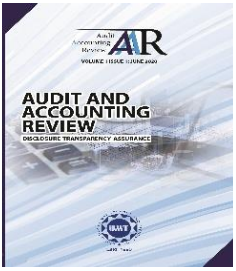

Journal of Audit and Accounting Review (AAR)
Volume 1 Issue 2, Fall 2021
Homepage: https://journals.umt.edu.pk/index.php/aar

Article: **Evaluating the State Laws and Regulations of Microfinance Institutions (MFIs) in Asia: A Comparative Study**

Journal QR

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Article QR

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Article History:
Received: September 5, 2021
Revised: November 28, 2021
Accepted: November 29, 2021
Available Online: December 1, 2021

Citation: Rasheed, B., Malik, Z. F., Shakeel, A., & Kazmi, A. S. T. F. H. (2021). Evaluating the State Laws and Regulations of Microfinance Institutions (MFIs) in Asia: A Comparative Study. *Audit and Accounting Review*, *1*(2), 91−110.

Estd. 1990

A publication of the
School of Commerce and Accountancy University of Management and Technology, Lahore, Pakistan

Evaluating the State Laws and Regulations of Microfinance Institutions (MFIs) in Asia: A Comparative Study

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Abstract

This study evaluates the laws and regulations of Microfinance Institutions (MFIs) in Asia. It compares the regulatory framework of MFIs with institutional development and macroeconomic perspective and concludes that central banks control formal MFIs by applying legislation. Conversely, semiformal MFIs are regulated and controlled by a government body or an apex organization. Unfortunately, informal MFIs are not regulated at all. It was observed that even though regulations are effective; however, the ownership structure, governance, and internal controls are not adequate and appropriate for all types of MFIs. Since the existing rules do not apply to all MFIs, this study recommends formulating special prudential regulations for MFIs, similar to the ones used in the banking sector. Formulating regulations should be the responsibility of the government, central banks, private sector, and the donors. Furthermore, regulators should develop a separate team of qualified members to monitor the regulatory environment, protect the interest of depositors and donors, and encourage MFIs to attain sustainability as well as outreach.

Keywords: central banks, Microfinance Institutions (MFIs), prudential regulations, regulatory body

JEL classifications: G2, G21, G28

Introduction

Microfinance (MF) comprises the rendering of different financial services such as credits, deposits, money transfers, and payment services to poor and low-income households. The main objective of Microfinance Institutions (MFIs) is to help poor people to come out of poverty by enhancing their source of income and building of assets (Iqbal et al., 2015; Ullah et al.,

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2020). According to Microfinance Barometer (2018), total clients of MFIs have reached 139 million, who are living in extreme poverty with a total loan portfolio of 114 billion dollars.

The main objective of MFIs is the delivery of financial services, especially in developing countries (Hermes & Hudon, 2018). Self-sufficiency is also an important factor in the mobilization of savings because savings help them to create more MF for lending, resulting in better growth (Fletschner & Kenney, 2014). In the last a few decades, some MFIs started deposit-taking activity from their customers. Since they have started this activity, a regulatory framework is required to protect the interest of the depositors and donors. Further, regulations and good governance can also protect them from inappropriate practices, resulting in financial stability and enhanced transparency.

MFIs normally have a small base of assets as compared to other financial institutions but they have a large number of poor customers who have no or a little collateral but they can come out of poverty with financial help (Ukanwa & Anderson, 2018). Owing to the apparent risks, they have to maintain diversified loan portfolios to cover their risk on investment (Lelgo & Obwogi, 2018). Traditionally, they have followed the subsidized programs with the help of the government and donors. But currently, they work as a commercial institution to raise their funds with sustainable programs. Here, a question comes to mind: are MFIs allowed to work like that with little formal regulation or should they be regulated?

The cost of regulation and supervision of MFIs affect the outreach of MFIs because they have to maintain profit rates to remain sustainable (Nyanzu et al., 2019). The costs and benefits are associated with the regulation and it is the tradeoff between outreach and sustainability. Therefore, it is the objective of this research paper to identify a better regulatory framework for MFIs to maintain outreach and sustainability at the same time. So, they can reduce the asymmetry of information with regulation and can also improve the structure of ownership and governance. Further, their impacts have to be seen which is related to innovation, competition, social welfare and financing costs. This paper examines the regulatory framework of MFIs in India, Bangladesh, Thailand, Indonesia, Vietnam, and Pakistan. Institutional development and macroeconomic perspective are also examined with the regulatory differences.

Rationale for Regulations

The objective of regulations is to strengthen the financial system of financial institutions by building the confidence of clients. Usually, regulations in developing countries are ineffective due to a lack of accounting standards, data collection problems, political interferences, and lack of professionalism (Sainz-Fernandez et al., 2018). Hence, the logic behind the regulation of MFIs is to enhance liquidity management, safeguard the interest of the depositors, develop financial and operational sustainability, and safeguard against moral hazards.

MFIs clients are poor households so any loss of their savings due to MFIs activity would be dreadful to them. They are not capable of assessing the risks of MFIs; therefore, regulations should have to be designed to minimize risks to support MFIs. Regulations of MFIs are also helpful in building trust and confidence among their customers with earnings, internal control, and capital management.

To attain long-run sustainability, commercial funds are required from the financial market which can only be possible with the help of proper regulations. In developing countries, MFIs are supported by some donor agencies. If these agencies fail to provide funds, it will affect the sustainability of MFIs (Bayai & Ikhide, 2018). Therefore, to reduce this dependency, appropriate regulations are required for self-sustainability. Regulations are all about strengthening MFIs to increase transparency in their financial reporting and also improve financial and operational sustainability (Nyanzu et al., 2019).

Overview of Microfinance in Asia

With the expansion of MFIs in South Asian countries, they can improve the lives of poor households by just giving small loans, which enable them to come out of poverty. A report issued by South Asia Micro-Entrepreneurs Network (SAMN) in 2014 reveals that the total Gross Loan Portfolio is $ 10.48 billion with the total active microcredit borrowers of 58.51 million. India has the largest number of borrowers which is 28.69 million, Bangladesh has 25.67 million, Pakistan has 3.14 million, Sri Lanka has 0.84 million and Afghanistan has 0.17 million (SAMN, 2014).

Table-1 shows the top ten countries based on borrowers of MFIs in 2017, out of the six are Asian countries. Loan portfolios have increased in all these countries but seven of them have increased their total number of borrowers (Microfinance Barometer, 2018).

Table 1

Top Ten Countries (Based on Total Borrowers of MFIs)

Rank	Country	Borrower FY 2017 & growth since 2016	Loan Portfolio FY 2017 (dollar) & growth since 2016
1	India	50.9 M (+5.8%)	17.1 B (+26.3%)
2	Bangladesh	25.6 M (+3.5%)	7.8 B (+17.0%)
3	Vietnam	7.4 M (+2.8%)	7.9 B (+18.9%)
4	Mexico	6.8 M (-3.8%)	4.4 B (+5.5%)
5	Philippines	5.8 M (+16.3%)	1.3 B (+17.5%)
6	Pakistan	5.7 M (+25.9%)	1.8 B (+39.6%)
7	Peru	5.1 M (+9.5%)	12.6 B (+17.0%)
8	Brazil	3.5 M (+1.1%)	2.6 B (+2.7%)
9	Columbia	2.8 M (-0.7%)	6.3 B (+5.6%)
10	Cambodia	2.4 M (-4.7%)	8.1 B (+21.6%)

(Microfinance Barometer, 2018)

Types of MFIs

To understand the laws and regulations regarding MFIs, it is of paramount importance to know about the different types of MFIs. MFIs can adopt three different forms; formal, semi-formal, and informal. State of the Campaign Report (2015), formal MFI National Bank for Agriculture and Rural Development India (NABARD) have the highest number of borrowers in the world which is 54,561,000. Another formal institution Grameen Bank (Bangladesh) which has the second-highest number of borrowers is 8,543,000 (State of the Campaign Report, 2015).

Formal Institutions (FIs)

Those institutions which work under the state regulations are recognized as FIs, like microfinance banks or commercial banks. The banks that work under some special regulations like Grameen Bank in Bangladesh are also included in the list of FIs. NABARD provides MF by combining the initiatives of state and private commercial banks in India. Industrial Credit and Investment Corporation of India (ICICI) bank offers a different range of MF services to poor households under NABARD programs. In India, non-profit companies and cooperative societies also play a key role in the development of MF.

Semi-Formal Institutions (SFIs)

These institutions do not have specific laws or regulations but they can be register under an existing Act. The range of these institutions is very vast in Indonesia which include Badan Kredit Desa (BKD), cooperative, village credit organizations, finance and insurance companies and NGOs. But in comparison to those of India, these institutions work as a mediator and help informal groups to transform into federations. Many Rotating Savings and Credit Associations (ROSCAs) in India have been converted into SFIs under Indian Chit Fund Act, 1982 and in Pakistan most of the SFIs (e.g. Akhuwat) work under The Societies Registration Act, 1860.

Informal Institutions

This is the oldest form of MFIs that currently exist in each country. It is normally known with the name of ROSCAs and Self-Help Groups (SHG). These informal institutions are unregistered and unregulated and cover 83% of the total credit supply in Pakistan while in Bangladesh and India they cover 65% to 75% of credit supply. In Pakistan and Vietnam ROSCAs are dominant as compared to other types of MFIs. Table-2 shows the microfinance providers in India, Bangladesh, Thailand, Indonesia, Vietnam, and Pakistan.

Table 2

Microfinance Providers

Country	Formal MFIs	Semi-formal MFIs	Informal MFIs
India	*Banks* • Public • Private • Domestic • Commercial • Local area • Regional Public trusts, cooperatives, non-profit companies, Self-help groups and NGOs	NGOs	Self-Help Groups (SHG) Rotating Savings and Credit Associations (ROSCAs)
Bangladesh	*Banks* Grameen Specialized Cooperatives	NGO-MFIs	(ROSCAs)
Thailand	Commercial & retail banks Bank for Agriculture and Agricultural Cooperatives (BAAC) Cooperatives	NGOs	Input suppliers and money lenders
Indonesia	Commercial banks like BRI's Unit Desa system, non-bank financial institutions like rural funds and credit institutions	*NGO-MFIs* • Islamic lending cooperatives • Community banks • Cooperatives • Foundations	ROSCAs, SHG and money lenders

Country	Formal MFIs	Semi-formal MFIs	Informal MFIs
	(People's Credit Banks: Bank Perkreditan Rakyat or Lembaga Dana Kredit Pedesaan), village credit institutions (Badan Kredit Desa, BKD) and savings and credit cooperatives		
Vietnam	*Banks* •Microfinance •State-owned •Cooperative •Commercial •Shareholding Cooperatives, including people's credit funds and credit cooperatives.	NGOs and government programs	ROSCAs and moneylenders
Pakistan	Microfinance, Non-banking microfinance companies, and commercial banks	NGO-MFIs, rural support programs (RSPs)	ROSCAs, money lenders and input suppliers

(Haq et al., 2008; MFIN, 2019; Microcredit Regulatory Authority, 2018; PMN, 2019)

Comparison of Regulations and Supervision

Regulations and supervision of MFIs vary from one country to another but the objective of regulations remain the same, i.e., to protect the interest of customers for poverty alleviation. Table-3 shows the comparison of regulations and regulatory bodies of India, Bangladesh, Thailand, Indonesia, Vietnam, and Pakistan.

Table 3

Comparison of Regulations and Supervisions

Country	MFIs		NGO-MFIs	
	Laws and Regulations	Regulatory Bodies	Laws and Regulations	Regulatory Bodies
India	Companies Act, 2013	Reserve Bank of India National Bank for Agriculture and Rural Development	Societies Registration Act, 1860 Indian Trust Act, 1882 Cooperative Societies Act, 1995	State-appointed Registrar of Cooperative Societies (RCS) National Bank for Agriculture and Rural Development
Bangladesh	Grameen Bank Ordinance, 1983 Companies Act, 1994	Bangladesh Bank Microcredit Regulatory Authority (MRA)	Societies Registration Act, 1860 Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961	Microfinance Research and Reference Unit Microcredit Regulatory Authority (MRA) NGOs who are accepting grants/donations are required to take a certificate of permission from the NGO Affairs Bureau
Thailand	The Bank for Agriculture and Agricultural Cooperatives Act, 1966	Bank of Thailand with Ministry of Finance	The Cooperative Societies, 1968	Ministry of National Development
Indonesia	Banking Law, 1992	Bank Indonesia	Microfinance Law, 2013	Provincial Government with Bank Indonesia

	MFIs		NGO-MFIs	
Country	Laws and Regulations	Regulatory Bodies	Laws and Regulations	Regulatory Bodies
		Bank for Agriculture and Agricultural Cooperatives		Bank for Agriculture and Agricultural Cooperatives
Vietnam	Law on the State Bank of Vietnam, 1998	State Bank of Vietnam	Decree on Organization and Formation of MFIs in Vietnam (2004) Law on Credit Institutions, 1997	Provincial Government with State Bank of Vietnam
Pakistan	Microfinance Institutions Ordinance, 2001 Non-Banking Finance Companies and Notified Entities Regulations, 2008 Companies Ordinance, 2017	State Bank of Pakistan Securities and Exchange Commission of Pakistan	The Societies Registration Act, 1860 Voluntary Social Welfare Agencies Ordinance, 1961 Trust Act, 1882	Provincial Government

(Ahmed & Bank, 2013; C-CIER, 2013; CGAP, 2017; Haq et al., 2008; MFIN, 2019; MRA, 2018; PMN, 2011, 2019)

Approaches to MFIs Regulations

Regulations of MFIs are divided into the following three classes:

- Banking Regulation
- Special Regulation
- Self-Regulation

In banking regulation, MFIs are treated like all other financial institutions so they are regulated accordingly. Banking laws of many countries are extended to cover MFIs, like in Bangladesh and Thailand. The main advantage of this approach is that a law already exists to govern the matters of MFIs and their deposit-taking activity (Tang et al., 2020). In this case, the Bank of Rakyat Indonesia (BRI) and Bank for Agriculture and Agricultural Cooperatives (BAAC) are examples in Thailand.

In special regulation, MFIs have their special law which usually offers lower barriers to MFIs but such laws are also supervised by the central bank. As in Bangladesh, Grameen Bank is under special regulation with the name of Grameen Bank Ordinance 1983 and in Pakistan, Microfinance Institutions Ordinance, 2001. This law allows MF banks to operate under the supervision of the central bank; State Bank of Pakistan (PMN, 2011).

In self-regulation, the responsibility of supervision lies in the hands of MFIs without the involvement of the government. In this category, MFIs are normally regulated under the industry apex body, e.g. Palli Karma Shahayak Foundation (PKSF) in Bangladesh. Owing to lack of government involvement, different problems are raised such as lack of safeguarding financial system and depositor protection (Gupta & Mirchandani, 2019).

Each regulatory approach has its own merits and demerits, normally seen that if MFIs are placed under the supervision of banking legislation it is more effective than the special regulation. Experience has shown that in developing countries self-regulated institutions have failed owing to enforcement problems. Nevertheless, due to the diversified economic environment of various countries, it is a subjective discussion and can vary from country to country (Haq et al., 2008). As mentioned above in Table-3, NABARD is regulated under banking ordinance while Grameen Bank is regulated under special regulation but both are FIs.

Choice of Regulatory Bodies for MFIs

MFIs are regulated and supervised by central banks and government apex bodies; these are the two types of MFIs regulators. FIs are regulated and supervised by the central bank as in Pakistan MF banks are regulated by the State Bank of Pakistan. In India, the Reserve Bank of India regulates both bank and non-banking finance companies. SFIs are supervised by government apex bodies like in Bangladesh; NGO-MFIs are regulated by the "Microfinance Research Unit" (MRRU). In Pakistan, there is a Social Welfare Department to govern the matters of NGOs and small MFIs are regulated and supervised by Pakistan Poverty Alleviation Fund (PPAF). In Vietnam, those NGOs, that are providing financial services are regulated by the State Bank of Vietnam.

Ownership and Governance

Governance and ownership structure is a major problem while regulating MFIs (Kassim et al., 2018). According to global standards, managers, board members and owners of the MFIs must be appropriate and accountable for their jobs. This should apply to all types of financial institutions and cooperatives but MFIs have their issues regarding ownership and governance. It is believed that good ownership and governance is the result of appropriate regulations. Besides, bad ownership structure in MFIs leads to low profitability and poor accountability (Kassim et al., 2018). An appropriate ownership structure leads to a better operation of MFIs. As in Bangladesh, 88% ownership structure of Grameen Bank is distributed to over 1.5 million borrowers and the remaining ownership is controlled by the government. In divergence to NGO-MFIs, they do not have a proper ownership structure. Jansson et al. (2004) reported that private ownership in MFIs led to proper management of funds as compared to the ownership of donors and social investors. Poor risk management and weak internal controls are covered by good governance and it is only possible with the help of proper ownership structure.

There are mainly two components of good governance: the first one is the duty to care and the second is the duty to loyalty (Otero, 1998). MFIs are required to have an appropriate ownership structure and good governance at a large scale, like in BRI. Regulators have to focus on sound policies and board composition, like in Grameen Bank. Their board of directors includes nine members of shareholders and three are from the government. Khushhali Bank in Pakistan has social developers and professional bankers in their list of board of directors and NABARD in India have government-appointed directors. NGO-MFIs normally have appointed board members which lead to bad governance but there is also an example of Akhuwat who is working efficiently in such conditions. There are also some NGOs that are controlled by their members and their performance is also good; such organizations include Self Employed Women's Association (SEWA) and Women's Thrifts Cooperative (WTC) in India.

Reporting and Risk Management Tools

Effective supervision and regulatory practices are only possible with the inclusion of risk management and quality financial reporting; FIs include both. Nevertheless, the majority of the MFIs are not capable of doing so. These reporting and risk management tools are discussed as, minimum capital & capital adequacy ratio, disclosure and auditing, internal controls and flexibility in interest rates.

Interest Rates in Asia

Table 4 provides an overview of interest rates:

Table 4

Interest Rates in Asia

Country	Formal MFIs	Semi-formal MFIs	Informal MFIs
India	20% - 30%	20%-40% (Restriction on interest rate)	24% - 120% SHG determines its own interest rate.
Bangladesh	Grameen Bank 20% and other banks 12%-15%,	5% - 7%	Informally charged at 120%-240%

Country	Formal MFIs	Semi-formal MFIs	Informal MFIs
Thailand	15% - 36%	15% (interest rate ceiling)	Informally charged
Indonesia	Cooperatives interest rate:18% and rural banks charge : 36%-48%	28%-63%	Informally charged at 120%-720%
Vietnam	20% - 34%	20% (interest rate ceiling)	Informally charged at 50% - 100%
Pakistan	Normally at 18%-20%	Upto 20% service charges	Informally charged at 50%-120%

Sources: FinDev Gateway; resource centre on comparative analysis of regulation and supervision of MFIs, www.adb.org, www.mixmarket.org.

Minimum Capital (MC) and Capital Adequacy Ratio (CAR)

MC has different functions: first, it works as a cushion in the starting years of operations of MFIs; and is also helpful in the time of losses. It is also the source of long-term finance and support in building the confidence of depositors. As in Pakistan Finca Bank exists with $63.5 million capital but Grameen Bank in Bangladesh has just $10 million capital. CAR protects the customers as MFIs risk increases on account of an increase in size. CAR at a minimum of 8% is enough in India, Bangladesh, Indonesia, and Vietnam but in Pakistan, its minimum value is 15% (Haq et al., 2008).

Internal Controls

Brennan, G. (2020) has stated that the objectives of internal control are to manage risk, to control employee behaviour and to minimize fraud and irregularities to achieve organizational goals. Management Information System (MIS) helps to compare the performance of MFIs which results in a better and transparent operational system (Haq et al., 2008). However internal controls are still ineffective in developing countries like Indonesia, Bangladesh and Thailand although they have developed MIS.

Disclosure and Auditing

Regulators enforce FIs and SFIs to report and disclose their financials in audited financial reports. The disclosure also includes loan loss reserve, loan loss provision, and also write-offs. But in Bangladesh NGO-MFIs also have to submit their balance sheet, income and expenditure account and all other necessary statements to their regulators. In Thailand cooperatives also have to get their accounts audited from an external auditor.

Policy Implications

If MFIs have a legal status it attracts more investors and it also provides a good signal regarding medium and long-term plans. Prudential regulations should depend on the financial system of each country; because, they cannot be standardized for every country. MFIs especially need help in saving mobilization through a regulatory framework. Formal and semi-formal MFIs have a growing impact on poor households as mentioned in Table-1. Semi-formal MFIs are the major part of this sector, a regulation is required to further enhance their operations so that they can be able to get operational self-sufficiency, minimizing their risks and deriving positive returns.

Those MFIs that are involved in deposit-taking activity, require strict compliance with the prudential regulation but those MFIs which deal only in credit activity should have less compliance. MFIs are still in the early stages and need some moderation in regulation so that they can grow and become self-sufficient. The regulators should also design some policies to reduce political interference.

Research Implications for Government

Government is the ultimate regulator of MFIs; its role varies from one country to another but it depends on the financial system, macro condition of the country and performance of MFIs. Both formal and semi-formal MFIs are under the umbrella of the government but their direct involvement leads to politicized MFI. The ownership of government affects the innovation and outcomes of banks and also resulted in corruption (Kassim et al., 2018). Direct involvement is only acceptable if it helps in poverty alleviation as in the case of Akhuwat they receive money from the Government of Punjab.

Research Implications for Central Banks

The central bank is a direct regulator so they have to design a separate team of professionals to review the work of MFIs. They should have to conduct training to integrate the new MFI into financial markets. The Head of the central bank should review the process of granting licenses to MFIs and also check its capability to comply with prudential regulations. Central banks can also delegate their authority to an apex government organization to enhance transparency in financial reporting, audit and internal controls.

Research Implications for Private Sector and Donors

In the past, the private investors were avoiding MF due to high risk but now in recent years they have started their investment in this sector that is a good sign. No doubt this sector has high risk but their returns are also high. The private sector should have to invest more in MFIs so that this sector can grow more like the banking sector. Then MFIs would be able to make a dent in poverty. Donors are the main investors in semiformal MFIs; they should have to remain intact with the government in the development of regulations and supervisory framework.

Conclusion

This research examined the state laws and regulations of MFIs in Asia. It showed that MFIs in India and Bangladesh are operated under the Companies Act, while Grameen bank has its own regulation known as the Grameen Bank Ordinance, 1983. In Thailand, Indonesia, and Vietnam, MFIs have cooperatives acts, banking laws, and laws related to the state bank. In Pakistan, MFIs work under Microfinance Institutions Ordinance, 2001 and Companies Ordinance, 1962. In all these studied countries, NGO-MFIs are regulated with different kinds of cooperative and social laws. It was observed that MFIs regulated by central banks and NGO-MFIs are controlled by the provincial governments.

Since MFIs maintain their compliance with prudential capital and reserves, they are also flexible with regards to interest rate. NGO-MFIs do not maintain their compliance with the regulation because they lack formal ownership structure but good governance can be found at large scale in MFIs, especially in India and Bangladesh. There is room for improvement in reporting, disclosure, management information system and credit rating of MFIs, thus, MFIs have to consider them for the betterment of MF systems.

A continuous discussion among MFIs and regulators should persist to determine beneficial outcomes of the regulations, since, it is not so simple to create regulations and then wait for the regulations to work. Some MFIs have also claimed that their high transaction cost is due to their compliance with the regulations. On the contrary, it is due to their non-compliance with the regulations. An empirical study can be conducted in the future by including more Asian countries, so that the results are more comprehensive and generalizable.

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