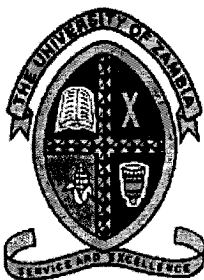


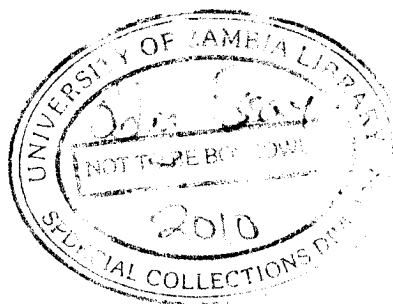
THE CHALLENGES FACED BY THE BANK OF ZAMBIA IN
REGULATION AND SUPERVISION OF MICROFINANCE
INSTITUTIONS

**BEING A DIRECTED RESEARCH SUBMITTED IN PARTIAL FULFILMENT FOR
THE AWARD OF A BACHELORS OF LAWS DEGREE (LLB)**

BY
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DECLARATION

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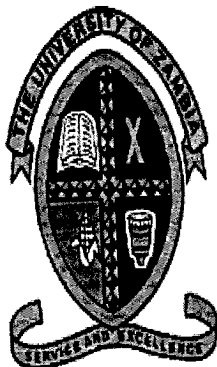

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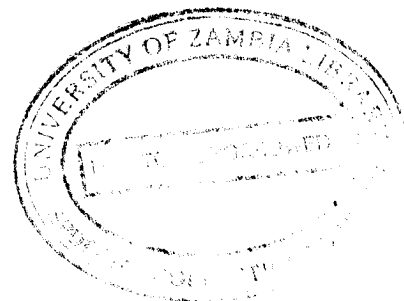
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Hon. Justice Dr. Matibini, SC
Supervisor

12th APRIL 2010

Date

ABSTRACT

This research paper highlights the challenges that the Bank of Zambia (BOZ) faces in regulating and supervising microfinance institutions (MFIs) in Zambia, following the coming into effect of the Banking and Financial Services (Microfinance) Regulations in 2006. Some of the challenges identified include (1) Licensing challenges, including institutional forms and documentation, ownership and corporate governance issues, and compliance with the regulations and other applicable laws. For example, most of the MFIs were registered as either companies limited by guarantee or non-governmental organizations under the Companies Act and the Registrar of Societies, respectively, while the regulations required MFIs to be companies that were limited by shares; and (2) BOZ capacity, including the development of microfinance supervisory tools and building its staff capabilities to effectively and efficiently regulate and supervise the MFIs. The paper also recommends some incentives and other interventions that the government and other key stakeholders could provide to MFIs in order to promote financial inclusion. These include (1) Government should help create an enabling environment for the sound and stable growth and development of the microfinance industry in Zambia through the development of the microfinance policy and effective implementation of the key legislation and regulations i.e. the Banking and Financial Services Act and Microfinance Regulations, and continuous reviews of legal, regulatory and supervisory frameworks to embrace current innovations; and (2) infrastructure development such as efficient operation of the credit reference bureau, credit rating, consumer protection and rights, and financial education, etc; and development of appropriate performance standards and documentation tools.

ABSTRACT

This research paper highlights the challenges that the Bank of Zambia (BOZ) faces in regulating and supervising microfinance institutions (MFIs) in Zambia, following the coming into effect of the Banking and Financial Services (Microfinance) Regulations in 2006. Some of the challenges identified include (1) Licensing challenges, including institutional forms and documentation, ownership and corporate governance issues, and compliance with the regulations and other applicable laws. For example, most of the MFIs were registered as either companies limited by guarantee or non-governmental organizations under the Companies Act and the Registrar of Societies, respectively, while the regulations required MFIs to be companies that were limited by shares; and (2) BOZ capacity, including the development of microfinance supervisory tools and building its staff capabilities to effectively and efficiently regulate and supervise the MFIs. The paper also recommends some incentives and other interventions that the government and other key stakeholders could provide to MFIs in order to promote financial inclusion. These include (1) Government should help create an enabling environment for the sound and stable growth and development of the microfinance industry in Zambia through the development of the microfinance policy and effective implementation of the key legislation and regulations i.e. the Banking and Financial Services Act and Microfinance Regulations, and continuous reviews of legal, regulatory and supervisory frameworks to embrace current innovations; and (2) infrastructure development such as efficient operation of the credit reference bureau, credit rating, consumer protection and rights, and financial education, etc; and development of appropriate performance standards and documentation tools.

*To my dearest mother and my late father
Both of whom inspired me to bring out the best of me.*

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Above all I wish to thank God for his never ending love and to him I owe my life.

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LIST OF ABBREVIATIONS

AMIZ	Association of Microfinance Institutions in Zambia
BFSA	Banking and Financial Services Act
CGAP	Consultative Group to Assist the Poorest
EU	European Union
FI	Financial Institution
FSA	Financial Sector Assessment
GRZ	Government of the Republic of Zambia
MBT	Micro Bankers Trust
MFI	Microfinance Institution
MFC	Microfinance Company
MFRC	Microfinance Regulatory Council
MOF	Ministry of Finance
NBAA	National Board of Accountants and Auditors
NBFI	Non-Bank Financial Institution
NDTMFI	Non-Deposit Taking Microfinance Institution
NGO	Non-Governmental Organisation
NSCB	National Savings and Credit Bank
ZNCB	Zambia National Commercial Bank

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CHAPTER ONE

INTRODUCTION

Access to financial services has long been accepted as an important means of improving income generating opportunities, and overall living conditions among households. A wide range of financial institutions have been involved in providing various financial services to households in Zambia over many decades. Zambia, like most countries in sub-Saharan Africa, is characterised by financial systems that do not adequately cater for people in the rural areas or the peri urban areas.¹ As a result, the role of the financial sector in economic development and poverty reduction is not being significantly achieved. Some of the reasons why it is difficult to develop a strong financial system that will contribute to development include the following:

- Managing large numbers of small loans which need substantial costs to issue and monitor;
- The dispersion of population (low density, long distances between villages), which leads to more travel time and costs;
- Poor state of infrastructure especially roads and socio-economic infrastructure; and
- Others include low economic activities, low entrepreneurial skills, and a poor savings culture.²

Most banking institutions do not serve the poor because of perceived high risks, high costs involved in small transactions, perceived low relative profitability, and inability of the poor to

¹ S. Maimbo, ‘The Implications of the Evolving Microfinance Agenda for Regulatory and Supervisory Policy’ Development Policy Review (2000), p 22.

² Ibid.

provide the physical collateral usually required by such institutions.³ The business culture of these institutions is also not geared to serve poor and low-income households. Lacking access to institutional sources of finance, most poor and low-income households continue to rely on small self-finance or informal sources of microfinance.⁴ However, these sources limit their ability to actively participate in, and benefit from the development process. Thus, a segment of the poor population that has viable investment opportunities persists in poverty for lack of access to credit at reasonable costs. The poor also lack access to institutional credit for consumption smoothening, and to other services such as payments, money transfers, and insurance. Most of the poor households also find it difficult to accumulate financial savings without easy access to safe institutions that provide deposit services.⁵

It is against this background that saw the emergence of microfinance institutions. The microfinance services are supplied mainly by informal sources. Their collective outreach, both breadth and depth, is vast in most countries. They supply mainly short-term credit, and charge higher interest rates than formal sources. Because of the relatively greater bargaining power enjoyed by the informal suppliers in general, the terms and conditions under which services are provided do not enable the clients to fully harness economic opportunities.⁶ The informal sources operate in highly localized areas. Therefore, their contribution to financial intermediation and improvement of resource allocation is also limited. For example, informal sources do not allow

³R.C. Vogel, 'Microfinance Regulation and Supervision Concept Paper' Microenterprise Best Practices (2000), p 16.

⁴ Ibid.

⁵ Zambia Review, 10th Edition. Directory Publishers of Zambia: Lusaka, Zambia (2009), p 12.

⁶ Supra note 1, p 23.

savings to be collected from more than a small group of individuals well known to one another, and they do not move funds over large distances. The involvement of formal sources in microfinance has increased during the last two decades. However, the formal operations concentrate mostly on providing credit facilities, and savings mobilization has yet to receive adequate attention, with few exceptions.⁷

1.1 Statement of the problem

In recognition of the growing number of microfinance institutions, the Bank of Zambia (BOZ) in conjunction with the Association of Microfinance institution in Zambia (AMIZ) and other interested parties commenced the review of the legislation governing the operations of the microfinance sector and in 2000, the Banking and Financial Services Act (BFSA) was amended to bring MFIs under the supervision of the Bank of Zambia⁸.

Further, following consultations with various stakeholders, the Bank of Zambia developed the Banking and Financial Services (Microfinance) Regulations which came to effect on 31 January 2006. The Regulations aim at strengthening the MFI sector and ensuring accountability and transparency of the sector operations and more importantly a smooth integration of the sector into mainstream financial sector.⁹

However there are certain obstacles that have been faced by BOZ in regulating and supervising these institutions. As to the impact of the Regulations on the MFI sector in Zambia and the

⁷ Supra note 5, p 12.

⁸ Supra note 5, p 13

⁹ ibid

appropriateness of the Regulations, it is the objective of this research to establish that. Further, the research will identify the challenges faced by the Bank of Zambia in the regulation and supervision of microfinance institutions and provide policy recommendations on how to overcome the challenges

1.2 Research questions

Proponents of financial regulation have reached a consensus that regulation of microfinance institutions is necessary for reasons of systemic risk and financial stability. However, differences arise from the applicability of legal and regulatory requirements, and those differences have important implications for outreach and sustainability of the microfinance institutions. Further, the variant nature and large number of MFIs make their supervision and regulation difficult, and challenging.¹⁰ They also tend to differ on whether prudential regulation could be applied to MFIs and whether a single model may be applied for all MFIs. It is therefore important to consider the basis and forms of regulation. This paper will establish what the challenges are in regulating

MFIs by answering the following questions:

- Should microfinance be regulated;
- What risks should regulation address;
- What are the benefits of regulation;

¹⁰ Supra note 1, p 23.

- Is there need to distinguish between the different types of MFIs for regulation depending on their objective, i.e. the alleviation of poverty or profit maximisation?
- Who should regulate the microfinance sector; and why?
- What are the challenges and constraints that central banks are facing in the regulation and supervision of microfinance institutions;
- What are the licensing requirements for microfinance institutions;
- What are the reporting requirements for microfinance institutions; and
- What information do microfinance institutions provide to the regulator?

Some of the reasons advanced in the regulation of MFIs are that regulation and licensing in particular will subject MFIs to established procedures, reporting requirements, and guidelines for operations. The most common guidelines / regulations pertain to capitalisation, corporate governance, asset quality, liquidity, accounting and disclosure standards to instil market discipline. Further, it is argued that regulation will develop sustainable institutions.¹¹ However, it is also argued that imposition of regulation would create rigidities detrimental to MFIs, and also constrain their operations. Therefore, it is important that appropriate benchmarks and models are developed for MFIs. This research paper aims at assessing the impact of regulation, and supervision on the microfinance sector in Zambia following the coming into effect of the

¹¹ Ibid.

Banking and Financial Services (Microfinance) Regulations of 2006. The research questions below will also establish to what extent regulation would foster the development of an inclusive financial system.

- What are the permissible services that MFIs can provide under the Regulations?
- What has been the institutions' performance in terms of outreach (number of clients served), area of coverage, loan portfolio, financial sustainability, including cost minimisation, before and after the coming into effect of the Regulations? This question will be directed to an MFI that has operated in an unregulated environment and is now a licensed institution.
- What are the major regulatory and supervisory related obstacles for providing financial services and in reaching out to the un-served segments of the population?
- What are the major sources of funding for MFIs in the country .i.e. donor funds, deposits, commercial loans, government or equity? To what extent has regulation been able to shape funding sources?
- What are the regulatory requirements for branch expansion?
- What are the weaknesses and deficiencies that regulation intends to address in the microfinance industry in Zambia? and
- Have the objectives of regulation and supervision been met?

1.3 Research methodology

1.3.1 Research Design

The research will adopt a descriptive and qualitative approach based on both primary and secondary data.

1.3.2 Sampling

The financial service providers to be studied will be randomly selected from microfinance institutions.

1.3.3 Sources of Information

Primary data will be collected through a survey from microfinance institutions, operating in the Zambia. Data will also be collected from apex coordinating and regulatory authorities such as AMIZ, Bank of Zambia, and Registrar of Societies and Cooperatives.

Secondary information will be obtained from different sources including working papers, publications, books, annual reports, and other microfinance related reference material. The internet will also be used to identify and analyse innovative approaches/ partnerships being used regionally to deliver rural financial services.

1.3.4 Data Collection methods

Data will be collected through personal interviews with representatives of the microfinance institutions.

A structured questionnaire will also be used to elicit responses from various microfinance institutions. Documentary review will also be conducted.

This research paper is organised into five chapters. Chapter 1 comprises the introduction. Chapter 2 introduces the concept of microfinance and thereafter looks at the history of microfinance institutions in Zambia, stating how they began and the current position of these institutions. Chapter 2 further looks at the regulation of microfinance institutions in Zambia. It also looks at financial regulation and supervision of the financial sector in general, stating the rationale for regulation and supervision, as well as the benefits and limitations of regulation.

Chapter 3 looks at regulation and supervision of MFIs specifically, stating the rationale behind their regulation and supervision. Further chapter 3 further looks at the risks associated with MFIs. In Chapter 4, the research dwells on the various regulatory approaches to MFIs. It explains why the distinctive characteristics of MFIs must be taken into account when developing the regulatory and supervisory framework. In Chapter 4 the paper further looks at the status of the financial sector in Zambia. This Chapter concludes by identifying the challenges that the Central Bank may be facing in regulation and supervision of Microfinance institutions.

Having identified these challenges, Chapter 5 makes policy recommendations on what ought to be done in order to overcome the challenges that may be faced in regulation and supervision of MFIs. It will comprise of the findings of the research, and conclusions.

CHAPTER TWO

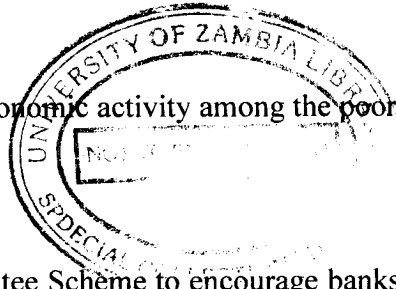
2.0 MICROFINANCE INDUSTRY IN ZAMBIA

2.1 Emergence of the Microfinance Sector in Zambia

The microfinance industry in Zambia is relatively new. Until the mid 90s, it was primarily the Government of the Republic of Zambia (GRZ) that took the lead in providing finance to small, medium and micro enterprises. The GRZ initiatives included creating Export Guarantee Scheme, Lima Bank, Cooperative Bank, and the National Savings and Credit Bank (NSCB). In 1969, the Government set up Zambia National Commercial Bank (ZNCB) to meet the credit needs of indigenous Zambians not being served by the foreign banks, and to extend banking into rural areas. Although one of the objectives of ZNCB was to finance local business, the bank has been reluctant to extend credit to this sector, especially the small farmer, which it considers too risky and unprofitable, and, consequently, the bank has not met its mandate of serving this sector.¹²

To meet the financial service needs of rural and low income households on a broader scale, the Government established NSCB in 1972, through an Act of Parliament. The main objective of the bank was to mobilise savings in rural areas. Conceived as a post office bank, it served the interests of small savers well into the early 1990s. To date, however, its performance has been dismal. In 1999, it terminated its agency agreement with the Post Office, due to the Post Office's failure to pass on deposits mobilised to the bank. NSCB is to be recapitalised and has been given

¹² Supra note 5, p 12.



a fresh mandate to play an active role in stimulating economic activity among the poorer sections of the population¹³.

The Bank of Zambia (BOZ) created the Credit Guarantee Scheme to encourage banks to lend to small, medium and micro enterprises without adequate collateral. This scheme failed to work because the underlying reasons for the bank's reluctance to lend to the microfinance sector had not been addressed. The high transaction costs associated with lending small amounts of money, rather than the absence of collateral, was the major concern of banks. Interest rate ceilings at the time constrained banks from additional transaction costs¹⁴.

The closures of Lima Bank and the Cooperative Bank and the weakened operations of NSCB disadvantaged rural communities that were dependent on these institutions for their savings and financial services. Further, as commercial banks continued to pull out of rural areas, due to low profitability and concentrate their activities in more developed centers and urban areas of the country, the availability of vital banking and financial services to the rural communities had declined. These developments resulted in a financial sector that focused on meeting the needs of the corporate sector and the more affluent working class. The growth of MFIs, therefore, resulted in part from an identification of a gap in the market, and the need to fill this gap¹⁵.

To foster the interests of the microfinance sector, two organisations, the Micro Bankers Trust (MBT), and the Association of Microfinance Institutions of Zambia (AMIZ), were set up.

¹³ Ibid, p 12.

¹⁴ C. Chiumya, 'The regulation of Microfinance Institutions: A Zambian case study', Doctor of Philosophy Dissertation. The University of Manchester (2006), p 11.

¹⁵ Ibid.

MBT was set up in 1996 by the Government and the European Union (EU) as part of the Microcredit Delivery for the Empowerment of the Poor Program to provide wholesale funds and training to MFIs. The primary objective of MBT was the “economic empowerment of vulnerable individuals through the provision of credit to financial intermediaries for on-lending to vulnerable individuals in Zambia”¹⁶. Other objectives included staff training to strengthen institutional capacity; assisting in the design and operation of microcredit delivery in a viable and effective manner; and improving performance through evaluation, research, performance monitoring, and sound lending policies¹⁷. Since 2000, however, MBT has changed its orientation. It no longer provides wholesale funds and provides microcredit directly to clients. The change in orientation was a direct result of the failure of MFIs to repay their loans.

AMIZ was established by microfinance practitioners, and was officially registered in March, 1998. It took a leading role in campaigning for new legislation, standard setting, and staff training for new MFIs. Its mission is to “facilitate, support and strengthen the services provided by member MFIs and represent them in the best way possible by utilizing microfinance best practices”¹⁸. The main objectives of the Association are: (1) To disseminate and exchange information on key issues related to microfinance; (2) To lobby government, donors, and other stakeholders on issues of law, enabling environment and support programs for microfinance, as well as the need to develop strong and dedicated micro entrepreneurs in order to spur sustainable microfinance development; (3) To become a coordinating and representative body for member

¹⁶ Supra note 1, p 24

¹⁷ Supra note 5, p 15

¹⁸ Ibid.

microfinance institutions; (4) To strengthen lateral learning among practitioners; (5) To facilitate sustainable business development services to microfinance institutions; (6) To support best practices and innovative techniques utilised by microfinance institutions in Zambia; and (7) To establish and maintain professional standards of microfinance conduct among member MFIs and the industry in general ¹⁹.

2.1.1 The Regulation and Supervision of Microfinance Institutions in Zambia

In recognition of the growing number of microfinance institutions, BOZ in conjunction with the AMIZ, and other interested parties commenced the review of the legislation governing the operations of the microfinance sector. In 2000, the Banking and Financial Services Act (BFSA) was amended to bring MFIs under the supervision of the BOZ²⁰. Further, following consultations with various stakeholders, BOZ developed the Banking and Financial Services (Microfinance) Regulations which came to effect on 31st January, 2006. The Regulations aim at strengthening the MFI sector and ensuring accountability and transparency of the sector operations and more importantly a smooth integration of the sector into mainstream financial sector.

The Regulations define microfinance service as “the provision of services primarily to small and micro enterprises and/ to low income customers and, includes the following:(a) the provision of credit facilities usually characterised by frequent repayments; and(b) the acceptance of remittances and any other services that the Bank of Zambia may designate”.

¹⁹ AMIZ (2003), 2004-2007 Business Plan, p 34.

²⁰ Ibid.

The Regulations also provide that a person shall not, without prior approval of the BOZ, own more than fifty (50) percent shares in a non-deposit taking microfinance institution (NDTMFI) and that NDTMFI may be: (a) a company incorporated under the Companies Act; (b) a NGO registered under Societies Act; or (c) a cooperative registered under the Co-operative Societies Act.²¹

Further, the Regulations have provided minimum capital requirements which are as follows:

Table 1: Minimum Capital Requirements for MFIs

Type of MFI	Minimum Capital Requirement
Deposit taking MFIs	K250m or 15% of total Risk Weighted Assets, whichever is higher
Non Deposit taking MFIs	K25m or 15% of total Risk Weighted Assets, whichever is higher
Tier 3 MFIs	With capital below K25m

Source: Banking and Financial Services (Microfinance) Regulations

²¹ Opcit.

Following the coming into effect of the Regulations, twenty-five MFIs have been licensed by the BOZ, of which five are deposit taking and twenty are NDTMFI.

2.2 Financial Sector Regulation and Supervision

Interest in the regulation and supervision of MFIs has arisen from their growth and their desire to mobilise deposits. The debate surrounding whether MFIs should be regulated and supervised lies in the belief that through regulation, they will become self-sustainable and achieve massive outreach. Through regulation, MFIs can also be integrated into the formal financial sector. In some countries, MFIs have grown to such an extent that the failure of one could result in the loss of confidence in the financial sector, thus attracting regulatory concern.²² When regulation is discussed in relation to MFIs, it is usually in terms of ‘banking type’ regulations, what is termed ‘prudential’ regulation. In other words, MFIs should be regulated in the same manner as banks, by the same supervisory authority, usually, but not always, the central bank. Although MFIs have different characteristics and risk profiles from traditional formal FIs, such as banks, deposit-taking MFIs can be likened most closely to banking institutions. There is need to ask, therefore, the question whether “microfinance is essentially different from other forms of financial intermediation or is just a variant of basic banking”²³.

²² Supra note 17, p 35.

²³ Supra note 3, p 23.

2.2.1 Definitions of regulation and supervision

Historically, financial services, FIs and financial markets have been more heavily regulated in all countries than virtually any other industry²⁴. “It is almost universally assumed that this should be so and that the risk taking activities of financial institutions should be constrained”²⁵. For various reasons, most notably market failure, the government has on numerous occasions stepped in to regulate the financial sector²⁶, with the overriding objectives of maintaining financial system stability, through systemic stability and maintenance of the safety and soundness of FIs, and depositor protection²⁷. Thus, regulation is usually thought of in terms of state regulation, but this need not be the case. In instances of state intervention, enforceable public regulation replaces market incentives with government mandates. Regulation must be able to correct market failure in an effective and efficient manner.

The more government regulation mimics regulation by efficient markets, the more effective it will be. For regulation to be effective it must be enforceable²⁸. Government’s involvement in the process of regulation, directly or indirectly, is important because, ultimately, it is only the government that has the legal power to enforce compliance²⁹.

²⁴G. J. Benston, ‘Regulating Financial Markets: A Critique and some Proposals’ The Institute of Economic Affairs (1998), p 44.

²⁵ Ibid.

²⁶ J. R. G. Barth, *Rethinking Bank Regulation: Till Angels Govern*. New York: Cambridge University Press (2006), p 45.

²⁷ Ibid, p 46.

²⁸ Ibid.

²⁹ Supra note 12, p 24.

Regulation is defined as “a set of enforceable rules that restrict or direct the actions of market participants, and as a result alter the outcomes of those actions”³⁰. Llewellyn provides a more elaborate definition of regulation as “a body of specific rules or agreed behaviour, either imposed by some government or other external agency, or self imposed by explicit or implicit agreement within the industry, which limits the activities and business operations of financial institutions”.

³¹Thus, regulation may be performed by the market itself (self-regulation), without government intervention, or with the participation of other external forces. The main theme running through all these definitions is that the behaviour and decisions of market participants is influenced in some manner by these rules and as a result, the outcome is not necessarily what it would have been in the absence of the regulations.

Although the terms ‘regulation’ and ‘supervision’ are sometimes used interchangeably, supervision “is the systematic oversight of market participants to ensure they comply with the rules”. Rosenberg³² defines supervision as, “the process of monitoring that institutions are conducting their business either in accordance with regulations or more generally in a prudent manner”. Therefore, “regulation typically refers to the rules that govern the behaviour of financial institutions whereas supervision is the oversight that takes place to ensure that financial institutions comply with those rules”³³. The distinction is important where the regulatory and

³⁰ Ibid.

³¹ Supra note 24, p 47.

³² M. Robinson, *The Microfinance Revolution Sustainable Finance for the Poor*, Washington, D. C: World Bank, (2001), p 98.

³³ Ibid.

supervisory functions are split between different agencies as they may have different policy implications.

In the area of financial regulation, a further distinction is made between ‘prudential’ and ‘non-prudential’ regulation. Non-prudential regulation is about the safety and soundness of financial institutions for purely systemic reasons by providing standards for business operations, and oversight, such as operating and financial reports to be submitted, to protect the interests of clients or members (i.e. because the social costs of the failure of an institution exceed the private costs). Prudential regulation involves the regulatory authorities verifying the compliance of institutions with mandatory standards such as minimum capital levels and adequacy, liquidity management ratios, and asset quality standards as measures for financial soundness.³⁴ Thus regulators are most likely to have a prudential concern for the liquidity, solvency and riskiness of FIs.

2.3 The Rationale for Regulation of Financial Institutions

2.3.1 Market Imperfections

One of the major justifications for regulation and supervision of financial institutions is the need to correct market imperfections and failures which compromise consumer interest in a regulation-free environment.³⁵ Examples are such measures which reinforce the degree of competition and ensure proper disclosure requirements. Market failure is said to exist when the

³⁴ Supra note 22, p 49.

³⁵ Supra note 1, p 34.

market is unable to produce an outcome that maximizes economic welfare.³⁶ Regulation in such cases is justified because an “uncontrolled market place will, for some reason, failure to produce behaviour or results in accordance with public interest³⁷ .

2.3.2 Depositors’ Protection

The protection of depositors has come to be generally accepted as the most basic reason for banking regulation and supervision. This objective is hinged on the fact that bank depositors have difficulty protecting their interests when compared to other bank creditors and investors.³⁸

2.3.3 Systemic Considerations (To minimize the Impact of Failure)

Because financial institutions, especially banks, are closely connected to each other financially through the inter-bank market, the payments clearing system, and the holding of deposit balances, the failure of one financial institution is likely to affect another and do so more quickly than the failure of a firm in another industry.³⁹ The banking system is, thus, perceived as being more susceptible to systemic risk, “the risk that disturbances in a financial institution or market will spread across the financial system, leading to widespread bank runs by wholesale and retail depositors, and possibly, the collapse of the system”⁴⁰.

The systemic argument is based on the premise that bank failures may produce losses to depositors and other creditors, break long-standing bank - customer relationships, disrupt the

³⁶ Ibid.
³⁷ R.Baldwin, Understanding Regulation: Theory, Strategy and Practice, Oxford: Oxford University Press, (1999) p 134.
³⁸ Ibid.
³⁹ Opcit.
⁴⁰ S. Heffernan, Modern Banking in Theory and Practice, Chichester: John Wiley and Sons, (1996), p 66.

payments system and spill over in a domino fashion to other banks, FIs and markets, and even to the entire macro-economy. Bank failures are therefore, more likely to involve contagion or systemic risk than are failures of other firms.⁴¹ The risk of such actual or perceived damage is often a popular justification for prudential and banking supervision which includes the provision of a formal mechanism for dealing with failing and failed banks with a view to protecting depositors, the payments system, and the entire macro-economy from the adverse effects of such failure.⁴²

Thus, regulation for systemic reasons is warranted when the social costs of the failure of a FI, particularly banks, exceed private costs and such potential social costs are not incorporated in the decision making of the FI. In this way, regulation contributes to the attainment of the overriding objective of financial system stability.⁴³ The argument for regulation on systemic considerations cannot be over-emphasized with the experiences of the financial crisis in the United States of America which affected the global economy. However, these considerations are less applicable to non-bank financial institutions (NBFIs). Firstly, systemic risk is less evident and often does not exist at all. Secondly, contagion is less likely because of the nature of the contracts involved. Thirdly, the potential disruption of the payments system does not arise⁴⁴.

⁴¹ Supra note 1, p 76.

⁴² Ibid.

⁴³ Supra note 5, p 33.

⁴⁴ Supra note 12, p 43.

2.3.4 Information disclosure

There is an asymmetrical relationship in many financial transactions between the provider and the consumer. Because of the information asymmetries associated with financial transactions, consumers may have inadequate information and tend to be less well informed than the suppliers of financial services⁴⁵. Consequently, consumers can be more easily exploited and have problems in assessing the quality of services and products being purchased, or the safety and soundness of FIs, except at inordinate cost.⁴⁶

It is therefore argued that regulation of the industry provides consumers with convincing information to enable them distinguish between bad and good financial products in the market place. It also sets minimum standards that all participants in the market respect. The end result is to boost consumer confidence in the system.⁴⁷

Lastly, the consumer is often uncertain about what is relevant information to demand when complex products are involved. Thus, mandatory disclosure sets out the minimum disclosure requirements on a consistent and standardised basis that all firms must adhere to for all retail customers⁴⁸.

2.4 Benefits of Regulation to the industry

The industry also stands to gain from regulation. To the extent that it enhances competition and overall efficiency in the industry, regulation creates a market which works more efficiently. If

⁴⁵ Ibid.

⁴⁶ Supra note 5, p 42.

⁴⁷ Ibid.

⁴⁸ Supra note 22, p 76.

consumer confidence is improved by setting minimum standards, the increased demand for financial services and products is beneficial to both consumers (to the extent that they are no longer discouraged from buying what might be desirable and competitive products), and the industry itself.

Regulation also benefits the industry to the extent that it guarantees to all firms, that what they believe to be appropriate behaviour will also be followed by their competitors. Lastly, in the case of prudential regulation, financial firms' own counterparty risks should be reduced. As the industry also stands to gain, the regulatory process need not be antagonistic in nature⁴⁹.

2.5 Limitations of Regulation

There is need to acknowledge that there are limits to what regulation and supervision can realistically achieve. External regulation and supervision by official agencies is not an alternative to robust and effective internal supervision processes and responsibilities. The management of FIs are not absolved of their responsibilities simply because there is external supervision. Consumers need to be aware of the limitations of regulation; otherwise the demands placed on regulation will be excessive, and result in costs far exceeding any benefits for such demand to be met. Thus, regulation may encourage moral hazard on both the part of consumers, who are less likely to exercise due care and diligence, and owners and managers, who are more likely to engage in risky behaviour. "There needs to be a public policy recognition of the limitations of regulation; that it has only a limited role; that even in this restricted dimension it can fail; that not

⁴⁹ Ibid.

all risks are covered; and that the optimum level of regulation and supervision falls short of eliminating all possibility of consumers making wrong choices in financial contracts”⁵⁰.

Second, critics argue that regulation may overestimate either the severity or possibility of risks. By seeking to render products or services risk free, regulations may generate such costs that outweigh any potential benefits⁵¹. This pre-occupation with minimising risk must be weighed in light of the practicability of producing a risk free environment. Products and services may have both good and bad features. Focusing excessively on minimising risk will thus eliminate many good products and services from the market. Third, because regulation is costly and burdensome for suppliers, it can lead to declining competitiveness⁵². Regulation can also be welfare reducing if, for instance, it “raises unnecessary entry barriers, restricts competition in other ways, controls prices, stifles innovation, restricts diversification by financial firms and impedes market disciplines on financial firms”⁵³.

Lastly, the steady increase of regulatory objectives leads to ‘over-regulation’⁵⁴. As regulation continues, other values, such as income distribution, enter into the regulatory framework. This leads to regulatory complexity which firms may find difficult to meet. Also, there may be a

⁵⁰ C. Goodhart, *Financial Regulation: Why, How and Where Now?* London: Routledge, (1998), p 29.

⁵¹ Ibid.

⁵² Op.cit.

⁵³ Supra note 48, p 34.

⁵⁴ Ibid.

paradox to over-regulation: regulators are given so many responsibilities that they are unable to regulate effectively.⁵⁵

The next chapter examines the regulation and supervision of MFIs. Specifically, the chapter will address the rationale behind their regulation and supervision. The chapter will also consider the risks associated with MFIs.

⁵⁵ Op.cit.

CHAPTER THREE

3.0 THE REGULATION AND SUPERVISION OF MFIS

3.1 The Rationale for Regulating and Supervising Mfis

The core objectives for regulation are the same for microfinance activities and institutions as for other components and segments of the overall financial system. However, the key principles, and standards for the design of a regulatory framework for institutions providing financial services to rural finance and microfinance sector, are likely to be different from those for formal banking, and finance institutions, because the design must consider the operational, market, and client characteristics of rural finance, and microfinance sector⁵⁶.

In most countries, MFIs' total assets when compared to the total assets of the financial sector are too small, and insignificant to warrant regulation and supervision on the basis of financial system stability⁵⁷. There are exceptions to this, though, such as in Bangladesh, where MFIs have grown to such an extent that the failure of one of the larger MFIs would adversely affect confidence in the financial sector. Similarly, in the Philippines, MFIs (rural banks) are integrated into the payments system. Thus, the failure of an MFI may disrupt the smooth operations of the payment system⁵⁸.

Prudential regulation and supervision is justified on the grounds of protecting depositors, and should be carried out by the government agency responsible for the financial sector, usually the central bank. However, only deposit-taking MFIs need to be prudentially regulated, and common

⁵⁶ Supra note 12, p 44.

⁵⁷ Ibid.

⁵⁸ Supra note. 22 p 21.

bond institutions, such as village banks and ROSCAs, may be excluded⁵⁹. While recognising the need for depositor protection, Wright⁶⁰ states that it is naively optimistic to think that a system of central bank regulation and supervision will secure deposits. He cites a number of examples, such as the Bank of Credit for Commerce and Industry (BCCI), which was regulated by the Bank of England and the Loans and Savings debacle in the United States of America (US), where regulators failed in this respect⁶¹. In developing countries, central banks, with resource and capacity constraints, often have problems regulating the commercial banking sector. They cannot, therefore, realistically be expected to regulate and supervise large numbers of MFIs, of which they may have little understanding, and that may be geographically dispersed throughout a country. Wright⁶² also cautions against the prevention of MFIs from offering savings facilities simply because they are not subject to regulation. Individuals are willing to take risks as long as they believe the risks to be worthwhile, and this is a decision the poor should be allowed to make for themselves. The poor are often obliged to save informally; in livestock, jewellery, ‘cash under the mattress’, and or with other individuals, e.g. Susu collectors in Ghana. In addition to being illiquid and indivisible, such alternative forms of savings are usually riskier than deposits with an MFI; cash may be stolen, livestock may die. Clients are often well aware that such institutions might be risky, but continue to use them as the alternatives are perceived to be riskier. “A policy of prohibiting MFIs (community based ones) from providing savings services simply because they are small or too remote to be supervised effectively is tantamount to telling

⁵⁹ Ibid.

⁶⁰ Op.cit.

⁶¹ Supra note 22, p 56.

⁶² Ibid.

people in those communities that if high-quality (i.e. effectively supervised) deposit services can't be delivered to them, then they should have no deposit services at all”⁶³.

Advocates for regulation argue that the ‘massive sustainable delivery of financial services to the poor’ can only be achieved in a regulated setting⁶⁴. Therefore, although they do not necessarily justify prudential regulation, the following reasons are sometimes put forward for the regulation and supervision of non deposit-taking MFIs. First, regulation can increase access to funding by signalling to potential investors that the MFI is sound. Also, in some jurisdictions, access to certain lines of funding may be dependent on regulation. A second reason often given is that regulation is needed to ensure the effective use of public (and donor) resources if the MFI has access to government credit lines for on-lending. However, both these reasons are questionable as wholesale lenders, whether public or private, should assume responsibility for monitoring their loans and investments and not delegate this function to bank supervisors.⁶⁵

The third reason given is that regulation, by raising the minimum performance standards in microfinance, can promote sustainable FIs, thus contributing to financial sector development. Donors and governments sometimes think that setting up a special regulatory window for microfinance will speed up the emergence of sustainable MFIs. However, Christen and Rosenberg, note that it is the absence of licensable MFIs, and not the absence of a tailor-made regulatory regime, that limits the growth of microfinance. They also state that bank supervisors are better at ‘excluding’ or ‘shutting down’ bad organisations rather than ‘improving’ them.

⁶³ Supra note 5, p 66.

⁶⁴ Supra note 12, p 25.

⁶⁵ Ibid.

Fourth, regulation is needed to clarify the legal position, particularly of non-governmental organisation (NGO) MFIs. In some countries, it is illegal for NGOs to offer credit because it is not an activity explicitly authorized under which the NGO is registered. In many countries, the financial laws, if interpreted strictly, would prohibit anyone without a financial institution licence from providing credit facilities, regardless of the source of funds⁶⁶. Under these scenarios, loans may be legally uncollectible, and MFIs may be at risk of prosecution⁶⁷. Additionally, unclear legal status deters the growth of the industry and its attractiveness to private investors.

Lastly, regulation is advocated to prevent the poor from being exploited, especially with regard to high interest rates; either by setting interest rate ceilings, or through the clear and transparent disclosure of interest rates and charges.

3.2 Risks Associated with Mfis

In developing an appropriate framework for the regulation and supervision of microfinance, it is important to note that MFIs differ from traditional commercial banks in a number of respects, and that the risk features of commercial banks are not directly applicable to microfinance. Consequently, many of the regulatory and supervisory features adopted to address the risks of standard commercial banking FIs do not apply to MFIs. In addition to the other risks that FIs typically have to deal with, literature identifies ownership and governance, management, portfolio and new industry risks as being particularly pertinent to MFIs⁶⁸. Thus, an appropriate

⁶⁶ Supra note 22, p 29.

⁶⁷ Ibid.

⁶⁸ Supra note 5, p 78.

regulatory framework must take into account the risk profiles of MFIs. Because owners of MFIs tend to be, or have evolved from, donors and donor funded agencies, government agencies, and socially responsible commercial investors, the ownership and organisational structures of MFIs are often opaque. Owners and directors do not usually have the knowledge or experience to manage an MFI. Their priority lies in meeting their social objectives. In many instances, there may be political interference. In cases where there is private individual ownership, these are often minority interests and, therefore, the appropriate level of oversight is not exercised. Like other FIs, MFIs face credit, interest rate, operational and liquidity risks. In addition to the aforementioned risks, MFIs also face management, portfolio and solvency/ capital adequacy risks.

MFI owners may lack the financial depth required to inject more capital when needed. Donor and government institutions have to go through lengthy approval processes to secure the disbursement of funds; private sector investors with modest holdings may be unwilling to place more funds into a troubled organisation. Thus, MFIs may face problems raising additional capital promptly⁶⁹. This makes MFIs more vulnerable to temporary shocks that could quickly undermine the financial health of the institution.

Management risk arises because of the delivery methods used to service this market. This risk tends to be high due to the decentralised operating methods, high volumes, low returns per loan, rapid portfolio turnover, and requirement for efficient service delivery. Management must be

⁶⁹ Supra note 1, p 54.

familiar with microfinance methodologies, as well as have banking experience. Thus, the quality of management to ensure brisk and timely services is essential to the financial success of microfinance portfolios⁷⁰.

Credit risk arises because most loans are unsecured and alternative forms of collateral, such as character references and group guarantees, may not be legally enforceable, and have little liquidation value⁷¹. The management of delinquency rates is very important as delinquency problems become very serious very quickly, and could rapidly cause deterioration in the MFI's capital base, especially if it affects borrowers' access to further loans. If borrowers believe that they will not have access to further loans, this removes one of the major incentives to repay.

As regards portfolio risk, it is argued that MFIs are more susceptible to sector or geographic concentration risk as their clients are more likely to come from a single geographic area or market segment that is vulnerable to common economic shocks⁷². Also, unlike other FIs, their products tend to have highly specialised portfolios that consist of short-term working capital loans to informal sector clients⁷³.

⁷⁰ Supra note 22, p 34.

⁷¹ Supra note 12, p 45.

⁷² Supra note 22, p 35.

⁷³ Supra note 5, p 8.

3.3 Considerations in Developing The Regulatory Framework for Mfis

Differences between MFIs and traditional formal FIs, and the risk profiles highlighted above, mean that a modified approach is required to the regulation and supervision of MFIs. The following are some of the considerations that need to be borne in mind: Are the prudential standards applied to specialized banks and financial institutions in the rural finance and microfinance sector consistent with and adapted to the nature and characteristics of the market clientele they service (e.g. microfinance loans are short term, repeating, and unsecured with group guarantees being widespread practice), or are prudential standards used the same as those that apply to regular commercial banks? Does the central bank or supervisory authority have microfinance dedicated staff members assigned to supervision and examination of MFIs?⁷⁴ What is the judgmental assessment of the technical capability of staff members, and the quality of their examination of the MFIs?

Further considerations have been suggested that problems that do not require the government to oversee and attest to the financial soundness of regulated institutions should not be dealt with through prudential regulation⁷⁵. It is also suggested that minimum capital requirements should be set high enough so that supervisory authority is not overwhelmed by more new institutions than it can supervise effectively⁷⁶. Further, due to the ownership and governance structure of MFIs, supervisory tools used for banks, such as capital calls, would not be suitable for MFIs⁷⁷.

⁷⁴ Supra note 22, p 29.

⁷⁵ Ibid.

⁷⁶ Supra note 5, p 7.

⁷⁷ Supra note 22, p 33.

It has also been suggested that performance benchmarks, such as capital adequacy ratios should be higher for MFIs, than for comparable banks because of the risk profile of MFIs, particularly with regard to management and portfolio risk⁷⁸.

The design of MFI regulations should not proceed very far without estimating supervision costs realistically and identifying a sustainable mechanism to pay for them⁷⁹.

Lastly, before regulators decide on the timing and design of prudential regulation, they should obtain competent financial and institutional analysis of leading MFIs, at least if the existing MFIs are the main candidates for new licensing window being considered⁸⁰.

3.4 Conceptual framework for the Regulation of MFIs

The aim of supportive regulatory framework is to build strong regulated and unregulated institutions of all types (a) to provide services on a sustainable basis under uniform, common, shared performance standards and (b) to encourage the regulatory authority to develop appropriate prudential regulations and staff capacity that are tailored to the institutions' operational and risk profiles. This objective requires defining different tiers of financial institutions with different degrees of regulatory requirements. The requirements could vary from (a) simply registering as legal entities, to (b) preparing and publishing periodic reports on operations and financial results, to (c) observing non-prudential rules of conduct in business

⁷⁸Supra note 12. p 40.

⁷⁹ Ibid.

⁸⁰ Ibid, p 34.

operations, to (d) securing a proper licence and being subjected to prudential regulation by a regulatory authority, prudential supervision, or both by a central supervisory authority.

As the microfinance sector grows, adding a licensing tier that permits MFIs to legally mobilize savings and other commercial sources of funds can encourage capacity building and innovation that are aimed at self-sufficiency and greater outreach. Licensing of MFIs can also facilitate the emergence of new types of MFs that serve specific markets. However, the premature creation of special tiers with easy entry may result in weak institutions, may affect the development of commercial financial system, and may risk overwhelming inadequate supervisory resources.

Thus, the licensing of MFIs should be designed to balance promotional and prudential objectives. The main potential threats pertaining to deposit-taking MFIs are that; (a) deposit-taking MFIs could collapse, thus adversely affecting the commercial system, and that (b) prudential regulation of deposit-taking MFIs could prove to be an administrative burden that distracts supervisors from adequately protecting the safety and soundness of the main financial system.⁸¹ The Consultative Group to Assist the Poorest (CGAP) Microfinance Consensus Guideline takes a balanced view, arguing that deposit taking on a small scale may essentially go unsupervised especially where the deposits consist of only forced-savings components of the lending product, so that most depositors are net borrowers from the MFI at most times. This

⁸¹ Supra note 12, p 44.

approach would leave supervisory apparatus unencumbered from having to deal in-depth with a profusion of tiny MFIs.⁸²

Regulation of microfinance activities and institutions may take five approaches namely: (1) no regulation; (2) self regulation; (3) delegated supervision; (4) existing law; and (5) special law⁸³. The different regulatory approaches are discussed in more detail in the following chapter. Chapter Four also examines the challenges faced by the Bank of Zambia in regulation and supervision of MFIs

⁸² Ibid.

⁸³ Supra note 5, p 13.

CHAPTER FOUR

4.0 REGULATORY APPROACHES TO MFIS

This section describes the five approaches and outlines alternative options to ‘central bank’ based regulation and supervision.

4.1 No Regulation

To date microfinance has essentially evolved outside a regulatory framework. Consequently, they have been free to innovate and develop non-traditional approaches to the provision of financial services. As the cost of designing, developing, and implementing regulations is more than likely to exceed the benefits of leaving the industry without a regulatory regime, plus the fact that the total assets of the microfinance sector are too small to pose a threat to financial stability, it is argued that it may be best to continue with the status quo, i.e. no regulation. For instance,⁸⁴ recommend that supervisory attention should not be diverted away from bank supervision as a bank failure is more likely to result in systemic crisis, and central banks have a hard enough time regulating and supervising the commercial banking sector due to resource constraints and limited capacity.

It is also stated that the supervision of MFIs is likely to be much more expensive given that MFIs generally have a smaller asset base, a much larger number of accounts and a higher degree of decentralisation. In addition, regulation and supervision may inadvertently cramp competition

⁸⁴ Supra note 12, p 34.

and stifle innovation; hampering efforts to maximise outreach⁸⁵. This, or self regulation discussed below, is the approach that would be the most appropriate for non-profit NGOs making microfinance loans that do not exceed their funding from grants and donated/concessional funds (loan capital).

4.2 Self-Regulation

Self-regulation, also referred to as self-supervision, refers to the industry developing its own supervisory and governance bodies and the adoption of a code of conduct⁸⁶. Christen and Rosenberg,⁸⁷ defines self-supervision as the “arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organisations to be supervised - usually a member-controlled federation of MFIs”. The main advantage of self-regulation is that the supervisory agency in this case possesses more expertise and technical knowledge of practices within the industry than a public agency would. Secondly, the rules issued are less formalised than those of a public regulatory regime. This reduces the cost of rule making, facilitates quick adaptation of the rules to developments, and changing economic conditions, and permits more flexible enforcement⁸⁸. Lastly, the costs are typically borne by the industry as opposed to the taxpayer⁸⁹.

⁸⁵ Supra note 12, p 44.

⁸⁶ Supra note 22, p 67.

⁸⁷ Supra note 12, p 45.

⁸⁸ Ibid.

⁸⁹ Supra note 22, p 67.

However, there are disadvantages and the main disadvantage being the conflict of interest that inevitably arises. As practitioners are likely to be better informed than a public agency about what is happening in the industry, their ability to discover and expose malpractice is superior.

However, the self-regulatory organisation may be reluctant to publicise and punish wrong doers as its survival may be dependent on the very members that require disciplining⁹⁰. Consequently, enforcement can be problematic, especially where membership is voluntary. Much depends on the incentives to participate that are provided by the self-regulatory system⁹¹.

Self regulation is an approach usually taken whilst an industry is still in its infancy. However, it is unlikely to succeed due to the diversity in size, scale of operations, objectives and resources of various institutions providing microfinance. According to Christen⁹², self-regulation of financial intermediaries in poor countries has repeatedly proven to be ineffective, the main reason being the conflict of interest that inevitably arises as noted above.

4.3 Delegated Supervision Approach

The delegated supervision approach is where the central banking and financial institutions supervisor delegates direct supervision of an identified set of institutions to a body or agency outside the central supervisory authority, while monitoring and controlling that other body's or agency's supervisory work⁹³. This agent might be an MFI association, apex institution or an independent technical entity. The supervisor's role lies in periodically testing the reliability of

⁹⁰ Supra note 22, p 57.

⁹¹ Ibid.

⁹² Supra note 1, p 20.

⁹³ Supra note 1, p 34.

the delegated agent's monitoring, inspection and reporting; and intervening in problem situations⁹⁴.

Limited examples of delegated supervision are being used for MFIs; thus, there is little experience to date on the effectiveness of this approach. An example of the delegated approach can be found in South Africa, where micro lenders are regulated by the Microfinance Regulatory Council (MFRC). The Usury Act Exemption Notice of 1999, permits MFIs to opt out of complying with the conditions of the Usury Act on the proviso that they register with a regulatory institution approved by the Minister of Trade and Industry. The only institution approved to date is the MFRC. The MFRC is called a 'hybrid institution' as its board comprises members from the microfinance and banking industry, and from public institutions such as the central bank, the Department of Trade and Industry (DTI), and state owned wholesale FIs. The MFRC is a functional regulator. It focuses on a set of activities that it licenses and supervises, regardless of the organizational form or other financial licence held by the lender⁹⁵.

The MFRC's key mandates are the formalisation of the micro-lending sector, the provision of customer protection, and the improvement of information and understanding.

Disclosure requirements have been standardised. The reduction in reputational risk has resulted in banks entering the sector. Furthermore, the MFRC has launched various educational

⁹⁴ Ibid.

⁹⁵ Supra note 12, p 47.

campaigns aimed, amongst others, at informing consumers on their rights when borrowing money and prudent financial management⁹⁶.

If delegated supervision approach were to be applied even on an interim basis, it is critical to answer the following questions in advance: (1) who bears the costs of the delegated supervisory body or agency and the additional costs of the central supervisory authority's oversight and monitoring of the agency? (2) Should the delegated supervision arrangement prove unreliable or ineffective, and should the mandate to the delegated supervisory agency need to be withdrawn, does a realistic and practicable fallback or alternative option exist for the central supervisory authority? (3) In the event that a supervised institution fails, which agency will have the authority and capability to clean up and rectify the situation by suspension, intervention, or liquidation? and (4) Does a delegated supervisory agency bear any legal liabilities in the exercise of the delegated responsibilities.⁹⁷

4.4 Existing Law Approach

The existing law approach refers to regulating MFIs within the existing legal and regulatory framework for formal FIs, but to adapt ratios and supervisory practices to address the unique risk profiles of MFIs. This can be costly and may require organisational changes to the structures of MFIs and additional reporting requirements resulting in increased operational costs⁹⁸. It is based on the assumption that MFIs are doing bank type business. A variant of this approach is where MFIs are exempted from certain rules and laws, individually or generally.

⁹⁶ Supra note 1, p 34.

⁹⁷ Ibid.

⁹⁸ Supra note 12. p 49.

MFIs choosing formal status can choose which legal form best suits their needs and capabilities. Tanzania is an example of a country which decided, after a review of its existing legal framework, that there was no need for a special law for microfinance. The existing legal framework did not contain serious impediments to the microfinance sector. Furthermore, it was felt that incorporating microfinance into the existing legal framework for the banking system would “facilitate integration into the broader financial system, encourage innovation and competition, enable proper harmonisation of the regulatory changes with the existing regulatory framework, as well as minimise possibilities of regulatory arbitrage”⁹⁹.

However, it was necessary to amend certain aspects of the existing legal framework. This was done through the introduction of two categories of regulatory instruments. Namely regulations that: (1) focus on best practices in microfinance as provided for in the National Microfinance Policy (NMP); and (2) relate to independent audit and internal control and audit.

Consequently, Microfinance Regulations were introduced in March, 2005, followed by a host of regulations to cater for the required amendments. The Microfinance Regulations focus on specific risks related to the business of microfinance with emphasis on credit services, since credit risk is one of the major risks for FIs. All banks and FIs engaged in microfinance, including microfinance companies (MFCs), are subject to prudential regulation, and are required to report on their microloan portfolios.

⁹⁹ Supra note 12, p 34.

In order to ensure a level playing field for both regulated and non-regulated microfinance providers, the NMP stipulates that all MFIs be subjected to a best practice, non-prudential, regulatory framework. Thus, NGO MFIs are subject to regulation by the National Board of Accountants and Auditors (NBAA) to ensure transparent disclosure. NGOs that receive donor and or government funding, are regulated under the Public Finance law. In addition, credit only MFIs may apply for accreditation from the Ministry of Finance (MOF). The accredited institutions, referred to as microcredit institutions (MCIs), thus, receive formal government recognition enhancing their credibility. Accreditation of NGOs is not mandatory¹⁰⁰.

The fact that the banking laws required amendment to suit the specific features of MFIs implies that the regulation of MFIs under banking laws cannot serve as a general model for the majority of MFIs. According to Christen and Rosenberg (2000), it would be the second best solution where regulation is considered necessary or desirable.

4.5 Special Law Approach

Some countries have created distinct legal status and regulation for non-bank MFIs. The creation of a special law or a separate window for MFIs is justified on the need to develop standards better suited to the microfinance sector and lower barriers to entry. The main advantage of this approach lies in the fact that it permits MFIs to pursue their goals and maintain their distinct characteristics, whilst providing a reduced range of financial services without necessarily becoming a bank. It has been suggested that the special category could provide a link between

¹⁰⁰ Supra note 22. p 58

the informal sector and mainstream economy, possibly bringing savings from ‘under the mattress’ and into circulation. Examples of where special laws have been promulgated for MFIs are West Africa, Ethiopia, Uganda and more recently, Zambia. Developing legislation involves writing rules which necessitates a certain amount of ‘model building’ and “making decisions as to what kind of institutions are the best to do microfinance, and sometimes even what kind of loan methodologies or operating procedures are best”, a task for which most countries do not have the expertise¹⁰¹. Additionally, one needs to ask whether the country has MFIs suitable for licensing but can’t use an existing window. In answering this question, it is important to note that licensing implies that the government is making a representation regarding the safety and soundness of the licensed FI, including, where applicable, the fact that the MFI is strong enough to be a safe intermediary of commercial sources of funding, be it from retail deposits, institutional investors, or government credit lines.

Therefore, it would be irresponsible to licence an institution that cannot demonstrate its sustainability. The degree and quality of access to financial services available to low income households and their small businesses is influenced by the quality of the legal and regulatory framework. The framework should be guided by the following core principles of good microfinance: (a) to provide a level playing field among participants in the provision of a range of financial services beyond credit and savings facilities; (b) to allow the institutional transformation of non-traditional and non-regulated MFIs (such as multipurpose and microcredit NGOs) into specialized, regulated, or licensed MFIs; (c) to promote and reward transparency in

¹⁰¹ Supra note 22, p 59.

financial accounting and transaction reporting; and (d) to foster the exchange and sharing of credit histories of borrowing clients ¹⁰².

4.3.2 Financial Sector Review

4.5 Zambia Country Context and Financial Sector Status

4.5.1 Zambia Economy¹⁰³

Zambia is a landlocked country in the Southern Africa with eight (8) neighbours (Angola, Botswana, Democratic Republic of Congo, Namibia, Malawi, Mozambique, Tanzania and Zimbabwe. Its population is estimated to around 11.1 million as at 2005.

Table 2: Economic and Financial Indicators for Zambia

Total Population (2005 est.)	11.1 million
Population Growth rate (2006 est.)	2.11%
Number of Districts	72
GDP Per Capita (2008)	US\$1,181.50
Real GDP (2008)	6.0%
Inflation (December 2009)	9.9%
Currency	Zambian Kwacha (ZMK)

¹⁰² Ibid.

¹⁰³ The information presented in Sections 4.1.2 and 4.2.2 are mainly based on data from the Bank of Zambia and can be accessed on www.boz.zm

Source: Bank of Zambia website (www.boz.zm) (16 March 2010)

4.5.2 Financial Sector Review

There are a lot of actors in the Zambian financial sector. Table 2 below provides the different types of institutions that are supervised by the Bank of Zambia.

Table 3: Institutions Supervised by the Bank of Zambia

Types of Institutions	Total Number
Commercial Banks	18
Leasing Companies	12
Development Finance Institutions	01
Building Societies	03
Microfinance Institutions	25
Savings and Credit institutions	01
Foreign exchange bureau de change	44
Credit reference bureau	01

Source: Bank of Zambia website (www.boz.zm) (16 March 2010)

⁶⁴ The information presented in Sections 4.3 are mainly based on data from the Bank of Zambia can be accessed on www.boz.zm

4.5.3 Financial Sector Regulation¹⁰⁴

There are various laws that govern the different types of financial institutions in Zambia. Table 3 below provides the laws that govern the financial sector in Zambia and the regulatory authority mandated to administer the laws.

Table 4: Laws Governing the Financial Sector in Zambia

Types of Institutions	Applicable Laws	Regulatory Authority
Commercial Banks	Banking and Financial Services Act of 1994, as amended in 2000 and 2005	Bank of Zambia
Leasing Companies	Banking and Financial Services Act of 1994, as amended in 2000 and 2005	Bank of Zambia
Development Finance Institutions	Banking and Financial Services Act of 1994 as amended in 2000 and 2005, and the Development Bank of Zambia Act of 1973, as amended in 2005.	Bank of Zambia
Building Societies	Banking and Financial Services Act of 1994, as amended in 2000 and 2005, and the Building Societies Act of 1968 as amended in 2005	Bank of Zambia
Microfinance Institutions	Banking and Financial Services Act of 1994, as amended in 2000 and 2005, and the Banking and Financial Services (Microfinance) Regulations of 2006. Money Lenders' Act	Bank of Zambia Ministry of Finance and National Planning

¹⁰⁴ The information presented in Sections 4.3 are mainly based on data from the Bank of Zambia can be accessed on www.boz.zm

Savings and Credit institutions	Banking and Financial Services Act of 1994, as amended in 2000 and 2005, and the National Savings and Credit Act, as amended in 2005.	Bank of Zambia
Foreign exchange bureaux de change	Banking and Financial Services Act of 1994 as amended in 2000 and 2005, and the Banking and Financial Services (Bureau de Change) Regulations of 2003.	Bank of Zambia

Source: Bank of Zambia website (www.boz.zm) (16 March 2010)

4.6 Financial Institutions Visited By the Researcher

Below are brief descriptions of the MFIs that the researcher had interviews with.

4.6.1 Pulse Financial Services Limited

Pulse Financial Services Limited (PFSL) started operations as a non-governmental organization under a CARE Zambia initiative in 1996. It was later transformed into a company limited by shares. The Development International Desjardins, CARE International Zambia and Zambian investors took up shares in PFSL in 2008. PFSL was licensed by the BOZ in 2008, as a deposit-taking microfinance institution and was officially launched in July 2009. Its mission is to increase peri-urban and micro small and medium enterprises' access to specialized financial services on a permanent basis while contributing to poverty reduction, improvement for living conditions and development of the Zambian sector. Currently PFSL's operations are still in Lusaka and has 1521 clients with a loan portfolio of about K4 billion.

4.6.2 Cetzam Financial Services Limited

Cetzam Financial Services Limited (Cetzam) was established in 1995, as a company limited by guarantee. Its mission is to transform the lives of the poor by providing them with access to client useful financial services and training. Cetzam was licensed by the BOZ as a deposit-taking microfinance institution in 2008. Cetzam offers the following services: solidarity group loans, trust bank loans, individual loans, agricultural loans, and insurance and savings products.

4.6.3 Micro Bankers Trust

Micro Bankers Trust (MBT) is a registered corporate body under the Land (Perpetual Succession) Act¹⁰⁵ and it is overseen by a board of trustees which is appointed by the Minister of Community and Social Services who are agents of the Government of the Republic of Zambia (GRZ), who is the main trustor. MBT was established in 1996, as an autonomous body to implement the Micro Credit Delivery for the Empowerment of the Poor Program (MCDEP), as a joint venture of the Government and the European Union, through the Ministry of Community and Social Services (MCDSS) as the settler of the Trust on 12 September 1996. Currently MBT is governed by a Trust Deed.¹⁰⁶

The primary objective of MBT was the economic empowerment of vulnerable individuals through the provision of credit to financial intermediaries for on-lending to vulnerable individuals in Zambia. Other objectives included staff training to strengthen institutional capacity; assisting in the design and operation of microcredit delivery in a viable and effective

¹⁰⁵ Chapter 186 of the Laws of Zambia.

¹⁰⁶ Supra note 12, p 49.

manner; and improving performance through evaluation, research, performance monitoring, and sound lending policies. Since 2000, however, MBT has changed its orientation. It no longer provides wholesale funds and provides microcredit directly to clients. The change in orientation was a direct result of the failure of MFIs to repay their loans. MBT is currently operating in 25 districts of Zambia.¹⁰⁷

¹⁰⁷ Ibid.

CHAPTER FIVE

5.0 CONCLUSIONS AND RECOMMENDATIONS.

5.1 Regulation of MFIs in Zambia

The findings of the research indicate that MFIs in Zambia are regulated by BOZ. BOZ draws the regulatory and supervisory authority from the Banking and Financial Services Act (BFSA), which considers microfinance services as one of the financial services to be regulated by the BOZ. In view of the foregoing, BOZ developed specific regulations namely, the Banking and Financial Services (Microfinance) Regulations of 2006 (Microfinance Regulations), to govern the operations of the microfinance industry in Zambia.

The Microfinance Regulations categorises the microfinance institutions into three (3) tiers, and therefore the requirements for licensing differ from one category to the other. The three (3) tiers are as follows:

- ***Tier 1*** – These are deposit-taking MFIs (whose minimum paid –up capital is K250 million;
- ***Tier 2*** – These are non deposit-taking MFIs that meet the minimum paid up capital of K25 million; and
- ***Tier 3*** - These are non deposit-taking MFIs, that do not meet the prescribed minimum paid-up capital of K25 million, and are regulated by their primary regulators; and are required to register as a MFI with such body as may be designated by the Bank of Zambia (BOZ).

The following are the licensing requirements:

5.1.1 Capital

The capital requirements for microfinance institutions are as follows:

Type of MFI	Minimum Capital Requirements
Deposit taking MFIs (Tier 1)	K250 million or 15% of the risk weighted assets, whichever is higher.
Non-Deposit taking MFIs (Tier 2)	K25 million or 15% of risk weighted assets, whichever is higher.

5.1.2 Shareholding

It is a licensing requirement that applicants for licensing as a microfinance institution must be companies limited by shares. Further, Regulation 35 of the Microfinance Regulations provides as follows:

Type of MFI	Percentage shareholding Limit
Deposit taking MFIs (Tier 1)	Maximum of 25% shares per person
Non-Deposit taking MFIs (Tier 2)	Maximum of 50% shares per person

5.1.3 Board of Directors

Regulation 20 of the Microfinance Regulations requires that MFIs (both deposit taking and non-deposit taking) have a board of directors constituting of not less than five (5) members, the majority of whom shall be permanent residents in Zambia.

5.1.4 Management

Regulation 21 of the Microfinance Regulations provides that the management of a microfinance institution shall include:

- (a) A chief executive officer; and
- (b) A chief financial officer.

Further, the regulation provides that the above mentioned positions shall not be held by one person.

5.1.5 Other Requirements

The other requirements for licensing include:

- Must provide a Certificate of incorporation and Articles of Association for the company;
- Evidence of minimum paid-up capital for the category of the microfinance institution.
This is by way of the auditor's confirmation of the company's paid-up capital;
- Applicant must submit a business plan with financial projections and forecasts for a minimum period of three (3) years. This should include an income statement, balance

sheet, cash flow statement and a copy of the accounting policies to be adopted by the proposed microfinance institution; and

- The applicants should also provide the curriculum vitae, including details of nationality and residence, for the proposed directors and management of the microfinance institution.

As at 28 February 2010, there were 25 MFIs licensed with BOZ of which 6 were deposit-taking MFIs. BOZ conducts its supervisory function through the Non-Bank Financial Institutions Supervision Department. The findings indicated that there were MFIs that were registered under the Money Lenders' Act which is administered by the Ministry of Finance and National Planning (MoFNP).

The findings also indicated that there was need to regulate both DTMFIs and NDTMFIs in Zambia. DTMFIs should be regulated prudentially to protect depositors' fund, preserve the core health of an institution, ensure stability and soundness of the microfinance industry and build public confidence in the industry and entire financial system. NDTMFIs, on the other hand, should be regulated non-prudentially in order to govern the conduct of the MFI industry and to ensure transparency and full disclosure in the conduct of their business.

5.2 Microfinance Policy

The findings of the research indicated that there was no microfinance policy in Zambia. However, the policy was being developed under the Rural Finance Programme under the MoFNP.

5.2.1 Risks, Weaknesses and Deficiencies That Regulation and Supervision Intends To Address in Zambia

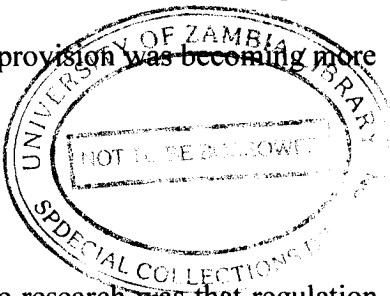
The findings of the research indicated that prior to the coming into effect of the Microfinance Regulations, since there was no specific legislation to guide the operations of the microfinance sub-sector in Zambia; the industry was faced with a number of challenges. The major problems included: inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standards, among others.

Therefore, regulation and supervision of the industry aimed at ensuring the orderly growth and development of the industry as an integral part of the financial system. BOZ expects that MFIs will play a pivotal role in deepening the financial market; expanding access to financial services and products to majority Zambians; increasing competition and efficiency; and safeguarding the safety, soundness and stability of the microfinance industry, and the entire financial system. Further regulation and supervision of DTMFIs allows the institutions mobilize deposits from the public while ensuring depositors' funds were protected. Consequently, prudentially regulated and supervised institutions were more able to mobilize savings on a viable and sustainable basis.

5.2.2 Whether Objectives of Regulation Were Met

The findings of the research indicated that objectives of regulation were being met which were access, sustainability and efficiency. More MFIs were entering into the regulated space; banks were downscaling, innovations were being realised. These among others were increasing access to financial services for low households, and the poor especially in peri-urban areas. MFIs were developing better systems, structures processes, and capacity to meet regulators requirements

and hence their institutional stability was improving. The findings also noted that competition was increasing and innovations were being adopted, hence service provision was becoming more efficient.



5.2.3 Benefits of Regulation and Supervision of Mfis

The perception by most MFIs as observed from the findings of the research was that regulation has helped to improve governance issues in their institutions and had brought about transparency in the conduct of their business. MFIs were required under the regulations to publish their quarterly financial statements in the papers of national circulation, and they were also required to publish the interest rates and financial charges and fees on the services that they provided. Further, the MFIs indicated that systems and procedures were well documented as required by BOZ. Some MFIs also indicated that as a result of being regulated, that gave confidence to potential partners to invest in their institutions.

5.2.4 Existence of Industry Association and its Role

The findings were that a microfinance industry association exists in Zambia, namely the Association of Microfinance Institutions of Zambia (AMIZ). AMIZ was established by microfinance practitioners and was officially registered in March 1998. It took a leading role in campaigning for new legislation, standard setting, and staff training for new MFIs. Its mission is to “facilitate, support and strengthen the services provided by member MFIs, and represent them in the best way possible by utilizing microfinance best practices”. The main objectives of the Association are: (1) to disseminate and exchange information on key issues related to microfinance; (2) to lobby government, donors, and other stakeholders on issues of law,

enabling environment and support programmes for microfinance, as well as the need to develop strong and dedicated micro entrepreneurs in order to spur sustainable microfinance development; (3) to become a coordinating and representative body for member microfinance institutions; (4) to strengthen lateral learning among practitioners; (5) to facilitate sustainable business development services to microfinance institutions; (6) to support best practices and innovative techniques utilised by microfinance institutions in Zambia; and (7) to establish and maintain professional standards of microfinance conduct among member MFIs and the industry in general (AMIZ, 2003).

As on the effectiveness of the Association and whether it would assume the role of the regulator (self regulation), the results of the research indicated that AMIZ was not effective in implementing its objectives because its existence was not backed by law and could not mandate all MFIs to be members of the Association so that they could all speak with one voice. In view of this, it was submitted that AMIZ would not be in a position to assume the role of regulator for the industry.

However, one MFI interviewed indicated that AMIZ had been effective in achieving its objectives as it had managed to bring together a number of MFIs that had been sharing information including that of bad debtors and had been able to organize training and funding opportunities to its members.

5.2.5 Challenges and Constraints Faced By The Bank of Zambia In Regulating and Supervising Mfis

The following challenges and constraints were identified from the research:

- Industry capacity and understanding of the transformation process from being unregulated to being regulated;
- Licensing challenges, including institutional forms and documentation, ownership and corporate governance issues, and compliance with the regulations and other applicable laws. For example, most of the MFIs were registered as either companies limited by guarantee or non-governmental organizations under the Companies Act and the Registrar of Societies, respectively, while the regulations required MFIs to be companies that were limited by shares; and
- BOZ capacity- BOZ was developing microfinance supervisory tools and building its staff capabilities to effectively and efficiently regulate and supervise the MFIs.

5.2.6 Costs of Regulation and Whether Regulation has Stifled The MFI Operations

From the regulator's point of view, the cost of regulation was the amount of resources that went into conducting an onsite inspection of the MFIs, as well as the cost of capacity building. However, the MFIs indicated that there were no major costs related to regulation.

Further, the MFIs indicated that regulation had not in any way stifled their operations.

5.2.7 Regulatory and Supervisory Related Obstacles for Providing Microfinance Services

All the MFIs interviewed indicated that there had been no regulatory obstacles that they had faced during their operations.

5.3 Recommendations

1. Government should help create an enabling environment for the sound and stable growth and development of the microfinance industry in Zambia through:
 - (a) Development of the microfinance policy and effective implementation of the key legislation and regulations i.e. the BFSI and Microfinance Regulations; and
 - (b) Continuous reviews of legal, regulatory and supervisory frameworks to embrace current innovations.
2. Infrastructure development
 - (a) E.g. efficient operation of the credit reference bureau, credit rating, consumer protection and rights, and financial education, etc; and
 - (b) Development of appropriate performance standards and documentation tools.
3. Human Resources Development - Development of public private sector partnerships geared towards industry capacity building training and development;
4. Research and Development to embrace best practice in introducing and sustaining innovative and appropriate product and service provision.
5. AMIZ can assist in:
 - (a) Policy formulation, implementation and monitoring.

- (b) Lobbying for appropriate policies e.g. consumer protection
- (c) Training, marketing, technological development and transfer
- (d) Information collection and dissemination
- (e) Provision of other support services e.g. financial education, business training marketing information, among others.

6. The Private Sector can:

- (a) Provide services to the market;
- (b) Provide investment capital for MFIs and MSEs growth and wealth creation;
- (c) Monitor policy implementation

7. Development Partners can support and supplement in terms of;

- (a) Financial support
- (b) Technical assistance
- (c) Capacity building including infrastructural development

QUESTIONNAIRE FOR THE MICROFINANCE INSTITUTIONS

Dear respondent,

My name is Lushomo Ndovi, a 4th Year student at the University of Zambia pursuing a Bachelor of Laws Degree and I am conducting a research on the Challenges faced by the Bank of Zambia in the Regulatory and Supervisory of Microfinance Institutions. This is in partial fulfilment for the award of the Degree. The main objectives of the research are to establish whether microfinance institutions in Zambia are regulated and if so, what the challenges of regulating them are, and also to establish the impact of regulation on the MFI industry including fostering the development of an inclusive financial system. The research will also establish what incentives or interventions, if any, should Government and other key stakeholders provide to microfinance institutions in order to promote financial inclusion.

Therefore, I would be grateful if you could take your time to respond to the questions below:

QUESTIONS

1. Name of microfinance institution: _____
2. Year established: _____
3. Current legal status (Profit/ Non-Profit): _____
4. Is your organisation registered, and if so, what is it registered as i.e. society, cooperative, limited company, or non-governmental organisation:

5. What's your institution's mission:

6. Background information/ History:

7. What are your major sources of funding i.e. donor funds, deposits, commercial loans, government or equity? To what extent has regulation been able to shape your funding sources?

8. What are the permissible services that MFIs can provide under the regulations?

9. What has been your institution's performance in terms of outreach (number of clients served), area of coverage, loan portfolio, financial sustainability including cost minimization, before and after the coming into effect of the regulations?

10. Does your institution provides or intends to provide mobile phone / cell phone based financial services? Please provide explanations.

11. In your opinion how best mobile phone / cell phone based financial services should be regulated if any? Please provide explanations.

12. From your experience, what are the major regulatory and supervisory related obstacles for providing financial services and in reaching out to the un-served segments of the population?

13. From your experience, what benefits are you deriving from being regulated?

14. From your experience, what are the costs of being regulated?

15. What information are you providing to the regulator, and has the coming into effect of the regulations altered your financial reporting formats? Explain.

16. Is there a microfinance industry association in your country and are you a member of that association? What has been the role of the association and what benefits are you deriving from being a member?

17. In your opinion, would the industry association assume the role of the regulator (self regulation) and how effective would it be in ensuring microfinance institutions' sustainability and transparency in the sector?

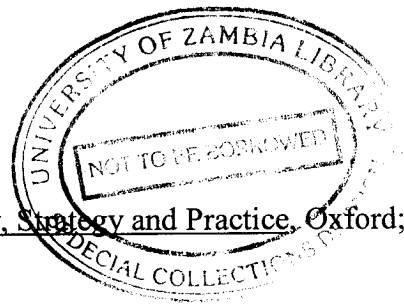
18. In your opinion, has the industry association(s) been effective in discharging their stated objectives? Please explain.

19. In your opinion, has regulation stifled the operations of your institution and to what extent? Please provide an explanation.

20. What incentives, if any should Government provide to microfinance institutions in order to promote financial inclusion? Please provide explanations.

THANK YOU

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