UMM Workshop Report

Investments and Regulation in Microfinance

7th University Meets Microfinance Workshop
Frankfurt School of Finance & Management, 11-12 July 2011

PlaNet Finance

ABOUT UNIVERSITY MEETS MICROFINANCE

University Meets Microfinance (UMM) is a programme which fosters cooperation between university students in Europe and microfinance practitioners. UMM was launched by PlaNet Finance and the Freie Universität Berlin and is co-funded by the European Commission within the framework of its Education for Development Programme until 2011. In 2010 the European Microfinance Platform (e-MFP) has set up an e-MFP Action Group "UMM" to further enhance students' research and microfinance education. As of today, 47 academics from 32 universities and 49 microfinance practitioners from 25 organisations volunteer to support UMM as Selection Committee members. In total the UMM events gathered 1886 students, professors and practitioners from 10 European countries.

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ABOUT PLANET FINANCE

PlaNet Finance's mission is to help poor people develop income generating activities, in order to sustainably improve their living conditions. PlaNet Finance has a worldwide network of 122 experts and is active in about 50 countries. It offers advisory services and technical assistance to microfinance actors so as to improve their financial and social performance as well as supporting microentrepreneurs in their endeavours. PlaNet Finance also contributes to the improvement of knowledge and spreading of good practices in microfinance. PlaNet Finance is member of the PlaNet Finance Group.

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The seventh University Meets Microfinance workshop on "Investments and Regulation in Microfinance" took place at the Frankfurt School of Finance & Management on July 11th to 12th 2011.
This workshop was organized in close cooperation with:

Frankfurt School of Finance & Management
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Thanks to the participation of:

Laurent Chauvet, Planet Rating; Malkhaz Dzadzua, JSC MFO Crystal; Sébastien Duquet, PlaNIS responsAbility SAS; Prof. Dr. Barbara Fritz, Freie Universität Berlin; Hanns Martin Hagen, KfW Entwicklungsbank; Prof. Dr. Michael Klein, Frankfurt School of Finance & Management / Johns Hopkins University School of Advanced International Studies; Dr. Annette Krauss, Center for Microfinance / University of Zurich; Prof. Dr. Robert Lensink, University of Groningen and Wageningen University; Dr. Anja Lepp, ProCredit; Prof. Dr. Manfred Nitsch, Freie Universität Berlin; Amber O'Connell, Oikocredit; Prof. Dr. Reinhard H. Schmidt, Goethe-Universität Frankfurt am Main; Charlotte Wagner, Frankfurt School of Finance & Management; Sophie Wiesner, ADA; Prof. Dr. Adalbert Winkler, Frankfurt School of Finance & Management; Therese Zak, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)

and thanks to the financial support of:

European Union; ESCEM Sogeti; Ernst & Young GmbH; Frankfurt School of Finance & Management, PlaNet Finance Foundation

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Foreword from the Frankfurt School of Finance & Management

Investment and regulation were the key themes of the 7th “University Meets Microfinance” (UMM) workshop at the Frankfurt School of Finance & Management. About 100 participants from academia, international financial institutions, investment funds and microfinance institutions met to discuss issues reaching from mobile banking to microinvestment vehicles, from over-indebtedness to microfinance crisis management.

The Frankfurt School of Finance & Management has been proud in hosting the workshop, also because our Business School – in a nutshell – lives the very mix of academic excellence, practical experience and exposure to the financial sector, which UMM is aiming at in its day-to-day activities. With the concentration on “development finance” in our flagship Master of Finance programme, microfinance has become a core part of our teaching curriculum. Moreover, in 2011 we offered for the first time a two week summer school on development finance. The Centre for Development Finance is becoming increasingly active in disseminating and publishing high-quality research on microfinance, and most importantly on the impact of the financial crisis on microfinance institutions. The Frankfurt School’s International Advisory Services (IAS) provide consultancy on microbanking worldwide, with products offered ranging from feasibility studies, project evaluation as well as assistance in managing transformation of microcredit NGOs into deposit-taking institutions, to name just a few. In addition, IAS organizes the annual summer academies for practitioners, focusing on microbanking, housing and renewable energy finance. Finally, the FS subsidiary Connective Capital (ConCap), an asset manger focusing exclusively on development finance, aims at providing creditworthy entrepreneurs in emerging markets with the capital they need to expand their business.

This unique combination of teaching, research, consultancy and investment allows us to stay in close touch with the microfinance industry. Moreover, it makes us sensitive to the various issues the community is discussing. This also holds for most recent developments, like the mixed results of state-of-the-art impact studies, as well as concrete country experiences, like over-indebtedness and alleged links between microfinance and suicides in the Indian state of Andhra Pradesh. However, while some commentators draw from this evidence the conclusion that microfinance does not work, a long-standing involvement in the field provides for a more balanced perspective. Indeed, on the one hand the more critical view on microfinance is welcomed because it puts an end to a hype that made microfinance almost a panacea for everything, from poverty alleviation to financial inclusion. On the other hand, the evidence currently discussed does not seriously challenge the more modest microfinance promise of facilitating risk management, consumption smoothing and realization of business and investment opportunities for the economically active poor in developing countries.

Over the last years, the environment in which microfinance institutions operate has changed considerably. Competition has increased and funding opportunities, including those from the private sector, have expanded enormously. Against this background, the discussion on regulation and investment, the key themes of the 7th UMM workshop, was also of high relevance when entering the debate about what microfinance can achieve and how some of the shortcomings and challenges which the industry has been exposed to can be addressed in the future.

Prof. Dr. Adalbert Winkler
Centre for Development Finance
Frankfurt School of Finance & Management

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1. Investments and Regulation in Microfinance
Some introductory remarks about the UMM Workshop and this publication

Hanns Martin Hagen (Chief Financial Sector Economist, KfW Entwicklungsbank)
Katja Kirchstein (Freie Universität Berlin/PlaNet Finance Deutschland e.V.)

The microfinance sector has been going through profound changes in the last decade. Since the foundation of the Grameen Bank in Bangladesh and primarily credit-granting NGOs in other parts of the world in the 1970s, the microfinance industry evolved from an NGO and donor-driven community to an increasingly commercially sustainable and growing market. Through its ongoing professionalization and commercialization the microfinance sector has successfully attracted institutional and retail investors who seek social impact along risk-adjusted returns. Besides, there are good reasons to believe that this trend will continue. Socially responsible investments are expected to grow further in the years to come, and the microfinance industry could benefit from this trend if it meets the challenges from the global financial crisis, and if it develops in a responsible manner after having learned its lessons from the undesirable developments in Andra Pradesh, Bosnia, and elsewhere.

Growing Investments into Microfinance

Total cross-border microfinance investments have grown significantly over the last years reaching 13 billion USD in 2010. In the two years prior to the global financial crisis of 2007/2008, the growth rates of investments by Microfinance Investment Vehicles (MIVs) was particularly high, reaching 86% in 2007. Even though public funders are still dominating the scene, providing almost 2/3 of total cross-border funding, private investors have increased their share. A number of private institutional investors were attracted by the social impact as well as by the potential risk diversification when investing in an MFI, in comparison to the ones obtained when investing only in traditional asset classes such as government bonds or securitizations.They almost tripled their funding since 2006, reaching 3.5 billion USD in 2010. Yet, the microfinance investment landscape is highly fragmented. Almost half of the international MFI investments (mostly debt) originates from around 100 MIVs with the top ten MIVs accounting for 2/3 of the total MIV assets (El-Zoghbi, Gähwiler et al. 2011; Reille, Forster et al. 2011; Symbiotics 2011). Access to external funding can contribute to financial inclusion as it allows MFIs to diversify their funding sources and to receive long term funding enabling them to extend longer term loans. However, not all MFIs have the capacity to borrow internationally as it calls for a professional asset and liability management. As a result, many MIVs have focused on larger, more mature MFIs. Nevertheless, repayment crisis in single microfinance markets linked to rapid credit-led expansion, (e.g. Chen, Rasmusen et al. 2010) led to critical concerns over whether microfinance investors might be chasing too few MFIs (Wiesner and Quien 2010). Indeed, the concentration of MIV funds into single world regions, countries, and even MFIs is pronounced (Symbiotics 2011). However, the challenges in some countries might be less linked to an oversupply in funding than to the irresponsible lending practices of some MFIs as well as the use of inadequate systems and processes. Some MFIs proved to be less resilient to external (macroeconomic) factors than initially thought. Despite the problems in some markets, a large number of MFIs have accompanied their clients through the global financial crisis in a responsible manner. They have swiftly reacted to their client's shrinking credit demand as microenterprises reduced their investments given the difficult economic environment. This had an impact also on the MIVs, for instance, since 2008 the annual growth rate of MIV funding constantly decreased reaching a more sustainable growth rate of 10% in 2010 (Symbiotics 2011). The decline of MIV funding was also linked to the fact that, given the global economic uncertainty, investors started to become more conservative when extending (new) loans to MFIs (MicroRate 2011).

The Importance of Responsible Finance

When irresponsible lending practices became evident, the international microfinance community reacted promptly by defining, for example, client protection principles (above all the SMART campaign initiated by ACCION and CGAP) encouraging MFIs to review their business model and lending practices. Responsible finance became more urgent than ever. The responsibility to foster a sound development of the microfinance sector(s) lies within MFIs, their investors, but also regulators and national governments in charge of creating the necessary sets of rules (potentially including client protection mechanisms) and infrastructure to allow MFIs to grow in a healthy manner, putting clients' needs at the top of the financial inclusion agenda.

As one of the largest investors in microfinance and a long-term supporter of responsible finance practices, KfW has made responsible finance criteria an essential part of its due diligence of MFIs and MIVs. KfW supports MFIs to become fully licensed and regulated deposit taking institutions as deposits are an essential service to the client, as well as a stable funding source for the MFI. KfW has initiated and structured a number of MIVs. One example is the Regional MSME Investment Fund for Sub-Saharan Africa (REGMIFA) aimed at improving the access of local microfinance providers to funding in local currencies. REGMIFA has a transparent corporate governance and is domiciled in Luxemburg. REGMIFA is a platform of investors which pooled their funding to support microfinance and who have agreed on common criteria for lending to MFIs in Africa, a good example of donor and investor collaboration. REGMIFA has a technical assistance facility which helps the microfinance providers improve their processes and systems.

About the 7th UMM Workshop and this Publication

The 7th UMM Workshop on “Investments and Regulation in Microfinance” gathered 99 participants from 25 universities and 20 different practitioners’ organizations to discuss some of the urgent issues outlined above. The event took place at the Frankfurt School of Finance & Management from July 11th-12th, 2011 in the fringe of its first two week summer school on microfinance. The following workshop publication contains three articles written by students who presented their research. Furthermore, four practitioners and academics shared their views on recent developments in the microfinance sector, and on how critical developments could be confronted.

The first article by **Vivien Kappel, Anette Krauss and Laure Lontzek** from the Center of Microfinance at the University of Zurich directly tackles the issue on how investors could detect, and therewith prevent over-indebtedness of clients and future microfinance repayment crisis. Commissioned by some important microfinance investors they tried to find out how an early warning index of over-indebtedness could be constructed. Yet, in their article they also highlight the challenges to find adequate and reliable data for such an undertaking at the present moment.

The focus of **Sasha Huijsman’s** article is the impact of economic and financial crisis of 2007/2008 on microfinance institutions. She states that MFIs were indeed negatively affected by the crisis, also leading to a deterioration of portfolio quality. Nevertheless, there are regional differences regarding the degrees of difficulty experienced by MFIs due to the crisis: MFIs from Eastern Europe and Russia were the most affected. Furthermore, MFIs capturing deposits and those with a higher proportion of female clients were less affected by the recent economic downturns.

As the CEO of Crystal, a Georgian MFI, **Malkhaz Dzadzua** provides insights into this topic from an MFI’s perspective by presenting the regulatory environment of the Georgian microfinance sector and the development of his MFI within this specific context. He further highlights the role of refinancing through international donors and investors, as well as the specific challenges which occurred during and after the 2007/2008 financial crisis. MFI’s prohibition to capture deposits is heading the list of challenges which they are facing under the current regulatory regime. Dzadzua also stresses the growing importance microfinance investors are putting on social responsibility.

Therese Zak from GIZ highlights the importance of savings in order to prevent over-indebtedness. She presents the successful model of SHG Linkage Banking in India where clients showed to be less indebted than those of other microfinance providers.

Roméo Zomahoun Tchala then turns to the topic of regulation in microfinance. He assesses in how far low interest rate caps imposed by the government effect MFIs’ sustainability. Analyzing the case of Benin, he finds that MFIs are not able to provide small loans at an interest rate below the market interest rate, and encourages some MFIs to have an in-transparent pricing policy.

Prof. Michael Klein rather focuses on the role of regulation in fostering new ways of providing adapted financial services to the poor. He presents the case of M-PESA in Kenya, which offers highly flexible transfer services with a promising potential of outreach. He raises the point that innovative regulatory approaches have to be found in order to reach a large number of clients. Regulating schemes should be decoupled from the (legal) form of an organization providing financial services, in order to have a rather functional or service-oriented perspective independent from the specific institutional setting.

Finally, **Dennis Hänsel** reflects on the question of how to regulate mutual microinsurance schemes by introducing the advantages and disadvantages of direct, self-, and delegated supervision depending on the type of institution offering microinsurance. Therewith, he also contributes to the discussion on how to support small-scale financial products beyond microcredits which are potentially even more valued by the world's low-income population.

The 7th UMM workshop tackled the topic of microfinance investment and regulation from different angles. This publication aims at contributing to a balanced picture of the microfinance industry, and the challenges which it is currently facing. We hope, you will enjoy reading it!

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2. Over-Indebtedness and Microfinance – Constructing an Early Warning Index

Vivien Kappel, Annette Krauss, Laura Lontzek;
(Center for Microfinance, University of Zurich)

The University of Zurich's Center for Microfinance (CMF) presented an applied research study at the 7th UMM workshop "Investments and Regulation in Microfinance" at the Frankfurt School of Finance & Management on July 12th, 2011. The study results of a collaboration between the CMF and three microfinance investment agencies (responsAbility Social Investment AG, Council of Microfinance Equity Funds, and Triodos Investment Management). In 2010, they commissioned the research to establish an early warning index for over-indebtedness in microfinance.

Why an investigation of early warning signs for over-indebtedness?
Microfinance is globally maturing, and it seems less prone to crisis than the formal financial sector. However, there is one particular type of crisis that different countries have been increasingly experiencing: over-indebteness. Indeed, today there is consent that over-indebtedness of borrowers is a growing risk in microfinance. This study defines over-indebtedness as a chronically occuring situation (i.e. in several periods in a row) in which, against their will, microcredit borrowers' households cannot cover all payment obligations in a given period of time because they do not dispose of enough excess cash. Over-indebtedness is considered detrimental to microcredit borrowers due to the material, psychological and social consequences of being unable to respond to repayment obligations. To date, over-indebtedness crises that shook an entire country's microfinance market often became evident only at the moment when over-indebtedness of individual borrowers was already quite prevalent.
This study examines a method towards an early-warning index for over-indebtedness in microfinance. It collects and explores data on the conditions that could lead to crises due to microcredit borrowers' over-indebtedness, with the goal to support the industry in preventing future crises.

Approach of the study
To construct a composite index for predicting over-indebtedness crises in a local microfinance market, the study proposes the "signaling approach", a simplified version of one of the main approaches to early warning systems.The index is built for a sample of 13 countries, among which some have already experienced over-indebtedness and other repayment crises in the past.
The study follows a quantitative approach by measuring a range of variables suspected to react before the onset of a crisis. Data stems from a triangulation of primary and secondary data sources. Over-indebtedness in microfinance should be measured by comparing periodic obligations from all types of debt with net periodic household income. Unfortunately, such data are not collected systematically for households or for the range of loan suppliers available to microfinance clients. For this reason, the study uses an indirect approach and examines a broad range of country-, industry- and firm-level data to identify influences on microcredit borrowers.

A preliminary early warning index but lack of data
A key outcome of the study is the composition of the over-indebtedness index. The index is composed of a set of 14 leading indicators that can potentially signal a growing risk for over-indebtedness in any given microfinance market. From a list of 57 variables initially considered, the final index includes 14 quantitative and qualitative variables for which data were available and that showed significant changes at some point in time prior to the outbreak of an over-indebtedness crisis: 1. remittances, 2. market penetration, 3. growth rates of total volume of loan portfolios, 4. quality and use of credit information sharing systems, 5. perceived commercial bank involvement, 6. perceived level and trends in competition, 7. perceived investment flows, 8. MFI liquidity, 9. average loan balance per borrower, 10. loan requirements and lending methodologies, 11. productivity, 12. growth and market targets, 13. multiple lending, and 14. consumer lending.
Another key finding is the lack of available, accurate and consistent data, making a thorough quantitative analysis of the past crises difficult. The study, therefore, also makes recommendations on the data collection for further validation of the index before it is expanded to a larger set of countries.

Need for further research

As a consequence, the results of this study must be treated with caution. The determination of the 14 indicators for the sample countries results in a preliminary classification of the sample countries according to their current risk for an over-indebtedness crisis. This classification presents an ordinal scale, and so comparisons between countries remain difficult. Moreover, the early warning index is merely a predictor for a heightened level of over-indebtedness risk. The index does not include the possible preventive measures or policy responses to crisis outbreaks in the countries. It is therefore still possible that a country marked as associated with a higher risk can preempt an over-indebtedness crisis by reacting early. This is exactly the main purpose of trying to establish an OID Early Warning Index.

Summary by Annette Krauss, 27 July 2011

3. The impact of the current economic and financial crisis on microfinance

Sascha Huijsman
(University of Groningen)

Introduction

Based on several MFI specific characteristics[1], there has been a widespread belief that microfinance has a low correlation with formal financial and economic markets, which is often mentioned as one of the reasons why mainstream investors were largely attracted to investing in the microfinance sector (Deutsche Bank Research, 2007). Empirical studies partly support this assumption, but results are ambiguous (Ahlin, 2006; Gonzalez, 2007; Hermes and Meesters, 2009). Moreover, the few available case studies specifically focusing on MFI performance during times of adverse economic conditions, show that most MFIs are not immune to regional and domestic financial and economic crises (Marconi and Mosley, 2006; Jansson, 2001; Mcguire and Convoy, 1998).

The global financial crisis provided an opportunity to test the resilience of MFI performance during a period of global market distress and to investigate the linkages through which today's microfinance sector is integrated into formal economies and financial systems. Insight into the exposure of MFIs to adverse market shocks has become more relevant due to: (1) the growing importance of microfinance as part of local financial systems of developing countries (Gonzalez 2007), and (2) the increased involvement of commercial investors in the microfinance sector in recent years. The latter are typically more concerned about the risk of their investment than the traditional non-profit driven microfinance investors. In addition examining whether MFIs differ in the extent to which they react to market fluctuations is relevant, as this may be an argument for specific institutional designs which make MFIs more resilient to macroeconomic crises.

Study focus and methodology

Through this study we aimed at filling the gap of a quantitative empirical analysis of the impact of the global economic and financial crisis on MFI performance by empirically analyzing a panel of monthly financial data of 57 MFIs worldwide, covering the period from January 2007 through August 2009. In addition, these results were complemented by the outcome of a survey held with 82 MFI managers of which the last responses were received in May 2009. Fixed effects regressions are used to study structural breaks in MFI performance indicators related to profitability, growth and portfolio quality. This survey explores the effects of the crisis on MFIs observed or expected by MFI managers. It attempts to grasp the underlying mechanisms through which the current financial crisis affects MFI performance. Lastly, based on both the survey among the 82 MFI managers, and the financial data of the 57 MFIs, we examined whether the impact differs across MFIs in different regions and with different characteristics. Considering the limited period over which the data was collected, this study should be perceived as a preliminary analysis of the impact of the current crisis on microfinance. At this point in time it is not clear how the crisis will evolve, let alone what its final consequences for the microfinance sector will be.

Results

The significant adverse impact on all performance indicators, portfolio quality, growth and profitability shown by the analysis of the monthly financial data, and the underlying reasons provided by MFIs participating in the survey, demonstrate that on average MFI performance is substantially negatively affected by the current financial crisis. A negative structural shift of measures for growth and profitability occurred in the last quarter of 2008. Results of our survey show that lower net interest margins, higher foreign exchange losses, and the deterioration of repayment rates (through its impact on the loan loss provisioning expense) are putting pressure on profitability rates. Growth is in particular restricted by less availability of funding, a stricter lending policy and by lower loan demand from clients, although the impact on the latter is not unambiguous. Repayment rates experience an adverse impact of the crisis, which became visible in November 2008, through the impact on the earliest indicator of portfolio quality followed by structural shifts in the time series of the other indicators of portfolio risk in March 2009 and of actual loan losses in August 2009. Survey respondents report the current macroeconomic situation, declined employment and lower remittances to be the main causes of the current deterioration of repayment rates.

If we look at the impact across regions, results from our financial performance study show MFIs from Eastern Europe & Russia to be most affected, which was to be expected due to the direct impact of the current financial crisis on this region and due to the nature of the microfinance sector in this region. Also MFI performance in Central Asia & the Caucasus and Central America & the Caribbean was highly affected by the financial and economic crisis which could be explained by the geographical proximity of these regions to the affected economies of Russia and the United States. Performance of MFIs in South America is highly resilient. Portfolio quality of MFIs in this region may be controlled by the acute measures taken by South American MFIs in anticipation to the expected negative impact of the economic crisis on their clients' repayment behavior. Also MFIs in South- and South East Asia seem to feel a relatively low impact from the crises possibly due to the quick revival of economies in this region.

An analysis of differences of impact across MFIs shows evidence that savings make MFIs' portfolio quality more resilient to the impact of the current crisis, possibly by providing a financial cushion to microfinance clients in this economic difficult time. Results show that a higher proportion of female clients reduces the impact at the early stages of the crisis, whereas a high proportion of urban clients seems to increase the impact. However, these effects disappear if we look at later indicators of credit risk, implying that repayment rates of different types of clients are similarly affected in the course of the crisis.

Discussion

Therese Zak (GIZ) comments on the presentation. Her main question is what the practical implications following from the study are, especially for providers of technical assistance which aim to strengthen institutions. For this group the most interesting results are probably those related to differences across MFIs as this shows that certain institutional design characterics, such as savings, make MFIs more resilient in times of crisis. This would provide a case to, for example, support MFIs in becoming regulated so that they could attract savings which next to being a valuable service for clients, is apparently also a helpful source for building up a cushion during time of distress. Also, the study describes recent developments in the years before the global economic crisis, of which over-indebtedness is the most prominent one, which left MFIs more vulnerable to adverse conditions and which were undeniably seen as they came to the surface when economic condition deteriorated. As it is commonly understood, after over-indebtedness crisis in a couple of microfinance markets, the establishment of credit bureaus, more prudent lending policies of MFIs and awareness among investors of highly saturated markets are important steps to take in order to avoid more problems in this respect in the future. Annette Krauss (University of Zurich) suggests that it would be very valuable to hold the survey about the impact of the crisis among MFI managers again as the crisis was still unfolding at the time the survey was held.

The last question raised by the audience; was related to whether MFIs which rely heavily on commercial funding were more affected by the crisis than MFIs depending also on subsidized funding. MFIs participating in the survey most often perceived commercial funding to have become harder to obtain and to have become more expensive, suggesting that MFIs relying on this type of funding suffer most. Indeed, MFIs which experienced refinancing problems all heavily relied on commercial funding, but an adverse impact on the profitability of MFIs did not seem to increase in the dependence of the MFIs on commercial funding.

Footnotes

[1] E.g. highly committed funders which often have strong social motives, the favorable maturity mismatch due to short term assets of MFIs in combination with long-term liabilities, low financial and operational leverage resulting in high flexibility, the economic activities of microfinance clients and microfinance specific lending methodologies.

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The Author

Sascha Huijsman studied International Economics and Business and Finance at the University of Groningen. Her research interests focus on the relationship between the macro-economy and microfinance. The global financial and economic crisis offered her an opportunity to test her theories on this relationship during a period of distress.

4. Investments and Regulation in Microfinance: The Case of JSC MFO Crystal, Georgia

Malkhaz Dzadzua
(CEO of JSC MFO Crystal)

Industry Analysis

Microfinance in Georgia started in the mid nineties and has developed thanks to several NGO MFIs which have benefited from the support of international donor agencies (USAID, UNHCR, World Vision and other). Later, it was further developed by 3-4 commercial banks which actively entered the microfinance market that was mainly supported by the EBRD.

Today the Georgian financial sector counts 19 commercial banks, and 55 non-bank microfinance organizations, including 6 MFIs (with profiles on the MIX-Market), who conduct “real” micro-lending and demonstrate some extent of social responsibility and transparency. This points out that the Georgian MFI sector stimulates the income generation to become sustainable clients, rather than trying to directly alleviate poverty.

At the start of 2011, Georgian Non-Bank (NB) MFIs were serving around 90,000 clients and managing an overall Loan Portfolio of $129 million. The NB MFI’s market share represents up to 3.6% of the entire financial market. The industry demonstrated significant growth in the last few years (around 70% annual growth), and despite a global financial crisis and political instability in the country (Russian-Georgian military conflict in August 2008), its total loan portfolio increased almost 4 times in last 5 years. The charts below show the industry’s dynamic growth between 2007 and 2010:

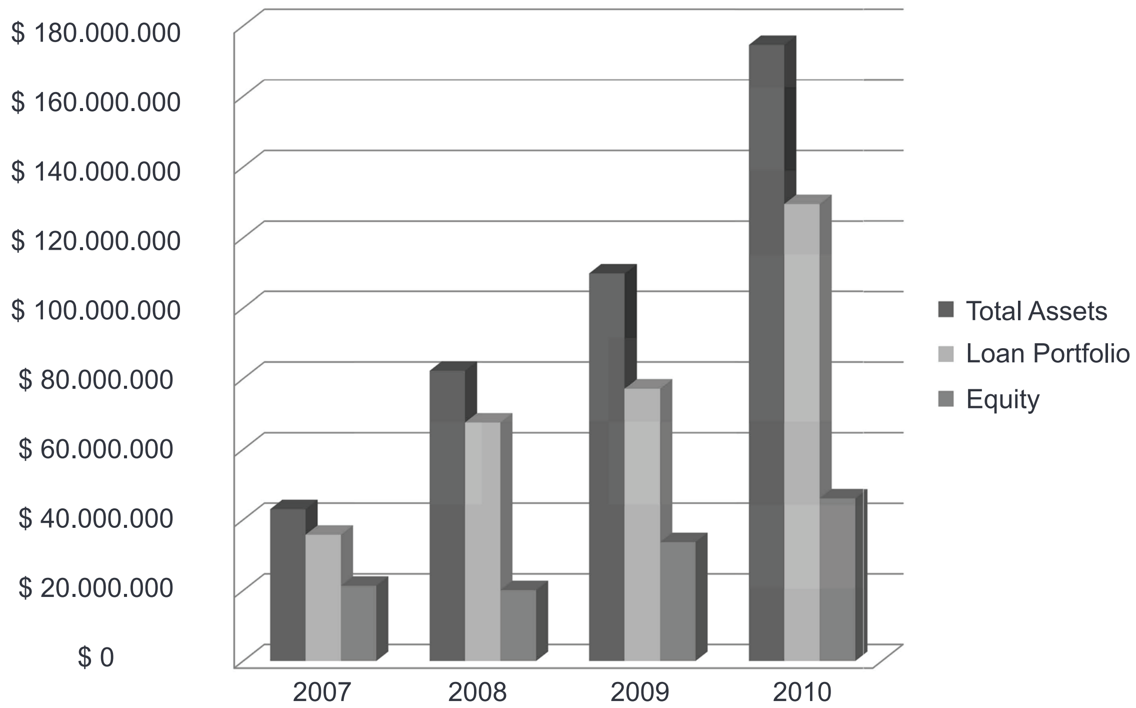
Chart 1: Number of Financial Institutions in Georgia

# of Financial Institutions	2007	2008	2009	2010
# of Commercial Banks	18	20	19	19
# of Non-Bank MFIs	15	27	38	49
# of Credit Unions	24	18	18	18
# of Insurance Companies	15	13	14	16

Chart 2: Repartition of Credit Portfolios size in Georgia among types of credit institutions

Credit Portfolio (in USD)	2007	2008	2009	2010
Commercial Banks	2,883,475,682	3,595,008,900	3,076,604,656	3,531,535,082
Non-Bank MFIs	35,719,055	67,598,198	77,179,625	129,473,299
Credit Unions	605,496	824,764	910,397	884,629
TOTAL PORTFOLIO	**2,919,800,234**	**3,663,431,862**	**3,154,694,678**	**3,661,893,010**

Chart 3: Non-Bank Microfinance Sector



Legal Environment and MFI Regulation in Georgia

In the last decade Georgia has become known for its pro-liberal reforms and light regulatory environment. Following successful government reforms, the World Bank/IFC ranked Georgia 11 in the "Doing Business Report" in 2010 which assesses the ease of doing business in 183 countries. The number of taxes and rates has been reduced. The number of regulatory bodies as well as level of corruption has been significantly cut.

The National Bank of Georgia is the key regulator of the finance industry (Commercial Banks, MFIs and Credit Unions). Microfinance organizations are obliged to report to the Financial Monitoring Service of Georgia, which is the state agency responsible for ensuring Georgia's compliance with FATF recommendations concerning anti-money laundering, counter terrorism financing and other types of financial crime.

The legal status of all NB MFIs in Georgia is regulated by the Law on Microfinance Organizations adopted on July 18th, 2006. The Law regulates the activities of the microfinance organizations in Georgia, and creates the legal environment for their development (Clause 1).

It defines a microfinance organization as "a legal entity in the form of limited liability company or joint stock company, registered on the basis of its application by the National Bank of Georgia which conducts activities described in this Law under the supervision of the National Bank of Georgia" (Clause 3 Paragraph 1).

Clause 4 sets out permitted activities for microfinance organizations:

- Providing micro loans to legal and physical persons including: consumers, pawn shops, mortgages, non-collateralized, groups and other loans (credits);
- Investment into government and public financial papers;
- Money transfers;
- Acting as an agent for an insurance company;
- Consulting work related to micro lending activities;
- Receiving loans (credits) from resident and non-resident legal or physical entities;
- Hold shares in other legal entities which should not exceed 15% of microfinance organization's statutory capital

- Other financial services contemplated by the legislation of Georgia, including micro-leasing, factoring, currency exchange transactions, issuance, sales and other transactions related to notes and bonds.

Paragraph 3 of Clause 4 explicitly prohibits microfinance organizations from taking deposits from physical or legal persons.

The Law also defines the notion and amount of micro credit. Clause 5 (Paragraph 2) states that the maximum loan amount per borrower should not exceed 50,000 Georgian Lari (about $ 30,000).

Clause 7 prohibits Directors (board members) of microfinance organizations from being partners (shareholders), members of the supervisory and/or directors' boards of commercial banks, non-banking deposit taking institutions – credit unions, and other microfinance organizations. It also prohibits people with a record of financial misuse to become Directors of a microfinance organisation.

The Law regulates the audit, record-keeping and reporting obligations of microfinance organizations. Other clauses set requirements for loan agreements and determine the responsibility of microfinance organizations to ensure client information confidentiality.

JSC MFO Crystal – short history and background

Crystal started in 1995 as the local non-governmental organization CHCA established by a group of internally displaced persons from Abkhazia. In contrast to almost all significant MFIs in Georgia, Crystal was not a part of an international NGO network, or an entity instituted by international donors. Crystal's establishment and development was fully supported by private contributions from the local individual founders. Only in late 1998 did Crystal receive its first grant funding from donor agencies for implementation of micro-lending activities.

Crystal's microfinance program started in 1998 with only $ 10,000 as a start-up loan fund. The organization initially served just 70 clients and was fully donor-driven. Today, after 12 years of successful performance, Crystal serves more than 11,000 clients, manages $ 12 million credit portfolio, and operates across Georgia through the network of 15 offices. Having a market share of 6.2% in total non-bank micro-financial sector, Crystal is the third largest MFI in Georgia among 55 registered institutions. The core organizational values of Crystal are: Responsibility, Transparency, Accessibility, Partnership and Professionalism.

Crystal offers a wide range of financial services including: micro and SME loans, currency exchange services, money transfers, remittances, utility payment services, etc. Loans are disbursed both for start-ups and existing businesses. Generally, the volume of the loans varies from $ 100 up to $ 10,000. Monthly interest rate fluctuate from 1.7% to 3% with a loan duration of 4-36 month and no collateral requirement for loans up to $ 5,000. The company's head office is located in Kutaisi, west Georgia, and focuses on serving regional micro-entrepreneurs: 95% of portfolios are located outside of the capital - Tbilisi. 42% of its clients are rural, of which 49% are female borrowers. Crystal is one of the leading Georgian MFIs in the agriculture sector which represents 25% of their portofolio's total.

Crystal was the first Georgian MFI to receive international credit (in 2003) and social ratings (in 2010). Crystal is also the first Georgian MFI to have obtained commercial credit (in 2003). In 2010 Crystal was also awarded by the Mix Market with a silver prize for its social performance reporting. In the beginning of 2011, Crystal was recognized a Tool Winner in the international Smart Campaign's Call for Tools «Plain Language Loan Contract» (http://smartcampaign.org/tools-a-resources/2/275).

Investments and funding structure

Crystal is mainly financed by international MIVs such as: EBRD, IFAD, Developing World Markets /SNS Institutional Fund, MicroVest, Oikocredit, Incofin /Rural Impulse Fund, ResponsAbility SICAV, Symbiotics / Finethic Microfinance CSA, Dual Return Fund, MicroCredit Enterprises, UNDP and TBC Bank (Just one local commercial bank).

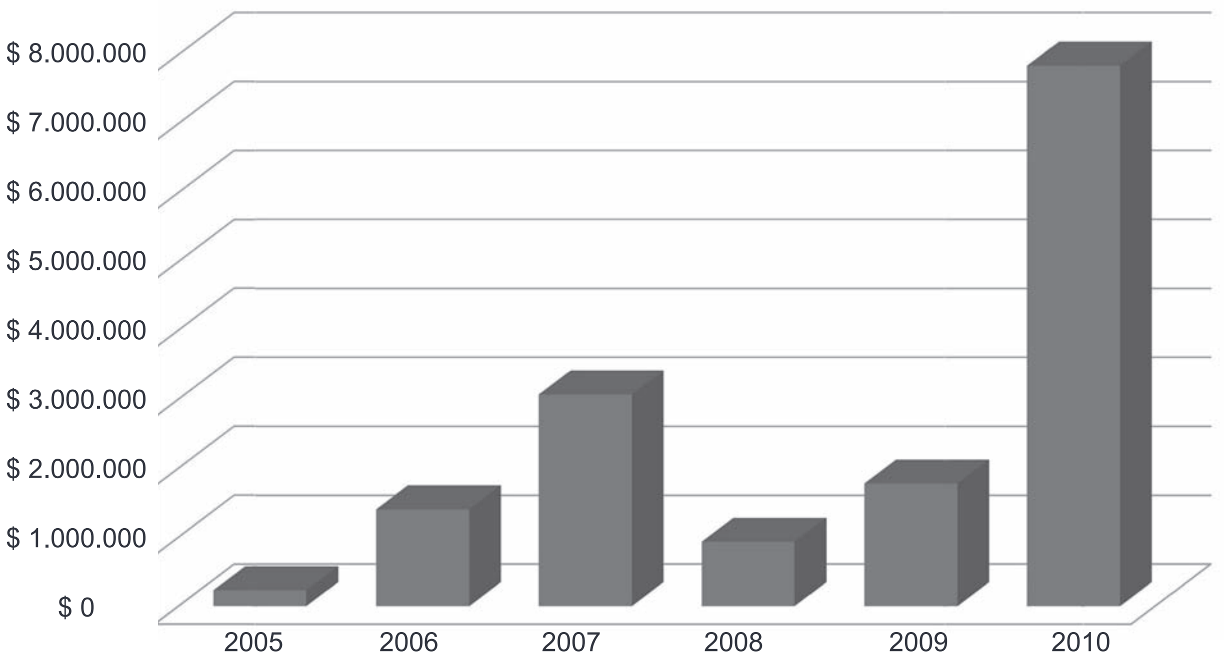
However strange it may sound, the first initiative and funding proposal mainly came from the above-listed MIVs, though Crystal was also actively engaged in fund-raising campaigns and search for potential investors. Microfinance institutions generally get such opportunities by taking part in various conference meetings (where there is a chance to have face-to-face interaction with several potential investors), and by searching for information on potential funders through the use of different web-sites (MIX Market, CGAP, etc).

It is important to mention that, when taking decisions, international MIVs pay much attention not just to financial and commercial indicators, but also, and just as equally to: the presence of a clear and appropriate organizational structure, the quality of corporate governance, company's social responsibility and performance, and to the level of transparency. Country risk factors as well as macro-economic parameters are also taken into account.

In the case of Crystal, debt terms and conditions are generally quite similar and show the following characteristics: an average loan size of $ 1 million, a duration of 3 years, the use of USD currency (in some cases it is possible to have multi-currency loans, however prices and conditions for local currency debt funding are very unattractive), and interest rates between 8% and10%.

Based on chart #4's findings, it is obvious that the company had significant difficulties to get fundings in 2008 and the first half of 2009.

Chart 4: Debt Funding



This was mainly caused by the global financial crisis and the war with the Russian Federation in August 2008. Since then, Georgia has experienced a difficult period of economic recession, fuelled by the global economic crisis and internal political turbulence stemming from the result of the war. However, this has been mitigated by the unprecedented international donor assistance pledged to the Government of Georgia in autumn 2008, which helped stabilize the economy.

This post-war and global financial crisis has had a negative impact on Georgia's finance sector, including microfinance. Problems faced by the sector are very similar to those experienced by the majority of countries featured in the "Banana Skins" report. The main Banana Skins for 2009 were: a surge in bad loans, shortages of liquidity and funding, and declining profitability.

In 2009, Crystal put greater emphasis on achieving operational efficiencies, optimizing the credit process, and decentralizing decision-making all the while introducing stringent internal control mechanisms monitored by an independent internal auditor. Crystal has increased the frequency of staff training and has invested in better communication and knowledge transfer across the organization. One of the most important lessons drawn from this difficult period was the importance of avoiding over-indebtedness both for MFIs and borrowers. First among Georgian Banks and MFIs, Crystal has joined the international client protection principles (Smart campaign) and adopted the campaign guidelines to ensure client protection is at the heart of Crystal's credit strategy.

In the second half of 2009, following the changes in its business strategy, Crystal demonstrated an impressive growth and improvement in portfolio quality, which can be put down to a combination of a better business climate as well as the impact of recent structural decisions. This positive trend was continued in 2010 and Crystal demonstrated significant portfolio growth (from $ 4.3 million to $ 8.1 million) with almost 90% of annual growth rate and an excellent improvement of portfolio quality (from 2.59% to 0.35%), making it one of the best in Caucasus.

In the beginning of October 2011 Crystal successfully closed the first equity transaction and DWM became the first institutional shareholder of Crystal by investing USD 2 million in the Company's equity. Currently, Crystal is actively involved in equity negotiation process with one of the bigger international financial institutions, and it intends to introduce the first institutional investor in company's ownership in 2011. According to the plan, at the first stage 25% of company shares will be transferred to the investor, while during the coming 4-5 years it is planned to attract additional investors and raise the total number of their shares to more than 50%. This will significantly strengthen the company's market opportunities and will enable it to attract additional debt funds more easily.

Main challenges and Obstacles of Microfinance Investments and Regulation in Georgia

- Restriction of taking deposits
- Limited loan size
- Not recognizing loan loss reserve as an expense item
- Not differentiation of classical MFIs, pawnshops, and purely commercial financial institutions
- Unstable political environment (country risk) and conflict zones
- High inflation rate (10%-14%)
- Unstable local currency
- Lack of business experience among micro and small entrepreneurs
- Limited market size

Footnotes

National Banks of Georgia (www.nbg.gov,ge)
Mix-Market (www.mixmarket.org)

The Author

Malkhaz Dzadzua is a CEO of Crystal since 2004. He has 12 year experience in microfinance management, fund raising, loan product development and portfolio management. Malkhaz is economist-manager and started his career in 1995 as a volunteer of local NGO - CHCA (www.chca.org.ge) where he was involved in different social projects. In 1998 he joined CHCA's micro-lending program as a loan officer. After two years of successful experience, in 2000 Malkhaz was promoted to the position of Credit Manager. Finally, in 2004 he was appointed as a CEO of Crystal where he is working till now.
Contact: director@crystal.ge

5. Regulate Yourselves! – The Indian SHG linking programme

Therese Zak
(Deutsche Gesellschaft für Internationale Zusammenarbeit, GIZ)

Today NABARD's self-help group (SHG) bank linkage programme has 7.5 million groups who regularly save about 50 Rupees a week and 5.3 million SHGs who currently have an outstanding loan. More than 400 banks are part of the programme and lend to SHGs, more than 5,000 NGOs support SHGs in strengthening their capacities (e.g. bookkeeping) or group formation. The programme is supported by NABARD via capacity development measures and refinance. It is the world's largest microfinance programme.

The groups, with their average of 13 members, save regularly. At a later stage, once "linked", they borrow from a scheduled bank and then lend internally. The SHG becomes a financial intermediary and takes the lending decision as a group itself. Loan monitoring is also done as part of the weekly meetings. The groups select a leader and define rules according to which they wish to work. Reliability, discipline and regular meetings are very important in this group lending approach and strengthen its members. Hence the groups regulate themselves.

The last impact assessment conducted in 2008 has confirmed that members of SHGs, who at the time were mostly women (more than 90%), have considerably improved their living standards: expenditures for education and health per member household have increased by 35%. Most importantly the programme has encouraged its members to be more self-confident, to improve their communication skills as well as their family status.

SHG Bank Linkage during the crisis?
In 2011 Andhra Pradesh became the epitome of the microfinance crisis. According to the IFMR in Chennai, more than 93% of all households had a loan outstanding at the beginning of the year 2010 - many of them over indebted at multiple sources. Against the background of this critical and highly political situation, it is interesting to see how clients of the SHG Bank Linkage Programme were affected. In 2010 over half of rural households in Andhra Pradesh borrowed from SHG.

While 54 per cent of indebted households had an outstanding loan from an SHG, this represented only 5 per cent of the total amount of loans outstanding, whereas 1 per cent could be attributed to MFIs, 18 per cent to banks, and 75 per cent came from informal lending sources.

For the SHG bank linkage programme savings have always come first and formed the basis for lending, hence the credit savings ration remained at about 5:1 throughout the recent years.

Success factors of the model
Today, 7.5 million self-help-groups put together save more than one billion Euros, meaning approximately 150 Euros per group; A trend that is increasing with a stable growth of groups.

This is a distinct feature of the programme: a linkage to the formal financial system via self-regulated banks and savings. A model, which will be central for the future.

Further Reading

- Microfinance in India: State of the Sector Reports, Access, published annually
- Status of Microfinance in India, NABARD, published annually
- Access to Finance in Andhra Pradesh, Doug Johnson and Sushmita Meka, IFMR Research
- Portfolios of the Poor: How the World's Poor Live on $2 a Day, Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, Princeton, (Princeton University Press, 2009)
- http://www.microsave.org/research_papers

Discussion

The discussion emerged around the weaknesses of the SHG model and the lack of opportunities for members who have become stronger and who have therefore moved beyond the initial microfinance stage. SHG Bank Linkage, what next?

The Author

Therese Zak, Advisor, Financial Systems Development Team in GIZ –Deutsche Gesellschaft für Internationale Zusammenarbeit – in Germany.

Therese has spent the past three years in India as a technical expert in GIZs Rural Financial Institutions Programme. Her key areas of work are in rural finance, regulation and supervision, domestic remittances and payment systems.

Prior to joining GIZ in 2007, Therese worked for the Frankfurt School of Finance & Management as a project manager mainly responsible for bank training and microfinance projects in Eastern Europe and the Middle East. Therese holds a Masters Degree in International Relations from the University of Kent.

6. The impact of interest rate regulation on MFIs' development: case of Benin

Zomahoun Tchala
(Université Libre de Bruxelles)

Introduction

This study tackled the question of interest rates ceiling through field data analysis, and discussed different points of view. It shows specifically whether the interest rate regulation is respected by MFIs or not; if the interest rate regulation actually do generate mission drift in Benin, and if so whether it truly prevents MFIs from reaching profitability. ww

We applied a deductive hypothetical methodology, this means that each hypothesis was justified by different concepts found in the literature and verified by the result of indicators' calculation with data collected on the field.

Sample description

The present research sample includes 16 MFIs (Networks had taken as an entity) out of the 40 operating in Benin. For the last five years, the general statistics of the study's sample can be presented in these few lines. In terms of branches and representation throughout the country, the sample covers 74.5% of the total of the MFIs of Benin. This sample represents 90.2% of Benin MFIs' clients and 95.6% of the total amount of savings. In term of outstanding loan, the amount granted by the sample represents 94.0% of the whole sector.

What makes the work relevant for researchers and practitioners?

Up to now such a study does not exist mainly because of a lack of adequate data to our knowledge. Generally, most MFIs do not provide accurate information about the annual effective interest rate they charge and therefore make it difficult to evaluate. Portfolio yield offers a proxy for interest rates. Usually, people use it in order to make statements about the interest rate charged by a certain MFI. It is generally calculated by dividing total cash financial revenue (all income generated by the loan portfolio, but not accrued interest) by the period average gross portfolio. The advantage of this method is that even the hidden costs are considered. Nevertheless, it also has a severe shortcoming by not taking late or defaulted payments into account. Therefore, the portfolio yield does not allow drawing conclusions regarding the correlation between the interest rate charged by an MFI and its PAR. Another drawback is that the portfolio yield does not consider differentiated pricing and only provides an average for the gross loan portfolio.[1] Also, most MFIs offer different loan products without itemizing their respective shares to their total loan portfolio. As a result it is not possible to calculate a weighted average even if the rate stated by the respective MFI could be transformed into an effective interest rate.[2]

The originality of the present study is that it avoids all these difficulties. The calculation of the Effective Interest Rate is possible since all the different fees charged on the loan are taken into account. We tried to get all detailed fees charged on loan products by Benin MFIs selected in our sample. By doing this, we avoided applying a proxy (portfolio yield) approach. The use of the CGAP interest calculation tool which is really flexible helps to evaluate the annual percentage rate per product per MFI whatever the characteristic of the loan product. The mean on all the loan products of each MFI gives the annual percentage rate of the MFI.

Results

As a result, none of the sixteen MFIs selected in our sample had an APR below the 27% set by the regulator[3] over the period under study (1998-2010). This rate set by the regulator seems very low compared to the market rate (55%) and especially compared to the sustainability rate (60.8%). This situation highlights a lack of transparency and mission drift when pricing the loan.

The non respect of the cap helps loan product diversification, but at the detriment of the borrower since loan scheme includes several fees put at the charge of the client. Despite the ceiling, Benin MFIs are seeking for exceptionally high profits, as large profits can still be generated on larger loans.

When the government intervenes in the market, demand and supply cannot freely determine the

equilibrium price and quantity. In the case where artificial ceiling is below the equilibrium price, MFIs should not be sustainable by respecting the cap.[4] None of Benin's MFIs respect the cap, and most of them (68.8% of our sample) have an average operating self sufficiency ratio below 100%. This means that those MFIs are not sustainable. Compared to sustainable MFIs (31.2%), the share of 68.8% of non sustainable MFIs is so high that the difference is significant and reveals that the non respect of the cap does not drives MFIs toward sustainability.
The two variables, Annual Percentage Rate (APR) and Operating Self Sufficiency ratio (OSS), are correlated with a rate of 82.2% significantly at 1% level (2-tailed). This means that as the interest rate decreases, so does the operating self sufficiency ratio. Therefore, the higher the APR, the higher the OSS ratio will be as well.
This situation highlights the low level of the cap set by the regulator since the market rate that insures sustainability rate to MFIs is likely to be 60.85%. Compared to 27% of cap, the difference is excessively huge (33.85%).

Conclusion

The very low level of the interest rate set by the regulator involves the missing of the sustainability. Benin MFIs are not developed: they changed their mission by increasing the loan amount per borrower, and by trying to comply with the regulation they reduced the level of interest rate. But at that level they need to increase even more the loan size in order to reach sustainability or to increase the interest rate up to the sustainability rate (60.8% at least).
The reality here is that, in fact, competition is the only thing that determines the price of loan products, not legislation. The non respect of the cap did not conduct MFIs toward sustainability. The main reason for this is that the cap is 34 points below the market rate.

Before regulating the interest rate, the government should insure that it really has the means to guarantee the respect of this disposition. In order to truly succeed in protecting the poor borrowers all the while insuring MFI's development, an interest rate regulation should take into account both aspects of transparency and the market rate.

Footnotes

[1] MBB, n°19 (2009). P. 17
[2] Sebastian Schwiecker, (2004), "The Impact and Outreach of MFI- The Effect of Interest Rates"
[3] The Law n°83-0008 of May 17th, 1983, defining and repressing of usury in Republic of Benin and the Law n°2003-22 of November 11th, 2003 modifying it.
[4] MBB, Issue 19, December 2009

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7. Regulation and microfinance: The case of M-PESA in Kenya

Prof. Dr. Michael Klein
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Johns Hopkins University School of Advanced International Studies)

A financial revolution is in progress. It is not happening in the skyscrapers of New York or on the streets of London. It is not taking place in Beijing or Mumbai but in the slums of Nairobi and in the markets of Kisumu. The revolution is mobile banking – the use of mobile phones to make financial transactions, taken to a new level by M-PESA in Kenya. It has fundamental implications for financial development and financial inclusion, for our understanding of financial systems, and for their regulation and supervision.

Launched in March 2007 by the telecommunications company, Safaricom, the M-PESA payment and saving service signed up over 50 per cent of adult Kenyans by the end of 2010. The annual number of payment transactions rose to exceed that of Western Union globally and now accounts for almost 60 per cent of the number of electronic payments in Kenya. The system allows users to send or withdraw money at over 23,000 shops compared with approximately 1,000 bank branches. The absolute amounts are very small reflecting the income level of the users with average savings of around $3.

In Kenya, M-PESA is everywhere. Shops, often within just a few meters from each other, proliferate in slums and villages. Changing money at these cash merchants works like buying products at any shop. No or few lines, opening hours from early till late, close to places of business or residence, money is harder to steal or lose, waiting at the bank is over, and in any case no bank account is needed, life is easier and safer: mobile phones have made it possible. People have voted with their feet and money: payment services are what they want from financial inclusion.

As for regulatory lessons, M-PESA's business model makes it clear: to think clearly about regulation one needs to "unbundle" the various functions a bank typically performs and look at each in turn. Suitable regulatory approaches will differ by function. Each function may, in fact, be performed by a different entity. What basic functions are involved in banking?: Exchange of types of money, storing money, transferring money and investing money.

The cash merchants are money changers. Suppose a worker in Nairobi wants to send money to his wife in a village. The worker goes to see a cash merchant to give him cash. In return, the merchant gives the worker book-entry money (BEM), by instructing M-PESA via mobile phone to transfer BEM from his account to that of the worker. Exchanging one form of money for another is like exchanging bills for coins. No need for prudential regulation. Otherwise all machines that spit out coins for bills should be regulated as well.

M-PESA, provides two functions. It stores money in the form of BEM and it transfers it. People storing money with M-PESA are rewarded in the same way as if they had stored the money in a safe-deposit box. There are no interest rates, and the nominal value of the money is preserved. It is practical to store the money in the electronic equivalent of a safe-deposit box, because it is cheaper than maintaining actual boxes and it helps with the remote transfer of the money. The system requires reliability and integrity. This means standard protections from commercial law and maybe some special consumer protection to help insure the system is safe. No prudential regulation with capital requirements and the like is required.

So far, it all happens entirely outside the banking system. However, M-PESA and the Central Bank came to an understanding that the net cash deposited with M-PESA at any time, should be deposited in a bank, actually two banks now, to diversify risk. The banks can invest the deposits. This creates the typical banking risks based on maturity mismatches between deposits and loans. The money is as safe as any deposit in a bank supervised by the Central Bank. No need to subject M-PESA to additional supervision beyond specifying both the banks and the types of deposits which are acceptable to the regulator. M-PESA, therefore, acts as an aggregator or conduit for bank deposits. What strictly needs regulation is not “deposit-taking” institutions, but “deposit-investing” ones, i.e. the banks, not M-PESA. The fundamental consequence for regulation is to think in terms of “regulation by service”, not regulation by “institutional label” (e.g. “bank”).

The M-PESA experiment also provides important insights into the regulation of financial services in developed economies. The recent financial crisis has highlighted the need to protect taxpayers from risks emanating from investment activities. What M-PESA clearly demonstrates is that a payment system can operate independently of a banking system. Indeed given the cheapness, speed, convenience and transparency of payments transacted by mobile phones, it is very likely that in due course similar technologies will replace the bank clearing systems which exist in developed economies.

The borrowing and lending functions of banks can therefore occur independently of payments. Individuals can have access to payments and custody systems without the need for prudential regulation. With mobile payments systems offering full liquidity and security outside of the banking system, the conventional functions of banks performing liquidity and maturity transformation become less critical. Individuals can allocate some of their savings to transactions outside of the banking system and then determine their savings in more illiquid and longer assets separately. Not only does mobile banking clarify the nature of financial regulation in developing countries, but it also sheds important light on the real sources of market failure and regulatory requirements in developed countries as well.

8. The Challenge of Supervision in Microinsurance

Dennis Hänsel
(Universität Mannheim)

What is Mutual Microinsurance?

Microinsurance can be defined as risk pooling for the low income population with the means of contribution-based benefits (e.g. credit-life insurance, health insurance). The focus of this article lies on mutual microinsurance schemes which follow the principles of self-help, self-governance and self-responsibility. Such organizations are owned by their members and thus strive to maximize the utility of its beneficiaries. Furthermore, members share the liability for their scheme, i.e. potential losses and surpluses of the scheme are shared.

Why Regulate Microinsurance?

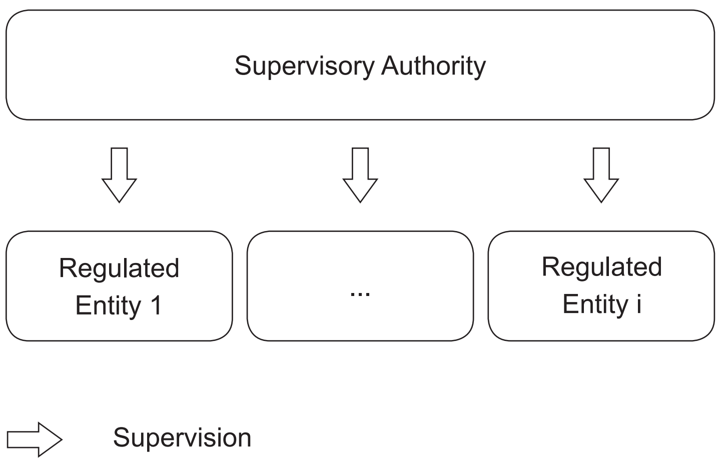
In the case of microinsurance, just like in other industries, regulation may tempt to achieve several objectives:
1) Sector Stability: Maintaining trust in insurance by ensuring soundness of operating entities.
2) Consumer Protection: Minimizing losses for customers and setting standards for the distribution process of microinsurance products.
3) Market Development: Achieving financial inclusion, i.e. increasing the number of people with access to insurance products.
4) Market Efficiency: Preventing anti-competitive behaviour and reducing information asymmetries.

What is The Bottleneck of Supervision?

Several governments and international organizations (e.g. the Microinsurance Network and the International Association of Insurance Supervisers) are looking into the issue of regulation for (mutual) microinsurance schemes. So far, less attention has been paid to the institutions which are supposed to supervise the regulation. Indeed, this is a significant challenge since there may be a large number of schemes, and the microinsurers' size and governance structure are very heterogeneous. For example, in South Africa there are an estimated 5,000 – 10,000 informal mutual microinsurance schemes operating, which can hardly be overseen by the supervisory authority alone (i.e. the Financial Services Board).

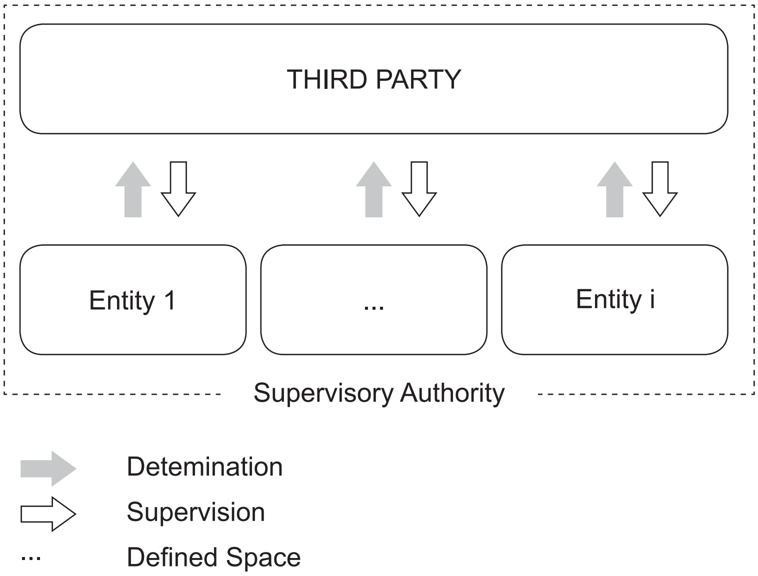
Direct Supervision

This is the first of three different organizational approaches to supervision. Also, it is the most classical supervision system used by commercial insurers in many industrialized countries. In short, the supervisory authority is solely responsible for the supervision of regulated entities. However, it may use market based signals to supplement own information gathering (e.g. reports and ratings from regulated entities as well as prices for reinsurance).



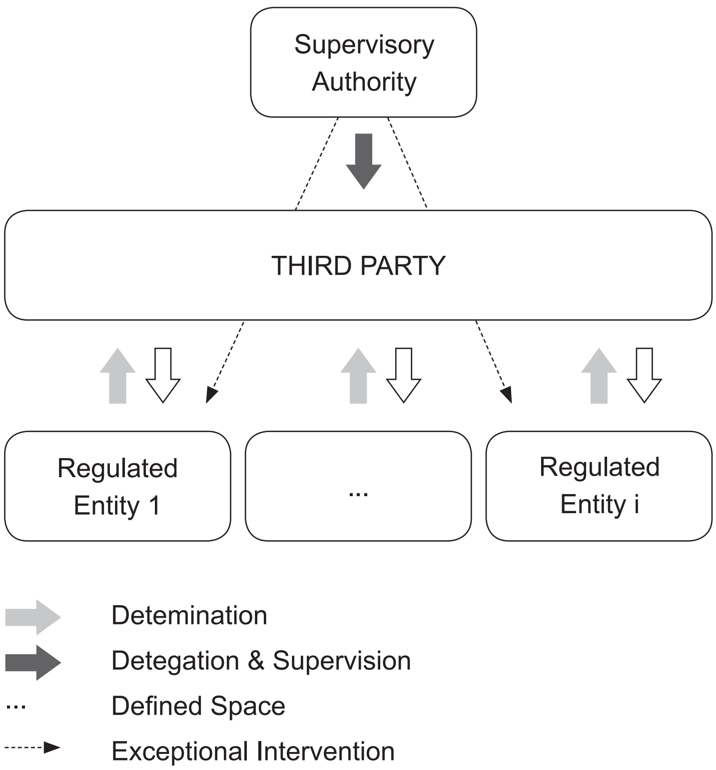
Self-Supervision

Second, in the model of self-supervision, the market entities agree on a code of conduct and determine a self-supervisory body (third party). The self-supervisory body subsequently supervises its subordinate entities, while the supervisory authority (government) only defines the space where self-supervision may take place and refrains from interventions. In this model, the supervisory authority saves a lot of resources. However, it has been tried repeatedly and often showed disastrous results. The reason for this verdict is that the third party is subject to an inherent conflict of interest since it is financed and controlled by the entities that it is supposed to oversee.



Delegated Supervision

Third is the delegated supervision. It is a hybrid model, combining features from both direct and self-supervision. The supervisory authority sets the regulatory requirements, while a third party supervises the regulated entities (e.g. a federation of mutuals). However, in contrast to self-supervision, the supervisory authority keeps control of the third party and reserves the right of direct interventions if needed. For this reason, one can assume that the conflict of interest is reduced.



Who Are Potential Contributors?

A supervisory system may consist of several institutions. Therefore, the question of knowing which institutions are suited for the variety of tasks that supervision comprises arises. E.g., a government authority may draft a legal framework and conduct on- and off-site inspections of the regulated entities. A private auditor could audit the financial statements and agree-upon procedures. An apex body may gather statistical data, a reinsurer may help with capacity building and a rating agency may create incentives to comply with regulation e.g. by rating an organization or a product.

How to Compare Different Institutions?

This question comes-up immediately after saying that several institutions may contribute to supervision. Several criteria may help answer this question:

1) The cost of monitoring: This is a key issue, given the limited resources of supervisors. One can argue that the lower the monitoring costs are for an institution, the better it is suited to inspect the microinsurance schemes.
2) Level of trust: The more trust a supervisor enjoys among the regulated entities, the easier information retrieval will become.
3) Understanding of the market: The better an institution understands the micro-insurance market, the better it can interpret the information it is gathering and develop adequate responses.
4) Enforcement power: The more enforcement power an institution has, the better it can uphold a credible threat of punishment in the case of unsound behaviour.
5) Ability to transfer know-how: Non-compliant behaviour may be related both to unwillingness and inability of regulated entities. In the latter case, capacity building is an important component of supervision.
6) Cost of adaption to change: Regulatory requirements are shifting according to the stage of market development. Thus, supervisors have to adjust internal processes to these changes.
7) Self-interest: Self-interest determines the commitment of an institution to a given assignment. The higher its self-interest, the higher its commitment to supervision.

Conclusion

Several institutions may contribute to the supervision of mutual micro insurance. An efficient supervisory system could take comparative advantages of these institutions into account. Therefore, the first task is to understand the role of potential players in a country. Subsequently, one can think of a way to make them interact with each other. Feasible prototypes for such an arrangement could be the concepts of direct supervision and delegated supervision.

Information for the thesis stems from an extensive literature research about cooperatives, microfinance, regulation and supervision of financial institutions. Moreover, the author joined the Delhi-based Microinsurance Academy during his research in 2010. During his stay in India, he conducted an exploratory survey among 11 regulatory authorities (Benin, Brazil, China, Egypt, Ivory Coast, Kenya, the Philippines, Morocco, Namibia, South Africa, and Uganda) and 20 non-government microinsurance experts from different countries. The thesis is available for download at www.universitymeetsmicrofinance.eu

Discussion

Prof. Manfred Nitsch from Freie Universität Berlin commented the presentation and moderated the subsequent discussion. In short, it was suggested to further structure the criteria used to compare different institutions in order to develop a workable approach for the design of a supervisory system.

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100 Poorest Countries [online], The Microinsurance Center; National Treasury (2008): The Future of Micro-Insurance Regulation in South Africa [online], Republic of Southafrica.

The Author

Dennis Hänsel studied Business Administration at University of Mannheim and HEC Montréal, with majors in finance and information systems. Since the time of his volunteer service in Bangladesh in 2003/2004, he is involved in international cooperation and microfinance. Internships at the Canadian German Chamber of Commerce, KfW Development Bank and Allianz SE paved the way for a praxis-oriented thesis. For this endeavour, Dennis joined the Delhi-based Microinsurance Academy in 2010, in order to compile a strategic background paper about the supervision of mutual microinsurance schemes. During this time, he also experienced the importance of knowledge transfer between institutions and individuals. Since 2011, Dennis is working as a teacher for business studies and information systems in a German school.

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9. Closing Remark

The organization of the 7th workshop was made possible thanks to:

- The Frankfurt School of Finance & Management, Prof. Dr. Adalbert Winkler and Christina Heiss
- Ernst & Young GmbH, Ulrich Plett & Carsten Klug
- The European Commission

We also wish to thank all speakers and participants for their valuable contributions.
This report summarizes our discussions on “Investments in Microfinance and Regulation”. With a strong growth, and the entrance of new stakeholders, the microfinance investment landscape has dramatically changed within the past decade. The development of new services implies the need for new regulation (mobile banking, microinsurance etc.). These topics offer a wide variety of research fields making it sometimes difficult for researchers to have access to data.

A few ideas for future research:

Research can be done in close collaboration with investors to investigate questions of strong interest for them. For example: Prof. Annette Krauss presented an early warning index developed for an investor (article 2), as Sascha Huijsman (UMM Award Winner 2010, University of Groningen) analyzed the impact of the 2008 economic and financial crisis on microfinance; her sample was composed of MFIs in which an investor had invested (article 3). Another area of research based on larger MFI samples and their funding structure could be the contribution and relevance of specific re-financing instruments to the development of microfinance.

Research on regulation can cover new services. For instance, Prof. Dr. Klein presented a paper on mobile banking regulation (article 7), while Dennis Hänsel (UMM Scholarship Winner 2010, University of Mannheim) looked at the challenge of supervision in microinsurance (article 8).

Lastly, research can also look at specific developments in the field of investments or regulation in a country: Malkhaz Dzadzua presented the case of JSC MFO Crystal, Georgia (article 4), and Zomahoun Tchala (Université Libre de Bruxelles) analyzed the impact of interest rate regulation on MFIs’ development with the case of Benin (article 6).

As a final word, we hope you enjoyed the workshop and the reading of the report. We welcome any comments or suggestions you may have (umm@planetfinance.org, Topic “UMM Workshop Frankfurt School 2011”).

Delphine Bazalgette
Project Director UMM

Annex I: Photo Gallery

Annex II: Workshop Programme

University Meets Microfinance | PlaNet Finance | Frankfurt School of Finance & Management Bankakademie | HfB | Project co-financed by the European Commission

7th "University Meets Microfinance" – Workshop

Frankfurt School of Finance & Management
July 11th - 12th 2011

"Investments and Regulation in Microfinance"

Monday, July 11th

Time	Programme	Room
2:30 – 3:00 pm	*Registration*	
3:00 – 4:30 pm	**Opening and Welcome** Prof. Dr. Adalbert Winkler, Frankfurt School of Finance & Management (Center of Development Finance) Delphine Bazalgette (PlaNet Finance Deutschland) Introduction into the topics: **Regulation and microfinance** Prof. Dr. Michael Klein (Frankfurt School of Finance & Management, Harvard Kennedy School of Governance) **Investing in microfinance** Martin Hagen (Chief Financial Sector Economist, KfW Entwicklungsbank) **The perspective of private investors** Amber O'Connell (Microfinance Officer Caucasus, Oikocredit) *Moderation:* Prof. Dr. Adalbert Winkler, Frankfurt School of Finance & Management (Center of Development Finance)	**Audimax**
4:30 – 5:00 pm	*Coffee break*	
5:00 – 6:30 pm	**Discussion in small groups** Prof. Dr. Michael Klein (Frankfurt School of Finance & Management, Harvard Kennedy School of Governance) Martin Hagen (Kreditanstalt für Wiederaufbau) Malkhaz Dzadzua (JSC Micro Finance Organisation CRYSTAL) Amber O'Connell (Microfinance Officer Caucasus, Oikocredit) Therese Zak (GIZ)	**Rooms 2, 3, 5, 6, 14** *Room 2* *Room 3* *Room 5* *Room 6* *Room 14*
6:30 pm	*Cocktail*	

Workshop Programme

Project co-financed by the European Commission

Tuesday, July 12th

Time	Programme	Room
10:30 – 11:15 am	*Registration*	**Audimax**
11:15 – 12:45 am	**Introduction** Prof. Dr. Reinhart H. Schmidt, Goethe-Universität Frankfurt am Main **Keynote speech:** **"International Diversification and Microfinance"** Prof. Dr. Robert Lensink, University of Groningen and Wageningen University (development economics group) Comments by practitioners: Sébastien Duquet / PlaNIS responsAbility SAS Dr. Annette Krauss, Center for Microfinance / University of Zurich	
12:45 – 1:45 pm *Lunch*		**Mensa**
1:45 – 3:30 pm	**Presentation of students' research**	**Rooms 2 and 3**

Room 2/ Group A: Regulation of microfinance institutions
Moderation: Sébastien Duquet, Managing Director PlaNIS responsAbility SAS

- Romeo Zomahoun Tchala, graduate of the Université Libre de Bruxelles: "Impact of interest rate regulation on MFI development: The case of Benin"
  Comment by: Laurent Chauvet (Planet Rating)
- Dennis Hänsel, graduate of the University of Mannheim: "The Challenge of Supervision in Microinsurance"
  Comment by: Prof. Dr. Manfred Nitsch, Freie Universität Berlin
- Denis Lewa Muganga, graduate of the University of Bergamo: "To which extend does regulation contribute to increase financial access? Reaching the Unbanked in South Africa, and its Relevance to the Development of Regulation in Kenya"
  Comment by: Prof. Dr. Barbara Fritz, Freie Universität Berlin

Room 3/ Group B: Investments in Microfinance

Moderation: Martin Hagen, Chief Financial Sector Economist, Kreditanstalt für Wiederaufbau

- Katja Kirchstein, Freie Universität Berlin: "The Role of Rating Agencies in Microfinance"
- Najma Azmat, PhD student at LGC - University of Toulouse 1: "Commercialization of Microfinance - How can Microfinance Institutions attract Investors?"
  Comment by: Charlotte Wagner, Frankfurt School of Finance and Management
- Sascha Huijsmann, graduate of the University of Groningen / Triple Jump: "The Impact of the Global Economic and Financial Crisis on MFIs' performance"
  Comment by: Therese Zak, GIZ

3:30 – 4:00 pm	*Coffee break*	
4:00 – 5:30 pm	**Discussions with practitioners**	**Rooms 2 and 3**

Room 2/ Group A
Moderation: Katja Kirchstein, Freie Universität Berlin

- Dr. Annette Krauss, Center for Microfinance / University of Zurich: "Over-indebtedness and microfinance / Constructing an Early Warning Index"
- Dr. Anja Lepp, Managing Director, ProCredit

Room 3/ Group B
Moderation: Charlotte Wagner, Frankfurt School of Finance & Management

- Sophie Wiesner, ADA: "Can "Bad" Microfinance Practices Be the Consequence of Too Much Funding Chasing Too Few Microfinance Institutions?"
- Sébastien Duquet, PlaNIS responsAbility SAS

5:30 pm *Cocktail*

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Annex III: List of Participants

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10 Bustos, Andrea; Los Andes Colombia
11 Chauvet, Laurent; Planet Rating
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13 Crossland, Jarrod; Griffith University
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