

# Some Legal and Regulatory Issues Relating to Microfinance

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# Historical Regulatory Issues Unique to Microfinance

- Microfinance often ignored by banking sector.
- Tradeoff between outreach and sustainability.
- Not practical (and no need) for non-depositing taking MFIs to be governed by prudential regulation.
- Non-prudential microfinance regulation important to protect microfinance clients.
- Community based MFIs often too small or remote for effective regulation.

# Microfinance in Transition

- 92m+ micro-borrowers have \$65 bn in credit – average loan of \$520 –up from \$24 bn in 2006.

Microfinance Information Exchange, available at <http://www.mixmarket.org>.

- Poor people want savings accounts as shown by 1.3 bn "accessible" savings accounts worldwide (i.e. low average balance, and low costs).

CGAP Global Estimates, available at <http://www.cgap.org/p/site/c/template.rc/1.11.1792/1.26.2108>.

- Between 2.1 bn and 2.7 bn adults, 72% of adult population in developing countries do not have a basic bank account.

G20 2010 Innovative Financial Inclusion Report, available at [http://www.microfinancegateway.org/gm/document-1.9.44743/Innovative\\_Financial\\_Inclusion](http://www.microfinancegateway.org/gm/document-1.9.44743/Innovative_Financial_Inclusion).

- In 2007, the growing number of MFIs was estimated as over 10,000.
- Microfinance evolving from donor-driven NGO-dominate framework towards increasing involvement of international capital markets.

CGAP, Cross-Border Funding for Microfinance (2010), available at [http://www.cgap.org/gm/document-1.9.48412/Cross-border\\_funding\\_to\\_microfinance\\_2010.pdf](http://www.cgap.org/gm/document-1.9.48412/Cross-border_funding_to_microfinance_2010.pdf).

# Microfinance Goes Global

- At end of 2009, global microfinance cross-border funding totaled \$21.3 bn.
- Foreign capital investment in microfinance estimated at \$12 bn.  
CGAP, Microfinance Investors Adjust Strategy in Tougher Market Conditions (Oct. 2010), *available at* <http://www.cgap.org/gm/document-1.9.47946/MIVBrief.pdf>.
- Commercial cross-border debt and equity invested in microfinance surpassed \$11 bn.  
CGAP, Microfinance Foreign Exchange Facilities: Performance and Prospects (Apr. 2010), *available at* [http://www.cgap.org/gm/document-1.9.43712/OP17\\_rev.pdf](http://www.cgap.org/gm/document-1.9.43712/OP17_rev.pdf).
- Foreign capital investment managed by microfinance investment vehicles more than \$6 bn .  
CGAP, Microfinance Investors Adjust Strategy in Tougher Market Conditions (Oct. 2010), *available at* <http://www.cgap.org/gm/document-1.9.47946/MIVBrief.pdf>.
- MFIs increasingly access capital markets through securitization and CDOs.  
Brad Swanson, *The Role of International Capital Markets in Microfinance* (2008), *available at* <http://www.dwmarkets.com/media/pdf-international-capital-markets.pdf>.
- Websites allow peer-to-peer cross-border micro-lending.

# Microfinance Goes Mobile

- According to CGAP those who lack a bank account but have a mobile phone will reach 1.7 bn in 2012, over 50% of the unbanked population worldwide.

CGAP, Mobile Banking: From Concept to Reality (Jun. 25, 2009), available at <http://www.cgap.org/p/site/c/template.rc/1.26.10806/>.

- Mobile payment users predicted to exceed 190 ml in 2012 and money transfers could total 600 bn globally by 2013.
- Rapid public acceptance of mobile financial services in the Philippines, Brazil, India and Kenya demonstrates that the technology is mature and provides an effective and low-cost microfinance solution.

# New Regulatory Issues

- **“Microfinance is rapidly shifting from a niche product to a globally recognized form of finance. Yet as microfinance offerings become more sophisticated and diverse, regulatory and market gaps keep the industry from operating as well as it should.”**

Economist Intelligence Unit, *Global Microscope on the Microfinance Business Environment 2010*, available at <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35379430>.

- Exchange rate risk arises from mismatch between deposits in local currency and foreign funding.

CGAP, *Microfinance Foreign Exchange Facilities: Performance and Prospects* (Apr. 2010), available at [http://www.cgap.org/gm/document-1.9.43712/OP17\\_rev.pdf](http://www.cgap.org/gm/document-1.9.43712/OP17_rev.pdf).

- Commercial MFIs subject to increasing demands for profits.
- Risk management failure as systems and controls become overstretched.
- Insolvency concerns with rapid expansion, especially non-regulated MFIs.

Daniel Rozas, *Throwing in the Towel: Lessons From MFI Liquidations* (Sep. 2009), available at <http://www.microfinancefocus.com/news/wp-content/uploads/2009/09/Throwing-in-the-Towel.pdf>.

# More New Regulatory Issues

- Client over-indebtedness through multiple loans as competition for market share intensifies.
- Increased use of collateral fosters abusive collection practices by some MFIs.

Jude L. Fernando, *The Myths Behind Microfinance*, Forbes (Dec. 9, 2010), available at <http://www.forbes.com/2010/12/09/microfinance-myths-muhummad-yunus-entrepreneurs-finance-jude-fernando.html>.

- Need for regulation of both bank-led and non-bank led mobile financial service providers.

G20 2010 Innovative Financial Inclusion Report at 16.

- Legal structures inadequate for complex cross-border financing.

Steven L. Schwarcz, *Disintermediating Avarice: An Inquiry Into Commercially Sustainable Microfinance*, Ill. L. R. 29-32 (2011) (forthcoming), available at [http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2944&context=faculty\\_scholarship](http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2944&context=faculty_scholarship).

- “The rise of peer-to-peer intermediaries has meant that a growing number of unsophisticated funders and recipients have become involved in some of the riskiest activities in international finance.”

Kevin E. Davis and Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries* at 54 (Jun. 2010), available at [http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1010&context=fac\\_works\\_papers](http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1010&context=fac_works_papers).

# Need For International Standard-Setting

- “Regulatory and supervisory efforts in microfinance and financial inclusion have focused on national level.”
- “Financial access for the poor is growing both in reach—through innovations such as branchless banking technologies—and the role of global investors and donors as funders and advocates for standardized practices and principles across the industry.”
- **“This has opened up space for an increased role of international standard-setting and advisory bodies to promote improved financial access across the globe.”**

CGAP, *G20 Identifies Nine Principles for Innovative Financial Inclusion*, available at <http://www.cgap.org/p/site/c/template.rc/1.26.13722/>.



# BCBS Guidance on Microfinance and the Basel Core Principles

- Guidance concerns general applicability of the Basel Core Principles to bank and non-bank MFIs engaged in microfinance deposit taking.
- Deposit taking institutions should be subject to regulation commensurate to type and size of transactions.
- Key regulatory considerations:
  - Allocate supervisory resources efficiently, especially where depository microfinance not large portion of financial system but large number of small institutions;
  - Recognize proven control and managerial practices that suit the microfinance business; and
  - Clarify permitted microfinance activities to different institutional types, while retaining flexibility to deal with individual cases.

# International Standards: Secured Lending

- A modern secured credit regime, such as that contained in the UNCITRAL Legislative Guide on Secured Transactions, has the potential to provide a positive adjunct for upper tier microenterprise lending.

World Bank, Reforming Collateral Laws to Expand Access to Finance at 20, available at <http://elibrary.worldbank.org/content/book/9780821364901>.

- *Financial Access 2010* reports that “For firms, especially SMEs, lack of access to finance is often the main obstacle to growth.”

CGAP/World Bank, Financial Access Report 2010 at 1, available at <http://www.cgap.org/p/site/c/template.rc/1.26.14234/>.

- The Guide, along with the UNCITRAL Model Law on Cross-Border Insolvency and the Convention on the Assignment of Receivables, also offers a supportive legal framework for cross border funding of MFIs through securitization and CDOs.

World Bank, Reforming Collateral Laws to Expand Access to Finance at 21, available at <http://elibrary.worldbank.org/content/book/9780821364901>.

# G20 Principles for Financial Inclusion

- Leadership
- Diversity
- Innovation
- Protection
- Empowerment
- Cooperation
- Knowledge
- Proportionality
- Framework

G20 2010 Innovative Financial Inclusion Report at 25-33.

# Leadership

- *Financial Access 2010* reports that “on average, across the financial inclusion topics surveyed, only about 80 percent of economies with responsibility for a financial access area have an allocated team or unit implementing the policy.”
- “The capacity gap is larger in low-income countries, with the paradox that it is precisely in these economies that the agenda is broader.”
- Economies with financial inclusion strategies are more likely to cover more topics and have allocated resources.

# Diversity: Microfinance Products

- *Financial Access 2010* reports empirical evidence demonstrating that access to basic financial services such as savings, payments, and credit can make a substantial positive difference in poor people's lives.
- As microfinance institutions have begun offering a wider variety of financial services, the meaning of the term “microfinance” evolved to encompass all financial tools designed for poor clients.
  - Micro-credit
  - Micro-savings
  - Micro-insurance
  - Micro-payments
  - Remittances

# Diversity: Inefficiency of Interest Rate Caps

- A number of countries in Latin America and East and South Asia continue to set caps on market interest rates and /or MFIs are subject to unfair competition from subsidized programs and institutions.

Economist Intelligence Unit, *Global Microscope on the Microfinance Business Environment 2010*, available at <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35379430>.

- CGAP/World Bank report – interest rate caps and outright bans on usury have “proven to be unsustainable and difficult to enforce.”  
CGAP/World Bank, *Financial Access Report 2010* at 23.
- “Interest rate ceilings make it difficult or impossible for formal and semi-formal micro-lenders to cover their costs, driving them out of the market (or keeping them from entering in the first place). Poor clients are either left with no access to financial services or must revert to informal credit markets (such as local moneylenders), which are even more expensive.”

CGAP/World Bank, *Interest Rate Ceilings and Microfinance: The Story So Far* (Nov. 2004), available at <http://www.cgap.org/gm/document-1.9.2703/OP9.pdf>.

# Diversity: Micro-Savings

- The *Economist* suggests the government “allow MFIs to take deposits, which they are currently prevented from doing [in India]: this would make them less dependent on capital markets for funding.”

The Economist, *Leave Well Alone*, Nov. 18, 2010, available at <http://www.economist.com/node/17522606>.

- CGAP/World Bank reports that nonbanks play an important role in providing basic deposit services, including in Burundi, Chile, Uganda, Peru, Cambodia, Bolivia, Benin, Burkina Faso, Côte d’Ivoire, and Niger, among others.

CGAP/World Bank Financial Access Report 2010 at 8.

# Diversity: Micro-Savings Policy Questions

- How can a range of microfinance providers be allowed to operate?
- When is the right time for a specialized license for microfinance deposit institutions?
- Which MFIs should be eligible to operate with a specialized license?
- What does (and does not) require regulation and supervision?
- What is an appropriate level of minimum capital for this new tier of institutions?
- How can tiered micro-savings be supervised effectively?

Microfinance Africa, *Formalizing Microsavings: A Tiered Approach to Regulating Intermediation* (May 7, 2010), available at <http://microfinanceafrica.net/resources/formalizing-microsavings-a-tiered-approach-to-regulating-intermediation/>.



# Innovation

- *Financial Access 2010* reports that “Despite the numerous hurdles to implementing sound policies, there are promising trends in financial inclusion, including the expansion of retail infrastructure and use of new technologies to deliver financial services cost effectively.”
- Globally, one bank branch, five ATMs, and 167 point-of-sale (POS) terminals were added per 100,000 adults in 2009.

CGAP, *Survey Shows Financial Access Growing Despite Effects of the Financial Crisis* (Dec. 28, 2010), available at <http://www.cgap.org/p/site/c/template.rc/1.26.14234/>.

# Innovation

- Innovation creates regulatory challenges since MFI capacity to take on alternative delivery channels—such as POS, ATMs, mobile financial services—needs to be evaluated from a standpoint of the back-office capacity to take on the front end technology, and the human capacity to manage the back-office functions on a continuous basis.
- Most unregulated MFIs do not have this capacity.

# Protection: Regulation and Enforcement

An effective financial protection regulatory framework for microfinance users:

- protects against unfair or deceptive practices by financial service providers, including in advertising and collections.
- improves transparency through a requirement to disclose full, plain, adequate, and comparable information about prices, terms, and conditions of financial products and services; and
- provides a practical recourse mechanism to address complaints and resolve disputes quickly and inexpensively.

# Protection: Regulation and Enforcement

Yet *Financial Access 2010* found that of the economies surveyed:

- Broad fair treatment provisions are in place, but they may not address specific issues.
- Only half of the economies surveyed have legal provisions restricting unfair and high-pressure selling practices and abusive collection practices.
- Banks are more likely to be subject to disclosure requirements while unregulated MFIs are rarely subject to such rules.
- There are stark discrepancies between the stated requirements and the available enforcement powers, capacity and mechanisms.

# Protection: Self-Regulation

- “Can self-regulation work when it comes to sharing credit information and establishing codes of conduct on issues around culturally acceptable collection systems, dispute settlement systems, etc.?”
- “Going forward, the microfinance industry as a whole needs to be serious about implementing a responsible finance agenda, including transparency about interest rates charged to clients.”

CGAP/World Bank, Focus Note, *Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance* at 6 (2010), available at <http://www.cgap.org/gm/document-1.9.48945/FN67.pdf>

- MFIs have already begun the process that will lead them to report their interest rates publicly through Microfinance Transparency.

CGAP/World Bank, Focus Note, *Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance* at 5 (2010) (citing MFTransparency, available at <http://www.mftransparency.org/>).

# Empowerment: Financial Literacy

- *Financial Access 2010* reports that approximately half of the economies surveyed have a team within the government financial regulation department allocated to financial literacy.

CGAP/World Bank, Financial Access Report 2010 at 17.

- Honduras and Ghana, among others, are noted for efforts to establish Financial Literacy Programs.
- Private corporations in the Philippines and South Africa have sought to fill the need for financial education of their consumers.
- Third-party consortium of government, civil society, and private firms may be able to best provide financial literacy training to the public.

G20 2010 Innovative Financial Inclusion Report at 29-30. See also Appendix 5 pp. 70-82.

# Cooperation

- According to the BCBS survey, there is a fair level of clarity and transparency concerning responsibilities and objectives of different supervisors charged with microfinance supervision.
- However, when more than one agency is involved in the supervisory process, survey responses indicated common deficiencies in coordination, cooperation and systems for information sharing among different microfinance supervisors.
- In some middle and low-income jurisdictions, supervisors report lack of authority to gather information on non-depository entities or depository institutions overseen by another agency, particularly in the cooperative sector, where the supervisory arrangement is more fragmented and based on their size (i.e. assets, deposits, clients).
- Overall, there is mixed recognition among supervisors in the sample that allocation of scarce resources should take into account the relative risks posed by small institutions and the different tools available to mitigate those risks.

# Cooperation

- Implementation of alternative model of governance — in which policy and decision-making reflect balanced participation of business, civil society, and governments, and in which the poor and their advocates have a voice from the outset in the framing of new mandates is essential.

Centre for Global Studies, *The Need for a Global Microfinance Facility* (Jan. 2002), available at <http://www.globalcentres.org/html/docs/Policy%20%20Brief.pdf>.



# Knowledge: Need for Data

- *Financial Access 2010* reports, robust analysis of the changes in the number and volume of loans and deposits between banks and nonbanks is challenging because of data limitations for nonbanks.

CGAP/World Bank, Financial Access Report 2010 at 8.

# Knowledge: Need for Definitions

- *Financial Access 2010* reports “Lack of a clear definition is the main challenge in measuring SME finance.”
- “Definitions vary greatly across countries, and financial regulators in 68 economies reported that their SME definition is based on number of employees, sales volume, or loan size. Number of employees and sales volume seem to be the most widely used criteria, present in 50 and 41 economies, respectively. Sixteen economies use the value of loans. Often, the definition relies on multiple criteria and depends on the industry.”

# Knowledge: Need for Definitions

- The BCBS Guidance defines microfinance as “the provision of financial services in limited amounts to low-income persons and small, informal businesses.”
- According to the BCBS survey, 59% of the surveyed countries reported having some sort of definition related to microfinance in their financial laws or regulations.
- Most also have definitions of “microcredit”. Some countries define microcredit for the purpose of classifying loan portfolios, setting provisions, and otherwise differentiating rules applicable to regulation and supervision of microcredit portfolios from those applicable to conventional retail portfolios of banks.
- The definitions used a variety of different parameters, such as the maximum loan size, maximum income or assets of the borrower, and source of funds to be used to repay the loan.

# Knowledge: Need for Definitions

- The definition of “micro” also varies:
  - Russian law: “microloan meaning a loan . . . not exceeding one million rubles” (approximately \$33,000).

Russia Federal Law No. 151-FZ of July 2, 2010, available at <http://www.cgap.org/p/site/c/template.rc/1.9.46017/>.

- Philippines regulations: “the maximum principle amount of microfinance loans shall not exceed PHP 150,000” (approximately \$3500).

Philippines Circulation No. 272 Microfinance Operations, available at <http://www.cgap.org/p/site/c/template.rc/1.9.44799/>.

# Proportionality: Branchless Banking

## Emerging Issues

- The explosive growth of mobile money has had increasing public involvement in the formal financial system, including expansion of savings accounts in the regulated financial intermediaries.
- However, it has also converted widely distributed consumer risk into a concentrated systemic risk, where the value of the items in transit on deposit through trustee accounts is no longer insignificant.
- For example, what steps need to be taken to ensure that branchless banking is not vulnerable to electronic crime, fraud and other risks?

# Proportionality: Non-Bank E-Money Issues

- Should e-money be treated as savings, and the associated entailment of paying interest on those funds?
- Should these funds be covered by deposit insurance schemes to lower risk?
- Should the administer funds through 'trust account' to ensure individual mobile banking clients are the real owners of the funds in case of bankruptcy?
- Should the MFI or mobile operator be required to set aside matching reserves in cash or short-term debt (equivalent to value of e-money) with a licensed commercial bank (also known as e-float)?
- Should there be diversification of risk through placing e-float in different commercial banks?

Alliance for Financial Inclusion (AFI), Policy Note, *Mobile Financial Services Regulatory Approaches to Enable Access* (Nov. 2010), available at [http://www.microfinancegateway.org/gm/document-1.9.48603/AFI\\_Policynote\\_%20Mobile%20Financial%20Service\\_EN.pdf](http://www.microfinancegateway.org/gm/document-1.9.48603/AFI_Policynote_%20Mobile%20Financial%20Service_EN.pdf) .

# Proportionality

- Dialogue with regulators, policymakers and with other stakeholders will be essential to the development of risk based regulation that is proportionate with the need to encourage innovation and efficiency in mobile money transfers.

Cynthia Merritt, *Mobile Money Transfer Services: The Next Phase in the Evolution in Person-to-Person Payments*, Retail Payments Risk Forum White Paper, Federal Reserve Bank of Atlanta (Aug. 2010), available at [http://www.frbatlanta.org/documents/rprf/rprf\\_resources/wp\\_0810.pdf](http://www.frbatlanta.org/documents/rprf/rprf_resources/wp_0810.pdf).

- USAID, in partnership with others, created a Mobile Financial Services Risk Matrix to help harmonize legal and regulatory environments for mobile financial services. The Matrix contains detailed analysis of various risks involved in different models of mobile financial services, as viewed from each of the key stakeholders involved in these transactions.

USAID, in partnership with Kenya School of Monetary Studies and Booz Allen Hamilton, *Mobile Financial Services Risk Matrix* (Jul. 2010), available at <http://bizclir.com/galleries/publications/Mobile%20Financial%20Services%20Risk%20Matrix%20July%202010.pdf>.

# Framework: Cooperation on International Standards

- Given that there is no common standard for creating an enabling environment, especially in the context of branchless-banking, different regulators respond in different ways, leading to a proliferation of inconsistent operating environments for account providers, and in some cases, limitations on the range of services that can be provided based on factors other than the underlying risks.

USAID, Mobile Financial Services Risk Matrix, *available at*

<http://bizclir.com/galleries/publications/Mobile%20Financial%20Services%20Risk%20Matrix%20July%202010.pdf>.

- In many countries regulations including restrictions on who can provide remittance services, capital controls or simply limits on account sizes that are below what customers typically send, all provide obstacles to the use of branchless banking services to facilitate international remittances.

Mobile World Congress in Barcelona, Feb. 2009.



# Appropriate Risk-based AML CFT Regime

- According to the BCBS:
  - ODTIs and MCIs are required less often than other types of institutions such as banks and money or value transfer service providers to implement FATF-related compliance controls.
  - Similarly, in the jurisdictions where cooperatives are not prudentially supervised they are not required to implement such controls.
  - In most places where AML/CFT controls are imposed, rules are largely the same for all types of institutions, but some countries have lighter rules for smaller institutions, such as exemption from having a formal AML/CFT compliance unit or function.
  - Only 30% of the respondents (most middle-income) reported having undertaken a formal AML/CFT risk assessment to identify and define low-risk operations.

# Framework: Agent Banking

- An important constraint to financial services access is the lack of banking infrastructure in rural areas.
- “To achieve universal access, banks will need to adapt their systems to a low-value, high-volume transactional environment and to build more flexible, scalable retail networks of points at which people can conveniently pay into or cash out from their transactional accounts.”

CGAP, Overview, available at <http://www.cgap.org/p/site/c/template.rc/1.11.1029/1.26.1525/>

- According to the BCBS survey, many jurisdictions, including high-income countries with little microfinance activity, have explicit regulatory permission – or do not prohibit – financial institutions to outsource activities such as collecting deposits, to non-bank retail agents.

BCBS, Microfinance activities and the Core Principles for Effective Banking Supervision, at 27, 48-49.

# Framework: Agent Banking

- “An important trend in microfinance involves outsourcing activities— such as collecting deposits and verifying customer identity— to retail establishments under agency agreements. Agent banking also may be linked to the use of electronic and mobile phone banking delivery channels, in increasingly complex and far-reaching outsourcing arrangements. New delivery channels, by relying heavily on technology and third-party relationships can add extra layers of complexity in risk management, therefore requiring tailored operational risk standards.”
- “These standards should be carefully crafted to avoid curbing innovative models while ensuring the safety and soundness of institutions and customer funds. Aligning standards with industry trends requires supervisory personnel to develop a deep understanding of how new business models function and design specific tools and procedures to identify signs of increased operational risk in microfinance operations.”

BCBS, Microfinance activities and the Core Principles for Effective Banking Supervision, at 25,48-49.

# Framework: Group Loans

- According to the BCBS survey:
  - “Microcredit can be based on a group lending model (also known as village banking or solidarity groups), a methodology usually employed for very poor clients. Eight countries in the sample – all of them low- and middle-income – have regulatory provisions for group microcredit methodologies applied by banks, ODTIs and MCIs.”
  - “In such cases, existing lending limits are either not applicable or higher than for individual loans. A few countries have developed supervisory programs that deal specifically with group lending. In one Asian country, for instance, supervisors evaluate the incentives and the performance of loan officers using different parameters for individual and group lending methodologies.”

# Conclusion

- Financial access for the poor is growing both in reach through innovations such as branchless banking technologies and through the role of global investors and donors as funders.
- **As the G20 has recognized, “this has opened up space for an increased role of international standard-setting and advisory bodies to promote improved financial access across the globe.”**
- **“Key elements of a regulatory framework that supports the safe and sound spread of innovative financial inclusion emerge from countries leading in the use of new approaches to reach unserved poor people.”**

*CGAP, G20 Identifies Nine Principles for Innovative Financial Inclusion, available at <http://www.cgap.org/p/site/c/template.rc/1.26.13722/>.*