

# **Policies, Regulations and Systems that Promote Sustainable Financial Services to the Poor and Poorest**

*Women's World Banking*

## **Evolution of the Microfinance Industry**

Poor people, especially women, have demonstrated that they are excellent borrowers, when provided with efficient, responsive loan services at commercial rates. When lending, savings and other financial services are offered in an efficient and financially sustainable way, these services have a real impact on helping poor people build income and assets, manage risk, and work their way out of poverty.

The growth in the industry has occurred largely in the absence of specific financial sector policies for microfinance. Beginning in the mid-1990s, leading microfinance institutions have worked together to build performance indicators and standards for the microfinance industry. These initiatives have been motivated by recognition of the importance of demonstrating microfinance's strong performance, transparency and accountability to both the financial sector as well as to international donors and commercial lending agencies.

The spectrum of institutions operating in the microfinance industry has become increasingly more diverse. This is in part due to the recent entrance of several private mainstream commercial banks, finance companies and insurance firms into microfinance, either as retailers or wholesalers. Additionally, some NGOs have "transformed" into regulated, for-profit structures, owned and governed by shareholders, in part due to pressure from the microfinance community, donors in particular. The increased range of institutional types within the industry indicates the need for an expansive set of policies and regulations to encourage its continued growth.

## **Building Financial Systems that Work for the Poor Majority**

Strong institutions mean financially sustainable institutions that can provide the poor with continued access to financial products and services. Financial sustainability will be achieved increasingly through wholesale financing arrangements, commercial borrowings and/or broad-based savings mobilization rather than concessional funds. Savings mobilization is key as it is a highly valued service to poor people. Savings can become the dominant source of funds for the microloan portfolio, if the necessary legal structures and capabilities are in place.

Financial systems need to encourage a range of institutional types to enter and expand sound, efficient and financially sustainable microfinance operations. The government's role in encouraging this burgeoning industry should not be as a retailer of microfinance services but rather as the creator and supervisor of regulations and norms that encourage sound and responsive microfinance operations across the range of regulated legal structures.

## **Building Transparency and Performance Standards in Microfinance**

Shared performance standards, transparency and accountability are key to building solid and responsive financial services for poor households—for both regulated and unregulated microfinance institutions. These measures increase the entire industry's integrity as well as highlight why the industry's unique character must be reflected in the kinds of performance measurements used.

There is rapid convergence on definitions for these standards, which will make it possible for wholesale financing institutions, international funders, microrating agencies, and country, regional and global networks to compare the performance of institutions around the world.

It is important that these performance monitoring systems not be seen as a substitute for building the changes in prudential regulations and legal structures needed to encourage sound microfinance by regulated institutions and the increased reliance on savings and commercial borrowings by microfinance institutions. They are however very important to build transparency, create shared commitment, facilitate the flow of funding, and help networks provide rich products and services.

## **Banking Regulation that Fits the Needs of Microfinance Portfolios**

Central banks and bank superintendencies are beginning to see the importance of understanding the nature of microfinance. This awareness has led to, in some cases, the modification of conventional regulatory requirements to fit the needs of microfinance operations. These special features of microfinance include the limited size of the microfinance market in relation to the financial sector as a whole, the replacement of traditional collateral by the demonstration of portfolio quality, high transaction costs, different approaches to branching and delivery systems, lack of scale and sophistication to deal with typical reporting requirements.

The key dimensions in policy, banking regulation and supervision adapted to the needs of microfinance include the removal of interest rate ceilings, the evaluation of portfolio risk by looking at aggregate portfolio quality, with rigorous standards on loan loss provisioning and reserve and at the adequacy of systems, rigorous but simplified reporting requirements, and flexibility in branching operations.

## **Legal Structures that Work for Regulated MFIs**

Legal structures need to be built or adapted to enable a subset of strong microfinance NGOs to convert to regulated financial institutions that can mobilize public savings and rapidly expand commercial funding. This is necessary because many of the larger microfinance institutions will increase their reliance on these sources of funds in the near future. These legal structures are extremely important to protect savers, investors and the banking industry. While becoming a regulated institutions is helpful in terms of seeking commercial funds and investments, it is essential in terms of mobilizing public savings.

Several features must be present for these legal structures to encourage the growth of the microfinance sector, including: relatively low minimum capital requirements, appropriate

capital adequacy ratios (generally more conservative than for commercial banks), flexible ownership structures, high performance standards, and appropriate tax treatment.

Finally, prudential regulation must be coupled with strong supervision. The systems of supervision for commercial banks are not easily transposed onto the microfinance industry. Central banks and bank superintendencies must recognize the importance of understanding the nature and nuances of microfinance in order to execute proper supervision.

Increasingly, financial sector policy makers are recognizing the importance of microfinance, understanding its special features, and working with local microfinance leaders to ensure that the needed changes are made in financial sector policies, regulations and support systems to encourage the growth of a sound, responsive financial system that works for the poor majority. While consensus exists on the key features of pro-poor financial systems, policies, regulations and support services need to be designed to respond to each country context.