

# **Impact of Government Regulation on Microfinance**

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## **EXECUTIVE SUMMARY**

Microfinance, defined as “a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to microentrepreneurs,”<sup>1</sup> has demonstrated success as a poverty reduction strategy. Microfinance was initially developed by and is today still primarily deployed by non-government organizations (NGOs) who receive donor funds and on-lend to microfinance clients (often at subsidized interest rates). In many cases, governments also play a critical role—setting policy for the microfinance industry (most frequently vis-à-vis interest rates), providing lump sum grants to NGOs or other microfinance institutions (MFIs), or lending directly to the poor. Credit unions, cooperatives, commercial banks, and small informal groups (self help groups—SHGs) are other important players in microfinance.

The critical challenge now is to make microfinance a sustainable and ubiquitous methodology. “Scaling up” will require increasing the scope (number of individuals reached), impact (effect on the well-being of borrowers), and depth (ability to reach the poorest of the poor) of microfinance. The idea is to make microfinance available not just to the moderate poor at whom it has traditionally been targeted, but also to the extreme poor and the vulnerable non-poor, and to expand the set of microfinancial products offered.<sup>2</sup>

The emerging consensus is that achieving an order of magnitude change in the scale of microfinance will require deposit mobilization. Continued reliance on donor or government funds is both detrimental and unrealistic. Instead, deposit mobilization will be facilitated by commercialization of microfinance—MFIs transforming themselves into formal financial institutions, and commercial banks offering microfinance products.

As microfinance evolves, so too must the nature and degree of government involvement. More specifically, governments can encourage the shift toward sustainable, market-based microfinance through three specific roles: (1) eliminating unfair competition from public institutions; (2) undertaking regulatory reform; and (3) improving the business environment.

### **Unfair Competition**

Ideally, governments should exit the microfinance sector. Short of this, they should act to ensure transparency and reinforce market mechanisms by providing for specific line item budgetary disclosure and annual reporting for all government microfinance activities, and lending only at commercial rates (wholesale and retail).

### **Regulatory Reform**

Regulatory reform should maintain the prudential integrity of the financial system, facilitate the scaling up of microfinance and its integration with the formal financial sector, and create conditions conducive to commercialization. Key agenda items include:

1. Permit “credit-only” non-depository MFIs to lend freely without prudential supervision
2. Abolish financially repressive prudential regulations
3. Adjust prudential standards to reflect the specialized nature of microfinance
4. Revise bank branching rules

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<sup>1</sup> CGAP (2003a)

<sup>2</sup> CGAP (2003b).

5. Harmonize taxation
6. Allow foreign equity participation in microfinance

### **Business Environment**

In addition to regulatory reform, there are a number of actions governments can take to improve the business environment for microfinance:

1. Focus on macroeconomic stability
2. Strengthen the banking system
3. Develop infrastructure, especially in rural areas
4. Encourage the development of credit assessment mechanisms
5. Encourage the establishment and streamlining of registration and titling systems for assets owned by rural and poor urban households

## ORIGINS OF MICROFINANCE

Microfinance was originally conceived of as an alternative to both banks, which in most developing countries serve only 5-20% of the population,<sup>3</sup> and informal and semi-formal sources of finance for the poor such as moneylenders. Microfinance has been defined as “a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to microentrepreneurs.”<sup>4</sup> Microfinance is differentiated from commercial lending by the concepts of joint liability or group lending, dynamic incentives that allow for an increase in size of loans over time, regular repayments schedules and alternative collateral through forced savings (Gine 2003)<sup>5</sup>. For example, joint liability helps to overcome adverse selection (borrowers know who in their community is a credit risk) and moral hazard (borrowers can monitor each other), and to enforce auditing (by ensuring borrowers are honest in the case of default) and repayment (borrowers can impose social sanctions on defaulters).<sup>6</sup> These alternatives to collateral are especially important for borrowers who do not have assets to pledge, and for lenders who operate in countries with weak secured lending laws and enforcement.

Microfinance was initially developed by and is today still primarily deployed by non-government organizations (NGOs) who receive donor funds and on-lend to microfinance clients (often at subsidized interest rates). In many cases, governments also play a critical role—setting policy for the microfinance industry (most frequently vis-à-vis interest rates), providing lump sum grants to NGOs or other microfinance institutions (MFIs), or lending directly to the poor.

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<sup>3</sup> Gallardo, Outtara, Randhawa & Steel (2003).

<sup>4</sup> CGAP (2003a).

<sup>5</sup> Due to the nature of the contract, microfinance is not appropriate for farmers who faced by seasonal variations in income are unable to make regular repayments. Hence most borrowers from microlending institutions are self-employed (Gine 2003).

<sup>6</sup> Ghatak and Guinnane (1999).

Credit unions, cooperatives, commercial banks, and small informal groups (self help groups—SHGs) are other important players in microfinance.

The model of non market-based microlending has had mixed success—in terms of both financial performance metrics and broader social indicators. Numerous case studies demonstrate high repayment rates through effective screening of borrowers and the use of social capital to enforce repayment.<sup>7</sup> However, political interference in lending operations reduces recovery rates.<sup>8</sup> In terms of the broader effect of microlending institutions on welfare of borrowers, the studies suffer from self-selection biases (Gine 2003). Researchers disagree over the extent to which access to microcredit impacts borrower welfare. They give mixed evidence on impact of program loans (Morduch, 1999). For instance in the case of Indonesia, microfinance institutions help smooth consumption against health shocks (Gertler et. al. 2003), however in Northeast Thailand, NGO microfinance loans had little impact on welfare, although village committee members do separately see an improvement (Coleman 1999, 2001).<sup>9</sup> However, a broad examination by the Consultative Group to Aid the Poorest (CGAP) concludes that microfinance has proven to be an effective poverty reduction strategy. Evidence from multiple programs across multiple regions demonstrates that access to microfinance benefits the poor. Microcredit enables borrowers to attain higher household incomes, increase savings rates, smooth consumption pattern over their lifetime and finally be able to diversify their sources of income generation. Access to financial services also translates into broader social benefits, including improved health (better nutrition, better living conditions and preventive health practices, higher immunization rates); increased educational participation (children of microfinance clients are more likely to go to school, and drop-out rates

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<sup>7</sup> See, among others, Wenner (1995), Wydick (1999).

<sup>8</sup> World Bank (2003).

<sup>9</sup> See, for example, Morduch (1999).

of these students are lower than average); and greater gender equality (increased confidence and assertiveness, increased participation in household and community decision-making)<sup>10</sup>

## **CURRENT CHALLENGES**

By 2001, more than 1,000 microfinance programs around the world had reached approximately 20 million borrowers (Granitsas and Sheehan, 2001). These large absolute numbers still represent a small percentage of the poor worldwide. It is estimated that in Bangladesh, one of the most well-developed microfinance markets, only 18.4% of the poor are reached; at the other end of the spectrum, microfinance services in Brazil are limited to 0.4% of the poor (World Bank, 2003). The critical challenge now is to make microfinance a sustainable and ubiquitous methodology.

“Scaling up” will require increasing the scope (number of individuals reached), impact (effect on the well-being of borrowers), and depth (ability to reach the poorest of the poor) of microfinance. The idea is to make microfinance available not just to the moderate poor at whom it has traditionally been targeted, but also to the extreme poor and the vulnerable non-poor, and to expand the set of microfinancial products offered (CGAP, 2003b).

The emerging consensus is that achieving an order of magnitude change in the scale of microfinance will require deposit mobilization. Continued reliance on donor or government funds is both detrimental and unrealistic. Availability of subsidized funds reduces incentives for MFIs to increase scale and efficiency of services (Morduch, 1999). Access to savings—most likely the unmobilized savings of the same population targeted by existing microloans—will be necessary. Practitioners and academics alike agree that the future for microfinance lies in developing a well-regulated microfinance environment that will allow the poor to access a wide

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<sup>10</sup> Littlefield, Morduch and Hashemi (2003).

variety of financial services, effectively linking them to the developed sectors of the economy (Gallardo, 2001).

While a small number of NGOs have transformed themselves into financial institutions (either full-fledged banks or “Tier 2” specialized banks or non-bank financial institutions (NBFIs)), and a small number of commercial banks have entered the microfinance field, the majority of providers are still MFIs dependent on donor and/or government funding. MFIs that are organized as NGOs typically have a low leverage of capital and use one of the lowest percentage of external funds relative to the average amount of loans. This arises due to legal restrictions that do not allow NGOs to raise voluntary deposits or access funds from commercial banks (Gallardo, Outtara, Randhawa, and Steel, 2003). Transformation into formal, prudentially regulated, deposit-taking institutions enables MFIs to access new funding sources (commercial funds and deposits), offer a broader range of microfinancial products, and achieve greater legitimacy in the financial sector (Rhyne, 2002).

Traditionally, banks have shied away from microfinance for a number of reasons. In particular, the high costs of microlending compared to commercial lending, and the absence of credit scoring models have been major factors. In addition, uncollateralized loans are typically classified as risky by regulators, presenting prudential complications for banks. Finally, there may also be political/public relations risks involved if banks charge interest rates high enough to cover the costs of microfinance operations (World Bank 2003). However, the entry of existing commercial banks into microfinance in a meaningful way could bring important advantages, including economies of scale; risk management expertise; physical infrastructure and branch networks; and information, administrative and accounting systems—as well as access to commercial funds, and multiple financial products (CGAP, 1998). Partnerships between banks

and MFIs, NGOs, or self-help groups (SHGs) may prove particularly effective at bridging the gap between today's microcredit practices and a sustainable, commercial future for microfinance.

Between 1992 and March 2003, 39 NGOs in 15 countries transformed into full-fledged banks while roughly another 200 have transitioned into supervised NBFIs (either permanently or as an interim step in becoming a bank).<sup>11</sup> By 2003, microfinance provision worldwide was split roughly in thirds between NGOs, microfinance divisions of mainstream banks, and local credit unions and cooperatives (Kresbach, 2003). The shift has been even more pronounced in Latin America where by 2001 commercial banks provided 29% of microfinance; and NGOs that had transformed themselves into licensed financial institutions along with other specially licensed financial intermediaries, an additional 45% (CGAP 2001).

*Example: ProDem/BancoSol*<sup>12</sup>

The transformation in 1992 of ProDem, a microfinance NGO, into BancoSol, the first commercial bank in Latin America dedicated to the provision of microfinance is one of the best known examples of commercialization. ProDem had limited donor funded which prompted the directors decided to obtain a license for commercial banking as a route to mobilizing funds. BancoSol was financially self-sustaining within two years; and by 1998, the most profitable licensed bank in Brazil. More importantly, the transformation enabled significant expansion of microfinance: in 1992, ProDem transferred to the newly-chartered BancoSol 14,300 clients and a loan portfolio of US\$4.0 million with a default rate of 0.2%; after 13 months of commercial operations, BancoSol had 44,000 clients, a loan portfolio of US\$11 million, and a default rate of less than 1%. Within five years, the client base had crossed the 70,000 mark.

## GOVERNMENT INVOLVEMENT IN MICROFINANCE

Governments play an active role in microfinance : setting policy for the microfinance industry (most frequently vis-à-vis interest rates), providing lump sum grants to NGOs or other microfinance institutions (MFIs), or lending directly to the poor. Prior to microfinance,

<sup>11</sup> Kresbach (2003).

<sup>12</sup> Example drawn World Bank (2002) and CGAP (1997a).

governments also supported agricultural banks and promulgated regulations requiring commercial banks to direct a proportion of credit to particular economic sectors (World Bank, 2003). These efforts failed due, in large part, to low repayment rates, politically-motivated loan write-offs, and capture of subsidized credit by wealthy farmers.<sup>13</sup> Similarly, government involvement in microfinance may crowd out private sector activity; this is most likely to be the case when government programs charge or mandate below market interest rates which render microfinance unviable for institutions concerned with sustainability, e.g. commercial banks.

Government involvement has had negative effects in many countries. However, there are best practice examples of government microfinance; not surprisingly, these operations tend to be more market-oriented:

<p><i>Example: Bank for Agriculture and Agriculture Cooperatives (BAAC)</i><sup>14</sup></p> <p>The BAAC was established in 1966 as a state-owned specialized agricultural credit institution to replace the Bank for Cooperatives which could only lend to cooperatives and suffered from low repayment rates. BAAC, by contrast, lends to farmers, agricultural cooperatives, and farmer associations—and recently began providing non-agricultural loans to farming households (up to 20% of total lending). Dependent for many years on government subsidies, BAAC began to mobilize new funding sources in the mid 1990s. By 1998, savings deposits from the general public and proceeds from bond issues accounted for 60% and 14% of total operating funds respectively.</p>
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As microfinance evolves, so too must the nature and degree of government involvement. More specifically, governments can encourage the shift toward sustainable, market-based microfinance through three specific roles: eliminating unfair competition from public institutions; undertaking regulatory reform; and improving the business environment.

## **UNFAIR COMPETITION**

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<sup>13</sup> Adams, Grahan, and Von Pischke (1984), Besley (1994) and Yaron, McDonald, and Charitonenko (1998).

<sup>14</sup> This example draws upon Yaron (1997) and Yaron and Townsend (2001).

Ideally, governments should exit the microfinance sector. Short of this, they should act to ensure transparency and reinforce market mechanisms by providing for specific line item budgetary disclosure and annual reporting for all government microfinance activities, and lending only at commercial rates (wholesale and retail).

## **REGULATORY REFORM**

Regulation of the microfinance industry to date has followed a rough pattern in which institutions relying on other people's money (e.g. donor-supported NGOs) are legally registered, but not regulated or supervised; institutions leveraging members' money (e.g. credit unions) are overseen by a non-financial cooperatives authority; and institutions mobilizing the general public's money (e.g. banks) are subject to prudential regulation and supervision (van Greuning, Gallardo and Randhawa, 1998). The changing nature of the microfinance industry—namely the move toward deposit mobilization—requires regulatory reform to maintain the prudential integrity of the financial system.

In addition to achieving this objective, regulatory reform should facilitate the scaling up of the microfinance industry and its integration with the formal financial sector. Particular attention should be paid to creating conditions conducive to commercialization of microfinance—MFI transformation and commercial bank downscaling. For example, regulatory reform that ensures that high interest rates will be tolerated by politicians, and that regulators will consider the riskiness of loans rather than whether they are collateralized or not would begin to address some of the factors that deter banks from entering the microfinance sector (World Bank 2003). Experience supports the assertion that commercialization and regulatory reform can act as catalysts for development of the microfinance sector:

*Example: Bolivia*<sup>15</sup>

In Bolivia, the transformation of ProDem into BancoSol discussed above was contemporaneous with two major changes in the regulatory environment which marked an inflection point in the development of the local microfinance sector. In 1995, a credit bureau was created, and in 1998, risk-based regulation of MFIs was introduced. Spurred by these developments, outstanding loans of all microfinance providers in Bolivia grew from less than \$10 million to almost \$300 million at the end of 2002.

Regulatory reform related to the microfinance sector should follow the fundamental tenant of prudential regulation: that deposit-taking institutions must be regulated, while non deposit-taking microfinance institutions can be left to the market for disciplining. In other words, the liability side of the balance sheet determines the need of regulation and supervision of a financial institution (Meagher, 2002).

*Example: West Africa Monetary Union (Union Monétaire de l'Ouest Afrique)*<sup>16</sup>

The PARMEC Law (Projet d'Appui à la Réglementation sur les Mutuelles d'Épargne et de Crédit, Project to Assist the Regulation of Savings and Credit Cooperatives) passed in 1993 illustrates a situation in which prudential regulation was inappropriately applied, thus overburdening supervisory capacity. Under this law, financial intermediation can only be carried out by licensed banks, NBFIs, and cooperative financial institutions (CFIs). Not only does the law exclude small and informal institutions, including NGOs, from performing microfinance intermediation (exceptions under a five year convention-cadre agreement signed with member countries' Ministries of Finance), but it also subjects CFIs to far more stringent prudential regulation and supervision, and places this burden on ill-prepared member countries' Ministries of Finance.

Keeping in mind the goals of regulatory reform, and the distinction between prudential and non-prudential regulation,<sup>17</sup> the following constitutes a potential reform agenda:

### **1. Permit “credit-only” non-depository MFIs to lend freely without prudential supervision**

The majority of MFIs operating today do not take deposits; rather, they lend funds provided by donors, banks, or other sources that presumably have the right to place their own

<sup>15</sup> Example drawn from World Bank (2003).

<sup>16</sup> Example drawn from Gallardo, Outtara, Randhawa and Steel (2003).

<sup>17</sup> Non-prudential regulation does “not involve the financial authority in vouching for or assuming any responsibility for the soundness of the ‘regulated’ institution.” Prudential regulation, on the other hand, involves just this sort of government “vouching” and is typically paired with supervision to ensure “soundness.” CGAP (2000).

money at risk, and the wherewithal to monitor those investments. While certain non-prudential regulation may be called for, e.g. public registration, permitting, disclosure of major shareholders and/or management, audited annual statements, etc., these credit-only institutions should be allowed to lend freely without prudential supervision.

<p><i>Example: Central and Eastern Europe</i><sup>18</sup></p> <p>In Central and Eastern Europe and the New Independent States (NIS), legal entities can only engage in activities that are stated and provided for in the related legal regulation. For example, in Serbia, no institution can lend without a license from the national bank. In most other states in the region, the legal frameworks are such that authorization to engage in microfinance activities remains murky. NGO MFIs struggle to determine if they are permitted to lend at all; if they are permitted to on-lend capital from borrowings (or if this constitutes financial intermediation); if they can take cash collateral (forced savings, compensating balances); and if participation in microfinance endangers their non-profit status.</p>
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## **2. Abolish financially repressive prudential regulations**

### **A. Interest rate ceilings**

CGAP suggests that interest rate ceilings must be set such that they can cover all administrative costs, costs of capital adjusting for inflation, loan losses and also a provisions for an increase in equity. By following this strategy MFIs can be sustainable and driven by client needs, instead of by donor or government goals (CGAP, 2002a). In addition, because many costs of making a loan are fixed, costs constitute a higher percentage of a small loan than a large loan. Moreover, microcredit available at high costs compared to the formal financial sector nonetheless represents a significant improvement in the credit options available to the poor. A study by CGAP on credit availability in Philippines, finds every standard money lender loan to be a 5/6 loan i.e. 6 pesos must be repaid in the evening for every 5 pesos borrowed in the morning, translating into a daily interest rate of 20% (CGAP, 2002a). Typical solution to this kind of rent extraction is the imposition of interest rate caps.

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<sup>18</sup> Example drawn from Forster, Greene, and Pytkowska (2003).

However, these usually do more harm to the poor because instead of lowering interest rates, they result in a contraction of financial services for them.

Finally, interest rate ceilings are often a greater disincentive for commercial banks to enter the microfinance field than for NGOs with a non-profit orientation. Banks operating in countries that undertook stabilization efforts and associated deregulation of interest rates in the 1980s were thereby encouraged to enter the microfinance sector (CGAP, 1998). This dynamic was observed in India with the advent of financial liberalization in the 1990s and the entry of commercial banks ICICI and Citibank into microfinance activities.

*Example: Bank Rakyat Indonesia (BRI)<sup>19</sup>*

Now hailed as an example of best practice government-owned microfinance, BRI's "unit *desa*" system had its roots in a largely unsuccessful government agricultural credit program. In the 1970s, there were large operating losses, primarily due to wide-spread corruption and low interest rates that had limited the outreach of the services to poor. BRI benefited from overall financial sector deregulation in Indonesia in the 1980s, and took the opportunity to redefine itself. More specifically, the removal of interest rate controls in June 1983 allowed BRI to experiment with new financial products, most notably market-priced working capital and investment capital loans. As a result of these measures, by 1986, it became a profit-making enterprise.

B. High reserve requirements

High reserve requirements (often used to fund government budget deficits) play a similar role in terms of discouraging commercial entry into the microfinance sector. Reserve requirements restrict the proportion of deposits available for on-lending; with less credit to disperse, commercial banks are less likely to look beyond the formal financial sector.

*Example: Latin America<sup>20</sup>*

In Latin America, commercial banks made a late entry into microfinance in the early 1990s. This was only when there was a decline in reserve requirements from approximately 50 percent to between 10-30 percent.

<sup>19</sup> Example drawn from CGAP (1997b).

<sup>20</sup> Example drawn from CGAP (1998).

### **3. Adjust prudential standards to reflect the specialized nature of microfinance<sup>21</sup>**

Adjustments to existing prudential standards to accommodate the ways in which microfinance differs from traditional banking should be applied equally to depository MFIs as well as to microfinance divisions within commercial banks, and other NBFIs. While a number of areas may require attention, the most pressing issues include:

#### **A. Higher capital adequacy requirements**

Microfinance portfolios tend to be geographically concentrated, more volatile and subject to contagious delinquency. Given the cost structure of microfinance, non-payment results in decapitalization of an MFI more quickly than a traditional bank.

#### **B. Relaxation of unsecured lending limits and loan loss provisions**

Regulations limiting unsecured lending to, say, 100% of an institution's equity base or requiring 100% loan loss provisioning for all unsecured loans (at distribution vs. when delinquent) are inappropriate for microfinance. However, once a loan is delinquent, loan provisioning for microfinance should be more conservative than for traditional loans, and based on number of missed payments rather than days (given the frequent repayment schedules associated with these types of loans, 30 days of delinquency could represent not one, but two to four missed payments).<sup>22</sup>

#### **C. Different loan documentation standards**

Prudential logic requires some form of documentation for every loan. However, applying the same loan documentation standards as in existing banks would be inappropriate for microcredit. For example, few microentrepreneurs have formally registered businesses, let alone financial statements.

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<sup>21</sup> Key ideas in this section are drawn from CGAP (2002b) and Meagher (2002).

<sup>22</sup> Jansson and Wenner (1997).

D. Waived restrictions on co-signers as borrowers

Regulations that prohibit a bank from lending to anyone who has co-signed a loan from the same bank are at odds with the common microfinance practice of having members of self-help groups (SHGs) cross-guarantee each others' loans.

E. Simplified reporting requirements

Microfinance activities often operate in rural areas, and/or without the sophisticated communications infrastructure to report their financial position as frequently (e.g. daily) as may be required by traditional prudential regulation.

F. Shareholder suitability and diversification requirements on a case-by-case basis

While regulation aimed at ensuring bank owners can meet a capital call and at preventing the capture of a bank by a small number of owners serves legitimate objectives, these requirements would hinder the conversion of an NGO into a fully-fledged bank or require it to take on owner-partners who are not capable of providing good oversight.

**➔ Special Consideration: Lower minimum capital requirements**

Considerable attention has been paid to the idea of lowering minimum capital requirements to facilitate the transformation of MFIs into financial institutions. Acknowledging that a number of countries in Africa (Uganda, Ghana, Tanzania, Ethiopia, Zambia), Asia (the Philippines, Indonesia), Eastern Europe (Macedonia, Albania, Tajikistan, Bosnia and Georgia) and Latin America (Bolivia, Peru) have or are moving toward a tiered regulatory structure to accommodate specialized financial institutions, we still do not recommend this approach. Focus must be shifted from creating new regulatory rules towards reforming existing regulations that allows institutions to extend microfinance under existing bank or finance company licenses (CGAP, 2000).

In most countries, minimum capital requirements to acquire a bank license are in place both to help ensure financial stability of new institutions, and to ration supervisory capacity. Lowering the minimum capital requirements could overwhelm the supervisory authority (in terms of capacity and/or skill), create moral hazard for MFIs not yet ready to face the discipline of the market, and present a regulatory arbitrage opportunity for undercapitalized financial institutions searching for a way around more rigorous prudential standards and supervision applied to banks. Creating new regulatory options when existing MFIs are weak can flood the market with poor depository institutions, multiplying responsibility of supervisors (CGAP, 2002b).

There is no reason to believe that opening a new regulatory window will enable MFIs to achieve profitability or afford commercial costs of capital if they are not able to do so prior to application or licensing. Although economies of scale can be important for microfinance, most of the benefits are captured between the 5,000-10,000 client range. Moreover, minimum capital requirements for a bank charter are less than \$10 million in many countries and often as low as \$1-3 million (CGAP, 2000). A study of Latin American NGOs that had transformed into financial institutions, found that the minimum capital did not impose a constraint as the amount required by these institutions was either the same or less than the amount required to create and maintain profitable operations (Rhyne, 2002).

However, tiered regulatory structures in Latin America have generally been well-regarded and a number of other countries are pursuing this approach to deepen the microfinance sector. We can draw an important lesson from it : that supervisory capacity and regulations go hand in hand. If countries ease regulatory requirements for institutions, they must supplement this expansion by strengthening supervisory capacity to deal with the influx of new entry. What

we do know is that countries that ease regulations, need to strengthen supervisory capacity to deal with subsequent entry due to accommodation regulations.<sup>23</sup> In addition, implementing tougher regulation in operational areas mentioned above, e.g. higher capital adequacy requirements and stricter loan loss provisioning, may help to offset the risks associated with lower minimal capital requirements.

#### **4. Revise bank branching rules**

One of the challenges of microfinance is reaching remote customers. In most developing countries, the populations are still overwhelmingly rural, and many villages do not have banking services. Bank-NGO or bank-self-help group (Bank-SHG) partnerships, in which the non-bank entity assumes the on the ground activities (including credit assessment, lending decisions, collection, etc.) while the bank provides the capital and takes the investment risk on its books have emerged as a mechanism for overcoming this spatial divide. This arrangement benefits the banks who do not have the infrastructure or knowledge to assess microcredit risk, as well as the MFIs by reducing capital constraints. However, in some countries branching rules originally designed to protect consumers may prohibit these types of creative, and pro-poor, arrangements.

*Example: India<sup>24</sup>*

In India, a bottleneck for the use of bank agents in the type of bank-NGO scheme outlined above is the regulatory prohibition on cash handling by agents. This prevents collection by bank agents on behalf of the lenders and forces individual borrowers or SHG representatives to travel significant distances (as far as two to three days time) to make loan payments.

#### **5. Harmonize taxation**

Regulation and taxation should focus attention on the form of transaction that takes place rather than the type of the institution that undertakes it (CGAP 2002b). In some countries tax advantages and favourable tax treatments are only available to regulated institutions, although in

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<sup>23</sup> Gallardo, Uttara, Randhawa, and Steel (2003).

<sup>24</sup> World Bank (2002).

most cases there is no relationship between the tax treatment and the objectives of prudential regulation. Therefore, an important aspect with regard to tax treatment is the need to harmonize taxes across different institutional types (CGAP, 2002b).

*Example: Central and Eastern Europe*<sup>25</sup>

In Georgia and Tajikstan, microfinance institutions are not eligible for the same tax deductions as other financial institutions. In Tajikstan, VAT (value-added tax) is not assessed on financial services, but offering credit (a strategy to which many microfinance institutions resort to avoid constraints on NGO 'lending') is not classified as a financial service. In Romania, interest on microloans is not tax deductible.

## **6. Allow foreign equity participation in microfinance**<sup>26</sup>

In many countries, foreign equity participation in MFIs is limited or prohibited. As in other financial sectors, foreign presence in microfinance could have a catalytic and strengthening effect. Foreign / social investors are interested in investing in MFIs in developing countries, but are unable to do so due to restrictions imposed by governments. However, MFI's may also be unable to bear foreign exchange risk related to foreign currency borrowing (Fernando)

*Example: Shorebank Advisory Services (SAS)*<sup>27</sup>

Shorebank Advisory Services (SAS), a subsidiary of the U.S.-owned Shorebank Corp. has transferred its expertise in providing commercial and housing loans in underserved markets in the U.S. to the international development field. SAS' objective is to increase financing for SMEs, and it has ownership relationships with institutions in Asia, Eastern Europe, and Latin America. For instance, Shorebank began operations to finance new businesses in Azerbaijan in 1998. By 2002, their credit portfolio in Azerbaijan reached US\$1 million, and loan sizes increased from US\$4,000 in 1998 to US\$100,000 in 2002.

## **BUSINESS ENVIRONMENT**

In addition to regulatory reform, there are a number of actions governments can take to improve the business environment for microfinance.

<sup>25</sup> Example drawn from Forster, Greene and Pytkowska (2003).

<sup>26</sup> Fernando (2003).

<sup>27</sup> Turnag News Agency (2003).

## 1. Focus on macroeconomic stability<sup>28</sup>

The effect of macroeconomic factors on microfinance are similar to their effects on the rest of the financial sector. “Macroeconomic instability adversely affects overall economic growth and thus limits productive economic opportunities and potential for sustainable microfinance. High inflation in particular erodes the capital of financial institutions and makes it difficult to mobilize resources to expand services. In general macroeconomic instability increases the volatility of interest rates, exchange rates, and relative prices and impose additional costs and risks on the financial institutions and their existing and potential clients.”<sup>29</sup>

*Example: Brazil<sup>30</sup>*

Despite having the largest number of microenterprises in Latin America, high poverty rates (by extension, a large potential client base), and little downscaling by commercial banks, microfinance failed to take off due in part to high inflation.

## 2. Strengthen the banking system

In general, the establishment of a sound traditional banking system should precede or take priority over the development of microfinance services. Even though the banking system may not provide microfinance services, basic banking system must still exist to serve as a base and support for development of a sustainable microfinance environment. For instance, NGOs and non-bank MFIs will require banking services to deposit funds. The banking system may also ease cost of finance for MFI’s that may require access to external finance for their operations (Fernando, 2003).

## 3. Develop infrastructure, especially in rural areas

Infrastructure enables financial service provision, e.g. by banks, as well as more productive use of these financial resources by customers, e.g. borrowers. The need for improved

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<sup>28</sup> Fernando (2003 )

<sup>29</sup> Fernando (2003).

<sup>30</sup> Example drawn from Fernando (2003).

infrastructure is especially acute in rural areas. For example, better health care facilities, education and infrastructure will improve economic opportunities for the poor and also allow them to use basic financial services (Fernando, 2003). Information and communication technologies are especially important to enable rural institutions to meet prudential reporting regulations, and to incent commercial banks to expand into rural areas.

<i>Example: Bangladesh vs. Nepal</i> <sup>31</sup>
Microfinance spread faster in Bangladesh than in Nepal in the 1980s and 1990s due in part to the better rural road network in Bangladesh.

#### **4. Encourage the development of credit assessment mechanisms**

##### **A. Improve credit information on borrowers**

Credit bureaus are one of the best ways to improve the availability and quality of information about microfinance customers, e.g. cash flows, character, etc. Credit bureaus can also bring on board non-regulated entities that may not otherwise be compelled to join. Microfinance-specific credit information could be tracked by an existing consumer bureau, or through a specialized microfinance bureau. A private sector bureau would be preferable, but the public good aspect of credit assessment provision justifies government involvement if necessary (World Bank, 2003). The development of credit information about microfinance customers has three main benefits: raises the overall quality of loan portfolios and profitability of MFIs; incents existing financial institutions, e.g. banks, to offer microfinance products; and enables poor borrowers to build a credit history, facilitating their graduation to the formal financial sector.

<i>Example: Microcredit bureaus in South Africa</i> <sup>32</sup>
South Africa has two private credit bureaus operating in the microfinance sector. The Micro Lenders Credit Bureau collects information from and provides it to microlenders in Western South Africa. This information can be accessed by

<sup>31</sup> Example drawn from Fernando (2003)

<sup>32</sup> Example drawn from Klapper and Kraus (2002).

touch-tone phone, and the bureau charges much lower fees than larger bureaus—making it affordable even for small microlenders. Another credit bureau, CompuScan, provides positive and negative information on microcredit customers to microlenders and banks via the Internet. The two bureaus provide additional information such as notification of credit inquiries, new loan burdens, or court judgments. The existence of these two bureaus has increased the size of the microfinance sector, fueled competition, and decreased fees.

**B. Create greater transparency about lenders**

Rating MFIs is one way to begin bringing market discipline to bear in anticipation of an increasingly commercialized environment. In the near-term, the logic for rating MFIs is similar to that for calculating the subsidy dependence of other state-owned, controlled or funded development finance institutions: to create effective disclosure on the use of public funds (Yaron, 2003). Such ratings could also help donors to allocate limited wholesale funds to efficient, sustainable and profit-oriented (if not yet profitable) MFIs. In the longer-term, rating MFIs is aimed at providing the infrastructure necessary to ensure microfinance operates on market principles.

*Example: MFI rating agencies*<sup>33</sup>

Three examples of independent agencies which rate MFIs are M-CRIL in India, the Credit Unions Rating System in Guatemala, and MicroRate in Latin America. M-CRIL has rated 88 MFIs in Asia, most in India for the purpose of on-lending by the state-owned Small Industry Development Bank of India, but some in other countries in the region as well. The Credit Unions Rating System in Guatemala uses data submitted by member credit unions to generate systematic and objective ratings. MicroRate is a private rating agency that has assessed 29 MFIs in Latin America and the Caribbean.

**5. Encourage the establishment and streamlining of registration and titling systems for assets owned by rural and poor urban households**<sup>34</sup>

The poor have a range of assets—land, housing, crops, businesses/economic activities—that could be used as loan collateral if appropriate legal mechanisms were in place to verify,

<sup>33</sup> Example drawn from World Bank (2002).

<sup>34</sup> World Bank (2000) and Woller and Woodworth (2001).

document and protect ownership. Provision of land title (Hernando de Soto) is the clearest example, but other options include warehouse receipt systems for post-harvest financing, and recognition of businesses operating in the gray market.

*Example: Business licensing in Peru*<sup>35</sup>

In 1990, the Government of Peru decided to make a major effort to facilitate the formalization of large microenterprises and small businesses operating in the informal sector. To do so, they slashed the time required for registration and permitting from 300 days to one day, created a single authority/point of contact for the transactions, and reduced the cost from US\$1,200 to US\$174. More than 670,000 previously informal operations became legal entities between 1991 and 1997. “Having formal legal status greatly enhances the ability of large microenterprises and small businesses to participate actively in the formal economy. Even where microenterprises continue to be serviced by non-bank MFIs, it makes it easier for the MFIs to refinance or rediscount with commercial banks their own loans to legally registered microenterprises.”

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<sup>35</sup> Example drawn from World Bank (2002).

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