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THE ULTIMATE BALANCING ACT:

Investor Confidence and Regulatory Considerations for
Microfinance

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THE ULTIMATE BALANCING ACT:

Investor Confidence and Regulatory Considerations for Microfinance

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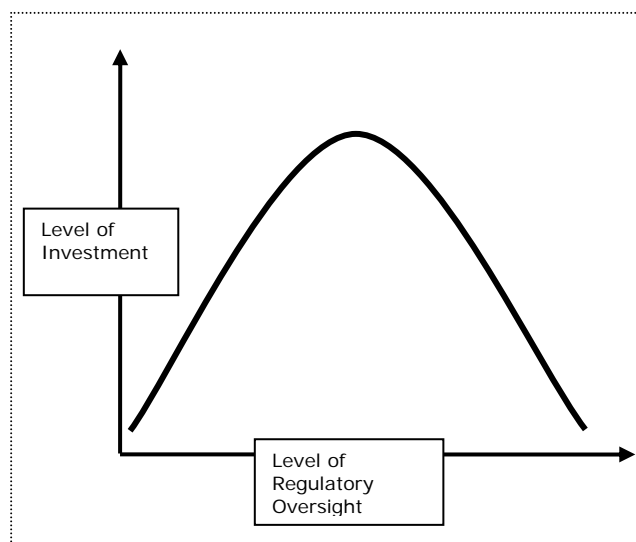
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EXECUTIVE SUMMARY

This paper explores the legal and regulatory framework for MFI investment transactions and its impact on investor confidence in the transition to private capital. Drawing upon recent field visits to Uganda, Peru and the Philippines, the paper attempts to address the questions: What regulatory practices promote investor confidence and provide the impetus to increase private investment in microfinance? At what point do legal and regulatory obstacles become too costly to bear and deter commercial investment in microfinance?

Two trends emerge from this research. First, facilitating private sector investment in microfinance is a challenging balancing act for regulators who can easily create significant barriers to investment in pursuit of their own mandates (including protecting the soundness of the financial system). Second, at some point along the “regulatory spectrum” between no regulatory oversight and heavy regulatory involvement, a balance can be achieved where regulators promote sound practices that also build investor confidence (see diagram).



LIGHT REGULATORY OVERSIGHT

If no regulatory oversight exists, any MFI, regulated or not, may accept any type of capital investment (including deposits) and engage in any type of activity, while investors enjoy a similar freedom with their microfinance investments. While this rarely occurs, there are environments which may be characterized as having “light” regulatory oversight practices. These include:

No or unclear legal status. Some countries do not have clear regulations on MFIs’ organizational registration and the authority to conduct microfinance operations. This is an impediment to industry growth as well as its attractiveness to the private sector.

Low level of oversight/monitoring. Some investors believe that receiving a license or permit to operate implies certain standards were met in the licensing or registration process. Government regulations that require transparent information disclosure and good corporate governance similarly comfort investors. It is hard for investors to make informed decisions about microfinance without this level of regulation and private sector involvement.

Secured lending: ability to pledge intangible assets. An issue of increasing importance for potential investors is portfolio secured lending. Some MFIs pledge their loan portfolios as collateral for commercial bank loans, however, there are many legal uncertainties surrounding an MFI’s ability to pledge this intangible asset. If the MFI defaults, it may be difficult for the lender to act on or seize this asset.

Lack of protection of minority investor rights. Investor protection includes: 1) information disclosure that allows an investor to make an informed investment decision, 2) legal protection of minority investors’ rights, and 3) ability to enforce claims in court. In many developing countries, these investors’ rights are not protected, which may further deter private investors from taking minority stakes in microfinance.

HEAVY REGULATORY OVERSIGHT

At the other end of the spectrum is heavy regulatory oversight. This would involve an excessive number of permissions required for any type of microfinance investment and restrictions on what investments are possible.

Restrictions due to legal status. An MFI’s legal status often directly affects its financing strategy. In some countries restrictions based on an MFI’s legal status may include limitations on accepting certain types of investment.

Forms of capital allowed. Countries may restrict the form of capital allowed, e.g. only donor funds, no foreign sources of equity, etc.

Limits on loan size or term. Regulators may set specific limits on loan terms and sizes, which ultimately restrict the profitability of the institution.

Interest rates. Some governments have instituted interest rate controls for microfinance, which limit the credit available and prohibit institutions from covering costs. Interest rate caps also restrict an institution's ability to seek a diversified capital base.

Capital and reserve requirements. Most regulated MFIs must meet reserve and liquidity requirements, which are sometimes stricter than the regulations for commercial banks. Higher reserve and capital requirements means that capital is not being put to productive use and may scare potential investors.

Cost of regulatory compliance. This is the cost an institution must consider before deciding how to register itself. Although a regulated MFI may attract more private capital, the cost of being a regulated entity may outweigh the potential benefits.

Restrictions on ownership. Ownership restrictions may limit the options an MFI has for equity investors and will also limit the number of interested investors. These restrictions may either limit the proportion of an institution that a single investor can own or restrict foreign ownership of a financial institution.

Tax burdens. Tax burdens for MFIs can be quite heavy. Although some financial institutions have certain tax exemptions, ambiguous circumstances may plague MFIs, who must plan carefully. Questions and uncertainty around an MFI's tax status can be a deterrent for investors.

CONCLUSIONS

As external factors evolve (such as a change in government, economy, MFI market environment, investor interest, etc.), regulators and stakeholders must continually re-evaluate the balance required to promote investor confidence. Three fundamental lessons emerged from the desk study and three country case studies conducted:

- Transparent regulation of financial institutions provides security for both institutions and investors.
- Government attitude towards microfinance and investment is very important, particularly in creating a solid enabling environment.
- Clear communication about requirements is helpful for both MFIs and potential investors. Developing a consultative process when reappraising the regulatory environment results in increased investor confidence and better informed MFIs.

INTRODUCTION¹

Much has been written about the evolution of the microfinance industry: maturing institutions reaching larger numbers of people, greater diversity in the types of MFIs being established, the need for better governance and administrative systems to further facilitate this growth, and so on. In addition, regulators and stakeholders have begun regularly commenting on the appropriate regulation and supervision of microfinance, with varying levels of agreement on the degrees of oversight and monitoring required.²

Pervasive in this literature is the assumption that microfinance institutions need to access private sources of commercial capital³ in order to continue growing and to become an important part of financial sector development in developing and transition countries. The importance of private capital is also clear considering diminishing donor funding and improved profitability, which makes MFIs both more interested in attracting commercial funding and attractive to private investors.⁴ What is fundamentally absent, however, is the question of the legal and regulatory framework in which these interactions occur, and the impact this has on investor confidence for microfinance.

Behind the scenes of every investment transaction, investors, MFIs, local lawyers, and consultants navigate a sea of permits, restrictions, approvals, and potential obstacles in the local legal and regulatory environment. At what point do these hurdles become too costly to

¹ The author would like to thank Deborah Burand for her comments on previous drafts of this paper and her insights in preparing the fieldwork. Marc de Sousa-Shields provided valuable project direction. All errors are the responsibility of the author.

² See especially the Essays on Regulation and Supervision series on the Microfinance Regulation and Supervision Resource Center (<http://www.cgap.org/regulation>).

³ Private capital is meant to include equity, commercial debt, both private (where borrowers and lenders have a personal relationship, such as private placements) and public (where borrowers and lenders have no personal relationship, such as bond issuances), and deposits.

⁴ Recent editions of *Small Enterprise Development* (Vol. 16, No. 1, March 2005) and the *MicroBanking Bulletin* (Issue No. 11, May 2005) have focused on the attitudes and actions of all types of microfinance investors, and the types of MFIs willing and able to access their investments.

bear and actually deter commercial investment in microfinance?
What regulatory practices promote investor confidence and provide impetus to increased private investment in microfinance?

This paper seeks to answer these questions, drawing on fieldwork conducted in Uganda, Peru, and the Philippines, as well as international experience gained through desk research and interviews with leading experts. The findings of this research suggest one fundamental lesson: facilitating private sector investment in microfinance requires a difficult balancing act for regulators, who must juggle their own goals to ensure the safety and soundness of the financial system as a whole, while not creating significant barriers to investment and, in the best case scenario, promoting investor confidence. Many actions that create safety in the financial sector overlap with the actions that promote investor confidence. Applying these successfully to microfinance, however, with its unique risks and its role in the local financial system, is particularly difficult.

There is a spectrum within which regulatory oversight occurs, ranging from one extreme in which regulatory oversight is absent, to another extreme where regulatory oversight becomes intrusive and overbearing. Both sides of the spectrum are likely to dampen investor interest in putting their funds at risk in a microfinance institution. Somewhere in between, both regulators and investors find a comfortable balance that allows for sound regulatory practices and investor confidence – even investment promotion. This regulatory spectrum traverses complicated legal landscapes, as it is not only financial regulation that is involved; company, tax, securities, and bankruptcy laws are also connected to any investment, and the implementation and enforcement of these legal frameworks are as important as the legal language itself.

This paper will explore the specifics of this spectrum. The following sections will introduce the Transitions to Private Capital project under which this research was funded, the fieldwork conducted, and then turn to discussing the characteristics of regulatory practices along this spectrum. Topics such as MFI legal status, secured transactions law, investor protection, and tax considerations will be discussed to show how an overall regulatory environment affects investor confidence. Finally, lessons learned about balancing the two extremes and the process required to achieve this balance are examined.

RESEARCH OVERVIEW

In the first phase of the Transitions to Private Capital project, a concept paper summarized ways in which microfinance institutions access private capital during the course of their business lifecycles, how MFIs are valued as an asset class, the influence of non-commercial capital in microfinance, and other challenges faced by MFIs in accessing private sources of capital. (de Sousa-Shields and Frankiewicz 2004). This paper stressed the importance of understanding the investor's perspective for evaluating microfinance as a potential investment. Regulatory developments affecting MFIs were a key consideration for future research also identified in this paper.

To that end, a brief note was written to provide background information about the types of regulations that affect investments in MFIs and that affect an investor's ability to invest in an MFI (Reinke 2005). This paper showed that company and tax laws could inadvertently create obstacles to an MFI's ability to accept private capital investments, and that inadequate bankruptcy protection for lenders or narrow or limiting ownership requirements imposed on potential shareholders also might deter investors. And, finally, transparent and uniform implementation of a given regulatory framework is also important in shaping investors' appetite for investing in microfinance.

As the research entered its second phase, country case studies were designed to provide an in-depth analysis of a country's microfinance sector, the supply of and demand for private capital, and the regulatory environment which framed the supply and demand. Uganda, Peru, and the Philippines were chosen to represent a variety of ways in which this occurred, each of them with a distinct microfinance market and regulatory environment.

While in country, researchers met with the major microfinance institutions to determine their current capital composition, decision-making processes that led to this composition, and future plans each

FIGURE ONE: COMPONENTS OF THE REGULATORY SPECTRUM

Government Legal and Regulatory Components:

- Financial laws and regulations; supervision
- Capital markets laws and regulations; supervision
- Company laws and registration practices
- Non-profit laws and registration practices
- Secured transactions law and registration practices
- Bankruptcy law
- Tax laws and administration

Government Policy Level Components:

- National policies on investment and/or microfinance
- Directed lending policies
- Government financing (both subsidized and unsubsidized)
- Government involvement in financial institutions, especially government ownership

Rule of Law Components:

- Level of corruption
- Independence of the judiciary
- Streamlined administrative processes
- Overall investment climate and tradition

had to attract a variety of investments. The team also spoke with investors in the country to learn about their vision of the investment climate and where microfinance fits within it. Finally, regulators were consulted, including banking and securities market regulators and tax authorities to better understand the regulatory environment not only affecting the MFIs themselves, but also that affecting debt and equity investors. Both MFIs and investors were questioned about the regulatory process of investment, what obstacles they may have faced, and other perceptions concerning the regulatory environment for investment in microfinance.⁵

THE REGULATORY SPECTRUM

The regulatory spectrum is characterized by numerous components – some of which reflect a more traditional view of “what is regulation” and others that encompass a broader range of potential government involvement. See Figure One for examples.

Within these components, there are those that directly affect the MFI and those that affect the investor. (Reinke 2005) Microfinance practitioners will not be surprised to note that financial regulation, company laws, and non-profit laws directly affect the MFI. However, they also will affect investors—by limiting what investments an MFI can accept or by limiting the types of activities in which an investor may engage.

At the policy level, the regulatory spectrum most importantly affects an investor’s confidence in the MFI and the environment in which the MFI operates. When national policies supporting investment exist, they often result in better circumstances for investors such as fewer restrictions on the types of possible investments, fewer approvals required, or streamlined registration processes. Similarly, national policies on microfinance, when well-conceived, tend to allay investor fears about the government’s level of intervention in the industry and whether circumstances could change quickly. When the government pays little attention to microfinance, an investor may fear the day when politicians or policy-makers ‘wake up’ to discover a higher level of risk in the financial system than they imagined, and quickly place restrictive sanctions on MFIs that suddenly limit the profitability of their investment.

Framing this discussion is the general implementation of the rule of law in a given country. This includes such considerations as the independence of the judiciary, such that if an investment ends poorly, it may be fairly and quickly adjudicated according to the legal framework of the country. Administrative processes for registering investments should be transparently administered. If corruption

⁵ This research does not address the regulatory considerations around deposit-taking. This has been largely addressed in basic guidelines written on microfinance regulation and supervision, which deal with how and when to prudentially regulate microfinance such that deposit-taking can occur. (CGAP 2003; Jansson, et al. (2004))

FIGURE TWO: MFI INVESTMENT REGULATORS

Regulators Involved Could Include:

- Banking regulator
- Microfinance regulator (if applicable)
- Capital markets regulator
- Insurance regulator
- Tax authority
- Companies registrar

exists at any of these levels, it has been shown that this clearly impacts the level of investment in a country. (Lanyi 2004)

The regulators involved in these financial transactions, then, extend beyond the financial regulator that may or may not be supervising microfinance. (See Figure Two) The mix of relevant regulators will depend on the country's financial supervisory structure and the types of investment being discussed.⁶

The involved financial regulators (banking, capital markets, insurance) have systemic protection of the financial system as a main goal in their activities. This occurs by ensuring the safety and soundness of individual financial institutions, ensuring that information is transparently disclosed such that investors can make decisions from a stable knowledge base, and by evaluating potential regulatory actions against the risk an institution (or type of institution) poses within the entire financial system. Banking, capital markets, and insurance regulators often work towards similar goals, but use different tools according to the segment of the sector with which they work and the nature of the risks they are trying to mitigate or deter.⁷ At one extreme, any single regulator may choose to not impose any regulatory oversight. This can occur when financial system safety is not at risk, or when market forces (such as credit rating agencies) are providing enough information to the market that regulatory requirements would be redundant. At the other extreme, a regulator may put in place heavy-handed oversight when risks are perceived to be very high or policymakers have a difficult time objectively weighing the risk of a certain regulatory requirement against the costs of enforcement and compliance.

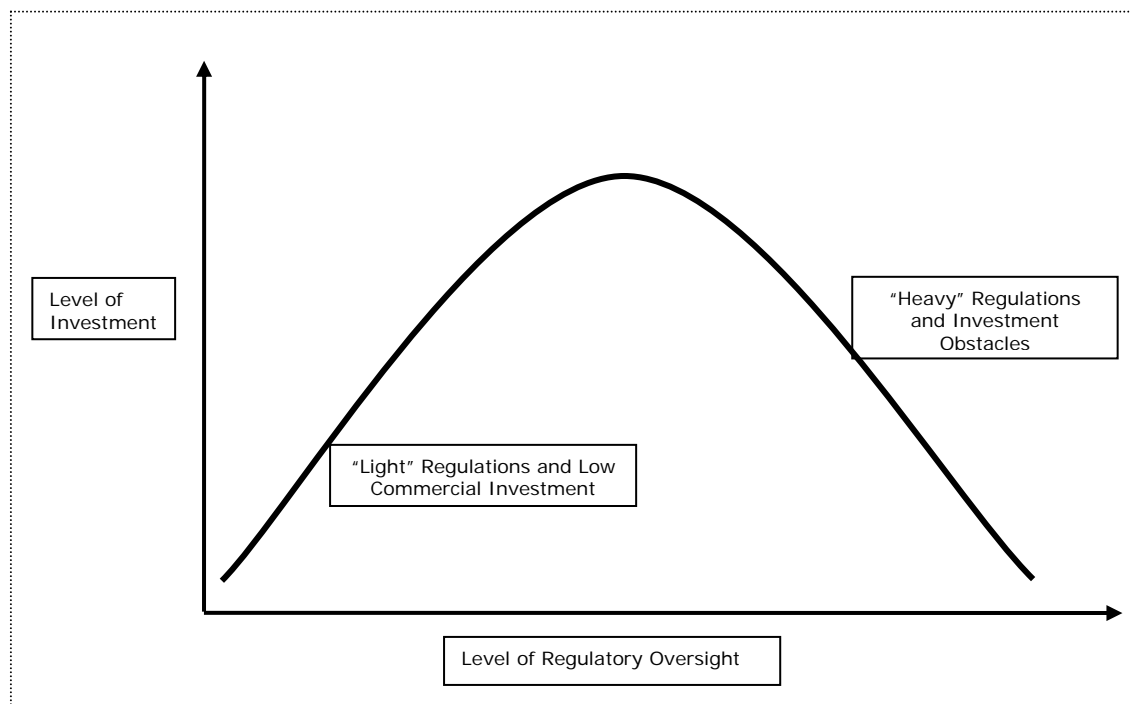
It is difficult to firmly plot specific country experiences along the regulatory spectrum, as the practices of any given country span a range of approaches. What can more easily be plotted, however, are the specific tools a regulator may employ. (See Figure Three below.) A lack of clear legal status for MFIs and little oversight or monitoring of MFIs are items that may exist on the side of "light" regulation. In addition, this side of the spectrum includes a lack of legal enforcement (weak rule of law), unclear or uniformly implemented tax regimes, and little protection of minority investor rights -- all of which have as much of an impact for MFI investment as the financial regulatory environment. Finally, specific items such as the inability to

⁶ In some countries, banking, securities, and insurance regulators – or some combination of two of these - exist within one regulatory authority. Other countries have separate regulators for all three functions, while still others have carved banking regulation and supervision out of the central bank's purview and created a separate bank regulator (Llewellyn 2004). Some countries have also chosen to create a separate microfinance regulator, such as South Africa, or to give regulatory authority to an apex institution, such as Mexico.

⁷ See Carmichael (2004) for an overview of recent discussions held at the World Bank regarding these different types of financial regulation and how best to structure supervisory authorities to efficiently reach these goals.

perfect the loan portfolio as security for a commercial loan can also be cause for investor concern due to insufficient regulatory oversight.

FIGURE THREE: THE REGULATORY SPECTRUM



On the side of “heavy” regulatory oversight, a number of things can happen. First, restrictions are placed on the MFI due to its legal status which directly affect its ability to attract commercial capital. Restrictions on an MFI’s ability to take certain investment instruments such as sophisticated forms of debt are introduced. Interest rate controls may play a role. Restrictions on ownership begin to appear, be it restrictions on foreign ownership or restrictions on the percentage of the institution any one individual or group can own. These are particularly important considerations in conjunction with the local investment climate of a country. The presence of higher capital adequacy or reserve requirements may limit the profitability of an MFI and hence its attractiveness to investors, as do heavy tax burdens.⁸

With such a myriad of different considerations, the difficulty of achieving the right balance can be seen clearly. Furthermore, the point of balance changes along with shifting financial markets,

⁸ There are instances, however, when “light” or “heavy” regulatory approaches are appropriate to the level of risk in the financial system and/or a country’s recent economic history. These terms are not meant to be value-judgments about a universal standard for regulatory oversight, but rather characterizations of the spectrum.

performance of individual institutions, political climate, and other forces. Because of this a country needs not only to struggle to achieve the proper balance but also to have the processes in place that allow continual readjustment and realignment to ensure the proper balance is sustainable. Such processes include a continual evaluation of proper regulatory requirements using a risk-based analysis and uniform and transparent application of such regulation. It includes, perhaps most importantly, the political commitment to ensuring this balance: champions within the policy-making community who understand the importance of microfinance in financial sector development plus regulators who are committed to a transparent enforcement of rules. Finally, this process needs to occur in a consultative environment, not necessarily one where rules accommodate all players (or how else would the 'bad' players be kept out of the game?) but one which fairly weighs the impact of regulatory environments on all actors. For microfinance, this must include the potential investors, an area often overlooked.

Below, specific aspects of the regulatory spectrum will be examined to better illustrate the difficulty of achieving this balance.

LIGHT REGULATORY OVERSIGHT

The furthest extreme of light regulatory oversight is total regulatory forbearance, such that any type of microfinance activity can be carried out by any type of institution, regulated or not. In this extreme, any MFI, regulated or not may accept any type of capital investment, including deposits; and engage in any type of activity, while investors enjoy similar freedom with respect to their investments in microfinance. In the extreme case, there is no regulatory oversight of either the MFIs or their investors and the microfinance industry operates wholly under the radar screen of would be regulators and supervisors. While this does not happen much, if ever, in reality, there are several practices that translate into a “light-touch” on the part of the regulator, each of which have a direct impact on an investor’s willingness to consider a possible investment in microfinance in a given country.

NO OR UNCLEAR LEGAL STATUS

The legal status of an MFI can often play a role in the investment decision. As a general rule, the legal status of an MFI is dictated by the organizational law under which the MFI is registered –such as the country’s company law or non-profit law, and secondarily determined by the financial laws and regulations under which the MFI is regulated. Sometimes an MFI may be categorized as one type of organization, e.g., charitable, under organizational law, yet categorized differently elsewhere, e.g., as a tax-paying entity under tax law. There are also implications stemming from the legal tradition – whether common or civil law – of the country, and the ensuing treatment of that organization.

A clear legal and regulatory environment occurs when an MFI has a clearly written pathway for organizational registration and the legal authority to conduct its microfinance business. This does not

necessarily mean that the MFI is subject to financial regulation by a regulatory authority such as the central bank or other delegated authority; rather, it could be as simple as permission within the non-profit law for lending-only activities to be carried out, subject to certain restrictions. Such certainty gives private capital investors, and often donors too, more confidence in the institution's long term prospects.

For example, in Brazil, microcredit NGOs (Civil Society Organization with a Public Interest, or OSCIPs), are legally registered as non-profit organizations, just as any other non-profit organization might be. The NGO can then register with the Ministry of Justice as a microcredit provider, a simple process that gives the organization the legal authority to lend. Until very recently, by contrast, Georgia's non-profit organizations offered microcredit in a legally ambiguous vacuum: the non-profit law stated that the organizations' primary objective must be charitable, but it was unclear whether lending would be deemed "profitable" and therefore a prohibited activity. (Druschel and Reinke 2005) With such uncertainty, it was often quite difficult to convince local banks to lend to Georgian MFIs

An unclear legal status for microfinance is an impediment to the growth of the industry and hence, its attractiveness to a private investor. China and the eight countries in the West Africa Monetary Union are examples of how unclear legal status can stunt the growth of a microfinance industry. In China, banks are largely not reaching the low-income sector, while the network of 38,000 rural credit cooperatives and postal savings institutions are rapidly collecting savings. Lending to low-income customers, however, lags severely behind, especially as the rural credit cooperatives are largely plagued by government intervention in governance issues and lending practices. The few microcredit NGOs that exist operate based on memoranda of understanding negotiated with local governments for set time periods, and are sometimes even housed within or established in conjunction with a local government agency. There is no long-term status for such institutions beyond the life of each memorandum. As a result, in the world's most populous country where income inequalities continue to grow, microfinance is still an infant industry. Sustainable institutions attractive to most investors can not be created under such impermanent circumstances. Few of China's MFIs have begun to access commercial sources of capital – those MFIs that have mainly worked with international microfinance investors, and donor funds are also diminishing due to this legal uncertainty. (Du 2005; Druschel 2003)

In the West African Monetary Union there is a standardized law for microfinance, the PARMEC, which allows cooperative style microfinance institutions to be licensed and supervised by local Ministries of Finance. Any other type of MFI that would like to be formally established must negotiate a five year memorandum of understanding (called a *convention cadre*) with the local government. Again, such time-bound licensing creates insurmountable uncertainty

for investors looking for stable institutions in which to invest in the medium to long-term. (Lolila-Ramin 2005 and Ouattara 2005)

LEVEL OF OVERSIGHT/MONITORING

The level of oversight or monitoring a prudential regulatory framework applies to a financial institution should depend largely on the level of risk that such an institution poses to the financial system. This is why more complicated prudential regulation should apply only to deposit-taking microfinance institutions (CGAP 2003). However, receiving a license or permit to operate, even just as a credit-only institution, may imply certain standards have been met in the licensing or registration process. For credit-only institutions, this can even include minimum eligibility criteria for executives and/or shareholders or a manual or business plan stipulating the types of activities to be carried out.⁹ For deposit-taking institutions this implies more rigorous requirements regarding capital adequacy, liquidity, loan loss provisions, and reserve requirements.

Sometimes, an investor may take comfort in the idea that some minimum standards have been applied to the institution – even more so when the investor can trust the regulatory system (i.e., believes no corrupt practices have allowed a license to be given to an institution not meeting the minimum criteria). For one commercial bank in Uganda, this was a significant factor in deciding whether to open a line of credit to a microfinance institution. Before that institution obtained a Micro Deposit-Taking Institution (MDI) license, the commercial bank would not have considered the non-regulated MFI as a potential investment.¹⁰ As a regulated financial institution, however, the MDI fit easily into the bank's existing underwriting standards and the bank was comforted by the oversight applied by the Bank of Uganda. The bank expected to begin lending to regulated MDIs at a standard money market rate offered to other licensed financial institutions. This rate was substantially lower than the non-regulated MFIs had been accessing from other banks, even with guarantees from donors.

However, regulatory oversight is not the only oversight that works to ensure the safety and soundness of an individual institution. As any investor knows, investor oversight through strong and active board members, credit rating agencies, and the scrutiny offered when shares are publicly traded can be equally important. Cross-country analysis

⁹ Minimum eligibility criteria for executives and/or shareholders, which generally include things like no past criminal convictions and financial statements, can be found in Albania, Armenia, Brazil, Mongolia, Morocco, Nicaragua, and Peru for credit-only financial institutions. Manuals stipulating business plans or scope of operations are required in Armenia, Bosnia (Republika Srpska), Morocco, and Peru for credit-only financial institutions. (Examples compiled from the Comparative Database on Microfinance Regulation and Supervision, available at <http://www.cgap.org/regulation>.)

¹⁰ The Micro Deposit-Taking Institution Law was passed in 2003 in Uganda, creating a non-bank deposit-taking window for MFIs, abbreviated MDIs. See Kalyango (2005) for more information.

has shown that government regulation that encourages private monitoring of financial institutions, by requiring accurate and transparent information disclosure and enforcing good corporate governance, has a better effect than direct regulatory oversight. (Barth, Caprio, Levine 2001) When market-based monitoring of financial institutions is not encouraged, or when no such industry exists, it is harder for investors to make informed decisions about microfinance, especially traditional private equity investors who are accustomed to having access to such types of information.

SECURED LENDING: ABILITY TO PLEDGE INTANGIBLE ASSETS

Secured transactions laws establish the ways in which pledged security is perfected in a loan contract and ease with which collateral can be seized by the lending institution in the event of a default. For the most part, such laws help lenders accept tangible assets, such as real estate, as collateral. Tangible assets can usually be identified and registered, such that it is clear to the lender whether any other lenders have an existing claim on the property. Intangible assets, however, are not always addressed in pledge laws. When they are, access to credit generally will expand, because the universe of assets that can be pledged to support a loan has expanded. (Welsh 2003) However, microfinance institutions usually do not own many tangible, physical assets. More often, the most valuable asset an MFI owns is its loan portfolio. However, this is a shifting, intangible asset, as the value and size of these portfolios are continually changing as borrowers repay loans and start new loan cycles. Because in some developing countries the secured transactions laws have not yet fully embraced the pledging of non-tangible or changing assets, such as a loan portfolio, it may not be possible for a MFI to pledge its loan portfolio as security for a loan in such a way the lender can clearly perfect the security interest. As a result, although a lender may accept the contractual pledge of assets, the lender's legal authority to act on such a security interest may be severely impaired because it was not publicly registered, making the pledge rather ineffectual if there are several competing claims on the MFI's assets. Furthermore, for donor-funded MFIs, grant restrictions may limit the ability an MFI has to pledge grant-funded assets, which may include some or part of the loan portfolio if donor funds were used as loan capital.

Despite this legal uncertainty, some commercial banks have begun lending to MFIs based on their loan portfolios. Considerable legal uncertainty still exists around whether the banks' security interest in these pledged portfolios have been legally perfected. Again, the risk is that the same assets may turn out to have been "pledged" to multiple lenders. In the three fieldwork countries, there was a somewhat high degree of informality in these arrangements. Most lenders offered debt on the basis of the loan portfolio's value without securing it in the same legal manner as they would real estate collateral. Thus, it is unclear whether, in the case of default, the loan portfolio could legally be transferred to the lender.

The Philippines central bank, *Bangko Sentral ng Pilipinas (BSP)*, has begun to take an interest in this discussion. In the Philippines, most MFIs borrow a considerable amount from a government-owned wholesale-finance institution, the People's Credit and Finance Corporation (PCFC). PCFC currently makes loans to MFIs at a 12 percent interest rate, plus a 1 percent service charge. Because of the large amount of government credit available to the microfinance industry at relatively low costs, most MFIs are not looking to borrow from other sources. Local banks, however, have begun actively considering making loans to microfinance providers including rural banks and other types of MFIs.¹¹ This is coupled with a discussion with the BSP to better understand how to secure these loans, as banks are nervous to begin lending to microfinance providers before they know whether a loan portfolio can be legally perfected. Furthermore, there is a 30 percent limit on the amount of unsecured (non-collateralized) loans in a bank's total loan portfolio. Accordingly, banks are loathe to lend to MFIs if it is possible that such a loan will count towards the 30% limitation due to problems with the perfection of their security interest. It is expected that the BSP will address this issue soon. Until this is done, however, most commercial banks are reluctant to lend to the sector.

Typically, a loan made on the basis of a perfected security that has been registered as required by local law has a clear priority of payment over other unsecured claims. This means that secured transaction or pledge laws, as well as bankruptcy and company laws, will determine, when there are multiple claims on the same collateral, which claims take priority over others. This is usually determined by the date on which the security was registered. In a transparent system, lenders with lower level priority will be aware of this and can decide how to value the security or even whether to lend based on that knowledge.

The issue of portfolio secured lending is relevant only for lenders interested in MFIs. This issue, however, is becoming more worrisome as a potential danger for investment because of its current informal nature. The first time an MFI defaults or goes into bankruptcy where competing creditors assert claims on its assets, it will quickly become clear what the dangers are of lending on informally 'secured' collateral and how difficult it will be for lenders facing multiple claims to exert control over the "pledged loan portfolio." It could quickly become detrimental to future sources of commercial bank debt for MFIs should this occur. To be sure, most lenders interviewed did not express concern about this uncertainty. However, it must be stressed that in each of the fieldwork countries, the legal status of the loan portfolio as security was as yet

¹¹ The major players in the Philippines microfinance market are rural banks and NGO-MFIs. More on this industry and regulatory considerations can be found in Charitonenko.(2003). It should be noted that the government financing may continue to crowd out any commercial sources of credit. As an example, one particularly strong MFI stated that they had seven different open lines of credit, but had only drawn down less than half of the total amounts.

undetermined. This is a precarious situation and may become a serious issue in the future as MFIs begin to access private debt sources in greater numbers.

LACK OF PROTECTION OF MINORITY INVESTOR RIGHTS

Investor protection is a consideration for equity investors considering microfinance. Investor protection can occur in three ways: 1) transparent information disclosure that allows an investor to make an informed decision about whether to invest; 2) legal protection of small investor's rights; and 3) ability to enforce claims in courts or with the securities regulator. (World Bank 2005) Legal investor's rights can include process issues such as the ability to place a member on the board of directors, the ability to place an item on the board meeting's agenda, or the ability to call a meeting of the board. It can include the rights to access internal information such as the full list of shareholders, annual financial reports, and minutes of annual general meetings. These rights can be expounded externally, through company laws and regulations promoting good corporate governance, or internally, through shareholder's agreements negotiated between majority and minority stakeholders, which are only applicable to those actors that have signed on to the agreement.

These rights are vitally important because they stem the risk an outside investor faces that returns on the investment will be expropriated by insiders (controlling shareholders and managers). Such investor protections play a role in explaining ownership concentration in publicly traded firms, dividend policies, and firm access to external finance. (La Porta et al. 2000) Research has shown that investors are more willing to take a minority position in cases where minority investor rights are protected through an external regulatory framework. (Gianetti and Koskinen 2004)

This issue arose in Uganda, where minority investor rights are not clearly protected in law and weak rule of law exists. At the time research was conducted, MFIs that had begun transformation to regulated, for-profit MDIs had already faced the primary hurdle of finding equity investors. Uganda's transforming MFIs had largely turned to a mix of shareholders from among the founding NGOs, upper management of MFIs, and international microfinance investors such as Triodos, AfriCap, and ShoreBank. With one exception, local investors and purely private investors are not entering into the transforming microfinance market in Uganda, despite a number of promising investments to be made.¹² One local investor highlighted that the history of private sector development in Uganda revolved around family-owned business and very little portfolio investment. An inability for minority investors to play a

¹² One MFI had made an agreement with the East African Development Bank which contained a five year exit clause. Another MFI that had, since inception, an NBF license, does have local equity investors – venture capitalists with a tie to the management of the institution.

role in the direction of the business and the poor court system to enforce claims has meant that investors are wary of taking a minority position. Until minority investor rights can be legally stated and transparently enforced, investors will avoid minority shareholding in any investment, including microfinance.

In the Philippines, on the other hand, where family-owned rural banks are becoming more dominant in microfinance, the protection of minority investor rights has a unique aspect to it. Under Philippine law, majority shareholders who want to sell the company must first offer the sale of the company to all minority shareholders, giving them the first right to take over the company. In addition, company law requires at least two members of the board of directors, or 20 percent of the total, whichever is less, to be independent (i.e., not connected to the other shareholders). Some rural banks are starting to ponder the idea of diversifying their ownership base and opening up to outside investors. It is plausible that these types of minority investor protections will play a role in attracting outside investors.

Thus, in areas where regulation seems to be absent, either in the legal form of the institution or in the legality of the investment, investors will have less confidence in the microfinance investment.

HEAVY REGULATORY OVERSIGHT

At the other extreme of the regulatory spectrum is a system of heavy regulatory oversight. The most extreme case would involve an excessive number of permissions and approvals required for any type of microfinance investment to occur and restrictions on what is possible. A regulatory system that aims to eliminate all risks by implementing such overbearing oversight will cripple the financial sector, thereby lowering investor confidence and their willingness to invest in an MFI.

RESTRICTIONS DUE TO LEGAL STATUS

While an unclear or complete lack of legal status for MFIs can lower investor confidence, some countries also impose restrictions based on legal status that have a direct effect on MFIs' ability to accept certain types of investment, or that limit the growth capacity of MFIs and, hence, their attractiveness as an investment opportunity. Most MFIs carefully weigh the cost of regulatory compliance with the potential benefits that may be achieved in the form of access to capital because of these implications.

FORMS OF CAPITAL ALLOWED

In some countries, the type of financial license restricts the forms of capital allowed.

In Brazil, for example, OSCIPs can only access donor funds, capital put in by the founders, and debt finance from the government-owned wholesale lender. Brazil's for-profit microfinance companies (SCMs) are not permitted to issue securities. The same is true for MFIs in Tajikistan. In Albania, commercial banks are limited in the types of activities they can engage in according to their level of

capital. At the minimum capital level, they may only borrow funds. With increasing levels of capital, banks can begin to engage in more sophisticated financing strategies. Financial private development organizations in Honduras and licensed microcredit organizations in Bosnia are both unable to distribute profits, largely due to their status as a non-profit institution. In the Philippines, rural banks can not accept foreign sources of equity at all.¹³

To be sure, there are often prudent reasons regulators impose such restrictions. For non-profit institutions, it is quite common to restrict distribution of profits, as doing so would logically mean the institution was “for profit,” as net income is allowed to escape the system and is not being reinvested in the original charitable purpose. For restrictions such as those on the issuance of public debt, the regulator’s own capacity to oversee such transactions may be the cause of the restriction, assuming that oversight would need to be greater in institutions with lower levels of capital (and, it can be added, less sophisticated management). It could be because the requirements for the license do not provide enough assurance that the management of the institution could adequately manage asset/liability mismatches. In addition, securities issuance, whether public or private, will largely depend on notification to or approvals from the securities regulator, sometimes in addition to the banking regulator.¹⁴

Thus, a MFI’s legal status often directly affects its financing strategy. In countries where certain types of commercial finance are restricted outright, such as public debt in Brazil and Tajikistan, investors may automatically turn to opportunities with greater financial freedom. On the other hand, in places where the approvals process from the banking and securities regulator is quite onerous, this may also detract from an investment’s attractiveness.

LIMITS ON LOAN SIZE OR TERM

In many instances, regulators who have decided to actively regulate microfinance have created a regulatory definition of microfinance or microcredit. This definition helps to contain regulatory arbitrage where there are lower entry limits for a financial institution to engage in microfinance activities than those imposed on formal banking activities, especially lower minimum capital requirements, or when a license to conduct microfinance offers access to other preferred terms such as lower interest rate ceilings. Definitions of microfinance can take several forms, ranging from a vague definition akin to Morocco’s “offerings of credit where the objective is to permit poor people to create or develop their own business producing goods or services, helping these people succeed

¹³ Examples compiled from the Comparative Database on Microfinance Regulation and Supervision, available at <http://www.cgap.org/regulation> as well as from fieldwork.

¹⁴ The notification versus approvals distinction largely depends on the size of the transfer.

economically,” which is relatively unenforceable, to Colombia’s defining the size of business that can be lent to as less than ten employees. In their most restrictive form, definitions of microfinance will place limits on loan terms and sizes (see Table 1). (Jansson, et al., 2004)

TABLE 1: EXAMPLES OF LOAN LIMITS FOR MICROFINANCE¹⁵

COUNTRY	LOAN LIMIT
Bangladesh	Loan size US \$171 (10,000 BDT) Loan term 12 months
Bosnia (Republika Srpska)	Loan size US \$3,240
Brazil	Loan size US \$3,600
Colombia	Loan size US \$67,635 (501 monthly wages)
Ethiopia	Loan size US \$625 (5320 ETB)
Georgia	Loan size US \$4,650 (GEL 10,000)
Ghana	Loan size US \$120 (984,576 GHC), up to US \$1,200 (9,845,760 GHC) with group guarantee.
Kazakhstan	Loan size approx \$5,300
Kenya	Loan size equal to GDP per capita (law not yet passed Parliament)
Pakistan	Loan size US \$1,745 (100,000 PKR)
Peru	Loan size US \$20,000 (69,500 PEN)
Philippines	Loan size US \$2,667 (150,000 PHP)
Romania	Loan size 10,000 EUR Loan term max. 36 months
South Africa	Loan size US \$1,200 (7,955 ZAR) Loan term max. 36 months
Uganda	Loan size 1% of core capital (5% for group guarantees) Loan term max. two years

For the most part, loan size limits are set at a certain dollar amount and do not fluctuate with changes in the macro economy, such as periods of high inflation. They tend not to allow the flexibility to continually provide larger loan sizes or longer loan terms to repeat clients, which restricts an MFI’s ability to follow a client as they progress or to diversify into other types of lending such as, for example, housing loans that require longer terms and larger amounts than working capital loans. Such restrictions on business activity

¹⁵ Examples compiled from the Comparative Database on Microfinance Regulation and Supervision, available at <http://www.cgap.org/regulation> as well as from fieldwork.

ultimately restrict the profitability of the institution, and a private investor would be keenly aware of such restrictions.

A few countries have created more flexible limits, such as limiting loan sizes to GDP per capita (Kenya), or allowing the maximum loan size to fluctuate according to the core capital of the institution (Uganda). In the former case, the institution can respond to changes in the economy, while in the latter, the institution can grow with its clients. It is assumed that investors are more likely to respond in a positive manner to such flexibility.

INTEREST RATES

The subject of interest rate controls has ridden political waves in many countries.

High interest rates, originally associated with moneylenders and other informal providers of finance, have also become a perceived characteristic of microfinance. , Microfinance interest rates can easily become a target from politicians anxious to be seen “helping the poor” by reducing the cost of credit to the borrower. Those familiar with the financial sector understand that these interest rate restrictions will only limit the total amount of credit available and lead to institutions being unable to cover costs.

Alternatively, in some places, regulating microfinance as a separate activity or institution has meant that the regulatory framework can easily allow interest rate freedoms. For example in South Africa, usury limits are placed on most financial transactions. Exemptions are provided for companies registered with the Microfinance Regulatory Council. The freedom provided in allowing any type of company to apply means that there does not have to be a separate “microfinance” institution.

TABLE 2: LOCATION OF INTEREST RATE RESTRICTIONS¹⁶

INTEREST RATE CONTROLS	USURY LIMITS	DE FACTO CONTROLS
Algeria	Armenia	Brazil
Bahamas	Bolivia ^d	China
China	Brazil ^a	Ethiopia
Libya	Chile	India
Morocco ^a	Colombia ^b	Laos
Myanmar	Ecuador ^b	Pakistan
Paraguay	Guatemala	Vietnam
Syria	Honduras ^a	
Tunisia ^a	Indian States	
UEAC ^b	Nicaragua ^c	
UMOA ^a	South Africa ^b	
Uruguay		
Venezuela ^c		

Notes:

- A separate regulation on interest rate ceilings exists for the microfinance sector.
- Microfinance lenders are excluded from interest rate ceilings, or are authorized to charge additional fees.
- Interest rate ceilings apply only to institutions and individuals not regulated by banking authorities (including NGOs).
- Introduced in January 2004.

Table 2 provides information on where different types of interest rate restrictions can be found, compiled in Helms and Reille (2004). For those areas where interest rates for microfinance are restricted to a level below cost-recovery and below profitability, investors are likely to shy from the investment because there is little chance of profits to be earned or, in the worse case, for MFIs to break-even. Interest rate restrictions not only harm an institution's long-term sustainability because of the inability to cover cost, but also restrict the institution's ability to access a diversified capital base. They virtually condemn the institution to donor subsidies.

CAPITAL AND RESERVE REQUIREMENTS

Prudentially regulated MFIs generally must meet reserve and liquidity requirements, especially if they are given a license to take deposits. Among these are capital adequacy requirements designed to ensure institutions have enough capital to offset liabilities and risk-taking and sufficient reserve requirements. Leading experts in microfinance regulation and supervision have promoted higher capital adequacy

¹⁶ Original table from Helms and Reille (2004). UEAC refers to the Union of Central African States. UMOA refers to the West Africa Monetary Union.

ratios to be applied to deposit-taking MFIs, coupled with lower total minimum capital requirements than full-scale commercial banks. (CGAP 2003)

In Uganda, the capital adequacy ratio of 15 percent of risk-weighted assets for core capital and 20 percent for total capital far outweighs the respective 8 and 12 percent required of commercial banks. This requires a sophisticated understanding on the part of an MFI manager to ensure that assets do not grow so large as to require huge influxes of capital. For regulators, it ensures that for a riskier institution, there is more capital to call upon in the case of a problem. For investors, however, it means that more capital is required to increase the level of business. For an increase in lending to occur, a larger increase in capital would be required than at a commercial bank, making profits more costly than they would be for comparable investments in a commercial bank.¹⁷

TABLE 3: EXAMPLES OF RESERVE REQUIREMENTS¹⁸

COUNTRY	RESERVE REQUIREMENT
Bulgaria	Banks: 1.25% of the total balance-sheet assets plus off-balance-sheet commitments
Colombia	Banks and NBFIs: 50% of subscribed capital
Ecuador	Banks and NBFIs: 50% of paid in capital
El Salvador	Banks: 25% of paid-in capital NBFIs: 50% of paid-in capital
Ghana	Rural banks: 53% of paid-in capital
Jamaica	Banks and NBFIs: 100% of paid-in capital
Jordan	Banks: 14% of total deposits
Nepal	Banks: 200% of paid-up capital
Nicaragua	Banks and NBFIs: 15% of net profit set aside annually
Peru	Banks: 20% of foreign-currency denominated deposits, and 6% for local-currency denominated deposits
Tanzania	Banks: 10% of outstanding total deposits.

¹⁷ Whether this would truly affect an investor's decision to work with an MFI versus a commercial bank would require further research about investor risk tolerance and other behaviors. Logic would suggest, however, that a more socially-oriented investor would be less affected by this difference, unless commercial banks in the region were also offering microfinance.

¹⁸ Examples compiled from the Comparative Database on Microfinance Regulation and Supervision, available at <http://www.cgap.org/regulation> as well as from fieldwork. In general, reserve requirements are placed incrementally into the reserve fund from annual profits. For example, in El Salvador, 10% of annual profits are placed in the reserve fund until it reaches the required amount.

Mandatory reserves and liquidity requirements are another prudential tool of the regulator to ensure the financial soundness of an institution and of the whole financial sector. In some countries, no standard reserve requirement exists, although banks must provision against loans at a progressive rate as loans become past due and maintain liquidity requirements against deposits. In other countries, a portion of paid-in capital must also be held at the central bank in a reserve fund, ranging from 25-200 percent of paid-in capital. (See Table Three).

While stringent reserve requirements may be put into place after times of high inflation, when banks may have experienced sudden losses and the regulator seeks redress against such risk in the future, these assurances come at the expense of putting capital to profitable uses. As Andah (2005) explains in Ghana,

“Raising the secondary liquidity reserve (investment in blue chip Government Bonds and Bills) requirement in 1996 from 20 percent to 52 percent meant that, with the primary reserves of 10 percent, the [Rural Community Banks (RCBs)]... had only 38 percent of the total savings they mobilized available for lending. Whilst some considered this directive to be unduly restrictive to the Satisfactory RCBs, in practice many RCBs maintained secondary reserves far in excess of the regulatory minimum to take advantage of relatively high interest rates on Treasury Bills throughout the 1990s. As a result, the share of RCBs in total Banking industry investments has risen from about 3.4 percent in 1998 to 7.6 percent in 2004 despite [the Bank of Ghana’s]... lowering of the secondary reserve requirement to 43 percent in 2002.”

Thus, as Andah points out, there is a trade-off between regulatory prudence and putting capital to productive uses that create profits to attract investors. This is one area that illustrates the difficult balancing act between regulators and investors.

COST OF REGULATORY COMPLIANCE

The four areas outlined above, allowable forms of capital investment, loan limits, interest rate controls, and capital and reserve requirements, are but a few ways in which the regulatory status of an institution directly affects its investment strategy. All of these add to the cost of regulatory compliance, the cost an institution must consider before deciding how to register itself to conduct business. These costs are all in addition to the cost of additional reporting requirements, higher tax liabilities (and often becoming more visible to tax authorities in the first place) and greater upfront costs in order to transform into a regulated entity.

It has often been argued that MFIs need to become regulated entities to access private sources of capital, as if regulation is a “magic key” that will easily create a direct path to greater funding sources. While, as discussed above, investors may place greater confidence in regulated institutions because they come under some regulatory

oversight, for the MFI, the cost of becoming a regulated entity may outweigh potential benefits. This has been seen in Albania (Gannon 2005) and Kazakhstan (Stallard 2005), each of which initiated regulatory reform for microfinance only to see it stall when few institutions decided to undertake transformation, perceiving the costs of compliance to be too high relative to the perceived benefits. This is interesting to note in conjunction with three other increasingly obvious trends: first, most equity investments are being made in regulated institutions, second, there are few good investments to make, and third, most investors invest in the same institutions (Rhyne 2005). One could speculate that perhaps those institutions currently opting out of regulation could have added to this pool of potential investments.

One Philippine NGO describes an extraordinary story of weighing the costs of regulatory compliance with the benefits of becoming a regulated entity. This NGO has twice applied for and received some sort of banking license, but neither time did it utilize the license to begin banking activity. (As a general rule, licenses are revoked if not utilized within a certain time period after issue.) The NGO manager identified several reasons for why it did not begin banking activity. First, the NGO did not have a sufficient MIS in place to meet the reporting requirements requested of banks and the cost of compliance to attain the bank branching license would have been too high. Second, the NGO did not believe it could continually meet the minimum capital requirements and maintain profitability given the size and scope of its operations. This organization's interest in licensing in the first place, however, was in order to accept deposits that would be used to finance plans for a massive upscale in lending operations. The organization's inability to effectively use the licenses it had been issued, however, shows that the perceived costs of maintaining this license outweighed the perceived potential benefits that could be received in financing.¹⁹

RESTRICTIONS ON OWNERSHIP

In countries where minority investor rights are not protected and the rule of law may be absent, restrictions on ownership can become cumbersome as they limit the options an MFI has in equity investors and will simultaneously limit the number of interested investors. This can occur in two ways.

First, ownership limits seek to limit the proportion of an institution any investor can own. These limits are often put in place in order to minimize the risk of a narrow capital base. (Ware 1996) Some countries, such as Uganda, put such limits into place after bank failures occurred as a direct result of singular ownership with no clear

¹⁹ It should be stressed that this occurs in a country where debt finance from government sources is ubiquitous and guarantee financing from international donors is helping to leverage even more. This particular MFI manager noted that he was "oozing with lines of credit." The desire to access deposits can easily be outweighed by this easily accessible credit and factors into the cost-benefit analysis of regulatory compliance vs. access to capital.

checks on the business decisions of that owner. It can be a useful tool for mitigating these risks in a simple fashion.

Table 4 provides examples of the types of ownership limits that can be placed on financial institutions. They range in size, from a restrictive 5 percent limit for commercial banks in Thailand (see Thailand Commercial Banks Act, Section 5) to a larger 49 percent limit for commercial banks in Uganda (see Uganda’s Financial Institutions Act, Art. 18-19). They range in definition, from restrictions on total shareholding, to restrictions based on proportion of core (tier one) capital.

TABLE 4: EXAMPLES OF OWNERSHIP LIMITS²⁰

COUNTRY	OWNERSHIP LIMIT
Bosnia (Republika Srpska)	MFIs: Must have at least three founders
El Salvador	NBFIs: Single owner max. 10% of total capital
Georgia	Banks: Single owner max. 25% of paid-in capital
Ghana	Rural banks: Single owner max. 30% of total shareholding
Kenya	Banks: single owner max. 25% MFI: single owner max. 33%
Mexico	Banks: Single owner max. 5% of total capital
Nicaragua	Banks: Single owner max. 20% of social capital (with exceptions)
South Africa	Banks: Single owner max. 15% of controlling shares
Sri Lanka	Banks: Single owner max. 15% (20% for a group)
Tanzania	Banks, NBFIs: Single owner max. 20% of core capital (exceptions for MFIs, which may allow up to 66% ownership of share capital)
Thailand	Banks: Single owner max. 5% of total shareholding
Uganda	Banks: Single owner max. 49% of total shareholding MDIs: Single owner max. 30% of total shareholding

From the regulator’s perspective, such restrictions serve the best interests of financial system soundness. From an individual investor’s point of view, however, this can limit the types of transactions in which he or she is willing to engage. In Uganda, most MFIs that had decided to transform from a non-profit model to the for-profit Micro Deposit-Taking Institution (MDI) had to look for equity investors in the new for-profit institution. While few had trouble attracting these investors, as was mentioned above, the only domestic equity investment came from the founding NGOs or existing managers of the NGO. External, private domestic equity was virtually absent. One main reason for this is the ownership limit that does not allow

²⁰ Examples compiled from the Comparative Database on Microfinance Regulation and Supervision, available at <http://www.cgap.org/regulation> as well as from fieldwork.

for a single majority shareholding of the institution.²¹ A lack of protection of minority investor rights meant that minority investors would not have the ability to exert power over the board (especially when the majority of shares went to some combination of the founding NGO owner and managers). In addition, few Ugandan investors were familiar with the business of microfinance. When faced with the ownership limit in such a situation, local investors were not willing to take the risk in Uganda's MFIs.

Second, restrictions on foreign ownership of financial institutions are in place in several countries. These restrictions range from absolute restrictions against foreign ownership of any kind, as in the Philippines' rural banks or Ethiopia's commercial banks, to restrictions on the amount of foreign ownership in one institution, such as the 49 percent limit in El Salvador's banks. Some evidence suggests that in developing countries banks with some amount of foreign ownership out-perform domestically-owned banks (Micco et al 2004). But for microfinance institutions, this places a short-term restriction on their ability to reach to the currently interested investors in microfinance, the international funds. With fewer domestic equity investors convinced of the profitability of microfinance, foreign investors can often play a demonstration effect, if they are allowed to do so. The Rural Bankers' Association of Philippines, whose member institutions are increasingly moving towards microfinance as a main business, is currently lobbying the BSP to change the restriction against foreign ownership.

In addition to ownership limits, any transfer or sale of shares above a certain proportion will generally require additional approvals from the banking regulator. While this process will always entail registration with the securities regulator, it is usually the banking regulator who takes responsibility for ensuring that owners with a certain percent equity stake (usually the minimum threshold ranges from 5-20 percent) have a background in banking or microfinance and that their own financial situation can sufficiently withstand a capital call. This entails a detailed look at the financial statements of an investor. This is something which some investors may be unwilling to undergo, especially in less transparent countries where avoiding scrutiny by regulatory authorities can be a main goal, for such reasons as avoiding taxes, ensuring physical security, or avoiding being asked for bribes.²²

Therefore, while such considerations regarding the ownership of a financial institution have a clear rationale for regulators in ensuring the safety and soundness of the financial system and of individual institutions, they should be carefully weighed with the type of

²¹ There is an exception allowed for wholly owned subsidiaries of banks or reputable financial institutions (Micro Deposit-Taking Institution Act, Art. 21). FINCA Uganda was granted an exemption under this clause.

²² It could also be argued that such a person who finds this a problem might not be the best investor in a financial institution.

restrictions they may place on the willingness of an investor to participate.²³

TAX BURDENS

As registered institutions in a country, MFIs are subject to tax liabilities. This often can take MFIs by surprise, especially when founded as a charitable organization. For the most part, financial institutions have some exemptions from tax liabilities, but in the three fieldwork countries, tax liabilities were still quite high (see Table 5). MFIs must be able to carefully understand when they are subject to taxation, how to properly file and report tax liabilities and how to plan for such liabilities. Taxes need to be considered in the areas of withholding and transfer taxes, as even when an MFI itself holds a tax exemption, it may still be liable for such taxes to be withheld on interest income or payroll accounts. In planning for tax liabilities, an MFI must understand how to calculate net income and what expenses are deductible. This and a myriad of other concerns can create uncertainty around a MFIs' tax status that could, in turn, cause concern for an investor. (Gibian and Burand 2003)

TABLE 5: TAX RATES IN FIELDWORK COUNTRIES

COUNTRY	INCOME TAX	CAPITAL GAINS TAX	WITHHOLDING TAX	STAMP TAX
Uganda	30%	30%	15%	
Philippines	32% plus 5% gross receipts	5-10% depending on size of transfer		.15 – 75% depending on document
Peru	30%		4.1%	0.08% (2005) 0.06% (2006)

Obviously, when profits must be plowed into tax liabilities, this reduces the potential returns for an investor, but no more than would be found in another company, provided tax regimes are uniformly and transparently implemented. It can, however, have greater consequences for the financing strategy of the MFI, which may choose to remain unregulated or in a non-profit status to avoid tax burdens it can not meet. MFIs may also decide not to distribute profits because of greater taxes on capital gains, or not take certain types of debt because of costly withholding taxes. Taxes on income did have an impact on MFI financing strategies in countries where fieldwork was conducted.

²³ One might include priority sector lending targets in the list of items that affect the profitability – and attractiveness to an investor – due to the legal status. These lending targets are generally aimed at commercial banks for lending to the agricultural sector, although in some cases (India, Brazil), it has also been for microfinance. They will not be discussed further here.

For example, one NGO-MFI in the Philippines received a rural banking license in 1997. In the intervening eight years, however, the founding NGO has maintained its microfinance operations and even expanded. Of the 102 branches under this MFI, 92 are under the NGO operations and only 10 are bank branches, although because of the branch licensing requirements, it takes three NGO branches to comprise a single bank branch. This has happened for several reasons. First, the bank was not as successful at mobilizing deposits as had originally been hoped. Second, with a 32 percent profits tax plus a 5 percent gross receipts tax, the organization found it too costly to transfer operations when it was doing quite well in the NGO operations, which had access to significant amounts of grant and debt financing, all of which came with tax exemptions due to the non-profit status.

While this is but one example, it is clear that these costs are calculated into the expense of becoming a regulated institution and into the cost of accepting certain types of financing. In addition, the uncertainty about tax status, including when tax liabilities can be hidden, or even retroactively applied, can act as a deterrent for investors, as is an MFI's inability to carefully plan for such tax liabilities.

Therefore, a number of areas where regulators may be imposing greater restrictions or requiring more significant approval processes, such as restrictions on capital or ownership limits, have effects on the transition to private capital for microfinance. This effect can be seen on the part of the MFI and its own financing strategy, when it evaluates the costs of regulatory compliance, and on the part of the investor, who may see greater costs being imposed on an MFI and thus greater hardship in extracting profits.

This is not to say that it is not impossible to achieve a balance that does in fact promote investor confidence. In Uganda, Peru, and the Philippines, interesting investments were taking place alongside any of these regulatory hardships discussed. What is more critical is the regulatory process that allows for a continual appraisal of the regulatory framework in a manner that takes into account all affected actors – the financial system, MFIs, and investors.

THE PROCESS REQUIRED TO ACHIEVE BALANCE

The preceding sections outlined the types of regulatory requirements that may make investors nervous about microfinance, or that reduce the profitability of a microfinance institution. As has been pointed out in the preceding text, the regulatory spectrum ranges from insufficient oversight to overbearing oversight

Logical arguments can be made on the part of the regulator to how each requirement helps them to do their job. Does this mean there is a fundamental disconnect between the goals of a regulator and the comfort level of an investor? As U.S. Federal Reserve Board Governor Donald L. Kohn once stated, "Market participants should understand the nature of the chances they are taking. . . . We central bankers are by nature a gloomy lot, trained to focus on what could go wrong; avoiding really bad outcomes helps to shape our policy, and a dose of central banker-like risk assessment is also good advice for investors." (Henderson 2005)

While Mr. Kohn may be admonishing investors, the truth lies somewhere in between. Investors, too, understand the importance of mitigating risk in a regulatory fashion. Two prime examples of this are the Ugandan banker who will now lend to MFIs because they have gone through a central bank licensing process and the Philippine banks waiting until the legal ability to perfect the loan portfolio as security before lending to MFIs. But financial systems and investments do not exist in static environments. Politicians change, macroeconomic factors shift, and the institutions involved, both investors and MFIs, change their own scale of business and appetites for risk. All of this means that achieving the balance

between insufficient and overbearing regulatory oversight in a way that captures investor confidence requires continual reappraisal. Regulators must have in place a system that allows re-examination of the fundamental assumptions they make about the risk of an institution or a sector in order to adjust the requirements that are placed upon it.

IS THERE HOPE FOR SUCCESS?

To do this well, however, requires instilling a process that allows re-evaluation in a successful manner. Some fundamental lessons emerge from the three fieldwork countries.

First, evenhanded regulation of financial institutions that is uniformly applied in a transparent manner provides security not only to institutions but to investors. This is something relevant not only for microfinance, but the entire financial system. To proceed secure in the knowledge of what will be required and how much it will cost means an institution can plan for the future. An investor, moreover, has greater confidence in a uniformly applied system. She knows that the investment will not be crippled by a change in regulatory requirements, and she knows how to navigate the legal system in order to make the investment go through smoothly. This is valuable, especially when an investor has a choice of countries and institutions.

Furthermore, the legal framework needs to ensure that microfinance can not be twisted by political tides. This is especially true for interest rate caps, which can be easily politicized. One example of how to mitigate this risk is in the Philippines, where the right to charge a market interest rate is codified in two separate laws plus its National Microfinance Strategy. This means that any politician wishing to change this would need to have a long tenure and many allies to change so many legal texts.

Second, the government attitude towards both investment and microfinance are quite important. In all three fieldwork countries, early commitments were made on the part of the government to getting microfinance 'right.' This involved political champions who were willing to learn about microfinance best practice, instead of blindly calling for microfinance to be heralded as a poverty alleviation strategy, as some political "champions" have done. This involved, simultaneously, government commitment to creating a sound investment climate for all investors. Alex Silva (2005) remarked that an inadequate enabling environment that contributed to shifting investment climates was one of the major challenges faced by ProFund, one of the first microfinance investment companies. On the other hand, Uganda's Investment Promotion Authority has done significant work around ensuring transparent information about how to conduct investment in Uganda is disseminated, and the Capital Markets Authority has streamlined operations. The Philippines worked on a National Microfinance Strategy that makes sense for the country and instills the ability for microfinance to charge market interest rates regardless of provider.

Third, the process of reappraising the regulatory environment should be one that is consultative. Consultative processes can work in several different ways. In one type, all views are accommodated, even those that might want what is best for their institution, but not always what's best for the system. In another type, regulatory authorities 'consult' by telling their constituents what the regulatory changes are without regard to the impact this may have on their businesses. Finally, consultative processes can be conducted in such a way that while the regulatory authority is able to take the final decision about what is right for the environment, clear communication from all sides about why certain requirements are necessary and the impact this will have not only for MFIs, but for *investors* as well, is incorporated into the process. It is this final type of process that will be required in order for regulators to achieve the balance between regulating microfinance and ensuring investor confidence.

Regulatory reform for microfinance is on-going in many countries, and will continue to evolve as the microfinance industry grows and matures. It will be imperative to start integrating the investor's perspective into this policy dialogue, so that all can understand the impact such decisions will have.

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