Global microscope on the business environment for microfinance

Evaluating the legal environment for microfinance

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Economist Intelligence Unit

What is the global microscope?

- **An index that assesses country-level business environment for microfinance**

  - Covers 55 countries, at a national level
  - Updated annually

- **Specifically, it evaluates and benchmarks countries' legal, regulatory, and institutional frameworks for microfinance**

- **Focuses mainly on *microcredit* and *microdeposits*, though it also considers the regulatory framework for financial transactions through agents**

Global Microscope: 2012 categories

What does it include?

- **There are three index categories**

Regulatory framework and practice (Category 1)

Supporting institutional framework (Category 2)

Political stability adjustment factor (Category 3)

- **Of these, the first is devoted entirely to laws and regulations**
  - Assumes that broader financial regulations are not entirely adequate to properly facilitate and oversee microfinance
  - Also accounts for the fact that some regulatory environments, while differentiated, may stifle microfinance
  - Regulatory assessments look at both institutional formalisation as well as operating requirements (reporting to the main regulator, prudential standards, etc)
  - As microfinance is largely an informal sector, the indicators do also consider the environment to allow unregulated institutions
  - Also looks at regulatory capacity for microfinance specifically, which is the main source of more nuanced laws and regulations and oversight

How about institutions?

- **The second category is also just as important as the first**

Regulatory framework and practice (Category 1)

Supporting institutional framework (Category 2)

Political stability adjustment factor (Category 3)

- **The "Supporting institutional framework" category evaluates whether MFIs are operating in a vacuum of standards or a well-supported market**
  - Assumes that although much of the sector may be informal, standards and institutions specific to microfinance (or at least accessible) are required to ensure sector health
  - Credit information, dispute resolution, accounting standards and pricing transparency all play a role here
  - Also considers regulations and use of technology for financial transactions
  - The question is how good are these are at a ***micro level***, not just for the broader financial sector

Full indicator list

- **There are a total of 12 indicators across the three categories**
  - Focus is on commercial and private actors; a total of 11 are sector-specific

Microscope indicators, by category:

Category 1

1. Regulation and supervision of microcredit portfolios
2. Formation of regulated/supervised microcredit institutions
3. Formation/operation of non-regulated microcredit institutions
4. Regulatory and supervisory capacity for microfinance
5. Regulatory framework for deposit taking

Category 2

1. Accounting transparency for microfinance institutions
2. Client protection: Transparency in pricing
3. Client protection: Dispute resolution
4. Credit bureaus for microfinance
5. Policy and practice for financial transactions through agents

Category 3

1. Political shocks to microfinance
2. Political stability (overall country)

The Global Microscope: Methodological overview

External evaluation which considers a variety of information and data sources

How is it done? It is a collection of qualitative indicators constructed using specific scoring criteria developed in consultation with expert group & benchmarking specialists

- All information collected on a country-by-country basis, building upon previous years of data and analysis, and referring to other comparable indicators
- Includes an important primary research component-- interviews provide depth
- Survey provides breadth of information
- Primary legal and policy research

- Comprehensive evaluation
  - Laws on books and standards on paper
  - Implementation and practice
- Transparent design and scores with analysis stimulate discussion

The Global Microscope: Significance

Indicator importance

- **Analysis conducted by staff at the World Bank research department shows a significant, strong correlation between the Microscope overall score and key microfinance sector variables such as:**
  - Average loan portfolio size and microcredit borrowers as a % of total population and as a % of the poor population

Regression Framework[1]

Penetration$_i = \alpha + \beta_1 MICROSCOPE_i + \beta_2 Country_i + \varepsilon_i$

MICROSCOPE: overall index, broad components (regulatory framework and practices and institutional framework), sub-components

Country: GDP growth, inflation, institutional development, banking efficiency, overall business environment (Doing Business)

- **At an indicator level,** client protection sub-components related to (a) transparency in pricing and (b) dispute resolution, as well as regulatory capacity, demonstrate the strongest correlation with sector variables

- **Does not yet establish causal relationships-- a good start**

[1] From FOROMIC Barbados Conference Presentation, Oct 2 2012, Bob Cull, World Bank

The Global Microscope: Indicator criteria example

<u>Client protection, Dispute Resolution: Indicator 8</u>

Does the regulatory and business environment provide for timely dispute-resolution at reasonable cost in the event of disagreements between microfinance lenders and borrowers?”

Scoring:

0=There is no mechanism for dispute resolution;

1=A mechanism for dispute resolution exists on paper, but few resources, if any, have been devoted to it;

2= A mechanism for dispute resolution exists, but it does not work well in practice (for example, it is too costly, time-consuming, unfair, or is only available to a limited number of potential users);

3=A mechanism for dispute resolution exists, and provides reasonable recourse for borrowers and lenders, but it can sometimes be slow and inefficient;

4=A well-functioning dispute-resolution mechanism exists and is available to most borrowers and lenders

THE CONCEPT

Absence of dispute resolution

Dispute resolution exists, but has drawbacks

Accessible, affordable, efficient <u>*microfinance-appropriate*</u> dispute resolution

Implications: Indicator 8

- **Most countries scored 25 or 50 points out of a possible 100 in 2012.**
  - E.g. countries have some sort of mechanism on paper, but accessibility and effectiveness are limited or non-existent.
  - No country out of the 55 examined in the study received a perfect score, suggesting a need for new solutions to encourage the appropriate design of such mechanisms for microfinance.
  - A majority of countries have experienced no significant score change; nevertheless, more countries improved their dispute resolution score than underwent deterioration in 2012.

Bolivia, score 3

According to the Financial System Supervisory Authority (ASFI), Bolivian law provides for a clear dispute resolution mechanism for regulated institutions, the Client Complaints System (Sistema de Atención de Reclamos de Clientes, SARC). All financial institutions, including banks, Fondos Financieros Privados (FFPs, private financial funds), cooperatives and NGOs, must have personnel dedicated to dispute resolution. After submitting a dispute to an MFI, a customer may appeal to ASFI for intervention. According to an MFI informant, ASFI tends to favour clients in dispute cases. This results from high instances of age discrimination in the past, as credit was generally not extended to those over 55. This recently changed when a dispute from an older applicant was brought to ASFI, which deemed this discrimination unlawful. NGOs and other MFIs that are not yet fully-regulated by ASFI (pending an amendment to the Banking Law), are encouraged by the authority to participate in SARC; however, this is not yet a legal requirement.(ASFI; EIU Microscope Survey 2011; personal interviews: June-July 2011)

India, score 0

There are no effective grievance-redressal systems. Sa-Dhan, an association of community-development-finance institutions, has a code of conduct that includes a commitment by members to establish an effective and efficient grievance mechanism. Indeed, it claims that it has a national-level Ethical Grievance Redressal Committee, but experts thought it to be neither fully operational nor effective. Similarly, MFIN has an enforcement committee for dealing with violations of its code of conduct. While calling the above industry-sponsored initiatives commendable, the Malegam Committee, a blueprint for future RBI regulation of the microfinance sector, including in this policy area, recommends the institution of an ombudsman to whom aggrieved borrowers could turn. As envisaged, the ombudsman could be either an employee at a lead bank in each of India’s 640 districts or a “mobile ombudsman”, who would visit each village by rotation on specified days. The committee has also recommended that every MFI establish a proper grievance-redressal procedure.(Sa-Dhan Code of Conduct, July 2011; Malegam Committee Report 2011; personal interviews, June 2011).

For more detail, the Global Microscope is available online

The Excel model contains all indicators scores and descriptions for all 55 countries

A PDF report in English and Spanish outlines the key findings and methodology

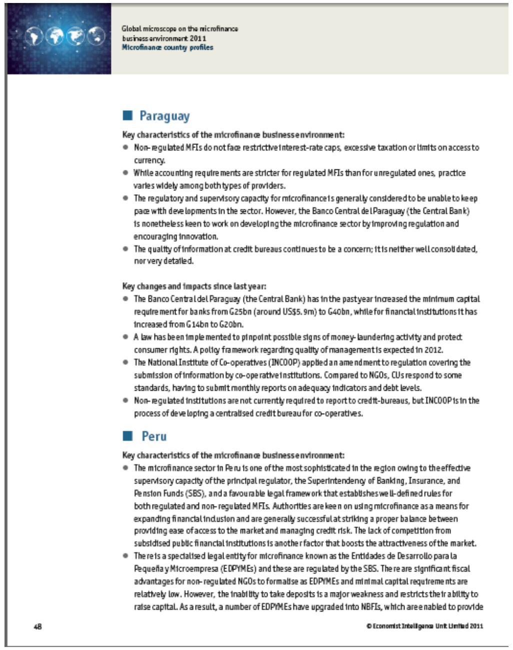
You can download both the model and report for free at:

www.eiu.com/microscope2012

LACdata.fomin.org

www.caf.com/microfinanzas

www.ifc.org/microfinance



Global microscope on the microfinance business environment 2011
Microfinance country profiles

Paraguay

Key characteristics of the microfinance business environment:

- Non-regulated MFIs do not face restrictive interest-rate caps, excessive taxation or limits on access to currency.
- While accounting requirements are stricter for regulated MFIs than for unregulated ones, practice varies widely among both types of providers.
- The regulatory and supervisory capacity for microfinance is generally considered to be unable to keep pace with developments in the sector. However, the Banco Central del Paraguay (the Central Bank) is nonetheless keen to work on developing the microfinance sector by improving regulation and encouraging innovation.
- The quality of information at credit bureaus continues to be a concern; it is neither well consolidated, nor very detailed.

Key changes and impacts since last year:

- The Banco Central del Paraguay (the Central Bank) has in the past year increased the minimum capital requirement for banks from G25bn (around US$5.9m) to G40bn, while for financial institutions it has increased from G14bn to G20bn.
- A law has been implemented to pinpoint possible signs of money-laundering activity and protect consumer rights. A policy framework regarding quality of management is expected in 2012.
- The National Institute of Co-operatives (INCOOP) applied an amendment to regulation covering the submission of information by co-operative institutions. Compared to NGOs, CUs respond to some standards, having to submit monthly reports on adequacy indicators and debt levels.
- Non-regulated institutions are not currently required to report to credit-bureaus, but INCOOP is in the process of developing a centralised credit bureau for co-operatives.

Peru

Key characteristics of the microfinance business environment:

- The microfinance sector in Peru is one of the most sophisticated in the region owing to the effective supervisory capacity of the principal regulator, the Superintendency of Banking, Insurance, and Pension Funds (SBS), and a favourable legal framework that establishes well-defined rules for both regulated and non-regulated MFIs. Authorities are keen on using microfinance as a means for expanding financial inclusion and are generally successful at striking a proper balance between providing ease of access to the market and managing credit risk. The lack of competition from subsidised public financial institutions is another factor that boosts the attractiveness of the market.
- There is a specialised legal entity for microfinance known as the Entidades de Desarrollo para la Pequeña y Microempresa (EDPYMEs) and these are regulated by the SBS. There are significant fiscal advantages for non-regulated NGOs to formalise as EDPYMEs and minimal capital requirements are relatively low. However, the inability to take deposits is a major weakness and restricts their ability to raise capital. As a result, a number of EDPYMEs have upgraded into NBFIs, which are enabled to provide

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