Microfinance regulation and supervision in Zambia

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Zambia microfinance legislation and regulation

The Zambian financial system comprises the Bank of Zambia, which is the country’s central bank, 15 commercial and merchant banks, 3 building societies, 21 insurance and pension firms, securities firms, and other non-bank institutions such as leasing companies, foreign exchange bureaus, and microfinance institutions (MFIs). Commercial banks at the end of 2000 held deposits of approximately K2,079 billion (US$547 million, where 3,800 Kwacha = US$1) and had loans outstanding of K970 billion (US$255 million). Non-bank financial institutions (NBFIs) held deposits of about K40 billion (US$11 million) and outstanding loans totalled K57 billion (US$15 million.)

The supervision of the financial system by the Bank of Zambia is presently handled in two market segments. The commercial banks are supervised by the Banking Supervision Department, while the newly formed Non-Bank Financial Institutions Supervision Department oversees all NBFIs under its legal purview, including MFIs. Securities firms, the Lusaka Stock Exchange, and pensions and insurance firms are regulated and supervised by other authorities, with coordination meetings regularly held between regulators.

Weaknesses in the microfinance institutional framework

Microfinance services are currently being provided in Zambia without regulation or supervision, which is historically consistent with the worldwide start-up of this market under unregulated conditions. Significant amounts of money are being channelled into this ‘market without rules’. This lack of a legal and supervisory structure for MFIs means that checks on their operations or legitimacy are absent. Donors are providing funds without the usual checks and balances consistent with private investor behaviour. The result is a risky, rapidly growing, ungoverned sector with significant gaps in accountability, transparency, stability and efficiency.

Historically, the role that the Bank of Zambia should play towards MFIs has been unclear. This is because information on the industry is unreliable, and in many cases non-existent; nor has any MFI traditionally had much incentive to be transparent. This lack of transparency has also isolated MFIs from the natural linkages to banks and other financial institutions that are so common within the financial sector, and limited the important jump to local ownership and local investment in MFIs.

MFIs are now delivering financial services but are not supervised like other financial institutions. This has led to a number of problems, clearly reflected in the 1999 Bank of Zambia survey of MFIs:

- Although MFIs are committed to serving the poor, many do not focus on efficient, transparent, sustainable service provision.
- While some MFI professionals are honest, staff at other service providers are self-interested, sacrificing both economic efficiency and services to their clients in order to receive higher salaries and travel allowances.
- External reporting by MFIs to clients or investors seems either erratic or non-existent.
- There are cases of fraudulent persons presenting themselves as MFI officers, taking client money, and disappearing.
- Some donors give out money without sufficient safeguards, or in time periods and amounts or under conditions insufficient to ensure institutional soundness and self-sufficiency.
- Many clients are not provided with full information about MFI services, requirements and costs.

These findings represent unsafe and unstable conditions for borrowers, potential savers, and the public. With widely varying conditions of investment, it is also not a level playing field for MFIs. The issues listed above provide a persuasive case for immediate attention to regulation and supervision matters.

The Bank of Zambia will develop regulations and introduce a supervision process that enables responsible growth of microfinance services in the Zambian context for the long term. Ultimately, the goal is to broaden and facilitate the poor’s access to affordable and reliable financial services, by creating room for every reasonable model of microfinance savings and lending to operate legitimately and fairly. These changes will allow microfinance providers to gain the systemic credibility to be able to borrow wholesale from domestic sources, and to gain the legal right to use client savings for loan expansion.

Benefits from improved microfinance regulation

The public is expected to substantially benefit from better microfinance market governance, in particular women under the poverty line who are the main clients of microfinance services. Poor women and men will be protected to a much greater degree
from increasing circumstances of pyramid schemes, quasi-MFIs, and other forms of fraud. Clients can be more certain that they are making agreements with bona fide institutions. The registration process will provide a checkpoint where the poor can verify the legality of an MFI before placing funds. The regulatory system can also provide an avenue for recourse by people in case of unfair treatment or dispute.

The emphasis on transparency in the regulatory process, and the inclusion of a public awareness programme, will enable poor people to make informed choices about MFIs. Actual and potential clients will better understand their rights and obligations. With more transparency, confidence is likely to increase, leading to more actual clients for MFIs. MFI investors, required to commit themselves more significantly to programmes leading to full self-sufficiency, may be more careful about internal institutional governance. Financial services will deepen, a key factor in economic growth. With more opportunities to use financial services, a significant tool in poverty alleviation will be provided to Zambians.

If, as predicted, the microfinance industry becomes more effective and efficient as a result of judicious regulation and supervision, there are a number of potential spin-off benefits in the social sphere. First, those who most need them—poor women—will have better options for financing income-generating opportunities. Second, people are better able to plan for lumpy expenditures, such as school fees or business-related investments, if they have access to nearby savings services. Third, with regulatory responsibilities, compliance will require better management of MFIs, with subsequent better/more efficient services available for those that choose to stay in existence. Fourth, donors will also have an independent source of information on MFI operations and can accordingly assist their funded MFIs to reach compliance in a much more efficient manner.

**Regulatory issues to be addressed**

**Which options for microfinance regulation and supervision?**

Until very recently, regulatory authorities have ignored the existence of MFIs. Regulators perceive that their operations are too small to pose a threat to the overall stability of the financial system. Where credit is extended and no deposits are collected, the collapse of the organisation poses no risk to its borrowers. Even when deposits are collected, depositors are often net borrowers and thus face little risk in case of organisational failure.

However, lack of market governance assumes that the market operators will function in an economically sensible manner. Evidence from the 1999 Bank of Zambia survey indicated problems with cost structures consistent with sub-optimal supervision by investors (largely donors.) In addition, market players themselves are asking for supervision to enhance legitimacy, enable links to other financial players such as banks for credit lines, and help prevent the occurrence of fraud in the market.

The first alternative to no regulation is self-regulation. In the early stages of its development, the industry may choose the option of setting its own standards and regulations. This may be useful where the authorities have no experience with regulating MFIs. Industry self-regulation is more likely to succeed if the MFIs share the same objectives and operational characteristics, such as being cooperatives, NGOs or credit unions.

The risks associated with self-regulation are twofold. First, it allows organisations to be vulnerable to political pressure. The once-strong credit union movement in Zambia was unable to resist governmental insistence that cooperatives be agricultural input conduits. This caused widespread failures as clients refused to repay what they deemed government largesse. Second, it tends to be vulnerable to whichever institutions have the strongest voice, whether due to size, financing or local influence. Therefore, where there is diversity in size, scale of operations, objectives and resources, setting common standards might be difficult to achieve.

The second alternative is supervision using existing regulations. MFIs are encouraged to register as formal financial institutions under a country’s existing banking and financial services legislation. This option saves the need to establish a new regulatory framework, and to train staff to deal with MFIs as distinct financial institutions.

The provisions of the BFSA (Banking and Financial Services Act 1994 (as amended)) and Regulations governing banks and NBFi in Zambia as currently operating do not encourage MFIs to seek registration with the Bank of Zambia. For example, the Act restricts ownership of a bank or NBFI to 25 per cent of the minimum capital for setting up a small credit financial institution. Capital requirements are significant. In addition, regulatory reporting requirements are comprehensive and do not focus on the special circumstances of MFIs. Because of these difficulties, only two MFIs are currently registered.

Increasingly, countries around the world are opting for the third alternative of establishing special regulations to provide for the specific characteristics of MFIs. The new regulations set entry standards and authorisation levels for the provision of different services that are commensurate with the demonstrated institutional and capital capacity of MFIs, and with the applicant organisation’s capital at risk. The exact details of the legislation and regulation are dependent on the individual country’s approach to financial sector development.

The advantage with special regulations is that they permit MFIs to maintain their distinct characteristics without becoming a bank or a large NBFI in exchange for a lower capital requirement. This approach accommodates a more varied range of financial institutions, encouraging innovation, which adds depth to the financial system without weakening it.

**Which MFIs should be regulated?**

One regulatory agency is unlikely to have both human and financial resources to regulate and prudentially supervise every single MFI operating within a country. Additionally, the risks of systemic or sectoral failure are not best managed by such heavy
supervision. Accordingly, a mechanism of tiered regulation and supervision may be most appropriate. In Zambia we refer to the development of appropriate subgroup supervision as ‘light touch regulation’.

The literature weighs heavily in favour of only regulating MFIs that accept deposits from the public. Deposit-taking MFIs have the potential of presenting regulators with systemic problems in case of financial distress. MFIs that only provide credit have very little impact on regulatory issues pertaining to the protection of the financial system, protecting small depositors and managing money supply (Maimbo 2000).

However, both Meagher and Wilkinson (2000) and Maimbo (2000) observe that, although the failure of one MFI is unlikely to bring down the entire financial system, it is possible that confidence within the microfinance subsystem would be adversely affected by the failure of a larger MFI. The failure of one MFI is likely to have an impact on the depositors’ willingness to entrust their small funds with other MFIs, and the failure of a credit-only MFI can cause ‘unzipping’ or repayment failure in other MFIs. This argues for consideration of either prudential or non-prudential supervision of the largest credit MFIs.

Maimbo (2000) and discussions in international e-mail groups, such as the Development Finance Network, indicate that it is useful to make a distinction between ‘prudential regulation’ and ‘non-prudential regulation’. Non-prudential requirements refer to those legal responsibilities and duties that do not involve the regulatory authority assuming responsibility for the soundness of the ‘regulated’ financial institutions. These requirements may include the registration of licensed entities, disclosure of ownership and control structures, reporting or publication of financial statements, external audits, and the transparent disclosure of interest rates to customers. These requirements do not attract any accountability (explicit or implicit) for depositors’ losses in the event of failure.

‘Prudential regulation’, on the other hand, involves the definition of detailed standards for financial structure, accounting policies and management practices. Enforcing prudential regulations requires much more intensive reporting as well as on site inspections. There are suggestions that non-prudential regulation can be applied to all MFIs, while prudential regulation is restricted to deposit-taking institutions and potentially the largest credit MFIs.

Should MFIs be allowed to accept deposits from the public?

MFIs are keen to accept deposits in order to achieve self-sustainability and autonomy from donor financiers at a more rapid rate. Public deposit mobilisation provides them with a source of funds for on-lending. Hence, savings services are as important to microenterprises as are credit facilities. They are particularly important for the viability of the MFI serving microenterprises. Additionally, work such as Hickson’s (1999) shows that the poorest households are far more in need of savings services than loan services.

Prior to BFSA amendments, the taking of deposits from the public was restricted to commercial banks. However, mobilising savings from members is permissible under the Cooperatives Act, the Building Societies Act, the National Savings and Credit Bank Act, and the Co-operative Bank Act. Regulations on MFIs will need to be specific to address this issue explicitly.

MFIs that may be permitted to accept deposits from members of the public should be subject to prudential requirements or have significant restrictions on how the deposits are held. For example, in Mozambique, MFIs hold all savings in commercial banks, adding a level of security to the funds. However, MFIs that accept funds as a partial guarantee of loans, and safeguard those funds held in excess of client loan balances, may not need to be prudentially supervised.

**What services should be allowed under microfinance licences?**

Currently, the focus of MFIs is on the delivery of credit services. Savings, called by Dale Adams of Ohio State University the ‘forgotten half’ of rural finance, is added later or considered in the context of membership, as with savings and credit groups and credit unions. However, recently MFIs have been introducing insurance services, and in some countries foreign exchange services and transfer services are offered. The relative public benefits and supervisory costs must be considered when determining what services should be allowed under MFI licences. Tiering provides a convenient mechanism for dealing with this issue. As MFIs become larger and wish to provide more sophisticated financial services, they in turn become more able to provide information and reporting consistent with a deeper supervision engagement.

**What mechanisms should be used to graduate MFIs?**

If the graduation process from NGO to more formal ownership and expanded service provision is to be encouraged, regulators need to establish criteria by which it is to be regulated and to understand the conditions under which it can be successful. The process requires the existence of certain market conditions: interest rate liberalisation, the elimination of barriers to entry, and the establishment of adequate supervisory and regulatory agencies and rules. Fortunately, these preconditions already exist in Zambia.

The process of graduation to taking deposits attracted some risks. For the MFIs, there is the risk of failing to comply with the loans provisioning and reporting requirements imposed by regulators. For the regulator, there is the risk of granting a licence before licensees are adequately prepared to operate as deposit-taking financial institutions. Regulating and supervising such institutions requires additional resources.

Meagher and Mwiinga (1999) have suggested tiering regulation and supervision, to enable MFIs to grow into both reporting and provision of other services. This suggestion, along with that of De Gruening et al. (1998), will be carefully considered as options for the Zambian microfinance sector.
Who should bear the cost of regulating and supervising MFIs?

MFIs have a smaller asset base, a larger number of accounts, a high degree of decentralisation, and a long period to reach financial self-sufficiency. They are generally more labour intensive in terms of inspection requirements, and their capacity for accurate, timely, useful financial reporting is more limited than that of other financial institutions. Thus, supervision costs can be expected to be relatively high. Because it is harder to pass on high supervision costs to MFIs and their clients, regulators are generally reluctant to accept additional responsibility for MFIs. For this reason, tiering and potential supervision surcharges to clients as the natural beneficiaries of supervision should be considered.

What are regulatory and supervisory best practices in microfinance?

Overall, the literature on microfinance is yet to develop international standards or principles of best practice in regulation and supervision. Meanwhile, other issues not discussed here are already influencing industry supervision: the setting up of apex institutions and their internal push for self-regulation, the use of rating agencies to evaluate loan applicants, and the creation of deposit insurance schemes. Unlike for commercial banking, there is insufficient experience with MFI regulation and supervision to enable certainty on governance principles.

It is important, therefore, that new regulatory frameworks developed in countries with an emerging microfinance industry take into account the specific institutional environment. The regulatory method adopted must promote a competitive balance among all financial institutions in the country. It must be flexible enough to accommodate different financial institutions and to facilitate their growth and financial sustainability. It is important that an excessive level of prudential regulatory requirements is not imposed on emerging microfinance sectors. A regulatory structure that is too detailed in its prescription of prudential requirements may stifle, rather than promote, the growth of the industry.

Conclusion: Achievements and challenges

MFIs promise to be a fundamental delivery vehicle of financial services to the poor. In Zambia, the opportunity to organise this sector cannot have come at a better time. The initiative has commenced to develop a regulatory and supervisory framework, but it should be accelerated to capitalise on the goodwill exhibited by donors, various government agencies and the players themselves.

Progress in sector governance has so far been limited to passage of the amendment to the BFSA to provide for the development of MFI regulation and supervision. This achievement was a result of close collaboration with stakeholders.

The Bank of Zambia has indicated that it seeks to apply a ‘light touch’ regulatory and supervisory framework that will nurture rather than impede MFI growth. The challenge to be a front-runner in Africa to develop best practice for legal, institutional and regulatory systems for microfinance will be embraced wholeheartedly.

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Note

1. This section draws from Maimbo (2000) and numerous in-house discussions, as well as from Rosenberg and Christen (2000) and Meagher and Wilkinson (2000).

References


