microNOTE #10

The Ultimate Balancing Act

Investor Confidence and Regulatory Considerations for Microfinance

Facilitating private sector investment in microfinance requires regulatory practices that balance protecting the financial sector with promoting investor confidence.

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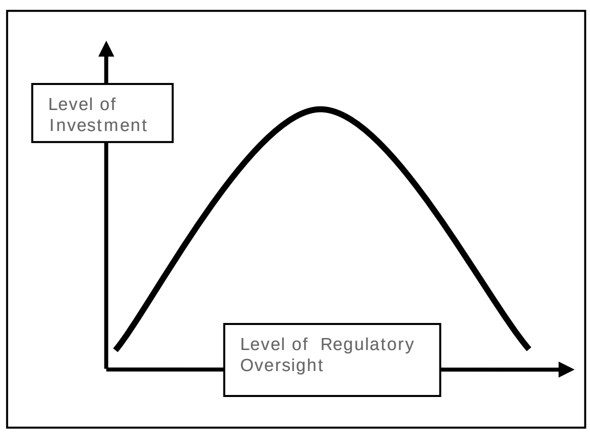
Introduction[1]

This paper explores the legal and regulatory framework for MFI investment transactions and its impact on investor confidence in the transition to private capital. Drawing upon recent field visits to Uganda, Peru and the Philippines, the paper attempts to address the questions: What regulatory practices promote investor confidence and provide the impetus to increase private investment in microfinance? At what point do legal and regulatory obstacles become too costly to bear and deter commercial investment in microfinance?

Two trends emerge from this research. First, facilitating private sector investment in microfinance is a challenging balancing act for regulators who can easily create significant barriers to investment in pursuit of their own mandates (including protecting the soundness of the financial system). Second, at some point along the "regulatory spectrum" between no regulatory oversight and heavy regulatory involvement, a balance can be achieved where regulators promote sound practices that also build investor confidence (see diagram).



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[1] This document summarizes a longer microREPORT of the same name.

Light regulatory oversight

If no regulatory oversight exists, any MFI, regulated or not, may accept any type of capital investment (including deposits) and engage in any type of activity, while investors enjoy a similar freedom with their microfinance investments. While this rarely occurs, there are environments which may be characterized as having "light" regulatory oversight practices. These include:

No or unclear legal status

Some countries do not have clear regulations on MFIs' organizational registration and the authority to conduct microfinance operations. This is an impediment to industry growth as well as its attractiveness to the private sector.

Low level of oversight/monitoring

Some investors believe that receiving a license or permit to operate implies certain standards were met in the licensing or registration process. Government regulations that require transparent information disclosure and good corporate governance similarly comfort investors. It is hard for investors to make informed decisions about microfinance without this level of regulation and private sector involvement.

Secured lending: ability to pledge intangible assets

An issue of increasing importance for potential investors is portfolio secured lending. Some MFIs pledge their loan portfolios as collateral for commercial bank loans, however, there are many legal uncertainties surrounding an MFI's ability to pledge this intangible asset. If the MFI defaults, it may be difficult for the lender to act on or seize this asset.

Lack of protection of minority investor rights

Investor protection includes: 1) information disclosure that allows an investor to make an informed investment decision, 2) legal protection of minority investors' rights, and 3) ability to enforce claims in court. In many developing countries, these investors' rights are not protected, which may further deter private investors from taking minority stakes in microfinance.

Heavy regulatory oversight

At the other end of the spectrum is heavy regulatory oversight. This would involve an excessive number of permissions required for any type of microfinance investment and restrictions on what investments are possible.

Restrictions due to legal status

An MFI's legal status often directly affects its financing strategy. In some countries restrictions based on an MFI's legal status may include limitations on accepting certain types of investment.

Forms of capital allowed

Countries may restrict the form of capital allowed, e.g. only donor funds, no foreign sources of equity, etc.

Limits on loan size or term

Regulators may set specific limits on loan terms and sizes, which ultimately restrict the profitability of the institution.

Interest rates

Some governments have institute interest rate controls for microfinance, which limit the credit available and prohibit institutions from covering costs. Interest rate caps also restrict an institution's ability to seek a diversified capital base.

Capital and reserve requirements

Most regulated MFIs must meet reserve and liquidity requirements, which are sometimes stricter than the regulations for commercial banks. Higher reserve and capital requirements means that capital is not being put to productive use and may scare potential investors.

Cost of regulatory compliance

This is the cost an institution must consider before deciding how to register itself. Although a regulated MFI may attract more private capital, the cost of being a regulated entity may outweigh the potential benefits.

Restrictions on ownership

Ownership restrictions may limit the options an MFI has for equity investors and will also limit the number of interested investors. These restrictions may either limit the proportion of an institution that a single investor can own or restrict foreign ownership of a financial institution.

Tax burdens

Tax burdens for MFIs can be quite heavy. Although some financial institutions have certain tax exemptions, ambiguous circumstances may plague MFIs, who must plan carefully. Questions and uncertainty around an MFI's tax status can be a deterrent for investors.

Conclusion

As external factors evolve (such as a change in government, economy, MFI market environment, investor interest, etc.), regulators and stakeholders must continually re-evaluate the balance required to promote investor confidence. Three fundamental lessons emerged from the desk study and three country case studies conducted:

1) Transparent regulation of financial institutions provides security for both institutions and investors.
2) Government attitude towards microfinance and investment is very important, particularly in creating a solid enabling environment.
3) Clear communication about requirements is helpful for both MFIs and and potential investors. Developing a consultative process when reappraising the regulatory environment results in increased investor confidence and better informed MFIs.