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243

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Microfinance Regulation

Lessons from Benin, Ghana and Tanzania

This article identifies key issues and lessons about how the overall regulatory framework affects the ability of microfinance institutions (MFIs) to become more market-oriented and integrated with the financial system. It is based on a review undertaken by the World Bank of microfinance regulation in Benin, Ghana and Tanzania to better inform advice and project design regarding the appropriate balance between the objectives of promotion, performance, and prudential supervision.

African countries increasingly promote microfinance as part of their strategies to reduce poverty. Donors are demanding higher performance in terms of financial sustainability and outreach of the microfinance institutions (MFIs), to better leverage their support. As MFIs grow and begin mobilizing substantial savings, legal and regulatory frameworks are demanding greater prudential regulation by central banks — which often lack the staff and a clear understanding of microfinance methodologies. In the underdeveloped financial markets typical of African countries, legislation intended to promote MFIs may impose untenable supervisory burdens, while an excessively restrictive approach may constrict innovation and expansion. Microfinance regulation works best when it applies different approaches appropriately to different tiers of the financial system and when capacity limitations of both MFIs and supervisory authorities are also addressed.

Tiers of microfinance institutions and regulation

Regulations may be applied in "tiers" by defining different categories for which different degrees of regulation and supervision may (or may not) be warranted. In principle, tiers should be defined as a function of the responsibility of the authorities to safeguard the public's deposits and the safety of the financial system. "Microfinance" refers to small financial transactions with low-income households and microenterprises (both urban and rural), using non-standard methodologies such as character-based lending, group guarantees, and short-term repeat loans. Such methodologies can be applied in a wide range of financial (and even non-financial) institutions, which can be grouped under three main regulatory tiers according to whether they: (A) are conduits for other people's money; (B) serve to mobilize and lend out members' own money; or (C) utilize funds mobilized from the general public (Table 1).[1]

Regulation of MFIs (or microfinance products) may take three main forms: simple registration; (non-prudential) regulation that provides some standards (e.g., audits or interest rate information to protect the interests of members or consumers) and oversight, and may include criteria for membership in an association; and prudential supervision, which involves authority to sanction institutions that fail to comply with specified requirements (e.g., minimum liquidity and adequacy of capital, portfolio quality). Prudential supervision of category C institutions most clearly has a role to play in protecting public savings that are being mobilized and lent out ("intermediated"), which puts them at risk of being lost if loans are not repaid. But in some countries, microfinance legislation has extended the authority of supervisory authorities beyond what it can — or needs to — manage.

While member-based MFIs in category B are assumed to be self-regulating through their governance structure, this principle may break down in practice as they become larger. Non-prudential regulation may be appropriate to improve information and governance, e.g., a requirement to provide audited financial statements. While small groups are beyond the reach and necessity of regulation, for more formal (registered) Savings and Credit Cooperatives (SACCOs) and credit unions a transition to external supervision may be appropriate at some stage of growth — which is hard to define in general, but should be related to the size at which their assets approximate those of licensed financial intermediaries or pose risks that could destabilize the financial system.

Although there is little public benefit in external supervision of NGOs (category A) or informal moneylenders that do not utilize public funds, some monitoring may be needed to forestall fraudulent abuses such as pyramid schemes when registered non-financial organizations can legally engage in financial operations. In some countries, such as South Africa, non-prudential regulation such as interest rate disclosure is applied for consumer protection by an independent regulatory agency. Some degree of reporting consistent with central bank requirements may be suitable for NGOs that have organized as companies limited by shares, as part of a transition to licensed status.

Country experiences

Good microfinance legislation, regulation and supervision involves adapting basic principles to the conditions prevailing in a given country in terms of the varieties of institutions engaging in microfinance, the thresholds already established in the financial system, and the capacity of the regulatory and supervisory authorities. Although they represent comparable levels of economic development, low but growing income per capita, and shallow financial sectors, Benin, Ghana and Tanzania vary in the nature of their MFIs and in their experiences with microfinance regulation.

Benin

Despite its relatively small size, Benin has a diverse array of MFIs and the largest number in the West Africa Monetary Union (WAMU), which controls banking and finance in eight member states through a unified central bank. These consist of licensed credit unions or mutuelles (the only officially-recognized licensing format), registered credit-only MFIs, several donor projects with microcredit components, and a variety of informal groups and associations. The microfinance sector has an estimated outreach of 700,000 clients, with some US$ 33 million in loans outstanding and US$ 40 million in savings deposits.

WAMU's law for microfinance was intended both to promote and to bring order into the sector. The law defined SACCOs (or mutuelles) as the only officially sanctioned format, but allowed NGOs, donor projects and informal organizations to engage in microfinance if registered with the Ministry of Finance, which was tasked with supervising the entire sector.

Ghana

Ghana's formal and semiformal MFIs reach some 1.5 million clients, members and depositors, of which less than a third have loans. They include 115 licensed rural and community banks (RCBs) with over a million depositors and 150,000 borrowers; 9 licensed savings and loan companies (S&Ls) with more than 160,000 depositors and 10,000 borrowers; and 253 credit unions with over 120,000 members. Some 60,000 borrowing clients are served by 50 microcredit non-government organizations (NGOs), but most of these entities, as well as even smaller community-based organizations, have fewer than 1,000 clients each.

Ghana's multi-tiered regulatory structure evolved through early efforts in the 1970s to extend the outreach of the formal financial system and service the cocoa sector by permitting locally-owned unit Rural Banks and through the 1993 Non-Bank Financial Institutions Act, which was intended to diversify the financial sector. Credit unions were included in the latter, but central bank supervision proved unworkable, and a new Credit Union law was prepared that envisages dual responsibility of the central bank and the Department of Cooperatives, which registers credit unions.

Tanzania

Three categories of registered financial institutions provide financial services to Tanzanian households, micro and small enterprises: (i) licensed commercial, regional and rural banks, (ii) SACCOs, and (iii) NGO-based MFIs. In contrast to Benin and Ghana, the Tanzania Postal Savings bank and several commercial banks are the leading providers of microfinance services, with outreach that exceeds the combined outreach of SACCOs and MFIs. The 650 active urban and rural SACCOs have an estimated membership base between 130,000 to 160,000, only a fifth of them borrow-

Table 1. Regulatory Structure and Triggers, by Type of MFI

Type of MFI	Activities that trigger regulation	Forms of external regulation	Recommended regulatory authority
Informal savings and credit groups funded by member fees and savings	None	None required	None required
Category A: Nongovernmental organizations (NGOs) funded by donor funds			
Category A1: Donor funds only	None, if total loans do not exceed donated funds, grants and accumulated surplus	Registration as a nonprofit society, association or trust	A registrar of societies, self-regulatory body if any
Category A2: Also borrowing commercially or issuing securities	Generating liabilities through borrowings to fund micro-loan portfolio and operations	Registration as a corporate legal entity, authorization by a banking authority or securities commission	A registrar of companies, banking authority, securities agency
Category B: Financial cooperatives and credit unions funded by members' money and savings	Accepting deposits from and making loans to members	Registration as a financial cooperative	A registrar of cooperatives or banking authority
Category C: Special-licensed banks and MFIs funded by the public's money (deposits, investor's capital, commercial borrowings)	Accepting wholesale and retail public deposits for intermediation into loans and investments	Registration as a corporate legal entity, licensing as a finance company or bank (with full prudential requirements)	A registrar of companies, banking authority

Note: This regulatory classification of MFIs was originally proposed in Hennie Van Greuning, Hennie, Joselito Gallardo, and Bikki Randhawa, "A Framework for Regulating Microfinance Institutions," Policy Research Working Paper no. 2061, World Bank, Washington, D.C. (1999).

ers. The 60 NGO MFIs are dominated by two large NGOs that have three-quarters of the market, estimated at 100,000 client-members.

Establishment of a National Microfinance Bank to retain the rural branch network of the privatized National Bank of Commerce helped motivate Tanzania's establishment of an explicitly multi-tiered regulatory framework, both to facilitate engagement of formal financial institutions in microfinance and to ease the graduation of unregulated microfinance institutions to formal status. The regulatory requirements are still emerging, and so far there has been little entry or conversion to licensed categories such as regional and rural community banks.

Key issues

Commercial microfinance on a well-organized, national scale is a relatively new development in the three case study countries. Formally established and regulated microfinance providers are still few, and a significant portion of microcredit services are provided by the numerous informal and semi-formal entities which are mostly not regulated and often not registered. The case studies raised a number of issues pertinent to microfinance promotion and regulation.

Can regulation promote growth of microfinance? Incorporating microfinance into the formal financial system offers an attractive alternative to using microcredit as an instrument for socially-motivated poverty alleviation projects in that it emphasis the financial sustainability necessary to continue serving the poor over time without subsidy dependence. However, regulatory frameworks designed for objectives other than regulating the taking of deposits from the public and intermediating them into loans often result in standards that are disproportionately restrictive and unmanageable. On the other hand, vigorous microfinance industries have developed without conducive regulatory environments in countries such as Uganda and Kenya — where specialized legislation has become necessary to enable growing MFIs to mobilize deposits.

New legislation has not proven very effective in establishing well-regulated microfinance systems when MFIs brought under new regulatory regimes are unable to comply and when supervisory authorities lack adequate capacity. Benin's Ministry of Finance was unable to cope effectively with the large number of MFIs it was supposed to regulate under its microfinance law, and the central bank now plans to take over supervision of the largest MFIs. While new laws and regulations in Ghana encouraged entry of rural unit banks and savings and loan companies to serve rural areas and microenterprises, the excessive regulatory burden on the central bank led to the creation of an Apex Bank to help service the rural banks and to raise the minimum capital requirement for savings and loans to restrict entry.

Capacity to supervise and be supervised: The benefits from regulating microfinance may be limited when commercial banking standards are applied to MFIs without adequate consideration of microfinance methodologies. For supervision to be effective, the data requirements and the indicators used must be relevant to the operations of MFIs, and they in turn must adapt their systems to central bank reporting requirements. A further issue that has received scant attention is measuring and paying for the costs of supervision. The costs of supervising MFIs may well be greater than for commercial banks, but their much smaller asset base makes it more difficult for them to bear the costs. Donors have generally supported central banks in developing regulatory guidelines and standards for MFIs, as in Ghana and Tanzania. However, more resources will be needed to address deficiencies in technical capacity — not only for the supervisory agencies, but especially for the MFIs subject to regulation.

Who should regulate? An important issue is the extent to which regulatory authority should be centralized, delegated, or decentralized. Like many other countries in Africa, regulatory responsibilities in Benin, Ghana and Tanzania have been fragmented among a central bank responsible for prudential supervision of licensed financial institutions, a cooperatives authority responsible for member-based SACCOs, and other government agencies that register NGO MFIs. registered under non-financial authorities. In deciding how to implement regulatory responsibilities, two distinctions are important: regulatory *policy* should have a single locus, while application of regulatory functions can be delegated to different regulatory units with specialized responsibilities; and the criteria and authorities for prudential supervision should differ from those for non-prudential regulatory oversight, along the lines indicated in Table 1.

Cooperative financial institutions: Financial cooperatives offer important potential for decentralizing financial services, but integrating them into formal financial regulatory systems has proven difficult. While Benin's microfinance law prioritizes financial cooperatives, the supervisory burden has proven overwhelming. Financial policy-makers in Ghana and Tanzania have recognized the need to incorporate financial cooperatives into the regulatory framework, and Ghana's proposed approach of recognizing dual responsibilities of central bank and cooperatives authorities for credit unions bears watching.

Lessons learned

The experience in the three countries does not support the proposition that establishing new regulatory categories will necessarily promote commercialization of microfinance or the creation of financially sustainable MFIs where few or none exist. The capacities of authorities to implement their regulatory obligations and of MFIs to comply are a critical constraint on the effectiveness of new legislation in promoting and regulating microfinance. Key lessons include the following:

- MFI legislation has limited use as a promotional tool, and excessive coverage risks giving legal authority to weak institutions that cannot be adequately supervised. licensing criteria should balance ease of entry for financially sustainable MFIs against the capacity of supervisory authorities to provide effective prudential supervision.
- Licensing and supervision of MFIs works best when it is narrowly targeted to enable commercially-oriented MFIs to take deposits and attract investors in order to fund their growth.
- Legal and regulatory requirements should distinguish between when prudential supervision is warranted and when non-prudential regulation is sufficient, with different criteria and regulatory authorities; in particular, regulations should distinguish between deposit-taking MFIs, whose financial soundness needs to be verified through prudential supervision, and MFI categories that may simply be registered and subjected to non-prudential regulations and standards, but do not pose financial system risks for which the financial authorities should bear responsibility.
- While the self-governance mechanisms of financial cooperatives may be sufficient at relatively small sizes, external prudential supervision is warranted as they reach the financial size of licensed financial intermediaries.
- Regulatory *policy* should have a single locus, while application of regulatory *functions* can be delegated to different regulatory units with specialized responsibilities.
- Capacity-building of supervisory authorities and development of appropriate regulatory requirements in parallel with application of new legislation is essential.
- Development of the regulatory framework should have complementary development of other business laws and regulations, especially taxation, contract enforcement, collateral, securities regulation, and consumer protection.

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1 Entities that are normally beyond the scope of regulation include semi-formal groups registered for non-financial purposes that mobilize their own funds and establish rules for their use, as well as informal rotating or accumulating savings and credit associations and individual agents such as moneylenders and savings collectors.

This article written by William F. Steel is based on "Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana, and Tanzania" by Joselito Gallardo, Korotoumou Ouattara, Bikki Randhawa, and William F. Steel (World Bank Africa Region Financial Sector Group and Financial Sector Operations and Policy Department, May 2004 draft).