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KEY ISSUES IN MICROFINANCE LEGISLATION AND REGULATION

The regulation of microfinance is becoming increasingly topical and significant to microfinance institutions (MFIs). Regulators around the world seem to be increasingly aware of the necessity of implementing legislative and regulatory frameworks allowing the microfinance industry enough flexibility to innovate and grow, whilst maintaining rules and restrictions to protect low income and often vulnerable microfinance clients. Ghana offers an example, where in July 2011 the regulator issued new legislation that covers the entire microfinance sector, including semi-formal and informal institutions which were previously unregulated.
This briefing provides an overview of the key factors to consider when assessing legislative and regulatory frameworks for microfinance. These issues are relevant to all actors operating or considering to operate in microfinance, from MFIs to governments, non-governmental organisations (NGOs) and commercial banks.

Prudential and non-prudential regulation

Many of the regulatory concerns which are relevant to any financial institution apply in the field of microfinance and it is therefore instructive to consider the types of regulation which generally apply to credit institutions, and more particularly those institutions which deal with individuals. Prudential regulation seeks to protect the soundness, financial health and stability of the financial system, and ensures that financial institutions behave without taking excessive risks that could affect their performance. Prudential regulation includes rules on reporting, as well as capital adequacy and liquidity requirements.

Whilst deposit-taking institutions should be (and, in the vast majority of jurisdictions, are) subject to prudential regulation to make sure that customer deposits are protected, it is generally considered that it would be too burdensome for non-deposit taking MFIs (i.e. credit-only MFIs) to comply with prudential rules. In most countries it is not necessary to be prudentially regulated to lend money, although there are often regimes intended to protect consumers from mis-selling, abusive lending practices, etc. Non-deposit taking MFIs should be subject to non-prudential regulation, which seeks to promote good behaviour in the financial system, and includes rules on consumer protection, information disclosure, fair business practices, prevention of fraud and financial crimes and implementation of credit bureaux. Non-prudential rules allow credit-only MFIs to evolve within a structure of regulatory requirements and guidelines that allow them to exist sustainably whilst protecting the interests of vulnerable customers.

The distinction between prudential regulation for deposit-taking MFIs and non-prudential regulation for credit-only MFIs is upheld by the Basel Committee Report "Microfinance activities and the Core Principles for Effective Banking Supervision" (August 2010), which recommends that non-banks that mobilise deposits from the public should be subject to prudential regulation and supervision, but such regulation and supervision should be proportionate to the type and size of their transactions. The Basel Committee Report distinguishes between (i) Core Principles which should apply equally to banks and other deposit-taking institutions in microfinance regardless of the nature of

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microfinance activities and the size of MFIs (including Core Principles relating to independence, transparency and cooperation, or major acquisitions) and (ii)

Core Principles which require a tailored approach to ensure proportional regulation and supervision (including Core Principles relating to permissible activities, licensing criteria, or capital adequacy). The Basel Committee Report further emphasises that compliance with prudential rules and other requirements can be costly for both supervised institutions and supervisors compared to the risks posed, and supports the idea of a tiered approach to regulation of MFIs, proportionate to the type, complexity and size of their transactions.

The regulator

A regulatory framework is only as good as the supervision behind it. The supervision and regulation of microfinance is typically more efficient when the same regulatory agency is in charge of both microfinance and the financial sector at large, because of economies of scale in information, knowledge and expertise. Whilst the supervisory role is generally overseen by central banks, certain countries have successfully created separate divisions within the central bank to deal specifically with microfinance, such as Bolivia or Peru. A specialised division within the regulator should help the regulator to adapt to the fast-changing environment of microfinance whilst maintaining sufficient information, knowledge and expertise. The Basel Committee Report also states the importance of developing a specialised knowledge within the supervisor team to effectively evaluate the risks of microfinance activities, particularly micro-lending.

Levels of legislation

Flexibility is key in the growth of microfinance. Flexibility can be achieved by the creation of a special regulatory framework tailored to the characteristics and risk profile of MFIs. This approach is known as the 'special window' for microfinance and allows for the insertion of MFIs to the regulatory structure according to the range of financial services they provide. Peru provides an example of the 'special window' approach, whereby the regulatory regime that applies to MFIs depends on the range of financial services they provide. Other emerging markets which have adopted this approach with a tiered financial and regulatory structure include Bolivia, Ghana, Uganda and Zambia.

Legal structures for MFIs

The legal structures available to MFIs should be varied enough to reflect the different services and activities involved in microfinance. Some countries focus on microcredit only, but financially underserved people also need to have access to a wider range of financial services (such as savings or insurance). In Egypt for example, microfinance is limited to microcredit and can be provided through two channels only, mainstream banks and NGOs. Such an approach is severely limiting for MFIs, as non-profit structures are not always appropriate for the activities that MFIs want to engage in.

Legal frameworks should offer different structures according to the nature and size of the activities of MFIs. Peru for example offers different legal structures that MFIs can adopt according to the activities they provide. Other countries have introduced special legal vehicles for microfinance which offer an additional option of legal structure specifically designed for MFIs. Examples include the Private Financial Fund in Bolivia, which is an intermediary legal form between an NGO and a fully licensed bank, or the Savings and Loan Company in Ghana which allows for the provision of limited banking services, including a limited range of deposits and loans.

Microfinance interest rates

Microfinance interest rates are higher than mainstream banking interest rates, with the global average around 35%. Whilst this figure may seem high compared to mainstream banking interest rates, it should be noted that administrative costs (the largest single contributor of microfinance interest rates) are inevitably much higher for micro-lending, which involves a different lending methodology from traditional banking, with reliance on local players to administer the loans.

There is now widespread agreement within the microfinance industry that there should be no caps on interest rates to allow MFIs to be financially sustainable by charging interest rates high enough to cover the costs of lending and other services.

Governments which cap interest rates tend to set them at levels too low to allow sustainable MFIs. By way of example the Tunisian government imposes a very low cap on interest rates (5%) which has proved to be a critical barrier to the growth of the Tunisian microfinance industry. Where a country caps interest rates for microfinance loans, practical politics will usually make it difficult to set an interest rate cap high enough to allow for the development of sustainable microfinance providers. Morocco offers another example, where banks and other licensed credit institutions are prohibited from charging interest and other loan charges in excess of a usury ceiling calculated every 6 months, which has also proved to be an obstacle to the growth of the microfinance industry in Morocco.

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Transparency and consumer protection

Whilst microfinance helps to provide the poor with access to financial services which have been traditionally denied to them, it also seeks to lift people out of the poverty cycle. As such any microfinance regulatory framework should have consumer protection as a core objective to prevent, amongst other things, abusive lending and collection practices and over-indebtedness.

In terms of transparency, the law should oblige financial institutions to include a clear explanation about rights and obligations in financial services contracts. In many countries, lenders are required to disclose their effective interest rates to loan applicants, using a uniform formula mandated by government.

In terms of over-indebtedness, credit bureaux which contain the credit history of the clients of the financial system have proven to be powerful tools against over-indebtedness by preventing debtors from borrowing with several financial institutions and repaying only those they choose. Credit bureau administration can be appointed to a public agency or the private sector, but should be available to all financial institutions. Credit bureaux benefit both MFIs (by helping them to assess the risk of a credit operation and to verify the repayment record of a client) and clients (by increasing the possibility to access a loan by demonstrating their credit history). Some jurisdictions, such as Portugal, have legislation that make credit bureau consultation mandatory. In Morocco, one of the main factors that led to a microfinance crisis in 2007 which saw indebtedness rise to unsustainable levels among microfinance borrowers was the lack of general credit information services. One of the measures which the Moroccan government adopted in the aftermath of the crisis was the implementation of a credit bureau.

Another factor of importance is financial education as part of the protection of microfinance borrowers. Some regulators have explicitly recognised in their policies the need to inform microfinance borrowers about the basics of financial services to ensure their ability to make informed judgments and effective decisions about the use and management of their finances. Regulators in Bosnia Herzegovina, India and Morocco have responded to over-indebtedness crises between 2007-2009 by introducing financial literacy programmes. The financial regulator in Lesotho has also implemented advertising campaigns informing the population at large of the benefits and risks of financial products. Peru also stands out as one of the few jurisdictions where the regulator has implemented a wide range of financial literacy programmes.

Taxation

Certain countries offer tax exemptions as incentives for MFIs to enter the microfinance market. Morocco offers an example of such incentives, where for a period of 5 years following receipt of an operating permit, microcredit associations are entitled to fiscal privileges including exemption from principal forms of taxation.

In some countries, favourable tax treatment is only available to prudentially regulated institutions. However, taxation policy seems to be a more effective means of ensuring a level playing field amongst MFIs when the tax treatment is based on the type of activity or transaction, regardless of the nature of the institution.

Another factor to consider is whether additional tax breaks are offered to not-for-profit MFIs. Certain countries offer favourable tax treatment to not-for-profit MFIs (including exemption from taxation on profits) on the basis that such MFIs render a public benefit and do not distribute their profits to private individuals, but re-invest any profits to finance more socially-beneficial work.

Diversification

The prohibition in certain countries for MFIs to provide financial services beyond just microcredit is a important barrier to the expansion of microfinance. MFIs should have the possibility to engage in a wider scope of financial services, including savings, insurance, mortgages or mobile banking. Deposits are particularly important for MFIs to reach financial sustainability. For deposit-taking MFIs, savings are the main source of funding, whereas MFIs which are barred by law from taking deposits tend to rely heavily on debt with commercial banks to fuel their growth, or donations. For example, in India, the heavy reliance on bank debt has left certain Indian MFIs vulnerable to refinance risks in times of market stress. Peru's regulatory framework offers a good example of a regulatory framework allowing for diversification of microfinance products, offering a 'modular scheme' under which MFIs can apply for authorisation to provide additional services under specified conditions (for example, if they reach a higher liquidity ratio).

Other regulatory and legislative issues

Other issues to consider when looking at a country's regulatory and legislative framework for microfinance include: entry regulations establishing the basic requirements for MFIs to enter the financial sector; regulation of credit risks including any limits on the maximum amount that MFIs can lend to a single person or microenterprise; regulation of liquidity risks including any minimum liquidity ratio and maximum leverage ratio that a financial institution is allowed to reach in its operations; and regulation of market risks, including any limit to the exposures of financial institutions to foreign currency.

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In conclusion, the current expansion of the microfinance industry means that regulation is key. In certain countries MFIs have become very significant providers of financial services, providing in some cases more loans than mainstream banks. A country's regulatory framework for microfinance needs to not only be compatible with the core objectives of financial regulation, but also in line with that country's macroeconomic environment and stages of microfinance development. and as such there is no single universal regulatory model that can be adopted for microfinance. However, one common denominator for regulatory frameworks is the need for the supervisory authorities to carefully adjust the benefits which microfinance regulation is expected to create. Whilst over-regulation may lead to financial repression, hampering the growth of the microfinance industry, too lenient rules may allow unscrupulous practices and over-indebtedness, and at worst, exploitation of vulnerable people. This delicate balance is crucial to allow the microfinance industry to exist and grow in a controllable and sustainable manner.

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