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microNOTE #7

Transitions to Private Capital

Regulatory Challenges to Private Sector Investment

Private sector investment is the key to microfinance entering the mainstream and growing significantly. Yet, private sector investment in microfinance is lagging. Although funding by donors and governments is insufficient to satisfy the potential capital needs of a rapidly growing microfinance sector, so far private sector investment is dwarfed by non-market sources of capital.

This paper looks at two broad sets of regulations that hinder private sector investment in microfinance institutions (MFIs).[1] First are those regulations that limit the ability of MFIs to accept all forms of private investment, second are those that limit potential investors' ability to choose microfinance as their preferred investment destination. This paper sets out to summarize pertinent regulatory issues that restrict private sector investment and what additional research is needed to address the problem.

1. Regulations Affecting Investments in MFIs

Finding a willing investor is often assumed to be the most critical requirement to access private capital. However, many MFIs are subject to regulatory restrictions that make it difficult for them to accept private investment when it is offered or available. The types of regulations that limit private investment in MFIs are primarily concentrated in three fields: 1) company and tax laws, including bankruptcy law; 2) restrictions on foreign ownership and foreign

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[1] For the purpose of clarity, this paper uses the terminology of standard economics. Investment refers to the provision of capital in any form, be it equity, long or short term loans. Regulation, on the other hand, is taken to include rules, laws, decrees and supervisory action regardless of its precise legal standard.

borrowing; and 3) ownership restrictions on regulated financial institutions.[2] In addition, the lack of legal clarity and transparency further hinders MFIs' access to commercial capital.

Company and tax laws define commercial and fiscal rights, and specify obligations of companies engaged in microfinance. Since many MFIs are non-profit companies, they may not accept equity investment. In addition, tax codes often prohibit certain types of commercial transactions for tax-exempt companies. In some countries, non-equity investment in non-profit companies is restricted. Not all MFIs are non-profit companies, and generally for-profit entities are less restricted since they do not have any tax privilege to lose.[3]

In some cases, the institutional type of an MFI restricts its ability to borrow funds and then on-lend them. The Georgian regulatory environment is another example where non-profit entities are restricted from having "commercial" activities as their primary activities. This leaves microfinance NGOs in a state of limbo, and lenders and equity investors are hesitant to invest in such an environment.

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[2] Microfinance institutions, for the purpose of this discussion, are incorporated entities with or without a banking license.

[3] However, tax exemption is fundamental to the viability of many microfinance institutions.

Almost all jurisdictions exempt financial institutions from transaction taxes, such as sales tax and value added tax (VAT). However, financial institutions constituted as corporations are normally liable for corporate tax, unless specifically exempted. The fact that taxation is country-specific complicates the issue. For example, one country may levy sales tax on credit-only institutions because they are not licensed as a financial institution while another country may revoke corporate tax exemptions if an MFI charges market interest rates.

Bankruptcy law has been a major issue that discourages potential investors, both foreign and domestic. If an institution has to be liquidated, investors worry about their ability to be repaid, especially whether their investment takes precedence over other claims. Also, if part of the liquidation process forces an institution to convert its debt into equity, the lender's investment would be trapped in the institution and therefore, more difficult to liquidate. This concern exists for already wary investors in microfinance. Although bankruptcy law applies to all companies in an economy, microfinance is an unfamiliar investment and exit strategies may be particularly important for non-equity investors.

Foreign investment regulations. Regulations governing foreign investment are the second broad category of restrictive regulations. These regulations may be specific to a particular type of organization, affect all financial institutions or impact all companies. Particularly important is the difference between restrictions that can emanate from primary company legislation and from secondary financial legislation. In some countries, companies limited by shares need majority local ownership, but the financial law may be silent on foreign ownership restrictions. Alternatively, a country may not place any foreign ownership restrictions on companies but may require that licensed financial institutions are primarily locally owned.

In many cases, the interaction between primary and secondary legislation may create more complex situations. For example, financial regulation may stipulate a form of company registration that limits equity investment. Unintended limitations may result if primary and secondary laws are not well synchronized. Restrictions on foreign investment also apply to debt financing since many countries restrict borrowing from foreign sources or in foreign currencies.

Ownership restrictions. Ownership restrictions in some countries can also restrict investment in financial institutions. Supervised institutions are frequently required to provide evidence that their owners are in good financial standing. This may exclude potential investor groups, particularly foundations and NGOs, but also donors. Some countries limit or exclude non-profit institutions from owning supervised financial institutions. There are some good reasons for restricting ownership, especially for ensuring controlling stakes go to well-capitalized and reputable entities. Such regulations, however, can have some unintended and adverse effects. This is especially true when inappropriate banking regulations are expanded to all financial institutions, and if avenues for institutions to graduate to another licensing tier are not available to existing, non-licensed microfinance institutions. For example, the restriction on non-profit companies owning banks may prevent a microfinance organization from acquiring a financial license.

Lack of legal clarity and transparency. Discrepancies between primary and secondary laws often impede transformation into licensed and supervised institutions. A lack of transparency about the specifics of how transformations could occur for existing financial institutions –,for example, how existing loan portfolios can be legally transferred to a new, licensed entity – makes investment decisions risky (see textbox). In addition, specific regulations, such as high minimum capital requirements, often prevent institutions from acquiring financial licenses.

In Jordan, for example, high minimum capital requirements have impeded NGOs from converting into banks, yet no legal structure for credit and savings NGOs exist. This lack of legal structure hinders the transformation of Jordanian microfinance NGOs into formal, regulated institutions. Such a legal structure would help to lessen the risk for investors and would define the MFI's activities as legal, thereby increasing the attractiveness for loans or investment. When no obvious route to transformation exists, some institutions, such as ACEP (Senegal), NOA (Croatia) and Nachala (Bulgaria), have chosen to register as a credit union or co-operative, which restricts their ability to access private sources of capital, particularly new equity.

2. Regulations Affecting Investors

Regulations that prevent a potential investor from investing in microfinance typically vary depending on whether the transaction is domestic or international. Since donor funding, which has been the major source of capital for microfinance to date, has been largely international, the potential of domestic investment has been neglected. However, most developing countries have well-capitalized domestic investors and regulatory reform could start by removing regulatory barriers to domestic investment in MFIs.

Domestic Investment

There are three primary categories of domestic private investors: social entrepreneurs, institutional investors, and other market-motivated investors. The first source of private capital for most MFIs is from social entrepreneurs, mainly non-profit companies or organizations, who often accept

flexible terms and great financial risk. However, as a source of substantial fresh capital, this group is unlikely to play a decisive role. Domestic institutional investors are a more likely source of the next round of capital for MFIs.

In many developing countries, institutional investors, such as pension and insurance companies, are often obliged to invest a certain share of their portfolios in domestic assets and find the return profile below that available on international markets. In fact, it is not uncommon for governments to finance deficits through domestic bonds that local financial institutions are legally obligated to undertake. Understandably, alternative investment opportunities with a favorable risk-return profile would likely attract the interest of such institutional investors.

Moreover, institutional investors are typically not allowed to invest in just any type of asset. Normally, their assets must have proven value and be reasonably liquid. Many jurisdictions require that the bulk of these assets be held in negotiable instruments, while lower limits are set for investment in long-term assets, such as commercial property. Investments in microfinance would probably not meet the regulatory requirements on asset quality and liquidity.

One approach would be for microfinance investments to become more liquid and easier to transfer. For example, MFIs may issue bonds, securitize their portfolios or list their shares on domestic stock exchanges.[4] Another strategy to increase MFI investment would be to reduce the regulatory requirements that limit investment in non-traditional assets. If institutional investors were allowed to invest in non-listed shares or non-negotiable debt instruments, investments in microfinance would be feasible. Given the large asset base of institutional investors in some countries, even small portfolio shifts could result in large investment flows to microfinance.

There are other market-based investments that could be additional sources of funding for MFIs. Individuals, family-owned companies and groups of companies are less restricted by regulation and often consider unusual investment opportunities with a longer time horizon. However, the investment size tends to be much smaller than those funds invested on capital markets. In addition, marketing costs can be substantial. However, smaller investments may be ideal for many MFIs since many institutional investors will not consider investments below certain thresholds, which may be too high for the MFI.

[4] This assumes the existence of stock markets and appropriate securities legislation in the country, which many countries, e.g. Cambodia, do not have, hindering large, successful MFIs, such as ACLEDA Bank, from exercising this option. Establishing domestic stock markets in small developing countries is often not worth the cost and therefore, MFIs are unlikely to benefit from stock markets is such countries in the foreseeable future.

Filipino collateral laws impede debt financing for microfinance.

Collateral laws in the Philippines do not support the use of intangible items, such as a loan portfolio (the traditional security offered by MFIs), and the Central Bank requires a 100% reserve requirement against any unsecured loans. Therefore, while the rural and thrift banks move forward in the microfinance market, they are unable to access loans for this business; banks assert that the MFI must offer traditional forms of collateral, such as real estate.

Regulations can also restrict domestic debt investment in microfinance. Collateral requirements that limit lending to low-income individuals equally affect the ability of MFIs to secure debt financing. Most MFIs simply do not have the type or value of assets that collateral laws often require to secure loans from licensed banks. Financial institutions in the Philippines are having a particularly difficult time in this regard (see textbox).

Foreign investment In principle, foreign investment in microfinance is no different than domestic investment. However, since it is subject to additional regulations, foreign private investment is probably a more difficult source of capital source to tap, especially when investments are sought from rich for poor countries. Regional investment is another option, which is discussed at the end of this section.

Institutional investors are the most likely source of foreign capital for microfinance. However, the rules under which they invest raise the threshold that microfinance institutions, local capital markets and regulators have to achieve in order to attract foreign portfolio investment. Issues such as country risk and accounting standards work against private investment in most developing countries. Institutional investors typically require liquid capital markets and strong regulatory frameworks. Developing country investments have little chance of being considered by all but the most specialized investment funds. It is important to recognize that it is primarily the local capital market, rather than the quality of individual assets, that keeps institutional investors at bay.

Companies from developing countries occasionally try to trade debt and to a lesser extent equity securities on international markets, to get around local market constraints. However, this requires adhering to the rules of developed capital markets and entails substantial costs. This approach works primarily for companies with a large asset base and strong cash flows. While established financial institutions in developing countries have successfully launched bonds or even established secondary listings on main international markets, it is unlikely that MFIs could use this approach in the near future.

In the past few years, special funds have been established for investment in the least developed countries (LDCs).[5] Although these funds may take a more sympathetic view on weaknesses in the investment environment, as long as return prospects are good, they have not been very innovative in their investment choices. This is partially attributed to the fact that they are subject to the same regulations and economic pressures as non-specific funds. Furthermore, developing country capital markets are often not liquid enough; volumes of particular assets are too low and specific investment expertise more difficult to develop.

International investment by individuals and companies in unrelated businesses in developing countries is rare.[6] More typically, companies invest in their own subsidiaries through equity and debt. Therefore, as part of international mergers, acquisitions or other strategic long-term alliances, banks and other financial institutions do invest across borders. MFIs have found both equity and debt investors abroad. The regulatory restrictions are mostly on the recipients' side, in the form of limits on foreign borrowing and ownership. Only countries with capital controls restrict outward investment in microfinance. However, none of the major source countries for foreign investment apply capital controls today.

India is an example of a country which restricts inward investment in finance, Foreign investors such as Oikocredit, Deutsche Bank Community Development Fund, and Blue Orchard have been eager to tap into this diverse market for microfinance. The Indian government, ostensibly in response to fears of terrorism financing, has prohibited non-bank financial institutions from accessing foreign funding. Interested investors must set up Indian registered subsidiaries in order to channel funds into the country for the support of microfinance.

Overall, regulations constrain foreign investment, as well as domestic investment, but there is arguably less demand for private international investment. This is partially due to market-related factors inhibiting most international investment flows, related to country and currency risk, market size, liquidity and information costs. In addition, regulatory restrictions that coincidentally inhibit international investment in microfinance are unlikely to be removed simply for the benefit of the microfinance sector. Regulators' concerns, which

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[5] Such funds are normally thought of as high risk and high return vehicles for the portfolio management of larger institutional investors, seeking exposure to volatile but potentially remunerative assets. However, social investment vehicles can also be included in this category despite the fact that they accept lower overall return in exchange for perceived social returns, such as poverty alleviation.

[6] Corporate bank loans are the exception.

led to the establishment of such regulations in the first place (particularly with regard to asset quality and risk control in international portfolio investment), are unlikely to be overridden. Hence, regulatory reform with respect to private investment in microfinance is more likely to be achieved in domestic markets than in international ones.

3. How Regulator Implementation Impacts Private Investment

Investors make decisions based on multiple variables, not all of which are quantifiable and verifiable. While laws and regulations are written and therefore easily accessible, their interpretation and implementation is more difficult to grasp. Changing laws, varying interpretations, and uneven implementation and enforcement make regulations unpredictable and their impact difficult to measure, which is a source of great concern to investors.

Investors are concerned not only with the set of rules and regulations affecting their own investments directly, but also with the stability, rationality and predictability of regulatory changes affecting market conditions more broadly. Sound regulations and processes for drafting, passing and implementing legal and regulatory changes signal a positive investment environment. Governments have an opportunity to signal their positive attitudes toward investors by consulting the private sector on policy changes, making decisions in a transparent manner and generally promoting a positive relationship with private sector stakeholders.

In many developing countries, the microfinance sector is small with few significant stakeholders. The more prominent microfinance institutions and professionals often enjoy good relationships and access to relevant policy-makers and regulators. In addition, donors often take a strong interest in microfinance issues and, at least in LDCs, have substantial persuasive powers in government circles. Hence, policy debates in the arena with NGOs, experts, donors and government officials may function reasonably well. However, potential private sector investors do not always participate or have access to this group. Consequently, the forum in which microfinance-related policy is discussed may not favor private financial institutions or their investors.

Transparent and fair policy processes may harness regulation as a means to promote private sector investment in microfinance. This would require that regulators and stakeholders who discuss and implement regulation adopt these minimum standards:

Understand the investment market, as well as the client market

Policy debates around microfinance sometimes emphasize the objective of poverty reduction at the expense of understanding the means of market-based capital. Emphasis on the poor tends to alienate private investors who may share the moral perspective, but are primarily interested in economic fundamentals. Regulation should be compatible with plausible business models.

Accept that a fair return in welcome

Private capital is more expensive than donor funding, although some MFIs argue that the marketing and reporting requirements of donors are onerous and costly. Financial returns consistent with the level of risk have to be achieved reliably to attract and maintain private sector investment into the microfinance sector. Regulation that interferes with financial returns, perhaps in misguided efforts of consumer protection, reduce the willingness of private investors to engage in microfinance.

Affirm property rights

Enforceable property rights make lending easier at every level, both to microfinance clients and to microfinance institutions. A stable and predictable regulatory environment is a condition for ensuring property rights.

4. To What Extent is Regulation the Problem?

It is not clear whether regulation is the main hindrance to private sector investment in microfinance or whether other factors, such as long term financial prospects for the sector and the financial health of individual institutions, play a greater role. Arguably, the microfinance sector has not yet demonstrated sufficient long term profitability to attract significant private sector investment. However, regulatory bottlenecks can contribute to the malaise of market-oriented microfinance. Lack of private investment has also reinforced the sector's dependence on donor funding, with sometimes negative consequences on management practices, product and institutional development. Arguably, the microfinance sector could benefit from private sector capital and the management expertise it would bring. In addition, if microfinance was an activity where profitability was widely achieved, regulators and lawmakers would probably be more motivated to address the efficiency of regulation in the context of microfinance.

Future Research

Prior research on the regulatory constraints of microfinance development has mostly concentrated on financial regulation, and on the written laws underlying regulation. Future research should be more directed at understanding the role of regulation in constraining microfinance and on identifying the specific regulatory practices that inhibit profitability and sustainable growth of microfinance.

Research should also highlight the interaction between different sets of regulation, such as those regarding company law and financial law, that adversely affect microfinance. These interactions are much less understood than the provisions of single sets of regulations, and their negative impact is often as severe.

Finally, it is important to understand not only regulation as a set of rules, but also how regulation is created, implemented, and enforced. Laws are often less inhibiting to private investors than the uncertainty around their adoption, durability and implementation.

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