinance business”. The core capital requirements imposed by the draft enactment should be suitably modified keeping in mind the average quantum of deposits raised by MFIs. Thereafter, to the extent necessary, such licensed MFIs could be subjected to the general framework of the Finance Business Act. Several provisions of the draft Act in particular support such an approach:

a. Part II – Directions, Rules and Requirements on Finance Companies: Section 10 allows for the Monetary Board to issue directions to finance companies or to any group or category of finance companies regarding the manner in which any aspect of the business and corporate affairs of such companies are to be conducted. These include, *inter alia*, directions on the terms and conditions under which deposits may be accepted by such companies, the maximum rates of interest payable and the maximum amount that may be deposited with the company in the name of one person in one or more accounts. Therefore in order to limit the activities of MFIs licensed under the Finance Business Act, directives could, for example, be issued restricting the value of deposits per person that may be taken thereby (e.g. Rs. 10,000/- per depositor etc). If necessary, the Monetary Board could issue directives covering all aspects of the microfinance business to be carried out by licensed MFIs without the need for significant amendment to the said Act itself. The aspects (in addition to those discussed above such as organisational structures, core capital requirements) which may be subjected to regulations different to those issued to finance companies in general may include:-

- (i) terms and conditions under which deposits may be accepted by MFIs;
- (ii) the maximum rates of interest payable on such deposits;
- (iii) the maximum period for which deposits may be accepted;
- (iv) the maximum amount that may be deposited with a MFI in the name of one person in one or more accounts;

- (v) the terms and conditions under which investments may be made by MFIs;
- (vi) the minimum ratio which the liquid assets of such companies should bear to the total deposit liabilities of MFIs;
- (vii) the maintenance of cash balances with the Central Bank and the minimum ratio which such cash balances should bear to the total deposit liabilities of MFIs;
- (viii) conditions applicable to withdrawal of deposits before maturity.

- b. Part VI – Insurance of Deposits: Similar to the Finance Companies Act, the draft Finance Business Act empowers the Monetary Board to “*establish, maintain, manage and control*” an insurance scheme for the deposits held by licensed finance companies. In effect, once such a scheme is established, each finance company is required to apply to the relevant body (i.e. the Monetary Board or the body corporate which has been authorised to carry out the scheme) to insure the value of the deposits held by it, and, *inter alia*, a premium, determined by the aforesaid body in accordance with the risks involved etc., shall be payable by the respective finance company for such insurance. Such an insurance scheme will, if implemented, allay the fears of the various stakeholders of a possible collapse of the finance sector.

Moreover where the insurance premium is proportionate to the value of the deposits held, it should arguably be affordable to even the smallest of MFIs. Whilst it is appreciated that the sustainability of such a scheme would necessarily be contingent on adequate supervision/regulation of the finance companies and MFIs to prevent, as far as possible, any mass scale “deposit runs” or “collapses” etc., it is opined that the framework of the Finance Business Act is suitably structured to ensure such supervision and regulation.

- c. Section 3 of the draft Act provides for the non application of the Finance Business Act to certain entities as follows:

*“(t)he provisions of this Act shall not apply in respect of any bank licensed under the Banking Act No. 30 of 1988 and an institution exempted in terms of section 76A thereof*

*save and except a finance company licensed under this Act, a co-operative society registered under a statute of a Provincial Council, and an institution exempted from the application of this Act by any written law for the time being in force”.*

Hence, any MFI which has been approved by the Monetary Board under Section 76A of the Banking Act (other than finance companies ) are exempt from the application of the proposed Finance Business Act. The language of section 3 (set out above) seems to indicate that co-operative societies registered under the Provincial Council statutes are not exempt from the application of this Act. We are of the view that this is could be due to an error. It is best however to seek clarification of this aspect.

It should also be noted that the draft Finance Business Act, unlike the Finance Companies Act, provides a definition for the term “deposit”. A “deposit” is defined in section 68(1) as meaning, inter alia, *“a sum of money paid on terms under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed to by or on behalf of the person making the payment and the person receiving it”*. This definition is however qualified by the provisions in subsections (2) and (3) thereof, whereby certain instances of payment which would prima facie constitute “deposits” are excluded from the scope of section 68(1).

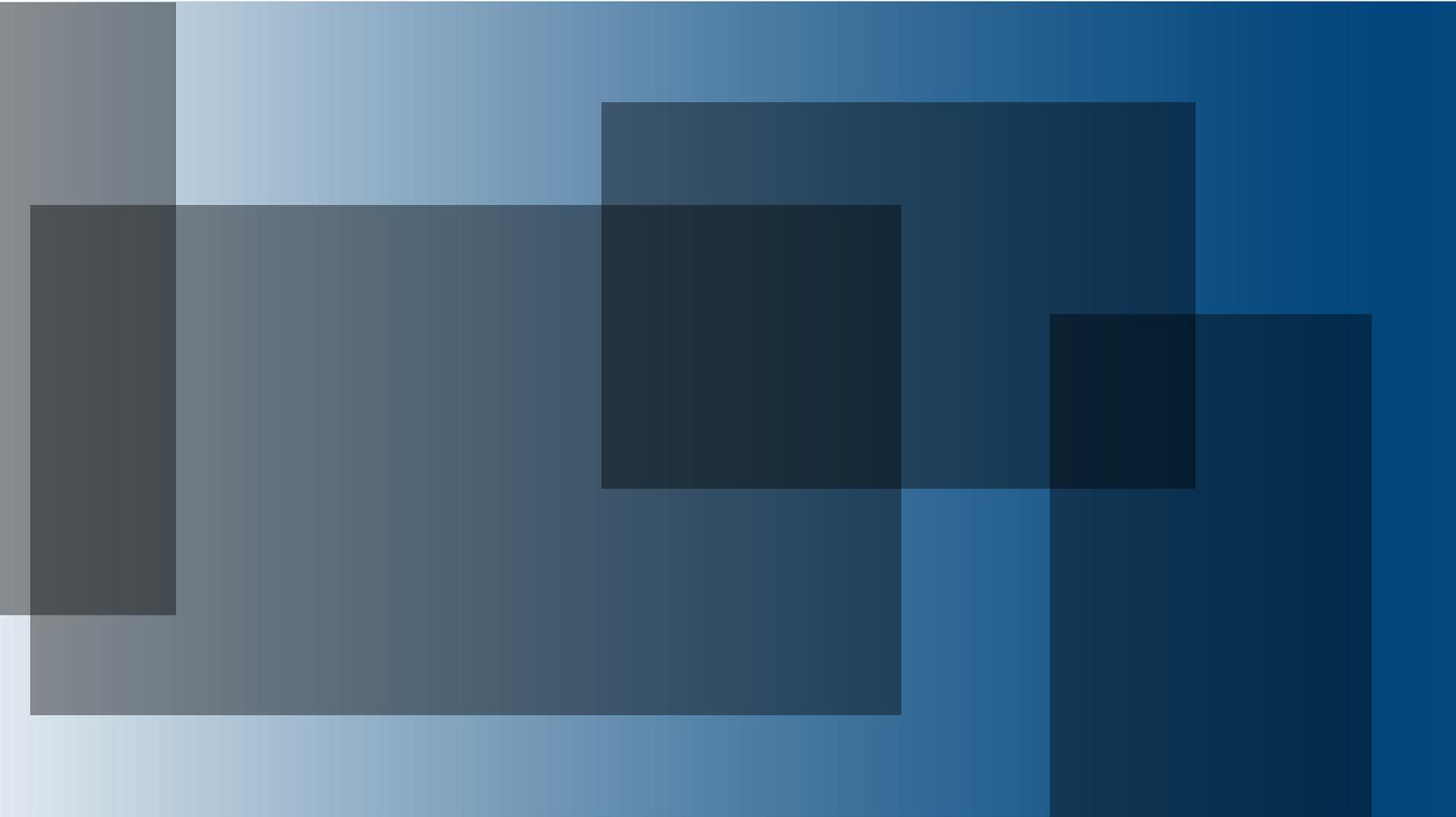
The issue at hand is that, by way of such a definition, the scope of what would constitute a deposit, as defined under the Banking Act, is extended. As morefully discussed in our response to question 2, the definition of a “deposit” in the Banking Act may be interpreted to exclude instances where the person accepting/receiving the money does not, in the usual course of business, lend money or make available the use or the benefit of the money received/accepted to *third parties*. Moreover as the Finance Companies Act did not contain a definition of the said term, under the general rules relating to interpretation of statutes, there is, arguably, scope for interpreting the same in conformity with the aforesaid definition in the Banking Act (i.e. that a deposit would exclude an instance where the money received/accepted is not given to *third parties*). However the inclusion of an apparently exhaustive definition in the draft Finance Business Act closes any such loophole and the word “deposit” is in effect given its general meaning, save and except certain limited and clearly defined circumstances.

Whilst it is possible to suggest an amendment to the said definition in order to exclude, for example, the limited savings mobilisation activities of non-profit MFIs, the likelihood of Central Bank accepting such an amendment should be considered.

The policy behind the Finance Business Act appears to be to provide a more stringent and comprehensive framework for the regulation/supervision of persons carrying out “finance business” and there is no evidence of an intention to make special allowances for MFIs, regardless of the nature or scope of their “deposit taking” activity.

Therefore any amendments/recommendations to provide an enabling environment for such deposit taking by MFIs necessarily requires a fundamental re-evaluation of the policy and principles behind the draft enactment. Whether such re-evaluation would be forthcoming, particularly in light of the measures to introduce a Microfinance Act, is questionable. However it is imperative that dialogue be commenced with the Central Bank and other stakeholders on the implications of the Finance Business Act on the activities of the MFIs in the interim.

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