Microfinance Regulation and Social Protection [1]

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Abstract

Arguably, microfinance provides social protection for the vulnerable by enabling them to access finance, create assets and avoid backsliding into poverty traps. This paper aims to survey the *status quo* of regulation of microfinance services in Africa and map out patterns of microfinance regulation. The paper explores the relationship between regulation and outreach in microfinance provision in Africa, with the implication that outreach enhances the provision of financial and social protection for the poor. The performance of MFIs depends largely on MFI regulation, which eventually affects social protection in several ways mainly through effectiveness and outreach. We conclude by pointing out the need for closer engagement between government and microfinance institutions in developing required regulatory legislation in Africa.

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1. Introduction

In recent times, there is an enhanced recognition of the contributions by a broad based financial system in developing an effective social protection strategy. The UN approach extends the role of social protection to securing basic needs as a precondition for human and social development (United Nations, 2000). As a public good, access to financial services enable people to participate in the benefits of a market-based economy analogous to access to safe water, basic health services and primary education (Peachey and Roe, 2004). Access to financial services forms a fundamental basis for the sustainability of many of the essential interventions and is a critical contextual factor with strong impact on the achievement of the Millennium Development Goals (Littlefield, Hashemi and Morduch, 2003). However, in many countries, access to financial service is limited to a small section of the population.

The current thinking among development stakeholders, including governments and non-governments is that microfinance offers significant opportunities for a broad based financial system, poverty reduction and economic regeneration and development strategies (see, for example, Yunus, 2003; Banerjee and Duflo, 2007; Arun and Hulme, 2008; Ahlin and Jiang, 2008; Imai et.al, 2010). Over the years, the microfinance industry has introduced a range of product lines in loans, savings and insurance to low income groups in developing countries. The development of the microfinance sector is an answer to the notion on financial services as not an option for low-income groups due to the notion that the poor were not able to afford the associated costs.

There are different kinds of microfinance programmes that provide opportunities to mitigate risk through *ex ante* (based on diverse economic activities and conservative production and/or employment opportunities) and *ex post* strategies (for example, consumption smoothing by borrowing, depleting and accumulating non-financial assets), hence providing social protection measures to deal with vulnerability. In many ways, the microfinance sector provides social protection for the vulnerable by enabling them to access finance, create assets and prevent people from sliding back into poverty traps. However, the need to identify the extent of trade-off between dual objectives and the multiplicity of

pathways imperatively calls for systems of checks and balances for the operations of MFIs[2] (Arun and Annim, 2010), an indication to the need for regulation in the sector.

The regulatory concerns in the microfinance sector lie in the special nature of these institutions, mainly to address the needs of those who are not in the formal financial sector. Most of the microfinance clients are subjected to high levels of uncertainties in the sector such as innovative procedures and high operating costs (Arun, 2005). The arguments for regulation in microfinance is primarily about ensuring systemic ability and protecting depositors[3]. The enhanced private investment in the sector has some benefits to the sector, but this also raises more challenges on the regulatory practices in microfinance. In the context of recent financial crisis, many of respondents to the CGAP survey (2009) indicates that the the liquidity drought is hurting, with smaller institutions suffering more acutely than their larger counterparts do. The financial failures in the sector could lead to a serious impact on the financial system through affecting the other financial institutions (who lends money to microfinance institutions) and the public confidence (ibid, 350), and affecting the social protection fabric it self.

The section on introduction sets the context for the paper. Section 2 of the paper assesses the current state of the microfinance industry on a global level and in Africa specifically. Further, we dwell on the perspective of regulation of microfinance institutions (MFIs) globally and in Africa. Following this, the paper deals with understanding the rationale behind regulation, the key types of regulation and the circumstances in which regulation are implemented. Here we take a critical view of the relationship between microfinance regulation indicators and social protection. Specifically, we conceptualise social protection using the Social Protection Index (SPI). We analyse a sample of data of microfinance institutions (MFIs) from 10 African countries and establish that MFI regulation directs the performance of MFIs and in turn affects the social protection. This investigation explores the relationship between regulation and outreach in microfinance provision in Africa, with the

[2] The discourse on poverty lending vis-à-vis financial system approaches to microfinance moved to a consensus in the late 1990s towards financial sustainability arguments. However, the heterogeneity of MFIs indicates that the future of microfinance is unlikely to follow a single path (Cull et al; 2009).

[3] The need for regulation of economic activities is justified in the economic literature as a policy instrument to minimize the effects of market failures, and the issue has gained substantial attention in the course of reform measures in developing countries (Armstrong, Cowan and Vickers, 1994; Majone 1996)

implication that outreach enhances the provision of financial and social protection for the poor.

We conclude by pointing out some emerging concerns between regulation and outreach in microfinance services in Africa. We also use the evidence to propose some prototype regulatory framework for a kind of microfinance service industry that can substitute for social protection and therefore serve as much more effective strategy for reducing poverty.

2. Microfinance and its role in Africa

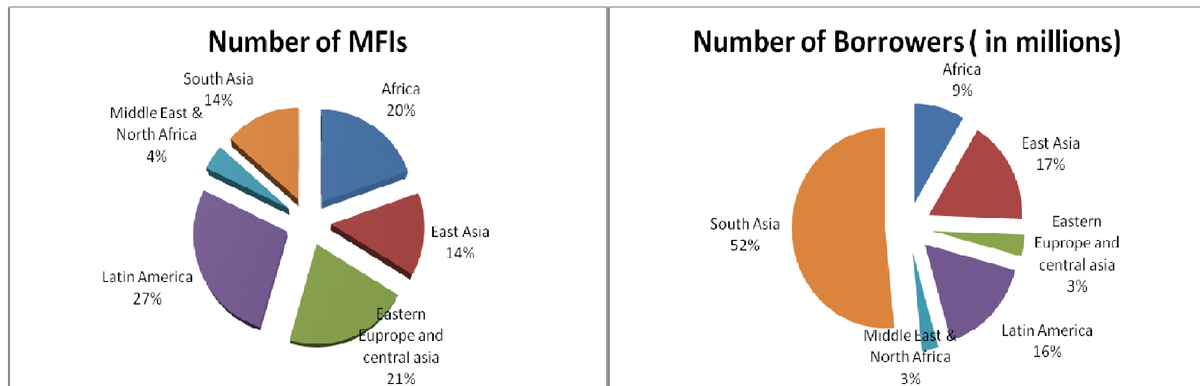
Traditionally, a large percentage of people have been ignored by the banking sector and are deprived of organised services such as loans, insurance, remittance and saving instruments. Based on the access to finance composite index developed by Honohan (2007), SSA has the lowest proportion (on the average, just about a fifth of the population have access to finance). It is then apparent that, one of the recent UN report argues that the overarching goal of financial inclusion requires the availability of a range of financial institutions offering a range of products and services at reasonable costs supported by legal and regulatory infrastructure (UNCDF, 2006). In most scenarios, the poor are not seen to be 'bankable' by the formal financial sector and are uninsurable to the wide variety of risks they face (Morduch 1999; Dercon 2002). People living in poverty, like everyone else, need a diverse range of financial services to run their businesses, build assets, smooth consumption, and manage risks[4].

Microfinance offers a mechanism by which, organisations such as banks, non-governmental organisations (NGOs), non-bank financial institutions (NBFIs) and governments offer financial services (loans, savings, money transfer services and micro insurance) to the poor. In Africa, during the past two decades microfinance schemes emerged as an alternative to ensuring access to financial services for small borrowers (Aryeetey, 2008). Due to the limited success achieved by top-down policies and programmes as well as the non-sustainability of previous government-backed credit programmes specially designed for the

[4] CGAP- http://www.cgap.org/p/site/c/template.rc/1.11.947/

poor (Steel and Andah, 2003), many countries in Africa have followed the microfinance pathway.

Figure 1: Number of MFIs and number of borrowers – Africa in a global context



Source: MixMarket - http://www.themix.org/sites/default/files/Microfinance%20at%20a%20Glance%202009-12-31.pdf

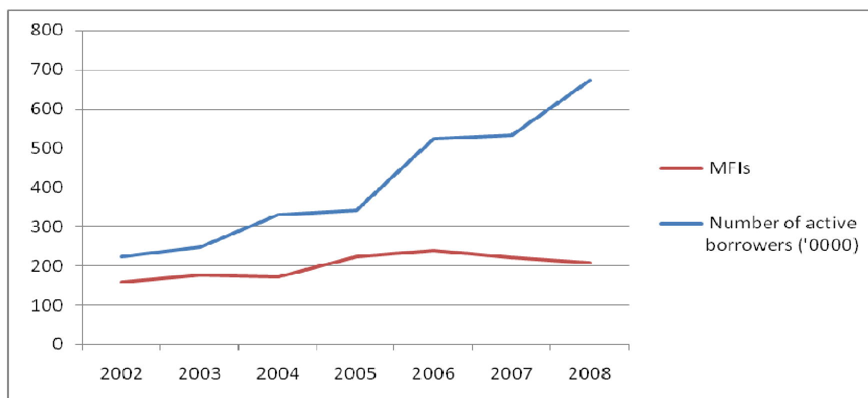
The African region is home to around 800 million people and almost half of the region is rural with agriculture as the biggest occupation. The region lacks basic infrastructure such as roads, electricity and communication aids. The region has been steadily improving its economic state with the GDP rising from 3.2% in 2002 to projected 6.7% in 2007.[5] The microfinance sector represents a diverse picture in Africa – Credit Unions, Credit only institutions and donor projects with a microfinance component. However, the "parallel model" approaches commonly used in African countries "integrates disadvantaged clients into the formal financial system through building up self reliant groups that can reduce cost and risks to banks in dealing with small savers and borrowers" (Bennet, 1998, p.109).

As shown in Figure 1 below, Latin America leads the microfinance sector with maximum number of MFIs (384) while Africa ranks third with 275. In terms of number of borrowers (which is an indication of the outreach of the MFIs) South Asia leads the charts with more than half the number of borrowers worldwide. Africa (9%) lags behind other regions, such as East Asia (17%) and Latin America (16%). However, since 2002 there has been a steady

[5] Regional Economic Outlook : Sub-Saharan Africa -- [Washington, D.C.] : International Monetary Fund, 2007.

improvement in the African MFI sector. Figure 2 indicates that the rate of increase in the number of MFIs is much lower than the rate of increase in the number of active borrowers, may clearly indicates better performance and efficiency of the MFIs.

Figure 2: Recent growth of MFI sector in Africa



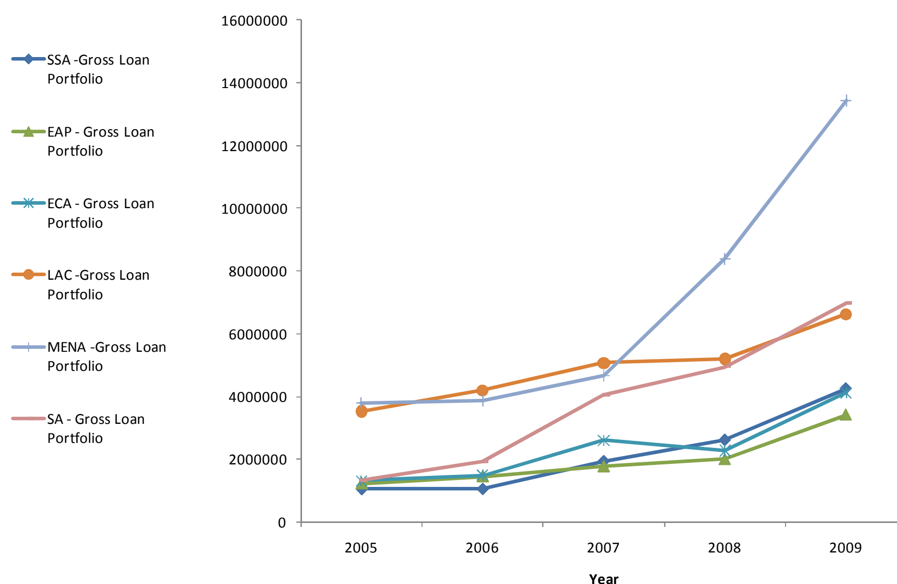
Source: http://www.mixmarket.org/mfi/region/Africa/2009/

In spite of growing number of MFIs and active borrowers, there is a genuine concern of whether the region has achieved its full potential? As of date, the microfinance industry in Africa contributes to merely 9% of global MF borrowers[6]. Again, relatively few MFIs have managed to reach a higher scale of more than 25,000 clients in Africa and provision mainly focuses on the cities, towns and major rural trading centres (Arun and Hulme, 2008). Only 71 MFIs out of 439 who reported their performance to CGAP have more than 25000 borrowers.

Since 2005, the size of MFIs (measured by the gross loan portfolio) in SSA show an increasing trend and inched pass EAP in 2007 and ECA in 2008 (Figure 3 below). This indicates increasing outstanding loans in the hands of microfinance clients.

[6] MixMarket data

Figure 3: Regional Trend of Gross Loan Portfolio



In addition to the above concern, it is important to verify the sustainability of MFIs in the region. The situation currently seem gloomy as benchmark indicators[7] reveal that SSA is the only region that has constantly failed to show a financial self sufficiency index of more than 100 percent. This presents a challenge for the protection of poor households and therefore exploring the idea of regulation is right. Table 1 lists the top 16 out of 439 MIFs in Africa who contribute to more than half (54%) of number of total MFI borrowers in Africa.

One of the main reasons for slow growth of the sector is due to some of the unfortunate experiences of microfinance in some countries where other agents, especially *ponzi* game actors (people such as Gideon Mwiti Irea linked to the collapsed Kenya Akiba Micro-Finance, offered a monthly interest rate of 16 per cent), have undermined the microfinance revolution[8]. In Nigeria, the Microfinance banks started to compete with formal institutions and detached solely from the core constituency that led to liquidity challenges and other management capacity concerns. Also, in South Africa the controversy that emerged on 'go-banking' contractual relationship between NEDBANK and pick 'n' pay created doubts on the reliability of the new financial schemes that genuinely aim at expanding access to finance.

[7] Generated from the MixMarket (www.mixmarket.org/mfi/benchmarks)

[8] However, Kenya has introduced tighter legislations in the sector and became an example of how to develop a regulatory framework with productive engagement with major players.

Most of these concerns are due to the lack of inadequate regulatory practices in the sector. The industry is largely either unregulated or self-regulated through social capital contracts. In many countries, the governments had followed a laissez-faire approach in regulating microfinance institutions (Arun, 2005). However, recently the issues of regulatory concerns of microfinance sector attract larger than usual interest from the policy makers and many countries, particularly in Africa.

Table 1: Total number of borrowers in selected MFIs in Africa, 2009

MFIs in Africa with number of borrowers	
MFI Name	**Total number of borrowers**
ACSI	710576
Capitec Bank	638616
Equity Bank	542249
Al Amana	472339
DECSI	464622
OCSSCO	364584
Zakoura	326766
ASBA	219662
KWFT	208010
LAPO-NGR	200115
FBPMC	177869
Lead Foundation	156833
FONDEP	138514
ADCSI	112259
PRIDE - TZA	106082
ABA	100807
Total	4939903
Total for Africa	9160535
% share	54

Source: Mixmarket

A regulated microfinance sector provides an enabling environment for enhancing financial outreach (attracting extreme poor by reflecting upon demand-supply mismatch among the products etc, see Arun et.al, 2005) and the growth of microfinance institutions, which in turn supports broader social protection agenda. Perhaps, the regulatory requirements may bring forth a better understanding of the financial service preferences and behaviours of the poor and poorest which is still needed to expand the scope of microfinance services

particularly in addressing concerns about welfare implications of MFIs (Rutherford, 1999; Morduch, 1999). Moreover, MFIs are significantly different in their risk profiles such as risks on credit, interest, liquidity which provide a further argument for regulation and rapid integration with practices such as prudential regulation (Arun, 2005, p.351)

Table 2: Indicators of MFIs in Africa in a global context (2008)

	Africa (Sub-Saharan)	East Asia and Pacific	Eastern Europe and Central Asia	Latin America	Middle East & North Africa	South Asia	Total
Number of MFIs	275	194	292	384	60	190	1395
Number of Borrowers (in millions)	7.5	14.6	3	14.1	2.5	44.4	86.1
Number of voluntary Savers (in millions)	18	25.7	5.2	14.4	0.1	32.4	95.8
Gross loan portfolio (USD million)	3335	8185	10065	16739	1178	4697	44199
Voluntary Savings (USD million)	1890	6457	899	6674	0	203	16124

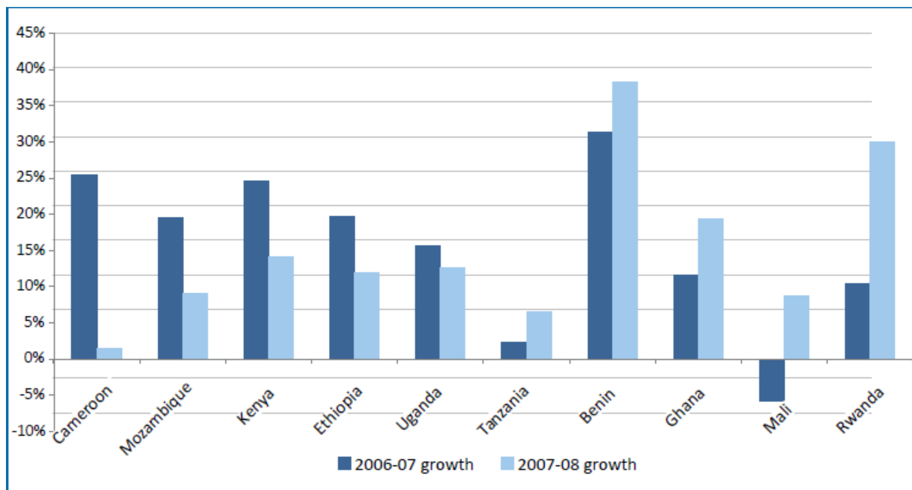
Source: Mixmarket

Perhaps, it does matter which type of MFI, given that MFIs may differ, depending on their legal or management structures; for example, government owned MFIs such as the rural credit society in China, the member owned credit society in West Africa, NGOs worldwide and commercial banks. The services offered by MFIs depend on the legal structure of the institutions; for example, the services may include secure savings; loans for various reasons such as starting a business, emergencies, education of children, housing; insurance; remittances and money transfers; and others.

Table 2 shows the comparison of SSA’s share in the world MFI industry. In line with the current financial crisis and its expected impact on the MFI sector, the growth in the number of borrowers fell from 22% in 2007 to 20% in 2008. This had a massive impact on the gross loan portfolio. It shrunk to less than half from US$45.4 billion to US$20.1 billion.

As shown in Figure 4 , although the MFI is growing in terms of its outreach in the SSA region, the range of outreach to borrowers in various countries is quite large with highest being 28.4% of all borrowers in SSA being from Ethiopia, while only 2.6% of all SSA borrowers come from Cameroon.

Figure 4: Growth in MFI activity in selected African countries



Source: MIX Market, 2006-2008. Results based on medians.

In spite of overall SSA region showing a dip in the borrowers in 2007-08 over 2006-07, countries like Tanzania, Ghana, and Rwanda showed a higher growth. The most conspicuous of the countries registering growth is Mali, who recovered from a negative growth of around -7% to almost 7%[9]. As expected, the MF market structure in the region varies with macroeconomic imbalances and other structural factors.

[9] MIXMarket reports 2008

Table 3: Top 10 countries in Africa by borrowers

Top Ten Countries By Borrowers			
Number	Country	Borrowers	% of African region Borrowers
1	Ethiopia	1,840,788	28.4
2	Kenya	1,093,515	16.9
3	South Africa	722,559	11.9
4	Ghana	354,293	5.5
5	Nigeria	348,750	5.4
6	Tanzania	270,069	4.2
7	Uganda	262,106	4
8	Mali	218,291	3.4
9	Senegal	217,891	3.4
10	Cameroon	165,470	2.6

Source: MIX Market 2008, results are totals

Table 3 gives a snapshot of the top countries in SSA in terms of their outreach (borrowers). The absence of retail MFI capacity is the most dominant constraint in expanding outreach of financial services in Africa (ADB, 2006). According to this study, the possible constraints in expanding outreach are: (1) extending access to rural areas in a cost effective way (2) impression that MF is a social system of resource transfers rather than a part of the financial sector (3) lack of institutional infrastructure (4) unfavourable policy environment for sustainable growth of MFIs and (5) inability to raise finance from formal sources. Broadly, these factors indicate lack of coordinated efforts between government and microfinance institutions, and appropriate legislations in the African microfinance sector.

3. Regulating MFIs in Africa

In general, regulation of banking and other financial services in Africa is problematic. African countries have been in a transition process from Basel I to Basel II, but now in the post-crisis era, Africa is at a crossroads (see Murinde, 2010). More so, regulating the microfinance industry remains a challenge for many countries (see Arun, 2005). Recently, WSBI (2008)

argues in a position paper that any type of regulatory practices in the microfinance sector needs to support the enlargement of access to finance, to guarantee a level playing field between all microfinance providers and to protect customers. The challenge although lies not in the regulation, but in the need to differentiate the MFIs from formal sector banks. The aim of regulating microfinance is two fold (Arun 2005): To secure the interest of the vulnerable and uneducated consumers; and to ensure smooth operations of the industry and thus safeguarding the financial system as a whole. The regulation provides a secure climate to the consumers. But there is also a danger of hampering the growth of microfinance; for example, if there is a cap on the interest rates charged by the MFIs, the consumer is protected from unwarranted high rate. This also makes the operations of the MFI, impractical due to low income and high costs of operating under the interest rate cap. This may have an adverse effect on the MFI and would certainly stop growth.

For this matter, it is useful to distinguish between prudential and non-prudential regulation of the MFI industry. The former is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions[10]. But, prudential regulation is much complex and fairly expensive to implement. It usually requires the governments to supervise and ensure the solvency of the MFIs. This type of regulation includes capital adequacy or liquidity of the MFI thus ensuring the interest of the consumers and the banking system as a whole, should the MFI turn insolvent. MFIs who accept deposits from the consumers are governed by prudential regulation, while non-deposit seeking MFIs do not need to be. Since MFIs involved in lending-only activities do not pose any danger in case they are insolvent, they are not subject to prudential regulation and for such types of MFIs, there is a much simpler and less complex set of regulations termed as non-prudential regulation. In general, non-prudential regulation refers to a set of regulations, which do not deal with the depositors' safety, and the well-being of the financial system as a whole. The regulations are much simpler and do not need to be implemented by specialised financial authority / Governments. These regulations are often

[10] See the guiding principles on regulation and supervision of microfinance by Christen, Lyman and Rosenberg (2003).

self-executed and include instances of declaring the people who are in control of the MFI and clearly disclosing the rates charged and the terms and conditions.

This demarcation of prudential and non-prudential regulation helps make the process of “regulation” much simpler and manageable. There is no point in exposing non-deposit seeking MFIs to prudential regulations since these institutions do not pose any threat to the financial system. However, the non-prudential regulations will not do any good to the consumers when they invest with a MFI prone to insolvency. Thus understanding the nature of the MFI and exposing it to the proper regulation saves a lot of time, money and government interference.

There could be an argument that exempting lending MFI from prudential regulation could be disastrous since almost all the lending by these institutions is sub-prime lending. In the recent context of the sub prime lending crisis, it may be argued that even the lending only MFIs should be protected by prudential regulations. This argument can be countered by the fact that although all the lending by the MFIs is subprime due to the nature of its intended clientele, the entire lending portfolio of MFIs is a very small part (in value) of the total lending including that by the commercial banks. Hence, there is no real danger to the economy even if certain MFIs run in trouble. On the contrary, by not subjecting MFIs to prudential regulation, lot of money and scarce resources such as time of competent financial authority and the Government are saved. In addition, this reduces the entry barrier for the potential MFI entrants in the market, thus promoting the microfinance sector.

Table 4: Regulatory framework of MFIs in SSA

Type of Legislation	Countries (names in bold indicate a change occurred between 2007 and 2008)	
Specialized Microfinance Laws (29)	**Burundi** CEMAC Countries (6)[7] Comoros DRC **Djibouti** Ethiopia The Gambia Guinea	Kenya Madagascar Mauritania **Mozambique** **Rwanda** **Sudan** Uganda **WAEMU Countries (8)** Zambia
Drafting Specialized Microfinance Laws (5)	**Cape Verde** **Liberia** **Malawi**	**Sierra Leone** **Zimbabwe**
MFIs implicitly or explicitly fall under the broader banking or non banking financial institutions legislation (15)	Angola Botswana Ghana Lesotho Liberia Malawi Mauritius	Namibia Nigeria Sao Tome Sierra Leone Somalia South Africa Tanzania Zimbabwe
No Legislation/No Framework (3)	Eritrea Seychelles	Swaziland

Source: 2009 Overview of Microfinance-Related Legal and Policy Reform in Sub-Saharan Africa, CGAP

Akin to many developing countries, SSA also regards regulating of MFIs as a serious task (see Christen, Lyman, Rosenberg, 2003). The policies on regulations are distinctly moving towards higher transparency, more standards that are rigorous and adoption of a new law regulating MFIs in West Africa Economic and Monetary Union (WAEMU)11. Except for three, all the countries in SSA have specific microfinance laws that cover the MFIs and financial cooperatives but not the commercialised banks. Only Eritrea, Swaziland and Seychelles do not have any legislation to cover microfinance. Table 4 highlights the current state of the regulatory framework of MFIs in the SSA countries.

In Africa, there are a large number of MFIs operate without any kind of formal registrations and some are in the expansion phases with specific licensing rules. Because of the large variety in the type of institutions, it has been suggested that institutions be fitted into a tiered structure that provides opportunities and incentives for MFIs to graduate between tiers and creates appropriate regulatory requirements for different type of institutions (Meagher, 2002). This approach has benefited the development of sustainable microfinance in some countries - For instance, *Susus* of Ghana and SACCOs in East Africa belongs to both these categories according to their size of operations by clearly identifying pathways for

[11] http://www.themix.org/sites/default/files/2009%20Africa%20Microfinance%20Analysis%20&%20Benchmarking%20Report.pdf

MFIs to become legitimate institutions and gain access to financial services from commercial markets.

Table 5: Emerging Regulatory frameworks in Africa

Regulatory Frameworks	Countries	
E-Money Guidelines/ Laws (25)	Botswana CEMAC Countries (6) DRC Ghana Mauritania Namibia	Nigeria Rwanda South Africa Tanzania Uganda WAEMU Countries (8) Zimbabwe
M-Banking Guidelines/ Laws (7)	Botswana Ghana Nigeria South Africa	Tanzania Uganda Zimbabwe
Use of Agents Guide-lines/Law (18)	CEMAC Countries (6) DRC Ghana	Kenya South Africa WAEMU Countries (8)

Source: 2009 Overview of Microfinance-Related Legal and Policy Reform in Sub-Saharan Africa, CGAP

The technological advances have brought in new challenges for the regulations to be as up to date as ever. With the emergence of branchless banking, real time gross settlements and mobile banking, just like the commercial banks, the MFIs too need to have regulations in place. The authorities in SSA are gearing up to embrace these technological changes and have specific laws and regulations to tackle potential threats posed by these new channels, which are summarised in Table 5. In the context of recent financial crisis, regulators have identified the need for institutional strength of MFIs and their ability to get through the crisis.

Table 6 – Risks in the Sector – Perspective from Regulators

Biggest Risks	**Fastest Risers**
Transparency	Too little funding
Credit Risk	Competition
Corporate Governance	Corporate Governance
Management Quality	Credit Risk
Depositor Confidence	Political Interference
Reputation	Macroeconomic Trends
Competition	Refinancing
Liquidity	Depositor Confidence
Managing Technology	Fraud
Political Interference	Interest rate

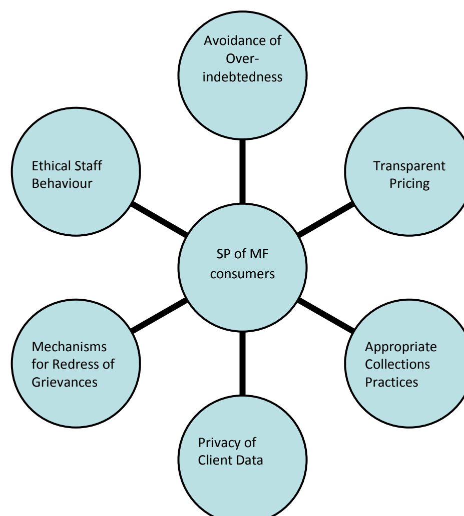
Source: Microfinance Banana Skin 2009

The nature of these concerns highlights the need for specific regulations in the sector and more closer involvement between government and industry in developing regulations. The lack of specific MF regulations affect the viability of the business model, undermines depositor and investor confidence, and expose MFIs to political interference (Microfinance Banana Skins 2009). Dieudonné Gnanvo, Director of RENACA, the Benin savings bank network, said that “new West African regulations do not conform to the realities on the ground, and could introduce new constraints on the development of the sector” (ibid).

4. Microfinance regulation and social protection

The social protection trajectory of Sub-Saharan Africa is heavily dependent on donor design and financing in comparison to other regions in the World (Barrientos and Hulme, 2008). The social protection institutions are deeply embedded, informal systems of social protection, especially in rural areas (ibid, p.319). Broadly, microfinance regulations seems to be a public intervention measure to assist and protect individuals to better manage risks and deposits, and supports the arguments on access to finance and development. The microfinance regulations seem to follow the social risk management framework that adds on the issues of macroeconomic stability and financial market development in addition to the social protection measures (Holzmann and Jørgensen, 2000).

Figure 5: The social protection of microfinance consumers



Source: Adapted from Forster, Lahaye, and McKee (2009)

Social Protection (SP) serves dual purpose - One is of assisting the poor to survive in adverse conditions and the other that of promoting a better lifestyle for these consumers. The SP policies vary from region to region and are depends on a range of factors such as the culture and needs of the local residents. These policies need to consider the short term and long-term impact of SP policies on targeted/general customers/programmes.[12] According to a consultative guide (Forster, Lahaye, and McKee, 2009) there are six principles that drive the SP of microfinance consumers, which are summarised in Figure 5. We discuss each principle below.

(1) Avoidance of over-indebtedness

There could be two perspectives on this issue. On one side, the low-income borrowers will take on more credit and finally end up being over-indebted and unable to repay. On the other hand, due to competition in the market, the lenders may seek to heighten the risk[13] at the cost of providing more credit than the borrowers' ability to repay. The recent Microfinance Banana Skins (2009) has identified Credit risk as the biggest risk facing by MFIs globally. The African response precedes credit risk with institutional issues such as weakness in management, staffing and governance. However, the over-indebtedness of clients continues to be a major problem in the microfinance sector. According to Peter Wall, executive director of the Microfinance Information eXchange (MIX), which compiles data about the global MF industry, credit risk is rising "across the chain, from micro-borrower through MFI and even among MFI lenders. The chain is increasingly being broken at different points" (ibid).

(2) Transparent pricing

Transparent pricing becomes a moral (and legal in many cases) responsibility of the MFIs to disclose the rates and all the costs explicitly since Microfinance is devised to protect poor and vulnerable[14]. Until now, the consumer protection awareness in Africa is in its infancy,

[12] Dag Ehrenpreis, UNDP 2006

[13] http://www.cgap.org/gm/document-1.9.35203/Microfinance%20Banana%20Skins%202009.pdf

[14] Protecting Low-Income Consumers: An interview with CGAP microfinance expert Kate McKee, July 15, 2008

but is growing[15]. Ensuring transparency and fair treatment of clients is the key for good lending practices. This is even more important in the context of new services that uses extensive technology applications. Transparency practices improve the funding scenario as well. An Italian microfinance investor said: “The limited availability of funding will trigger a greater effort towards transparency, information sharing and clear governance” (ibid).

(3) Appropriate collaborative practices

The guide proposes diligence and a risk based approach in the debt collection practices. Bank Negara Malaysia uses such approach complimented by financial education and market intelligence to highlight products and practices posing undue risk to consumers, such as aggressive credit-card marketing or outsourcing debt collection[16].

Civil group may play a significant part in such financial protection. Consumer Association of Penang (CAP) handles complaints from the public on a wide variety of issues. CAP’s legal section provides legal advice to customers, handles public-interest cases, and represents communities in need of legal assistance. CAP also provides educational Web and print resources in several languages. Recent examples of finance-related complaints posted on its Web site include problems with transparency of fees; debt-collection practices; rising credit-card debt; and actions of unregulated, private credit bureaus[17].

Rejection or modifications of high-risk cases not only reduces lender costs, but also saves the borrowers from worrying about coercive and abusive collection visits. Risk assessment can be a regional as well as case-to-case. e.g. It is found that in Latin America, a person who does not consume alcohol is more likely to take the repayment seriously. Similarly, someone who attends religious services daily/weekly is thought to be likely to follow the repayment schedule faithfully (see Schreiner, 2003).

[15] CGAP http://www.cgap.org/p/site/c/template.rc/1.26.4412/

[16] CGAP Consumer Protection Policy Diagnostic Report, Malaysia 2009

[17] CGAP Consumer Protection Policy Diagnostic Report, Malaysia 2009

(4) Ethical staff behaviour

The staffs of MFI institutions is required to behave ethically and it is the MFIs' managements' responsibility to ensure that adequate measures are taken to detect and curb unethical and corrupt behaviour. The need for this client protection measure is being recognised widely. In 2008, Deutsche Bank along with many others, laid out their agreement on the need for industry wide code of ethics for microfinance (see Forster, Lahaye, and McKee, 2009). While unveiling a draft Client protection Principles, Elizabeth Littlefield, CGAP CEO was quoted as saying "A broad coalition is forming and investors are signing on to address issues of investor ethics, accountability, and responsibility,[18]".

(5) Mechanisms for redress of grievances

It is imperative that MFIs have in place timely and responsive mechanisms for complaints and problem resolution for their clients. In Nigeria, the Consumer Protection Council, amongst its core functions includes "Speedy redress and awareness campaign" (see Access to finance in Nigeria, Isern et al, 2009). Since the poor consumers have limited access or options for redressing grievances, there should be a protective approach by supervisory authorities to establishing and enforcing fair standards. The absence of simple and practical means of redressing their issues leaves the inexperienced MFI consumer vulnerable to a balance of power that unduly favours MFIs. In poor countries such as Cambodia, powerful local village leaders may play the role of advocate and mediator to fill the gap, as do elected commune councils, but their effectiveness depends on how well educated they are on legal issues (see CGAP Consumer Protection Policy Diagnostic Report, Cambodia 2009). In India, the Reserve Bank of India (RBI) has stipulated to regulated and authorized institutions that there should be well laid grievance redressed procedures backed by an efficient redressed mechanism. According to RBI, this should be the first point of reference for any customer to lodge a complaint or register a grievance[19].

18 Responsible Finance, 2008 - http://www.cgap.org/p/site/c/template.rc/1.26.2902/

[19] http://www.cgap.org/gm/document-1.9.42213/India_Consumer_Protection_Diagnostic_Report.pdf

(6) Privacy of client data

There is a need to respect the privacy of client data and needs to require permission of the consumer before using the data for any other purposes. Data Privacy is one of the specific areas of investigation for CGAP while meeting with policy makers regulators, banks, specialized financial institutions targeting low-income customers, mobile network operators, technology companies, other knowledgeable parties, and donors, which are often engaged in long-term advisory relationships with the host country[20]. The new techniques such as branchless banking and technologies such as mobile banking in Microfinance pose a major threat to the data privacy of MFI consumers (see CGAP; Tim Lyman, 2009).

As seen earlier, in the last few years there has been significant growth in the Microfinance sector. This sector growth attracted many of the commercial entities who further increased the outreach of the services. However, this shift in focus of microfinance landscape gives the issue of SP even more importance in the sector to safeguard the consumers' interests.

A significant factor that has notable impact on the social protection is the regulations of Microfinance. In SSA, several countries have now started paying attention to the MFI regulations and social protection[21]. However, less than a dozen countries have consumer protection measures and even fewer have consumer protection measures for financial consumers. Only two countries – South Africa and Mauritius have consumer protection for consumers of financial institutions. In some countries, there is a specific language requirement for MFIs[22].

In a draft bill for regulation of Microfinance in South Africa (See- Microfinance analysis and benchmarking report – Sub-Saharan Africa 2009), it was made mandatory to ascertain the borrower's ability to repay. The critics of this bill were of the opinion that this process would burden the MFI with additional expenses and would make many of them opt out due to non-sustainability of running the lending programme. This would in turn reduce the

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20 http://www.cgap.org/p/site/c/template.rc/1.26.1472/

[21] CGAP - http://www.cgap.org/gm/document-1.9.43711/2009_SSA_Microfinance_Analysis_Benchmarking_Report.pdf

22
http://www.themix.org/sites/default/files/2009%20Africa%20Microfinance%20Analysis%20&%20Benchmarking%20Report.pdf

competition amongst the MFIs and drive the interest rates higher. This example[23] indicates how a MFI regulation can have an impact on the social protection. This impact of MFI regulations on social protection and the interrelation of MFI and social protection are further elaborated in the next section.

At least three factors have a major impact on the effect of Microfinance regulations on social protection. The first is the cost of implementation. The cost of implementing the regulations affects the way the MFI moves ahead in terms of its outreach and segments served. The cost can also have implication on the average loan size of the MFI. Reduced outreach, targeting specific consumer segments (in other words, avoiding the rest of the segments) and concentrating on increased average loan size means less number of people being served. This also results in the extreme poor people being neglected, one of the main concerns of existing Microfinance operations.

As explained earlier, Microfinance regulations are directed towards the protection of MFI consumers and the financial system. But recent studies show that in practice Microfinance regulations tend to have a somewhat negative correlation with the outreach and profitability (Cull et al 2009). This effect when further investigated indicated that the outcome of such regulations depends on the motivation of the MFIs. Implementing the regulations is a cost to the MFIs. The profit oriented MFIs adjust this cost by reducing and limiting their outreach to the market segments that are most profitable (secured, high value etc.). Thus the impact on the SP is limited to certain segments only. On the other hand, MFIs who are not motivated by profits (usually funded by non commercial vehicles like donors) do not compromise on such front, the downside is that their profitability goes down and their survival ability is tested[24].

When talking about the cost of implementing the regulations, it is vital to look at the magnitude of the cost. The best estimates can be gathered from financial institutions in developed countries and not from the MFIs (Cull et al, 2009). It is estimated that in USA, the cost of complying with the regulations is around 13% of the total non-interest cost of a

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23 CGAP portfolio issue 3, 2005

[24] Cull et al (2009)

bank. It is logical to assume that MFIs who have a weaker infrastructure and operate on a relatively lower scale, compliance cost would be much higher (Thornton, 1993; Elliehausen 1998). This higher cost can be attributed to the following reasons:

- Scale of economies: The banks or financial institutions in the developed world operate on a large scale with the consumer base and average deposits or loans being much larger than that of MFIs. When the cost is seen as a cost per account/loan, it is much smaller for the banks and is much larger for the MFIs.

- Start up costs: In the developed countries, the banks are well versed with the implementation costs and have their own team for the same. On the contrary, the MFIs who are new to implementing regulations do not have such infrastructure and thus the start up cost for the MFIs is significantly high (CLR, 2003).

- Labour cost: Most of the implementation costs include labour costs (managerial and legal expenses). Skilled labour is likely to be in short supply in developing and poor countries and hence the cost for such heads tends to be very high (Shroeder, 1985; Elliehausen and Kurtz, 1985; Elliehausen and Lowery, 1997).

It is also worth noting that since implementation and supervision of prudential regulations need Government/financial expert intervention, the cost would be higher than that of implementing a non-prudential regulation.

The second main factor relates to sources of funds: This factor influences the MFIs' performance especially in case where the MFIs operate on a lend-only model. The higher the capital available, the better is the outreach. In addition to the outreach, adequate capital influences the attitude of the MFIs; not to be selective in the segments of the markets served. Adequate capital also empowers the MFIs to allocate funds for the implementation of prudential regulations, which motivates them to provide additional services like accepting voluntary deposits. Thus, adequacy of capital can lead to MFIs thriving and in turn, results in better social protection.

The third factor relates to the general perception of the MFI: A regulated MFI is perceived as more secure and trustworthy than a non-regulated. This is true for the consumers and the investing stakeholders. The consumers feel secure when they deposit their already scarce and hard-earned money with a MFI that is regulated by Government regulations. This helps the MFI to extend more credit to people who desperately need them and thus provide means for a better life. On the other hand, a regulated MFI, which regularly publishes its activities and financial performance, attracts more funders. A regulated MFI is more likely to get funders from the commercialised investors since they show their accountability through proper and systematic reporting, often carried out by authorised/capable personnel.

5. Social protection index (SPI)

The above criterions influence the outcome of MFI regulations in terms of influencing SP. But the challenge is how you measure the SP, so that the correlation between the regulations and the changes in SP can be robustly established. This section deals with the concept of Social Protection Index (SPI)[25]. While calculating the SPI in this paper we assume that the SPI is a reflection of performance of MFIs on (i) coverage, (ii) poverty-targeting. Furthermore, the coverage can be investigated in terms of number of individuals/households/small businesses being served by the MFIs and the amounts of deposits and loans as a percentage of the national GDP.

The data for this discussion has been collected from various sources such as World Bank Statistics, CGAP and MixMarket reports etc. The data collection was a challenge more so that there is no single source available that will give information about the African countries on all the parameters. Hence, the data had to be collated from various sources. To ensure the accuracy and correctness, the data from one source had to be verified with that from other source. Another challenge was that all sources are not up to date with the data, e.g. If the population is updated as of 2006, the GDP was updated as of 2004. Hence there is a small degree of gaps in the data periods. This marginal error in the entire dataset had to be incorporated due to lack of a single source and uniformity in data collection methods of

[25] See SPI and Multi country Analysis, Bob Baluch and Joe Wood (2006)

diverse bodies. These countries have different laws and regulations, as highlighted in Table 6.

Table 6: Comparative laws and regulations on MFIs

Country	Percentage of population with access to banking services	NGO microfinance provider formalization or transformation issues	Ongoing microfinance policy development status	Ownership structure of banks (and financial institutions if available)
Kenya	Fewer than 10% of households and micro/small enterprises have access to financial services through maintstream financial institutions (as of 2006)	Capitalization, ownership structure, and taxation prevent NGOs from transforming into regulated financial institutions	On December 30, 2006, Kenya enacted the Microfinance Act 2006. On March 27, 2007, the Central Bank of Kenya (CBK) released draft prudential regulations for deposit-taking microfinance institutions. The CBK is soliciting feedback on these draft regulations and has scheduled a stakeholder conference for April 19, 2007. It is hoping to finalize and enact these regulations in the near future	BANKS & FINANCIAL INSTITUTIONS: 4 branches of foreign-owned institutions; 6 majority foreign-owned locally-incorporated institutions (with local participation); all other banks locally-owned (private and public) (as of June 2005)
Nigeria	35% of the entire population--but less than 2% of the rural population	Until December ’05, NGOs could only transform into Community Banks, whose regulatory/supervisory framework is not microfinance-friendly. However, new MF Policy has created MF Banks with an enabling legal framework.	The CBN unvelied its Microfinance Policy, Regulatory and Supervisory Framework in December 2005, and is establishing a National Microfinance Consultative Committee; all Community Banks must convert into Community MFBs or State MFBs by Dec. 2007.	Commercial banks and community banks - largely privately-owned. Development Finance Institutions-government-owned.

For this paper a sample of ten countries is taken. These countries have the highest percentage of MFI borrowers amongst the total number of African region MFI borrowers. The sample represents a distributed set of countries in their geography, poverty levels, populations and GDPs. In contrast to many African countries that do not have accurate statistical records, the data in these countries was accurate. Also in line with the objective of the paper, i.e. to access the MFI regulations’ impact on the social protection, these countries represent a wide group of people who are under poverty and are in need of social protection the most. In the sample, the population under poverty (as defined below), ranges

from 13 per cent to 90 per cent of total population with the majority of countries showing poverty percentage as more than 70%.[26] These top ten countries are reported in Table 4:

By definition, the MFIs strive to reach out to the poor population who has been termed as non-bankable by the formal financial sector. SPI-1, Coverage attempts to gauge the extent of which the MFIs in different countries have been successful in serving this target group. This index is calculated by first calculating the poor/non bankable population of a country. For the purpose of this paper the same is done by:

$$PuP = TP * X\% \qquad (1)$$

Where *TP* is the total population of the country and *X* denotes the factor of *PuP*. *CGAP* and World Bank has been referred to for ascertaining this factor taking into account the above mentioned definition of PuP.

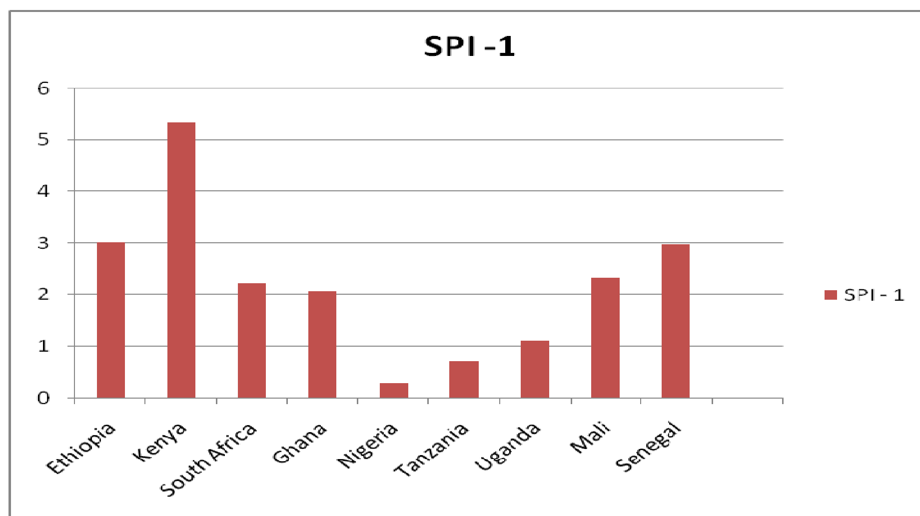
Once the PuP has been calculated, then the index aims to ascertain what portion of the PuP in a country is being served by MFIs. This is denoted by the SPI. The higher the SPI, the better is the outreach of the MFIs in the PuP. Consider the following table that lists the SPI and the subsequent figure that shows a comparison of SPI in the sample countries. The SPI is expressed in percentage terms to eliminate the variance in PuP of different countries and to provide uniformity. The SPIs of specific countries are highlighted in Table 7

[26] The total population of a country is taken from the World bank Statistics (as of 2008). The CGAP reports on country profiles give the percentage of population with less than $2 income per day. This criterion of income less than $2 per day is taken as an indication of poverty. This percentage is used to calculate the exact population of the country that can be termed as poor. The figures are stated as actual figures.
Gross domestic Product, is taken from World Bank statistics reports on individual countries. It is uniformly mentioned in USD billion. PuP/borrowers ratio is calculated using the following formula: PuP/borrowers ratio = Number of borrowers*100/PuP. Thus this ratio denotes the percentage of borrowers against the population under poverty.

Table 7: SPIs of selected African countries

Country	Population under poverty* (PuP)	SPI
Ethiopia	62956479	3.00
Kenya	21708575	5.36
South Africa	32620290	2.22
Ghana	17513195	2.08
Nigeria	136091029	0.29
Tanzania	38235531	0.71
Uganda	23932590	1.10
Mali	9796122	2.32
Senegal	7375553	2.96
Cameroon	NA	

Figure 7: SPIs of selected African countries



As shown in Table 7 and Figure 7, the SPI ranges from minimum of 0.27 in Nigeria to maximum of 5.36 in Kenya. Let us consider these findings in the light of current MFI regulations in these countries. In terms of access to banking or financial services in general, less than 2 per cent of Nigerian rural population had an access to such services. This can be largely attributed to the fact that until recently NGOs could only transform into community banks whose regulatory and supervisory framework is not very MF friendly. This was a very

big deterrent for the NGOs to engage into MF activities on a large scale[27]. This is further confirmed by the data on MixMarket website[28], wherein of the MFIs who have reported, only two are NGOs. According to legislation in 2007, all community banks must community MFBs or State MFBs. This means additional pressure on the community banks for adhering to regulations that will add to their already stained budgets. These banks are mostly private owned and do not have the resources to carry out the regulatory reforms and this has had an impact on the outreach.

In contrast to the outreach in Nigeria, Kenya has a better outreach of around 10 per cent households and micro/small businesses. This can be attributed to the fact that the recent Microfinance policy of Kenya is more concentrated on the deposit taking MFIs. According to Microfinance Act 2006, all deposit taking MFIs were subjected to prudential regulations. This had no connection to the lend-only MFI. There have been no regulations imposed in the recent past on NGOs and lending only community banks and MFIs. This kept the outreach safe and provided a secure atmosphere for these organisations to thrive. Also in contrast to Nigeria, Kenya has many foreign owned banks operating in the Microfinance sector due to its regulations. This has boosted the sector with more outreach. Foreign MFIs have the infrastructure to deal with the prudential regulations implemented by the above law. Hence the adverse impact of the law imposing costly prudential regulations has been somewhat diluted.

The above arguments are looked at from an another perspective. The outreach of the MFI is also measured in terms of the disbursed loans as a percentage of GDP. Again we find the same conclusions that Nigeria has the least GDP/loan portfolio ratio of 0.03 and Kenya has the highest GDP/loan portfolio ratio of 2.57 in the sample. The comparative data in Table 8 and Figure 8 show the GDP/loan portfolio ratio for the entire sample:

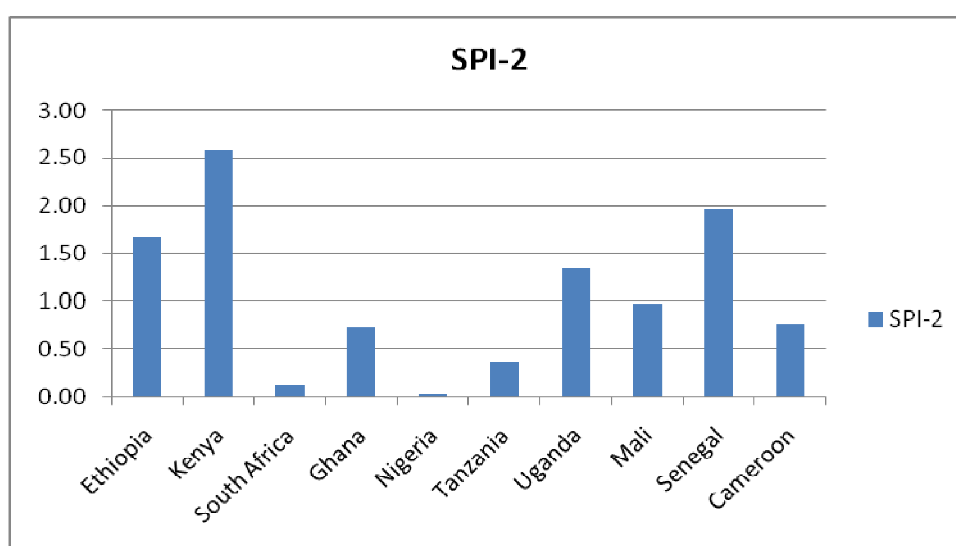
[27] CGAP country profiles - http://microfinanceregulationcenter.org/resource_centers/reg_sup/micro_reg/country/33/

[28] http://www.mixmarket.org/mfi/indicators?country[]=Nigeria&mix_region__c=All

Table 8: Coverage in terms of loan portfolio as a % of GDP

Country	GDP (USD billion)	Loan portfolio (USD billion)	GDP/loan portfolio ratio
Ethiopia	25.60	0.43	1.66
Kenya	30.40	0.78	2.57
South Africa	276.00	0.34	0.12
Ghana	16.70	0.12	0.74
Nigeria	207.00	0.07	0.03
Tanzania	20.50	0.08	0.38
Uganda	14.30	0.19	1.35
Mali	8.74	0.08	0.97
Senegal	13.30	0.26	1.97
Cameroon	23.40	0.18	0.76

Figure 8: Coverage in terms of loan portfolio as a % of GDP



The GDP/loan portfolio ratio is relatively straightforward and much easier to understand. The GDP/loan portfolio ratio is calculated as follows:

*GDP/loan portfolio ratio = loan portfolio*100/GDP* (2)

GDP/loan portfolio ratio is expressed as a percentage and it ranges from 0.03 for Nigeria to 2.57 for Kenya in the sample countries. To further straighten the argument that the MFI regulations impact SP, the following case study is considered.

Regulatory Practices – the Nigerian Case

Amongst many other issues, MFIs in Nigerian Microfinance industry are facing financial difficulty and potential liquidation. The previous governor of the Central Bank of Nigeria (CBN), Professor Chukwuma Soludo awarded hundreds of licenses without proper monitoring to create a large microfinance sector in the country. The regulations and guidelines in existence were not stringent enough to ensure that the services provided were purely for those that the licenses were granted. Some banks took up residence in expensive business districts and paid their senior managers high salaries and attractive benefits. Although, some MFBs started competing with commercial banks, many others saw this as an opportunity to embezzle from the poor. A recent article in The Daily Sun even suggests that churches have gotten in on the act of creating microfinance as a means of stealing from the poor[29].

Another example of poor regulations on MFI performance would be in case of "Mustard Seed Micro investment Bank[30]". Thousands of Nigerians deposited their savings with this bank. When they wanted to retrieve the money, they found out that the bank had shut down. The problem with the Bank was that in absence of proper regulations and regular supervision, the management of the bank was diverting the funds from the deposits of its consumers into other business owned by them. Activities of Micro finance institutions are supposed to be regulated by the Nigeria Deposit Insurance Corporation (NDIC), and the Central Bank of Nigeria (CBN) which issues licenses to these banks. The CBN website listed 899 licensed micro-finance banks, but several others operate who are not on the list.

Regulations help MFIs in Kenya thrive

The Ministry of Finance recognised the lack of a specific legal framework as well as appropriate regulatory oversight to guide the specific operations of microfinance institutions in Kenya. Followed by this, a review exercise enabled the licensed deposit-taking MFIs to start a Deposit Protection Fund Board to protect their clients[31]. The acknowledgment of impact of regulations on the SP in Kenya is spelled out by the Central Bank of Kenya communications, followed by the enforcement of the Microfinance Act 2006. This act allows the Central Bank to License, regulate

[29] *Source: http://microfinanceafrica.net/editors-views/the-state-of-microfinance-in-nigeria/*

[30] *Source - http://234next.com/csp/cms/sites/Next/Money/5506579-146/Poor_regulation_weakens_faith_in_micro-finance.csp*

[31] Source: http://microfinanceafrica.net/index.php?s=regulations+kenya

and supervise any deposit taking MFIs. The act is much elaborate in its scope and considers evaluating the MFIs in 6 different areas - governance and internal control systems; the management; credit technologies in place; information systems; the suitability of business; and policies and adequacy of resources deployed by the institution. The act spells out explicit requirements regarding minimum capital requirement - a small example of how this act helps in ensuring the SP. The authorities are also actively supervising the adherence such requirements that reflects in a statement by the Central Bank of Kenya – "an institution's minimum core capital levels will be monitored on a continuous basis by the Central Bank and may be reviewed from time to time.[32]"

6. Conclusions

The basic purpose of the MFIs is to provide financial services to the poor and non-bankable population. By providing such services, the MFIs aid in helping the poor to sustain day-to-day living, create income generation opportunities, provide for education for their children and care for the sick and elderly. The higher the outreach of the MFIs, more and more households and micro businesses benefit from it. Thus, efficient MFIs help the poor to sustain livelihood and to improve quality of life of not only individual households and businesses, but that of the society as whole. Thus for the social protection to be effective, MFI performance and outreach has to improve, which depends on the nature of regulations in the sector. The regulations in the microfinance sector needs to be seen as a set of required 'public actions to address vulnerability, risk and deprivation' (Conway, de Haan and Norton 2000), which clearly provides an argument for government in developing the regulations in a broader social protection framework.

However, the global experience shows that any single model of regulation is not an answer to the need for regulation in the sector. The sector specific regulations in the sector highlight the distinctiveness of the microfinance sector. These regulations may facilitate microfinance institutions to mobilise savings and grow with more linkages with formal sector. However, it is important to incorporate country specificities to make the regulatory practices practical. For instance, the experience in Ghana shows that through "tiered

32 http://microcapitalmonitor.com/cblog/index.php?/archives/761-Central-Bank-Gets-a-Grip-on-Microfinance-in-Kenya-as-New-Regulations-are-Introduced.html

approach", microfinance institutions could grow into commercial markets to access finance. In reality, the nature of Government regulations has varied impact on the MFI performance depends on both institutional and country contexts. Usually the prudential regulations have a cost implication on the MFI performance. At other times, absence of regulations may hamper the growth of the MFI. The performance of MFIs depends largely on MFI regulations, which eventually affect social protection in several ways mainly through its effectiveness and outreach. The governments, need to consider the consequences of regulation in the sector beyond the formal approach and ensure closer engagement with microfinance institutions in developing the appropriate regulatory framework. In brief, the regulations play a vital role in the development of the microfinance sector and can determine the nature of social protection provides by the sector.

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