

## **Proposed guidelines for Microfinance industry regulatory framework within forthcoming Basel new regulations**

We welcome the initiative of the Bank International Settlement's aiming at providing guidelines for regulating the microfinance industry: *Microfinance activities and the Core Principles for Effective Banking Supervision*. All of us witnessed the exponential trend of microfinance industry over the past three decades. Recently, mainly because of above-mentioned uncontrolled growth, somebody talked about the death of the microfinance<sup>1</sup>. In a recent contribution<sup>2</sup> on the matter we concluded that the industry now needs a "break for refocusing" and allow the insiders to answer to a simply question: *where now?*

The Consultative document produced by Basle Committee on Banking Supervision should be taken as a great opportunity to provide a suitable answer to the future of the industry on the grounds that it can properly map out the future of the industry.

The document under review recognized the difficulties of providing rules for a business line that can be carried out by a wide range of institutions offering a wide range of financial services, such as lending, deposit taking, insurance, payments and funds transfers, etc.

In our understanding of current trend, Microfinance has become the name of a financial game played in different tables like poverty alleviation, entrepreneurship promotion, social enterprise, financial linkages and political instrument to fight the world crisis, besides the initial goal as a grass roots organization tool helping people to lift from poverty. Around the tables there are groups of players having different interests, objectives and expectations: visionaries, volunteers, developers, bankers, investors, charity houses, government, funding agencies and private businesses.

In this picture, the need to regulate the activities is urgent and perhaps vital; hopefully, there is a wide consensus that MFIs have to give account of what they are doing and how they do it.

Microfinance industry has grown and developed along a trend that, in our interpretation, may be depicted in the below Figure 1. In parallel with the increased sophistication of the services made available – mostly social oriented - (left side of the figure), new management and evaluation methodologies have been applied and the social performance management seems to be the most recent acquisition (right side).

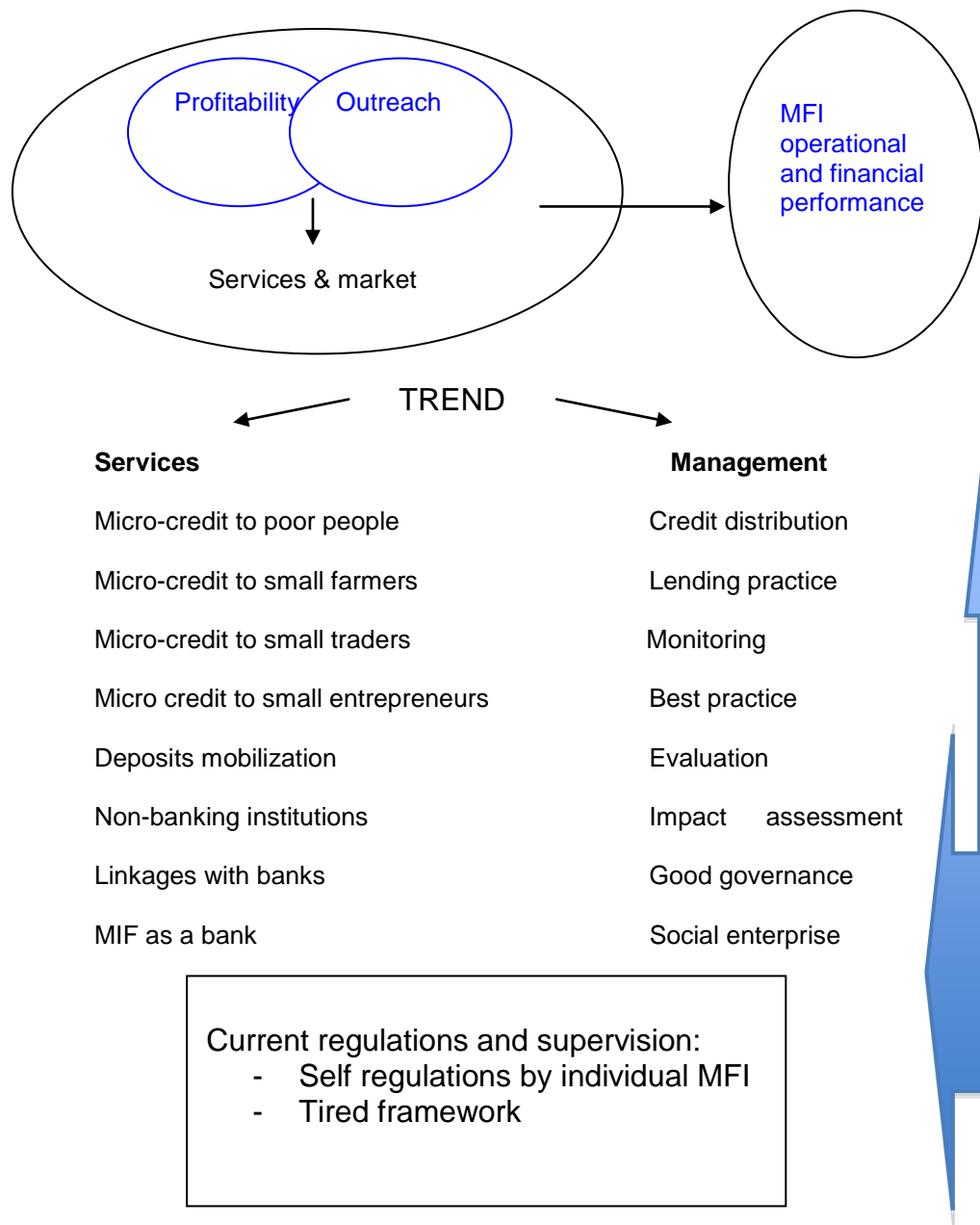
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<sup>1</sup> Damian Von Stauffenberg, chairman and founder of Microrate House, speck reported by Associated Press

<sup>2</sup> Graziosi Ascanio, <http://www.linkedin.com/groups?homeNewMember=&gid=2609718&trk=>

The recent microfinance's wave is the combination of social value mission with profit venture, which implications we discussed two years ago with Development Gateway <sup>3</sup>.

Figure 1 - MFI trend in marketing financial services



Over the years, rules have been promulgated to regulate the micro credit's governing bodies and currently we are in presence of a variety of regulatory

<sup>3</sup> "Social enterprise in microfinance industry: what does it mean?", Microfinance Gateway, Sept 2008. <http://microfinance.developmentgateway.org/Highlights/content.9199.0.htm>.

systems referring to the country's environment, local credit tradition and the existing legal framework.

Currently the systems range from a rigid control to a more flexible intervention. The first option has prevailed in Africa, mainly in the Francophone area (UMEOA) where the disasters caused by the past failure of big financial institutions and some disappointed performances of credit programmes are still burning wounds. In some Africa Anglophone Countries the interventions of monetary and credit authorities haven't been so direct in ruling MFIs' functions and activities and the regulatory systems had the commercial law as a reference.

In a word it can be said that there is a "continuing process" in relation of the sophistication of the market. Some Countries have been debating how to regulate, others have been matching the benchmarks and in a third group new laws has been running at full speed.

It is worthwhile to notice that microfinance is no more seen as a distinct sector but as a component of the overall financial system.

## **1. Industry's features**

**1.1 Political influences** have been listed as a distinctive feature and indeed the risks to have Microfinance industry as a tool of a country's economic policy aren't little ones. Besides the predictable lobbies and pressures, the links between microfinance and politics are in the way the business has been carrying out. Here the milestones of such trend: the UN declared 2005 International Year of Microcredit and the same year the EU/ACP launched Microfinance Framework Programme, interest of EU being started well before at the end of nineties years with EU Council Resolution on microfinance and poverty reduction (May, 1998). This trend has received a new vigorous impulse in 2010 with the launch a € 139 millions for EU/ACP microfinance II programme

Microfinance implications with politics can be found with:

- Poverty issues, as an appropriate tool for alleviating poverty,
- Tool to subsidy poor people,
- Labour market by creating new jobs,
- Capital market by knocking down the existing barriers between the financial circuits at both national and international level,
- Local trade by financing new traders and entrepreneurs,
- Foreign trade by widening the list for exports,
- Communities' economic development by empowering people,
- Government policy by issuing new regulations and regulatory frameworks for the sector.

**1.2** Besides political influences, the Consultative document list nine distinctive features of micro credit that is defined as the heart of many microfinance business models. In our opinion **Governance & management** should have been included as a distinctive feature affecting credit risks. Indeed, governing

bodies and managers running micro credit business do require more than a conventional support.

To better understand micro credit organizations way of doing business (the hearth of microfinance, as the BIS define it), it shouldn't be forgotten that they, usually NGO, emerged as a grass roots organizations for servicing a neglected niche of the credit market, which before was receiving financial support mainly from the informal sector.

By and large NGO's stakeholders and executive managers hadn't the same professional background of their colleagues of the retail-banking sector or in any case their skills and qualifications were not equal to the task and it was hard for them to justify the positions in the organization chart. We were in presence of developers acting on voluntary basis who discovered a new profession by becoming credit's distributors and then lenders and now bankers.

The situation caused some management problems to the newly micro lending shops because one can't become a banker in a day or downloading credit material. With the increased sophistication of the services, managers with a different educational background have replaced those developers and the concept of good management good practice emerged along. However the above-mentioned professional DNA is still alive and, accordingly, this topic should benefit of specific attentions and interventions, being a distinctive feature.

In our field experience we witnessed situations where the main MFI's performance problem wasn't the lack of funds, but the lack of management expertise and professionalism.

**1.3 Ownership** does deserve attention as a distinctive feature and it is just a matter to think about the modalities micro credit organizations saw the light and the fact that there isn't a wide consensus on the role supposed to be played by foreign investors in the capital of a FMI<sup>4</sup>. As it has been mentioned earlier microfinance could mean everything, unless we provide a definition. Should foreign investors allowed to participate to MFI capital?

Under the circumstances we are in presence of an investment and as such it does expect a return and therefore here microfinance means Other Deposit Taking Institutions (ODTI) and Micro Credit Institutions (MCI), according to Basle proposed regulatory framework on microfinance.

In the two above mentioned financial circuits each one and ever institution can play its role and it is up to them to determine to which extent they can agree on having a partner and at which conditions. In this perspective it will be safe the objective to have a country financial inclusion within a regulatory framework.

## **2. Suggested guidelines**

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<sup>4</sup> A debate on the issue has been carried out with Microfinance Association, UK

There isn't a universal management formula for a regulatory framework for Microfinance industry, but a set of rules to be conceived in harmony with a particular environment such as existing law, credit services tradition, unwritten procedures, and so on.

In this context the problem of the regulator is how to keep save the objective to achieve an inclusive financial system. The Guidance seems to have found out a solution by proposing a tired framework "to encourage previously unregulated microfinance institutions to gradually upgrade the quality of their management, governance and operations to allow for participation in the formal financial sector".

**2.1.** Four consistent themes have been indicated with regard to Principles' implementation: allocation of resources, specialized knowledge, management & control practices and permitted activities (see page 2 of the BIS document).

The implementation of the Principles for MFI industry requires some adjustments compared to the traditional banking and hence the need for *tailoring* for regulations' implementation.

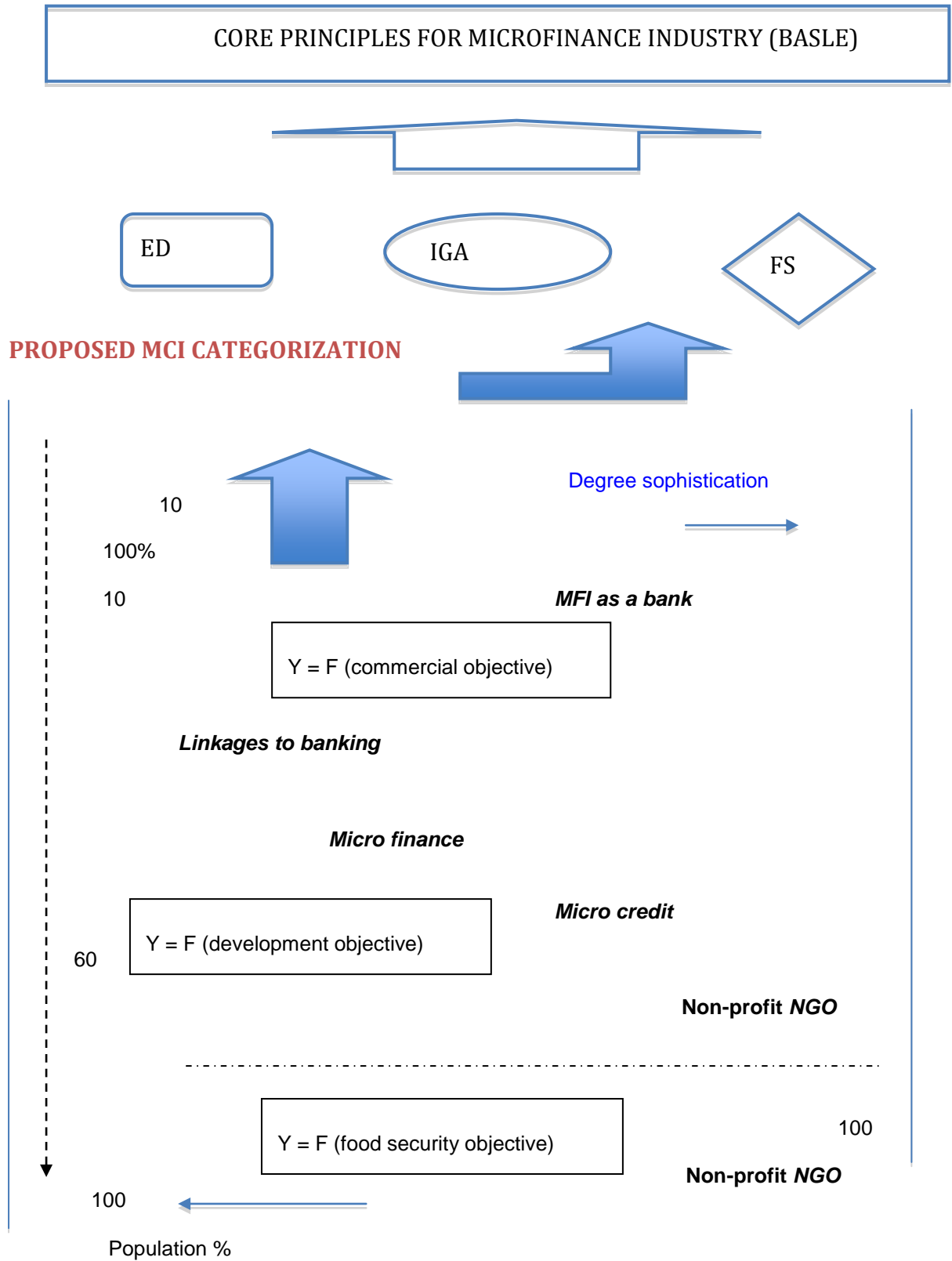
The consultative document defines three groups of institutions: banks (B), other deposit taking institutions (ODTI) and microcredit institutions (MCI). We fully agree with this approach because eventually microfinance isn't no longer considered as a distinct market but a component of the entire financial market, which comprises many circuits. Among other considerations, such approach favors the achievement of a country financial inclusion, which is an objective of the Basle Committee's guidance.

However the proposed categorization although is a good approach for regulation may be an obstacle for evaluation purpose, unless we introduce some specifications on the MCI group.

Can we measure credit risks, market risks, liquidity ratios and whatever MFI's performance with the same indicators for OTDI and MCI? In our view here the document should provide more specific guidelines.

We do have to consider that MCI group includes both profit and non-profit organizations. This is a crucial point. In the current trend of microfinance industry, all MFI have social objectives as a common denominator. From the below Figure 2 it emerges that although any MFI is social oriented the degree of achieving a social mission could be quite different whether the MFI is in the segment of Enterprise Development (ED, *accumulation*), Income Generating Activities (IGA, *increase family income*) and Food Security (FS, *distribution of basic food to very poor people*).

Figure 2 – Fitting market into regulations



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The different strategy to achieve a social goal may be represented by the below depicted equation where the social performance is function of various variables.

$$\text{Social performance} = F(\text{ED}; \text{IGA}; \text{FS})$$

All the financial circuits should be under a unique umbrella; however when we are going to evaluate an individual MFI, should we use the same yardsticks for Other Deposits Taking Institutions and Micro Credit Institutions? Obviously, we have to use different parameters.

In conclusion, while dealing with MCI's regulations, it could be advisable to have specific guidelines with regard to the microfinance activities and different institutions types. Here is the main problem because we have a variegated reality as the document under review has well recognized: *this problem can be sorted out by providing guidelines on how to design a country-tired regulatory framework and taking into account above proposed MCI categorization.*

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