

Development of Malawi's Microfinance Regulation and Supervision

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The *Essays on Regulation and Supervision* series has been commissioned for the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

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Introduction

ACCORDING to Christen et al (2003) microfinance refers to the provision of banking services to lower-income people, especially the poor and the very poor. Some of these clients are micro entrepreneurs seeking to finance their businesses. Other clients use financial services to manage emergencies, acquire household assets, improve their homes, smooth consumption, and fund social obligations. The services go beyond micro credit to include savings and transfer services.

The microfinance industry in Malawi is in its infancy stage, relatively underdeveloped, and operating with limited outreach. The industry has 20 registered actors; however, only six provide financial services as their core activity. (Mkulichi 2005) These non-banks – which are not subject to any kind of prudential regulation – include NGOs, parastatals, Savings and Credit Cooperatives (SACCOs), private companies, and projects of international development agencies and donors. Since legal regulations prevent most of these actors (with the exception of SACCOs) from mobilizing savings for on-lending, their focus is on providing credit (AMAP 2004).

The microfinance sector is currently regulated by an array of legislative instruments. The NGOs are registered under the Trustees Incorporation Act, the parastatals under specific Acts, and SACCOs under the Cooperative Societies Act. Most of these instruments are difficult to administer since they are outside the jurisdiction of the Reserve Bank Malawi (RBM), which is the formal regulatory authority for the financial services sector in Malawi.

There are no serious legislative issues to impede entry of more players into the microfinance sector or for the existing microfinance players to transform into main stream banks. The existing regulatory framework for commercial banks is based on the Basel accords and thus is similar to many countries and deemed non-prohibitive for micro finance. However, certain laws should be revised immediately to help the business of microfinance; for example, the Bill of Sales Act should be amended to allow shares, interest in real estate, and livestock to be used as security.

After noting that microfinance is the way forward to increase access to credit and savings by the poor, the Government of Malawi (GoM) Cabinet has approved a Microfinance Policy and Action Plan (2002). The plan aims at creating an environment that would facilitate and encourage the adoption of universally acknowledged best practices by the sector. Such a regulatory framework will ensure that Micro Finance Institutions (MFIs) are operationally and financially sustainable for the long term benefit of clients. Supervision will enforce compliance with a given legal and regulatory framework. Therefore, the plan authorized the creation of a national task force headed by the RBM and comprised of the Ministries of Finance, Agriculture

and Industry and Trade, the Malawi Microfinance Network and other donors such as USAID's Deepening Microfinance Sector (DMS) project as stakeholders to implement the action plan.

The task force has chosen a consultant to review the existing regulatory framework and determine how it can be aligned to microfinance activities by June 2006. If all goes to plan, then an appropriate bill of parliament will be ready one year later. However, the most urgent need will be to professionalize the MFIs so that they have appropriate governance structures and sound risk management policies and procedures, including effective management information systems and quality external audits. Since the industry is underdeveloped, self regulation is not an option. Therefore, it is necessary to build the RBM's capacity to be able to regulate and supervise the industry because of the unique nature of microfinance before developing the new regulatory framework bill. (AMAP 2004)

Evolution and Structure of the Financial System in Malawi

MALAWI INSTITUTED financial sector reforms in the late 1980s. The legal frameworks for the sector, the Reserve Bank of Malawi (RBM) and Banking Acts, were significantly reviewed and others, such as the Capital Market Development Act, were introduced to enhance the competition and deepening of the financial services and regulatory environment. (Mkulichi 2005) Prior to these reforms, two commercial banks dominated the market until 1991, when two leasing and corporate finance companies were licensed to engage in corporate banking. The Post Office Savings Bank was converted into the Malawi Savings Bank (MSB) in 1995 through an Act of parliament. The Capital Markets Development Act (1990) established a stock exchange and discount houses. New insurance companies and other commercial banks came on the scene, including Opportunity International Bank of Malawi (Opportunity Bank), which was established in 2002. Opportunity Bank is the only commercial bank focused on the provision of financial services to the previously un-banked and under banked people of Malawi. As a regulated provider, Opportunity Bank is subject to RBM prudential regulation.

The rest of the microfinance industry – classified as 'other financial institutions' by the RBM - is in its infancy stages and operates with limited outreach. The industry has 20 registered actors, although only six provide financial services as their core activity. (Mkulichi 2005) These non-banks, which include NGOs, parastatals, Savings and Credit Cooperatives (SACCOs), private companies, and projects of international development agencies and donors, are not subject to any kind of prudential regulation. Because legal regulations prevent most of these actors (with the exception of SACCOs) from mobilizing savings for on-lending

(intermediation), their focus is on providing credit. (AMAP 2004)

In a September 2003 Government of Malawi (GoM) Letter of Intent and Memorandum of Economic and Financial Policies to the IMF, the GoM underscored its intent, among other things, to liberalize the financial services sector and reduce the costs of financial intermediation by implementing a review of the financial sector regulatory framework (AMAP 2004). In that IMF Letter of Intent, the GoM makes microfinance a key element of its poverty alleviation strategy by stressing its intention to develop a regulatory framework for microfinance. In reality, the GoM Cabinet approved the Microfinance Policy and Action Plan in November 2002. The paper is the primary document that defines the broad framework for microfinance.

Microfinance Sector, Players and Registration Status

APPROXIMATELY 60.8% of Malawi's population of 10.7 million people is employed in agriculture. In the last three years, Malawi's economy has been characterized by high interest rates, declining inflation, flat to negative GDP growth, exchange rate volatility and increasing government debt (AMAP 2004). Consequently, the financial sector reforms of the 1990s aimed at deepening financial markets and improving financial intermediation have had little impact on the rural population, which is mostly engaged in agricultural activities (Nyirongo 1999). This also means that the demand for microfinance services has not been met by the existing major government owned players, such as the Malawi Rural Finance Company (MRFC) and Malawi Savings Bank (MSB), both of which have the largest network of offices. The success story of Opportunity Bank shows that there is untapped potential in the market. For example, within two years, Opportunity Bank now has 6,000 loan clients with an average repayment rate of 99%. The portfolio outstanding as at the time of writing was \$1.7m. The bank's clients have been introduced to electronic banking and other services such as money transfers.

MFIs include NGO micro-credit programs such as those run by World Vision International and Concern Universal; parastatals such as MSB and MRFC; Small Enterprise Development of Malawi (SEDOM), Development of Malawian Traders Trust (DEMATT); Savings and Credit Cooperatives (SACCOs) such as Malawi Union of Savings Cooperatives (MUSCCO); private sector microfinance companies such as Pride Malawi, INDEFUND and FINCA; projects of international development agencies and donors; and two commercial banks, NBS Bank and Opportunity Bank. NBS Bank was incorporated in 2004 when the only existing building society, the New Building Society, was restructured.

The parastatals usually have a specific Act to guide their activities, while the NGOs are registered under the Trustees

Incorporation Act. The companies are registered under the Companies Act, MUSCCO under the Cooperative Societies Act, and the commercial banks under both the Companies Act and the Banking Act.

Overview of Performance in Outreach

MALAWI is a pre-dominantly rural economy with more than 85% of the population living in rural areas conducting agricultural activities. Consequently, the market is driven by seasonal agricultural and related economic activities and is defined by the geographic spread of the population.

A Malawi National GEMINI MSE Baseline survey in 2000 established that 747,000 MSEs existed in Malawi at that time and these employed 38% of the labor force. Of the total, women accounted for 42% of the MSE sector. In addition, 65% of the population lives below the poverty line and 17% of MSEs are based in urban areas. The rest (83%) are in rural areas (AMAP 2004).

However, a 1993 GEMINI Report showed that only 1.2% of MSEs had received credit from formal financial institutions by 1992. (Nyirongo 1999; GoM 2002) This low outreach is because MSEs are believed to be high-risk clients and the cost of reaching them with credit and saving services is said to be very high. The GoM directly intervened in the sector through such initiatives as the Small Medium Enterprises Fund (SMEF), One Village One Product (OVOP) and recently, the Malawi Rural Development Enterprise Fund (MARDEF) to improve the country's financial intermediation and reduce the level of poverty in the population. However, previous initiatives had low loan repayment levels as the loans seemed to be driven by political gains to the ruling elite.

MRFC and MSB hold more than 80% of the microfinance market. MRFC satisfies 50% of micro credit demand through the provision of agriculture loans. However, analysis of the MRFC data suggests that historically speaking, losses on agricultural loans are close to 50%, and 47% of all loans issued were later written off. (AMAP 2004) This poor loan portfolio quality suggests that the credit culture in Malawi presents numerous challenges.

Opportunity Bank, though new in the market (2.5 years old at the time of writing), has 40,000 savings clients. According to its in-house survey, 72% of its clients are self employed and 61% of its clients have borrowed from the bank. Its loan portfolio at the time of writing was MWK212million (US\$1.7m) with a consistent portfolio at risk of around 3%. These clients have basically come from one district of about 1.3 million people in the Central region where 63% of its population is living below the poverty line, (AMAP 2004, p29). This success shows that more people can be

reached profitably with sound risk management policies and procedures.

The other major microfinance players have a well developed outreach network, but are highly dependent on government subsidies. Opportunity Bank does not have an extensive network but appears to have higher financial and operational sustainability levels. Overall, Malawian MFIs have weak capacity and are unable to cover costs, which is a major constraint to scaling up the sector. The prevailing market demand will not be satisfied in the medium term.

The Regulatory Landscape in Malawi

THE MICROFINANCE SECTOR is currently regulated by an array of legislative instruments under which the players are registered as noted above. Most of these instruments are difficult to administer since they are outside the jurisdiction of the Reserve Bank Malawi, which is the formal financial services regulatory authority.

The GoM Cabinet Approved Microfinance Policy and Action Plan (2002) endorsed the formation of the Malawi Microfinance Network which is tasked with disseminating industry best practices and, when sufficient capacity levels are reached, to regulate the industry.

MFIs operate under several legal forms and ownership structures. Several sponsoring agencies can facilitate entry into the microfinance market, such as the Ministries of Women, Youth and Gender, Industry and Commerce and Agriculture and the umbrella body of NGOs called CONGOMA. This body is backed by an Act of Parliament (passed in 2003) which requires that all NGOs be registered with the government based NGO Board, even though they have already been registered under the Trustees Incorporation Act. This NGO Board is given powers to issue directives on the structure and composition of NGO governance structures. (AMAP 2004) It is hoped that this will protect the general public from illegally incorporated NGO activities.

The legal requirements for commercial banks, as discussed in the Banking Act (1989) and RBM directives, are quite rigorous. The RBM is supposed to process new applications within three months, which was achieved when Opportunity Bank registered. The minimum capital requirement is US\$1.5million, which can be lowered if the exemption is required 'in the public interest or in special circumstances'. The commercial banks that have checking operations are required to keep a liquidity reserve requirement ratio of 27.5% of deposit balances. Banks in Malawi should maintain core capital of 4% and 8% of the risk weighted assets of their total capital (depending on the accounting basis for fixed assets). New conservative directives have been issued on provisioning and write offs. These directives are in line with

best practice asset quality standards for microfinance. For example, banks should account for all loans outstanding for more than 90 days on a non-accrual basis. In addition, most SME lending requires some form of collateral just as is done for other commercial lending. Only licensed commercial banks are allowed to mobilize and intermediate savings deposits. However, MRFC and MUSCCO are allowed to collect savings. The directive on credit concentration limits lending to an individual customer to 25% of the capital base, which is unlikely to present an issue for MFI lending. These provisions are not prohibitive for new entrants in the mainstream banking arena.

The Companies Act (1984) does not have serious ownership restrictions for foreign investors. In fact, the Malawi Investment Promotion Agency promotes foreign investment into Malawi. Usually special tax concessions are given to new companies.

Therefore, it can be concluded that there are no serious legislative issues to impede entry of more players into Malawi's microfinance sector. The existing regulatory framework for the regulated commercial banks is based on Basel accords and is thus similar to many countries.

However, the experience of Opportunity Bank reveals the need to update or remove certain provisions in specific laws which impede the activities of microfinance. Most loans for SMEs are secured using chattels though interests in real estate, shares, movable assets and livestock cannot be used as security under the Bills of Sale Act. This Act has a provision which gives a defaulting debtor five additional days before collateralized chattels are removed to be sold to settle a bad loan. The debtors can use this period to delay the enforcement of the security by obtaining a court injunction. Opportunity Bank has failed to lend to some rural based MSEs who offered their land as security because land in such areas is untitled and thus cannot be used as security for a loan. The bank has experienced significant delays in perfecting mortgages as security for certain loans since such loans require the consent of the Minister of Lands under the Land Registration Act. Further, though not seriously pursued by the authorities, the Business Licensing Act prohibits the activities of hawkers and peddlers, the main clients of MFIs. Nonetheless, to a large extent, secured transactions can be supported by the existing legal framework.

The GoM should consider ceasing its intervention in microfinance that provides micro credit at heavily subsidized rates. Under the poverty alleviation program of 1994, emphasis was placed on the distribution of credit to the poor using institutions that had no experience in channeling financial resources, such as DEMATT, at a rate below what prevailed in the market. Further, the stated objectives of these funds were not achieved due to the supply driven approach that was taken. Consequently, MWK 200million (US\$1.6m) was lost in the process. (Nyirongo 1999) In 2005, GoM created a similar initiative through the scheme; it is expected that the MWK1 billion (US\$ 80m) that has been invested will be lost for similar

reasons. These initiatives destroy the microfinance market, which should be driven by market forces. Typically loan proceeds from these government initiatives are used for consumption of other products and services as opposed to the growing or starting of a business. This destroys the loan repayment culture in Malawi as loan recovery procedures are not seriously enforced.

The Future

THE GOM MICROFINANCE POLICY and Action Plan (2002) notes that microfinance is the way forward to increase access to credit and savings by the poor. For this reason, an environment to facilitate and encourage the adoption of universally acknowledged best practices by the sector should be created. Such a regulatory framework will ensure that MFIs are operationally and financially sustainable for the long term benefit of clients. Supervision will enforce compliance with a given legal and regulatory framework. Therefore, the cabinet paper authorized the setting up of a national task force headed by the RBM with Ministries of Finance, Agriculture and Industry and Trade, Malawi Microfinance Network and other donors such as USAID Deepening Microfinance Sector (DMS) as stakeholders to implement the action plan.

The task force has chosen a consultant to review the existing regulatory framework and determine how best to align this framework with microfinance activities. However, according to AMAP (2004), the most urgent need will be to professionalize the MFIs so that they have appropriate governance structures and sound risk management procedures, including effective management information systems and quality external audits. Since the industry is underdeveloped, self-regulation is not an option. Therefore, it is necessary to build the RBM's capacity to be able to regulate and supervise the industry because of the unique nature of microfinance before developing the new regulatory framework.

The inclusion of the Malawi Microfinance Network in the task force suggests that its fourteen members would like to be regulated. The network was established to lobby government on microfinance issues, identify resources for capacity building, disseminate information to its members, act as a mouth piece for the industry, promote best practices amongst the players and represent the stakeholders in policy development. However, membership is not compulsory and other commentators have said it does not have the capacity to do the above mentioned things. Furthermore, five of its members, the biggest microfinance players, are parastatals, creating considerable opportunity for the introduction of politicized, market distorting policies and practices promulgated through the sector through the network. (AMAP 2004) For, instance, one member agreed to lend government money at below market rates in direct contradiction with the Network's Code of Conduct. No action was taken against this member.

These challenges mean that self-regulation, which is generally less expensive than government regulation, is not an option for the time being. Self-regulation requires the existence of good governance and risk management systems in the industry which do not yet exist. Nonetheless, the Network can be used to spread awareness of key features of microfinance, help integrate MFIs into mainstream banking, and help disseminate microfinance 'best practices.' (AMAP (2004)

Another challenge in the development of the regulatory framework is the apparent conflict of interest by government as noted above. Its loans are heavily politicized and subsidized. These are the very things that destroy competition which is necessary for the growth of any industry. Besides this, the macroeconomic and political environments are not stable enough at the moment to ensure the development of a supportive infrastructure to deepen rural outreach, as communication infrastructure and personal identification systems remain underdeveloped.

Although donors such as USAID have done their part in supporting the task force, the political will seems to be lacking. The policy paper was approved in 2002, yet nothing tangible was done until quite recently when bids to appoint a consultant to review the legal and regulatory framework in the country were opened and approved. The RBM was co-opted into the process in 2004 despite its nominal heading of the task force. The government is waiting for the financier, African Development Bank, to approve funding of the consultancy. According to the Assistant Director of Enterprises in the Ministry of Trade and Private Sector Development, if they do that before December 2005, then a draft framework will be available by June 2006. It might take as many as five years before a bill is discussed by various stakeholders and passed by parliament as law. Further, he notes that the Policy Paper (2002) is being revised to fill in existing gaps. For instance, the policy paper is silent on what are best practices, has not defined the roles of stakeholders on capacity building issues, and does not address issues contained in the anti-money laundering bill. These gaps will further delay the implementation of the regulatory framework.

Opportunity Bank is the only well funded player in the microfinance sector that is also fully regulated as a commercial bank. This means that the bank will be able to access cheap deposits and intermediate these deposits using sound risk management policies and procedures. The Banking Law does not allow any organization that is not registered under it to mobilize deposits and intermediate them - although Savings and Cooperative Societies can mobilize savings from their members only. This restricts the other MFIs that are registered under the other legal statutes from competing with Opportunity Bank in mobilizing savings. Therefore, Opportunity Bank is the only bank that is collecting micro savings in the country in a substantial way. Because it provides a full range of services to its clients, it could be considered the best microfinance service provider in Malawi. The bank plans to expand its outreach to the rural

communities through cheaper means such as the use of point of sale devices. The other MFIs can not copy this innovation due to the funding constraints posed by their regulatory status. If the other old and well established banks do not move into microfinance, Opportunity Bank is bound to dominate the market in five years time.

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