THE REGULATION OF MICROFINANCE INSTITUTIONS: A ZAMBIAN CASE STUDY

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ABBREVIATIONS

ACMP	Agricultural Credit Management Programme
AD	Assistant Director
AFRACA	African Rural and Agricultural Credit Association
AIMS	Assessing the Impact of Microenterprise Services
AMIZ	Association of Microfinance Institutions of Zambia
AMRF	Agricultural Marketing Revolving Fund (EU)
APO	Asian Productivity Organisation
ASA	Association for Social Advancement
ASP	Agriculture Support Programme
BAZ	Bankers Association of Zambia
BBZ	Barclays Bank Zambia plc
BFSA	Banking and Financial Services Act
BOT	Bank of Tanzania
BOU	Bank of Uganda
BOZ	Bank of Zambia
CBA	Cost Benefit Analysis
CCB	Cavmont Capital Bank Zambia Limited
CEO	Chief Executive Officer
CETZAM	Christian Enterprise Trust of Zambia
Cetzamicro	CETZAM Opportunity Microfinance Limited
CFO	Chief Financial Officer
CGAP	Consultative Group to Assist the Poorest
CLUSA	Cooperative League of United States
CMS	Credit Management Services Limited
Co	Company
CSO	Central Statistics Office
CU	Credit Union
CUSA	Credit Union and Savings Association
DAO	District Administrative Officer
DBR	EU Directors of Better Regulation Group
DBZ	Development Bank of Zambia

DC	District Commissioner
DFID	Department for International Development
DMFR	Draft Microfinance Regulations
DSA	Development Studies Association
DT	Deposit taking
DTI	Department of Trade and Industry
EFZ	Evangelical Fellowship of Zambia
ETB	Ethiopian Burr
EU	European Union
FAB	First Alliance Bank Zambia Limited
FAO	Food and Agricultural Organisation
FB	Finance Bank Zambia Limited
FG	Focus Group
FGD	Focus Group Discussion
FI	Financial Institution
FINCA	Foundation for International Community Assistance
FINNIDA	Finnish International Development Agency
FNCD	Food Consumption and Nutrition Division
FSDP	Financial Sector Development Plan
FSS	Financially self-sustainable
GDP	Gross Domestic Product
GNP	Gross National Product
GRZ	Government of the Republic of Zambia
GTZ	German Technical Cooperation
ICA	International Cooperative Alliance
IFS	Institutional financial self-sufficiency
ILO	International Labour Organisation
IMF	International Monetary Fund
IZB	Investrust Bank Zambia Limited
KCB	Kenya Central Bank
KZF	Keepers Zambia Foundation
LIF	Loan Insurance Fund
LLC	Limited Liability Company
LSF	Loan Security Fund

LuSE	Lusaka Stock Exchange
MACO	Ministry of Agriculture and Cooperatives
MBT	Micro Bankers Trust
MCI	Microcredit Institutions
MDI	Micro-Finance Deposit Taking Institution
MFI	Microfinance Institution
MFRC	MicroFinance Regulatory Council
MIS	Management Information System
MIX	Microfinance Information Exchange
MOF	Ministry of Finance
MUZ	Mineworkers Union of Zambia
MUZFIN	Mineworkers Union of Zambia Financial Services Limited
NAO	National Audit Office
Natsave	National Savings and Credit Bank
NBAA	National Board of Accountants and Auditors
NBE	National Bank of Ethiopia
NBFI	Non-Bank Financial Institution
NDT	Non-Deposit Taking
NGO	Non-Governmental Organisation
NMP	National Microfinance Policy
NSCB	National Savings and Credit Bank
OECD	Organisation for Economic Cooperation and Development
OI	Opportunity International
PRSP	Poverty Reduction Strategy Paper
PWC	PricewaterhouseCoopers
PWC	PricewaterhouseCoopers
RIA	Regulatory Impact Assessment
ROSCA	Rotating Savings and Credit Association
RP	Regulatory Policy
SACCO	Savings and Credit cooperatives
SACCOL	Savings and Credit Cooperative League of South Africa
SADC	Southern African Development Community
SARB	South African Reserve Bank
SB	Stanbic Bank Zambia Limited

SBP	Sustainable Banking with the Poor
SCB	Standard Chartered Bank Zambia plc
SCC	Swedish Cooperative Centre
SFIT	Small Firms Impact Test
SI	Statutory Instrument
SIDA	Swedish International Development Agency
SRO	Self Regulation Organisation
SSA	Sub-Saharan Africa
TB	Treasury Bill
UK	United Kingdom
UNCDF	United Nations Capital Development Fund
UNOSCAL	United Nations Office of the Special Coordinator for Africa and the Least Developed Countries
US	United States
USAID	United States Agency for International Development
VAT	Value Added Tax
WIDER	World Institute for Development Economics Research
WWB	Women's World Banking
Y.e.	Year end
YWCA	Young Women's Christian Association
ZCCM	Zambia Consolidated Copper Mines
ZCF	Zambia Cooperative Federation Limited
ZCF	Zambia Cooperative Federations Finance Services
ZCSMBA	Zambia Chamber of Small and Medium Business Associations
ZNBS	Zambia National Building Society
ZNCB	Zambia National Commercial Bank Limited
ZPA	Zambia Privatisation Agency
ZRA	Zambia Revenue Authority

ABSTRACT

The aim of the research is to contribute to the understanding of regulatory and supervisory issues in relation to microfinance in order to inform the design of regulatory policy in Zambia, and other developing countries in sub-Saharan Africa. This thesis provides a critical evaluation of the potential impact of regulation on microfinance institutions, using the Zambian case. The analysis is done at two levels, micro and macro. At the micro level, the potential impact of regulation and supervision on the three microfinance institutions licensed by the supervisory authority during the period of the study is evaluated. At the macro level, the analysis is extended to the entire microfinance sector using Regulatory Impact Assessment (RIA). One main finding of the study is that the regulation of the microfinance sector at the current stage of development would have a detrimental effect on the development of the sector. Moreover, the evidence suggests that the objectives for regulating the sector are unlikely to be met. The evidence also suggests that the costs of compliance would be considerable and would outweigh any potential benefits that would be gained. Consequently, the introduction of microfinance specific regulations would most likely result in regulatory failure. The study thus concludes with the recommendation that the current existing regulatory framework be maintained.

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To my Father and Mother

Both of whom inspired me to be the best I can be.

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1 INTRODUCTION

1.1 INTRODUCTION

In developing countries, the formal banking sector serves less than 20% of the population (Berenbach and Churchill, 1997; Robinson, 2001). The rest of the population, typically low-income households, historically has not had access to formal financial services. Innovative financial institutions (FIs) known as microfinance institutions (MFIs), have emerged to cater for this market. Providing microfinancial services, primarily credit, is seen as a way to generate self-employment opportunities for the poor. The World Bank (WB) estimates that approximately one billion people around the world live on less than $1 a day (WB, 2001). With the reaffirmation of the primary goal of reducing poverty in the development policy agenda, microfinance programs and institutions have become an increasingly important component in reducing poverty and or promoting micro and small enterprise development (Hulme, 1999) and a much favoured interventionist strategy amongst international development agencies for the alleviation of poverty (Wright, 1999).

With the increased interest in microfinance as a poverty alleviation tool, the regulation of microfinance has been added to the agenda for a number of reasons. Regulation and supervision is seen as a way of ensuring the provision of financial services to the economically active poor by financially sustainable institutions on a massive scale; promoting microfinance and improving performance; protecting depositors where MFIs accept deposits; and ensuring financial system stability where MFIs have grown to such an extent that the failure of one may disrupt the financial sector.

Zambia has been no exception to this trend. Zambia, which until two decades ago was one of the most prosperous countries in sub-Saharan Africa (SSA), now ranks as one of the least developed countries in the world. An estimated 86% of the population is living in poverty (WB, 2001). Thus, one of the main challenges for poverty reduction is how best to create an enabling environment that will provide the poor with opportunities to earn a sustainable income that will provide for their needs and take them out of poverty. The informal sector in Zambia, as in many other developing countries, remains the most dynamic in terms of

employment generation and polices to support this sector need to be put in place. The role of microfinance is perceived to be crucial in this regard (MOF, 2002).

In addition, the economic reforms, undertaken after the change in Government in 1991, which included decentralisation, privatisation and liberalisation of the financial market (Brownbridge, 1996a), led to the proliferation of FIs, including MFIs, in the financial sector. Prior to the economic reforms, the financial sector[1] was dominated by foreign owned banks and state owned FIs set up by the Government for various purposes, including the provision of concessional and long term finance to priority sectors, such as small and medium enterprises, as well as financial services to low income households.

The reforms and failure of government owned FIs resulted in a financial system that focused on meeting the needs of the corporate sector and the working class. Therefore, the growth of MFIs resulted from a need to fill the gap that had been identified in the market (Maimbo, 2000). These developments in the financial sector, specifically with regard to the increasing number of MFIs, led to calls for the sector to be regulated and supervised. Because MFIs provide financial services, whether as their core activity or part of a broader developmental agenda, it is argued that they should be considered part of the financial sector. Furthermore, the term 'MFI' is often associated with non-governmental organisations (NGOs) that provide financial services. Thus, the debate surrounding the regulation of MFIs is based on the premise that these institutions are not regulated for the provision of financial services and that they should be regulated in the same manner as banks, by the same supervisory authority, usually the central bank (Vogel et al, 2000). Consequently, this is the focus taken by the study.

This chapter introduces the thesis. The next section outlines the approach taken in the study followed, in section 1.3, by a discussion of the research objectives. The last section outlines the structure of the thesis.

---

[1] In this study, the financial sector comprises all those FIs that fall under the ambit of Bank of Zambia (BOZ). It excludes insurance companies, those companies regulated by the Securities Act of 1993 such as brokerage firms and security houses, and other financial service providers regulated by separate regulatory authorities such as money lenders and hire purchase companies, although they may fall within the broader definition of the financial system (Mwape, 1997: 2). Thus, in this context, the Zambian financial sector refers to the central bank, BOZ, which is the supervisory authority, commercial banks, and numerous non-bank FIs, such as leasing companies, building societies, MFIs, bureaux de change, as well as those institutions established by Acts of Parliament, such as the Development Bank of Zambia (DBZ), National Savings and Credit Bank (NSCB) and Zambia National Building Society (ZNBS).

1.2 THE RESEARCH

This thesis assesses the potential impact of regulation and supervision on the microfinance sector in Zambia. It does this, firstly, by surveying the microfinance sector in Zambia in order to gain an understanding of the environment that the regulations and supervisory framework will be targeted to. Secondly, the thesis evaluates the existing financial sector regulatory and supervisory framework. Third, the potential impact of regulation and supervision of the microfinance sector is then assessed.

The analysis is carried out at two levels, micro and macro. At the micro level, case studies of three MFIs are used. All three MFIs licensed by the central bank, the Bank of Zambia (BOZ), during the time of the field work are included in the study. The MFIs' experiences of being regulated and supervised and how they were affected are examined. At the macro level, the impact of regulation and supervision on the microfinance sector as a whole is evaluated. These results and other data collected during the fieldwork are then analysed within the Regulatory Impact Assessment (RIA) framework to determine the potential impact of regulation and supervision resulting from the proposed change to the existing framework. This proposed change is the passing of regulations specifically targeted to the microfinance sector. From these results, policy recommendations are then made as to whether the microfinance sector should be regulated and supervised as proposed. The research aims to contribute to understanding regulatory and supervisory issues relating to microfinance in the context of developing countries, and in particular, sub-Saharan Africa, and inform policy and the design of regulatory and supervisory frameworks in Zambia.

To date, much of the research has been limited to case studies of successful MFIs in Asia, Africa and Latin America. These studies have tended to focus on micro-economic impacts and the relationships between MFIs and their recipient credit clients (Hulme and Mosley, 1996; Wood and Sharif, 1997; Khandker, 1998). There has been very little research into the regulation and supervision of MFIs and the impact of regulation and supervision on the development of the sector. What research has been done has tended to be in the form of descriptive case studies charting the experiences of selected MFIs that have been licensed in their respective countries (Churchill, 1997; Rock and Otero, 1997; Drake and Rhyne, 2002). This study goes a step further by examining the overall impact of regulation and supervision on the microfinance sector as a whole, using the case of Zambia.

1.3 RESEARCH OBJECTIVES

Research objective 1: To assess the potential impact of regulation and supervision on the microfinance sector

The first research objective is to assess the potential impact of regulation and supervision on the microfinance sector in Zambia through the introduction of Microfinance Regulations. The results from the analysis are then used to determine how regulation and supervision will affect the development of the microfinance industry. This is closely linked to whether the objectives of regulation and supervision would be achieved by the proposed change in the existing framework. This research objective has, therefore, been distilled into the following research questions.

- *Does the proposed change to the existing framework address the weaknesses and deficiencies that currently exist?*
- *Are the objectives of regulation and supervision met by the proposed change?*
- *Do the perceived benefits of the proposed change outweigh the additional costs that would be incurred?*

In order to do this, it is important to understand the sector to which the regulatory and supervisory framework will be targeted. It is also important to understand the existing regulatory and supervisory framework and how it has affects the microfinance sector. Therefore, this study aims to address two further related research objectives.

Research objective 2: To obtain a better understanding of the microfinance sector in Zambia

For the analysis of the potential impact of regulation and supervision to be meaningful, it is important to understand what is to be regulated and supervised. This is especially important considering the diversity of MFIs, which range from non-governmental organisations (NGOs) to member based FIs, such as credit unions (CUs) and cooperatives, to commercial banks. This is also important when making recommendations for policy in other countries as the recommendations would depend on the characteristics of the microfinance industry in those countries. This research objective can thus be distilled into the following research question:

- *What are the characteristics of the microfinance sector in Zambia?*

Research objective 3: To obtain a better understanding of the existing regulatory and supervisory environment

As for research objective 2, for the analysis of the potential impact of regulation and supervision to be meaningful, it is important to understand the existing regulatory and supervisory framework. An evaluation can then be made of how this framework will be modified by the proposed change in the regulatory and supervisory environment. This process highlights strengths and weaknesses in the existing framework after which it is possible to determine whether the deficiencies will be rectified with the proposed changes. Thus, this research objective can be distilled into the following research questions.

- *What is the existing financial regulatory and supervisory environment in Zambia?*
- *What are the strengths and weaknesses of the existing framework?*
- *How has the existing framework affected the microfinance sector?*

1.4 STRUCTURE OF THE THESIS

The thesis is organised into nine chapters. Chapter 2 introduces the concept of microfinance and highlights the issues and debates in the microfinance arena regarding the definition of microfinance, sustainability and outreach versus poverty reduction. It reviews the manner in which microfinance is said to reduce poverty and the success of such programs. This is followed by a discussion of the increasing emphasis towards the creation of financially self-sufficient MFIs. Lastly, it describes microfinance in different parts of the world.

Chapter 3 defines regulation and supervision and discusses the rationale for regulation and supervision, specifically as it relates to FIs. This is followed by a review of the 'public interest' and 'private interest' theories of regulation. The chapter then goes on to examine the arguments cited in the literature for regulating and supervising MFIs. It explains why the distinctive characteristics of MFIs must be taken into account when developing the regulatory and supervisory framework, followed by a discussion of the different regulatory approaches that may be taken, thus setting the groundwork for appraising the existing regulatory and supervisory framework and potential impact of regulation and supervision in Zambia.

Chapter 4 provides an overview of the methodology used and the research methods employed for the study. It starts by discussing RIA, the benefits of using RIA and limitations of its use in developing countries. It then outlines the model used for the study which has been adapted

from the UK RIA model. Thereafter, the chapter details the data collection methods employed for the study and covers what was done, the sampling techniques used where appropriate and how the data was organised and analysed. The chapter ends with an examination of the challenges and constraints faced, their impact on the research, and how the limitations were mitigated.

Chapter 5 sets the scene for the research. It begins with a discussion of Zambia's economic performance since the early 1990's and poverty in Zambia. This is followed by an overview of the financial sector and description of government microfinance programs, focusing primarily on government owned FIs. It then details the emergence of the microfinance sector as it exists today. The second part of the chapter discusses the findings of the survey in relation to the main characteristics of microfinance in Zambia, specifically the types of institutions operating in the sector and their legal form, the ownership and funding of MFIs, areas of operation and outreach, products and services offered, and client profile. This is followed by an evaluation of the constraints faced by the microfinance sector. The chapter ends with an examination of the implications of the study results on the regulatory framework.

Chapter 6 discusses the research findings in relation to the regulatory and supervisory framework. It starts with a description of the current regulatory environment for microfinance. This is followed by an examination of stakeholders' views on whether the microfinance sector should be regulated, the reasons for regulation, who the supervisory authority should be, and regulatory obstacles in the microfinance sector. The chapter concludes with an analysis of stakeholders' perceptions vis-à-vis regulation, drawing on the literature and other country experiences with regulating the microfinance sector.

Chapter 7 begins by describing the MFIs used in the case studies and covers their establishment, ownership structures, services and products offered, lending methodologies, and accounts, where relevant, of the operational issues faced by the MFIs. The chapter then reviews the MFIs' experiences of being regulated. Thereafter, the chapter analyses the impact of the existing regulatory and supervisory environment on the selected MFIs and is followed by an analysis of the potential impact of the proposed change. The results from the case studies are then used as a basis for determining the potential impact of regulation and supervision on the microfinance sector as a whole in Chapter 8. The case studies also contribute to the broader study aims of; (1) obtaining a better understanding of microfinance

in Zambia through the detailed descriptions provided of the MFIs and (2) obtaining a better understanding of the Zambian regulatory and supervisory environment through the account of the MFIs' experiences with regulation and supervision and review of how they were affected.

Chapter 8 takes the analysis a step further with the application of the RIA model adapted for the study and described in Chapter 4 in assessing the impact of the proposed change. The chapter discusses the objectives, intended effects of passing legislation specifically targeted to the microfinance sector, and provides the rationale for government intervention. It also reviews the risks of not having regulation. The chapter then goes on to appraise the two options under consideration, specifically, (1) maintaining the existing regulatory and supervisory framework and (2) passing the Microfinance Regulations (DMFRs), followed by an evaluation of the benefits and costs of the two options. The chapter concludes with a recommendation to maintain the existing regulatory and supervisory framework based on the findings of the study.

Chapter 9 synthesises the research findings. It presents the conclusions of the study and discusses the implications of the findings for theory and directions for further research. The chapter concludes with a consideration of the policy implications of the research results.

2 THE MICROFINANCE PHENOMENON

2.1 INTRODUCTION

The majority of low-income households, in all parts of the world, historically has not had access to formal financial services. This is because most traditional formal FIs regard the poor as 'too poor to save', and consider potential borrowers as too high a risk. In most cases, potential borrowers do not keep written records, want to borrow small uneconomic amounts, and often have no assets to pledge as security.

Despite this, innovative FIs, referred to as microfinance institutions (MFIs), have emerged to cater for this market, offering varied solutions to the problems highlighted above, such as the use of group lending contracts and guarantees. The repayment of loans is ensured by intensive loan monitoring and supervision, compulsory saving schemes, and the offer of progressively larger loans that act as an incentive to repay (Hulme and Mosley, 1996; Armendáriz de Aghion and Morduch, 2005). "Microfinance presents itself as the latest solution to the age old challenge of finding a way to combine the banks' resources with local informational and cost advantages of neighbours and moneylenders" (Armendáriz de Aghion and Morduch, 2005: 8).

Moreover, microfinance is seen as a way to generate self-employment opportunities for the poor, thus alleviating poverty. The lack of capital makes it difficult for people to undertake productive employment generating activities. Providing microfinance, it is believed, is a way to generate self-employment opportunities for the poor (Robinson, 2001). The World Bank estimates that approximately one billion people around the world live on less than $1 a day (WB, 2001: 6). With the reaffirmation of reducing poverty as the primary goal in the development policy agenda, microfinance has become the much favoured interventionist strategy amongst international development agencies (Wright, 1999), not only in poor countries, but also in the poorer areas of the richest countries (Hollis and Sweetman, 1998).

This chapter reviews various issues regarding microfinance and is organised as follows. The next section outlines the evolution of microfinance. Section 2.3 then goes on to define microfinance and describe the institutional types of MFIs. Section 2.4 discusses the role of

microfinance in the alleviation of poverty. It briefly describes the manner in which microfinance is said to reduce poverty and section 2.5 reviews the difficulties with assessing the impact of microfinance interventions. This is followed by a discussion, in section 2.6, of the Financial Systems Approach which emphasises the creation of financially self-sustainable MFIs. Section 2.7 presents the results of studies undertaken in an attempt to provide an inventory of MFIs in Asia, Latin America and Africa. This is followed by a synopsis of the microfinance sectors in these three continents in sections 2.8, 2.9 and 2.10 respectively. The last section summarises and concludes.

2.2 HISTORY OF MICROFINANCE

Although there has been much discussion and debate about microfinance in the last few years, microfinance is not new. Despite the sudden surge in donor funding and media interest, it has existed for hundreds of years. Poor people have always had their own traditional financial systems, such as moneylenders, and the concept of microfinance as a development intervention is not new (Harper, 1998; Hollis and Sweetman, 1998; Roth, 2002; Seibel, 2005)[2].

Today the term 'microfinance' conjures up images of donor funded NGOs, providing small loans to low income households, to finance economic activity. What has generally come to be regarded as microfinance, started in the 1970s and was focused on the provision of credit to the poor in order to reduce poverty and instigate social change. The process was driven by NGOs and came to be known as the 'microcredit revolution'. It is often associated with Muhammad Yunus and the founding of Bangladesh's Grameen Bank. "Powered by donor support and international publicity, Grameen Banking became the new model of microcredit, its founder the prophet of the microcredit movement" (Seibel, 2005: abstract). The push to 'microfinance' came with the recognition that households can benefit from access to a broader range of financial services, especially savings. Microfinance now includes a whole host of other financial services, including payment services, remittances and insurance. The 'microcredit revolution' had thus been transformed into the 'microfinance revolution' (Seibel, 2005).

[2] The history of microfinance is outlined in Appendix 1.

2.3 MICROFINANCE DEFINED

Microfinance refers to the provision of financial services to low income households, including the self employed. These financial services include savings, credit, payment facilities, remittances and insurance (Ledgerwood, 1999; Wright, 1999; Christen and Rosenberg, 2000). Microfinance, therefore, encompasses microcredit, microsavings and microinsurance (Roth, 2002: 173). With the passage of time, there has been increasing emphasis on the importance of offering a range of quality, flexible financial services in response to a wide variety of needs of the poor (Wright, 1999).

MFIs are those organisations that provide financial services to low income communities, and include NGOs; member-based organisations such as village banks, CUs and savings and credit cooperatives (SACCOs); specialised government banks and private commercial banks. MFIs vary widely by organisational type, scale of operations and levels of professionalism. A study of microfinance shows that there is no single 'best practice model' for the provision of microfinance services (Seibel, 2005).

Table 2.1: Distinctive characteristics of MFIs

Characteristic	Description
Client profile	Low income and poor households Employed in the informal sector or self employed Lacks traditional collateral Interlinked household and microenterprise activities Predominantly women
Lending technology	Group or individual loans Simple and minimal documentation Cash flow and character based
Loan portfolio	Working capital, short term loans, repeat loans Clients mostly women
Collateral	Collateral substitutes e.g. group lending, joint liability, peer pressure, public repayments, compulsory savings Non traditional forms e.g. household items
Culture/ideology	Poverty reduction Provision of social services e.g. skills training, nutrition, health, basic literacy

Adapted from APO (2006: 16)

It is difficult to generalise about specific characteristics due to the broad range and variations in types of institutions. The broad range of institutional forms has resulted in MFIs being registered under different Acts and falling under different supervisory authorities. Consequently, the regulatory and supervisory environment in relation to microfinance in most countries is fragmented, and not all MFIs are regulated for the provision of financial services. Furthermore, MFIs differ from traditional FIs in terms of client features, lending technology,

loan portfolio features, culture or ideology and institutional structure (summarised in Table 2.1). Most of the distinctive characteristics of MFIs are the result of innovations developed by the microfinance sector to overcome problems of information asymmetry and high transaction costs that hinder financial service provision to low income households. These innovations include group lending, frequent repayments, public repayments, progressive lending, non-traditional collateral, and the targeting of women[3]. These distinctive characteristics need to be taken into consideration in developing a regulatory framework for microfinance, an issue which is explored further in Chapter 3.

2.4 THE POVERTY LENDING APPROACH

One of the main assumptions behind the development of the microfinance sector is that the poor possess the capacity to implement income generating economic activities. They are simply limited by a lack of access to capital due to the underdevelopment of the financial sector, the reluctance of commercial banks to lend to them, the failure of development projects and banks, and the fact that the informal financial sector is neither sufficiently large nor capable of responding to the challenges of development. By virtue of their design, microfinance programs can reach the poor and overcome the problems of asymmetric information and high transaction costs highlighted above. Consequently, microfinance programs have been credited with increasing the incomes of the poor, empowering repressed women, increasing access to better health care, education and nutrition, and providing a cost effective, sustainable development model that is applicable, not just in developing countries, but also among the poorer communities in the developed world (Wright, 2000a). Some enthusiasts argue that microfinance offers a unique opportunity to combine genuine humanitarian aid for the poorest with opportunities for trade and investment (Khandker, 1998). Consequently, the last few years has seen the proliferation of MFIs and increasing advocacy of microfinance as a panacea for poverty reduction[4].

However, there are those who refute the claim that MFIs work with the poorest of the poor, which would include the mentally and physically disabled, elderly street children, the destitute and refugees. In many countries, if one uses the official national levels of poverty, MFIs actually work with the non-poor. They assert that microfinance programs have a limited effect on income, address the symptoms rather than the causes of poverty, and drive women

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[3] These innovations are discussed in Appendix 2.

to greater dependence on their husbands. Hulme (2000) argues that it is only a partial cure for poverty. Poverty reduction requires action on many other fronts, such as the provision of social safety nets for the poorest and most vulnerable, effective education systems and sound macroeconomic policies. He argues that outside of Bangladesh, MFIs have not even begun to scratch the surface, citing Kenya as an example of where less than 70,000 people of an estimated nine to ten million poor people have access to microfinance.

Others, such as Rutherford (as quoted in Oberdorf, 1999: 4), acknowledge that financial services do help the poor in many different ways and "one of the indirect outcomes of that is a certain degree of poverty reduction". But they are reticent about concluding that the provision of microfinance has had a direct causal effect on the alleviation of poverty. Sceptics of these programs tend to view them as a social liability, using scarce resources that could be utilised in a different manner without significantly changing the long-term livelihoods of those they are supposed to benefit. They argue that the small enterprises supported by microcredit programs have no sustained impact on the poor but serve to make the poor economically dependent on the program itself. Additionally, most microcredit programs are heavily dependent on donors as they are often highly subsidised. Even if they reach the poor, they may not be cost effective and worth supporting as a resource transfer mechanism.

Poverty is usually the result of a number of factors, such as low economic growth, high population growth, and the unequal distribution of resources, in which case all factors need to be addressed in order to reduce poverty (Khandker, 1998). Financial services are not a panacea for poverty alleviation and may not necessarily be the most appropriate form of intervention (Robinson, 2001). In Africa, the majority of the poorest households live in rural areas which lack basic infrastructure. These deficiencies serve to hamper the establishment of viable microfinance systems. In addition, remote areas typically have very low levels of monetisation. It would be pointless to establish microfinance programs in these areas.

Lastly, although there has been growing recognition that there is a need to provide a broad range of financial services, there is still a tendency to focus on the provision of working capital loans for microenterprise using the well recognised individual, group lending and village banking methodologies. This model assumes that "credit will facilitate the growth of the

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[4] The reputed success of microfinance ties in with the dominant development ideology of the 1980s and 1990s, "which emphasised the development of new markets and promoted a culture of entrepreneurship, and argued for

enterprise from micro to small and medium. The enterprise will capitalise itself, generate employment and eventually contribute to economic growth. This linear growth path will allow microfinance clients to lift themselves out of poverty by crossing over the poverty line for good" (Helms, 2003)[5]. Helms states that the reality is very different and that the model is only valid for a very small number of enterprises. She then provides an example of what she describes as an 'average female entrepreneur'. The purpose of her business may not be to grow, capitalise, and create employment; but rather to generate income to invest in other asset-building activities such as children's education, fixing a leaky roof, better nutrition, and dealing with emergencies. She may not want her business to grow because she has other priorities to attend to and keep the household afloat. "The mistake of traditional microfinance in the case of this typical woman is twofold: (1) assuming that microfinance finances only the enterprise; and (2) depreciating her 'non-productive' investments and spending activities as somehow not important or relevant to development". Helms concludes that a better understanding of how poor people need and use financial services, which is essentially to better manage their financial lives, is what is required.

The model described above also assumes that there is scope for the growth of the microenterprise or economic activity by the poor. However, there may be factors limiting growth, including a preference to investing 'surplus funds' in land and real estate which are perceived as more secure, the high risk of doing business in jurisdictions with weak transitory government and the absence of property rights, and the poorly defined or non-existent markets. Buckley (1997: 1081) notes, however, that these factors do not mean that microcredit should be written off entirely; but taken as a whole, it implies the need to "at least appraise the existing tendency in some quarters to eulogise over the potential of microfinance to transform microenterprise and the economic conditions of the entrepreneur".

2.5 PROBLEMS WITH MEASURING POVERTY IMPACT

Theoretically, access to financial services can improve welfare, and from studies conducted with beneficiaries, beneficiaries do believe that microfinance interventions have improved their welfare. However, attempts to assess the impact of microfinance programs with any degree of accuracy have been fraught with problems. Firstly, any attempt to assess the impact of microfinance on poverty alleviation raises the question of how poverty reduction should be

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minimal state intervention and provision of loans as opposed to grants" Roth (2002: 178).

[5] http://microfinancegateway.org/website/viewpoint_entdev.htm

measured. What is meant by poverty, how it might be measured, and who constitute the poor, are the subjects of much debate. At the heart of the debate is the question of whether poverty is largely about material needs or whether it is about a much broader set of needs that permit well being, or at least a reduction in ill being (Hulme and Mosley, 1997). Implicit in the approach of assessing the impact of microfinance using income measures is the assumption that an increase in income will necessarily result in the reduction of poverty. As Wright (1999: 38) points out: "Despite the prevailing emphasis on raising incomes as the central objective of development programmes, the two are not synonymous. Clearly, the use to which income is put is as important in determining poverty and welfare as the level of income itself – increased income can be (and often is) gambled away."

Secondly, income can be attributed to many sources, such as age, education and experience, attributes which are generally measurable. However, another category of attributes, such as entrepreneurial skills, persistence in seeking goals, organisational ability and access to valuable social networks, are much harder to measure. These and other factors, such as the locality of the microenterprise and the political and macroeconomic environment, will all have an effect on the success of the economic activity undertaken. Calculating the impact of microfinance requires disentangling its effect from the simultaneous impacts of all these factors. Additionally, the poor usually have more than one source of income. Thus, it is difficult to conclusively state the microfinance intervention, in this case, credit, was solely responsible for increasing income levels, or improving welfare.

The third problem results from 'selection' and 'reverse causation' biases. Selection bias occurs because those who choose to participate in microfinance programs do so because they feel, for whatever reason, that they will be able to repay their loans, and therefore already have initial advantages over their neighbours. Therefore, not controlling for self selection into microfinance programmes, estimated impacts on income and empowerment will be misleading and the microfinance interventions will seem more positive than they really are. MFIs also make direct, non-financial interventions, such as skills training, health, nutrition, and family planning, which affect client outcomes. The multiplicity of channels means that it is typically impossible to assign a given measured impact to the strictly financial elements in microfinance (Armendáriz de Aghion and J. Morduch, 2005: 200). Additionally, respondents may give false information if the loan was used for purposes other than that stated on the loan

application and responses may be influenced by whom and the way in which the questions are asked (Wright, 2000a).

Lastly, it is very difficult to establish what might have happened if the microfinance intervention had not taken place (Roth, 2002). From a review of impact studies undertaken to date, Armendáriz de Aghion and J. Morduch (2005: 222) conclude that "there is no study as yet that has received wide consensus as to its reliability; and this reflects the inherent difficulty in evaluating programs in which participation is voluntary and different customers use the services with varying degrees of intensity."

2.6 THE FINANCIAL SYSTEMS APPROACH

What has been described thus far is referred to in the literature as the 'poverty lending' approach. It concentrates on reducing poverty through credit. However, some authors argue that the only way MFIs will achieve the primary goal of reducing poverty among truly large numbers of the poor is if they become 'financially self-sustainable' (FSS), what is sometimes referred to as the 'financial systems approach' (Robinson, 2001; Armendáriz de Aghion and Morduch, 2005). According to Gibbons and Meehan (2000: 3), the estimated cost of meeting the demand of 100 million of the poorest households is approximately US$1 billion. Such a staggering amount can not be met by donors or governments and, therefore, must come from the private sector. Other authors have referred to this process as the 'commercialisation' of microfinance (Drake and Rhyne, 2002). Thus, the Financial Systems Approach emphasises the large scale outreach of microfinance to the economically active poor, both to borrowers and savers. So, although financial services used to be regarded as a form of assistance to small enterprises, they are now coming to be seen as another type of enterprise in themselves (Harper, 1998).

Gibbons and Meehan (2000: 1) define 'institutional financial self-sufficiency' (IFS) as "the ability of an MFI to cover all actual operating expenses, as well as adjustments for inflation and subsidies, with adjusted income generated through financial services operations". Thus, MFIs would be able to operate profitably, without any charitable support, permanently, as opposed to the short time frames often associated with donor programs.

However, most MFIs world-wide are still funded by donors and many still rely on subsidies from governments or NGOs. Even Grameen Bank, which is often cited as being financially

self-sustainable, places great reliance on subsidies[6]. The fact that this support is necessary, and may continue to be necessary in many cases if institutions are to survive, suggests that microfinance is fundamentally not profitable (Harper, 1998). In most cases, the author argues, donors are not interested in repayment or the financial return on the investment and may not be concerned with sustainability if the project achieves its objectives within a given time frame and budget. This view is echoed by Dunford (2000b: 41) who sees nothing wrong with this approach as long as the MFIs "develop good strategies for eventually handing over their clients to more sustainable service institutions".

There is still a debate as to whether financial self-sustainability is an achievable objective, especially if the objective is poverty alleviation (Hollis and Sweetman, 1998). Mosley and Hulme (1998), in their study of MFIs, found that there was a trade-off between the objectives of poverty alleviation and sustainability. Furthermore, it has been pointed out that in the quest to achieve financial self-sustainability, MFIs are no longer serving the poorest of the poor, in what has been termed 'mission drift' (Helms, 2006). Advocates of the Financial Systems Approach assert, however, that attaining financial self-sustainability supports, rather than displaces, efforts in poverty reduction. Gibbons and Meehan (2000) provide empirical evidence that a trade-off is not inevitable using case studies of three MFIs operating in Latin America, Asia and Africa.

In order to achieve financial self-sustainability, MFIs need to diversify and increase their sources of funding (Hollis and Sweetman, 1998). In their study of historical FIs, they found that institutions that relied on depositors for a major part of their funding were more likely to be sustainable over the long term and tended to serve many more borrowers than microcredit organisations funded by donations or government grants. If MFIs are to mobilise deposits in their quest to be sustainable, the question of regulation becomes all the more pertinent.

2.7 A GLOBAL PERSPECTIVE OF MICROFINANCE

The following sections of this chapter attempt to provide a global view of microfinance. Due to the diversity of institutional forms and differences in their prevalence in different parts of the world, compiling a worldwide inventory of MFIs has not been easy, although there have

[6] "Closer examination … shows that while the bank reports profits that sum to $1.5 million between 1985 and 1996, the profits rest on S175 million in subsidies, both direct and implicit" (Armendáriz de Aghion and Morduch, 2005: 240).

been a number of attempts to do so. One of the earlier attempts to compile such an inventory was undertaken by the World Bank (WB, 1996).

Although by no means comprehensive, it was possible to draw some inferences from the survey data. The 206 institutions sampled had an outstanding loan balance of over US$7 billion at September 1995 from 14 million loans, and savings of over US$19 billion in over 46 million savings accounts. The survey results, summarised in Table 2.2, gave an indication of the general characteristics of the MFIs that responded.

Table 2.2: Analysis by institutional type

	Banks	Savings Banks	Credit Unions	NGOs
Loans				
Outstanding loan balance	68%	15%	13%	4%
Number of loans outstanding	78%	2%	11%	9%
Deposits				
Deposit volumes	32%	59%	9%	0%
Number of accounts	42%	51%	4%	3%
Funding sources				
Donor funds[a]	17%	2%	8%	9%
Deposits	46%	78%	16%	69%
Commercial loans	20%	10%	71%	7%
Other[b]	17%	10%	5%	15%
Age				
Average date of establishment[c]	1977	1924	1968	1983

Source: WB (1996)

Notes:
[a]Donor funds were most likely to be grants or loans given at concessional rates.
[b]Other includes government, equity and other sources. For banks, savings banks and CUs, this source was most likely to be equity and government for NGOs.
[c]The figures would be more recent if programs created after 1992 had been included.

Whilst most NGOs focused on the provision of credit alone, some of the largest sustainable institutions relied heavily on deposit mobilisation. Institutions that collected deposits were likely to be located in urban areas and offer larger loans than credit only institutions. Most MFIs were new, partly a reflection of increased interest in microfinance in the last twenty years, and the failure of the older institutions, mainly due to poor performance and low repayment rates. The majority of the newer institutions were NGOs which tended to adopt a credit only approach. The older institutions were CUs and banks and were more likely to mobilise deposits.

NGOs tended to focus on service, manufacturing and commercial loans, with average terms of one year. The majority of their clients were female. Banks and CUs were more likely to provide loans for agriculture, housing, consumption and enterprise development, with an

average term of three years. Their loan sizes were the largest in the sample. NGOs offered the smallest loans as they tended to target the poorest clients, whereas savings banks had the largest median loan size (Table 2.3).

Table 2.3: 1995 median loan and deposit characteristics by institutional type

	Median number of loans outstanding per institution	Median loan size	Median number of deposit accounts per institution	Median deposit size
Banks	44,271	$681	39,883	$186
Savings banks	2,866	$3,011	224,180	$950
Credit union federations	15,320	$449	38,610	$409
NGOs	1,781	$248	0	$0

Source: WB (1996: 26)

Asia accounted for most of the microfinance activity at 76% (Table 2.4), which was not surprising as seven of the eight largest MFIs were in Asia[7]. Donors accounted for a significant proportion of funding on all three continents. MFIs in Africa tended to be the youngest, whilst those in Asia were the oldest and growing at the fastest rate.

Table 2.4: Cross regional analysis

	Asia	**Latin America**	**Africa**
Loans			
Outstanding loan balance	76%	21%	23%
Funding Sources			
Donor	47%	55%	59%
Deposits[a]	21%	15%	30%
Commercial loans	15%	17%	9%
Other[b]	17%	13%	2%
Outreach			
Women[c]	75%	50%	50%
Rural	68%	39%	65%
Age			
Average date of establishment	1977	1978	1983

Source: WB (1996)

Notes:
[a]The relatively large figure for Africa may be due to the large deposit-based African CUs included in the sample.
[b]Government funding accounts for approximately 2% – 4% of funding in all regions.
[c]Figures for Latin America and Africa are approximations.

Social services, primarily literacy programs ran by NGOs and CUs, played a prominent role in Asian and African MFIs. This was reflected by the ratio of social service staff to financial services staff which was highest for Asian institutions. Asian institutions also reported more time spent on services and training in relation to nutrition, health and literacy, as well as group formation and client training. The ratio was lowest for Latin American MFIs. Median loan

[7] BRAC and Grameen Bank (Bangladesh); BRI Unit Desa (Indonesia); National Savings Bank (Sri Lanka); BAAC and the Government Savings Bank (Thailand); and Vietnam Bank of Agriculture (Vietnam).

sizes were highest for Latin America. This may be explained by the significantly higher GNP per capita in the region, as well as their orientation towards the provision of credit for enterprise development as opposed to poverty alleviation. Asian institutions had the smallest median deposit size and loan size. The small deposit size may have been a reflection of the requirement of microfinance clients to have compulsory savings in group lending programs.

Lapenu and Zeller (2002) built on this and other studies[8] and also covered Asia, Latin America and Africa. MFIs were classified by the type of technology used to provide financial services, namely cooperatives, solidarity groups, village banks, individual contracts and linkage models. Some institutions used a combination of approaches. These were classified as mixed. The study revealed that MFIs reached 54 million members who had received $18 billion in loans and accumulated $13 billion in savings. However, MFIs were highly concentrated with 3% of the largest MFIs accounting for over 80% of the total members.

If Indonesian MFIs are included, the individual contract approach predominated in terms of number of MFIs at 58.3% and number of members at 42.5% (Table 2.5). Solidarity groups had the largest number of borrowers at 67.8% and the cooperatives accounted for the largest loans and savings volume, followed by solidarity groups.

Table 2.5: Distribution of activities by type of MFI including Indonesia

	Cooperative	Solidarity group	Village bank	Individual contract	Linkage model	Mixed approach
Number of MFIs	11.9%	16.4%	7.0%	58.3%	4.0%	2.4%
Number of borrowers	9.9%	67.8%	1.8%	17.9%	0.3%	2.3%
Number of savers	31.2%	25.9%	0.5%	41.7%	0.0%	0.6%
Number of members	26.9%	28%	0.8%	42.5%	0.9%	0.9%
Volume of savings	60.5%	28.9%	0.1%	10.4%	0.0%	0.1%
Volume of credit	59.9%	34.8%	0.2%	4.5%	0.0%	0.7%

Source: Lapenu and Zeller (2002: 99)

However, if Indonesian MFIs are excluded, then solidarity groups accounted for the largest number of MFIs and members, as well as number of borrowers (Table 2.6). Proportionately, cooperatives still accounted for the largest volume of transactions for both credit and savings. The village bank and linkage models had the highest staff productivity as measured by the

[8] The Microcredit Summit Directory of Institutional Profiles (1998) and Calmeadow Microbanking Bulletin (July 1999).

number of loans per staff member, and achieved better depth of outreach than other MFIs. So, although the Indonesian individual MFIs were numerous in number, except for Bank Rakyat Indonesia (BRI), most were very small institutions at the village level. These village banks accounted for a large proportion of MFIs in terms of numbers, but they remained very small in terms of volumes.

Table 2.6: Distribution of activities by type of MFI excluding Indonesia

	Co-operative	Solidarity group	Village bank	Individual contract	Linkage model	Mixed approach
Number of MFIs	27.8%	37.1%	16.4%	3.9%	9.3%	5.6%
Number of borrowers	11.9%	80.6%	2.1%	2.1%	0.4%	2.8%
Number of savers	53.8%	43.6%	1.0%	0.5%	0.1%	1.1%
Number of members	41.1%	42.4%	1.3%	12.5%	1.4%	1.3%
Volume of savings	67.3%	32.3%	0.1%	0.1%	0.0%	0.1%
Volume of credit	62.2%	36.3%	0.2%	0.7%	0.0%	0.7%

Source: Lapenu and Zeller (2002: 99)

NGOs had good depth of outreach with 73% women clients and an average loan size of US$228, but low staff productivity at 104 loans per staff member. On the other hand, banks and cooperatives had high levels of staff productivity, 187 and 144 loans respectively per member of staff. However, they had low depths of outreach, with 40% women clients and average loan size of US$425 for banks and 45% women clients and average loan size of US$339 for cooperatives. Government organisations had the lowest levels of productivity and poor outreach.

The survey results further revealed that 91.5% of institutions with more than 100,000 members were regulated, whereas only 16% with members less than 20,000 were regulated (Table 2.7). In contrast, a large number of NGO MFIs were unregulated and accounted for 61% of the total sample. However, these institutions represented less than 2% of the total loans and savings volumes. Therefore, more than 95% of savings were with regulated institutions.

Table 2.7: Regulation of MFIs according to size

Number of members	0-20,000	20-100,000	>100,000	Total
Regulated (co-operative, bank, government organisation)	15.8%	51.6%	91.5%	24.6%
Unregulated (NGO, project)	69.0%	35.5%	8.5%	61.4%
Not available	15.2%	12.9%	0.0%	14.0%
Number total	538	62	47	650

Source: Lapenu and Zeller (2002: 102)

Considering the fact that the protection of depositors is often cited as the main rationale for the regulation of MFIs, these results can contribute significantly to the debate regarding the regulation of MFIs, especially because the majority of MFIs that were not regulated accounted for less than 2% of total loans and savings volume, but 61% of the sample in terms of numbers. The costs and benefits, as well as the practicalities of regulating such a large number of institutions that account for a very small proportion of transactions, would have to be carefully considered, especially as it may not be possible for the smaller MFIs to be effectively supervised, nor for them to be transformed into banks or other formal FIs. Lapenu and Zeller (2002) suggest that the larger regulated MFIs and smaller NGOs that use microfinance tools in the alleviation of poverty can coexist. Although not formally regulated, the smaller MFIs should be expected to "adhere to minimal internal rules to work on a professional and efficient basis" (Lapenu and Zeller, 2000: 103).

As for the World Bank survey, the results from this survey showed that Asia accounted for the largest volume of activities (Table 2.8). However, productivity was very low as measured by the number and volume of loans per member of staff compared to Africa and Latin America. This may be attributable to the lower cost of labour, which may also explain Asia's high repayment rates. Staff productivity, as measured by the number of loans per staff member, was the same in Latin America and Africa. However, employees in Latin America had loan portfolios three times the size of their African counterparts.

Consistent with the World Bank survey, Latin America accounted for the largest transactions and Asia the smallest. Both surveys found that Asian MFIs had a larger proportion of members in rural areas. Although the population is primarily rural in Africa and Latin America, the relatively low presence of MFIs in rural areas implied that the rural depth of outreach was low. Evidently, microfinance was most active in Asia. This may not be so

surprising as it is the most densely populated region of the three continents[9], has low labour costs and, therefore, the lowest transaction costs, especially in rural areas. In addition, Asia has had a more favourable environment of steady economic growth and relatively low inflation which has contributed significantly to economic stability and has been important for the development of the microfinance sector (ADB, 2000).

Table 2.8: Cross regional analysis

	Asia	Latin America	Africa
Volume of activities			
Percentage of MFIs	69.2	9.0	21.8
Percentage of members	77.2	12.9	9.9
Percentage of savings	54.5	40.5	5.0
Percentage of credit	64.9	32.5	2.6
Performance			
Repayment rates	95.6	93.1	88.7
Staff productivity			
Number of loans	81	146	145
Volume of loans (US$)	6,037	59,329	21,955
Volume of savings (US$)	3,034	5,888	16,253
Outreach			
Female	87.8	73.3	69.9
Average loan size (US$)	153	418	261
Average deposit size (US$)	62	590	75

Source: Lapenu and Zeller (2002: 105-106)

Latin America, on the other hand is characterised by low population density. Additionally, it experienced a period of hyperinflation and economic instability in the 1980s and early 1990s which may have had an adverse effect on the development of the microfinance sector (WB, 1996). Africa is also characterised by low population density, with poor infrastructure, especially in rural areas, resulting in high transaction costs. Dispersed populations and poor transportation and communication facilities make unit delivery costs very high for small financial transactions. With stagnant GNP per capita growth in the last two decades, Africa does not have an environment that is particularly conducive to the development of a vibrant microfinance sector (Chao-Béroff, 1999a).

A more recent study was conducted by CGAP (Christen et al, 2004). The study surveyed a broad range of FIs that aim to serve poorer clients and also cover their costs and make a profit. The research revealed that there were over 750 million savings and loan accounts collectively. The survey was based mainly on data from the year 2000. The survey found that a large number of accounts were highly concentrated, both geographically and in the types of

[9] 74.6% of the population (Lapenu and Zeller, 2002).

FIs. In line with the other studies, microfinance was the most active in Asia. Asia accounted for 91% of savings accounts and 88% for loans. The Asian numbers, in turn, were dominated by figures for China and India. These two countries alone accounted for 68% of the accounts in Asia and more than 50% of the total number for all regions.

Looking at the distribution by institutional type, state/agricultural/development banks accounted for the largest proportion of loan accounts at 62%, followed by MFIs at 33%[10]. CUs and cooperatives accounted for only 2% and community banks, 3%. Postal banks accounted for the largest proportion of savings accounts at 59%, followed by MFIs at 19% and state/agricultural/development banks at 13%. Cooperatives and rural banks accounted for the lowest proportion at 6% and 3% respectively. Banks and NBFIs were found to have greater outreach in Latin America than other regions; SACCOs were prevalent in West and Central Africa; and community banks, especially rural banks, dominated in certain countries like Ghana, Indonesia and the Philippines.

2.8 MICROFINANCE IN ASIA

The microfinance sector in Asia has a strong social orientation and started predominantly with the provision of loans to poor marginalised women. MFIs tend to focus on the provision of credit for microenterprise development, as opposed to a broad range of financial services, and a large number of institutions operate in densely populated rural areas. Unlike Latin America, fewer MFIs in Asia are financially self-sustainable (MicroBanking Bulletin, 2002). Most are heavily dependent on government subsidies and funding from donors. The economic environment means that Asian MFIs are often the most cost efficient than programs in other regions, with lower wages, and a focus on poorer clients (ADB, 2000). Approximately 550 million clients are served throughout Asia, but 200-400 million remain un-served in India and a similar number in China (Wright, 2005).

Bangladesh and Indonesia dominate, but their microfinance sectors differ considerably (Helms, 2006). In Bangladesh, MFIs reach approximately nine million people, with the twenty largest institutions accounting for 85% of all clients. An estimated 500 to 1,000 MFIs operate in the country. Approximately 80% of poor households are reached by microfinance services. The largest MFI, Grameen Bank, is regulated under its own Act, which exempts it from the provisions of the Banking Companies Act and other laws relating to banking. As long as they

do not accept deposits, all other MFIs are not classified as FIs and are not regulated or supervised by the central bank (McGuire and Conroy, 2000)[11].

Indonesia, unlike Bangladesh, has very few specialist MFIs that specifically target poor households. However, a range of regulated FIs provide financial services to rural areas, the largest of which is the state owned bank for agricultural development, BRI. In addition to BRI, there are a large number of rural banks and small FIs operating at the local level. Like BRI, they do not target the poor explicitly, but their clients do include many poor and near poor households. These institutions have extensive outreach, serving approximately thirty million clients. There are an estimated 400 NGOs, with approximately 200,000 clients engaged in microfinance. Therefore, NGO MFIs are not as predominant in Indonesia as they are in Bangladesh. And whilst the microfinance sector as a whole has considerable outreach, there are still significant numbers of households which do not have access to financial services.

2.9 MICROFINANCE IN LATIN AMERICA

The development of microfinance in Latin America took a somewhat different course. The mission of many of the 'first generation' MFIs in Latin America was to generate employment, develop entrepreneurship and provide financial services to the 'poorest of the working poor', as opposed to the 'poorest of the poor' (Christen, 2001). Whilst most MFIs focus on microcredit, an increasing number of MFIs are starting to offer a range of financial services to their clients, including savings and the management of international and domestic funds transfers.

Latin America has the longest tradition of commercially viable microfinance where it was realised early on that funds for growth would have to come from the private sector rather than donors and governments. The trend in commercialisation is reflected in the MicroBanking Bulletin statistics. In 2001, 64 of the 124 MFIs that reported to the Bulletin were financially

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[10] According to their classification, MFIs were NGOs and licensed NBFIs, commercial banks specializing in microfinance, and microfinance programs in full fledged commercial banks (Christen et al, 2004: 3).

[11] However, the government is now looking to regulate the sector. In June 2000, it formed the Microfinance Research and Reference Unit (MRRU) to bring MFIs under a regulatory framework. The MRRU has issued operational guidelines for monitoring the management and financial systems of MFIs and has requested NGO-MFIs to provide quarterly information since January 2004. A law has been drafted and submitted to government for its consideration. However, it would be a mistake to attribute the success of microfinance in Bangladesh solely to the 'lax' regulatory environment. Other contributing factors include the stable macroeconomic environment, high population density, good communications infrastructure and a largely homogenous market of significant scale in absolute terms (Zaman, 2004).

self-sustainable. Thirty-five of the 64 operated in Latin America, of which 29 were regulated banking institutions (Drake and Rhyne 2002: 6). Most microfinance clients are served by regulated FIs. More than 1.5 million clients hold about $877 million in outstanding loans from approximately 200 MFIs (Table 2.9). An estimated 25% of the potential market for microcredit in 13 countries has been reached. In some countries, market penetration exceeds 50%. However, only 600,000 of the 10 million potential microcredit clients live in areas in which the microcredit industry reaches at least half its market. The region's largest markets, including Brazil and Mexico, remain untapped (Christen, 2001).

Table 2.9: Institutions engaged in microfinance in Latin America

Latin America	Number of institutions	Number of clients	Portfolio outstanding	Average loan balance
Regulated	77	807,783	648,564,701	803
Specially licensed	21	284,218	225,771,171	794
Transformed	31	186,331	170,201,772	913
Commercial	25	337,234	252,591,758	749
Unregulated	128	711,955	228,962,203	322
Total	205	1,519,738	877,526,904	577

Source: Christen (2001)

Regulated MFIs in Latin America account for 74% of the loans provided to microenterprises, reaching 53% of the clients served. These are classified into three broad categories. The first group, transformed NGOs, is made up of financial NGOs that have been licensed under the same legal structures as that of traditional banks or finance companies. These serve approximately 12% of clients. Examples of these can be found in Bolivia, Columbia, El Salvador and Peru. The second group, specially licensed MFIs, consists of MFIs that have transformed themselves into regulated MFIs, CUs and municipally owned local non bank intermediaries called 'cajas' and are licensed under special microfinance laws. This group serves 19% of clients. However, these figures exclude those served by CUs. CUs tend to dominate in rural areas and other institutional types dominate in the cities. The third and largest group of regulated MFIs are the traditional commercial banks and finance companies, which together serve 22% of clients. This category is dominated by banks that believe that microcredit is a profitable business. Regulated MFIs in Latin America provide larger loans to their clients than unregulated MFIs whose loans are a third the size that of regulated MFIs. This may be explained by the fact that unregulated MFIs are dominated by poverty oriented NGOs inspired by village level programs in Asia.

Increased competition has meant that MFIs have had to attract or retain more clients by adapting strategies based on increased client responsiveness and efficiency. Consequently, the trend has been towards individual lending, reflecting client preference of individual loan products over group lending. MFIs have also improved product delivery mechanisms, by offering credit card services for established clients for example (Christen, 2001). Increased competition has also had the effect of reducing interest rates significantly in some countries, such as Bolivia (Helms, 2006).

2.10 MICROFINANCE IN SUB-SAHARAN AFRICA

Overall, the microfinance sector in Africa remains underdeveloped and faces higher operating costs than any other region. An estimated 80% of the poorest of the population live in rural areas. Microfinance can only make a significant impact in alleviating poverty if it establishes itself in these areas, which are typically characterised by a lack of basic infrastructure, such as telecommunications, roads, education and health care facilities, and primary services such as sanitation. This constitutes a major constraint to the establishment of vibrant, sustainable microfinance systems in the region (WB, 1997; Chao-Béroff, 1999a; and Hardy et al, 2002).

The microfinance sectors differ considerably in different parts of the continent. Financial cooperatives dominate in French speaking Africa, reaching several hundred thousand clients. Benin, despite its relatively small size, has the largest number of MFIs in the West Africa Monetary Union (UMOA). As of December 2001, the Ministry of Finance (MOF) estimated that there were more than 600 microfinance providers with approximately 700,000 clients, CFAF 30 billion (US$40 million) in savings deposits, and CFAF 25 billion (US$33.3 million) in loans outstanding. MFIs are formally classified into three categories; CUs, credit-only MFIs, and donor projects with a microfinance component. CUs dominate the microfinance sector, followed by credit-only institutions. Donor projects with a microfinance component are numerous and small with loans outstanding representing less than 5% of the microfinance sector (Ouattara, 2003).

In contrast to Benin, the Tanzania Postal Savings Bank and several commercial banks are the leading providers of microfinance services in Tanzania, exceeding the combined outreach of SACCOs and NGO MFIs. There are approximately 251 urban SACCOs and 395 rural SACCOs, with an estimated membership base between 130,000 and 160,000, of which only a fifth are borrowers. There are approximately 60 NGO MFIs which serve a predominantly

urban clientele (Gallardo et al, 2005). NGO MFIs have played an important role in reaching the poor, as well as in developing and testing innovative products and service delivery mechanisms. These two country examples serve to illustrate the diversity of microfinance in SSA.

2.11 CONCLUSION

The first part of this chapter introduced the concept of microfinance and went on to define microfinance, describe the different institutional types, and the manner in which MFIs have sought to overcome the problems of information asymmetry and high transaction costs which have hindered the provision of financial services to low income households.

This was followed by a discussion of the role of microfinance in alleviating poverty. A review of the literature revealed that the evidence regarding the effectiveness of microfinance as a poverty alleviation tool has been mixed and, therefore, inconclusive. As much as it has been claimed that microfinance has succeeded in improving the livelihoods of millions of poor people, especially in Asia, there is also evidence to suggest that it has not succeeded in helping the poorest of the poor. Experiences have differed from region to region, raising concerns as to the appropriateness of microfinance interventions and replicability of microfinance systems in different contexts and environments.

With the increased interest in microfinance as an interventionist strategy, the focus has shifted from donor and or government funded institutions to creating institutions that are financially self-sustainable in order to achieve maximum outreach and meet the global demand for microfinance services. Although self-sufficiency is a goal advocates insist all MFIs should be striving to achieve, it is debatable as to whether it is in fact obtainable. Microfinance by its nature is costly to administer. Whether these institutions can be profitable and serve the poorest of the poor is an area for which there is no clear consensus. As financial self-sufficiency is dependent on mobilising private sources of funding, including deposits, and the increasing awareness that the poor need savings facilities just as much as credit, if not more so, raises the question of whether MFIs should be regulated and supervised.

The chapter then attempted to review the major characteristics of microfinance systems in Asia, Latin America and Africa. Overall, MFIs have had the greatest impact in Asia, where it has achieved the greatest breadth of outreach. This is primarily attributable to the high

population density and the low costs of delivering microfinance services in this part of the world. From the studies reviewed, it is evident that Asian MFIs have achieved greater depths of outreach, with the lowest median loan size and deposit size. Latin America has lower depth of outreach, with the highest median loan amounts. However, this may be reflective of the fact that it has the highest average GNP per capita of the three continents, as well as an orientation towards the provision of credit for microenterprise development. Moreover, Latin American MFIs have made the most progress towards achieving financial self-sustainability.

It was not possible to draw any conclusions regarding the institutional types that predominate on the different continents, although it was noted that a relatively large number of MFIs in Africa take the form of savings cooperatives. This is due to the diversity of institutional types and microfinance methodologies employed for the delivery of microfinance services across continents, within continents, and even within countries. The analysis was severely constrained by the lack of information available, especially for Africa, on the microfinance sector. The sheer diversity of institutional types and delivery methodologies makes the development of an appropriate regulatory and supervisory framework all the more challenging. "Thus any approach to regulation and supervision needs to recognise their heterogeneity and accommodate the flexibility and scope for development that MFIs need" (Hardy et al, 2002: 20).

3 FINANCIAL SECTOR REGULATION AND SUPERVISION

3.1 INTRODUCTION

Interest in the regulation and supervision of MFIs has arisen from their growth and their desire to mobilise deposits. The debate surrounding whether MFIs should be regulated and supervised lies in the belief that through regulation, they will become self-sustainable and achieve massive outreach. Through regulation, MFIs can also be integrated into the formal financial sector. In some countries, MFIs have grown to such an extent that the failure of one could result in the loss of confidence in the financial sector, thus attracting regulatory concern.

When regulation is discussed in relation to MFIs, it is usually in terms of 'banking type' regulations, what is termed 'prudential' regulation. In other words, MFIs should be regulated in the same manner as banks, by the same supervisory authority, usually, but not always, the central bank. Although MFIs have different characteristics and risk profiles from traditional formal FIs, such as banks, deposit-taking (DT) MFIs can be likened most closely to banking institutions. There is need to ask, therefore, whether "microfinance is essentially different from other forms of financial intermediation or is just a variant of basic banking" (Vogel et al, 2000: 4). It is within this context, i.e. the prudential regulation of MFIs by the central bank, that this thesis explores the regulation and supervision of MFIs.

This chapter discusses regulatory and supervisory issues in relation to the financial sector and more specifically, MFIs and is organised as follows. Section 3.2 defines regulation and supervision and distinguishes between the different types of regulation. Section 3.3 then discusses the rationale for regulation. Section 3.4 reviews the regulatory theories in which the broader debate for the role of government has been set, followed by a discussion of regulatory failure and the arguments against regulation in section 3.5. Section 3.6 goes on to examine the arguments cited in the literature for regulating and supervising MFIs. It explains why traditional 'banking' type regulations and supervisory tools are not suitable for MFIs taking into consideration MFI distinctive characteristics. This is followed by section 3.7 which appraises the different regulatory approaches that may be taken to regulate MFIs. The last section summarises and concludes.

3.2 DEFINITIONS OF REGULATION AND SUPERVISION

Historically, financial services, FIs and financial markets have been more heavily regulated in all countries than virtually any other industry (Benston, 1998). "It is almost universally assumed that this should be so and that the risk taking activities of financial institutions should be constrained" (Llewellyn, 1986: 9). For various reasons, most notably market failure, the government has on numerous occasions stepped in to regulate the financial sector (Benston, 1998; Francis, 1993), with the overriding objectives of maintaining financial system stability, through systemic stability and maintenance of the safety and soundness of FIs, and depositor protection (Goodhart et al, 1998; Llewellyn, 1999).

Thus, regulation is usually thought of in terms of state regulation, but this need not be the case. In instances of state intervention, enforceable public regulation replaces market incentives with government mandates. Regulation must be able to correct market failure in an effective and efficient manner. According to Vittas (1991) much of the debate among the alternative theories of regulation is about the cost and effectiveness of regulation rather than about its rationale. The more government regulation mimics regulation by efficient markets, the more effective it will be. For regulation to be effective it must be enforceable (Chaves and Gonzalez-Vega, 1994). Government's involvement in the process of regulation, directly or indirectly, is important because ultimately, it is only the government that has the legal power to enforce compliance (Benston, 1998).

Regulation is defined by Mitnick (1980: 5) as the "intentional restriction of choice by a party not directly involved in, or performing the regulated activity". However this definition implies that market participants are not party to the rule making process which may not necessarily be the case, especially in instances of self-regulation. A more inclusive definition is given by Chaves and Gonzalez-Vega (1994: 55) as "a set of enforceable rules that restrict or direct the actions of market participants and as a result alter the outcomes of those actions". Llewellyn (1986: 9) provides a more elaborate definition of regulation as "a body of specific rules or agreed behaviour, either imposed by some government or other external agency or self imposed by explicit or implicit agreement within the industry, that limits the activities and business operations of financial institutions". Thus, regulation may be performed by the market itself (self regulation), without government intervention, or with the participation of other external forces. The main theme running through all these definitions is that the behaviour and decisions of market participants is influenced in some manner by these rules

and as a result, the outcome is not necessarily what it would have been in the absence of the regulations.

Although the terms 'regulation' and 'supervision' are sometimes used interchangeably, supervision "is the systematic oversight of market participants to ensure they comply with the rules" (Christen and Rosenberg, 2000: 1). Llewellyn (1986: 9) defines supervision as "the process of monitoring that institutions are conducting their business either in accordance with regulations or more generally in a prudent manner". Therefore, "regulation typically refers to the rules that govern the behaviour of financial institutions whereas supervision is the oversight that takes place to ensure that financial institutions comply with those rules" (Barth et al, 2006: 4). The distinction is important where the regulatory and supervisory functions are split between different agencies as they may have different policy implications.

In the area of financial regulation, a further distinction is made between 'prudential' and 'systemic' regulation. "Systemic regulation is about the safety and soundness of financial institutions for purely systemic reasons (i.e. because the social costs of the failure of an institution exceed the private costs). … prudential regulation is about the safety and soundness of an institution vis-à-vis consumer protection, in that the consumer loses when an institution fails, even if there are no systemic consequences" (Goodhart et al, 1998: 5). Yet a further distinction is made in the literature between 'prudential' and 'conduct of business' regulation. Prudential regulation "focuses on the solvency and safety and soundness of financial institutions" (Llewellyn, 1999: 10). Thus regulators are most likely to have a prudential concern for the liquidity, solvency and riskiness of FIs.

Conduct of business regulation, on the other hand, "focuses on how financial firms conduct business with their customers" (Llewellyn, 1999: 10). It focuses on the functions of financial firms, irrespective of the type of firm conducting the business, and covers issues of information disclosure, the honesty and integrity of firms and their employees, minimum standards for firms supplying financial services and products, fair business practices and the marketing of financial products. Overall, conduct of business regulation is designed to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers. In practice, however, it is often difficult to distinguish between the two. The debate as to whether MFIs should be regulated and supervised tends to be clouded because those involved seldom explicitly state what type of regulation is being referred to.

3.3 THE RATIONALE FOR REGULATION OF FINANCIAL INSTITUTIONS

3.3.1 Introduction

One of the principal reasons for government regulation is to correct market failure. This is sometimes referred to as the 'economic' rationale for regulation (Llewellyn, 1999). Market failure is said to exist when the market is unable to produce an outcome that maximises economic welfare. Regulation in such cases is justified because an "uncontrolled market place will, for some reason, fail to produce behaviour or results in accordance with public interest" (Baldwin and Cave, 1999: 9). In some cases, there may be no market at all, i.e. there is 'market absence'. "Providing regulation is properly constructed, it reinforces the efficiency of, rather than detracts from, market mechanisms" (Llewellyn, 1999: 48). There are a number of reasons for market failure, stemming most notably from the existence of externalities, information asymmetry, public goods and monopoly power (Majone, 1996; Llewellyn, 1986; Goodhart et al, 1998; Cook et al, 2003).

Externalities occur when the price of a product does not reflect the true cost to society of producing that good. In the case of negative externalities, because individuals and firms do not bear the full costs of the negative externalities they generate, they will tend to engage in an excessive amount of such activity. External intervention is needed to reduce the gap between the private costs of individuals and the true cost to the society of the activity producing the externality (Baldwin and Cave, 1999).

A second cause of market failure occurs when information needed for an informed choice is either lacking or asymmetrically distributed between firms and their customers (Majone, 1996). This may be due to the fact that the information may be too costly to produce, or the incentives to produce the information are very low or nonexistent, because the producer of the information may not be compensated by users of the information produced. Market failure also occurs when consumers and producers are unable to make optimal decisions in order to maximise their welfare despite the information being available. It may be that consumers, for instance, do not have the necessary expertise to make use of the information (Cook et al, 2003).

The third instance of market failure arises in the case of pure public goods. Public goods have two distinctive features. The first feature is that it does not cost anything for an additional individual to enjoy the benefits of these goods. The second feature is that it is very difficult, if

not impossible, to exclude individuals from the enjoyment of such goods. Because of these features, there are no economic incentives for the market to provide sufficient levels of these goods, if any at all. Therefore, they are often provided by the state (Majone, 1996).

Lastly, market failure arises where there are considerable economies of scale or scope, and the duplication in the supply of the good or service would be uneconomical[12] (Majone, 1996). Thus, regulation to correct for market failures will result in the overall objectives of financial sector regulation, namely financial system stability and depositor protection, being achieved. The following subsections discuss these market failures in more detail with specific reference to the financial sector.

3.3.2 Systemic considerations

Because DT FIs, especially banks, are closely connected to each other financially through the inter-bank market, the payments clearing system and the holding of deposit balances, the failure of one FI is likely to affect another and do so more quickly than the failure of a firm in another industry. The banking system is, thus, perceived as being more susceptible to systemic risk, "the risk that disturbances in a financial institution or market will spread across the financial system, leading to widespread bank runs by wholesale and retail depositors, and possibly, the collapse of the system" (Heffernan, 1996: 218).

The systemic argument is based on the premise that risk taking by FIs should be regulated; because unlike in other industries, the failure of a FI may, through confidence and contagion effects, undermine the stability of the financial system as a whole. It implies that exit is more costly than in other sectors because of substantial externalities related to disruptions in the provision of financial services, especially credit, which may have a knock on effect on the economy. This systemic risk would not be factored into the FI's pricing or portfolio behaviour as the market mechanism assumes a zero cost of exit from the industry (Llewellyn, 1986). Closely tied in to this argument are the macroeconomic effects of bankruptcy of a FI. Bankruptcy may disrupt the flow of credit to particular borrowers which may have knock on effects on the rest of the economy. Affected borrowers may have to cut back on their activities with further repercussions on their customers and suppliers.

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[12] In developing countries, natural monopolies may be pervasive because the market is insufficiently large to sustain a number of competing operators operating at an efficient scale (Cook et al, 2003).

Thus, regulation for systemic reasons is warranted when the social costs of the failure of a FI, particularly banks, exceed private costs and such potential social costs are not incorporated in the decision making of the FI. In this way, regulation contributes to the attainment of the overriding objective of financial system stability. However, these considerations are less applicable to non-bank financial institutions (NBFIs). Firstly, systemic risk is less evident and often does not exist at all. Secondly, contagion is less likely because of the nature of the contracts involved[13]. Thirdly, the potential disruption of the payments system does not arise. Lastly, so long as there is no perceived lender of last resort, problems of moral hazard[14] do not arise (Llewellyn, 1999).

3.3.3 Information disclosure

There is an asymmetrical relationship in many financial transactions between the provider and the consumer. Because of the information asymmetries associated with financial transactions, consumers may have inadequate information and tend to be less well informed than the suppliers of financial services (Benston, 1998). Consequently, consumers can be more easily exploited and have problems in assessing the quality of services and products being purchased, or the safety and soundness of FIs, except at inordinate cost.

Furthermore, information is in effect a pure public good (Llewellyn, 1999). Its consumption by one individual does not detract from another's consumption and it is very costly, if not impossible, to exclude others from its consumption. Thus, there are (positive) externalities involved in its acquisition. Others benefit from the information acquired by an individual, what has been termed the 'free-rider' problem. Because of these features, there will be underinvestment. Thus, markets which are information intensive, such as financial markets, are likely to be imperfectly competitive and generally inefficient.

Information disclosure is a particularly important element in regulation, thus alleviating the information asymmetry problem. Disclosure of relevant information is considered an essential ingredient of customer protection. Mandatory disclosure facilitates comparison between alternative products and hence lowers consumers' transaction costs, if disclosure is made on the same basis by all firms. Furthermore, standardised information can help

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[13] Banks rely on potentially volatile, unsecured short-term deposits for the bulk of their funding, whereas most other FIs have a much higher proportion of long-term funding (Llewellyn, 1999).

[14] Moral hazard occurs when: (1) depositors are no longer concerned about the solvency of their bank; and (2) bank managers take on greater risk because bank owners get positive outcomes and losses are restricted due to the existence of safety net arrangements, such as lender of last resort and depositor insurance (Benston, 1998).

consumers make choices. Lastly, the consumer is often uncertain about what is relevant information to demand when complex products are involved. Thus, mandatory disclosure sets out the minimum disclosure requirements on a consistent and standardised basis that all firms must adhere to for all retail customers (Benston, 1998).

3.3.4 Economies of scale in monitoring

Because of the nature of financial contracts between financial firms and their customers[15], the behaviour of financial firms must be continuously monitored. This is particularly important for long-term contracts since customers can not exit at low cost. Although not as applicable to depositors as they can exit at low cost, depositors may not have the necessary information to make such a decision. This monitoring can not be undertaken effectively by customers as it is too costly. In effect, customers delegate monitoring to a supervisory agency and the agency supplies monitoring services to customers of financial firms.

There are potentially substantial economies of scale to be gained through the collective regulation, supervision and monitoring of financial firms (Llewellyn, 1999). This avoids duplication and excessive social costs resulting from the loss of economies of scale gained from a specialist regulator acquiring expertise and establishing effective monitoring systems. Therefore, the monitoring of FIs is a 'natural monopoly', in that its duplication by several parties is technically wasteful. By delegating monitoring in this manner, consumers are able to reap the benefits of expertise and economies of scale and the 'free-rider' problem is avoided.

3.3.5 Confidence

Asymmetric information may reduce the demand for financial services because consumers are unsure of the quality of the financial services being purchased (Benston, 1998; Llewellyn, 1999). Risk averse consumers may exit the market altogether. In extreme cases the market may totally breakdown because customers are unable to distinguish between high quality and low quality products. Regulation provides customers with some independent quality assurance of the services being purchased. A role for regulation is to set minimum standards and remove low quality products from the market. In this respect, suppliers will also have an interest in regulation which sets common minimum standards and enhances confidence in the market by requiring all firms to adhere to these standards. Regulation can thus have a positive and beneficial effect by offering a guarantee that all FIs will behave within certain standards

[15] These characteristics include the long term nature of contracts, principal agent problems, problems of ascertaining the quality of financial products at the point of purchase and the fiduciary role of FIs.

preventing firms from adopting short-term time horizons and behaviour that results in short-term gains because they can not distinguish themselves from the 'bad' firms. Overall, consumer confidence in FIs appears to be greater when they are supervised by government agencies.

Thus, customers may demand a degree of comfort that can only be provided by regulation for reasons already noted. In addition to these, consumers may prefer regulation to prevent bad behaviour by financial firms as an alternative to claiming redress after the bad behaviour has occurred. One of the roles of regulation is to authorise or license suppliers of financial services. In this role there is a case for excluding those that will not meet certain minimum standards. Shareholders, directors and senior management are also screened with respect to their probity, qualifications and experience in running FIs. In this way, the probability of FIs being owned and managed by dishonest individuals, and hence bad behaviour, is reduced. Consequently, risk adverse consumers may be willing to pay for regulation. Although there are costs involved, Llewellyn (1999) argues that there is a welfare gain to be secured if, within reason, this demand for regulation is satisfied.

However, there is a major limitation to this argument in that consumers may have an illusion that regulation is a free good, in which case demand is distorted (Benston, 1998; Llewellyn, 1999). Because consumers do not explicitly have to pay for regulation and supervision and the costs are not obvious to consumers or taxpayers, it is seen as a 'free' good. Therefore, consumers need to be aware that regulation is supplied at a cost, even if the cost, hence price, cannot be precisely calculated.

3.3.6 Benefits of regulation to industry

The industry also stands to gain from regulation. To the extent that it enhances competition and overall efficiency in the industry, regulation creates a market which works more efficiently. If consumer confidence is improved by setting minimum standards, the increased demand for financial services and products is beneficial to both consumers (to the extent that they are no longer discouraged from buying what might be desirable and competitive products) and the industry itself. To the extent that 'cowboys' are removed, the industry's reputation is enhanced through the removal of badly behaved firms that contaminate the reputation of all firms in the industry. Similarly, regulation benefits the industry to the extent that it guarantees to all firms, that what they believe to be appropriate behaviour will also be followed by their

competitors. Lastly, in the case of prudential regulation, financial firms' own counterparty risks should be reduced. As the industry also stands to gain, the regulatory process need not be antagonistic in nature (Llewellyn, 1999).

3.4 THEORIES OF REGULATION

The next part of this chapter looks at the broad conceptual frameworks for financial sector regulation. Government interventions in the financial sector can be examined from the perspective of the broader debate on the role of government in the economy. Two opposing strands of regulation theory set the boundaries for this debate, the 'public interest' view and the 'private interest' view.

3.4.1 The public interest view

The public interest approach is one that has dominated thinking on regulation for most of the twentieth century and is still taken for granted in discussions of regulation (Barth et al, 2006). This approach, sometimes referred to as the 'helping hand' view, centres on the idea that those seeking to introduce or develop regulation do so in pursuit of public interest related objectives rather than group, sector, or individual self interests. Those advocating regulation thus act as agents of the public interest.

This public interest view assumes that there are significant market failures and government has the incentives and capacity to correct these market failures. In other words, "Public interest assumes that the state, acting in the public interest, establishes a legal framework to realise a specific set of regulatory objectives" (Llewellyn, 1986: 11). The emphasis is on the credibility and disinterestedness of expert regulators in whose public-spiritedness and efficiency the public can have confidence (Baldwin and Cave, 1999). The purpose of regulation, therefore, is to offset market failures which would work to the disadvantage of consumers if market mechanisms were allowed to operate unchecked.

The public interest is one that achieves the greatest overall good (Francis, 1993). In the financial sector, the public interest would be served if the financial system allocated resources in a socially efficient manner and performed well the other functions of finance, namely, facilitating payments, mobilising savings, allocating capital, monitoring managers, and providing tools for risk management. Regulation in the finance sector has, thus, been justified on notions of public interest. In other words, left to itself, the market would not produce efficient outcomes. The public interest view takes as given that financial sector supervisors

can overcome market imperfections and that they have the incentive to do so. Thus, strong, official supervision helps prevent FIs from engaging in excessively risky behaviour, thereby improving FIs' performance and stability. The public interest view involves adopting regulatory practices that increase output and opportunities for the many, while minimising unnecessary risks. Because financial sector crisis are expensive, reduce growth and worsen income distribution, their prevention is often is an explicit goal (Barth et al, 2006).

However, early empirical studies of the effects of regulation generally concluded that regulation failed to achieve the results that a public interest theory of regulation would have implied, namely to correct market imperfections so as to simulate the welfare maximising conditions of perfect competition and customer protection (Baldwin and Cave, 1999). The most likely explanation underlying the objectives of regulations were, therefore, different from the stated ones, giving rise to the notion that the regulatory process was subject to 'capture' as put forward by Stigler (1971) and Peltzman (1976). Capture theorists argue that public interest theory understates the degree to which economic and political power influences regulation. Regulatory policies and institutions are often influenced by those who are regulated, politicians, or consumers, so that regulation serves the interests of these groups rather than those of the general public (Majone, 1996; Posner, 1974). Thus many instances of regulation are not necessarily a result of a desire to correct market failures.

Secondly, it is questionable as to whether regulators are in fact 'disinterested'. It has been argued that regulators may be corrupted by opportunities for personal gain, so that regulation is biased by the pursuit of personal interests. Related to this is the notion that regulators are, or may become, incompetent and, therefore, do not achieve the desired outcomes, nor do they have the relevant expertise and efficiency attributed to them by the public interest view. Such a situation may arise due to inadequate salary and reward structures within the regulatory agency to attract the right calibre staff or because training needs and disciplinary emphases are poorly met (Mitnick, 1980; Baldwin and Cave, 1999).

A reformulation of the public interest view attempts to correct some of the weaknesses identified by arguing that, although regulations were initially intended to serve public interests, the regulatory process was subsequently mismanaged with the result that the original objective was not always achieved (Posner, 1974). "Regulators simply lacked an independent basis for judgement and gradually become the allies of the industry" (Francis, 1993: 27).

3.4.2 Private interest view

Although it accepts the presence of market failures, the private interest view considers regulation as a product, with suppliers and demanders interacting to determine the exact shape and purpose it serves. Governments are usually the main suppliers, and although consumers may demand regulation, industry itself is an important influence on the demand side, both for and against, certain types of regulation (Stigler, 1971; Posner, 1974; Peltzman, 1986).

Stigler's seminal paper of what has been referred to as a 'theory of regulatory supply and demand', was an attempt to provide a theoretical foundation for the concept that regulatory agencies are captured by producers. The central task of this theory was to explain who will benefit or bear the costs of economic regulation, what form regulation will take, and the effects of regulation on the allocation of resources (Stigler, 1971). The underlying theme in his theory is that since the state's coercive power can be used to benefit particular individuals or groups through economic regulation, the expression of that power can be viewed as a product whose allocation is governed by demand and supply (Posner, 1974). Political actors are presumed to be utility maximisers whose utility function includes securing and maintaining political power (the supply side). To achieve this objective, the politician needs votes and money which can be provided by groups positively affected by regulatory decisions, i.e. the constituents (the demand side). The essential commodity being traded in the political market is a transfer of wealth (Peltzman, 1976). Stigler's model, however, fails to take into account the role played by the regulatory agency. Regulatory agencies often have considerable discretion, are often not elected and are not necessarily subject to political appointment. They may be civil servant employees (Mitnick, 1980).

Related to the concept of 'regulatory capture' is the notion of 'political capture'. Political capture involves the regulatory machinery being used primarily to further the interests of government members. Regulation is shaped to advance the interests of the political elite and regulatory measures may be modelled to improve their economic welfare. Governments with powerful supervisory agencies could use this power to benefit favoured constituents, attract campaign donations and extract bribes (Barth et al, 2006). Powerful regulators, according to this view, will not focus on overcoming market failures and boosting social welfare; rather, they will focus on promoting their private interests. And even if supervisors attempt to behave in the public interest, they may be pressured by politicians motivated more by private concerns. "Political capture is thus a form of regulatory capture under which regulation is

designed and promoted to meet the needs of the political elite and to preserve its power" (Cook et al, 2003: 13). According to this view, powerful regulation and supervision will be positively related to corruption and negatively associated with performance with little or no benefit to financial stability (Barth et al, 2006).

Applied to the financial sector, the private interest view would expect regulations that enhance the power or well-being of FIs and the politically well-connected. It is the central role of FIs, especially banks, that attracts the interests of various interest groups. These groups compete in attempting to manipulate policies towards FIs in ways that favour themselves, even if these policies do not maximise social welfare. Furthermore, regulatory authorities in some countries may have been positively influenced to support 'modern prudential regulation and supervision' because it enhanced their budgets and other perquisites (Barth et al, 2006). Accordingly, the private interest view supports greater reliance on market discipline, information disclosure, a light hand by the regulatory authorities, and significant oversight of the regulatory process itself.

The private interest view maintains that the government regulates the financial sector to facilitate the financing of government expenditure, to funnel credit to politically attractive ends and, more generally, to maximise the welfare and influence of politicians and bureaucrats, even when loftier, public interest objectives are the ostensible goal. So although there may be significant market failures in the financial sector, the private interest view casts a cautious eye on an approach to regulation based on reliance on powerful official regulatory agencies.

3.5 REGULATORY FAILURE AND LIMITATIONS

3.5.1 Regulatory failure

Consequently, critics argue that market failure is not a sufficient justification for government intervention since 'regulatory failure' may have more serious consequences than market failure (Majone, 1996). Because the state is powerful and probably omnipotent, it becomes a source of patronage and economic advantage. Regulation is either at the outset set to favour special interest groups (the private interest view), or even if its origins lie in true concern with market failure (the public interest view), it is over time 'captured' by special interests intent in promoting their own economic agenda. The result is then a degree of state failure that could even exceed the market failure that regulation is supposed to correct (Cook et al, 2003).

Linked to this concept of regulatory failure, is the 'ineffective hand' view of regulation (Barth et al, 2006). It does not question the existence of market failures, or the incentives of the government. According to the ineffective hand view, even if there are market failures and even if governments demonstrate exemplary integrity, official regulation might be generally ineffective at actually easing market failures. It might be that the regulatory agency's responsibilities are simply too onerous. For instance, how will a supervisor in a country with poor accounting and auditing standards assess the riskiness of a FI? Regulatory agencies generally have problems attracting and retaining skilled staff in developing countries. The combination of ambitious mandates, which even the best regulatory agency in the world could not satisfy, inadequate skills, and meagre resources could result in a regulatory environment that does not achieve its goals. In contrast to the public interest view which would predict that stronger official supervision will boost financial sector performance and stability, the ineffective hand view would expect no improvement at all, even in the absence of any undermining of regulation by private interests.

3.5.2 Limitations of regulation

Therefore, there is need to acknowledge that there are limits to what regulation and supervision can realistically achieve. External regulation and supervision by official agencies is not an alternative to robust and effective internal supervision processes and responsibilities. The management of FIs are not absolved of their responsibilities simply because there is external supervision. Consumers need to be aware of the limitations of regulation; otherwise the demands placed on regulation will be excessive and result in costs far exceeding any benefits for such demand to be met. Thus, regulation may encourage moral hazard on both the part of consumers, who are less likely to exercise due care and diligence, and owners and managers, who are more likely to engage in risky behaviour. "There needs to be a public policy recognition of the limitations of regulation; that it has only a limited role; that even in this restricted dimension it can fail; that not all risks are covered; and that the optimum level of regulation and supervision falls short of eliminating all possibility of consumers making wrong choices in financial contracts" (Llewellyn, 1999: 51). Further, there may be occasional incidences of regulatory lapses and failures. However, these are a powerful signal and disciplining mechanism which should be regarded as the necessary cost of an optimum regulatory regime that takes account of the costs that regulation can impose on consumers and regulated firms.

Second, critics argue that regulation may overestimate either the severity or possibility of risks. By seeking to render products or services risk free, regulations may generate such costs that outweigh any potential benefits (Francis, 1993). This preoccupation with minimising risk must be weighed in light of the practicability of producing a risk free environment. Products and services may have both good and bad features. Focusing excessively on minimising risk will thus eliminate many good products and services from the market.

Third, because regulation is costly and burdensome for suppliers, it can lead to declining competitiveness (Francis, 1993). Regulation can also be welfare reducing if, for instance, it "raises unnecessary entry barriers, restricts competition in other ways, controls prices, stifles innovation, restricts diversification by financial firms and impedes market disciplines on financial firms" (Llewellyn, 1999: 53).

Lastly, the steady increase of regulatory objectives leads to 'over-regulation' (Francis, 1993). As regulation continues, other values, such as income distribution, enter into the regulatory framework. This leads to regulatory complexity which firms may find difficult to meet. Also, there may be a paradox to over-regulation: regulators are given so many responsibilities that they are unable to regulate effectively.

3.6 THE REGULATION AND SUPERVISION OF MFIS

3.6.1 The rationale for regulating and supervising MFIs

As for other FIs, similar reasons have been put forward for the regulation and supervision of MFIs, with the overall objective of achieving financial system stability and depositor protection. However, these objectives as they relate to the microfinance sector are questionable. In relation to the first objective of maintaining financial system stability, as noted in section 3.2, systemic risk is less evident and often does not exist at all, contagion is less likely, the potential disruption of the payments system does not arise and the problems of moral hazard are less likely in the case of NBFIs.

In most countries, MFIs' total assets when compared to the total assets of the financial sector are too small and insignificant to warrant regulation and supervision on the basis of financial system stability (Berenbach and Churchill, 1997). There are exceptions to this, though, such as Bangladesh, where MFIs have grown to such an extent that the failure of one of the larger MFIs would adversely affect confidence in the financial sector. Similarly, in the Philippines,

MFIs (rural banks) are integrated into the payments system. Thus, the failure of an MFI may disrupt the smooth operations of the payment system.

In relation to the second objective, it is argued that prudential regulation and supervision is justified on the grounds of protecting depositors and should be carried out by the government agency responsible for the financial sector, usually the central bank. However, only DT MFIs need to be prudentially regulated, and common bond institutions, such as village banks and ROSCAs, may be excluded (Chaves and Gonzalez-Vega, 1994). While recognising the need for depositor protection, Wright (2000b) states that it is naively optimistic to think that a system of central bank regulation and supervision will secure deposits. He cites a number of examples, such as the Bank of Credit for Commerce and Industry (BCCI) which was regulated by the Bank of England and the Loans and Savings debacle in the United States of America (US), where regulators failed in this respect. In developing countries, central banks, with resource and capacity constraints, often have problems regulating the commercial banking sector. They can not, therefore, realistically be expected to regulate and supervise large numbers of MFIs, of which they may have little understanding, and that may be geographically dispersed throughout a country.

Wright (2000b) also cautions against the prevention of MFIs from offering savings facilities simply because they are not subject to regulation. Individuals are willing to take risks as long as they believe the risks to be worthwhile, and this is a decision the poor should be allowed to make for themselves. The poor are often obliged to save informally; in livestock, jewellery, 'cash under the mattress', and or with other individuals, e.g. *susu* collectors in Ghana. In addition to being illiquid and indivisible, such alternative forms of savings are usually riskier than deposits with an MFI; cash may be stolen, livestock may die. Clients are often well aware that such institutions might be risky, but continue to use them as the alternatives are perceived to be riskier. "A policy of prohibiting MFIs (community based ones) from providing savings services simply because they are small or too remote to be supervised effectively is tantamount to telling people in those communities that if high-quality (i.e. effectively supervised) deposit services can't be delivered to them, then they should have no deposit services at all" (Christen and Rosenberg, 2000: 11).

Drawing on the results of Lapenu and Zeller (2002), noted in section 2.7, in which 91.5% of institutions with more than 100,000 members were regulated; but a large number of NGO

MFIs which accounted for 61% of the total number of institutions sampled, but whose loans and savings volumes accounted for less than 2% of the total, were unregulated, brings into question the benefits, as well as the practicalities of a 'central bank' based approach to regulating such a large number of institutions that account for a very small proportion of transactions, especially as it may not be possible for the smaller MFIs to be effectively supervised, nor for them to be transformed into banks or other formal FIs. Nevertheless, the objectives of maintaining financial system stability and depositor protection are often cited in arguments favouring the regulation of the microfinance sector.

In addition to the above, advocates argue that the 'massive sustainable delivery of financial services to the poor' can only be achieved in a regulated setting (Christen and Rosenberg, 2000; Robinson, 2001). Therefore, although they do not necessarily justify prudential regulation, the following reasons are sometimes put forward for the regulation and supervision of non deposit-taking (NDT) MFIs. First, regulation can increase access to funding by signalling to potential investors that the MFI is sound. Also, in some jurisdictions, access to certain lines of funding may be dependent on regulation. A second reason often given is that regulation is needed to ensure the effective use of public (and donor) resources if the MFI has access to government credit lines for on-lending. However, both these reasons are questionable as wholesale lenders, whether public or private, should assume responsibility for monitoring their loans and investments and not delegate this function to bank supervisors (Berenbach and Churchill, 1997; Staschen, 1999; Christen and Rosenberg, 2000).

The third reason given is that regulation, by raising the minimum performance standards in microfinance, can promote sustainable FIs, thus contributing to financial sector development. Donors and governments sometimes think that setting up a special regulatory window for microfinance will speed up the emergence of sustainable MFIs. However, Christen and Rosenberg (2000) note that it is the absence of licensable MFIs, and not the absence of a tailor-made regulatory regime, that limits the growth of microfinance. They also state that bank supervisors are better at 'excluding' or 'shutting down' bad organisations rather than 'improving' them.

Fourth, regulation is needed to clarify the legal position, particularly of NGO MFIs. In some countries, it is illegal for NGOs to offer credit because it is not an activity explicitly authorised under which the NGO is registered. In many countries, the financial laws, if interpreted

strictly, would prohibit anyone without a financial institution licence from providing credit facilities, regardless of the source of funds (Druschel, 2005). Under these scenarios, loans may be legally uncollectible, and MFIs may be at risk of prosecution (Christen and Rosenberg, 2000). Additionally, unclear legal status deters the growth of the industry and its attractiveness to private investors.

Fifth, regulation is advocated to prevent the poor from being exploited, especially with regard to high interest rates; either by setting interest rate ceilings, or through the clear and transparent disclosure of interest rates and charges. Lastly, resulting from the high political profile that microfinance has been getting since the 1997 Microcredit Summit, attention to regulation may have sprung simply "from a government's sense that it has to do something, for reasons that may combine concern for the poor and the demands of practical politics" (Christen and Rosenberg, 2000: 2).

3.6.2 Risks associated with MFIs

In developing an appropriate framework for the regulation and supervision of microfinance, it is important to note that MFIs differ from traditional commercial banks in a number of respects and that the risk features of commercial banks are not directly applicable to microfinance. Consequently, many of the regulatory and supervisory features adopted to address the risks of standard commercial banking FIs do not apply to MFIs. In addition to the other risks that FIs typically have to deal with[16], the literature identifies ownership and governance, management, portfolio and new industry risks as being particularly pertinent to MFIs (Berenbach and Churchill, 1997). Thus, an appropriate regulatory framework must take into account the risk profiles of MFIs.

Because owners of MFIs tend to be, or have evolved from, donors and donor funded agencies, government agencies, and socially responsible commercial investors, the ownership and organisational structures of MFIs are often opaque. Owners and directors do not usually have the knowledge or experience to manage an MFI. Their priority lies in meeting their social objectives. In many instances, there may be political interference. In cases where there is private individual ownership, these are often minority interests and, therefore, the appropriate level of oversight is not exercised. External oversight can not replace the

[16] These include balance sheet structure risk, profitability risk, solvency/capital adequacy risk, credit risk, treasury risk (consisting of liquidity, interest rate, market and currency exposure risk) and operational risk (van Greuning et al, 1998).

accountability that stems from proper governance and supervision performed by the owners and directors of FIs (van Greuning et al; 1998, Llewellyn, 1999). In addition, MFI owners may lack the financial depth required to inject more capital when needed. Donor and government institutions have to go through lengthy approval processes to secure the disbursement of funds; private sector investors with modest holdings may be unwilling to place more funds into a troubled organisation. Thus, MFIs may face problems raising additional capital promptly (Berenbach and Churchill, 1997). This makes MFIs more vulnerable to temporary shocks that could quickly undermine the financial health of the institution.

Management risk arises because of the delivery methods used to service this market. This risk tends to be high due to the decentralised operating methods, high volumes, low returns per loan, rapid portfolio turnover and requirement for efficient service delivery. Management must be familiar with microfinance methodologies as well as have banking experience. Thus, the quality of management to ensure brisk and timely services is essential to the financial success of microfinance portfolios (Berenbach and Churchill, 1997).

Portfolio risk arises because most loans are unsecured and alternative forms of collateral, such as character references and group guarantees, may not be legally enforceable and have little liquidation value. The management of delinquency rates is very important as delinquency problems become very serious very quickly and could rapidly cause deterioration in the MFI's capital base, especially if it affects borrowers' access to further loans. If borrowers believe that they will not have access to further loans, this removes one of the major incentives to repay. Additionally, it is argued that MFIs are more susceptible to sector or geographic concentration risk as their clients are more likely to come from a single geographic area or market segment that is vulnerable to common economic shocks (Christen and Rosenberg, 2000). Also, unlike other FIs, their products tend to have highly specialised portfolios that consist of short-term working capital loans to informal sector clients.

New industry risk results from the fact that this is a relatively new industry and the products, services and methodologies are relatively new and untested. Its growth has to be managed carefully and the challenge lies in developing a trained cadre of employees, implementing standard policies and procedures and maintaining portfolio quality. Additionally, there is little knowledge about the market's performance over time and most institutions are relatively

young (Christen and Rosenberg, 2000). Therefore, there is much to learn about how these institutions will behave in a crisis. However, this risk is likely to decrease over time as the industry matures.

3.6.3 Considerations in developing the regulatory framework for MFIs

Differences between MFIs and traditional formal FIs, and the risk profiles highlighted above, mean that a modified approach is required to the regulation and supervision of MFIs[17]. The following are some of the considerations that need to be borne in mind. Firstly, it has been suggested that minimum capital requirements should be lower than for banks. The small loan amounts would mean an inordinate number of clients would be necessary to attain adequate leverage. A decision also needs to be made as to what form this minimum capital should take. It has been suggested that performance benchmarks such as capital adequacy ratios should be higher for MFIs than for comparable banks because of the risk profile of MFIs, particularly with regard to management and portfolio risk.

Secondly, due to the ownership and governance structure of MFIs, supervisory tools used for banks, such as capital calls, would not be suitable for MFIs (Staschen, 1999b; Christen and Rosenberg, 2000). Preventing an MFI from lending would lead it into worse financial condition extremely quickly as clients often repay loans in the hope of accessing another. Therefore, if an MFI were to stop new lending, it is likely to result in existing loans not being repaid. The MFI's principal asset, microloans, is valueless once it is out of the hands of the team that originated the loans. With regard to provisions and write-offs, the higher volatility of the loan portfolio quality and shorter loan periods means reserves should be more conservative and write-offs made earlier than in traditional FIs while catering for different loan terms.

In some countries, there are limits to how much can be lent out unsecured. In most cases, the security accepted by MFIs is not recognised by bank regulators and supervisors. Portfolio reporting requirements would have to be appropriate to the volume, loan size and term of MFI transactions (Berenbach and Churchill, 1997; Christen and Rosenberg, 2000). Loan documentation for MFIs consists of simple loan application forms and basic cash flow analysis. Details as for banks are generally not required. Therefore, portfolio examination would not be appropriate in the manner carried out for banks due to the volume and

[17] For a brief account of the manner in which formal banking institutions are regulated and supervised, refer to Appendix 17.

simplicity of documentation required. It is more important to examine trends in the performance of the portfolio as a whole.

Lastly, serving clients in their communities during convenient times is a critical element to achieving sound micro lending portfolio. Therefore, MFIs need to operate close to their target market during business hours that the MFI has identified as the most appropriate. Thus, regulations in relation to branching would need to be more lenient than those for banks.

3.6.4 A framework for regulating MFIs

Van Greuning et al (1998) propose a framework for regulating MFIs (hereon referred to as the 'Greuning Regulatory Framework') dependent on an MFI's liability structure. They analyse MFIs' liabilities to highlight distinguishing features of different types of MFIs and focus on risk-taking activities that need to be managed and regulated. According to these authors, the important factors that differentiate MFIs from each other are found mainly on the liabilities side rather than the asset side of the balance sheet. It is the source of funding that determines the regulatory and supervisory issues that need to be addressed. A risk based approach to financial regulation focuses on the uses of those funds that need to be managed and regulated, the same issues that good managers and boards of directors should be concerned with in managing an MFI. The framework helps identify the risks that prudential regulation should address. The approach is useful in designing regulatory standards that recognise the fundamental differences in the structure of capital, funding and risks faced by MFIs. Their proposal provides a transparent and inclusive regulatory framework within which MFIs can progressively evolve into formal FIs.

The authors identify a continuum of MFIs which they classify into three broad categories: (i) category A are those MFIs which depend on other people's money; (ii) category B are MFIs that depend on members' money; and (iii) category C are those MFIs that leverage the public's money to fund microfinance loans. The authors propose thresholds of financial intermediation activities that would trigger a requirement for an MFI to satisfy external or mandatory regulatory guidelines. Table 3.1 summarises the regulatory framework model. They propose that MFIs that depend on donor grants and small scale compulsory savings as loan collateral should be self regulated; those that depend on commercial paper and large certificates of deposit should be regulated by the companies' registry agency, bank supervisory authority or securities and exchange agency. MFIs that depend on members' money should

be regulated by the cooperatives authority or bank supervisory authority. MFIs that leverage savings deposits should be regulated by the bank supervisory authority. According to their typology, therefore, Type 1 and Type 2 MFIs (Category A) should be allowed to operate with no regulation or self regulation. For Type 3 (Category A) and Type 4 (Category B) MFIs, the most appropriate regulatory approach would be the delegated approach; a market based approach, e.g. rating agency; or special microfinance law approach. For Type 5 (Category C) MFIs, special laws might be developed for these MFIs. Type 6 and 7 (Category C) MFIs may be regulated under existing laws. However, as noted earlier, it may be necessary to modify existing laws to accommodate the risk profiles of MFIs. The different regulatory approaches are discussed in more detail in the following section.

3.7 REGULATORY APPROACHES TO MFIS

The literature identifies five 'central bank' based[18] regulatory approaches to the regulation and supervision of MFIs, namely: (1) no regulation; (2) self regulation; (3) delegated supervision; (4) existing law; and (5) special law (Berenbach and Churchill, 1997; Christen and Rosenberg, 2000; Staschen 1999; Kirkpatrick and Maimbo, 2002). This section describes these approaches and outlines alternative options to 'central bank' based regulation and supervision.

3.7.1 No regulation

To date microfinance has essentially evolved outside a regulatory framework[19]. Consequently, they have been free to innovate and develop non-traditional approaches to the provision of financial services. As the cost of designing, developing and implementing regulations is more than likely to exceed the benefits of leaving the industry without a regulatory regime, plus the fact that the total assets of the microfinance sector are too small to pose a threat to financial stability, it is argued that it may be best to continue with the status quo, i.e. no regulation. For instance, Christen and Rosenberg (2000) recommend that supervisory attention should not be diverted away from bank supervision as a bank failure is more likely to result in systemic crisis and central banks have a hard enough time regulating and supervising the commercial banking sector due to resource constraints and limited capacity.

[18] Although not explicitly stated in the literature, the underlying assumption is that the regulation and supervision of MFIs will be conducted by the regulatory and supervisory authority responsible for the banking sector, usually the central bank. In some countries, a separate supervisory agency exists, e.g. the Financial Services Authority (FSA) in England. In the thesis, the term 'central bank' is used synonymously with 'regulatory' and 'supervisory' agency/authority.

[19] As noted by Valenzuela and Young (1999: 17), much of the recent interest regarding regulation and supervision came from the growing NGO sector and discussions have focused on the regulation of these types of institutions.

Table 3.1: Regulatory thresholds of activities by type of MFI

MFI Type	Activity that determines regulatory status	Proposed form of external regulation, if required	Regulatory agency	Regulatory Approach*
Category A MFIs				
Type 1 Basic non-profit NGO	Making microfinance loans not in excess of grants and donated/concessional funds (loan capital).	None - Voluntary registration with self regulatory organisation (SRO).	None, or SRO.	No regulation or self regulation.
Type 2 Non-profit NGO with limited DT	Taking minor deposits, e.g. forced savings or mandatory deposit schemes, from microfinance clients in the community.	None – Exemption or exclusion provision of banking law, compulsory registration with SRO	SRO.	Self regulation.
Type 3 NGO transformed into incorporated MFI	Issuing instruments to generate funds through wholesale deposit substitutes (commercial paper, large value certificates of deposit, investment placement notes).	Registration as corporate legal entity; authorisation from bank supervisory authority or securities and exchange agency, with limitations on size, term and tradability of commercial paper instruments.	Companies' registry agency, bank supervisory authority or securities & exchange agency.	Delegated regulation; market based regulation, e.g. rating agency; or special law.
Category B MFIs				
Type 4 Credit Union, Savings and Credit Cooperatives Society	Operating as closed or open common bond CU, DT from member-clients in the community, workplace or trade.	Notification to and registration with cooperatives authority or bank supervisory authority; or certification and rating by a private independent credit rating agency.	Cooperatives authority or bank supervisory agency or credit rating entity.	Delegated regulation; market based regulation, e.g. rating agency; or special law.
Category C MFIs				
Type 5 Specialised bank, DT Institution or Finance Company	Taking limited deposits (e.g. savings & fixed deposits) from the general public beyond minor deposits exemption in banking law. Microfinance activities more extensive than NGOs but operations not on scale of licensed banks.	Registration and licensing by bank supervisory authority, with a limitation provision (e.g. savings and fixed deposits, smaller deposits to capital multiple, higher liquidity reserves, limits on asset activities and uses).	Bank supervisory authority.	Special law.
Type 6 Licensed mutual-ownership bank **Type 7** Licensed equity bank	Non-restricted DT activities, including generating funds through commercial paper and large-value deposit-substitutes, from the general public.	Registration and full licensing by bank supervisory authority as a mutual-ownership or equity bank; compliance with capitalisation/capital adequacy requirements, loan loss provisioning and full prudential regulations.	Bank supervisory authority.	Existing law.

Source: Van Greuning et al, 1998: ii; Note: * Added by the researcher

They also state that the supervision of MFIs is likely to be much more expensive given that MFIs generally have a smaller asset base, a much larger number of accounts and a higher degree of decentralisation. In addition, regulation and supervision may inadvertently cramp competition and stifle innovation, hampering efforts to maximise outreach. Bangladesh is often cited as an example where microfinance has flourished in an unregulated environment. This, or self regulation discussed below, is the approach that would be the most appropriate for Type 1 MFIs, basic non-profit NGOs making microfinance loans that do not exceed their funding from grants and donated/concessional funds (loan capital), in the Greuning Regulatory Framework.

3.7.2 Alternatives to 'central bank' based regulatory approaches to MFIs

As noted above, central banks may not be ideally placed to supervise MFIs, nor may it be appropriate to supervise MFIs in the same manner as other FIs. Alternative options to the regulation and supervision of MFIs by central banks have been suggested. These include the use of rating agencies, savings guarantee schemes, market driven deposit insurance and voluntary registers.

The rating agency approach would involve the development of a 'logo of recognition' issued by an agency, representing its approval. The logo would be publicly recognised. The principal sanction for non-complying MFIs would be revocation of the logo. Contracts with participating MFIs would give the rating agency the right to replace the MFIs' boards or management in the event of non-compliance, although enforcement of such contracts is likely to take too long to be practical. However, there are limitations to this approach. Firstly, there needs to be a 'market' for ratings, either from investors, such as donor agencies, or depositors, who can use the ratings to judge the safety of their investments or deposits. Participating MFIs need to agree on the standards to be applied and to have achieved them prior to implementation so that there is no need to persuade or strengthen those that have not met the mark[20]. The rating agency would require the disclosure of information, and advertise compliance or non-compliance of registered MFIs, thus enabling the public to decide for themselves with whom they wish to invest (Christen and Rosenberg, 2000; Wright, 2000a).

The second proposed approach is a 'Savings Guarantee Foundation' (Wright, 2000a). The main purpose of the fund would be to certify organisations and provide financial backing to

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[20] This scheme was being tried in Guatemala but at the time of writing not enough time had elapsed to determine whether the scheme would be successful (Christen and Rosenberg, 2000).

guarantee deposits. To get this guarantee, MFIs would be stringently monitored on a continuous basis. Certified MFIs would be required to pay a premium for this service. There would be two types of guarantees provided. The first type would certify that MFIs have placed clients' deposits in identifiable bank accounts and these are not used for on-lending. For MFIs deemed to have the capacity, the second type would certify that their financial condition, lending policies, procedures, and management are of a quality acceptable to use member savings for on-lending.

The third option suggested in the literature is deposit insurance. The insurance would be issued by a non-governmental body, perhaps donor-supported, as a substitute for official regulation and supervision. The scheme could provide pure deposit insurance whose only function is to reimburse small depositors in the event of failure of a depository institution, or it might operate a stabilisation fund providing emergency liquidity to solvent MFIs, or capital support to MFIs that are willing to make corrective measures in danger of insolvency. However, in addition to the issues of moral hazard associated with deposit insurance schemes, deposit insurance for MFIs presents some special challenges. Given the relatively small number of MFIs, their unsecured portfolios, and the absence of historical loss experience, it would be difficult to determine the fund size that is adequate to safeguard depositors. If MFIs are included with the general insurance scheme for commercial banks, assuming one does exist, then this would imply normal supervision by the government's supervisory agency rather than act as an alternative to such supervision. One way to mitigate the actuarial problem would be to make the insurance fund international so that it covers a larger number of MFIs, and maintain safety standards that might be tighter than what would be practical in a fund limited to a single country. However, such an insurance fund would probably have very high supervision costs (Christen and Rosenberg, 2000; Wright, 2000a).

Similar to the above proposal is the provision of market based deposit insurance in which the insured MFIs may accept deposits. The insurer must be a licensed bank in the country in which the MFI operates with extensive reinsurance. It is proposed that some of the insurance must be offshore and in hard currency. The role of the state would be to define the minimum acceptable insurance contract, ensure the parties have the capacity to undertake their obligations, and to verify that parties are legal entities. The question then is whether banks would be willing to provide such insurance and whether offshore markets would be willing to reinsure them at a price that MFIs can afford to pay (Christen and Rosenberg, 2000).

The last proposal involves all MFIs wishing to accept deposits registering with a central state registry. In the registration document, the MFI provides details of itself regarding name, address, owners and backers, areas of operations, its resources and financial products. It would also have to provide details on how aggrieved parties can seek recourse in the event that the MFI fails to honour its obligations. The MFI would then be obliged to provide a copy of its registration document to every client and member of the public who requested one in the local language, and to display copies at local government offices. Clients would then be in a position to compare MFIs and unregistered MFIs would presumably lose business. The scheme centres round a voluntary register backed by the rule of law. There is no obligation to register, nor can an MFI be refused registration. Further, the MFI chooses what it wishes to disclose. However, to be effective and useful, the voluntary register must be accurate, up-to-date, simple, clear and accessible (Wright, 2000a).

It is said that options that involve accreditation or voluntary registration empower poor people by providing them with information, enabling them to make informed decisions about whether, where and how to save, and an opportunity to understand the associated risks. The poor are then in a position to evaluate the risks and compare them with alternatives such as keeping cash at home, livestock, jewellery, etc. There are problems, however, with the options, some of which have already been noted. Firstly, there is an assumption that clients have the ability to compare institutions with the information provided. This may not necessarily be the case, considering the level of sophistication of the clientele involved. Secondly, the choice of moving from one MFI to another may be limited, either because there are none others operating in the area or because clients would lose their place in graduation from one loan level to the next. Lastly, with deposit insurance, there are the problems of moral hazard and actuarial problems in determining insurance amounts, assuming the MFI can actually get a bank that would be willing to insure them in the case of market based deposit insurance (Kirkpatrick and Maimbo, 2002).

3.7.3 Self regulation

Self regulation, also referred to as self supervision, refers to the industry developing its own supervisory and governance bodies (Berenbach and Churchill, 1997) and the adoption of a code of conduct (Staschen, 1999b). Christen and Rosenberg (2000: 20) define self supervision as the "arrangements under which the primary responsibility for monitoring and enforcing

prudential norms lies with a body that is controlled by the organisations to be supervised - usually a member-controlled federation of MFIs". According to the Greuning Regulatory Framework, this approach would be most appropriate for Type 1, basic non-profit NGOs, and Type 2 MFIs, non-profit MFIs with limited deposit-taking, e.g. forced savings.

The main advantage of self regulation is that the supervisory agency in this case possesses more expertise and technical knowledge of practices within the industry than a public agency would. Secondly, the rules issued are less formalised than those of a public regulatory regime. This reduces the cost of rule making, facilitates quick adaptation of the rules to developments and changing economic conditions, and permits more flexible enforcement. Lastly, the costs are typically borne by the industry as opposed to the taxpayer (Majone, 1996).

However, there are disadvantages; the main disadvantage being the conflict of interest that inevitably arises. As practitioners are likely to be better informed than a public agency about what is happening in the industry, their ability to discover and expose malpractice is superior. However, the self regulatory organisation (SRO) may be reluctant to publicise and punish wrong doers as its survival may be dependent on the very members that require disciplining (Majone, 1996). Consequently, enforcement can be problematic, especially where membership is voluntary. Much depends on the incentives to participate that are provided by the self regulatory system (Baldwin and Cave, 1999).

Self regulation is an approach usually taken whilst an industry is still in its infancy. However, it is unlikely to succeed due to the diversity in size, scale of operations, objectives and resources of various institutions providing microfinance. According to Christen and Rosenberg (2000), self regulation of financial intermediaries in poor countries has repeatedly proven to be ineffective, the main reason being the conflict of interest that inevitably arises noted above[21]. Examples of MFIs that are supervised under this arrangement are the SACCOs in South Africa which are self regulated by the trade association, the Savings and Credit Cooperative League of South Africa (SACCOL). However, this system has been said to be ineffective[22].

[21] Most of the experience with self supervision has been with federations of financial cooperatives, but Christen and Rosenberg see no reason why the experience would be any different with MFIs.
[22] http://microfinancegateway.org/resource_centers/reg_sup/micro_reg/country/40/.

3.7.4 Delegated supervision approach

The delegated supervision approach is one in which the regulatory authority contracts a third party, for example an accounting or consultant firm, to perform some or all of the supervisory functions. This has also been referred to as the 'hybrid' approach (Berenbach and Churchill, 1997). The supervisory agency maintains legal authority over, and responsibility for, the supervised institutions, but delegates regular monitoring and on-site inspections to a third party. This agent might be an MFI association, apex institution[23] or an independent technical entity. The supervisor's role lies in periodically testing the reliability of the delegated agent's monitoring, inspection and reporting; and intervening in problem situations (Christen and Rosenberg, 2000). Because the failure of an MFI does not pose a significant threat to the stability of the financial system, it has been suggested that the supervisory authority is more likely to be willing to delegate this function of monitoring to a third party. According to the Greuning Regulatory Framework, this approach would be the most appropriate for Type 3 MFIs, NGOs that have transformed into incorporated MFIs and generate funds through wholesale deposit-taking e.g. commercial paper, and Type 4 MFIs, common bond credit unions. The framework proposes the bank supervisory agency as a possible regulator. However, this proposal raises the question of whether the bank supervisory agency should be concerned with protecting wholesale lenders as discussed in section 3.6.1.

An example of the delegated approach can be found in South Africa where microlenders are regulated by the Microfinance Regulatory Council (MFRC). The Usury Act Exemption Notice of 1999 permits MFIs to opt out of complying with the conditions of the Usury Act on the proviso that they register with a regulatory institution approved by the Minister of Trade and Industry. The exemption allows lenders to charge unregulated interest rates on loans under R6,000 (US$ 937)[24] with a term of less than 36 months.

The only institution approved to date is the MFRC. The MFRC is called a 'hybrid institution' as its board comprises members from the microfinance and banking industry, and from public institutions such as the central bank, the Department of Trade and Industry (DTI) and state owned wholesale FIs. The MFRC is a functional regulator. It focuses on a set of activities that it licenses and supervises, regardless of the organizational form or other financial licence held by the lender. Although the MFRC regulates only NDT MFIs, it does have the right to

[23] An apex institution is one that typically provides wholesale funding to local MFIs.
[24] 1 USD = 6.4 ZAR (as of 17 May 2005).

inspect lenders with or without prior notice and the registration criteria include fit and proper criteria for shareholders, directors and senior management. However, there is clear focus on performance monitoring rather than prudential regulation as would be expected from a regulatory framework for NDT FIs (Staschen, 2003b). All entities that provide money lending services, be they companies, NGOs, cooperatives, banks or mutual banks, can register with the MFRC. This is different for prudential regulatory frameworks, "which must necessarily focus on institutions because, after all, it is institutions and not functions that become insolvent" (Goodhart et al 1998: 144).

The MFRC's key mandates are the formalisation of the micro-lending sector, the provision of customer protection, and the improvement of information and understanding. Since its inception, approximately 1,900 lenders have been registered, along with thousands of branches. The MFRC has played a major role in 'cleaning up' the industry, provided an avenue for clients to seek recourse, and encouraged more responsible lending practices. Disclosure requirements have been standardised. The reduction in reputational risk has resulted in banks entering the sector. Furthermore, the MFRC has launched various educational campaigns aimed, amongst others, at informing consumers on their rights when borrowing money and prudent financial management.

3.7.5 Existing law approach

The existing law approach refers to regulating MFIs within the existing legal and regulatory framework for formal FIs but to adapt ratios and supervisory practices to address the unique risk profiles of MFIs. This can be costly and may require organisational changes to the structures of MFIs and additional reporting requirements resulting in increased operational costs. It is based on the assumption that MFIs are doing bank type business. A variant of this approach is where MFIs are exempted from certain rules and laws, individually or generally. MFIs choosing formal status can choose which legal form best suits their needs and capabilities. According to the Greuning Regulatory Framework, this approach would be most appropriate for Type 6 MFIs, licensed mutual ownership banks, and Type 7, licensed equity banks, both of which have non-restricted deposit-taking activities.

Tanzania is an example of a country which decided, after a review of its existing legal framework, that there was no need for a special law for microfinance. The existing legal framework did not contain serious impediments to the microfinance sector. Furthermore, it

was felt that incorporating microfinance into the existing legal framework for the banking system would "facilitate integration into the broader financial system, encourage innovation and competition, enable proper harmonisation of the regulatory changes with the existing regulatory framework, as well as minimise possibilities of regulatory arbitrage" (Rubambey, 2005: 7).

However, it was necessary to amend certain aspects of the existing legal framework. This was done through the introduction of two categories of regulatory instruments, namely regulations that: (1) focus on best practices in microfinance as provided for in the National Microfinance Policy (NMP); and (2) relate to independent audit and internal control and audit. Consequently, Microfinance Regulations were introduced in March 2005 followed by a host of regulations to cater for the required amendments. The Microfinance Regulations focus on specific risks related to the business of microfinance with emphasis on credit services, since credit risk is one of the major risks for FIs. All banks and FIs engaged in microfinance, including microfinance companies (MFCs), are subject to prudential regulation and are required to report on their microloan portfolios. However, SACCOs with deposits of less than TZS 800 million (US$ 800,000) are not supervised by the Bank of Tanzania (BOT). SACCOs with deposits of TZS 800 million or more, are subject to the Bank of Tanzania supervision[25], the reason being that as member based organisations grow, members' willingness and capacity to exercise their statutory role in governance and control declines, which can lead to a loss of accountability and transparency.

In order to ensure a level playing field for both regulated and non-regulated microfinance providers, the NMP stipulates that all MFIs be subjected to a best practice, non-prudential, regulatory framework. Thus, NGO MFIs are subject to regulation by the National Board of Accountants and Auditors (NBAA) to ensure transparent disclosure. NGOs that receive donor and or government funding, are regulated under the Public Finance Law. In addition, credit only MFIs may apply for accreditation from the Ministry of Finance (MOF). The accredited institutions, referred to as microcredit institutions (MCIs), thus, receive formal government recognition enhancing their credibility. Accreditation of NGOs is not mandatory. As at December 2005, three NGOs had initiated the process of transforming into MFCs.

[25] Financial Cooperatives Societies (FICOS) Regulations 2005.

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

3.7.6 Special law approach

Some countries have created distinct legal status and regulation for non-bank MFIs. The creation of a special law or a separate window for MFIs is justified on the need to develop standards better suited to the microfinance sector and lower barriers to entry. The main advantage of this approach lies in the fact that it permits MFIs to pursue their goals and maintain their distinct characteristics, whilst providing a reduced range of financial services without necessarily becoming a bank. It has been suggested that the special category could provide a link between the informal sector and mainstream economy, possibly bringing savings from 'under the mattress' and into circulation. Examples of where special laws have been promulgated for MFIs are West Africa, Ethiopia, and more recently, Uganda. In relation to the Greuning Regulatory Framework, this approach would be most appropriate for Type 5 MFIs, specialised banks, FIs or finance companies taking on limited deposits, but whose scale of operations is smaller than those of licensed banks.

Christen and Rosenberg (2000: 6) suggest that it is still premature for most countries to establish special laws for this sector. Developing legislation involves writing rules which necessitates a certain amount of 'model building' and "making decisions as to what kind of institutions are the best to do microfinance, and sometimes even what kind of loan methodologies or operating procedures are best", a task for which most countries do not have the expertise. Additionally, one needs to ask whether the country has MFIs suitable for licensing but can't use an existing window. In answering this question, it is important to note that licensing implies that the government is making a representation regarding the safety and soundness of the licensed FI, including, where applicable, the fact that the MFI is strong enough to be a safe intermediator of commercial sources of funding, be it from retail deposits, institutional investors, or government credit lines. Therefore, it would be irresponsible to licence an institution that can not demonstrate its sustainability.

Ethiopia is one of the few sub-Saharan African countries "with a well defined regulatory framework for microfinance institutions" (Shiferaw and Amha: 2001: 39). The Licensing and

Supervision of Micro-Financing Institutions Proclamation No. 40/1996 (hereon referred to as the 'Microfinance Law'), was passed in July 1996. In addition to the law, 17 directives have been issued by the National Bank of Ethiopia (Amha, 2003). The law is administered by the National Bank of Ethiopia (NBE), which is the licensing, regulatory and supervisory authority for MFIs.

The main objectives of the Microfinance Law are to "promote the microfinance sector as a rural poverty reduction tool, to protect savers, and to introduce discipline in the industry" (WWB, 2005a: 7). It allows for the establishment of formal FIs as profit-oriented share companies, owned solely by Ethiopian nationals and or organisations. It lays out the regulatory framework for their operation and supervision by the NBE. The law was expected to "improve access to credit to the rural and urban poor, raise saver confidence and help towards better integration and the orderly functioning of the financial delivery system in Ethiopia". Although the development and implementation of the regulatory framework was not a remedy for major constraints in the delivery of financial services to the poor, it was considered one of the important elements and preconditions to creating well-managed and permanent MFIs in Ethiopia. The regulatory framework would assist MFIs "to strengthen their organisation and operate as prudent and effective financial intermediaries" (Shiferaw and Amha: 2001: 32). SACCOs, however, are not covered by the law. These are regulated under the Cooperative Societies Proclamation No. 147/1998.

According to Amha (as quoted in Siquiet and Ouriemchi, 2004; 5), the regulatory framework has resulted in, despite its limitations, a favourable environment for microfinance. The enactment of the Microfinance Law has led to the following benefits. Firstly, there has been a reduction in market distortions and potential disturbances to financial system stability. NGOs that granted loans at subsidised rates of interest no longer operate in the market. Secondly, there has been an increase in the number of MFIs operating in certain regions, thus increasing competition and the provision of financial services to the poor. Thirdly, regulation has encouraged the mobilisation of savings, thus reducing money kept 'under the mattress'. Fourthly, the law has forced MFIs to adhere to higher standards of operation, improving their performance. Lastly, the reporting requirement has enhanced the transparency of MFIs, increasing confidence in MFIs and improving access to credit lines in local and international capital markets.

Table 3.2: Regulatory frameworks for South Africa, Tanzania and Ethiopia

	South Africa	Tanzania	Ethiopia
Regulatory approach	**Delegated**	**Existing law**	**Special law**
Definitions of microfinance or microcredit	For the purpose of exemption from the Usury Act, loans under approx. US $1,200 (7,955 ZAR), payable within 36 months	Microcredit means a credit whose security may include non-traditional collateral, granted to a natural person, individually or in a group, whose income depends on her own business or economic activity and who may lack formal financial statements or other accounting and operational records.	Legal duty to give preference to marginal farmers; loan ceiling = US $625 (5,320 ETB) Proclamation 40/1996 defines microcredit as, "an activity of expending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs."
Microfinance providers			
Regulated MFIs	Microlenders registered with the MFRC, SACCOs and banks with microlending activities.	Banks (commercial, regional, and rural), NBFIs, and SACCOs	Commercial banks; SACCOs; and MFIs
Non-regulated sources of microfinance	Unregistered microlenders; consumer sales credit; moneylenders	NGOs	n/a
General approach to regulating			
Legal basis for regulating	- Banks Act 1990, as amended - Usury Act No. 73 of 1968 - Usury Act Exemption Notice of 1999 and 2000 - MFRC Rules and Circulars - Cooperatives Act, 1981 (Act No. 91 of 1981)	- Banking and Financial Institutions Act of 1991 - Microfinance Companies and Micro Credit Activities Regulations of 2004: - Savings and Credit Cooperative Societies Regulations, 2004 - Financial Cooperative Societies Regulations 2004	- Monetary and Banking Proclamation No.83/1994 - Licensing and Supervision of Banks and Insurance Companies Proclamation No.84/1994 - Licensing and Supervision of the Business of Micro-financing Institutions Proclamation No.40/1996 - 12 Directives of the NBE - Cooperative Societies Proclamation No.147/1998
Regulator	- SARB - MFRC or other authorized regulatory institution for all MFIs within Usury Act exemption - SACCOL	- Bank of Tanzania	- NBE, Ministry of Finance, Federal, Regional or City Governments (depending on the size and area of the SACCOs)

	South Africa	Tanzania	Ethiopia
Supervision method	- Offsite inspection of statements; on-site inspection. - MFRC supervises MFI adherence to standards of management & consumer protection, deals with complaints and publishes industry information; MFRC performs inspections using outside auditors and can inspect with or without notice. - Self regulation by SACCOL.	- On-site surveillance by Bank of Tanzania staff approximately once a year at the head office of each bank. - Field inspection and examination of individual SACCOs by district cooperative officers and examination of externally-audited financial accounts by the Registrar of Cooperatives.	- None reported for commercial banks. - Annual external audit, regular on-site inspections, follow-up on quarterly reports (only five inspections took place between 1996 and 2001) for MFIs. - Audit and inspection for SACCOs.
Organisational registration			
Laws and regulations governing registration	- Banks Act 1990 - Any natural or legal person can be a microlender, hence no specific rules apply. - Co-operatives Act of 1981.	- Banking and Financial Institutions Regulations, 1997. - Company Law - Savings and Credit Cooperative Societies Regulations, 2004. - Financial Cooperative Societies Regulations 2004.	As for 'legal basis for regulating'.
Agency administering registration	- Registrar of Banks (SARB) - The Financial Services Authority for NBFIs. - MFRC (provisional registration) - SACCOL and Registrar of Cooperatives in the Department of Agriculture	- Bank of Tanzania - Stock corporation (section 33 of 1997 Regulations).	NBE
Required legal form of organisation	- Public company registered as a bank. - Private or public company, close corporation cooperative, trust, NGO, mutual bank, or bank. (Almost 80% of registered lenders are close corporations.) - Incorporation as a trading co-operative.	- Stock corporation (section 33 of 1997 Regulations) - Companies limited by shares. - No person or group may own more than 20% of the core capital of any bank or FI (section 36 of 1997 Regulations). - Cooperative Society	- Share company, 100% Ethiopian-owned (Article 304 of the Commercial Code) - Limited Liability Society

Source: compiled from http://microfinancegateway.org/resource_centers/reg_sup/micro_reg/country

On the other hand, according to Shiferaw and Amha (2001), the supervision of MFIs, especially on-site inspections has been limited due to institutional capacity constraints. Apart from issuing a few directives, the NBE has given little attention to the microfinance sector. At the time of writing, only five on-site inspections had been carried out by the NBE. Therefore, the NBE has not been very effective. Consequently, it is argued that savers and investors are not receiving appropriate protection. Furthermore, MFIs are using valuable resources preparing reports that are not necessarily audited. Additionally, Shiferaw and Amha (2001) argue that the provisions of the Microfinance Law have forced MFIs to cease operations, hindered the development of innovative approaches and methodologies in the delivery of microfinance financial services, and limited the services and products on offer, thus constraining growth in, and the development of, the microfinance sector in Ethiopia.

3.8 CONCLUSION

This chapter looked at the various aspects of regulation and supervision in relation to the financial sector, and specifically MFIs. It started by defining regulation and supervision. Broadly speaking, "regulation refers to the rules that govern the behaviour of financial institutions and supervision is the oversight that takes place to ensure that financial institutions comply with those rules" (Barth et al 2006: 4).

Regulation of the financial sector is justified on the basis of maintaining financial system stability (through systemic stability and maintaining the safety and soundness of FIs) and protecting customers (Llewellyn, 1986) and is usually thought of in terms of state intervention, although this need not necessarily be the case. A distinction is made in the literature between systemic regulation, prudential regulation and conduct of business regulation. Government intervention is often justified on the basis of correcting market failures. Thus, regulation can prevent possible systemic problems associated with the failure of FIs, thereby enhancing financial system stability. Secondly, it can alleviate information asymmetry problems through the mandatory disclosure of information. Thirdly, the overall objectives of regulation and supervision can be achieved by monitoring FIs, a function that is essentially a public good and a natural monopoly. Consequently, through regulation, positive externalities are generated, markets operate more efficiently and economic and social welfare is increased.

The chapter then went on to explore two broad conceptual frameworks for financial sector regulation, namely the public interest view and private interest view. The public interest

approach takes as given that financial sector supervisors can overcome market failures and that they have the incentive to do so for the benefit of society. Official supervision discourages FIs from engaging in overly risky behaviour and improves financial sector performance and stability. However, critics of this approach argue that public interest theories understate the degree to which economic and political power influences regulation. This led to the development of private interest theories in which regulation is conceptualised as a product with suppliers and demanders interacting to determine the exact shape and purpose it serves. According to this view, regulatory agencies are 'captured' by interest groups, usually politicians or the industry, and behave in ways which promote the interests of these groups. Thus, governments regulate the financial sector to facilitate the financing of government expenditure, channel credit to politically attractive ends and, more generally, to maximise the welfare and influence of politicians and bureaucrats, even when public interest goals are the ostensible goal.

Critics of regulation argue that market failure is not a sufficient justification for government intervention since regulatory failure may have more serious consequences than market failure. Regulation is either at the outset set to favour special interest groups, or even if its origins lie in true concern with market failure, it is over time 'captured' by special interests intent in promoting their own economic agenda. The result is then a degree of state failure that could even exceed the market failure that regulation is supposed to correct. Linked to the concept of regulatory failure is the ineffective hand view of regulation. It does not question the existence of market failures, or the incentives of the government, but simply states that even if market failures exist and governments demonstrate exemplary integrity, official regulation may just be ineffective at correcting market failures due to limitations and constraints faced by the regulatory agency. Thus, there is need to acknowledge that there are limits to what regulation and supervision can be expected to achieve.

Section 3.6 then outlined the rationale for regulating and supervising MFIs. There is consensus that only DT MFIs should be prudentially regulated. As for other FIs, the prudential regulation of MFIs is often justified on the need to maintain financial system stability and depositor protection. However, these objectives are questionable in light of the microfinance sector's size in relation, for instance, to the banking sector and taking into consideration the constraints and limitations faced by supervisory agencies, especially in developing countries. Despite this, regulation for NDT MFIs is also advocated on the basis

that it is only in a regulated setting that massive sustainable delivery of financial services to the poor can be achieved. However, MFIs differ from traditional formal FIs in a number of respects and exhibit different risk profiles. These differences have to be taken into consideration when developing the regulatory framework for MFIs and supervisory tools to be utilised.

Furthermore, van Greuning et al (1998) distinguishes between different categories of MFIs according their liability structures and proposes that the regulation of MFIs should be dependent on this structure. Their proposed framework was discussed in section 3.6.4. This was followed with a description of alternative approaches to the regulation of MFIs and accounts of regulatory frameworks found in three sub-Saharan African countries, namely South Africa, Tanzania and Ethiopia that are representative of the delegated, existing law and special law approaches respectively to the regulation of microfinance. The approaches have been summarised in Table 3.2[26].

This Chapter, therefore, serves to provide the theoretical basis for assessing the potential impact of regulation and supervision on the microfinance sector. The rationale for regulating the microfinance sector has been driven by the rationale for regulating the banking sector. However, extending the argument to MFIs in this manner requires consideration of the differences in the characteristics and risk profiles of MFIs as compared to banks. Furthermore, differences in the institutional forms and industry structures in different countries have resulted in various regulatory approaches being proposed and taken. The approach under consideration for Zambia is the introduction of microfinance specific regulations. The purpose of this thesis is to evaluate the potential impact of the proposal on the microfinance sector. The following chapter discusses the methodology and data collection methods employed for the study.

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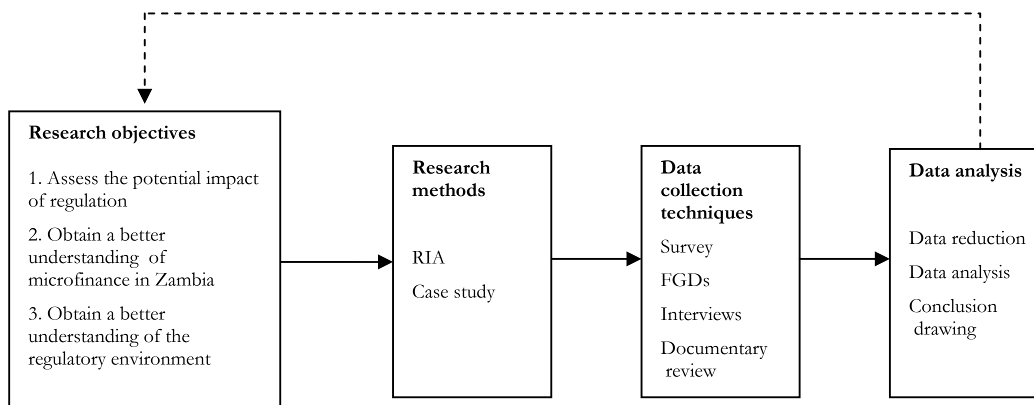
[26] More detailed information is contained in Appendix 3.

4 RESEARCH METHODS AND METHODOLOGY

4.1 INTRODUCTION

The purpose of this chapter is to provide an overview of the research methods used, the data collection techniques and the data analysis process employed in meeting the objectives of the research (Figure 4.1). It is organised as follows. Section 4.2 discusses the main features of RIA. It reviews the constraints and benefits of its use in developing countries and outlines the model used for the study. Section 4.3 provides a brief description of the case study approach and the benefits of using this method. This is followed by an account of the data collection methods employed and covers how the data collection was executed in section 4.4. Section 4.5 discusses how the data was organised and analysed. Section 4.6 examines the challenges and constraints faced during the research, how these were mitigated, where possible, and their impact on the study. Section 4.7 summarises and concludes.

Figure 4.1: Overview of the research process



4.2 REGULATORY IMPACT ASSESSMENT

4.2.1 What is RIA?

Regulation imposes costs and benefits, intended or otherwise, on stakeholders (Benston, 1998). These need to be taken into account during the policy making process to ensure policy decisions are well informed and do not lead to disproportionate or counterproductive impacts. RIA is a rigorous framework for policy making and analysis that helps to ensure policy decisions are as soundly based as possible (NAO, 2004) and "can inform the decision process

about the efficiency of the policy and about the cost effectiveness of the instruments" (OECD, 1996)[27]. To regulate 'better' has become a crucial goal. A poor understanding of the problems at hand or of the indirect effects of government action can undermine regulatory efforts and result in regulatory failure. Better regulation does not necessarily mean no regulation, but rather it is "a question of achieving more effective regulation through a combination of tools such as simplification, codification and impact assessment" (Mandelkin Group, 2001)[28]. "High quality regulation is increasingly seen as that which pursues efficient policies as cost effectively as possible" (OECD, 1996)[29].

RIA has been adopted as a popular reform strategy by OECD countries and is a clear example of the trend towards more empirically based regulation and decision making. RIA has been described as a "decision tool, a method of (i) systematically and consistently examining selected potential impacts from government action and of (ii) communicating the information to decision-makers" (OECD, 1996)[30]. Kirkpatrick (2001: 8) defines RIA as a "method for analysing the costs and benefits of regulatory change". Thus, RIA provides a method for assessing the positive and negative impacts of existing or potential regulatory measures and can be used for the ex ante assessment of proposed new or revised regulations or the ex post assessment of existing regulations. RIA provides empirical data that can be used to make wise regulatory decisions (Rodrigo, 2005).

RIA is an empirical method of decision making, i.e. a decision which "is based on fact finding and analysis that defines parameters of action according to established criteria" (OECD, 1996)[31]. It provides a comprehensive analytical framework for assessing the options and implications of government action and ensures government action is justified and appropriate. Thus, RIA is appropriate for this research because it is an evidence-based approach to decision–making and provides a structured framework within which to carry out the analysis in addressing the main research objective of assessing the potential impact of regulation and supervision on the microfinance sector. RIA is ideally suited to evaluating regulatory proposals, in this case the introduction of microfinance specific regulations. The evaluation within the RIA must also include an examination of alternative options, which in this study is maintaining the existing regulatory and supervisory framework, after which a comparison can be made of the alternative options. Thus, it provides a framework within which to appraise

[27] http://193.51.65.78/puma/regref/whatria.htm, accessed 20 May 2003.
[28] http://www.thecre.com/eu-oira/oira.be.mg.initial.htm, accessed 2 February 2006.
[29] http://193.51.65.78/puma/regref/whatria.htm, accessed 20 May 2003.
[30] http://193.51.65.78/puma/regref/whatria.htm, accessed 20 May 2003.
[31] http://193.51.65.78/puma/regref/whatria.htm, accessed 20 May 2003.

the benefits and costs of both options and ascertain the potential impact of either option on the microfinance sector.

4.2.2 The benefits of using RIA

According to Kirkpatrick (2001), RIA meets the four criteria for good policy making (OECD, 1997: 16-18 as cited in Kirkpatrick, 2001: 10). Firstly, RIA "improves the understanding of benefits and costs of government action" often drawing on economic empirical evidence. RIA encourages a far more structured examination of the objectives and impacts of regulating. In particular, it results in clearer and explicit consideration of the objectives behind regulations. RIA has proved invaluable in encouraging policy-makers to consider the reasoning and objectives behind their proposed regulations and to state these explicitly. Furthermore, the preparation of RIAs can lead to the explicit identification of information gaps and assumptions made in the decision making process where before these would have been implicit.

Secondly, RIA "integrates multiple policy objectives by identifying and comparing linkages and impacts between economic, social and environmental regulatory changes" (Department of the Taoiseach, 2005: 26). Policy makers are, thus, made aware of the effects of their decisions on other areas, such as economic efficiency and trade. In this way, RIA can be used as a coordination tool that can help decision-makers weigh the trade-offs in interests and achieving different policy objectives.

Thirdly, RIA "improves transparency and consultation". It "contributes to transparency in government by encouraging policy makers to set out in advance the reasons for their policy decision, how it addresses an identified and quantified problem and the anticipated costs and benefits" (Welch, 2004: 3). A requirement of RIA is consultation with different stakeholders. The process of public consultation provides quality control for impact analysis and improves the information available to decision-makers. This process adds considerable value to the regulatory process by highlighting costs that may not have been fully considered and in identifying more or less costly options for implementing various measures contained within the regulatory proposals. In this way, RIA can encourage policy-makers to identify fresh opinions and to search for less burdensome solutions.

Lastly, it "improves government accountability" with decision-makers having to report on the information used in decision making and demonstrating how the decision will affect society. "Regulators can only be truly accountable to the electorate if the consequences, the social

benefits and costs, of their actions are known" (OECD, 1996)[32]. RIA enhances the quality of governance through improved transparency, consultation and accountability resulting from the regulatory process. By focusing on simple clear regulations, wherever possible, that are not burdensome, and having them made publicly available, RIA contributes to minimising corruption opportunities. The more discretionary regulatory obligations are, the more likely businesses are inclined to pay regulators to avoid costly bureaucratic requirements.

In addition to meeting the four criteria for good policy making noted above, RIA serves as a tool for policy monitoring and evaluation. As stated by Lee (2002), it can be used both ex-ante and ex-post. Ex-post it helps "governments review the effectiveness of their interventions", it helps "businesses advocate for improvements if regulations turn out to be more burdensome than anticipated", and it helps "citizens hold their governments to account for delivery of the benefits promised" (Welch, 2004: 6).

In order to promote economic and social welfare, state regulation needs to be effective and efficient, effective in that it achieves its planned goals and efficient in that it achieves the goals at least cost. Thus, RIA helps governments design efficient regulations that address market failures and result in the optimisation of social welfare by highlighting aspects of regulation which limit consumer choice and the level of competition in an economy and ensuring regulations do not impose disproportionate costs and unintended impacts on business or society at large. RIAs help governments strike the right balance between the need to provide investors and citizens with protection and confidence without regulation being unnecessarily burdensome.

RIAs, in this way, ensure that regulatory proposals meet the five principles for good regulation of transparency, proportionality, targeting, consistency and accountability (Cabinet Office, 2003)[33]. Firstly, regulatory proposals are transparent in that they are open, simple and user friendly. Secondly, the proposals are proportional to the risk being addressed. Thirdly, the proposals are targeted in that they focus on the problem being solved and have minimal side effect. Fourthly, they are consistent, i.e. predictable, so that the affected parties know where they stand. Lastly, regulatory proposals should satisfy the principle of accountability to Ministers and Parliament, to users and to the public at large.

[32] http://193.51.65.78/puma/regref/whatria.htm, accessed 20 May 2003.
[33] As advocated by the Better Regulation Task Force (BRTF), an independent advisory body set up in 1997 "to advise the Government on action to ensure that regulation and its enforcement are proportionate, accountable, consistent, transparent and targeted" (http://www.corporateaccountability.org/regulation/brtf/main.htm).

4.2.3 Criticisms of RIA

However, there have been a number of criticisms of RIA. Firstly, RIA methods are not yet fully developed. There is little agreement on the analytical methods that should be employed and many countries use a combination of qualitative and quantitative methods (Rodrigo, 2005). Disagreements continue on a number of important matters such as the valuation of intangible benefits and dealing with risk and uncertainty.

Secondly, it has been suggested that RIA is overly technical and that it can slow down the regulatory process (Department of the Taoiseach, 2005). Cost Benefit Analysis (CBA) methods may be too complex and costly to be practical given the capacities of regulatory bodies. However, RIA is unlikely to slow down the regulatory process providing it is initiated at an early stage. Furthermore, RIA should ensure a more strategic and coherent approach to regulating, ultimately making the regulatory process more efficient. Related to this, it is argued that RIA can encourage an over-emphasis on economic efficiency at the expense of other values. However, it is not always possible to use full CBA techniques. Experience suggests that more focus on cost effectiveness and efficiency in the regulatory process is necessary even if it is not in the form of a full CBA.

Because of the second criticism noted above, it has been asserted that RIA can be too technical and difficult to assess for a lay person. However, it can be argued that this applies only to specialist, technical areas and, therefore, the draft regulations themselves would be complicated and challenging. The RIA does not make them more so (Department of the Taoiseach, 2005). Rather, the RIA ensures that the complexity of the proposals is demonstrated and that the issues are formally examined and explicitly stated. Otherwise debates and decisions on the proposals would be less transparent and accessible. The more complex economic calculations do not necessarily have to be studied in detail by all stakeholders. However, if the conclusions or findings of such calculations are communicated clearly using simple language, this enhances capacity.

Lastly, the lack of data and shortage of previous research, particularly because costs are often very specific to the particular regulation in question, also act as significant constraints within the RIA process (Rodrigo, 2005). Impact assessment necessarily involves looking at the details of a particular proposal in order to assess the effects. Thus, data collection is one of the most difficult parts of the RIA. The usefulness of RIA depends on the quality of the data used to evaluate the impact of a proposed or existing legislation. The data essential to

conducting good analysis are too often lacking and collection strategies often fail because they become overly time consuming or too costly. The selective provision of data by stakeholder groups seeking to promote their own sectional interests is also a real concern.

4.2.4 Core requiremnents of an RIA

For RIA to achieve the benefits discussed above and avoid the criticisms identified, its design must take into account the political, cultural and social characteristics of the country, as well as the institutional, and legal context. It needs to be implemented in a form that is suitable to the country's needs and to be accompanied by the necessary institutional and resource support. There is no ideal RIA model. There are, however, some minimal requirements or 'core aspects' of RIA that have been identified. These are summarised in Box 4.1.

Box 4.1: Core aspects of RIA

1. Appropriate problem definition and identification of policy objectives in such a way as to avoid ambiguities, vagueness and contradictions (with expected results expressed in quantitative, physical terms and an explicit hierarchy between objectives);

2. Beginning of assessment and consultation when the choice is still open, consideration of multiple options;

3. Information gathering, possibly through consultation, and data assessing, with an explicit choice of relevant criteria, procedures, and techniques for selecting a specific set of information;

4. Ex ante impact assessment of each relevant option, through some explicit and consistently used method; description and most of the times quantification of effects; explicit selection of types of effects to be considered;

5. RIA results expressed in and publicised in a thorough and transparent way.

Source: Report commissioned by the EU Directors of Better Regulation (DBR) Group, 2004.

Box 4.2: OECD Regulatory Quality Checklist

1. Is the problem to be addressed correctly defined?
2. Is the government action justified to deal with this problem?
3. Is regulation the best form of government action?
4. Is there a legal basis for regulation?
5. What is the appropriate level(s) of government for this action?
6. Do the benefits of regulation justify the costs?
7. Is the distribution of effects across society transparent?
8. Is the regulation clear, consistent, comprehensible and accessible to users?
9. Have all interested parties had the opportunity to present their views?
10. How will compliance be achieved?

Source: NAO (2004: 12)

In addition to the core aspects, guidance given by the OECD in 1995 listed ten questions which have been reproduced in Box 4.2 that policy makers should ask about any proposed regulation and, with adaptation, about existing regulations (NAO, 2004: 12).

4.2.5 Using RIA in developing countries

Although, there has been increasing use of RIA in OECD countries in the last twenty-five years, there is little recorded evidence of its use in developing countries (Kirkpatrick, 2001, Lee 2002, Kirkpatrick and Parker 2003). Few studies have considered the impact for using RIA in developing countries (Lee, 2002; Kirkpatrick and Parker, 2003). Although some developing countries are beginning to apply some form of regulatory assessment, their methods are generally incomplete and not applied systematically across policy issues (Kirkpatrick et al, 2003; Rodrigo, 2005).

It has been suggested that the OECD 'best practice guidelines' do not transfer readily to developing countries which have very different economies in terms of growth and development. Although the OECD guidelines do provide a useful basis, they need to be modified to reflect the particular issues that arise when regulating in developing countries, issues that relate to poverty reduction, development goals and regulatory capacity (Kirkpatrick and Parker, 2004: 340). Developing countries may not have the institutional capacities to carry out and make effective use of RIAs at the level of sophistication implicit in OECD 'best practice' guidance. For instance, they may not have sufficiently skilled and experienced staff and good quality data to apply the recommended assessment methods and utilise the assessment findings within the regulatory reform process. Also, the limited documentary evidence available suggests that developing countries are more likely to experience problems with the more technically-sophisticated methods of analysis and those that are very data demanding. They may also have trouble with some of the more participative methods of information gathering and analysis where there is limited country experience in their use.

Despite the constraints outlined above to the use of RIA in developing countries, benefits have been identified. According to Kirkpatrick (2001) and Welch (2004), RIA has the potential to contribute towards poverty reduction. By encouraging policy makers to focus on the needs of small and micro enterprises, RIA can help ensure that economic growth is pro poor. Secondly, the informal sector in most developing countries contributes significantly to employment generation. Most small and micro enterprises are owned and operated by the poor and operate in the informal sector and enable individuals to support large numbers of

family members. It is to this segment that microfinance is targeted and, therefore, an enabling regulatory environment that supports and encourages the growth of the microfinance sector would contribute positively to economic growth and poverty alleviation. It is important that any regulations are not seen to be unnecessarily burdensome, thereby acting as a disincentive to formalisation and possibly forcing existing MFIs to cease operations. RIA would force policy makers to assess the likely impact of their decisions on the provision of financial services to the unbanked sector. It would provide a framework for ensuring that this sector's needs are taken into account. If they prove to be burdensome and reduce the supply side, then regulations would only serve to further restrict and limit the alternatives and options that the unbanked sector has. "The regulations should aim to improve access to services and not make it harder!" (Welch, 2004: 12).

Well-functioning markets are needed if the private sector's role in generating growth and incomes is to be sustained. Governments in most developing countries now recognise that the private sector can be an engine of economic growth and acknowledge the need for public policy to enable the efficient functioning of markets (Kirkpatrick, 2001). A study carried out by Bannock Consulting in 2002 found that costs and barriers imposed by developing countries, and specifically African countries, are much higher than in other parts of the world (Welch, 2004: 7). The costs of doing business are important for investors, both local and foreign, when deciding where to locate. By forcing governments to consider the costs of their regulatory proposals, RIA can help minimise these costs, thus contributing to the efficiency of regulation.

Corruption is more pervasive in developing countries as reflected in Transparency International's Corruption Perception Index. Greater transparency, consultation and government accountability in the regulatory environment brought about through the RIA process are likely to result in lower levels of rent seeking behaviour and contribute to economic efficiency. Thus, the adoption of RIA could move developing countries in the direction of following criteria for good policy making as advocated by the OECD. Its application, however, needs to be appropriate to the expertise, resources and information base available to the analyst, all of which may be severely lacking in developing countries (Kirkpatrick, 2001).

4.2.6 The RIA model adapted for the study

The RIA model used for the study, and shown in Box 4.3, was adapted from the UK RIA framework[34]. The UK RIA framework was used as the basis for developing the RIA model used for the study for the following reasons. Firstly, the UK has a well documented policy regarding RIA with detailed guidelines that ensure consistency in approach regarding the stages to be followed, but allows for flexibility in the methods and approaches employed in carrying out the RIA[35]. This meant that there was a vast amount of literature that could be referred to. Secondly, as part of the familiarisation process, the researcher was able to attend a number of workshops on impact assessment and interview members of staff of the Regulatory Impact Assessment Unit (RIAU) of Cabinet Office and other government departments who were familiar with, or had been involved in, the preparation of RIAs[36].

For the study, sections 1 to 8 of the UK framework are considered relevant. All RIAs, regardless of which country they are for, be it a developed or developing country, require appropriate problem definition, the identification of policy objectives and the consideration of multiple options. These are covered in sections 1, 2 and 4 of the UK framework and are, therefore, relevant in the Zambian context (sections I, II and IV respectively of the model). Consultation, which is covered in section 3, is an essential component of the RIA and is automatically included in the model for the study (section III). Thus, the data collection methods employed, as detailed in later sections of this chapter, made significant use of public consultation and included a public survey, focus group discussions (FGDs), interviews, and the attendance of relevant seminars, workshops and meetings. Those interviewed included government and BOZ officials, consultants, microfinance practitioners, clients and donors. Section 5, Costs and Benefits, forms the main analytical component. It is in this section that the benefits and costs of each option are assessed, and so is relevant to all RIAs (section V). Thus, the analysis includes a description of the impact, in this case, on microfinance providers (businesses, churches and NGOs), clients (and the public generally), the public sector (government), and investors, including donors. Section 6, Small Firms Impact Test (SFIT), in this case, is considered particularly relevant because the majority of MFIs in Zambia are relatively small (section VI). The introduction of regulation and supervision would also have

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[34] Appendix 10.

[35] Formulation of the policy began in the 1980s, moving to the RIA system in 1998 when it became mandatory for all regulatory proposals which have an impact on businesses, charities or voluntary bodies to be accompanied by an RIA before ministerial consideration. The UK RIA framework incorporates the 1995 OECD 'best practice' guidance and covers the 'core aspects' identified in section 2.5 above.

[36] Appendix 4.

an impact, intended or not, on competition. Consequently, a formal assessment of the impacts on competition is necessary. As with any other regulations, the issue of how they are to be enforced cannot be ignored, regardless of the context in which they are being introduced. Therefore sections 7, Competition Assessment, and 8, Enforcement, Sanctions and Monitoring, respectively are also relevant within the Zambian context (section VII and VIII respectively).

Box 4.3: The RIA Model

I. Title of proposal
II. Purpose and intended effect
- Objectives
- Background
- Rationale for government intervention.

III. Consultation
- Within government.
- Public consultation.

IV. Options
V. Costs and benefits
- Sectors and groups affected.
- Benefits.
- Costs.

VI. Small Firms Impact Test
VII. Competition assessment.
VIII. Enforcement, sanctions and monitoring
IX. Summary and recommendation

Source: Adapted from the UK RIA Framework

However, within the context of this study, section 9, Implementation and Delivery Plan, and section 10, Post Implementation Review, are not considered to be relevant and have not been included in the model for the study. This is because the main research objective is that of assessing the impact of regulation and supervision on the microfinance sector, and does not extend to the modalities of implementation and related matters. Therefore, these sections do not apply. This is also true for section 12, Declaration and Publication. Hence, the model used for the study has nine sections as compared to twelve for the UK model. Section 11 summarises the evidence and analysis discussed in earlier sections of the RIA. It is in this section that the recommendation with justification is made and an explanation given of why the other options were not chosen. Therefore, this section has been included in the model (section IX).

4.3 CASE STUDY

At the time of the fieldwork, there were three MFIs that had been licensed by BOZ and all three were included in the study. The case studies provided a basis for analysing the impact of

the existing regulatory and supervisory framework on MFIs. From this it was possible to infer what the impact of the DMFRs would be on the microfinance sector. Thus, the case studies served to:

"*describe* an intervention and the real life context in which it occurred", i.e. the MFIs being licensed by BOZ;

"*illustrate* certain topics within an evaluation", i.e. the MFIs' experiences of being licensed FIs and supervised by BOZ under the existing regulatory framework (before the introduction of the DMFRs); and

"*explore* those situations in which the intervention being evaluated has no clear single set of outcomes", i.e. the outcomes of being a FI regulated and supervised by the BOZ (Yin 2003, 14).

The case studies also contributed to the broader study aims of: (1) obtaining a greater understanding of microfinance in Zambia through detailed descriptions of the MFIs used in the case studies; and (2) obtaining a greater understanding of the Zambian regulatory and supervisory environment through accounts of how the MFIs were affected as a result of being regulated FIs.

Case study research is often disparaged for its lack of rigor, dubious scientific generalisation of results and voluminous documents. Yin (2003) points out that the generalisation of results, either from a single case or multiple case design, is made to theory and not to populations and, therefore, follows a 'replication logic' rather than a 'sampling logic'. In other words, the results derived from a specific case can be expected to 'replicate' under similar conditions (a 'literal replication') and not generalised to the population from which a sample has been drawn. The case study "does not represent a 'sample' and in doing a case study, your goal will be to expand and generalise theories (analytical generalisation) and not to enumerate frequencies (statistical generalisation)" (Yin, 2003: 10). Multiple case designs facilitate replication, enhancing confidence in the robustness of the conclusions derived. Furthermore, the external generalisabilty of the results are immensely enhanced.

The case study approach was particularly suited to the study as it facilitated a holistic, in-depth investigation of the impact of regulation (both existing and potential) on MFIs. For the reasons noted above, the multiple case design was adopted and the small number of MFIs that had been licensed made it possible to include all three in the research. Most of the data for

the case studies was obtained from secondary sources. For two of the case studies, the chief executive officers (CEOs) of both MFIs were interviewed and for one of the case studies, data was obtained from the completed questionnaire.

4.4 DATA COLLECTION TECHNIQUES

The significant portion of field work was done from 10 February 2004 to 5 October 2004 with the aid of a research assistant[37]. Data were collected through FGDs, survey, semi-structured interviews, and documentary review. The FGD were used to get stakeholder views, mainly microfinance practitioners and MFI clients, on whether the microfinance sector should be regulated and supervised, the benefits of regulation and supervision, and who the most appropriate regulator would be. The survey was used principally to collect data on the microfinance industry structure, thus addressing the second research objective of ascertaining the microfinance sector in Zambia. The interviews served to obtain stakeholders' views on various aspects of regulating and supervising the microfinance sector. The documentary review addressed all three research objectives and was the main source of data for the case studies. The attendance of relevant workshops, seminars and meetings also facilitated the collection of data. The activities undertaken during the fieldwork are summarised in Table 4.1.

Table 4.1: Activities undertaken

Activity	Comment
Focus group discussions	28 scheduled, 16 held.
Survey	247 questionnaires distributed, 85 responses received.
Interviews	31 interviews conducted. Interviewees included government and BOZ officials, commercial bank officials, consultants, donor representatives and MFI practitioners.
Documentary review	Documents reviewed included legislation, policy documents, previous studies, reports, correspondence and articles.
Seminars, workshops and meetings	CGAP discussion forum, AMIZ AGM, FSDP workshop, BOZ sensitisation workshops, AFRACA workshop, CRC International Conference and DSA student workshops.

Visits were made to 30 districts[38] out of 72 districts, covering a distance of over 9,500 km as shown in Figure 4.2[39]. All nine provinces and provincial capitals were visited. These are listed in Table 4.2. The main criteria used for selection was accessibility in terms of the road network and transport. Other considerations included time and cost.

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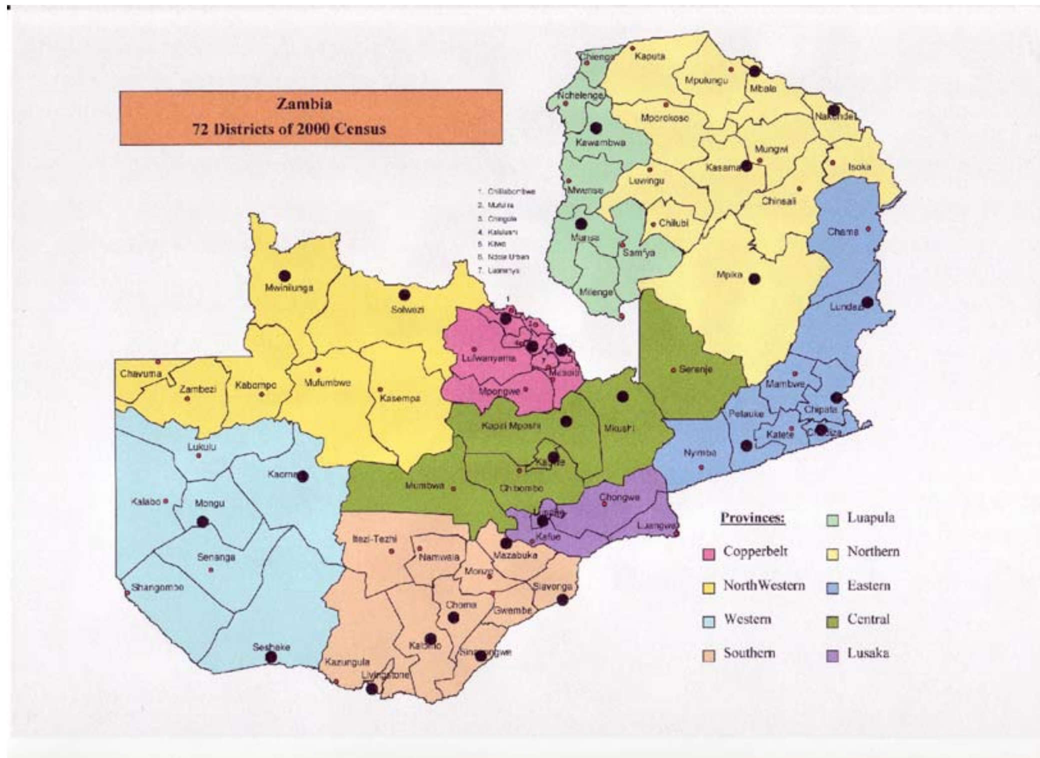
[37] The research assistant's main role was to take notes at the various meetings and write them up afterwards, as well as compile background data, such as district profiles.
[38] See Appendix 5 for district profiles.
[39] Zambia is approximately three times the size of the United Kingdom (UK) with only one sixth of the population.

Figure 4.2: Districts visited



● Districts visited

Table 4.2: Districts visited

Province	Districts visited
Copperbelt	Kitwe*, Chingola, Ndola
Northwestern	Solwezi*, Mwinilunga
Western	Mongu*, Sesheke, Kaoma
Southern	Livingstone*, Siavonga, Mazabuka, Choma, Kalomo, Sinazongwe
Luapula	Mansa*, Kawambwa
Northern	Kasama*, Mpika, Nakonde, Mbala
Eastern	Chipata*, Lundazi, Chadiza, Petauke
Central	Kapiri Mposhi*, Kabwe, Mkushi
Lusaka	Lusaka*, Kafue, Chirundu

* Provincial capital

4.4.1 Focus Group Discussions

The FGDs were planned for 26 districts[40]. The purpose of the FGDs was to obtain information on the level of microfinance activity in a particular district, participants' views on whether the sector should be regulated and supervised, and what they considered the advantages and disadvantages of regulating and supervising the sector.

[40] See Appendix 6 for schedule of FGDs planned.

The visits were organised through the district commissioners (DCs) who were identified as being the best placed to assist with this aspect of the research[41]. The DCs were requested to organise the venues and invite participants based on guidance given by the researcher. This approach was adopted because very little information was available on microfinance, especially in rural areas, making it difficult to identify prospective participants. The main advantage of this approach was that it saved time. It eliminated the need for the researcher to contact potential participants individually from Lusaka. The DC's office served as one point of contact. This reduced reliance on the post and telecommunication network which is not very reliable in rural parts of the country. The efforts of the DCs were complemented by placing advertisements in the national press. At the meetings, participants were asked to fill in participation forms. This enabled a record to be kept of all those who participated as well as those who received questionnaires.

Additionally, the researcher felt that organising the FGDs through the DCs would result in optimising participation levels. The researcher was fortunate in that a letter of introduction from the Permanent Secretary - Cabinet Office was sent to the Provincial Permanent Secretaries who then informed the individual DCs of the intended visit. In addition to the above, as an employee of the central bank, letters of introduction were also obtained from the Deputy Governor - Administration, notifying the DCs of the visits. These actions provided a sense of 'credibility' and 'authority' to the research, thereby increasing the likelihood of cooperation and participation.

Despite 27 FGDs having been planned, only 15 took place[42]. The main reason for this was poor attendance. Nevertheless, it proved to be a successful exercise considering the degree of reliance placed on the DCs' offices, which were under no obligation to assist in facilitating the meetings. The FGDs were written up by the research assistant and reviewed by the researcher. The transcripts were then analysed as described in section 4.5. As a matter of protocol, visits to the districts necessitated meeting with either the DC or a delegated official,

[41] The DCs are appointed by the President and are the heads of district government. They serve as a liaison between the district and central government through Cabinet Office. They ensure government policies are implemented at district level and are responsible for carrying out schemes and plans for the political, economic and social advancement of the district. The DCs, therefore, are familiar, or should be familiar, with all activities in their district. From this, the researcher reasoned that the DCs would know of any MFIs operating in their areas.

[42] This includes the FGD held with Chibansa, a village bank organised by Luangwa North Wildlife. The FGDs in Kawambwa and with Chibansa village bank were conducted in the local language, Bemba, with the aid of an interpreter.

such as the district administrative officer (DAO). These meetings were also used as an opportunity to obtain information.

4.4.2 The survey

According to Babbie (2004), survey research is ideally suited to collecting data for describing a population too large to observe directly. It is also an excellent means of assessing and measuring attitudes and orientations in a large population. The survey served three main purposes[43]. Firstly it was used to obtain information on the characteristics of MFIs operating in the sector regarding legal form, size, services provided, loan portfolio and client profiles. This information was used to get an understanding of the microfinance sector to which the regulatory and supervisory framework was being targeted. This was done because there was very little information on the microfinance sector[44]. Secondly, it was used to establish the current legal arrangements under which MFIs were operating. Lastly, it was used to get views as to whether the sector should be regulated, who should regulate and the benefits of regulating and supervising the industry. It was also used to obtain information on regulatory and non-regulatory obstacles in the microfinance sector.

Most questionnaires were distributed at the FGDs. In cases where the focus groups discussions did not take place, the questionnaires were delivered personally to institutions identified as providing microfinance services by the DC's office (Table 4.3). Other forums, such as the BOZ sensitisation program and the Association of Microfinance Institutions of Zambia's (AMIZ) annual general meeting (AGM), were also used as opportunities to distribute the questionnaires. All questionnaires were distributed by the researcher with the exception of those given to the Agriculture and Marketing Officer, Ministry of Agriculture and Cooperatives (MACO), in Mwinilunga (20), the DC in Kaoma (5) and Solwezi District Union Chairperson in Solwezi (10)[45].

The questionnaires were distributed with the aim of achieving as wide a coverage as possible to get a global picture of the microfinance sector in Zambia. There was no sampling because

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[43] Appendix 11, the Questionnaire.

[44] A survey was commissioned by the BOZ in 1998. Although it was meant to be a baseline survey, it only covered 32 institutions. Information as to how the institutions were selected was not available. Neither was it possible to get copies of the completed questionnaires. Despite its shortcomings, the 1998 survey was the most comprehensive study of the microfinance sector to date. For these reasons, and the fact that the data was now outdated, the researcher decided it would be best to carry out another survey with larger coverage that would specifically address the research objectives.

[45] The numbers in brackets denote the number of questionnaires left with the specified individuals for distribution.

a sampling frame[46] was not identifiable due to the non-availability of information. The absence of an identifiable population to base the sampling on meant it was not possible to pick a 'representative'[47] sample for the survey. As most questionnaires were distributed at FGDs, it was possible for an MFI operating in more than one district to receive more than one questionnaire if it had FGD participant in the different districts[48]. Although more than one questionnaire may have been received at an 'institutional level', in some cases only one completed questionnaire was returned as the organisation's policy required all external requests for information to be dealt with by headoffice. The respondents were provided with stamped addressed envelopes so that once completed, the questionnaires simply had to be placed in the envelop and dropped in the mail box. To increase the response rate, follow up phone calls were made to questionnaire recipients by the research assistant.

Table 4.3: Distribution of questionnaires

Number of Districts	FGD held?	Reason for not holding the FGD	Distribution of questionnaire
15	Yes	n/a	Yes
5	No	Low attendance	Yes
3	No	No arrangements made	Yes
3	No	Low attendance	No

Source: Fieldwork results
n/a = not applicable

Of the 247 questionnaires distributed, only 85 were returned, a substantial number of which were incomplete. The questionnaires were organised according to the 'degree of completeness' and numbered 1 to 85. After the screening process, the researcher decided that only the first 45 were sufficiently complete to be included in the analysis for the research. The responses were then analysed using Excel. Responses to the open ended questions underwent a process of analysis similar to that of the FGD and interview transcripts and described in section 4.5. The responses were analysed and themes extracted and tabulated. These underwent a process of synthesis and sorting to permit the presentation of the results in a meaningful manner. This process was documented and reviewed by a colleague to reduce researcher subjectivity and bias in interpreting the results. In some cases the respondents did

[46] A sampling frame can be defined as "That list or quasi list of units composing a population from which a sample is selected. If the sample is to be representative of the population, it is essential that the sampling frame include all (or nearly all) members of the population" (Babbie, 2004: 199). In this case, the population (i.e. all organisations/institutions providing microfinance in Zambia) is not known.
[47] Babbie (2004: 189) defines representativeness as "that quality of a sample of having the same distribution of characteristics as the population from which it was selected".
[48] If there was more than one participant from the same institution at the same FGD, then only one questionnaire was given.

not answer the question at hand and these responses were not included in the results. Some responses seemed more appropriate to other parts of the question and so were reclassified.

4.4.3 Interviews

Thirty-one interviews were conducted. The interviews were semi-structured following similar formats for the different classes of stakeholders, but largely influenced by the interviewees in terms of their appreciation and understanding of the subject matter at hand. This allowed for specific areas to be addressed, but still permitted flexibility in terms of the questions asked and responses. Furthermore, it permitted the clarification and follow up of issues that arose during the interview (Bryman, 2001).

Purposive sampling[49] was used to identify interviewees and their selection was informed by the researcher's experience in the financial sector and informal discussions with BOZ officials. The selection of interviewees was based on the desire to get views from a cross section of stakeholders and was dependent on the availability of the identified individuals. Some use was made of snowball sampling[50] as interviewees suggested other individuals to be interviewed for the research.

Interviews were held with the following[51]:

- Ministry of Finance officials (2);
- Bank of Zambia officials (3);
- The Registrar of Banks and Financial Institutions (1);
- Other Registrars (3);
- CEOs of MFIs (4);
- Association of Microfinance in Zambia (AMIZ) officials (2);
- The Chairperson of the Bankers Association of Zambia (BAZ) (1);
- Commercial Bank Management (7);
- Donor Agency Officials (5); and
- Consultants (3).

[49] Babbie (2004: 183) defines purposive (judgemental) sampling as "a type of non-probability sampling in which you select the units to be observed on the basis of your own judgement about which ones will be the most useful or representative".
[50] Snowball sampling is "a non-probability sampling method often employed in field research whereby each person interviewed may be asked to suggest additional people for interviewing" (Babbie, 2004: 184).
[51]See Appendix 8 for the list of interviewees.

Interviewees were asked questions covering what they understood by microfinance in the Zambian context, whether microfinance should be regulated, what they meant by regulation, what the benefits of regulation were, who should regulate, the role of microfinance in the development of the economy and the impact the proposed regulations would have on the development of the microfinance sector[52]. Notes were taken during the interviews, either by the researcher or research assistant which were then written up afterwards[53].

4.4.4 Documentary review

The documentary review process involved an examination of documents from various sources. The documents reviewed included:

- banking laws and subsidiary legislation that affect microfinance in Zambia;
- policy documents[54];
- BOZ documents relating to the microfinance sector including correspondence and memos;
- previous studies;
- newspaper and magazine articles; and
- speeches and presentations.

Documents were reviewed bearing in mind four issues relating to their quality of: "(1) authenticity - is the evidence genuine and of unquestionable origin; (2) credibility - is the evidence free from error and distortion; (3) representativeness - is the evidence typical of its kind and, if not, is the extent of its untypicality known?; and (4) meaning - is the evidence clear and comprehensive" (J. Scott 1990: 6 as cited in Bryman, 2001: 370). Documents that were not available to the public were coded to maintain confidentiality and a coding matrix drawn up.

4.4.5 Workshops and seminars

In addition to the above, the researcher attended workshops and seminars that were particularly relevant to the area of study. These included a discussion forum on the regulation of microfinance hosted by CGAP, the Financial Sector Development Plan (FSDP) workshop

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[52] See Appendix 7 for the interview guide.

[53] Two of the interviews were recorded. However, it was observed that when interviewees were asked whether the interviews could be recorded they were not comfortable with the idea although they did not mind notes being taken. Subsequently no requests were made by the researcher to record the interviews.

[54] Such as the annual budgets, the Financial Sector Development Plan (FSDP), the Poverty Reduction Strategy Paper (PRSP), etc.

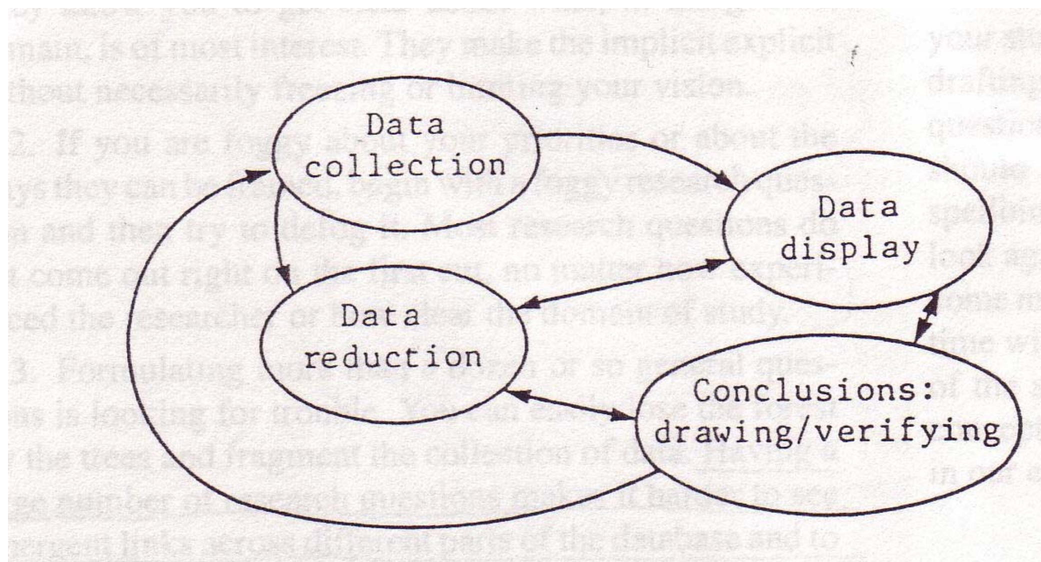
organized by BOZ, and the BOZ sensitisation tour in the Central Province. Informal discussions were held with participants and experts at these forums. The workshops and seminars, especially the Development Studies Association (DSA) Students workshops at which presentations were made, also served as opportunities to subject various stages of the research to discussion and criticism, enhancing the validity and reliability of the research approach and results.

4.5 ANALYSING AND REFERENCING THE DATA

4.5.1 Data analysis

Miles and Huberman (1994: 10) describe the process of analysis as "consisting of three concurrent flows of activity: data reduction, data display and conclusion drawing and verification" as shown in Figure 4.3.

Figure 4.3: Components of data analysis: interactive model



Source: Miles and Huberman (1994: 12)

Data reduction is the "process of selecting, focusing, simplifying, abstracting, and transforming the data", in this case 'words', gathered through interviews and documentary review (Miles and Huberman, 1994: 10). This can be done in a number of ways, which include selection, summarisation and or paraphrasing; and does not necessarily mean quantification. Data reduction occurs throughout the research until completion, through the process of writing summaries, coding, and extracting themes. Decisions regarding which data portions to code and extract, which patterns best summarise data portions and what they mean, are all analytical choices. "Data reduction often forces choices about which aspects of

the assembled data should be emphasised, minimised or set side completely for the purposes of the project at hand"[55]. Thus "data reduction is a form of analysis that sharpens, sorts, focuses, discards, and organises data in such a way that 'final' conclusions can be drawn and verified" (Miles and Huberman, 1994: 11). In this way, data can be organised and meaningfully reduced or reconfigured, making it more manageable and intelligible to the research question being addressed.

Data display is "an organized, compressed assembly of information that permits conclusion drawing..." (Miles and Huberman, 1994: 11). A data display may be an extended piece of text, diagram, matrix, graph or chart. As for data reduction, the authors state that this stage is also part of analysis. Data displays collate information into an immediately accessible, compact form so that the researcher can discern systematic patterns and interrelationships and draw conclusions, or move onto the next step of analysis. Deciding which data to include in displays also has data reduction implications and, consequently, analytic choices.

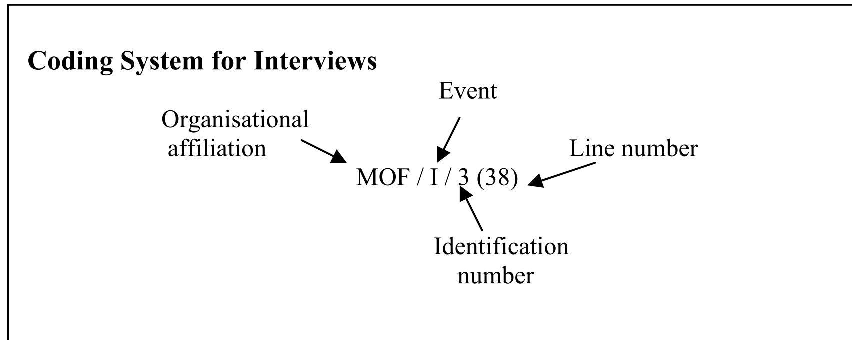
Conclusion drawing involves stepping back to consider what the analysed data mean and assessing their implication for the research questions at hand. Conclusions need to be verified, the meanings emerging from the data "tested for their plausibility, their sturdiness, their confirmability – that is their 'validity'" (Miles and Huberman, 1994: 11). Thus, the transcripts and responses to the open ended questions of the survey underwent a process of data reduction and display as described by Huberman and Miles. Emerging themes were extracted, categorised and labelled. The categories and labels were informed by the research questions. The results were then grouped by listing all references to that category into what the authors refer to as 'data category cards'.

4.5.2 Referencing the work

For ease of reference, and to maintain confidentiality where appropriate, the interviews, FGDs and documents that were not publicly available, such as BOZ correspondence, were coded. Thus all documents, interviews and FGDs were allocated a specific code for ease of reference and to facilitate analysis. The manner in which the coding was done is illustrated in Figures 4.4 and 4.5.

[55] http://www.ehr.nsf.gov/EHR/REC/pubs/NSF97-153/CHAP_4.HTM

Figure 4.4: Coding system for interviews



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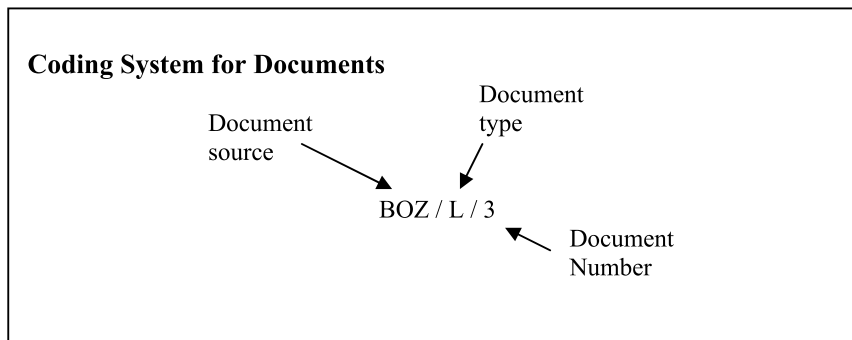
Organisational Affiliation

BS	Banking Sector	MOF	Ministry of Finance
BOZ	Bank of Zambia	OSH	Other Stakeholder
CON	Consultant	REG	Regulator
DCO	District Commissioner's Office	**Event**	
DON	Donors	D	Discussion
FG	Focus Group	M	Meeting
MFI	Microfinance Institution	I	Interview

Figure 4.5: Coding system for documents



INDEX

Document Source		**Document Type**	
BOZ	Bank of Zambia	F	Fax
CSA	Case Study A	L	Letter
CSB	Case Study B	M	Memo
CSC	Case Study C	R	Report

So for example, MOF/I/2 (38) refers to line 38 of transcript MOF/I/2, an interview with a Ministry of Finance Official numbered 2. BOZ/L/3 refers to a letter obtained from BOZ and numbered 3. Documents reviewed were summarised on working schedules[56] showing the date of the document, document type (e.g. memo, letter, report, minutes of meetings, etc), initiator and recipient, the subject matter and issues raised.

[56] Appendix 9 contains an example of a working schedule.

4.6 RESEARCH CONSTRAINTS

A number of challenges were encountered during the research, particularly during the fieldwork. This section describes these challenges and constraints and their impact on the study.

4.6.1 Questionnaire design and response rate

Due to time constraints, it was not possible to get clarification on responses to the open-ended questions. Some questions were misinterpreted by the respondents resulting in responses that were not relevant. This may have been due to language problems, especially in the more rural areas, such as Kawambwa and Mwinilunga, where English is not widely spoken. Moreover, some responses contradicted each other.

Some of these problems would have been minimised had a pilot been conducted. However, this was not possible due to time and resource constraints. Additionally, the fact that the sampling frame was not identifiable would have made it difficult to select a sample for the pilot. Nevertheless, the researcher did have the questionnaire reviewed by colleagues and suggestions and comments to improve the questionnaire design were incorporated. The problems would have been further minimised had the questionnaires been administered by the researcher. But considering the geographic coverage, resource and time constraints, this was not a viable option. The impact of these considerations on the findings of the study was not a significant limitation as some of the same issues relating to whether the microfinance sector should be regulated, the benefits of regulation, and the existing regulatory and non-regulatory obstacles, were explored at the FGDs and in the interviews. Thus, other sources of data were also relied upon to address these issues.

The response rate was poor. Two hundred and forty seven questionnaires were distributed, but only 85 returned. An attempt was made to increase the response rate with follow up telephone calls to questionnaire recipients. Most of the returned questionnaires were incomplete. In particular, the questions relating to the MFIs loan portfolios were poorly responded to. This may have been because: (1) the respondent, i.e. the person answering the questionnaire, may not have had the information (or access to the information), especially if they were located in one of the branches; (2) the information was simply not available (possibly due to poor record keeping); or (3) the respondent simply did not wish to provide the information for reasons of confidentiality and secrecy. As above, this problem may have been mitigated had a pilot been conducted. Had the questionnaire been administered by the

researcher, there would have been an opportunity to determine the specific reasons for these questions not being answered[57].

4.6.2 Conflict of interest

The researcher, as an employee of BOZ, was fortunate in that this facilitated access to interviewees, privileged documents and the aid of the DCs' offices in organising the focus group meetings. It was difficult at times, however, to separate the roles of researcher and central bank employee and maintain the distinction. So at the FGDs and some of the interviews, it became necessary to respond to queries and points of clarification regarding BOZ policy and actions.

Thus, in a lot of cases, the interviews and meetings were a two way process. Some participants and interviewees saw this as an opportunity to discuss BOZ policies and issues that were not part of the meeting agenda, such as bank failures and BOZ action taken to prevent them, the policy on interest rates, and the provision of affordable financial services in rural areas. In such circumstances, the researcher obliged and answered questions and queries, seeing it as part of the process of reciprocity and the realisation that some participants, especially in more rural parts of the country, may not have another opportunity to interact on a personal level with a central bank official. It was also difficult to assess the extent to which questionnaire respondents, FG participants, and interviewees were influenced by the fact that they were dealing with a BOZ official. After thinking through and reflecting on the possible consequences on the study findings, the researcher concluded that any impact on the study results would have been minimal, and that her willingness to indulge the FGD participants and interviewees probably encouraged more open dialogue than would have been the case had the agenda been strictly adhered to.

4.6.3 Targeting of FGD participants and survey limitations

Although the DCs were given explicit guidance as to whom to invite to the meetings, there were problems with the targeting of the focus group participants. This resulted in participants not suited for the intended purpose of the meeting. Eight meetings were cancelled because of this. This may not necessarily have been a bad thing, but simply an indication that, in that area at least, there was very little microfinance activity and very few, if any, MFIs. In some cases,

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[57] After noting this trend, however, informal discussions with various individuals revealed that the majority of MFIs, with the exclusion of the banks, had poor MIS and poor record keeping, a finding in line with the results of the BOZ 1998 survey. The non-availability of data was also exemplified by the fact that the Association for Microfinance Institutions in Zambia (AMIZ) did not have financial data for its members.

this was validated by individuals that did turn up for the meetings stating that there were no MFIs in the area, or that they had never heard of microfinance and that they did not know of any organisation providing microfinance services. Overall, therefore, the impact of this 'constraint' was beneficial in that it contributed in evaluating the level of microfinance activity in different parts of Zambia.

Related to the issue of targeting, is that some MFIs might have been excluded altogether from the survey. It might have been that they were not aware of the meetings or decided not to attend. This raises a number of matters for consideration, such as how many institutions decided not to attend and were consequently excluded from the survey? Assuming that these MFIs, and those that did receive the questionnaire but did not respond, had completed and returned the questionnaire, would this have presented a different picture? How different? The researcher did try to mitigate this by asking participants whether they knew of any MFIs operating in the area but were not present at the focus group meeting. Considering the low level of activity in the microfinance sector, especially in rural areas, the researcher did not feel that this was, in any way, a major set back.

4.6.4 Staff movements and leaves of absence

Shortly after the start of the field work, a number of key personnel dealing with the Microfinance Project in BOZ were either transferred to other departments or went on extended leaves of absence. This affected the flow and availability of information as other members of staff had to familiarise themselves with matters relating to the Microfinance Project. Due to the poor state of the records and the filing system, locating relevant documents to review was heavily dependent on assistance from relevant members of staff. It also meant that documents relating to phase one of the project were not reviewed as it was not possible to locate them. The effect of this was that the documentary review process took longer than anticipated. However, data obtained from the documentary review process was complemented and supplemented with data from other sources and collected by other means. Therefore, this was not considered a major impediment.

4.7 CONCLUSION

The purpose of this chapter was to set out the research methods used, the data collection techniques and the data analysis process employed for the study. It also highlighted some of the limitations encountered during the research. RIA and case study methods were identified as appropriate methods for addressing the research objectives of assessing the potential

impact of regulation and supervision on the microfinance sector, obtaining a better understanding of the microfinance sector in Zambia and lastly, obtaining a better understanding of the existing regulatory and supervisory environment.

RIA is an evidence-based approach to decision–making. As a tool that is used for analysing the costs and benefits of regulatory change, it provides a structured framework within which to carry out the analysis in addressing the main research objective of assessing the potential impact of regulation and supervision on the microfinance sector. The chapter highlighted the benefits of adopting RIA. Although the literature did identify some weaknesses associated with its use, these were considered minor as compared to the benefits that could be derived from its use. To date, RIA has mostly been used in OECD countries. Reservations were noted as to the transferability of RIA to developing countries, mainly due to the different economies and greater focus on developmental goals rather than the correction of market failures. But a number of authors did feel that developing countries had much to gain from adopting RIA as long as the RIA design was appropriate to the political, cultural and social characteristics of the country in question and took into account the institutional and legal context. The RIA model used for the study was adapted from the UK model as the UK has a well established policy and wealth of experience that the researcher was able to draw on.

The case study approach was particularly suited to the study as it facilitated a holistic, in-depth investigation of the impact of regulation (both existing and potential) on MFIs. Although case studies are often disparaged for their lack of rigor, dubious scientific generalisation of results and voluminous documents, they are valuable for describing an intervention and the context in which it occurred, illustrating certain topics within an evaluation, and exploring those situations in which the intervention being evaluated has no clear single set of outcomes. The criticisms of the case study approach were mitigated by adopting a multiple case design. Thus, all three MFIs that had been licensed by BOZ were selected for the study. The case studies were used to address all three research objectives.

Section 4.4 described the activities undertaken to collect the data, namely FGDs, survey, semi-structured interviews and documentary review. Two hundred and forty-seven questionnaires were distributed but only 85 returned. A review of the returned questionnaires resulted in only 45 being used due to the fact most were incomplete. Fifteen FGDs were held in various parts of Zambia and 31 interviews conducted with a cross section of stakeholders. The documentary review process involved an examination of documents from various sources. Use was also made of relevant forums and workshops that the researcher felt would

contribute positively to the study. The data was then organised and coded for ease of reference and analysed as described in section 4.5.

The challenges and constraints faced whilst carrying out the research, how these were mitigated where possible and their impact on the study were then examined. These included: (1) problems in relation to the misinterpretation of the survey questions, contradictory responses and unanswered questions; (2) the poor response rate; (3) the conflict of interest resulting from the researcher being a BOZ employee; (4) poor targeting of FGD participants in some instances; and (5) the fact that some MFIs may have been excluded from the survey altogether. The researcher reflected on these constraints and their impact on the results obtained. Overall, the researcher felt that the actions taken, such as the review of the questionnaire and the data reduction process for the responses to the open ended questions of the survey by colleagues, helped to mitigate some of the limitations. Furthermore, subjecting the research approach and findings to discussion and criticism at a number of workshops during the course of the study helped ensure that findings were valid and reliable.

5 THE MICROFINANCE SECTOR IN ZAMBIA

5.1 INTRODUCTION

The principle objective of this chapter is to describe and appraise the microfinance sector in Zambia, drawing on the results of the survey, FGDs, interviews and documentary review, with a view to addressing the research question of 'obtaining a better understanding of microfinance in Zambia'. The chapter is organised as follows. Section 5.2 outlines the economic reforms undertaken since the change in government in 1991, economic performance over the period, and poverty levels in Zambia. It then discusses, in section 5.3, the financial sector and the effects of the liberalisation policies. This is followed by a review of the microfinance sector in section 5.4. Section 5.5 examines the constraints identified to the development of the microfinance sector. The implications for developing a regulatory framework for the microfinance industry are appraised in section 5.6. Section 5.7 summarises and concludes.

5.2 ZAMBIA BACKGROUND

5.2.1 Introduction

The change in government in 1991 brought about radical economic reform, from state control to an economy led by private sector development[58]. Between 1991 and 2002, policy and structural reforms were adopted in a number of areas which are summarised in Table 5.1[59]. This section describes, in brief, the reforms undertaken.

Zambia was once one of the most prosperous countries in sub-Saharan Africa (SSA), but is now one of the least developed countries in the world. From 1980 to 1990 the country's economic growth rate was the second lowest in the Southern African Development Community (SADC) after Mozambique. From 1990 to 1999, it had the lowest average annual growth rate in the SADC region at 1%. This was also below the sub-Saharan African rate of

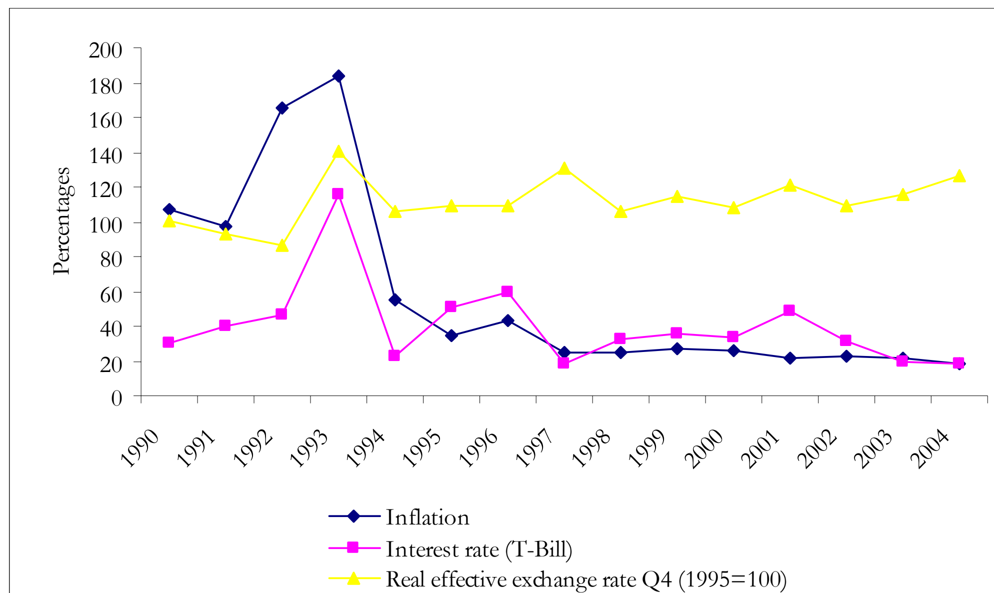
[58] Prior to 1991, the State controlled more than 80% of the economy (Kani, 1998).
[59] And detailed in Appendix 12.

2.4%. As a result, per capita GNP declined over the years since independence (MOF, 2002)[60]. However, the macroeconomic environment has improved significantly since the 1990s. For the last six years, Zambia has experienced positive per capita growth. The Government has taken fundamental steps to introduce better fiscal control and improve the budget management process. The kwacha has been relatively stable, lending interest rates have been reduced and inflation has been brought down to single digit figures.

5.2.2 Policy and structural reforms

In an effort to achieve price stability, borrowing and lending rates were decontrolled in October 1992 and the Treasury bill (TB) was introduced as a less inflationary form of deficit financing. In 1993, BOZ removed all restrictions on bank lending and deposit rates and allowed official interest rates to be determined by the market at the weekly TB auctions (WB, 2004).

Figure 5.1: Inflation, interest and real exchange rates



Source: IMF 1999 and 2006

Real interest rates rose dramatically, from largely negative rates at the end of 1992 to substantial positive rates by the end of 1993, with an annualised yield on 91 day TBs reaching

[60] GNP per capita fell by 31% from US$650 in 1980 to US$449 in 1990. It continued to decline, falling by 28% to US$322 in 1999.

almost 200% in July 1993 (McCulloch et al, 2000)[61]. Interest rates and inflation rates have since fallen substantially with the monthly average 91 day TB rate for January 2006 at 15.1% and the inflation rate at 12.2%[62].

Between 1992 and 1995, foreign exchange controls were also being removed (WB, 2004). In particular, the exchange rate and the allocation of foreign exchange were permitted to be market determined, first through the introduction of a 'bureau de change' market in October 1992 to determine the exchange rate. By March 1993, most foreign exchange controls on current transactions had been removed and in February 1994 the capital account of the foreign exchange payment systems was liberalised (McCulloch et al, 2000; Maimbo, 2001). In 1994, citizens and non-citizens were allowed to own foreign currency accounts and the kwacha became fully convertible[63]. In 1996, the final phase of liberalisation of the foreign exchange market was implemented with Zambia Consolidated Copper Mines (ZCCM) being allowed to retain all its foreign currency earnings and supply foreign exchange to the market directly (Kani, 1996)[64].

The third area of reform was in fiscal policy. In an effort to strengthen budgetary control, the Government introduced a 'cash budgeting system' in January 1993 in which government payments could only be made if cash was available. On the domestic revenue side, Government established the Zambia Revenue Authority (ZRA) in 1994 and introduced a value-added tax (VAT) to replace the former cumbersome system of sales tax. On the expenditure side, the Government abolished all agricultural subsidies as well as loans and loan guarantees for parastatals, except for ZCCM (WB, 2004). This, combined with the liberalisation of commercial banking loan rates, an increase in the reserve ratio, and the active issue of TBs, resulted in reducing inflation considerably.

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[61] Hitherto, interest rates had been negative for most of the time since independence (Kani, 1998).
[62] http://www.boz.zm (accessed Tuesday, 18 April 2006).
[63] The current exchange rate regime is a managed float with no preannounced path (WB, 2004).
[64] Prior to this, ZCCM was required to sell an agreed percentage to the BOZ which then supplied foreign exchange to the commercial banks through the foreign exchange auctions.

Table 5.1: Chronology of macroeconomic reforms, 1992 to 1996

Year	Macroeconomic reform
1992	**January** • Subsidies on maize meal removed **June** • Subsidies on maize meal (roller meal) removed • Controls on prices eased, most eliminated • Fertiliser market opened up for full competition **July** • Privatisation Bill enacted • Zambia Privatisation Agency (ZPA) established **September** • First phase of Government redundancy programme **October** • Bureaux de change system for foreign exchange introduced **December** • Exchange rates unified (with ZCCM selling at the market exchange rate) • First tranche of 19 parastatals offered for sale
1993	**January** • Cash budget introduced • Weekly TB tender commenced • General reduction in tariffs and excise • Reduction in corporate tax rate • Elimination of import and export licenses announced, import licence levy abolished • Company tax rate reduced **March** • Exchange controls on current transactions removed **June** • Import and export licences eliminated • Establishment of Zambia Revenue Authority (ZRA) **July** • Formal establishment of the Lusaka Stock Exchange (LuSE) • Markets for maize and fertiliser opened to full competition **November** • Commencement of Public Sector Reform Programme (PSRP)
1994	**January** • Exchange controls removed **April** • ZRA commences operations
1995	**July** • Value added tax introduced, sales tax repealed • Revised Land Act enacted enabling unused land to be purchased by investors
1996	**April** • ZCCM allowed to retain 100% of its foreign exchange receipts and supply the market directly

Source: WB (2004: 7-13)

Subsidies on maize meal, the staple food, and fertilisers were eliminated in 1992. In 1993, the Government decontrolled maize producer prices, withdrew agricultural inputs, eliminated maize transport subsidies and attempted to engage in government-supported lending institutions in maize marketing. However, the private sector was slow in replacing the Government in the liberalised grain market. This resulted in a lack of credit for maize purchases and financial losses for farmers. As a temporary measure, the Government established the Agricultural Credit Management Programme (ACMP) in 1994 to provide credit for fertiliser and seed and to strengthen the capacity of private traders to act as financial intermediaries.

In addition to the reforms outlined above, the Government implemented an extensive privatisation program, and sweeping trade policy and public sector reforms. The Privatisation Act was enacted in 1993 paving the way for the privatisation of Zambia's parastatals. Fifteen parastatals were sold by mid 1995, with the pace increasing rapidly and an additional 224 divested by 1997. By the end of December 2003, a total of 258 companies had been privatised of a total of 282 (WB, 2004)[65]. The radical programme of trade and industrial policy reform, started in 1992, eliminated all licensing and quantitative restrictions on imports and exports over a five year period[66]. Tariffs were reduced and the tariff structure simplified. The Public Sector Reform Program, also started in 1992, was aimed at reducing the civil service and improving its competence and professionalism (Kani, 1996).

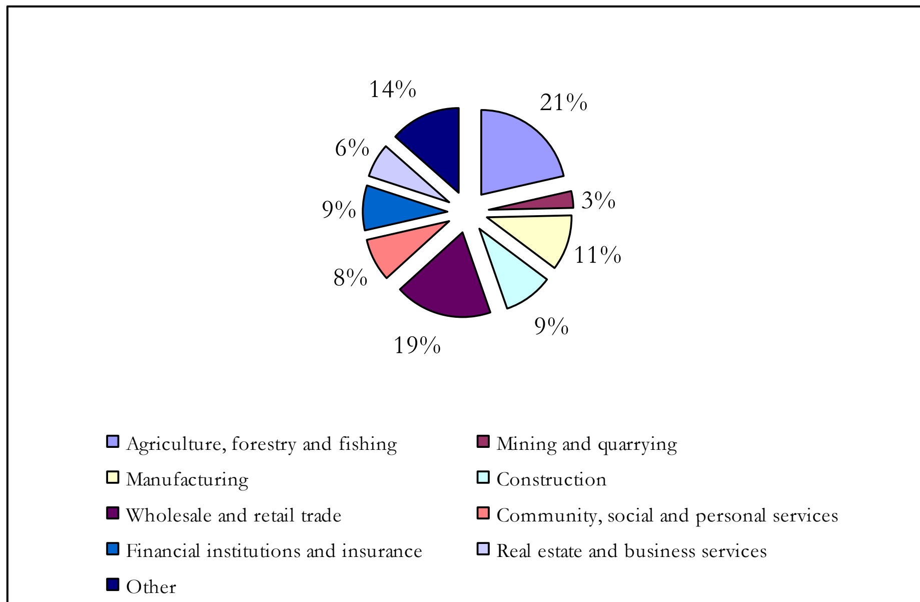
5.2.3 Economic performance

GDP growth fluctuated considerably in the 1990s but was not high enough to stop the decline in GDP per capita. In the years when real GDP growth rates were achieved (1993, +6.8% and 1996, +6.4%), the single biggest contributor to growth was the agricultural sector. The high growth in agriculture came from export crops like cotton, fresh flowers and tobacco (Kani, 1998; McCulloch et al, 2000). The agriculture sector accounts for the largest proportion of GDP as shown in Figure 5.2. Despite the fall in real US$ copper prices by more than a half between 1970 and 1990, and the sector's low contribution to GDP, Zambia

[65] ZCCM, the large integrated copper mining and processing parastatal was sold in 2000 to Anglo American Corporation. Unfortunately, Anglo withdrew in 2002 after suffering considerable losses.
[66] The ban on maize exports was lifted in 1993.

is heavily dependent on the mining sector, specifically copper, which accounts for over 60% of export earnings.

Figure 5.2: GDP by sector of origin at current prices, 2004



Source: IMF (2006)

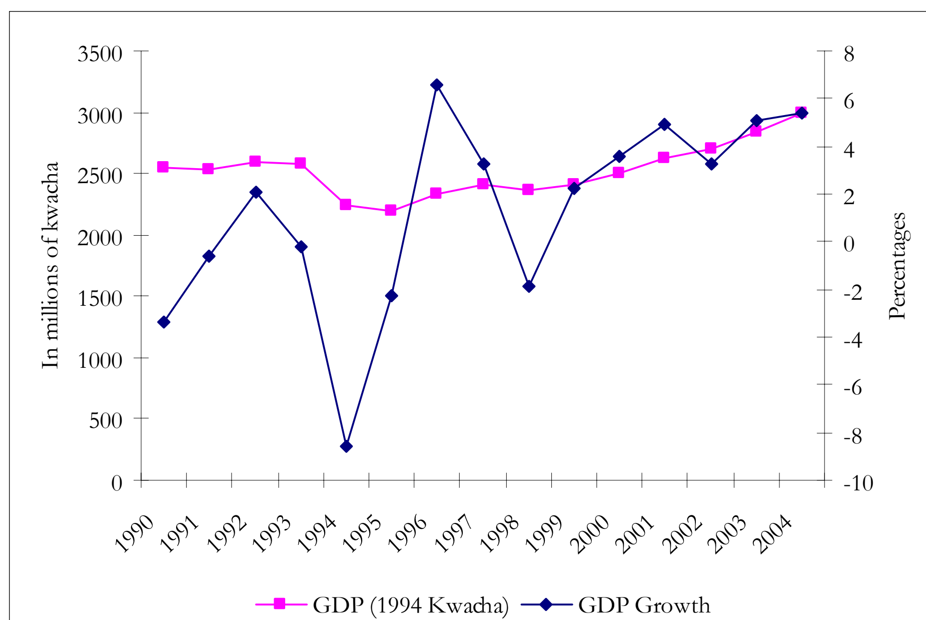
However, recent years have seen a marked improvement in Zambia's performance as reflected in the steady growth of GDP since 2000 (Figure 5.3). This improvement is mainly attributable to a rebound in copper sector output following the privatisation of ZCCM in 2000, as well as the recent rise in copper prices to historic highs (IMF, 2006). As a result of improvements in the terms of trade resulting from the increased copper exports on which Zambia is still heavily dependent, renewed confidence in the economy arising from the marked improvement in fiscal performance and the commitment of extensive external debt relief, the real effective exchange rate of the kwacha has appreciated over the last two years by 26%. Furthermore, interest and inflation rates have continued to fall steadily (Figure 5.1). Thus, it would appear that Zambia is on its way to achieving macro economic stability.

5.2.4 Poverty in Zambia

Zambia has a population of approximately 10.2 million people. According to the 2000 census, 61.3% of the population is below the age of sixteen. As shown in Table 5.2, the average population density ranged from 4.6 persons per square kilometre in the Northwestern

Province to 63.5 persons per square kilometre in Lusaka, with a national average of 13.1 persons per square kilometre (CSO, 2003).

Figure 5.3: GDP and GDP growth



Source: IMF (1999) and IMF (2006)

Table 5.2: Population density, 2000

Province	Population density (Population per sq.km)
Zambia	13.1
Province	
Central	10.7
Copperbelt	50.5
Eastern	18.9
Luapula	15.3
Lusaka	63.5
Northern	8.5
North-Western	4.6
Southern	14.2
Western	6.1

Source: CSO (2003)

Zambia's poor economic performance over the past thirty years, reflected by the declining per capita GDP, had a significant impact on the level of poverty in the country. Poverty increased

not only in income terms, but in all major non-income dimensions as well (MOF, 2002)[67]. An estimated 86% of the population is living in poverty, of which approximately 72% is living on less than a dollar a day (WB, 2001). Although Zambia is by SSA standards relatively urbanised, 65% of the population live in rural areas where poverty is more pervasive (CSO, 2003), with a poverty headcount of 83% compared to 56% in urban areas (Table 5.3). Small-scale rural farmers are one of the poorest groups in Zambia (Brownbridge, 1997).

Table 5.3: Percentage of population living below the poverty line by region, 1991-1998

Region	1991	1993	1996	1998
Zambia	70	74	69	73
Residence				
Urban	47	45	46	56
Rural	88	92	83	83
Province				
Central	70	81	74	77
Copperbelt	61	49	56	65
Eastern	85	91	82	80
Luapula	84	88	79	81
Lusaka	31	39	38	52
Northern	84	86	84	81
North-Western	75	88	80	76
Southern	79	87	76	76
Western	84	91	84	89

Source: WB (2004: 14)

The worsening poverty trend was attributed to a number of factors including: (1) poor economic performance; (2) the absence of well conceived policies that address rural and urban poverty and the non-prioritisation of pro-poor interventions in the budgetary process; (3) declining labour and land productivity due to unfavourable land ownership laws and unsupportive land tenure systems; and (4) weaknesses in governance, both economic and political (MOF, 2002: 11). The situation was exacerbated by the reforms initiated by the Government in the early 1990s, which resulted in the shrinking of the formal employment sector from 466,925 in 1998 to 416,099 in 2004 (IMF, 2006).

Consequently, as for many other developing countries, Zambia's informal sector remains the most dynamic in terms of employment generation. The informal sector was estimated to account for over 70% of the Zambian labour force (MOF, 2002: 43). The majority of the population, therefore, will probably continue to depend on this sector for their livelihood.

[67] Using the nationally determined poverty line, the proportion of the population below the poverty line increased to 73% in 1997 from 69.7% in 1991 (CSO, 1998).

Thus, polices to support this sector, including the provision of training programs for entrepreneurs, the provision of low cost workshops and trading facilities, and the development of specialised FIs, such as MFIS, need to be implemented (Brownbridge, 1997). In recognition of this, the Government, through the Poverty Reduction Strategy Paper (PRSP) addressed "the issue of strengthening credit markets for financing investment. The role of micro-financing is perceived to be crucial in this regard and both the Government and the private sector will have a role to play at this level" (MOF, 2002: 44).

One of the main challenges for reducing poverty is the development of an enabling environment that provides the poor with opportunities to earn sustainable incomes that provide for their needs and take them out of poverty. The main productive asset of the poor is labour, and in some cases, land. Thus, government policy should raise returns to labour and land. As small-scale rural farmers constitute a significant proportion of low income households, policies should be pro-agricultural and public expenditure directed to budget items which enhance their productivity. With regard to the non-agricultural sector, governments should seek to promote labour intensive industries, especially small scale and micro-enterprises, which provide employment opportunities for the poor (Brownbridge, 1997).

5.3 THE FINANCIAL SECTOR

5.3.1 Introduction

Prior to the economic reforms undertaken in the early 1990s, the financial sector was dominated by foreign owned banks and state owned FIs set up by the Government for various purposes. Three of the major banks, Barclays Bank (BBZ), Standard Chartered Bank (SCB) and Stanbic Bank (SB)[68] were established prior to independence to serve the interests of foreign corporate entities (Brownbridge, 1996b)[69].

To redress this perceived imbalance, the Government adopted policies that revolved around the nationalisation of foreign owned NBFIs; the establishment of government owned banks

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[68] Previously ANZ Grindlays Bank.

[69] These three banks account for over 50% of total banking sector assets. With Zambia National Commercial Bank (ZNCB), the state owned bank, the four largest commercial banks account for over 75% of total banking sector assets (www.boz.zm).

and development FIs to provide financial services to indigenous Zambians; the establishment of administrative controls over interest rates, and to a limited extent, credit allocation (Brownbridge, 1996b: 2). FIs set up by the Government included the National Savings and Credit Bank (NSCB), Zambia National Commercial Bank (ZNCB), Zambia National Building Society (ZNBS), Lima Bank and the Cooperative Bank. Furthermore, in line with the Government's policy of extending financial services into the rural areas, commercial banks were required to set up a rural branch for each new urban branch established after the bank's first four branches had been set up (Brownbridge, 1996b).

5.3.2 Government owned financial institutions

Until the 1990s, the Government took the lead in providing concessional and long-term finance to priority sectors; priority sectors included the micro, small and medium sectors of the economy (Maimbo and Mavrotas, 2003). Thus, the Government provided micro, small and medium scale financial services. Lima Bank, the Credit Union and Savings Association (CUSA) and the Zambia Cooperative Federation's Finance Services (ZCFFS) were established to provide short term production credit to farmers at subsidised interest rates. However, their performance was poor due to high default rates, either because harvests were poor, or because borrowers treated their loans as subsidies or grants. As part of the reforms started in 1992, the Government stopped providing funds for agricultural credit. Coupled with their poor performance, this led to the collapse of the Lima Bank and ZCFFS, and the cessation of the provision of short term rural credit by CUSA in 1997 (WB, 2004).

In 1969, the Government set up ZNCB to meet the credit needs of indigenous Zambians not being served by the foreign banks and to extend banking into rural areas. Although one of the objectives of ZNCB was to finance local business, the bank has been reluctant to extend credit to this sector, especially the small farmer, which it considers too risky and unprofitable, and, consequently, the bank has not met its mandate of serving this sector.

To meet the financial service needs of rural and low income households on a broader scale, the Government established NSCB in 1972 through an Act of Parliament. The main objective of the bank was to mobilise savings in rural areas (Musona and Coetzee, 2001b). Conceived as a post office bank, it served the interests of small savers well into the early 1990s. To date, however, its performance has been dismal. In 1999, it terminated its agency agreement with

the Post Office due to the Post Office's failure to pass on deposits mobilised to the bank. NSCB is to be recapitalised and has been given a fresh mandate to play an active role in stimulating economic activity among the poorer sections of the population (NSCB, 2004).

5.3.3 Effects of the liberalisation policies

The liberalisation policies outlined above led to the proliferation of institutions in the financial sector. It became easier to obtain a financial institution license, although prior restrictions may have been due more to political considerations than anything else. Additionally, capital requirements were low due to the depreciation of the kwacha (Brownbridge 1996b)[70]. Ten bank licences were issued between 1991 and 1994, with the number of commercial banks in operation increasing from ten in 1990 to thirteen in 2006, peaking at eighteen in 1994 and 1996. In addition to the banks, there are 8 leasing companies, 3 building societies, 4 MFIs, 1 development bank, 1 NBFI and 32 bureaux de change currently licensed with BOZ[71].

Unfortunately, Zambia, like so many other countries, experienced financial sector distress which resulted in the closure of nine banks[72]. The bank closures led to a loss of confidence and what was termed a 'flight to quality', i.e. the shift of deposits from the smaller, indigenous, locally owned institutions to foreign owned banks which are perceived to be 'safer' as all the banks which have failed to date, with one exception, have been in the former group. The bank closures also served to discourage people from placing deposits in FIs for fear of loss in the event of failure (Chiumya, 1999). Consequently, any new institution, especially a DT FI, entering the financial sector, faces a formidable task of inspiring trust and confidence in those it wishes to serve.

5.4 THE MICROFINANCE SECTOR

5.4.1 The emergence of the microfinance sector

The failure of government owned FIs, such as Lima Bank, the Cooperative Bank, CUSA and ZCFFS, denied a significant portion of the population access to financial services. The supply of credit to small scale farmers shrank dramatically since the liberalisation of the financial

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[70] In 1991, the minimum capital requirement for banks was K20 million (US$0.3 million). This was revised to K2 billion in 1994 (US$2 million). However, with the depreciation of the kwacha over the years, it is now the equivalent of approximately US$ 432,500 (at the BOZ mid-exchange rate of US$1/K4,635 at 13 April 2005).

[71] www.boz.zm, accessed April 2006.

sector in the early 1990s (WB, 2004). Access to financial services was further constrained by the closure of unprofitable rural branches by commercial banks, high bank charges and high minimum account balances (Chiumya, 2004)[73]. These developments resulted in a financial sector that focused on meeting the needs of the corporate sector and the more affluent working class. The growth of MFIs, therefore, resulted in part from an identification of a gap in the market and the need to fill this gap (Maimbo, 2000).

To foster the interests of the microfinance sector, two organisations, the MicroBankers Trust (MBT) and the Association of Microfinance Institutions of Zambia (AMIZ), were set up. MBT was set up in 1996 by the Government and the European Union (EU) as part of the Microcredit Delivery for the Empowerment of the Poor Program to provide wholesale funds and training to MFIs. The primary objective of MBT was the "economic empowerment of vulnerable individuals through the provision of credit to financial intermediaries for on-lending to vulnerable individuals in Zambia" (Mbanacele, 2000: 8). Other objectives included staff training to strengthen institutional capacity; assisting in the design and operation of microcredit delivery in a viable and effective manner; and improving performance through evaluation, research, performance monitoring, and sound lending policies (Mbanacele, 2000; Musona and Coetzee, 2001b). Since 2000, however, MBT has changed its orientation. It no longer provides wholesale funds and provides microcredit directly to clients. The change in orientation was a direct result of the failure of MFIs to repay their loans[74].

AMIZ was established by microfinance practitioners and was officially registered in March 1998. It has taken a lead role in campaigning for new legislation, standard setting and staff training for new MFIs. Its mission is to "facilitate, support and strengthen the services provided by member MFIs and represent them in the best way possible by utilizing microfinance best practices" (AMIZ, 2003: 3). The main objectives of the Association are listed in Box 5.1.

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[72] 3 in 1995, 3 in 1997, 1 in 1998, 1 in 2000 and 1 in 2001.
[73] See Appendix 13 for commercial bank account operating conditions.
[74] Email correspondence with M Nandazi, CEO of MBT.

Box 5.1: AMIZ objectives

The objectives of AMIZ are:
1. To disseminate and exchange information on key issues related to microfinance;
2. To lobby government, donors, and other stakeholders on issues of law, enabling environment and support programs for microfinance as well as the need to develop strong and dedicated micro entrepreneurs in order to spur sustainable microfinance development;
3. To become a coordinating and representative body for member microfinance institutions;
4. To strengthen lateral learning among practitioners;
5. To facilitate sustainable business development services to microfinance institutions;
6. To support best practices and innovative techniques utilised by microfinance institutions in Zambia; and
7. To establish and maintain professional standards of microfinance conduct among member MFIs and the industry in general.

Source: AMIZ Business Plan 2004-2007, December 2003: 3

5.4.2 Microfinance in the Zambian Context

The following subsections describe the microfinance industry in Zambia, drawing on the findings from the fieldwork, specifically the surveys, FGDs and interviews, as well as the documentary review. It starts by defining microfinance in the Zambian context. It then goes on to describe the microfinance sector with regard to the types of microfinance providers operating in the sector, the ownership and funding of these institutions, their outreach, the products and services offered, collateral requirements and client profile.

A starting point to understanding the microfinance sector in Zambia is to clarify what is meant by microfinance in the Zambian context. This is an area that has proved challenging with different views emerging as to what 'counts' as microfinance and what does not. Defining microfinance is particularly important as it has implications in determining whether the proposed government intervention is appropriately targeted.

Most definitions given by interviewees and FG participants (Box 5.2) were similar to the broad definition given in section 2.3, i.e. microfinance is the provision of financial services to low income households including the self employed. When asked how they would define microfinance in the Zambian context (Box 5.3), respondents made reference to the 'size' of the loan amount [FG/D/11 (30), MOF/I/1 (23), CON/I/1 (59)]. Some respondents were more specific stating that it should be an amount less than K50 million [FG/D/11 (59)]. A number of FG participants included *kaloba* (obtaining of loans from moneylenders) as microfinance [FG/D/14 (329)].

Box 5.2: General definition of microfinance

Ms Chiumya "What is your understanding of microfinance?"

[DON/I/2 (46)] "Well, it is the provision of credit facilities to the lower income bracket so that they can improve their lifestyles. And this credit is given to small traders and the economically active poor."

[MOF/I/2 (32)] "Microfinance is the provision of financial services in an informal manner. Microfinance institutions are financial institutions – they are there for 'ordinary people' because they can't go to banks like Barclays…"

[BS/I/8 (27)] "Microfinance is providing credit to the poorest of the poor."

Source: Fieldwork interview results

Box 5.3: Microfinance in the Zambian context

Ms Chiumya "How would you define microfinance in the Zambian context?"

[CON/I/1 (30)] "I would say microfinance is simply development finance because it looks at financial needs of small entrepreneurs. The word micro denotes small clients."

[CON/I/1 (463)] "The majority of institutions in Zambia are giving out microcredit. Strictly speaking we do not have microfinance as such. Because microfinance would involve the taking of deposits of some form, there is intermediation involved for it to be called microfinance. Now in microcredit, the majority of the institutions actually are projects. There are very few institutions whom you can call microfinance institutions. There are very few. The rest are projects."

[CON/I/3 (18)] "Microfinance is about providing financial services to the unbanked market. I wouldn't use the word poor because there are a lot of people who are not poor but do use financial services, especially credit. Microfinance is a market which is not sophisticated."

[MOF/I/1 (18)] "Microfinance is a simple and practical way of empowering people by giving them loans with no collateral requirement relevant to their situations."

[MOF/I/1 (23)] "Loans start at very low amounts such as K50,000 or K100,000 and it increases on the basis of performance."

[MOF/I/1 (27)] "But it should be kept below K5 million because once it exceeds this figure it breaks community ties."

[MFI/I/6 (17)] "It is financial services provision and business services to low income entrepreneurs for self employment and resources to sustain financial means."

Source: Fieldwork interview results

"The term 'microfinance institution' has become almost synonymous with NGO" (Valenzuela and Young 1999: 17). This was also evident in the Zambian context as reflected by some of the comments made; for example, "My hope is that Pride and these MFIs will be able to come

to this place" [FG/D/29 (273)]; "Apart from the three banks and Natsave, there is nothing" [FG/D/29 (34)]. These comments were made although the district, in this case Kasama, did have FIs that provided 'small loans' and catered to low income households, but in the minds of the FG participants, there were no MFIs in these districts. Other examples are given in Table 5.4.

Table 5.4: Districts with no NGO MFIs

District	FIs providing microfinance	Reference
Kawambwa	1 bank (ZNCB)	FG/D/24 (65)
Mansa	3 banks (ZNCB, BBZ, NSCB) and 1 building society (ZNBS)	FG/D/26 (46)
Sesheke	1 bank (FB)	FG/D/23 (98)
Kasama	4 banks (SCB, ZNCB, FB, NSCB) and 1 building society (ZNBS)	FG/D/29 (34)

Source: Fieldwork results

Similarly, microfinance was still predominantly associated with the provision of credit to low income households in the informal sector with the aim of improving welfare. Thus, there were differing views as to whether microfinance included the provision of consumer loans, backed by salaries or wages, with no poverty alleviation objective. As shown in Box 5.4, some interviewees felt what was relevant was the size of the amounts involved in the transactions and the profile of the clientele being served (CON/I/1, MFI/I/6, BS/I/8), not the purpose for which the loan was used or collateral requirements. This view was consistent with the definition given by Robinson (2001: 9), "Microfinance refers to small-scale financial services – primarily credit and savings – provided to people … who work for wages or commissions … both rural and urban".

She goes on to note that "analysts have restricted microfinance to narrower definitions. Thus, the term is often used to refer to those who work in the informal sector of the economy". While most microfinance services target the informal sector, Robinson's definition is broader and includes "the financial services to poor employees of the formal sector as well. Such employees can, in fact, be poorer than those in the informal sector. …Other uses of the term microfinance sometimes have the effect of restricting its meaning to specifics, such as village lending programmes or group lending methodologies" (Robinson 2001: 41). Consistent with this view of microfinance, there were those interviewees who felt that financial services provided that were not specifically intended for alleviating poverty, did not qualify as microfinance (MOF/I/1, MFI/I/1, MFI/1/4). Consumer loans, therefore, would not qualify (Box 5.4), as "Microfinance is a developmental tool. Muzfin and Bayport are exploiting their

clients. This is consumer lending and should be distinguished from microfinance!" [MFI/I/4 (93)].

Box 5.4: Classification of consumer loans

Ms Chiumya "How about personal loans from commercial banks, would you also include them under microfinance?"

[CON/I/1 (59)] "If we are to go just by the size of the loan provided, we can put these under microfinance. But we have to be careful because microfinance does not only look at the size of the loan but also the characteristics of the borrower as well. If the borrower can afford collateral, then we call it a micro loan and not microfinance. Under microfinance on the other hand we talk about collateral substitutes such social collateral. People get loans in groups which act as guarantee for individual members of the group."

Ms Chiumya "Would you include consumer loans like those provided by the banks in the definition?"

[MFI/I/6 (24)] "Yes. Microfinance institutions should take advantage of developments in the market as long as the regulatory environment permits. The loans by the banks are to low income households."

[BS/I/8 (33)] "Yes I would. Banks are now competitors. They are being encouraged by the high interest rates and they thought they could make a killing. But banks find that they have to work with microfinance institutions because they have the capacity."

Ms Chiumya "Would you include the consumer loans being offered by commercial banks in your definition of microfinance?"

[MOF/I/1 (40)] "No, I wouldn't include consumer loans because then you are bringing in individual elements that introduce elements of greed."

Source: Fieldwork interview results

Thus, there was no clear consensus as to what constitutes microfinance. The definition of microfinance from BOZ's perspective is that contained in the draft regulations [BOZ/I/4 (185)]. The definition focuses predominantly on the provision of microcredit, its characteristics (frequent repayments), and the client profile (small or micro enterprises and low income customers). This was similar to the definitions of microfinance of other SSA countries as shown in Table 5.5[75] which also made reference to the loan characteristics (non-traditional collateral, collateral substitutes), client profile (low income customers, small/micro enterprises) and the maximum loan amount (percentage of capital or GDP).

[75] See Appendix 14 for more detailed definitions.

Box 5.5: BOZ definition of microfinance

Microfinance institution

- A person who, as part of their business, advances micro credit facilities.

Micro credit

- A credit facility that does not exceed five per centum of the primary capital of a licensed microfinance institution as prescribed by BOZ.

Microfinance service

- The provision of services primarily to small or micro enterprises or low income customers and includes the following (a) the provision of credit facilities usually characterised by frequent repayments and (b) the acceptance of remittances and any other services that the Bank of Zambia may designate.

Low income customer

- A person, who is economically active, receives low income and does not have access to formal financial institutions.

Source: Draft Microfinance Regulations (DMFRs)

Table 5.5: Comparison of definitions of selected sub-Saharan countries

	Zambia	Ethiopia	Kenya	Tanzania	Uganda
Focus of definition	Microcredit	Credit	- Loans - Receiving deposits	Savings and deposits	- Deposit taking - Short-term loans
Product characteristics	Frequent repayments		"acceptable security and insurance"	Non-traditional collateral	- Loan term < 2 years - Collateral substitutes
Client profile	- Small/micro enterprises - Low income customers	- Peasant farmers - Urban small enterprises	Micro/small enterprises	Self employed with poor/non-existent financial records	- Micro enterprises - Low income households
Maximum loan limit	5% of primary capital	0.5% of capital	GDP per capita		1% of core capital for individuals, 5% for groups

Source: Compiled by the researcher using data from http://microfinancegateway.org/resource_centers/reg_sup/micro_reg/country

As would be expected, the diversity in institutional form was accompanied by diversity in legal form. Nineteen of the 39 MFIs were registered as societies, 8 were registered as companies, and another 8 were registered as cooperatives[76]. Two MFIs, the NSCB and ZNBS, were

[76] Appendix 16 provides a description of the cooperative sector in Zambia.

established by Acts of Parliament. The findings were consistent with the microfinance sectors of other countries such as Kenya and Tanzania, which have a diversity of microfinance providers, registered under different Acts and, therefore, falling under different supervisory authorities[77].

Table 5.6: Institutional types of MFIs

Institutional type	Number	%
NGO - MFIs	10	26
Cooperative	8	21
Commercial bank	6	15
NGOs	5	13
Business association	5	13
Church	2	5
Building society	1	3
Other	2	5
Total	39	100

Source: Fieldwork survey results

Table 5.7: Legal form of MFIs

Legal Form	Number	%
Society	19	49
Company	8	21
Cooperative	8	21
Act of parliament	2	5
Sole proprietorship	1	3
No response	1	3
Total # of MFIs	39	100

Source: Fieldwork survey results

The survey results revealed that 67% of the MFIs were established in the last decade, i.e. from 1996-2004 (Table 5.8). However, this may have more to do with Zambia's history than anything else. As noted earlier, prior to the economic reforms, the Government took the lead in providing financial services to the segment of the population that had been excluded from the formal banking sector. Furthermore, prior to the change in government, the political climate was not conducive to the setting up of donor driven NGOs or FIs. Another reason why most MFIs may have been set up in the latter part of the 1990s is that it is only in the last twenty years that international development agencies, as well as donors, have identified microfinance as an effective tool in poverty alleviation as noted by the World Bank Study in Section.2.7.

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[77] This is in contrast to those countries in which the legal form of MFIs is mandated by the law, e.g. Ethiopia which requires MFIs to be 'share' companies (Shiferaw and Amha, 2001) and similarly for Uganda, MFIs must be limited companies (Microfinance Deposit-Taking Institutions Act of 2003).

According to the survey results, eight of the MFIs (21%) were established prior to 1990. A closer analysis revealed that these MFIs comprised 2 banks, 2 FIs established by Acts of Parliament, a church, an NGO, a cooperative and an NGO MFI. This result was also consistent with the World Bank findings in which the older MFIs were mainly banks and cooperatives (Section 2.7). Therefore the microfinance sector can be described as still being in the nascent stage.

Table 5.8: Establishment of MFIs

Date	Number	%
– 1990	8	21
1991 – 1995	5	13
1996 – 2000	16	41
2001 – 2004	10	26
Total	39	100

Source: Fieldwork survey results

5.4.3 Ownership and funding

According to the survey results, member based organisations accounted for the largest number of MFIs at 49% (19). All the cooperatives and district business organisations were member based and these alone accounted for 12 of the 19 MFIs. This was followed by NGOs at 18%. Three respondents indicated that their organisations were owned by individuals. The results are summarised in Table 5.9.

Table 5.9: Ownership of MFIs

	Number	%
Members	19	49
NGO	7	18
Individuals	3	8
Companies	2	5
Government	2	5
Other	5	13
No response	1	3
Total # of MFIs	39	100

Source: Fieldwork survey results

Funding sources varied as shown in Table 5.10, with 9 MFIs reporting more than one funding source. The main source of funding was from donors with 16 (41%) respondents indicating that their institution was funded by donors. This result was also consistent with the World Bank study findings in which donor funding accounted for the bulk of funding sources on all

three continents surveyed (section 2.7). This was followed by deposits and equity at 21%. The least cited source of funding was government with 4 respondents stating that their organisation received funding from this source.

Table 5.10: Sources of funding

	Number	%
Donors	16	41
Deposits	8	21
Equity	8	21
Commercial loans	6	15
Members contributions	5	13
Government	4	10
Other	4	10
No response	2	5
Total # of MFIs	39	

Source: Fieldwork survey results

5.4.4 Outreach

According to the survey results, a significant proportion of MFI branches were located along the 'line of rail' (i.e. from the Copperbelt Province in the north to Livingstone in the Southern Province). The further away a district was from the line of rail, the fewer the number of FIs, including MFIs, operating in that area. The survey results are presented in Figure 5.4.

In some districts, FG participants remarked that there were no MFIs in their area (Box 5.6). This observation was corroborated by discussions held with individuals, including the DCs and DAOs, in outlying areas and the researcher's observations. The findings can be explained by the fact that the population density is highest along the line of rail; the quality of physical infrastructure, e.g. roads, telecommunications, and electricity is better than in outlying areas; and lastly, cash transactions dominate whereas barter is still common in rural areas.

Despite the growth in the number of MFIs in the last decade, the outreach of the microfinance sector has been very poor[78]. It is evident from the results that MFIs in Zambia are relatively small compared to those in other countries as illustrated in Table 5.11. The number of active clients reported by survey respondents totalled approximately 15,356.

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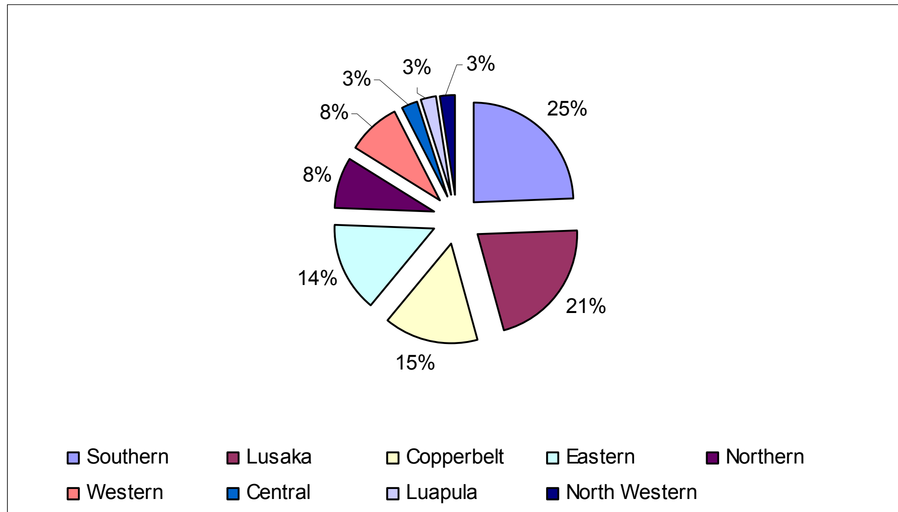
[78] Eleven of the respondents did not provide responses to questions relating to client profiles, and this included most of the banks. With the exception of three banks, Finance Bank (FB), Cavmont Capital Bank (CCB), and NSCB, banks in Zambia have not actively served the microfinance sector, although this is now starting to change. Of those respondents that did indicate the total number of active clients they had, numbers ranged from 3,948 to 10 per institution.

Figure 5.4: Distribution of branches



Source: Fieldwork survey results

Box 5.6: Perceived non-existence of MFIs in some districts

Sinazongwe

Ms Chiumya "Do you have any banks in the district?"

[FG/D/23 (71)] "We only have the Zambia National Commercial Bank in Maamba."

Ms Chiumya "So the people from here have to go to Maamba for the services?"

[FG/D/23 (77)] "Some people go to Barclays Bank in Choma. In fact most of the civil servants in the Ministry of Education get their salaries from Barclays in Choma."[79]

[FG/D/23 (244)] "There is FINCA operating in Maamba."

Chadiza

Ms Chiumya "Do you know what a microfinance institution is?"

[FG/D/15 (79)] "It's an institution that gives small loans to people. Unfortunately there aren't any in Chadiza. There is only one in Katete called Micro Bankers Trust. There used to be one programme under CARE International that used to deal in microfinance but it was phased out."

Kasama

[FG/D/29 (177)] "In fact, there are areas that are not too remote like Luwingu and Kaputa but don't have any banks."

Source: Fieldwork interview results

[79] The distance between Sinazongwe and Choma is approximately 100 km.

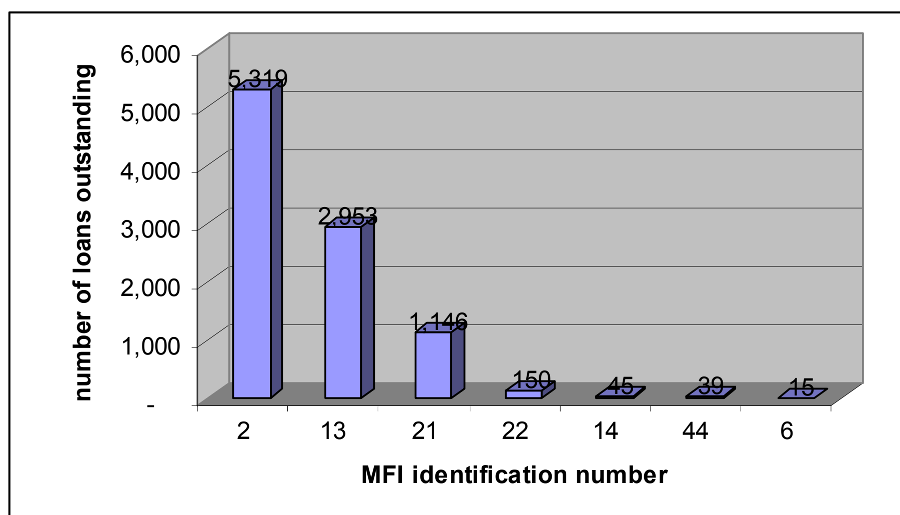
Table 5.11: Outreach of selected MFIs

Zambian MFIs	Active # of clients	Comparative figures	Active # of clients
MBT	3,175	PRIDE, Uganda	66,023
CETZAM	3,948	PRIDE, Tanzania	48,216
Pulse	2,953	K-Rep, Kenya	45,379

Source: Survey results and WWB (2005), Country Overviews

According to the survey responses, the number of loans outstanding ranged from 5,319 to 15 as shown in Figure 5.5[80]. Considering the fact that responses were received from two of the largest NGO-MFIs, this is further evidence that MFIs in Zambia are relatively small with low outreach.

Figure 5.5: Number of loans outstanding



Source: Fieldwork survey results

Considering the poor response rate, it could be argued that these figures are grossly understated, especially as they do not include any figures from the banks, such as FB, NSCB and CCB which service low income households. However, it does indicate that the microfinance sector in Zambia is not vibrant, an observation also noted by some of the interviewees (Box 5.7). In a study undertaken by M & N Associates (2003: 2), the 28 microfinance schemes surveyed had an outreach of 80,202 clients. The MFI with the largest outreach at the time of the study, CETZAM, had 20,451 active members, but now has only

[80] There were only 7 responses to this question (out of a possible total of 39).

3,948[81] and the smallest scheme, Africa Enterprises Trust, had 150 clients. AMIZ members had 37,207 active clients at the end of 2003 (AMIZ, 2004: 3).

Box 5.7: Poor outreach of MFIs

Ms Chiumya "So in terms of the types of institutions that you find in Zambia, are there any that predominate? You have just mentioned that village banking has come up in the last few years…"

[CON/I/1 (463)] "The majority of institutions in Zambia are giving out microcredit. Strictly speaking we do not have microfinance as such. Because microfinance would involve the taking of deposits of some form, there is intermediation involved for it to be called microfinance. Now in microcredit, the majority of the institutions actually are projects. There are very few institutions whom you can call microfinance institutions. There are very few. The rest are projects."

Ms Chiumya "And who are these projects run by?"

[CON/I/1 (474)] "By the church, these days almost every church has got a microfinance activity. We'll be visiting EFZ in my next work which we began and we are going to the field tomorrow. EFZ they have got a microfinance operation. You know it is the Evangelical Fellowship of Zambia. The Catholics, we'll also be visiting Salvation Army. So everybody is in microfinance. But these are not institutions, these are projects."

[CON/I/2 (139)] "Microfinance in Zambia is not growing."

Source: Fieldwork interview results

Despite indications to the contrary, some interviewees did feel the sector was growing as indicated by their responses quoted in Box 5.8.

Box 5.8: Growing microfinance sector

Ms Chiumya "Do you think the microfinance sector is growing?"

[BS/I/8 (44)] "It is a growing sector. Most formal banks operate along the line of rail. But institutions like Pride are becoming small banks catering to the needs of what was previously thought to be the unbankable sector."

[CON/I/3 (27)] "Absolutely! It is growing because there aren't that many financial institutions. The ones that are there serve large corporations and target a specific market. Even I am not in their target market so there is a wide range of clientele not being serviced."

Source: Fieldwork interview results

Overall, however, these results are not surprising. Other studies have shown that the outreach of MFIs in SSA still remains low compared to those found in Asia or Latin America. This is usually attributed to the low population densities, the poor physical infrastructure, low levels of monetisation, and lack of entrepreneurial spirit (Chao-Béroff, 1999a; WB, 1996).

[81] Even with this drastic fall in the number of active clients, CETZAM is still one of the largest NGO MFIs in Zambia.

5.4.5 Products and services

The survey results showed that the financial services offered by MFIs included savings, insurance, foreign exchange transactions and funds transfers, in addition to loans, as summarised in Table 5.12. All MFIs reported to be providing money transfer were banks. Of the 4 MFIs reported to be providing foreign exchange services, only one was a NBFI, the rest were banks. Four MFIs stated that they provided insurance services. However, most MFIs were acting as agents. As observed by one of the interviewees with extensive experience of microfinance in Zambia; "Indirectly they have some insurance, some of them now" [CON/I/1 (487)]. "We have some microfinance institutions that have gone into arrangements with insurance companies. They have been appointed as it were as agents for specialised products. Now this insurance product is designed to assist in situations where a client dies or an immediate member of the client's family dies there is a payment that is made to cushion the disruption that usually comes with such events" [CON/I/1 (490)].

Fourteen survey respondents indicated that their institutions do provide savings facilities, but for most MFIs (68%), it was forced savings that they required their members to have. Very few (32%) offered savings as a service. This may have been due to the fact that the existing legislative environment does not permit the mobilisation of deposits by an organisation not licensed to do so under the Banking and Financial Services Act (BFSA). However, BOZ had tended to turn a blind eye to forced savings, as depositors in such situations were usually net borrowers of the MFI.

Table 5.12: Other financial services offered by MFIs

Other financial services	**Number**	**%**
Savings	14	36
Insurance	4	10
Foreign exchange transactions	4	10
Funds transfers	3	8
Other	1	3
No response	21	54
Total # of MFIs	39	

Source: Fieldwork survey results

According to the survey results, a variety of loan products were offered by MFIs, the most common being agricultural loans (20) and trade/commercial loans (18). The results are summarised in Table 5.13.

Table 5.13: Loan products offered

Loan products offered	Number	%
Agriculture	20	51
Trade/commercial	18	46
Consumption	7	18
Manufacturing	6	15
Housing	5	13
Repay existing loans	2	5
Other	3	8
No response	9	23
Total # of MFIs	39	

Source: Fieldwork survey results

Only one of the MFIs surveyed provided credit to start ups. Almost all microfinance programs required borrowers to have existing income generating activities, thus proving their entrepreneurial abilities [FG/D/6 (144), FG/D/28 (81), MFI/I/1 (459), FG/D/14 (393), MFI/1/4 (60)].

Table 5.14: Loan profiles of selected MFIs

	Loan size		Interest rates		Duration		Repayment frequency
	Min	Max	Min	Max	Min	Max	
CETZAM	K 50,000	K20 m	36%	54%	16 wks	12 mths	wkly, mthly
NSCB	None[a]	K50 m[a]	49%				
Pride	K150,000[b]	K10 m[b]	19%	60%			wkly, fortnightly
ZNBS	K100,000[c]	K10 m[c]			6 mths	12 mths	mthly
ZNCB	K2 m[d]	K20 m[d]					
MBT	K50,000	K2 m	48%	60%	3 mths	18 mths	mthly, qrtly
PPS	K100,000	K2 m	24%	48%	6 mths	12 mths	mthly
Pulse	K150,000	K10 m	70%	70%	1 mth	12 mths	wkly, mthly
LWF	K100,000	K2.5 m	15%	20%	6 mths	12 mths	
DAPP	K350,000	K600,000	15%	30%	6 mths	8 mths	
Harmos	K100,000	K1 m	60%	60%	12 wks	12 wks	wkly

Sources: Survey results; [a]FG/D/6 (50); [b]FG/D/14 (403); [c]FG/D/14 (56) & (64); [d]FG/D/6 (82)
Note: m denotes million

According to the survey results, the minimum loan size was K50,000 and the maximum K10 million[82]. Interest rates varied widely as shown in Table 5.14. The minimum loan duration reported was for one month, the maximum three years. According to the survey results, on average, the minimum repayment period for loans was 6 months and the maximum, one year. For most institutions, loan repayments had to be made either weekly (13%) or monthly (28%). According to the survey results, both group lending and individual lending methodologies were used as shown in Table 5.15. Previous studies found that the most common

[82] Approximately US$10 and US$2,160 at the BOZ mid rate exchange of K4,625/US$ at 13 April 2005.

methodology adopted was the group lending approach (Wilkinson, 2003, M & N Associates, 2003)[83]. This was consistent with the Lapenau and Zeller study discussed in Chapter 3 in which they found the solidarity group methodology dominated if Indonesian MFIs were excluded from the results and the individual lending methodology dominated when Indonesian MFIs were included.

Table 5.15: Lending methodologies of selected MFIs

	Lending methodology			**Forced savings[a]**		**Used for onlending**	**Training**	
	Individual	**Group**	**Size**					
CETZAM	Yes	Yes	20-40	Yes	10%	No	Yes	10 wks
Pride		Yes	5-50	Yes	K36,000		Yes	4 wks
ZNBS*	Yes	No						
MBT	No	Yes	10-30	Yes	20%	No	Yes	4 wks
PPS	No	Yes	7-15	Yes	20%	No[b]		
Pulse	Yes	Yes	3-5	Yes	10%			
LWF	Yes	Yes	10-27					
DAPP	Yes	Yes	10-15					
Harmos	Yes	Yes	5-8	Yes	20%	No	Yes	7 days
KZF	Yes	Yes	2-8	Yes	30%	Yes		

Source: Survey results
Notes: [a]Usually stipulated as a percentage of the loan amount; [b]Some groups use their savings as revolving funds.

From the fieldwork, unless the MFI was a bank, the services offered by microfinance providers were restricted to the provision of microcredit for existing business activities. Therefore, there was still a massive gap in the market in terms of service provision. This coupled with the poor outreach of MFIs, meant that a significant portion of the population was without access to financial services.

5.4.6 Collateral requirements

Various forms of collateral were accepted. These included personal and group guarantees, land, forced savings, household goods, cars and livestock. Twenty one respondents indicated that their institutions required collateral. Nine respondents indicated that their institutions did not require collateral. In relation to forced savings, seven (18%) of the respondents indicated that their organisations did not require forced savings, whereas 15 (38%) said that they did. Where forced savings were a requirement for obtaining a loan, 4 respondents stated that their organisations required clients to have saved 10% of the loan amount and for another 3

[83] In the survey by M & N Associates, all respondents, except one, used the individual lending approach, the group lending methodology, or both. In cases where both methodologies were used, individuals would have most likely graduated from groups to individual lending. Further, M & N Associates distinguish 2 variants of

institutions, it was 20%. These savings were kept in commercial bank accounts. Five respondents indicated that their institutions did not permit the withdrawal of forced savings, whereas 13 indicated that they did, but only after the loans had been repaid in full. Where withdrawals were permitted before the loan was liquidated, the most cited circumstance under which this was permitted was for family emergencies (5). Eleven respondents indicated that the savings were used for on-lending. Six of the 11 institutions were commercial banks. Seven respondents indicated that their organisations did not use the funds for on-lending. Table 5.15 shows the results for selected MFIs. Overall, the results indicate that MFIs in Zambia were flexible in terms of acceptable collateral. This finding was consistent with MFI approaches to collateral in other parts of the world.

5.4.7 Client profile

According to the survey results, there was not much difference in the reported distribution of clients between genders. 14 respondents indicated that less than 50% of their clients were female compared to 12 that said that their female clients accounted for more than 50%. There was more of a difference in relation to the urban distribution with 9 respondents indicating that more than 50% of their clients were located in urban areas compared to 5 which stated that less than 50% were located in urban areas. The results are summarised in Table 5.16. These results corroborate the findings that microfinance activity is concentrated in urban areas as noted in section 5.4.4.

Table 5.16: Client distribution

	Female		Urban	
	#	%	#	%
0-25%	4	10	2	5
26-50%	10	26	3	8
51-75%	10	26	6	15
76-100%	2	5	3	8
No response	13	33	25	64
Total	39	100	39	100

Source: Fieldwork survey results

Client selection was based primarily on interest in the program (18) followed by poverty levels and locality both at 12. Most MFIs operating in urban areas operate in compounds (urban slums) and by implication, therefore, are targeting the population at the lower end of the

group lending, one version being similar to the solidarity groups of Latin America and the other, the village bank model (M & N Associates, 2003: 4).

income spectrum. Sixteen of the respondents indicated that more than one criterion was used to select clients. The survey results are summarised in Table 5.17.

Table 5.17: Client selection criteria

Selection criteria	Number	%
Interest in the program	18	46
Poverty levels	12	13
Locality	12	31
Experience in business	12	31
Gender	11	28
Other	2	5
No responses	8	21

Source: Fieldwork survey results

5.5 CONSTRAINTS TO THE DEVELOPMENT OF THE MICROFINANCE SECTOR

A number of obstacles to the development of the microfinance sector were identified by the survey respondents and interviewees. These obstacles were confirmed by various studies and policy documents reviewed during the research. The obstacles, summarised in Table 5.18, can be broadly grouped into 2 categories: (1) institutional and industry level obstacles and (2) macro level obstacles.

Table 5.18: Obstacles to the development of the microfinance sector

Institutional and industry level	Macro level
• Lack of capital • Poor internal controls and the lack of industry standards • Lack of experienced personnel • High dropout rates • Inappropriate lending methodologies • Low repayment rates	• Poor credit and savings culture • Poor infrastructure • Legal environment • Unstable economic environment • Lack of income generating opportunities • Zambia's demographics • Political interference • Natural calamities e.g. drought

Source: Fieldwork survey results

5.5.1 Institutional and industry level constraints

Most MFIs in Zambia are heavily dependent on donor funding as noted in section 5.4.3. This raises doubts as to their sustainability in the absence of donor funding. It has also been argued that a high proportion of resources are dedicated to the training of clients resulting in less resources being available for the provision of loans (BOZ, 1999; Maimbo, 2000; Mbanacele, 2000). Thus, the lack of capital was the most common obstacle identified by

survey respondents and interviewees. This finding was consistent with the study commissioned by Women's World Banking (WWB) and the Africa Microfinance Network (AFMIN) of Issues in Microfinance Policy and Market Segmentation in Eastern and Southern Africa (Chiumya, 2005).

Poor internal controls was the second most commonly identified obstacle by survey respondents. Inadequate management information systems (MIS) and the lack of industry standards were also identified as obstacles (AMIZ, 2004) and was the major cause of the fall in outreach noted in section 5.4.4 and further highlighted by the case studies in Chapter 7. This finding was also consistent with the experience of other SSA countries (Chiumya, 2005).

The third obstacle identified by the survey respondents was the lack of experienced personnel. This observation was consistent with the findings of other studies. In most cases, practitioners had very few years experience and still had a lot to learn with regard to microfinance lending methodologies, internal control procedures appropriate to microfinance business, and the establishment of appropriate governance structures. The lack of experienced personnel was said to have had a negative impact on the performance of MFIs (Maimbo, 2000; AMIZ, 2004).

The fourth obstacle identified, principally by previous studies, were the high dropout rates (M & N Associates, 2003). High dropout rates were costly because of the loss of the investment in training and 'social preparation' from clients leaving and the opportunity cost of losing older, more experienced clients who are most likely to graduate to larger loans which are more profitable for the institution. In Zambia, dropout rates range from 35% to 92% per annum (Musona and Coetzee, 2001a). This was in line with findings from studies conducted in other parts of East and Southern Africa. In East Africa, dropout rates ranged from 25% to 60% per annum. The most common reasons for dropping out were: (1) loan disbursement delays; (2) loans being used for consumption purposes, resulting in the failure to repay; (3) the resentment of the group guarantee scheme and requirement to have forced savings; (4) weekly repayments not coinciding with borrowers' cash flows; and (5) the low loan amounts. In other words, the inappropriate products and lending methodologies (Box 5.9) that did not suit customers' needs contributed significantly to the levels of dropouts. "MFIs need to provide products that are demand driven to minimise this mismatch" (AMIZ, 2004: 8).

Box 5.9: Appropriateness of the Grameen methodology

Ms Chiumya "Is the Grameen model suitable for the Zambian environment?" [MFI/I/4 (71)] "We have faced some challenges in implementation, one of which relates to the weekly repayment. Weekly repayments are difficult because of the economic environment."

Source: Fieldwork interview results

Low repayment rates were also identified as an obstacle to the development of the sector. The low repayment rates were the result of a number of other factors that have been separately identified, such as the poor credit culture, the over indebtedness of clients in localities with high concentrations of MFIs (e.g. in urban compounds), inappropriate lending methodologies, and the macroeconomic instability of the 1990s and first few years of the millennium (Maimbo, 2000; Mbanacele, 2000; AMIZ, 2004).

5.5.2 Macro level constraints

At the macro level, the poor credit and savings culture was the most commonly cited obstacle to the development of the microfinance sector. As noted by one of the interviewees, "The credit culture in Zambia was not very good. People need to be taught what it meant to get a loan. Business concepts are not known" [MFI/I/3 (110)]. This was exacerbated by the non-existence of credit bureaux, which would possibly ameliorate the problem (AMIZ, 2004: 8).

This was followed by poor infrastructure as identified by various sources and experienced first hand by the researcher during the fieldwork. "Like most other developing countries, Zambia suffers from a lack of basic infrastructure in rural communities. Electricity supply in outlying areas is unreliable and in some areas non existent. The telecommunications system is poorly developed, making it difficult to communicate. Thus, financial institutions have problems communicating effectively with head office and other branches. This also adversely affects the smooth and efficient operation of any payments system. Much of the country is covered by gravel roads. Away from the main line of rail, where roads are paved they are in bad need of repair" (Chiumya, 2004: 20). All these factors make the costs of operating in rural areas very high, even for MFIs (Box 5.10). Poor infrastructure adversely affects investment resulting in low levels of economic activity at any level, micro or macro (WB, 2004).

Box 5.10: Constraints to operating in rural areas

[MFI/I/3 (125)] "The organisation could not afford to go into rural areas as the loan sizes would be too small, volumes too low because of the low population density and high transport costs."

[MFI/I/3 (128)] "There was also the issue of supervising credit officers in these areas. All in all, the costs of doing business would be too high. ... It would be problematic and frustrating trying to find out what's going on."

Source: Fieldwork interview results

The third obstacle identified at the macro level was the legal environment. The inefficient legal system which was cumbersome and lengthy rendered legal action extremely costly making it an untenable option for recovering small outstanding loan balances.

As noted in section 5.2.3, Zambia's economic environment in the 1990s was characterised by high inflation, high interest rates and a volatile exchange rate, an observation made by one of the interviewees who stated, "The amount of money in people's hands is low, purchasing power has been declining. The economic fundamentals are that inflation is high, the exchange rate is not stable against the (South African) rand which makes it difficult to do business. Prices have to be continuously adjusted" [MFI/I/6 (44)]. The harsh macroeconomic environment negatively affected economic activity, making it difficult for borrowers to repay their loans. Tied in to this, was the lack of income generating opportunities available for individuals to engage in. However, as Zambia's economic performance has improved in the last few years with ensuing macroeconomic stability, this may prove to be less of an obstacle.

The fifth obstacle related to Zambia's demographics. Rural areas in Zambia are characterised by low population densities and an environment in which barter and self-sufficiency from peasant farming is common. Cash transactions off the main roads are unusual. Furthermore, the prevalence rate of HIV/AIDS is very high (AMIZ, 2004: 8). This has profoundly affected households' abilities to engage in income generating activities. "The industry was struggling. Zambia is a small country with a small population. Other countries had higher population densities and, therefore, could enjoy economies of scale. One also needed to take into consideration the clientele's ability to absorb capital. At the informal level, the businesses were not that vibrant compared to those found in other countries" [MFI/I/3 (102)].

Reference was also made to political interference as an obstacle, especially with regard to 'debt forgiveness' which had exacerbated the poor credit culture already mentioned earlier (AMIZ, 2004: 8), a finding consistent with obstacles identified in other SSA countries (Chiumya, 2005). Lastly, survey respondents identified natural calamities, such as drought, which adversely affect activities such as agriculture, thus affecting borrowers' abilities to repay their loans.

5.6 IMPLICATIONS FOR THE REGULATORY FRAMEWORK

The regulatory and supervisory framework needs to take into account the characteristics of the microfinance industry in order for it to be appropriate and effective. A clear understanding of the types of institutions operating in the sector and the activities undertaken makes it possible to assess the impact of a proposed government intervention, in this case, assessing the potential impact of regulation and supervision on the microfinance sector. This section, therefore, highlights the implications that the microfinance industry structure described in the preceding sections will have for developing the regulatory framework.

5.6.1 Definition of microfinance in Zambia

How microfinance is defined will have an impact on the targeting of the microfinance regulations. This is particularly important, as it will affect the impact that the proposed intervention will have and whether it will affect those for which it was not intended. It is important to be clear by what is meant by microfinance so that it is only the identified activities and institutions engaged in that activity that are affected by the proposed government intervention. The definition given by BOZ as given by the Microfinance Regulations is very broad and general and implies that all persons and organisations that provide microcredit will be covered, including the informal sector. The purpose for which the loan is used is not relevant and so consumer loans will be covered. In theory there is no maximum loan amount, as the maximum credit amount is limited with reference to the primary capital level (5% of primary capital). Therefore as long as primary capital is increased, the maximum credit limit will also increase (for an individual loan amount).

5.6.2 Microfinance providers

Although not always explicitly stated, much of the recent interest in regulation and supervision has come from the growing NGO sector and their involvement in the provision of financial services. These institutions are typically unregulated for the provision of financial services[84]. Thus, the discussion of regulation and supervision implicitly is about the regulation of these kinds of institutions as opposed to the microfinance activity. However, the reality, as illustrated by the Zambian case amongst others, is that microfinance providers take on a variety of legal and institutional forms and, therefore, it may be more appropriate to focus on regulating the microfinance activity rather than the 'special' types of institutions.

5.6.3 Ownership and funding

The findings of the survey indicated that the industry is dominated by member based organisations. This raises the question of whether there is any need to regulate member based institutions in the same manner as banking institutions. The literature states that member based institutions do not require external regulation as the members can exercise sufficient oversight. Furthermore, the main source of funding is donors and developmental organisations. The question then arises as to whether these 'investors' need protecting. According to the framework proposed by van Greuning et al (1998), described in Chapter 3, no external regulation is required if the industry is dominated by organisations funded by donors.

5.6.4 Industry performance

The microfinance industry in Zambia is still very young as evidenced by the fact that most MFIs were established in the last decade. The industry is not growing. If anything, it is showing signs of contracting. This raises the question of the desirability of introducing regulations for an industry that is stagnating before it has even taken off. On the other hand, some argue that regulations could in fact help boost the sector and promote growth. Furthermore, the outreach of the microfinance industry has been poor. This has implications in that the introduction of regulations will further affect the outreach of the industry depending on whether the regulations succeed in promoting growth or act as a further

[84] Other institutions, e.g. banks, cooperatives, and NBFIs typically are regulated.

hindrance to the development of the sector. Care needs to be taken that the regulations do not hamper what already appears to be an industry that is struggling.

The service provided is mainly microcredit. Therefore, there is scope for the expansion of the types of services offered, provided that the regulatory framework does not restrict the services that can be provided in an industry where the services being supplied are already severely limited, particularly with reference to the provision of savings. This especially relates to how forced savings will be treated, whether they will be classified as deposits, thus requiring MFIs that otherwise do not provide savings facilities in the strictest sense, to obtain licences as DT MFIs.

5.7 CONCLUSION

The principle objective of this chapter was to describe and appraise the microfinance sector, drawing on the results of the survey, FGDs, interviews and documentary review, with a view to addressing the research question of 'obtaining a better understanding of microfinance in Zambia'. The results of the study found that the microfinance sector was relatively new with the bulk of the institutions having been established after 1995. The majority of these institutions were financed by donors and developmental organisations that have come to believe that microfinance can be used as a poverty alleviation tool. Poverty levels in Zambia were relatively high with over 80% of the population living in poverty and over 70% living on less than a US$1 a day. Over the years, the situation worsened with the poor performance of the Zambian economy and the continued decline in GNP per capita. Thus, microfinance was identified by the Government as a means to reducing poverty levels.

The microfinance sector was found to be served by a diverse spectrum of organisations with different legal forms. However, this sector is still minuscule when compared to the banking sector and is concentrated in urban areas, with a significant number of branches operating along the line of rail. Outreach is low with an estimated active number of clients reported at 15,356 compared to a potential demand for microfinance services by two million prospective clients. Service provision by MFIs is focused on microcredit using either individual or group lending methodologies. MFIs were flexible in the types of collateral accepted.

A number of constraints, at both the institutional and industry level, as well as the macro level, to the development of the microfinance sector were identified. At the institutional and industry level, these included the lack of capital; poor internal controls and the absence of industry standards; the high dropout rates and inappropriate lending methodologies. At the macro level, these included the poor credit and savings culture; poor infrastructure; the inefficient legal system; the unstable macroeconomic environment; the absence of income generating opportunities, and the low population density.

These findings have implications for the development of the regulatory framework for the microfinance sector. A clear understanding of the industry structure is essential in assessing the impact of any proposed government intervention on the sector. Specifically, the issues raised related to how microfinance is defined in the Zambian context as it would affect the targeting of the regulations; whether regulations should focus on regulating microfinance activity as opposed to the institution; whether there should be any regulation at all in light of the ownership and funding structures of MFIs, and lastly the desirability of regulating an industry that is stagnating and performing poorly.

Furthermore, the constraints identified raised doubt as to whether the objective of promoting the industry through the introduction of a regulatory framework specifically for the microfinance sector would be met. The development of a vibrant microfinance sector is dependent on a number of contextual factors including: (1) high population densities; (2) the existence of quality physical infrastructure, such as roads and communication systems; (3) a stable macroeconomic environment characterised by stable growth and relatively low inflation; (4) monetisation; and (5) the existence of on going economic activity with room for expansion (Buckley, 1997; WB, 1998; Chao-Beroff, 1999).

From this, it is clear that Zambia is lacking in a number of prerequisites required for the development of a vibrant microfinance industry. Assuming the obstacles continue to exist, this raises doubt as to the likelihood of the microfinance sector developing beyond what it has done already and acting as an effective tool in the alleviation of poverty. It also raises questions as to the extent that the objective of regulation to promote microfinance can be achieved in light of these constraints. These issues are explored further in subsequent chapters.

6 UNDERSTANDING THE REGULATORY AND SUPERVISORY FRAMEWORK IN ZAMBIA

6.1 INTRODUCTION

As stated earlier, an understanding of the current regulatory framework is important and provides a baseline from which to assess the potential impact of the Draft Microfinance Regulations (DMFRs) on the microfinance sector. Knowing the current regulatory situation makes it possible to determine the extent to which the DMFRs will change the status quo, not only with reference to the legal environment, but also to supervisory practices and legal constraints. The study found that the diverse spectrum of microfinance providers is regulated under different Acts and supervised by different agencies. Not all are supervised for the provision of financial services. Thus, the introduction of microfinance specific legislation would harmonise the regulation and supervision of MFIs.

This chapter is organised as follows. The next section reviews the current legal and supervisory environment in relation to the microfinance sector. This is followed, in section 6.3, by stakeholder views on whether the microfinance sector should be regulated, the rationale for regulation and the most appropriate supervisor. The section then discusses the regulatory constraints as identified by the respondents. Section 6.4 examines stakeholders' perceptions derived from the fieldwork results, drawing on the literature and country experiences with the regulation of microfinance. The implications of the research findings for the regulatory framework in Zambia are evaluated in section 6.5. Section 6.6 summaries and concludes.

6.2 CURRENT LEGAL AND SUPERVISORY ENVIRONMENT

6.2.1 The legal framework

The change in government in 1991 brought about radical economic reform, from state control to an economy led by private sector development. The reforms included decentralisation, privatisation and liberalisation (Brownbridge, 1996a). In line with the changes that were occurring in the financial sector vis-à-vis liberalisation, the regulatory framework governing this sector also underwent extensive review. A new banking law, the Banking and Financial

Services Act (BFSA) of 1994 was enacted to replace the 1972 Banking Act which had become outdated.

However, the provisions of the BFSA 1994 focused mainly on the banking sector and was not clear in its application to NBFIs. The Act was amended in 2000 to cover all institutions that provided financial services as defined in the Act, including MFIs. The amendments to the Act strengthened the ability of BOZ to respond promptly and comprehensively to developments in the financial sector (BOZ, 2000). The key features of the amendments included: (1) enhancing the Act's applicability to NBFIs, including those institutions established by Acts of Parliament; (2) strengthening the regulatory and supervisory powers of BOZ; (3) incorporating best practices and internationally accepted standards for licensing and prudential regulation and supervision into the law; and (4) establishing higher standards of responsibility, accountability and professional competence and integrity for directors and senior officers of FIs.

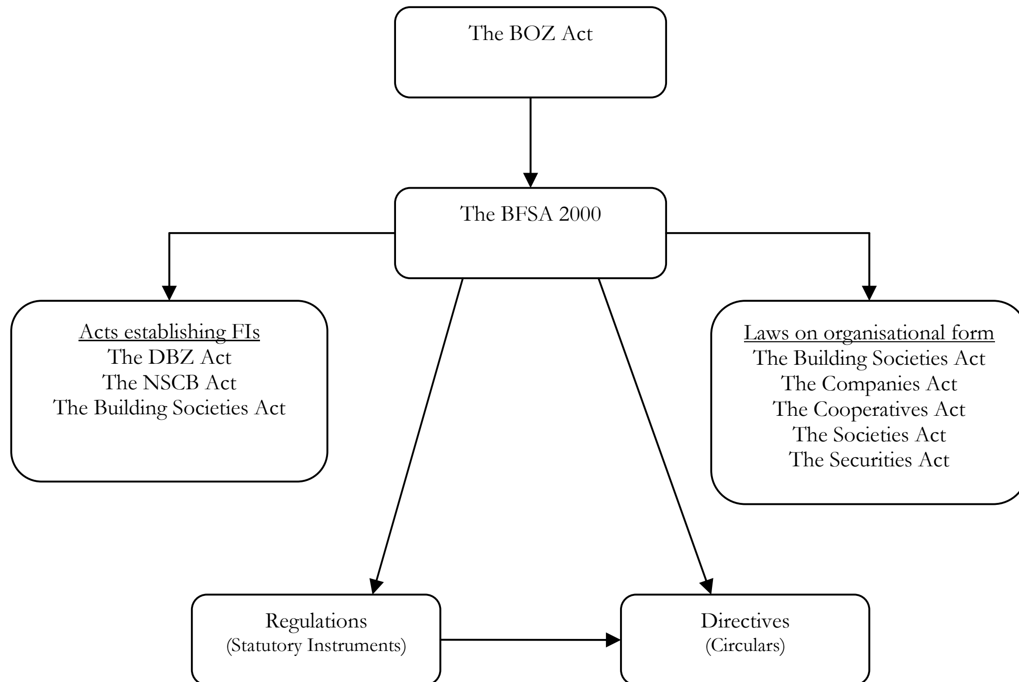
During the changes in the early 1990s, reforms were also made to the prudential regulation of the financial sector. Prior to this, the Central Bank's primary responsibility focused on ensuring that FIs complied with foreign exchange, domestic credit and interest rate controls (Brownbridge, 1996b; Chiumya, 1999). Additionally, because banks and NBFIs were either owned by well established foreign banks or the Government, and the controlled economy provided a relatively safe environment for banking business, it was felt that they required minimum prudential supervision (Mwape, 1997). The Bank of Zambia Act, 1996 (BOZ Act) established the central bank as the regulatory authority for the financial sector[85] and BOZ was restructured so it could meet its objectives as stipulated in section 4 of the BOZ Act[86].

The principal Act governing the financial sector is the Banking and Financial Services Act of 1994 as amended in 2000 (BFSA 2000). The Act authorises the Minister of Finance, on the recommendation of BOZ, to issue regulations[87] to facilitate implementation of the Act. It also authorises BOZ to issue directives[88] and guidelines[89]. Where there are conflicts in the provisions of the BFSA 2000 and other laws which establish and govern FIs, the provisions of

[85] Section 4(2)(a).
[86] Section 4(1).
[87] Section 124, BFSA 2000. Regulations are issued as 'statutory instruments' (SIs).
[88] Directives are issued as 'circulars'.
[89] Sections 124A and 125 respectively of the BFSA 2000.

the BFSA 2000 take precedence. The relationship between the laws are summarised in Figure 6.1.

Figure 6.1: Laws governing the financial sector



Despite the amendments to the BFSA and the authority to modify the provisions, MFIs were not compelled to apply for licences by BOZ, even though it was possible for them to be licensed as NBFIs (Chiumya, 2006). This may have been due to the fact that BOZ was reluctant to actively enforce the BFSA 2000, whose provisions focused primarily on the banking sector, on the microfinance sector. Consequently, only three MFIs were licensed as NBFIs.

However, there was evidence to suggest that this would change with the introduction of microfinance specific regulations as illustrated by the following comment, "At the moment what the Bank of Zambia is looking to have is legal backing for the regulation of microfinance institutions" [BOZ/M/1 (65)]. Thus, with the exception of the banks that were involved in the provision of microfinance services, it was felt that large numbers of MFIs were 'unregulated' and 'unsupervised'. As noted in Chapter 5, the microfinance sector is served by

a diverse spectrum of organisations with different legal forms. Consequently, the legal framework for microfinance is fragmented and not all MFIs are supervised for the provision of financial services as noted in the next section. As a result, BOZ was developing regulations for the microfinance sector[90].

6.2.2 Current supervisory practices

The microfinance sector in Zambia is served by a variety of microfinance providers with a variety of legal forms registered under different Acts. According to the survey results, 32 of the 39 respondents indicated that they were required to submit financial statements to the agency they were registered with. Furthermore, as shown in Table 6.1, twenty-one respondents indicated that their institutions were supervised for the delivery of financial services. Five organisations were supervised by BOZ[91], 5 by the Registrar of Cooperatives and 2 by the Registrar of Societies. The rest were supervised by various bodies as listed in Table 6.1 under 'Other'. Fifteen respondents stated that they were not supervised for the provision of financial services[92].

Table 6.1: Supervisory agency

Supervisory Agency	#
BOZ	5
Registrar of Cooperatives	5
Registrar of Societies	2
Other	9
- *Micro Bankers Trust (1)*	
- *ZCSMBA (2)*	
- *Donor (2)*	
- *Food Reserve Agency (1)*	
- *GRZ (1)*	
- *ZNCB (1)*	
- *Board (1)*	
Total number of MFIs	21

Source: Fieldwork survey results

Although institutions registered with either the Registrar of Cooperatives or the Registrar of Societies had statutory reporting requirements to comply with, this was not done. The Registrar of Societies did indicate that her office had neither the mechanisms to follow up nor

[90] The Banking and Financial Services (Microfinance) Regulations became law on 30 January 2006. However, the analysis carried out for the study is based on the draft microfinance regulations (DMFRs). In the researcher's view the differences between the provisions of the draft regulations and the law were minor and had no significant bearing on the results of the study findings.
[91] These were all banks.
[92] Three respondents did not answer the question and three indicated that their institutions were supervised for the provision of financial services but did not name the supervisory agency.

the capacity to monitor all the institutions registered. The situation was the same with the Registrar of Cooperatives. Therefore, even though survey respondents indicated that they were supervised for the provision of financial services, there was no effective supervision of these institutions.

According to the survey results, the supervisory agencies had been in contact with 11 of the institutions surveyed within a month of the survey of being carried out, and another 3 within the quarter. Seven of the institutions had been visited within the month and 4 within the quarter. The results are summarised in Table 6.2[93]. This implies that there is frequent contact between supervisory agencies and the supervised institutions. Where information was requested, in most cases it was for the financial statements, audited or otherwise.

Table 6.2: Frequency of contact with supervisory agency

	When was the last time the Agency made		
Within the last	**Contact**	**A visit**	**A request for information**
Month	11	7	10
Quarter	3	4	3
6 months	1	2	1
Year	1	2	1
2000	1	1	1
No response	22	23	23

Source: Fieldwork survey results

6.3 STAKEHOLDER VIEWS ON MICROFINANCE REGULATION

6.3.1 Introduction

All interviewees and questionnaire respondents, with the exceptions noted in section 6.3.3 below, felt that the sector did need to be regulated. The results are summarised in Table 6.3. In their view, the debate was not about whether the sector should be regulated, but the manner in which regulation is structured [MFI/I/6 (67)]. Therefore "It should not stifle initiative and growth" [MFI/I/6 (66)]. Regulation should be scaled to deal with the different types of MFIs [BOZ/I/3 (42)] and "… must take into account the fact that microfinance participants come in various sizes and shapes" [CON/I/1 (109)]. "Regulation should not be burdensome. It should be tiered and focused on regulating the bigger players who are likely to have an impact on the market. Therefore it should exclude moneylenders and people wishing

[93] Twenty-two respondents did not answer the question.

to lend money" [CON/I/3 (40)] and "should not apply to church MFIs or *chilimbas*"[94] [CON/I/3 (64)].

From the interviewees' responses, it was evident that stakeholders felt the sector should be regulated. However, a tiered approach was called for to take account of the different types of microfinance providers and those at the informal end of the spectrum, such as moneylenders and ROSCAs, should be excluded. As noted by Vittas (1991), the debate was not so much about the need for regulation, rather the cost and effectiveness of regulation. Furthermore, the views expressed in terms of which MFIs should be regulated closely followed the proposals contained in the Greuning Regulatory Framework (van Greuning et al, 1998). Therefore, those that relied on donor funds, grants and members' funds should not be regulated by the supervisory authority and DT MFIs should be regulated by BOZ.

6.3.2 The rationale for regulation

A number of reasons were given to regulate the microfinance sector by the different stakeholders. These reasons coincided with those given in the literature (section 3.6.1) and are summarised in Table 6.3[95].

Table 6.3: Reasons for regulating

Reasons for regulating	**DON**	**MOF & BOZ**	**MFIs**	**CON**	**REG**	**FGDs**
Financial system stability		✓	✓	✓		
Depositor protection	✓	✓	✓	✓	✓	✓
Increased access to funding		✓	✓	✓		
Investor protection		✓		✓	✓	
Setting standards and ground rules		✓	✓	✓		✓
Enhanced credibility		✓	✓			✓
Formalise microfinance		✓		✓		
Customer protection	✓	✓	✓	✓	✓	✓
Set interest rate ceilings			✓			✓
Data collection		✓		✓		✓
Increased confidence		✓	✓	✓	✓	
Vet entrants		✓		✓	✓	✓
Prevention of money laundering		✓			✓	✓
Checks and balances		✓	✓	✓		✓
Monitoring MFIs		✓		✓		✓

DON = donor views, MFIs = MFI practitioner views, CON = Consultant views, REG = Regulator views, MOF & BOZ = MOF & BOZ officials views, FGDs = FGD participant views

Surprisingly, only 3 interviewees cited the first reason, financial system stability, as a reason for MFIs to be regulated (Box 6.1). On the other hand, all categories of stakeholders identified

[94] A *chilimba* is a type of ROSCA.
[95] The reasons are not ranked in any particular order.

the second, depositor protection, as a reason for regulation as noted in Box 6.2. This applied whether MFIs provided savings as a service or used forced savings as part of their lending methodology. Thus, even where there were 'forced savings', there was need for regulation, the reason being that "When a client in the cycle becomes a net saver, there is need for regulation so that the money is safe" [FG/D/11 (117)].

Box 6.1: Financial system stability

[MFI/I/4 (113)] "Large institutions can affect the financial system so we need regulations."

[CON/I/3 (40)] "It should be tiered and focused on regulating the bigger players who are likely to have an impact on the market."

[CON/I/3 (56)] "The larger institutions such as CETZAM and PRIDE probably should be regulated."

[BOZ/I/2 (48)] "The Bank of Zambia is the best authority to license and regulate larger formal financial institutions to ensure systemic stability and the protection of depositors."

Source: Fieldwork interviews

Box 6.2: Depositor protection

[MFI/I/6 (86)] "The risks that are being addressed by the regulations are depositor protection and customer protection."

[CON/I/2 (90)] "But as MFIs start to accept deposits they will need to be regulated."

[MOF/I/2 (40)] "Society has an obligation to safeguard depositors."

[BOZ/I/4 (29)] "The objectives of regulating microfinance institutions … is to provide oversight, and promote safety and confidence to investors and provide depositor protection."

[DON/I/2 (28)] "Once MFIs go into savings, then the Bank would have to regulate."

[FG/D/10 (256)] "One other thing is that the Bank of Zambia should have keen interest in deposit taking MFIs."

[FG/D/26 (53)] "The first reason is that these institutions do take people's deposits that need to be protected."

[FG/D/27 (125)] "… there is need for regulation because these institutions handle people's money."

Source: Fieldwork interviews

The third reason given was increased access to funding, mainly through the mobilisation of deposits or commercial sources of funding, such as loans from commercial banks or the capital market. This was a view shared mainly by BOZ officials and MFI practitioners (Box 6.3). Additionally, BOZ officials stated that indications from the donor community were that they would be more willing to invest in microfinance if this sector was regulated [MFI/M/1 (114)].

Box 6.3: Increased access to funding

[MFI/1/1 (104)] "The idea for supervision was that we would become an organisation that can borrow and be listed on the Stock Exchange."

[MFI/1/2 (73)] "But we do intend to be regulated eventually so that we can attract voluntary savings."

[BOZ/1/4 (42)] "Because they have no legitimacy, it is very difficult for them to access funds from mainstream financial institutions such as banks and other financial institutions."

Source: Fieldwork interviews

The fourth reason given for regulating the microfinance sector was investor protection (Box 6.4). Linked to this was the view that the sector should be regulated to ensure the effective use of investor funds, donor funds in particular [FG/D/26]. BOZ's stance was that "…as a supervisory authority, it is our duty to ensure that donor funds are channelled through your institution for the purpose of promoting small scale entrepreneurs are lent out prudently" (CSB/L/11). Clearly, BOZ felt that it was its duty to ensure the effective use of donor funds.

Box 6.4: Investor protection

[REG/I/1 (51)] "Regulation is needed to protect the interest of donors."

[MOF/I/1 (113)] "It also gives give confidence to the investor such as DFID to know that they don't necessarily need to put in their audit."

[FG/D/10 (209)] "Probably the concern from the Bank of Zambia comes from complaints by the donors that they are pumping in a lot of money in these MFIs but are not seeing any tangible results."

[FG/D/26 (204)] "Monitoring also has to be done to see whether the funds are reaching the intended people or just end up financing illegal activities."

Source: Fieldwork interviews

Fifth, interviewees, particularly BOZ and MOF officials, consultants, and a few FG participants, felt that regulation was needed to raise minimum performance standards and set 'ground rules' (Box 6.5). By ensuring that MFIs are managing their risks prudently, "Regulation will strengthen the financial institutions" [BOZ/I/4 (100)].

Another reason put forward for regulating MFIs was to clarify the legal position and give MFIs legitimacy and credibility. Thus, "Regulation is very important because it will give microfinance providers some legality…" [(FG/D/12 (82)] and "Not every Jim and Jack can claim to be a microfinance institution" [REG/I/1 (53)]. One of the interviewees went as far as to say, "…you need a regulatory authority to say that you're okay. This strengthens the organisations reputation" [MFI/I/1 (127)]. It was also felt that regulation was necessary to

formalise microfinance, "Microfinance institutions need to be brought into the mainstream and this can only be done through regulation" [CON/I/2 (80)].

Box 6.5: Raise performance standards

Ms Chiumya "What do you think the benefits would be of regulating the microfinance sector?"

[CON/I/2 (116)] "…standards of the sector would improve and we would have more donations from the donors. … Regulation is one way to ensure that there is some standard."

Ms Chiumya "What do you think the benefits of regulation would be?"

[CON/I/3 (63)] "Firstly, they will serve to set industry standards so that everyone knows the rules of the game. … They should be required to keep proper financial records and procedures…"

[FG/D/12 (82)] "Regulation is very important because it will … bring uniformity in the practice of microfinance provision."

[MOF/I/2 (38)] "It is important to have ground rules to which participants are expected to adhere to."

[BOZ/I/2 (40)] "Regulation is important and is a formal way of ensuring the orderly conduct of business."

[BOZ/I/1 (86)] "It is better to have minimum guidelines to start with and improve them over time."

Source: Fieldwork interviews

All categories of stakeholders, particularly FG participants, identified customer protection as a reason to regulate MFIs (Box 6.6). There seemed to be a general belief that customers could be protected through the introduction of regulations. It was also felt that "Regulation would provide an avenue for clients to seek recourse and ensure that there were complaints procedures in place. They would have a body they could approach" [REG/I/1 (51)].

In this regard, FG participants felt that interest rates and other financial charges should be regulated [FG/D/12 (50)] even though it was a liberalised economy [DCO/M/8 (25)]. MFIs were said to be charging exorbitant rates of interest on loans and that "the lack of regulation leads to clients being swindled by unscrupulous people" [FG/D/1 (43)]. Surprisingly, two microfinance practitioners also felt that interest rates needed to be regulated with one blatantly stating, "There should be a cap on interest rates!" [MFI/I/4 (122)] and the other, "The need to regulate interest rates for microfinance institutions is also an issue. A lot of people think that MFIs are exploitative" [BS/I/8 (66)].

Other interviewees felt that the exploitation of customers would be curbed through greater information disclosure and transparency in relation to MFI charges and performance. Thus, regulation would promote transparency and enhance accountability [BOZ/I/1 (49)]. "They (MFIs) should be transparent and remain accountable so that we all have access to how much

they are charging and so on. The disclosure of information is important" [MOF/I/1 (83)] and "Microfinance institutions should be able to justify their lending rates" [MOF/I/1 (86)].

Box 6.6: Customer protection

[BOZ/I/1 (64)] "The regulation should … provide for the protection for members of the public and their rights."

[BOZ/I/4 (103)] "This (regulation) will result in … customer protection and legitimacy."

[MOF/I/1 (76)] "They should not be exploited!"

[DON/I/3 (62)] "Regulations need to protect customers and level the playing field."

[FG/D/1 (43)] "… the lack of regulation leads to clients being swindled by unscrupulous people."

[FG/D/6 (75)] "So there is need for regulation to stop such exploitative practices by MFIs."

[FG/D/12 (50)] "I think regulation should be there to protect people from exploitation."

[FG/D/10 (230)] "My view is that regulation should come in to safeguard both the organisations and the citizens."

[FG/D/14 (96)] "But these MFIs end up exploiting instead of helping. Because of this, regulation should come in so that such institutions are not tolerated. Regulation is vital!"

Source: Fieldwork interviews

FG participants also pointed out that in order to develop an industry "you need information and that information can only be readily available if institutions are regulated" [FG/D/6 (70)]. Therefore, "there is a need to have all organisations registered so that we can know who is doing what and be able to share information especially on unscrupulous clients" [FG/D/12 (96)]. This quote also highlights participants' view that a debtors' register was important for the sector. Some went as far as to state that regulation should prevent clients from borrowing from more than one MFI and becoming heavily indebted [FG/D/10 (153)]. Regulations should also prevent situations where a person borrows from one institution to settle a loan obtained from another institution [FG/D/10 (162)], although other participants felt that such decisions should not be legislated but made by the individual [FG/D/10 (166)]. Thus, regulation was important to facilitate data collection and monitoring developments in the microfinance sector as noted by a BOZ official, "Efforts to bring them under our ambit mean we would become more informed about their activities" [BOZ/I/1 76)]. "So Government must be interested in knowing what is obtaining on the ground, for example, how many MFIs are operating and how they are operating" [FG/D/14 (94)]; although, it was pointed out that this objective could be met with a simple registration process [CON/I/2 (89)].

Interviewees also felt that regulation would enhance confidence in the sector (Box 6.7). With the licensing process and vetting of entrants, the probability of unsuitable individuals operating in the microfinance sector would be reduced, thus lowering the likelihood of criminal activity, such as pyramid schemes, money laundering and fraud. "It would eliminate players that claim to be microfinance institutions" [(CON/I/2 (111)].

Box 6.7: Enhanced confidence

[MFI/I/3 (118)] "Clientele feel more secure because the institution is being regulated by the Central Bank."

[BS/I/8 (56)] "… and having the regulations will provide assurance and confidence that money is safe and that the MFIs are operating in good faith."

[FG/D/26 (57)] "The Bank needs to regulate so that there are no loopholes for funds to end up funding illegal activities."

[MOF/I/1 (126)] "I think the licensing should be done and be authorised by the Bank of Zambia. Because then you can also check on issues of character, who the investors are."

Source: Fieldwork interviews

When asked whether their organisations would obtain a licence after the DMFRs became law, sixteen survey respondents indicated that they would, the main reasons being that it would enhance credibility, improve performance levels through adherence to minimum standards and increase funding opportunities, mainly through deposit mobilisation. The results are summarised in the Table 6.4[96].

Table 6.4: Reasons to obtain a licence

Reasons to obtain a licence	#
Enhanced credibility	5
Standard setting	3
Increased funding opportunities	3
Standardise systems of operation	2
Sustainability	1
Increased accountability	1

Source: Fieldwork survey results

6.3.3 Reasons not to regulate

Despite the consensus that MFIs should be regulated, there were some dissenting views. Two of the survey respondents were not in favour of MFIs being regulated and supervised. Their

[96] Twenty-five respondents did not answer the question. Four respondents answered 'no', three were banks and were already licensed and the fourth was a project due to be phased out in a few months.

view was that it would hinder service provision [8][97] and market forces were sufficient to ensure that the industry operated effectively [11]. Interviewees felt that there was no need for the central bank to regulate and supervise credit only MFIs as they did not put depositors' funds at risk (Box 6.8).

Box 6.8: BOZ not to regulate NDT MFIs

[MFI/I/3 (33)] "Why regulate that which does not put clients' assets at risk? The risk is borne by the 'sophisticated' client. Why is it the mandate of the Central Bank?"

[MFI/I/6 (74)] "They can still be regulated but not as stringently. An agent can be appointed to regulate them, such as a network association like AMIZ."

[MFI/I/6 (79)] "Because regulation is also costly, therefore you can't regulate and wouldn't want to regulate everyone."

[BS/I/8 (64)] "It needs to be clear at what point an institution will be regulated. If there are blanket regulations then a lot of MFIs will go out of business."

[FD/D/20 (65)] "All we do is lend and if we are to close today, we won't have people coming to us to demand for anything because we don't take deposits. Instead, it is us who will go out to look for what people owe us. So regulation is not necessary."

Source: Fieldwork interviews

One of the consultants interviewed indicated that they felt that regulation in Zambia was premature, stating "We are rushing to regulate. The regulator needs to make a decision as to whether it is necessary to regulate microfinance at this stage. They need to …come up with something that is in line with international practice and what makes sense for Zambia and doesn't kill a young infant industry" [CON/I/3 (50)].

The other reasons related to the impact interviewees feared regulation would have on the microfinance sector. Firstly, there was concern that regulation might be too restrictive. "You may stifle the development of the industry. You may kill even existing institutions which are helpful to the community" [CON/I/1 (358)]. Secondly, it was felt that regulating the sector might result in MFIs focusing on meeting regulatory requirements rather than their clients' needs [CON/I/2 (128)]. Thirdly, it would increase MFIs' costs. "I feel regulation will increase the cost of operation of MFIs because they will have to hire an auditor to verify reports sent to the regulatory body. And auditing services are not cheap at all" [FG/D/10 (185)]. These issues are discussed further in Section 6.3.5.

[97] Figures in [ ] refer to the questionnaire identification number.

6.3.4 Who should regulate?

Overall, interviewees thought BOZ was the best placed to regulate the microfinance sector because it was responsible for the financial sector, had the relevant 'expertise', and was already established (Box 6.9). Nevertheless, some interviewees did express reservations about BOZ regulating the sector (Box 6.10). There was consensus amongst the interviewees and survey respondents that DT MFIs should be regulated by BOZ. Because MFIs provide financial services, it follows that they should be regulated by BOZ, the authority responsible for regulating other FIs that provide services of a similar nature, albeit to a different segment of the population.

Box 6.9: BOZ to regulate DT MFIs

[BOZ/I/1 (69)] "For now, it has to be the Bank of Zambia because financial sector matters fall under the Bank. In the current setting, no other institution is suited to carry out this function."

[MOF/I/2 (74)] "…otherwise we would be creating another infrastructure or bureaucracy."

[BOZ/I/1 (71)] "Maybe in time if we can develop another institution then it would be responsible."

[BOZ/I/4 (139)] "For deposit taking financial institutions, the most appropriate *regulator* should be the central bank."

[FG/D/11 (255)] "The Bank of Zambia is a major player in the financial market and has to be aware of what is going on in the market."

[REG/I/1 (57)] "By default, the regulator would probably be the Bank of Zambia, but it need not be."

[CON/I/1 (229)] "The Bank of Zambia can regulate certain segments, especially those that are taking deposits from the public…"

Source: Fieldwork interviews

Interviewees felt that there was no need for BOZ to regulate NDT MFIs (Box 6.8) as there were no depositor funds to protect. Therefore, there was scope for this responsibility to be delegated (Box 6.11), especially as it was felt that BOZ did not have the capacity to effectively supervise all MFIs operating in the sector (Box 6.12), a view also shared by some BOZ officials [BOZ/I/1, BOZ/I/2, BOZ/I/3]. One of the FG participants suggested that local government could license and monitor MFIs on the Bank's behalf [FG/D/12 (190)], but most interviewees identified AMIZ as the agency to whom the responsibility could be delegated.

Box 6.10: BOZ not to regulate

Ms Chiumya "who do you think would be the most appropriate regulator?"

[CON/I/3 (74)] "Maybe the Bank of Zambia. The market is still too small; there aren't that many MFIs…"

[REG/I/1 (57)] "Non bank financial institutions do not need to be regulated by the Bank. It should be left to concentrate on monetary policy."

Ms Chiumya "Do you think the Bank of Zambia should be the regulator for the microfinance sector?"

[CON/I/2 (98)] "Yes and No. Bank of Zambia has the skills but it is not the best placed. … for the following reasons. There is a lot of work involved in supervising MFIs because of the nature of the sector. Secondly it will be extremely costly. Thirdly the central bank is centralised. It only has branches in Lusaka and Ndola and supervising MFIs would need inspectors to be based in the areas where they (MFIs) operate. The Bank would have to have a microfinance window. The demands on inspectors would be too great and the Department at the moment is not big enough to concentrate on MFIs."

Source: Fieldwork interviews

Box 6.11: Delegated supervision for NDT MFIs

[BOZ/I/4 (144)] "… non-deposit taking institutions can be supervised by another body."

[BOZ/I/2 (48)] "Therefore, there is a role for AMIZ to have some sort of oversight for the lower end of the spectrum, i.e. those MFIs that are small and using their own resources."

[DON/I/2 (24)] "There seems to be an attempt by Bank of Zambia to over-regulate the sector. MFIs are principally involved in the provision of credit rather than savings, therefore, less regulation is required and this can be delegated to AMIZ. Self regulation in this case would be appropriate as the investors only stand to lose their own money and not other people's (depositors). Once MFIs go into savings then the Bank would have to regulate."

[FG/D/11 (261)] "To supervise these (all MFIs) would require a huge undertaking. So I feel smaller MFIs should be looked at by another body."

Source: Fieldwork interviews

Box 6.12: BOZ capacity constraints

[BOZ/I/3 (56)] "For the same reason that the banking sector has left it (the microfinance segment), may be the same reason why the Central Bank should not overstretch itself. Maybe it can delegate to another organisation."

[BOZ/I/2 (48)] "The Bank of Zambia does not have the capacity, or will not have the capacity, to monitor all MFIs."

[BOZ/I/1 (46)] "Currently the Bank of Zambia was ill-equipped to deal effectively with microfinance."

[CON/I/1 (229)] "The others, Bank of Zambia can delegate to a credible institution, for example AMIZ."

[DON/I/2 (56)] "There aren't that many (benefits). If anything it's too much to take on and unnecessary at the moment."

Source: Fieldwork interviews

Furthermore, interviewees felt that BOZ did not understand the special characteristics of the microfinance sector resulting in inappropriate regulatory provisions being proposed and supervisory practices employed in that "The Bank of Zambia has a very narrow view and lacks perspective on what microfinance is all about" [MFI/I/3 (28)]. Those involved in designing the regulatory framework were ignorant of the issues affecting microfinance [DON/I/3 (43)]. Thus, the approach being taken by BOZ was inappropriate for the microfinance sector in Zambia considering its level of development and would take "microfinance from the death bed to the grave" [DON/I/3 (23)], resulting in interviewees concluding that "The Bank wants to control everything even if it is not good for industry" [MFI/I/3 (69)].

Lastly it was pointed out that BOZ was not suitable because it was not 'independent' or "strong enough to cater for everyone" [FG/D/1 (148)] and so "…AMIZ should be strengthened and be made the regulator as it is more politically independent than the Bank of Zambia and will be more available to its clients", but should report to BOZ [FG/D/1 (245)]. The results are summarised in Table 6.5.

Table 6.5: Summary of interviewee responses

	DONS	**MOF & BOZ**	**MFI**	**CON**	**FDG**
Who should regulate?					
DT MFIs					
• BOZ	✓	✓	✓	✓	✓
NDT MFIs					
• AMIZ	✓	✓	✓	✓	✓
• Local government					✓
• Not at all			✓		✓
Reasons for BOZ to be the regulator					
• Expertise		✓		✓	✓
• Depositor protection	✓	✓	✓		
Reasons why BOZ should not be the regulator					
• Lacks understanding	✓		✓		
• Capacity constraints	✓	✓		✓	✓
• Regulating is costly			✓	✓	
• Lacks (political) independence					✓
Concerns of BOZ regulating					
• Increase MFI costs					✓
• Restrict MFI operations	✓			✓	
• Put MFIs out of business	✓		✓	✓	

Source: Fieldwork results

6.3.5 Regulatory constraints

The study also aimed to identify current regulatory obstacles in order to assess whether the introduction of the DMFRs would overcome these obstacles. However, most of the constraints identified were in relation to the provisions contained in the DMFRs noted below. With regard to the current regulatory constraints, the survey respondents identified the following obstacles.

The first related to the legal problems associated with the recovery of loans from defaulting borrowers, especially when dealing with informal groups; "the law is not firm on defaulters, especially those targeted by the microfinancing industry" [7][98]. The second obstacle was the ambiguity in the regulatory environment. According to the respondent, it was not clear where MFIs stood legally making it difficult to plan, especially on a long-term basis [13]. Thirdly, the capital requirement was considered to be too high [29]. Fourthly, the qualification requirement for chief officers was rather onerous, making it difficult for MFIs to recruit staff [29]. Lastly, the questionnaire respondent felt that the "registration process was too long and cumbersome" [29].

Most of the regulatory obstacles identified by the stakeholders were in relation to the provisions contained in the DMFRs and their perceived potential impact. Notably, constraints were identified by all categories of stakeholders except MOF and BOZ officials. These were as follows. Firstly, interviewees felt that the regulations should not be under the BFSA stating that "We need an Act specifically for microfinance like the one they have in Uganda" [MFI/I/4 (105)]; that "The regulations have been subordinated to the BFSA which is a culmination of what has transpired in the banking industry since Standard Chartered Bank came into existence in 1906, over 100 years ago" and therefore more suited to the banking sector [MFI/I/1 (174)].

Interviewees stated that the provisions should take into account the objectives of the institution [MFI/I/1 (210)] because "Microfinance was an offshoot of developmental work and MFIs were not interested in making a return. Investors in microfinance were social investors and the sector was driven by donors who were most comfortable working with trust ownership structures and did not allow individuals to be shareholders" [MFI/I/1 (179)].

[98] Figures in [ ] refer to the questionnaire identification number.

Thus, it was felt that the ownership and governance provisions contained in the DMFRs were not suitable for microfinance. "Most NGOs are set up as trusts especially as the funding is coming from donors and this is their preferred legal structure" [MFI/I/7 (27)]. Trusts, therefore, should be permitted to hold shares [MFI/I/1 (191)]. Furthermore, one of the consultants felt that the provisions in relation to the board of a village bank in a rural part of Zambia were simply not practical and as such "Governance should be seen in the context of size" [CON/I/1 (409)]. "At a smaller size, you don't need all the skills you need in the board of a big institution" [CON/I/1 (416)]. Likewise in this context, there was no need for the Bank to approve the appointment of the chief executive officer (CEO) or the chief financial officer (CFO) [CON/I/1 (434)]. Consequently, regulation needed to be tiered to take these issues into account [CON/I/1 (435), CON/I/2 (88), CON/I/3 (90)].

In relation to reporting requirements, it was felt that "Regulation will create a lot of problems because it will mean a lot of prudential returns[99]. The money is meant for the poor and cost of implementation will be high. And to send returns to the Bank of Zambia will be time consuming" [BS/I/8 (19)]. This view was echoed by another microfinance practitioner, "As it is, the reporting requirements in the draft regulations are onerous and expensive to comply with. We can't afford to fill in the reports" [MFI/I/4 (114)]. Thus, the reporting requirements were considered burdensome, time consuming and costly.

Interviewees considered the classification of forced savings as deposits inappropriate stating that "Cash collateral is not a deposit" [MFI/I/3 (52)]. "Microfinance institutions are taking forced savings and these are treated as deposits. But they are not really savings but serve as collateral. If the institution were to fold, depositors would not lose out because they are net borrowers" [MFI/I/7 (22)].

Lastly, it was pointed out that the regulations appeared to focus more on urban and peri-urban areas and that a distinction needed to be made between rural based and urban based organisations because some of the provisions of the DMFRs would be difficult to comply with by rural based MFIs [FG/D/22 (169)]. For instance, it was felt that the proposed licensing fees were too high, especially for rural based MFIs [FG/D/12 (80)]. Furthermore, the DMFRs did not contain any provisions covering producer groups and smaller rural communities [DON/I/3 (37)].

[99] 'Prudential returns' is the term used in Zambia to refer to 'prudential reports'.

Overall, it was felt that most of the provisions proposed in the DMFRs were more appropriate for the banking sector and not suited to microfinance. "The regulations limit and make it more difficult for microfinance institutions to operate. They are too restrictive. *We* would like to see increased access to financial services and not to see another door closed through restrictive regulations" [DON/I/2 (56)]. It was felt that the situation would be compounded by BOZ applying anti-money laundering legislation to the microfinance sector. This would exclude a lot of people because permanent addresses and utility bills were required before accepting clients, which most MFI clients would not have. Therefore, "We would need something that is more appropriate for Zambia and would suit the Zambian context" [DON/I/2 (68)].

6.4 AN ANALYSIS OF STAKEHOLDERS' PERCEPTIONS

From the views expressed by the stakeholders, it was clear that the general perceptions were: (1) that regulation was needed to meet certain objectives; (2) that these objectives would only be met with the introduction of microfinance specific regulations; (3) that regulation would overcome the regulatory obstacles identified; (4) that DT MFIs should be regulated by BOZ; and (5) that the regulation of NDT MFIs may be delegated to another body such as AMIZ[100].

In relation to the first point, that regulation was needed to meet certain objectives; a public interest view of regulation and supervision predicts that government will use regulations and supervisory agencies to improve performance. However, empirical evidence does not support this prediction[101]. Regulatory restrictions on activities, regulatory barriers to entry, and or the expansion of supervisory powers to monitor and discipline FIs were not associated with their improved development, efficiency, or stability. Greater power for official supervisory agencies to monitor and discipline FIs directly would not necessarily lead to improvements in performance and social welfare. Moreover, empowering official supervisors was likely to be detrimental in countries with weak political and legal institutions. Thus, the evidence overwhelmingly suggests that the most successful role for government and supervisors is in creating an environment conducive to effective market monitoring of FIs, and in using supervision to assist in verifying the information that is disclosed. Governments that implement policies that hold directors responsible for the provision of reliable and timely

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[100] However, as things stood, senior BOZ officials felt BOZ was obliged to regulate NDT MFIs under the provisions of the BFSA 2000 as noted in Section 6.3.4.
[101] The analysis in this section draws on Gallardo et al, 2005 and Barth et al, 2006.

information and provide private sector investors with the incentives and tools to exert effective corporate governance over FIs tend to produce better functioning FIs.

The literature suggests that many countries' political systems produce policies that maximise the welfare of the politically powerful, not social welfare more broadly. Thus sufficient checks and balances on the ability of government officials to exploit their positions of power for private gains are crucial for compelling government to maximise social welfare. The results are reflective of the private interest view of government that raises concerns about political and regulatory capture and endorses a more limited role for the government that focuses on information disclosure and strengthening the private market discipline of FIs. Thus, although most stakeholders believed that it would be beneficial to have government regulation for the reasons outlined, the extent to which this would in fact be beneficial, according to the literature, is uncertain.

The literature also suggests that the distinction between code of conduct regulation and prudential regulation is important for the benefits to justify the costs involved. From the discussions held with the different stakeholders, it was clear that this distinction was not being made, even by BOZ officials (Table 6.3). The mandate given to BOZ as stipulated in the BOZ Act does not extend to customer protection. This lack of distinction, therefore, would most likely result in regulations that are overly 'restrictive and unmanageable'.

Regarding the second perception that microfinance specific regulations were needed to meet the objectives, other country experiences do not support this view. Experiences in countries such as Kenya and Uganda showed that a variety of viable and sustainable MFIs can emerge and develop without a microfinance specific legislative framework; while microfinance flourished in Benin despite a restrictive legal and regulatory framework. Furthermore, the establishment of new regulatory categories did not necessarily promote the commercialisation of microfinance or the creation of financially sustainable MFIs where few or none existed as shown by the experiences of Benin, Ghana and Tanzania. Most questionnaire respondents did not provide information on the financial performance of their institutions. However, from the data available regarding MFIs' heavy reliance on donor funding, their poor outreach, and the poor performance of two of the MFIs considered in Chapter 7, it was possible to infer that there were few financially sustainable MFIs in Zambia, and that the introduction of microfinance specific regulations was not likely to result in the creation of financially self-

sustainable MFIs. Regulation to promote growth and the development of a vibrant microfinance industry was not an essential requirement as the experiences of Kenya and Uganda[102] show.

The goal of improving financial performance was not likely to be met because the number of institutions covered would greatly exceed the supervisory authority's capacity and the MFIs targeted for regulation are organisationally and financially weak. In Ghana, legislation stimulated the entry of new types of MFIs, broadening and deepening access to financial services. However, neither the MFIs nor the regulatory authority had the capacity to ensure compliance, resulting in more demanding requirements as a barrier to new entry. Thus, in relation to the reason given by interviewees for raising minimum standards and strengthening FIs, this goal was not likely to be met.

Ghana's experience also serves to show that the supervisory agency's capacity to carry out its regulatory obligations, and of the MFIs to comply, are a constraint on the effectiveness of new legislation in promoting and regulating microfinance. This was one of the major concerns raised by interviewees, including BOZ officials, in relation to BOZ being the supervisory authority for the microfinance sector. Interviewees felt BOZ did not have the capacity to supervise the microfinance sector effectively. They also felt that a significant number of MFIs would not be able to comply with the provisions of the DMFRs. Therefore, the objectives of regulating the sector were not likely to be met simply with the introduction of microfinance specific regulations.

In relation to the third perception, that regulation would overcome the regulatory obstacles identified, the literature suggests that a new regulatory framework would have to be accompanied by complementary changes to other pieces of legislation, especially those that deal with contract enforcement and customer protection. Thus, the regulatory constraints identified in relation to the legal impediments to loan recovery, for instance, would not necessarily be resolved by the introduction of microfinance specific regulations. This also applied to the objective of customer protection, especially in relation to customers being able to seek recourse.

[102] Uganda recently introduced a microfinance law, the Microfinance Deposit-Taking Institutions Act, in 2003.

Regarding the perception that DT MFIs should be regulated by BOZ, country experience has shown that microfinance legislation had proven least effective in developing well-regulated microfinance systems when MFIs brought under new regulatory regimes did not necessitate intervention by the supervisory authority. In Benin, for example, the compulsory licensing of MFIs effectively officially sanctioned their operations, although the supervisory agency was not able to assure the public that the MFIs were well managed and adequately capitalised. Thus, regulators and supervisors need to distinguish between DT MFIs and NDT MFIs. Credit only MFIs that do not mobilise public deposits should be excluded from prudential supervision to conserve scarce supervisory capacity and because the public's savings are not at stake. In such cases, donors, banks, and other investors can be expected to exercise adequate oversight. For these MFIs, regulatory oversight by an independent body or industry association is desirable for data-gathering and performance reporting in meeting established standards, but for which the government bears no responsibility. Therefore, regarding the fifth perception that the regulation of NDT MFIs may be delegated to another body such as AMIZ was in line with the views espoused in the literature. However, senior BOZ officials felt BOZ was obliged to regulate NDT MFIs under the provisions of the BFSA 2000. This interpretation of the law, therefore, was likely to result in BOZ overstretching itself and not being able to discharge its supervisory function effectively.

6.5 IMPLICATIONS FOR THE REGULATORY FRAMEWORK

In summary, stakeholders felt that the microfinance sector should be regulated (section 6.3.1). The rationale given for regulation was to enhance financial system stability, safeguard depositors' funds, protect investors, increase access to funding, raise minimum performance standards, protect customers, and promote confidence and growth in the microfinance sector (section 6.3.2). DT MFIs should be regulated by BOZ (section 6.3.4). The regulation of NDT MFIs could be delegated to another body such as AMIZ (section 6.3.4). Thus, a tiered approach would be the most appropriate taking into consideration industry structure and issues of locality (urban/rural), size (large/small), ownership (donors/private investors) and the organisations' objectives (poverty alleviation/profit maximisation).

However, when examined in light of the empirical evidence found in the literature, this prescription (the introduction of microfinance specific regulation) would not necessarily be the optimal solution. The private interest view of financial regulation, in which countries' political systems produce outcomes that maximise the welfare of the politically powerful, is

more likely to hold; rather than the public interest view in which regulation results in improved performance or social welfare. Country experiences of regulating (or not) the microfinance sector show that the objectives of regulating the sector would not necessarily be met. If anything, the failure to distinguish between 'prudential' and 'code of business regulation' results in regulation that is restrictive and unmanageable. Moreover, the prescription would not deal with the regulatory obstacle identified in relation to the legal impediments to loan recovery, although it would clarify the ambiguity in the regulatory framework. The other obstacles related to the specific provisions of the DMFRs which could be addressed by revising the relevant provisions before the introduction of the DMFRs.

The literature also states that the effectiveness of regulation would be dependent on the supervisory agency's capacity. In other words, constraints in supervisory capacity would result in ineffective regulation. Thus, the assumption that BOZ is the most appropriate regulator, a view implicit in the provisions contained in the BFSA 2000, is likely to result in ineffective supervision in light of the supervisory constraints identified. Additionally, regulation is least effective when FIs that do not necessitate intervention are brought under new regulatory regimes. The introduction of microfinance specific legislation might, therefore, result in the regulation of microfinance providers that do not warrant being regulated and rendering regulation ineffective. In conclusion, therefore, the results of the evaluation undertaken in this section suggest that the regulation of the microfinance sector is not likely to be beneficial.

6.6 CONCLUSION

The main purpose of this chapter was to appraise the current legal and supervisory environment applicable to the microfinance sector and to present stakeholder views and survey results regarding matters of whether the microfinance sector should be regulated, the reasons for regulation, and who the supervisory authority should be. Knowing the current regulatory situation makes it possible to determine the extent to which the DMFRs will change the status quo, not only with reference to the legal environment, but also to supervisory practices and legal constraints. Thus, this chapter mainly served to address the research objective of obtaining a better understanding of the existing regulatory and supervisory environment, specifically the first two research questions of: (1) 'what is the existing financial regulatory and supervisory environment in Zambia?'; and (2) 'what are the strengths and weaknesses of the existing framework?'. The third question 'How has the existing framework affected the microfinance sector?' is addressed in the following chapter.

The principal Act governing the financial sector, including MFIs, is the BFSA 2000 and the supervisory authority is the central bank, Bank of Zambia (BOZ). Despite the fact that MFIs can be licensed as NBFIs under the BFSA 2000, BOZ has been reluctant to apply the BFSA to the microfinance sector, possibly because the provisions of the Act are mainly applicable to the banking sector. However, there are indications that this will change once the microfinance specific regulations are introduced. The current regulatory framework is rather fragmented. The diverse spectrum of MFIs are registered under different Acts and supervised by different agencies. Not all are supervised for the provision of financial services. Thus, the introduction of the regulations would harmonise the regulation and supervision of MFIs.

From the fieldwork results, there was consensus amongst interviewees that microfinance needed to be regulated. However, a tiered approach was called for with BOZ supervising DT MFIs and the supervision of NDT MFIs being delegated to another body such as AMIZ. As there were no depositor funds to protect, the supervision of NDT MFIs by BOZ was not warranted. However, BOZ officials did feel that BOZ was obliged to supervise NDT MFIs as this was one of its legal obligations under the BFSA 2000. Furthermore, reservations were expressed in relation to BOZ being the supervisory authority as it was felt that it lacked the capacity and therefore would not be able to supervise effectively. It was also felt that BOZ lacked understanding, resulting in an approach that was more suitable to the banking sector and would stifle growth. These results were summarised in Table 6.5.

The reasons given for regulating the sector varied across the different stakeholders as shown in Table 6.3, with customer protection being identified by all categories of stakeholders. Other reasons given included financial system stability, depositor protection, investor protection, increased access to funding, the raising of performance standards, clarification of the legal position and increased information disclosure. The regulatory constraints identified mainly related to the provisions contained in the DMFRs which were considered inappropriate for the microfinance sector and onerous in relation to ownership, governance and capital requirements. It was also felt that they would be too costly for most MFIs to comply with.

It was evident from the views expressed by the stakeholders that the general perceptions were that regulation was needed to meet certain objectives; that these objectives would only be met

with the introduction of microfinance specific regulations; and that regulation would overcome the regulatory obstacles identified. A review of the literature suggests that regulatory frameworks designed for objectives other than the regulating the taking of deposits from the public and intermediating them into loans often result in standards that are disproportionately restrictive and unmanageable; that establishing new regulatory categories would not necessarily promote the commercialisation of microfinance or the creation of financially sustainable MFIs where few or none exist; that the capacities of authorities to implement their regulatory obligations and of MFIs to comply are a critical constraint on the effectiveness of new legislation in promoting and regulating microfinance; and that microfinance legislation had proven least effective in developing well-regulated microfinance systems when MFIs brought under new regulatory regimes did not necessitate intervention by the supervisory authority. Applying these findings to the microfinance sector in Zambia led to the conclusion that the stakeholders' perceptions were not likely to be validated with the introduction of microfinance specific regulations. Moreover, microfinance specific regulations and the supervision of the microfinance sector by BOZ would not necessarily result in improved microfinance development, efficiency or stability. Therefore, the focus of regulation and supervision should be on information disclosure so that private sector investors can exercise effective governance over MFIs. Overall, the conclusion arrived at from the analysis undertaken in this chapter was that the potential benefits of regulation are unlikely to outweigh the costs.

7 THE IMPACT OF REGULATING AND SUPERVISING MFIS

7.1 INTRODUCTION

This chapter seeks to address the research objective of assessing the potential impact of regulation and supervision on the microfinance sector in Zambia at the micro level by analysing the potential impact on selected MFIs. All MFIs licensed by BOZ during the period of the fieldwork were included in the study[103]. The analysis was done in two stages; firstly, by analysing the impact of the current regulatory and supervisory environment on the selected MFIs and, secondly, estimating what would have happened if the DMFRs had been in place.

The results from the case studies are then used as a basis for determining the potential impact of regulation and supervision on the microfinance sector as a whole in Chapter 8. The case studies also contribute to the related study aims of; (1) obtaining a greater understanding of microfinance in Zambia through the detailed descriptions of the MFIs used in the case studies and (2) obtaining a greater understanding of the Zambian regulatory and supervisory environment through accounts of how the MFIs were affected as a result of being regulated institutions.

The first case study is of MFI 1. MFI 1 was licensed by BOZ in August 1996. It was actively supervised and monitored and required to submit prudential reports, but subsequently went into voluntary liquidation in April 2004 due to poor performance and loss of confidence. In addition to assessing the impact of regulation and supervision on the MFI, this case study explores the extent to which regulation and supervision achieves the objectives often cited in favour of regulating and supervising MFIs. These objectives include promoting financial system stability, protecting depositors, improving performance standards, signalling to investors that the institution is sound, increasing funding opportunities and ensuring the effective use of public and donor funding. It was possible to use MFI 1 for this purpose as it was regulated and supervised for a period of approximately seven years before going into voluntary liquidation.

[103] There were three MFIs in total.

The second case study is of MFI 2. It was licensed by BOZ in November 2000. After the amendments to the BFSA came into effect in December 2000, it found that it was unable to comply with a number of the provisions contained in the legislation and subsequently relinquished its licence. Its experience of being licensed and supervised makes it particularly interesting as its experience is reflective of pertinent issues with regard to the regulation and supervision of the microfinance sector.

MFI 3 was the third case study used in the research to address the study objective of assessing the impact of regulation and supervision on the microfinance sector. The company was incorporated in 2002 and is a relatively young institution. The case study, therefore, focuses on the licensing process and the impact of obtaining a financial institution licence on the capital and governance structure of MFI 3.

The chapter is organised as follows. Section 7.2 reviews the characteristics of MFI 1, MFI 2 and MFI 3. It covers their establishment, ownership structures, services and products offered, lending methodologies and provides accounts of the operational issues faced by the MFIs. Section 7.3 then appraises the impact of the existing regulatory and supervisory framework on the MFIs, followed, in section 7.4, by an analysis of the potential impact of the DMFRs. Section 7.5 summarises and concludes.

7.2 THE CASE STUDIES

7.2.1 MFI 1

Background

MFI 1 was incorporated in November 1992 under the Companies Act as a private limited liability company whose principal line of business was that of fund management (CSB/R/1). The company was licensed by BOZ in August 1996 as an NBFI under the BFSA, 1994. MFI 1 had two shareholders with the shareholding split 64% and 36%. The shareholders were also the directors of the company and actively involved in its day to day operations. Its headoffice was located in Kabwe, and through the years, operations spread to Lusaka, Copperbelt, Luapula, Central and Southern Provinces.

In 1994, MFI 1 was asked to manage a rotating savings and credit scheme. This marked the beginning of MFI 1's involvement in micro-credit. Because of their experience in microcredit, the directors decided to enter the microfinance business for themselves and the company started lending its own funds and funds obtained from an apex organisation as a loan.

Overtime, MFI 1 gained donor confidence and subsequently benefited from substantial donor goodwill. Consequently, the company's major source of funding was revolving funds from donor agencies, followed by the loan from the apex organisation. Internally generated funds formed a very small portion of total funds loaned out[104]. Although its primary objective was to maximise profits, MFI 1 was also committed to helping the poor in their efforts to improve their livelihoods.

Services offered by MFI 1

By November 2003, MFI 1 was managing and administering funds on behalf of 4 donor agencies as shown in Table 7.1. In addition to donors, MFI 1 also managed funds on behalf of the Government, NGOs and private enterprises. In relation to the company's own microfinance portfolio, it provided loans, mainly to traders and farmers. Loans provided by MFI 1 were of two types, short term loans for working capital purposes and medium term loans for clients who wanted to purchase business equipment, machinery and plant. It also provided business and management skills training and business consultancy services. Other services offered by MFI 1 included loan consultancy services and the supervision and monitoring of outgrower schemes.

MFI 1 did not provide savings facilities as a product. However, the company did require prospective borrowers to have saved 50% of the loan amount before they were eligible for a loan. Interest was paid on these 'forced savings' which could not be withdrawn. There were cases, however, of clients opting to save without accessing credit facilities and these clients were permitted to withdraw their savings when they wished to do so. MFI 1 charged commercial rates of interest which it considered sufficient to cover its operating costs.

Lending Methodology

MFI 1's target group was predominantly women. MFI 1 lent to women who were members of existing women's clubs. The clubs were formed by facilitators who were community volunteers and members of the community. These clubs were divided into cells of 5 members each. Each cell was asked to mobilise savings from members and loans extended on a matching 50:50 basis. Loans were repayable in full, after four months in a single instalment.

[104] Accounting for less than 2% in March 1993.

Table 7.1: MFI 1 Microfinance portfolio, November 2003

Principal	Area	Total funding	Product	Interest rates	Repayment period
Donor 1	Luapula Province	K750 million			
Donor 2	Luapula Province	US$ 150,000	Min $100 Max S2,500	15% + BBZ base rate for individuals 10% + BBZ base rate fro groups	4 to 9 months
Donor 3	Mumbwa and Southern Province	US$200,000	Min $100 Max $8,000	3.5% per month	3 to 12 months
Donor 4	Selected rural groups	US$1,358,837 for onward lending and operational costs			
Loan from apex organisation	Central Province		Min $50 Max $500	10% per month for groups 12.5% per month for individuals	4 to 6 months

Source: CSB/R/25: 6

In the first instance, the savings plus the matching loan from MFI 1 was lent to 2 members selected by the cell for 4 months, with the cell leader being the last member of the cell to receive a loan. This measure was meant to deter the manipulation of the group by the leader who tended to be the most influential member of the group. The credit officer was not involved in deciding the order in which members received their loans. New loans were disbursed to 2 other members of the cell after the old loans were repaid. If the old loans were not repaid, then other members of the whole group to which the cell belonged, not just the cell itself, would not get new loans. If the cell failed to repay, the group was required to make good on the loan. Thus, each group member was responsible for a member who failed to repay their loan. Accordingly, all club members had to sign loan guarantee forms jointly with the club's elected committee. This way high repayment rates were ensured by peer pressure.

Members were eligible for loans only if they had a viable income generating activity with development potential, were at least 18 years of age with no criminal record or outstanding debts elsewhere, and had obtained a satisfactory reference from other group members. Members were required to attend orientation meetings and receive training before qualifying for a loan.

Operational problems faced by MFI 1

MFI 1 operated relatively successfully, managing credit programs on behalf of private enterprises, local and international organisations, NGOs and the Government. At the time of the first inspection carried out by BOZ, the MFI managed funds on behalf of two donor agencies for which it was paid a commission based on the level of recoveries. MFI 1 was not exposed to any credit risk other than that for its own loan portfolio which at the time amounted to K20 million. The approval of loan applications was done by the Steering Committees for the two Funds. MFI 1's responsibilities were limited to ensuring loan applications were complete and monitoring recipients' utilisation of the loans and their performance, as well as loan recoveries.

However, successive inspections carried out by BOZ revealed that MFI 1 was being poorly managed from its inception. MFI 1 did not have a formalised planning process. It had no documented strategic plan (CSB/R/1: 27). It was noted that the MFI had weak internal control systems as reflected by the absence of checks and balances in relation to work done by the chief accountant who was eventually dismissed for fraud. Bank reconciliations were not done. Management oversight over staff members and operations was poor with branches being inadequately supervised by head office. Records were poorly maintained and senior management, who were also the directors and shareholders, claimed that they did not keep hard copies of accounting records or backups. Thus, when office equipment was seized by bailiffs acting on a court judgement decided against MFI 1, the MFI was not able to produce its management accounts, nor was it able to submit statutory prudential reports to BOZ. Documentation was inadequate. Information on clients' files was incomplete with files missing pertinent documentation relating to the particulars of outstanding balances on its loan portfolio (CSB/R/25: iii).

In 1997, MFI 1 was asked to handover the management of one of the funds to an audit firm following concerns by the Steering Committee that recoveries were low and that the revolving fund was being depleted. The MFI's management of the funds was deemed inadequate due to "a complete collapse of the loan administration and follow up system evidenced by very low recovery rates of less than 7%" (CSB/R/25: 6). The audit firm was to streamline the administration of the Fund and collect the outstanding balances in the remaining project period.

In 2003, the regional manager for Southern Province and two other officers were discharged for the misappropriation of funds leading to the closure of offices in Monze and staff redundancies. In the same year, MFI 1 was sued by one of its former clients in relation to lost rental income from property that the client had secured as collateral and MFI 1 had attempted to liquidate in settlement of the client's outstanding loan when the client failed to repay. Judgement was passed in favour of the client and bailiffs sent to seize office equipment and motor vehicles in MFI 1's possession. However, the ultimate owner of the property to be seized was a donor agency which had contracted MFI 1 to manage various schemes on its behalf. Through the intervention of the donor agency, the property was retrieved and returned to MFI 1. However, bailiffs armed with a new writ seized property a second time. Although the donor agency did manage to retrieve the property the second time around, it opted not to return the property to MFI 1 pending a decision as to how to proceed.

In the end, the donor agency decided not to continue its dealings with MFI 1 because of lost confidence and trust as a result of the court case. The situation was exacerbated by an audit commissioned by the donor agency which revealed that MFI 1 had not complied with all the terms and conditions of the contract, that funds were being used to meet unauthorised expenditure, and deteriorating loan recovery rates (CSB/R/25: iv). The audit report also highlighted the fact that MFI 1 had weak internal controls and poor filing systems. It revealed that MFI 1 did not comply with provisions in the BFSA 2000 relating to shareholding, capital adequacy and the classification and provisioning of loans. Additionally, the auditors were not able to verify substantial balances in the accounts (CSB/R/25: 9). To make matters worse, MFI 1 refused to have a second audit commissioned by the donor agency done and would not allow the auditors onto the premises and access to the records.

Because of the donor agency's withdrawal, and the shareholders' inability to recapitalise the MFI, MFI 1 faced serious operational and liquidity problems. It was not able to submit prudential reports to BOZ on time (CSB/R/25: 4). The staff complement was reduced to 26 from 62 (CSB/R/25: 4). By the end of November 2003, the shareholders of MFI 1 had decided to exit the market and wind down operations. The company's reputation had deteriorated to such an extent that debtors had stopped repaying their loans as they expected the company to close (CSB/R/25: 13). The company's directors wrote to BOZ indicating that they would go into voluntary liquidation by 30 April 2004 (CSB/R/26: 3).

At the time of the decision to go into voluntary liquidation, MFI 1 owed approximately K15 million in the form of 'forced savings' on which it had been paying 1.5% interest per month to 300 clients. These clients had no outstanding loans as they were waiting to receive new loans. The CEO hoped to repay the forced savings once the outstanding loans had been repaid and assets sold off.

Table 7.2: MFI 1 - chronology of events

Date	Event	Reference
23 Nov 1992	Date of incorporation.	CSB/C/2
1992	MFI 1 asked to manage a crop input supply lending project in Mpongwe.	CSB/R/1
1994	Management of the Mpongwe Community Development Women Empowerment Project – start of microcredit.	CSB/R/1
10 May 1994	Application for a financial institution's licence.	Fieldwork notes
18 Jul 1996	Increase in nominal authorised share capital to K50 million and paid up share capital to K25 million from K5 million.	CSB/R/26
6 Aug 1996	Licence application approved.	CSB/L/27
1997	Audit firm engaged to manage one of the funds.	CSB/R/25
5 Feb 1997	Preliminary inspection.	CSB/M/6
18 – 21 Mar 1997	Inspection of MFI 1 as at 31 December 1996.	CSB/L/7
9 – 12 Mar 1998	Inspection of MFI 1 as at 31 December 1997.	CSB/M/9
5 Feb 1999	MFI 1 sign cooperative agreement with the donor agency to manage US$1,358,837 for onward lending to selected rural groups and to meet operational costs. Estimated completion date, 31 Jan 2003.	CSB/R/25
8 – 19 Feb 1999	Inspection of MFI 1 as at 31 December 1998.	CSB/M/12
22-23 Feb 2000	Special investigation of Mazabuka branch.	CSB/R/25
14 Aug 2000	Inspection as at 30 June 2000.	CSB/R/25
4 Dec 2001	Issue of licence.	CSB/C/24
Jul – Aug 2002	Audit firm contracted by the donor agency to audit funds availed under the cooperative agreement.	CSB/R/25
Sep 2002	The donor agency stops funding MFI 1.	CSB/R/25
7 Mar 2003	Judgement passed in favour of the MFI's client.	CSB/R/25
Mar 2003	Bailiffs seize property from MFI 1 offices.	CSB/R/25
18 Mar 2003	Death of shareholder with 36% shareholding in MFI 1.	CSB/R/25
23 May 2003	Agreement between the donor agency and MFI 1 extended to 31 Mar 2004 after intervention from the donor agency's Botswana office.	CSB/R/25
12 Sep 2003	Bailiffs seize property for a second time.	CSB/R/25
22 Oct 2003	Audit firm contracted by the donor agency to audit MFI 1 but refused entry to premises and access to records by MFI 1.	CSB/R/25
18-20 Nov 2003	Ad-hoc inspection by BOZ for the period 31 March to 12 September 2003.	CSB/R/25
Nov 2003	Decision by shareholder to liquidate MFI 1.	CSB/R/25

Experience as a licensed institution

Licensing

MFI 1 applied for a licence in May 1994 under the BFSA, 1994. The main motivation for making the application was to enhance its legitimacy and credibility. The licence application

was approved in August 1996[105]. The licensing process took approximately 2 years and 3 months (820 days). At the time of the application, MFI 1 was applying for a licence to act as loan fund mangers, an activity which did not require licensing by BOZ as it did not fall within the definition of financial service[106]. However, it is evident from the documentary review that BOZ was unsure as to whether it ought to process the licence application. In the end, BOZ did process the application (CSB/L/5: 3), which was eventually approved in August 1996 (CSB/L/27).

<u>Minimum capital requirements</u>

At the time of the licence application, the company's authorised and paid up capital was K5 million. MFI 1 was deemed to not to be accepting deposits, despite the fact that the lending methodology adopted (for the funds being managed) required prospective borrowers to make 'forced savings'. The minimum paid up share capital statutory requirement for DT NBFIs is K2 billion[107]. However, the minimum capital requirement for NDT NBFIs is K25 million[108]. Thus, in order for their application to be successful, the shareholders had to increase the authorised and paid up share capital from K5 million to K25 million to comply with the requirements of the law.

It is evident from documentary evidence that BOZ was not sure how to treat the matter of forced savings. One BOZ report explicitly states, "Since *MFI 1* is not a deposit taking institution, there are no public deposits to be protected" (CSB/R/25: 14). In another report, it is noted that "…*MFI 1* is not a deposit taking institution *per se* and as such it has no significant deposit liabilities to the public" (CSB/R/26: 13). In the same report it states that "…management will have to guarantee BOZ that all forced savings amounting to K15 million are paid off before 30 April 2004" (CSB/R/26: 4), which implicitly acknowledges that the company does have deposits in the form of forced savings. For the most part, all other reports are silent on the matter of the forced savings being mobilised by the MFI, a reflection of the lack of clarity regarding the treatment of forced savings and BOZ's willingness to turn a blind eye to the situation.

[105] However, the licence was only issued in December 2001 due to an oversight by BOZ.
[106] Section 2 of the BFSA, 1994.
[107] Regulation 4(1)(a) of SI 184, the Capital Adequacy Regulations.
[108] Regulation 4(1)(c), SI 184.

The Impact of the 2000 amendments on ownership and governance

Prior to the amendments to the BFSA, BOZ was reluctant to apply the Act in its entirety to NBFIs. Thus, at the time of licensing MFI 1, BOZ was silent on a number of issues, such as the governance structure of the MFI, even though MFI 1 only had two shareholders and two directors. With the amendments coming into effect in 2000, BOZ took more notice of the MFI's ownership and governance structure.

At the time of licensing, MFI 1 had two shareholders with the shareholding split 64% and 36%. After the amendments, the shareholding structure did not comply with the statutory provision limiting controlling interest to a maximum of 25% per shareholder (CSB/R/25: i)[109]. This was highlighted in the last inspection of MFI 1 that was conducted in November 2003[110]. MFI 1 had two years from the time the amendments were enacted, to December 2002, to regularise their position, unless prior approval to retain the existing ownership structure had been obtained from BOZ[111]. This had not been done.

Since its inception MFI 1 had two board members who were also the shareholders of the company[112]. After the amendments, MFI 1 was in breach of the provision which requires FIs to have a minimum of five board members (CSB/R/25: ii)[113]. MFI 1 did take steps to comply with this requirement and succeeded in appointing another three board members, bringing the total to four. However, the newly appointed directors never did take up their appointments due to the problems being faced by MFI 1 at the time.

On-site inspections

As a regulated FI, MFI 1 was inspected seven times from the time it was licensed (Table 7.3). The first inspection, carried out in February 1997, was a preliminary inspection of MFI 1. The objective of this inspection was for BOZ to familiarise itself with the MFI's business operations and obtain background information in preparation for the full inspection in March 1997. The preliminary inspection was followed by four routine annual inspections in March 1997, March 1998, February 1999 and August 2000. In February 2000, a special investigation of the Mazabuka branch, prompted by customer complaints that the company was exploiting customers, was carried out. The last inspection conducted by BOZ was an ad-hoc inspection

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109 Section 23(2)(b), BFSA 2000 (all sections cited hereon refer to the BFSA 2000, unless otherwise stated).
110 The first inspection after the amendments.
111 Section 23A.
112 The second shareholder and board member, died in March 2003.
113 Section 30(2).

in November 2003 following reported problems at MFI 1. The results of the inspection findings are summarised in Table 7.4.

Table 7.3: Schedule of on-site inspections

Date	Event	Reference
5 Feb 1997	Pre-inspection	CSB/M/6
18 – 21 Mar 1997	Inspection of MFI 1 as at 31 December 1996	CSB/L/7
9 – 12 Mar 1998	Inspection of MFI 1 as at 31 December 1997.	CSB/M/9
8 – 19 Feb 1999	Inspection of MFI 1 as at 31 December 1998	CSB/M/12
22-23 Feb 2000	Special investigation of the Mazabuka branch	CSB/R/25
14 Aug 2000	Inspection as at 30 June 2000	CSB/R/25
18-20 Nov 2003	Ad-hoc inspection of the period 31 March to 12 September 2003	CSB/R/25

Table 7.4: Summary of inspection findings

Date of on-site inspection	5 Feb 1997	18 – 21 Mar 1997	9 – 12 Mar 1998	8 – 19 Feb 1999	14 Aug 2000	18-20 Nov 2003
Inspection period	Pre-inspection	Y.e. 31 Dec 1996	Y.e. 31 Dec 1997	Y.e 31 Dec 1998	Y.e. 30 Jun 2000	31 Mar to 12 Sep 2003
Capitalisation		Satisfactory		Low	Insolvent	
Asset quality		Poor		Poor	Poor	
Credit lending policy			No			
Existence of credit committee				No		
Diversity in Board membership		No	No	No		
Earnings		Satisfactory		Negative	Negative	
Loan write-off and provisioning policy					No	
Internal controls	Weak	Weak	Weak	Weak	Weak	Weak
Separation of duties	No		No			
Internal audit function	No			No	No	
Data backup			No			
Operation manuals			No			
Qualified and experienced staff	No	No		No		

Source: BOZ inspection reports and correspondence

All previous full inspections carried out revealed issues of poor corporate governance, poor credit policy and weak internal controls at MFI 1 (CSB/R/25: 1). The last routine annual inspection conducted, in August 2000, found that the institution had recorded losses and was insolvent. At the end of June 2003, MFI 1 had a capital position of negative K2,407 million (CSB/R/25: 12)[114]. Asset quality was poor with 67% of the loan portfolio nonperforming. Provisions had not been made for loan losses, breaching the provisions of SI 142 of 1996 (CSB/R/26: 2). The company had been making losses since 1998, the poor earnings having

[114] It was noted that the capital position may in fact have been worse as no provision had been made for nonperforming loans.

been attributed to the high level of nonperforming loans, low recovery rates and the misappropriation of funds by unscrupulous employees (CSB/R/26: 2). Liquidity was poor and management conceded that it was not able to pay 'forced savings' amounting to K15 million and had not paid its statutory obligations with regards to taxes and pension contributions (CSB/R/26: 2).

Despite the same issues having been highlighted by successive inspections and corroborated by the independent audit commissioned by the donor agency, there was no evidence to suggest that MFI 1 took effective steps to rectify the situation. If anything, the MFI's performance continued to deteriorate over the years with recovery rates on loans declining, increasing problems with management and no improvements to weaknesses identified in internal controls.

Only in the fourth year after obtaining the licence, in a meeting held between BOZ and the CEO in September 2000 to discuss the findings of the August 2000 inspection, did the CEO indicate that two consultants had been hired earlier during the year. One consultant had drawn up a comprehensive training manual and organised workshops for management and the other had written up an operations manual for the company. He also informed the meeting that the donor agency intended to hire another consultant to provide training to credit officers, covering the methodology and delivery of credit (CSB/M/21). Other than the actions above, carried out on the initiative of the donor agency, MFI 1 had not taken any other action to address the various matters arising from the inspections that they had been alerted to them by BOZ.

7.2.2 MFI 2

Background

MFI 2 is a profit oriented NGO that is funded solely by donors, and aims to be financially self-sustainable. It was established in 1995 as an association by a group of Christian business people on the Copperbelt (CSA/L/26: 4) and was registered as a company limited by guarantee[115] on 29 August 1997 with the Registrar of Companies (CSA/L/5: 1). It was "set up as a Trust governed by trustees without any pecuniary interest to carry out the interests of donors" (CSA/L/23: 1).

[115] Of up to K2.4 million.

Through a donor agency (Donor A), MFI 2 managed to get funding from a developmental agency (Donor B), and was given a grant of £2.29 million in financial support for the program over a five year period starting in February, 1998. With technical assistance from Donor A, it started a microcredit project to the economically disadvantaged in urban areas of Zambia using the village banking model (trust bank). The first loans were disbursed in August 1998 and the levels of lending, outreach and portfolio quality were significantly above expectations (CSA/R/31: 17).

It applied for a licence to operate as a NBFI with BOZ in August 1998. It was eventually issued with a licence in November 2000. The trustees' objective for obtaining a licence was "to create a reputation and prove that *its* operations were water tight. In order to achieve this, you need a regulatory authority to say that you're okay. This strengthens the organisation's reputation. It is like being audited by internal auditors as opposed to being audited by international auditors like KPMG" [MFI/I/1 (126–130)]. The trustees' main objective of being regulated by BOZ was to be credible, sustainable and mobilise savings. "We intend to provide full financial services to the poor. We would like to source loan funds from savings. But in the short term we need to be prepared to get investor funding" [MFI/I/1 (407–410)].

As a result of its initial success, MFI 2 decided to expand nationally in September 1999. By July 2001, MFI 2 was operating in 5 Copperbelt towns and had over 12,000 active clients (CSA/R/39: 745). As part of the expansion programme, a company limited by shares, MFI 2 Limited (MFI 2 Ltd), was incorporated in May 2002 and the business of MFI 2 transferred to this company (CSA/L/15). The proposed shareholding of the new company, depicted in Figure 7.1, was a total of 10,000 shares split as follows; 4,250 (42.5%) for the NGO, 4,250 (42.5%) for Donor A, 500 (5%) for the founding board members and 1,000 (10%) for the employee share ownership trust (CSA/R/24: 9). After formation of the company, MFI 2 surrendered its licence to BOZ on 3 September 2002 asking for the licence to be transferred to the new company (CSA/M/32: 2). However, this was not possible, as transferring the licence would contravene section 15 of the BFSA 2000 which prohibits the transfer of a licence to another entity (CSA/M/32: 2)[116].

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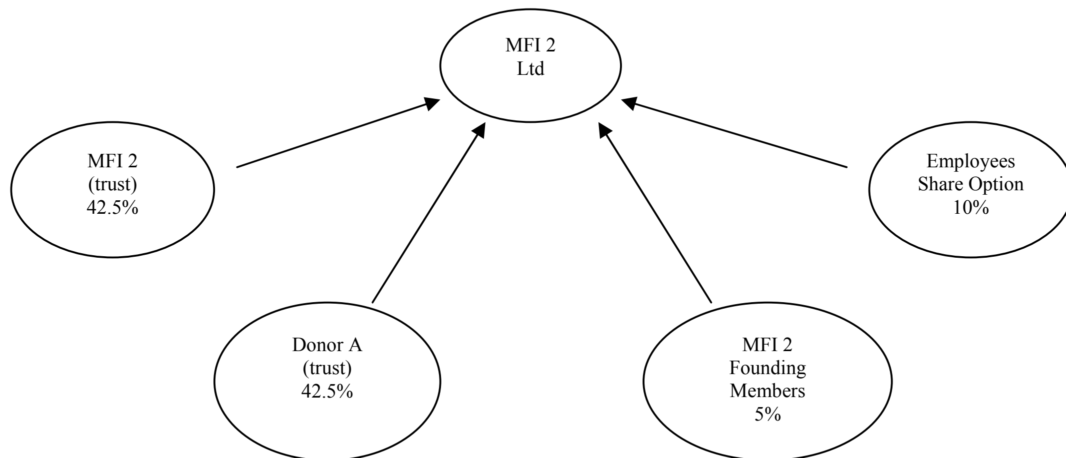
[116] Because MFI 2 Ltd was not licensed, BOZ felt that the MFI did not fall under its supervisory ambit and therefore, "the current status of the institution makes it difficult for BOZ to effect any supervisory action. … What was officially recognised was MFI 2, which no longer exists" (CSA/R/27: 6).

Figure 7.1: MFI 2 Ltd shareholding structure



Client profile and products

MFI 2's primary activities are the provision of loans to qualifying micro-entrepreneurs, preparing project and technical profiles, and providing technical assistance and training to micro-entrepreneurs (CSA/R/35: 1). Approximately 18% of its staff is dedicated to the provision of financial services and 45% to the provision of social services. The remaining 37% provide support services. Clients are selected on the basis of locality, interest in the program and prior business experience. Village/community leaders, friends and family, as well as the credit group selection process of eligible members, are all used as sources of information when evaluating potential clients.

MFI 2 has two products on offer, one of which is trade/commercial loans to individuals who are already in business. It does not provide start up capital. The main characteristics of the loans on offer are shown in Table 7.5. It employs three lending methodologies, trust banks[117], solidarity group lending and individual lending (CSA/R/35: 13). Table 7.6 provides information on the split of the loan portfolio between the different types of loans as classified by the lending methodology. Trust banks consist of 20 to 40 people. The groups self select and nominate their own leader. The groups undergo a ten week training session and they have to contribute to the loan insurance fund (LIF). During the ten weeks, some members

[117] A trust bank is a group of 15-40 poor entrepreneurs, primarily women, who receive small business loans and meet weekly to make loan repayments, address community concerns, and receive business training. Trust bank members guarantee each other's loans.

may fall out, but those that make it are given loans ranging from K50,000 to K800,000. The loan is given to the group which is then distributed amongst the group members. This loan has to be repaid within 16 weeks in weekly instalments.

Table 7.5: Loan characteristics

	Minimum	**Maximum**	**Average**
Loan size ➢ Group ➢ Individual	 K50,000 K2m	 K5,000,00 K20m	 K800,000 K5m
Annual interest rates (for 2003)	36%	54%	45%
Repayment period	16 weeks	1 year	32 weeks
Repayment frequency	Weekly	Monthly	Bi-weekly

Source: Completed questionnaire

Table 7.6: Product analysis

	2004		2003	
	o/s amount (K'm)	%	o/s amount (K'm)	%
Solidarity group	784	48	1,215	40
Individual loans	504	31	933	31
Trust bank	341	21	902	29
Total	1,629	100	3,049	100

Source: Completed questionnaire

Individuals can then graduate to solidarity groups which are smaller, with membership of between 5 and 7 individuals. The loans are larger, ranging from K1 million to K5 million. Individuals can pledge property to the group as security in addition to the contributions to the LIF. The repayment period ranges from 6 to 12 months and repayments can be made fortnightly or monthly.

The third mode of lending is individual lending. The first loan ranges from K2 to K10 million and may go up to K20 million in subsequent periods. Repayment is over a period of one year. Contributions are not required to be made into the loan insurance fund for individual loans.

MFI 2 also has a funeral insurance product. The product features are shown in Table 7.7. This product is underwritten by an insurance company and MFI 2 merely acts as an agent. Thus clients pay premiums to MFI 2 which it then passes onto the insurance company. The insurance covers the price of a coffin and some of the funeral expenses. This product was developed when MFI 2 realised that most poor people's businesses did not survive when they had a funeral [MFI/I/1 (425-427)] and so needed a way in which they could protect themselves against the negative impact of a death.

Table 7.7: Insurance product details

Product feature	Comments
Premium	Fixed K1,125 ($0.25) per week of the loan, irrespective of the age of the borrower. Premium deducted from disbursed loan.
Coverage	Death arising from any cause, including HIV, for client plus an additional five family members chosen by the client during the loan application.
Claim value	Fixed at K500,000 ($108) for an adult and K250,000 ($54) for a child. A child is less than 14 years old.
Period	Insurance active from date of loan disbursement until expected date of maturity (normally 16 weeks for group loans) plus an additional two weeks of "free cover" after the loan has matured to cover the loan application process for a subsequent loan.
Exclusions	1. If the claim is not reported within 14 days of the death. 2. If the deceased was not a listed family member on the application. 3. If the client (or client's group) is more than 14 days in arrears with its loan repayments the insurance is invalidated until the arrears are cleared.

Source: CSA/R/38

MFI 2 does provide training prior to lending which lasts approximately 10 weeks. Collateral is required in the form of 'forced savings' and group guarantees. The forced savings are referred to as a 'loan insurance fee' which is paid into the loan security fund (LSF). Clients are required to have saved 10% of the loan amount before disbursement. These 'forced savings' are deposited with commercial banks and are not used for on-lending. Clients are not permitted to withdraw their forced savings until they have finished paying off their loan (CSA/M/1: 1).

There is no waiting period between loans for those who have successfully completed a loan cycle. Loans are classified as delinquent four weeks after the scheduled payment date if no payment or only part payment has been received. There are no penalties for early repayments.

Table 7.8: Financial and performance indicators

Year end 31 March	2004	2003	2002	2001	2000
Total disbursed (K'm)	3,657	17,608	21,784	19,501	n/a
No. of LSF clients	5,711	15,610	19,217	3,511	3,664
No. of clients with loans	4,811	13,350	16,131	10,719	3,664
Gender split – Women	74	72	74	82	n/a
Men	26	28	26	18	n/a
Total loans disbursed to date	71,653	66,297	51,166	29,382	n/a
Loan amount outstanding (K'm)	1,461	2,774	2,352	1,365	368
Portfolio quality	88	90	93	94	n/a
Operational sustainability	24%	22%	58%	37%	n/a
Financial sustainability	23%	16%	37%	26%	n/a
Total no. of staff	71	128	165	162	46
No. of loan officers	n/a	31	63	31	53
Portfolio at risk	n/a	6	7	6	2
Repayment rate	n/a	94	93	94	98
Profit/loss	n/a	6,272	5,579	2,086	638
Total assets	7,242	7,489	6,918	5,183	n/a

Source: CSA/R/35, CSA/R/36 and MFI 2 questionnaire responses; n/a - not available

Operational problems experienced by MFI 2

Despite its initial success, MFI 2 did experience problems which culminated in a deterioration of its portfolio quality necessitating a slow down in business and growth prospects in the short term; and low and declining income levels decreasing sustainability prospects (CSA/F/22: 1). The MFI's poor performance was caused by a number of internal weaknesses which included rapid growth, inexperienced senior management, poor management information systems (MIS) compounded by poor internal controls, and the lack of an appropriate strategic focus.

Firstly, MFI 2 had expanded too quickly without the necessary personnel, internal controls and MIS in place. The huge amounts of funding available encouraged growth objectives which were unrealistically high. Table 7.9 compares the actual client figure at March 2000 to growth targets for the following four years (CSA/R/24: 1). It was not possible for MFI 2 to train loan officers or branch managers at a pace to sustain this level of growth.

Table 7.9: Growth targets

	March 2000	March 2001	March 2002	March 2003	March 2004
No. of clients	3,600	12,338	29,736	40,176	42,606
% increase		243%	141%	35%	6%
Loan loss %		3.0%	3.4%	3.8%	3.9%

Source: CSA/R/24: 1

Secondly, MFI 2 employed three new senior executives, the CEO, the operations manager, and the finance manager, who were not familiar with microfinance or the methodology being used by the MFI, to manage the expansion process. They instituted changes to the lending methodology which served to weaken group solidarity and led to the deterioration in repayment rates.

Thirdly, MFI 2 had acquired a computerised MIS that did not have a fully functioning microfinance facility[118]. In the final analysis, the issue was not so much that MFI 2 did not have a fully functional 'computerised' MIS, but rather that it did not have a sufficiently functioning MIS, albeit manual. This meant that there was a lack of adequate information on branch performance and transactions. Despite this, the board and senior management decided to go ahead with the expansion program. Additionally, the financial controls required for a decentralised branch structure which was handling cash were lacking.

[118] This system had been endorsed by the Consultative Group to Assist the Poorest (CGAP), a highly respected international authority on microfinance, and Donor A (CSA/R/31: 34).

After the appointment of an internal auditor in September 2002, it was discovered that there had been serious departures from operating procedures and wilful misstatement of the financial performance in branches. However, management did not respond effectively to deal with these deficiencies (CSA/R/24: 2). Lastly, the board and management spent an inordinate amount of time and attention on new initiatives rather than on managing the core business. The initiatives included transforming MFI 2 into a regulated FI, which required a great deal of meetings and planning for Donor A and local members of the Board, and the introduction of the individual loan service in Lusaka (CSA/R/24: 3).

To resolve these problems, a number of remedial actions were undertaken in 2003. These included streamlining the branch network with 3 branch closures and the merger of four branches into two. MFI 2 now has seven branches in Kitwe, Ndola, Mufulira, Kalulushi, Chingola, Livingstone and Lusaka (CSA/L/25: 2) from twelve (CSA/F/22: 2). A number of employees were retrenched and redundant assets disposed of (CSA/R/35: 13). In March 2003, over 7,000 loans were written off with the active number of clients falling from over 16,000 (CSA/R/24: 1) to just under 4,000 active clients in August 2004, of which 75% were female. MFI 2 has disbursed 71,653 loans to date (Questionnaire responses).

Table 7.10: MFI 2 - chronology of events

Date	Event	Reference
Dec 1995	Founding of MFI 2	CSA/L/26
29 Aug1997	MFI 2 was incorporated as company limited by guarantee.	CSA/L/26
Aug 1998	Commencement of operations	CSA/L/26
6 Aug 1998	Submission of licensing application.	CSA/M/2
3 Sep 1998	Submission of updated financial projections.	CSA/M/2
8 Sep 1998	Initial licence application evaluation.	CSA/L/14
Sep 1999	Decision to expand nationally	CSA/R/39
Sep 2000	Appointment of internal auditor	CSA/R/24
20 Nov 2000	Licence issued.	CSA/L/14
14 Dec 2000	Opening of Kitwe branch.	CSA/L/6
6 May 2002	Incorporation of MFI 2 Ltd.	CSA/L/15
3 Sep 2002	Surrender of licence and request to transfer to new company.	CSA/L/15
13 Sep 2002	Opening of Lusaka branch.	CSA/L/13
Jan 2003	New licence application.	CSA/R/37
1 Apr 2003	Appointment of interim CEO for 1 year.	CSA/L/19
13 Apr 2003	MFI 2 Ltd reverts to NGO status	CSA/M/33

Experience as a licensed institution

<u>Licensing and minimum capital requirements</u>

MFI 2 applied for a licence in August 98 under the BFSA, 1994. The licence was issued in November 2000, one month before the amendments to the BFSA were enacted. The

licensing process took approximately 2 years and 3 months (820 days). MFI 2 was one of the first MFIs to apply for a licence with BOZ. The length of time it took for the application to be evaluated may have been attributable to the Central Bank's lack of experience in dealing with MFIs.

At the time of the application, MFI 2 was a trust limited by guarantee up to K2.4 million (CSA/M/2: 3). However, the minimum capital requirement for DT NBFIs is K2 billion and NDT NBFIs is K25 million[119]. At the time of licensing, MFI 2 was deemed not to be accepting deposits, despite the fact that the lending methodology adopted required prospective borrowers to make 'forced savings' classified as a loan insurance fee of 10% of the loan amount. Thus, for their application to be successful, the trustees set up a capital fund to "represent the equivalent of share capital to conform to the minimum capital requirements" of K25 million in order to comply with the provisions of the law (CSA/R/36: 16).

As for MFI 1, documentary evidence shows that BOZ was not sure how to treat the matter of forced savings and went back and forth as to whether the forced savings should be treated as deposits and the subsequent implications on the minimum capital requirement. The final licence application evaluation stated that since "these 'deposits' are not available for use to either the clients or MFI 2 over the loan repayment periods; …the requirement for MFI 2 to meet the minimum capital requirement of K2 billion falls off" (CSA/M/1: 1). For the most part, all other reports are silent on the matter of the forced savings being mobilised by the MFI, a reflection of the lack of clarity as to their treatment and BOZ's willingness to turn a blind eye to the situation.

The impact of the 2000 amendments on MFI 2

Prior to the amendments of 2000 to the BFSA, BOZ was reluctant to apply the Act in its entirety to NBFIs. Thus, MFI 2 was granted a licence in November 2002 even though it was owned 100% by a trust. At the time of the licence application, the BFSA 1994 was silent as to whether trusts could own shares in FIs and so the ownership structure, in this regard, was not an issue at the licensing stage. However, this changed with the amendments. The BFSA 2000 does not permit trusts to be shareholders of a FI[120]. In addition, the Act does not permit more than 25% of the control of a FI to be vested in one person[121].

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[119] Regulation 4(1)(a) and 4(1)(c) of SI 184.
[120] Section 24A(1).
[121] Section 23(2).

Even the shareholding structure of the new company, MFI 2 Ltd, formed in 2002, violated the provisions of the BFSA 2000 in relation to trust ownership and the limitation of ownership by any one entity to a maximum of 25%, as both the NGO and Donor A owned 42.5% of shares in MFI 2 Ltd. A BOZ official did indicate that MFI 2 Ltd may be exempted (CSA/L/5: 3)[122]. However, there is no evidence that this course of action was ever pursued by BOZ despite the MFI's request for BOZ to make a recommendation to the Minister of Finance for an exemption (CSA/L/5: 4).

Despite numerous discussions with BOZ, MFI 2 and its 'investors', namely Donor A and Donor B, were not able to resolve the matter of the ownership structure[123]. Consequently, it was decided that MFI 2 Ltd should revert to NGO status until such time that the DMFRs came into effect. It was hoped that the Microfinance Regulations would address this matter specifically, especially as it would have a significant bearing on the microfinance sector.

Being a licensed institution meant that MFI 2 now had to submit prudential reports to BOZ on a regular basis. Discussions with the CEO revealed that this requirement was not problematic for MFI 2. They were able to comply with this requirement with very little adjustment and disruption to their MIS.

7.2.3 MFI 3

Background

MFI 3 was incorporated in January 2002 with an authorised and paid up share capital of K2 million (CSC/L/5) which was subsequently increased to K25 million in March 2002 (CSC/L/6). The company was set up to provide microcredit on a short term basis, initially to members of the unionised mineworkers and eventually to the broader public. MFI 3 would not be mobilising deposits and a significant portion of the company's working capital requirements was provided by an associate company (Co), Co 2, which committed itself to providing $750,000 (CSC/M/12: 1).

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122 Section 130.

123 Most MFIs are donor funded and set up as trusts with opaque ownership structures. Trusts are donors' preferred choice of vehicle for giving support to the microfinance sector.

MFI 3 applied for a financial institution licence in March 2002[124], at which time the MFI had 3 shareholders, Co 1 (94.5%), Mr X (5%) and Mr Y (0.5%) as shown in Figure 7.2. Co 1 was a company incorporated in the British Virgin Islands with 4 shareholders; Co 2 (42.11%) which was a quoted merchant banking group listed on the London, Johannesburg and Luxembourg Stock Exchanges with operations in South Africa; and 3 shareholders which were trusts.

The shareholding structure of Co 1 changed in November 2003 when the trusts sold their shares to 2 companies. Co 1 now had 3 shareholders; Co 2 (49.11%), Co 3 (25.05%) and Co 4 (25.05%)[125]. Therefore, at the time of being granted the licence, MFI 3 effectively had 3 major shareholders, through indirect shareholdings, and 2 minority shareholders as depicted in Figure 7.3.

The company's headoffice is located in Kalulushi (CSC/A/3: 1) with satellite offices in the other Copperbelt towns (CSC/M/12: 9). The company appears to have started trading as soon as it was incorporated although it had not yet obtained a licence from BOZ (CSC/M/19: 6). It opened a branch in Lusaka in March 2003, a month after being issued with a licence. In March 2004, the company's name was changed to reflect the directors' desire to broaden its client base and hence the need for a neutral name (CSC/L/22). Table 7.12 chronicles the main events in relation to MFI 3 since its inception.

Client profile and products

At inception, the target market was members of the miners' union estimated at 33,000. The company provided two types of personal credit products to miners, a short term 30 day loan and a short term 3 month loan. These are salary backed loans with repayments being made directly from the payroll via payroll deduction agreements with employers. MFI 3 planned to introduce longer term loans with repayment periods of up to 24 months after it had been operating for a while (CSC/R/2: 7).

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124 Section 17(2) & 17(4). A company providing financial services as defined in the Act, which includes the provision of credit, is required by law to apply for a licence.

125 The shareholding figures do not add up and could not be verified as the researcher did not have access to the share certificate for Co 1. However, the difference is very small and does not warrant any concern in relation to the study.

Figure 7.2 : Shareholding structure at the time of the licence application

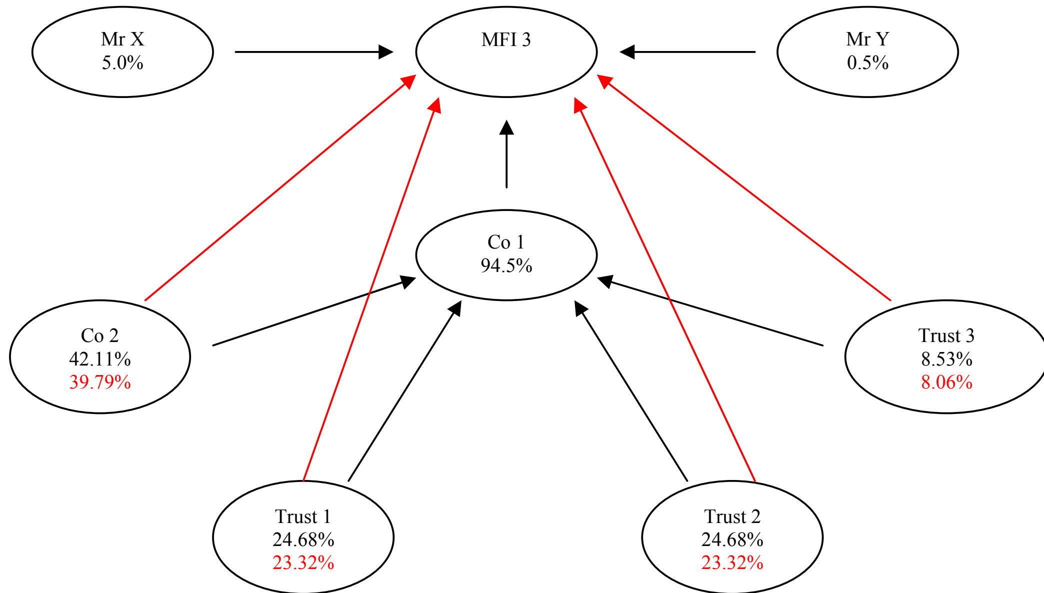
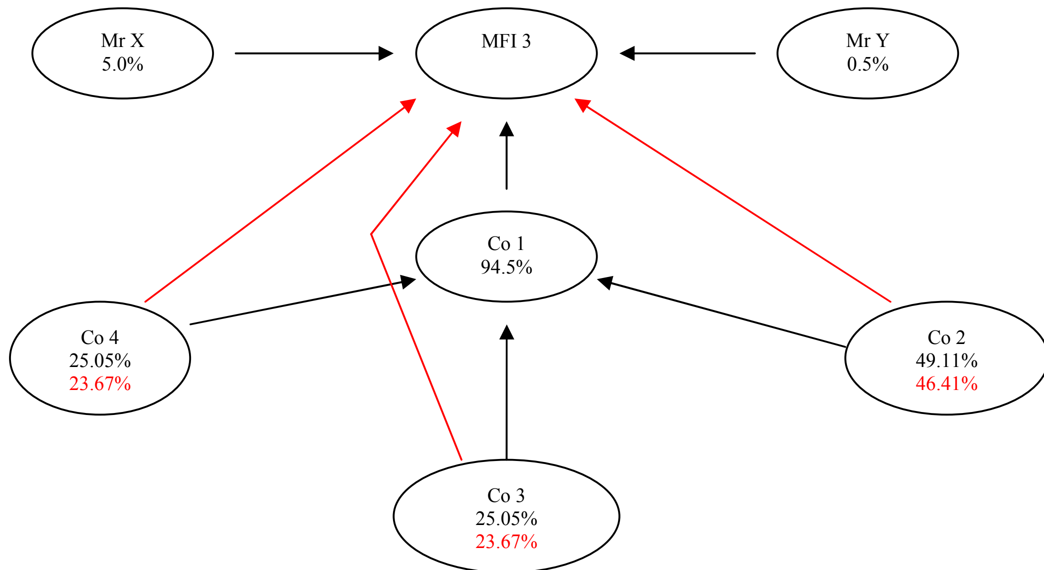


Figure 7.3: Shareholding structure after the sale of shares by the Trusts



The average loan amount in February 2003 was K130,000 and the bulk of the loan portfolio consisted of 30 day loans. Interest rates at the time were 25% per month. In addition, there was an administration charge of 10% on each loan (CSC/R/13: 3). By May 2003, MFI 3 had broadened its client base from miners to civil servants. Loans are provided for 30 days, 90 days and 180 days (CSC/M/16: 3). The MFI does not mobilise deposits of any kind (CSC/M/12: 1), nor does it require cash collateral.

Table 7.11: MFI 3 - chronology of events

Date	Event	Reference
18 Jan 2002	Incorporation of MFI 3.	CSC/R/2
1 Mar 2002	Change of shareholders, directors and company secretary	CSC/L/1
20 Mar 2002	Initial application for a financial institution licence.	Fieldwork notes
2 May 2002	Receipt of licence application fee.	Fieldwork notes
June 2002	Increase in share capital to K25 million.	CSC/L/4
18 Nov 2002	Changes in the shareholding structure.	CSC/L/11
1 Feb 2003	Inspection of the premises by BOZ.	CSC/R/13
18 Feb 2003	Approval and issuance of licence.	CSC/C/14
Mar 2003	Opening of branch in Lusaka.	CSC/M/16
15 May 2003	Ad-hoc inspection of Lusaka branch.	CSC/M/16
Oct 2003	Subordination of debt by Co 1.	CSC/L/18
1 Mar 2004	Change of CEO and appointment of new board director	CSC/L/20
11 Mar 2004	Change of company name	CSC/L/22

Experience as a licensed institution

Licensing, minimum capital requirement and ownership structure

MFI 3 applied for a licence in March 2002 but it was not accompanied by the application fee which was only paid in May 2002[126]. The licence was issued in February 2003 and the licensing process took approximately 9 months (292 days).

At the time of the licence application, the company's authorised and paid up capital was K2 million. However, the minimum statutory capital requirement is K25 million[127]. In order for the application to be successful, the shareholders had to increase the authorised and paid up share capital from K2 million to K25 million to comply with the requirements of the law.

[126] Although the initial licence application was lodged on the 20th of March, the licence fee was not paid until the 2nd of May and it is this date in May, therefore, on which the application is deemed to have been made.
[127] Regulation 4(1)(c) of SI 184.

Furthermore, three trusts had indirect shareholdings in MFI 3 (Figure 7.2). The BFSA 2000 does not permit trusts to be shareholders of a FI[128]. Therefore the initial recommendation resulting from the licence application evaluation was that the licence application be declined as it violated this provision of the Act (CSC/M/7: 7). The company was informed of this requirement (CSC/M/9) and as a result the shareholding structure was changed in November 2000. The shares held by the trusts were sold to 2 companies, Co 3 and Co 4 (CSC/L/11). The new shareholding structure is shown in Figure 7.3.

On-site inspections

The company was inspected twice by BOZ from the time of inception to the date when the field work for the research was carried out. The first inspection, conducted in February 2003, was an inspection of headoffice premises to determine whether the requirements of BOZ in relation to issues such as security and the display of relevant information at the premises had been complied with. The findings of the inspection were that the name had not been prominently displayed in accordance with the provisions of the BFSA (CSC/R/13: 1)[129]. However, the premises were found to be secure and an insurance policy for cash in transit and cash held on the premises had been taken out. At the time of the inspection, MFI 3 had 4 satellite offices. Headoffice did not deal directly with clients; this was done at the satellite offices.

During the inspection, the inspection team did point out that it felt the interest rates were too high and exploitative. The MFI was asked to review its pricing policy. Being a microfinance institution, it was expected to be a vehicle for social and economic development and poverty alleviation. The inspection team also asked the company to consider providing longer term loans for larger amounts that clients could use as capital in income generating projects rather than concentrate on salary advances at "excessively high interest rates which may not develop the concerned individuals on a sustainable basis" (CSC/R/13: 2).

The second inspection was carried out in May 2003, principally in response to a central bank member of staff having witnessed a huge crowd causing mayhem outside the Lusaka branch premises. However, the inspection found that nothing was amiss and the mayhem was caused by clients wishing to access new credit facilities from the MFI. According to the inspection

[128] Section 24A(1).
[129] Section 44(1)(a).

team, the ad-hoc inspection did reveal, though, that MFI 3 was insolvent[130]. BOZ brought this to the attention of the directors of MFI 3, but the directors insisted that MFI 3 was solvent (CSC/M/16). The disagreement was brought about by the liability on the company's balance sheet in relation to the support received from Co 2 through Co 1 of $750,000. This was despite the fact that the business proposal submitted with the licence application indicated that Co 2, through Co 1, would be providing financial support, with confirmation having been received in writing of this by BOZ (CSC/M/12: 1). It appears, however, that BOZ had made no further enquiry at the licensing stage as to the source of these funds and the terms on which this support was being provided[131]. Thus in October 2003, Co 1 was required to subordinate this debt for it to qualify as capital that would satisfy BOZ. It was also evident that BOZ was applying the concept of 'regulatory capital' to this FI even though there were no depositors' funds at stake.

7.3 IMPACT OF THE EXISTING REGULATORY AND SUPERVISORY FRAMEWORK ON MFIS

7.3.1 Attainment of the objectives of regulation and supervision

The main objectives of regulating and supervising FIs are to maintain financial system stability and protect depositors[132]. Other objectives often mentioned are that it would improve performance, act as a signal to potential investors that the FI is sound[133], increase opportunities for funding, and lastly, ensure the effective use of public resources and donor funds.

The microfinance sector as a whole is very small in relation to the financial sector which is still dominated by the commercial banking sector[134]. Nor is it part of the payment system. Therefore, although, MFI 1 was one of the larger MFIs, its assets as a proportion of total financial sector assets were minuscule. Its failure did not have any notable impact on the financial system as a whole. In this case, therefore, maintaining financial sector stability

[130] With negative capital of approximately K733 million.
[131] This is rather curious in light of growing concerns regarding money laundering in the last few years.
[132] Small depositors are not well positioned to monitor the institution's financial soundness themselves (Llewellyn, 1986; Staschen, 1999; Christen and Rosenberg, 2000).
[133] Even though inspection reports in most jurisdictions are confidential and are generally not made available to third parties to assist them in their investment decisions, licensing (often) implies that the regulatory authority is making a representation about the safety and soundness of the licensed institution (Christen and Rosenberg, 2000; Gallardo, 2001; Druschel, 2005).
[134] K1,995 million compared to K4,163,688 million for the banking sector alone, i.e. 0.05% at 30 June 2002. Figures were not available for the non banking financial sector.

should not be an objective as the failure of an MFI, even the largest, would not destabilise the system.

With regard to protecting depositors, MFI 1 still 'failed' in that it was wound up despite being regulated and supervised by BOZ. Effectively, depositors were not protected and ranked the same as other ordinary creditors in the order of priority for payment in the event of liquidation. BOZ sought assurances from the MFI that the K15 million owed would be settled. The case study shows that regulation and supervision does not necessarily lead to depositors' funds being protected as it does not prevent an institution from failing. Other mechanisms need to be put in place, such as an explicit deposit insurance scheme, for this objective to be met.

The objective of improving performance was not met. Although the same issues had been raised in successive inspections, MFI 1's directors did not take effective action to address these issues. As a result, the same matters were highlighted time and time again with no notable change in the MFI's policies and procedures. MFI 1's performance continued to deteriorate as noted in subsequent reports. Its poor financial position was exacerbated by the court case against MFI 1 by a former client which precipitated the MFI going into voluntary liquidation. Even then, the evidence did suggest that it was only a matter of time before the MFI would have been forced to wind up its operations. The low loan recovery rates, negative earnings and high levels of fraud would have resulted in MFI 1 not being able to sustain its operations. Thus, being regulated and supervised by BOZ did not have any significant impact on improving MFI 1's performance, one of the main objectives often cited for regulating and supervising FIs.

Looking at whether being regulated and supervised by BOZ acted as a signal to potential investors and donors that MFI 1 was financially sound did not appear to have been a major consideration for donors in deciding whether to use MFI 1 as fund managers. MFI 1 managed to gain donor confidence and substantial donor goodwill even prior to being licensed by BOZ. Thus, it was contracted to manage considerable fund balances for microfinance projects on donors' behalf. The steering committees were still maintained by the donors even after MFI 1 became a licensed institution, and one of the donor agencies still had independent audits carried out. This points to limited, if any, reliance being placed on the fact that MFI 1 was being monitored by BOZ.

In relation to the objective of increased opportunities for funding, this typically refers to the ability of the FI to mobilise deposits which it can then use for on-lending. Neither MFI 1 nor MFI 2 applied for a banking institution licence, as neither MFI classified the 'forced savings' as deposits and neither did BOZ. Therefore, MFI 1 and MFI 2 did not have any legal authority to mobilise deposits.

With respect to the objective of ensuring the effective use of public resources and donor funds, BOZ's stance is that "…as a supervisory authority, it is our duty to ensure that donor funds are channelled through your institution for the purpose of promoting small scale entrepreneurs are lent out prudently" (CSB/L/11). Clearly, BOZ feels that it is its duty to ensure the effective use of donor funds. Although this is one of the stated objectives, none of the inspection reports of MFI 1 referred to the effective use of funds. BOZ used the CAMEL rating model[135] for assessing the performance of NBFIs. There was no focus on funds utilisation, only to the extent that it affected BOZ's assessment of one of the criteria denoted by CAMEL. So although this was a stated objective, the evidence suggests that the monitoring of MFI 1 and on-site inspections were not conducted in a manner that determined whether funds were being used effectively.

7.3.2 Licensing and capital requirements

The licensing process for all three MFIs was lengthy. It is evident from the case studies that the licensing process was time consuming. This may have been due to BOZ's lack of experience in licensing MFIs. The licensing of MFI 3 was considerably shorter at nine months compared to 27 months for both MFI 1 and MFI 2, which may have been reflective of experience gained with the other two MFIs. Therefore, it is expected that the licensing time will continue to decrease with more experience. In order for the applications to succeed, all three MFIs had to increase their capital levels to the statutory minimum of K25 million.

7.3.3 Ownership structure

MFI 1 was required to change its ownership structure to comply with the statutory 25% shareholding limit after the amendments to the BFSA in 2000. Thus had the MFI continued to operate, the shareholders would have been compelled to sell their excess shareholding unless they obtained BOZ approval to maintain the existing shareholding structure.

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[135] The CAMEL rating framework was developed for banking institutions. C refers to capital adequacy; A, asset quality; M, Management; E, Earnings; and L Liquidity.

MFI 2 violated the provisions of the Act in relation to trust ownership and the 25% shareholding limit. The shareholding structure of the new company, MFI 2 Ltd, also violated the statutory provisions. The failure to resolve this matter resulted in the MFI's decision to revert to NGO status in April 2003 and surrendering its licence. MFI 2 is no longer licensed or regulated by BOZ.

MFI 3 was also forced to change its shareholding structure to ensure trusts did not directly or indirectly own any shares in the company. In this case, this was accomplished with relative ease because, ultimately, the company was owned by private individuals with their own funds at stake, and not donor agencies or government whose preferred investment vehicles are trusts, making changes in the ownership structures of MFIs problematic, as was the case for MFI 2.

7.3.4 On-site inspections and reporting requirements

Despite being classified as NDT MFIs, with only shareholders' and investors' funds at risk should they fail, both MFI 1 and MFI 3 were prudentially regulated. This was exemplified by the on-site inspections and the application of certain provisions such as regulatory capital, the 25% shareholder limit, the composition of the board of directors, and reporting requirements by BOZ.

The first on-site inspection of MFI 3 was an inspection of the premises, whose focus was to ensure that the premises are secure, in line with BOZ's procedures prior to granting a licence. This is done predominantly with the objective of ensuring depositors' funds are safe and secure when stored on the premises. But in this case, there are no depositors' funds to protect.

All three MFIs were able to comply with the requirement to submit monthly prudential reports without making major changes to their MIS. However, all three MFIs used in the case studies were relatively large compared to other MFIs in the sector.

7.4 POTENTIAL IMPACT OF THE DMFRS ON THE MFIS

7.4.1 Attainment of the objectives

In relation to meeting the main objectives of regulation and supervision, that is, maintaining financial stability and protecting depositors, had the DMFRs been in place, there would not

have been a different outcome. Without an improvement in performance, MFI 1 would still have gone into voluntary liquidation. The MFI's total assets as a proportion of the financial sector's total assets was minuscule, it was not part of the payments system, and its closure would not have had a negative effect on other FIs as was borne out when it went into voluntary liquidation.

The second objective is the protection of depositors. Despite being regulated and supervised by BOZ, MFI 1 still 'failed'. The outcome would not have been any different under the DMFRs. The DMFRs do not specifically or directly address the issue of protecting depositors' funds[136]. All things being equal, MFI 1 would probably still have failed because having the Regulations in place would not have necessarily resulted in changes to BOZ's supervisory approach. Attitudes and practices are not automatically altered by introducing new laws. This relates to enforcement as well. Thus, it is not likely that MFI 1's performance would have improved as a consequence of being regulated and supervised under the DMFRs. The same issues would have been raised successively by the inspection teams as was done under the existing legislative framework with the MFI's continued deterioration in performance over time, and BOZ not taking supervisory action against the MFI. Also, as stated by one of the interviewees "more legislation would not have achieved anything because you can not legislate against bad management…" [DON/1/6 (66)]. Neither does regulation prevent an institution from failing. This highlights the need to have an alternative safety net mechanism in place, such as prohibiting MFIs from using the forced savings for on-lending and requiring them to be deposited in a regulated FI such as a commercial bank[137], having an explicit deposit insurance scheme or private insurance, if available.

Considering the amount of funding made available to MFI 2, and the amounts MFI 1 was contracted to manage prior to the MFIs obtaining licences, one can conclude that the level of reliance placed by donors on the MFIs being regulated and supervised by BOZ under the DMFRs would not necessarily have been higher, especially taking into account the size of the microfinance market. MFI 1 managed to obtain contracts prior to being licensed, an indication that donors were not concerned about it being regulated by the Central Bank as they had their own systems in place for monitoring performance. The donor agency called for an independent audit in the wake of the court case against MFI 1 which would have occurred

[136] Depositors still rank the same as other creditors in the event of winding up.
[137] This is the approach that has been adopted in Uganda (Kalyango, 2005).

anyway. The evidence suggests, therefore, that it is unlikely that donor action would have been influenced even under the existence of the DMFRs.

In order to mobilise deposits under the DMFRs, MFI 1 would have had to have a minimum of K250 million authorised and paid up share capital. It is difficult to conclude as to whether the shareholders would have been willing to invest additional capital in the MFI or whether it would have considered a change to its lending methodology in order not to be classified as a DT MFI. In informal discussions with the CEO, his view was that forced savings should not be classified as deposits and that BOZ did not fully understand microfinance. However, this would not have been a problem for MFI 2 as it had adequate funding to meet this requirement.

In relation to the last stated objective of ensuring the effective utilisation of public resources and donor funds, there are no provisions in the DMFRs that require BOZ to ensure the effective use of funds. This, coupled with no anticipated change in the supervisory approach, the evidence suggests that this objective would not have been met.

7.4.2 Shareholding structure and minimum capital requirements

Had the DMFRs been in place, the forced savings would have been classified as deposits and MFI 1 and MFI 2 categorised as DT MFIs. Both MFIs would have to be limited liability companies registered with the Registrar of Companies with a minimum of four shareholders with shareholdings not exceeding 25% each. Trusts would still not be permitted to own shares. MFI 2 and MFI 3 would have had to change their shareholding structure and MFI 2 would have faced the same problem complying with this provision.

The minimum capital requirement for DT MFIs is K250 million. Therefore, MFI 1 and MFI 2 would have had to increase their minimum authorised and paid up share capital to K250 million. Considering the level of funding received by MFI 2, meeting this requirement would not have been a problem. MFI 3's share capital would still have had to be increased to the statutory minimum of K25 million.

7.4.3 Service provision and reporting requirements

Another effect of the DMFRs relates to service provision. As DT MFIs, MFI 1 and MFI 2 would have been restricted to providing credit facilities, linkage banking, money transfer

facilities and compulsory savings[138]. But under the current legislative environment, they are permitted to carry out a wider range of financial services, including foreign exchange transactions and international remittances unless expressly restricted from doing so by the Registrar. Therefore, being licensed under the DMFRs would have been more restrictive for MFI 1 and MFI 2 than being licensed under the principal Act. The same applies to MFI 3. As a NDT MFI, MFI 3 would be restricted to providing credit facilities only[139] whereas, under the current regulatory environment, it is permitted to carry out a wide range of financial services[140], with the exception of the collection of deposits[141].

The reporting requirements are not much different under the DMFRs. Although there are fewer reports, they are still detailed, especially for NDT MFIs. All three MFIs would still have had to submit prudential reports to relatively the same level of detail on a monthly basis for DT MFIs and quarterly for NDT MFIs.

7.5 CONCLUSION

This chapter analysed the impact of regulation and supervision on the three MFIs licensed by BOZ during the fieldwork. The results are summarised in Table 7.12.

Table 7.12: Case study summary of findings

	MFI 1	MFI 2	MFI 3
MFI characteristics			
Legal form	Limited company	Company limited by guarantee	Limited company
Date of registration	23 November 1992	29 August 1997	18 January 2002
Date of licensing	6 August 1996	20 November 2000	18 February 2003
Main source of funding	• Self • Donor funds • Loan from MBT	Donor grants	Associate company
Services/products	• Loan fund management. • Loans. • Business and management skills training. • Loan consultancy services. • Supervision and monitoring of outgrower schemes.	Loans Funeral insurance Technical assistance and training. Project and technical profiles	Salary backed loans

[138] Regulation 18.
[139] Regulation 19.
[140] Section 10.
[141] Section 17(1).

	MFI 1	MFI 2	MFI 3
Collateral	• Forced savings • Group guarantees	Forced savings Group guarantees	Repayments deducted directly from the payroll.
Impact of regulation and supervision			
Licensing	820 days	820 days	292 days
Forced savings	Treatment of forced savings unclear.	Treatment of forced savings unclear.	n/a
Services/products	Wide range of financial services permitted.	Wide range of financial services permitted.	Wide range of financial services permitted.
Capital requirement	Increase in capital from K5 million to K25 million.	Setting up of non-distributable capital fund of K25 million	Increase in capital from K2 million to K25 million.
Ownership structure	Required to increase number of shareholders from 2 to a minimum of 4 and limit controlling interest to a maximum of 25% per shareholder. However, NBFIs may have any legal form.	Trust ownership not permitted. Failure to resolve this matter led to MFI 2 surrendering its licence and reverting to NGO status. However, NBFIs may have any legal form.	Restructured to remove trust shareholders. However, NBFIs may have any legal form.
Board of directors	Required to increase board membership from 2 to a minimum of 5.		
Reporting requirements	Submission of reports on a monthly basis.	Submission of reports on a monthly basis.	Submission of reports on a monthly basis.
On-site inspections	7 inspections in total, inspection of premises as part of licence evaluation, 4 routine inspections and 2 ad-hoc.	None carried out	2 inspections in total, inspection of premises as part of the licence evaluation and one ad-hoc.
Impact of DMFRs			
Forced savings	Classified as deposits.	Classified as deposits	n/a
Service/products	Restricted to provision of credit facilities, linkage banking, in country money transfers and compulsory savings.	Restricted to provision of credit facilities, linkage banking, in country money transfers and compulsory savings.	Restricted to credit facilities only.
Capital requirements	Would have had to raise capital to a minimum of K250 million.	Would have had to raise capital to a minimum of K250 million	Would have had to raise capital to a minimum of K25 million.
Ownership structure.	Must be a limited company with controlling interest limited to a maximum of 25% per shareholder.	Must be a limited company with controlling interest limited to a maximum of 25% per shareholder. Trust ownership not permitted.	Any legal form permitted but if it's a company, then maximum controlling interest limited to a maximum of 50% per shareholder. Trust ownership not permitted.
Board of directors	Would have had to increase board membership from 2 to 3. New appointment would have been subject to BOZ approval.		
Reporting requirements	Submission of reports on a monthly basis.	Submission of reports on a monthly basis.	Submission of reports on a quarterly basis.

The main findings of the analysis were, firstly, that the objectives often cited in favour of regulation and supervision are not always met. The analysis, as illustrated mainly by the case study of MFI 1, showed that four of the six objectives were not met under the current regulatory framework. The objectives that were not met were that of depositor protection, improved performance, signalling to donors that an MFI is sound, and the effective utilisation of public resources and donor funds. Nor would they have been met if the DMFRs had been in place. In light of the size of the MFIs in question in relation to the financial sector, the objective of maintaining financial system stability was questionable. Assuming MFIs would have been able to meet the minimum capital requirement of K250 million under the DMFRs, as MFI 2 would have been able to do had it chosen to, then MFIs would be permitted to mobilise deposits legally, thus meeting the objective of increased sources of funding.

Under the DMFRs, forced savings would be classified as deposits. Thus both MFI 1 and MFI 2 would be categorised as DT MFIs and would have had to raise their capital levels. MFI 3, as a NDT MFI, would maintain its minimum capital level at K25 million. Trusts would still not be permitted to own shares and, so, both MFI 2 and MFI 3 would still have been forced to change their ownership structures. Under the DMFRs, however, MFI 2 would not have been able to continue operating after surrendering its licence for failing to comply with this provision. DT MFIs would have to be companies with shareholders' shareholdings limited to a maximum of 25%. Lastly, all the MFIs would have to submit prudential reports to BOZ on a monthly basis for DT MFIs and quarterly for NDT MFIs. The next chapter takes the analysis a step further with the application of RIA in assessing the impact of regulating and supervising the microfinance sector as a whole.

8 IMPACT ASSESSMENT OF THE DMFRS

8.1 INTRODUCTION

This chapter uses the RIA approach to analyse the potential impact of the proposal to introduce microfinance specific regulations in Zambia. RIA is a method for analysing the costs and benefits of regulatory change and improves the evidence basis for regulatory decisions to ensure that policy decisions are as soundly based as possible. In this context, RIA is being used to assess the potential impacts, both positive and negative, of a regulatory measure.

In this chapter, the field work results are analysed within the RIA framework to address the research objective of assessing the potential impact of regulation and supervision on the microfinance sector in Zambia. In order to do this, two options are considered. The first option, option 1, is 'do nothing'. In other words, maintain the status quo. The second option, option 2, is to 'introduce microfinance regulations (DMFRs) with BOZ as the supervisory authority'.

In developing the Microfinance Regulations, BOZ initiated the 'Development of the Microfinance Regulation' Project in 1998[142]. The Project had three main objectives. These were to develop regulations, prudential reports and the systems necessary for the effective regulation and supervision of MFIs; to develop BOZ's capacity to effectively supervise MFIs; and to educate MFIs so that they understand and comply with regulatory and supervisory requirements (BOZ/R/4: 2). It was anticipated that this process would lead to the development of an appropriate regulatory and supervisory framework, and foster the reliable and stable provision of services to the poor, as well as establish a greater degree of confidence in MFIs (BOZ/R/6: 4).

The USAID/SIDA project was broken down into two phases. Phase I, undertaken in 1998-1999, involved a survey of the microfinance sector. The objective of this phase was to obtain an understanding of the market and its players to develop an appropriate regulatory and

[142] The Project was funded jointly by the Swedish International Development Agency (SIDA), the United States Agency for International Development (USAID) and BOZ.

supervisory framework. This was done by conducting a survey of 35 MFIs, all of which were registered with AMIZ at the time (BOZ/M/2: 1) covering key issues of governance, lending, financing, equity, accounting, staffing and legal status (BOZ/R/4: 1). Phase II of the project commenced in September 2001 and was expected to run for a period of 2 years to September 2003. Phase II was "focused on developing and implementing regulations and establishing and commencing operation of a supervisory framework for MFIs" (BOZ/R/4: 2) based on the results of Phase I.

The chapter is organised as follows. The next section reviews the objectives and intended effects of passing legislation specifically targeted to the microfinance sector. It also provides the rationale for government intervention. Section 8.3 discusses stakeholders' views obtained from the interviews, FGDs and questionnaire responses. It also discusses the risks of not having regulation. Section 8.4 outlines the two options under consideration, followed by an appraisal of the benefits and costs of the two options in section 8.5. This section also identifies the sectors and groups affected by the proposal. Section 8.6 assesses the impact of the proposal on smaller MFIs and section 8.7, the impact on competition in the microfinance sector. This is followed by an evaluation of enforcement and monitoring in section 8.8. Section 8.9 summarises and concludes.

8.2 THE PROPOSAL

8.2.1 Purpose and intended effect

The proposal under consideration is the Banking and Financial Services (Microfinance) Regulations (DMFRs) with BOZ as the regulatory and supervisory authority. The majority of Zambians do not have access to financial services. The Government believes that the microfinance sector needs to be developed and that MFIs have the potential to be a "fundamental delivery vehicle of finance for the poor" (BOZ/P/3: 1). Thus, "the regulations are designed to provide the necessary legal framework for the operation and development of the microfinance industry in Zambia"[143].

With increased activity in the microfinance sector and the growing number of MFIs, there were calls from various stakeholders, including the MFIs themselves, for the sector to be

[143] Explanatory notes for the Banking and Financial Services (Microfinance) Regulations (DMFRs).

regulated, "Calls to regulate the sector were also put forward by AMIZ to ensure that the public is safeguarded from unscrupulous businesses that pose as microfinance institutions"[144].

A number of reasons have been given for regulating and supervising the sector. These are numerous and varied. Those given by BOZ include the following. Firstly, regulation is needed to maintain financial stability and secondly, to safeguard deposits, protect customers, as well as investors. "As a supervisory authority, it is our duty to ensure that donor funds that are channelled through your institution for the purpose of promoting small scale entrepreneurs are lent out prudently" (CSB/L/11).

The fourth reason is that regulation will improve the integrity and credibility of MFIs operating in the sector. It will set minimum performance standards, reporting requirements and provide checks and balances. Regulation will enhance confidence in the sector. BOZ also believes that regulation is necessary to promote the industry and encourage growth. It is believed that through regulation, access to financial services by the majority of Zambians that currently do not have access can be increased. It believes that the "provision of financial services in the rural areas has been slow due to unsatisfactory supportive infrastructure and absence of an appropriate regulatory and supervisory framework" (MOF, 2004: ix). Lastly, it is thought that regulation will reduce the amount of ambiguity that exists in the current regulatory environment, especially with regards to the classification and treatment of forced savings (BOZ/P/3).

8.2.2 Rationale for government intervention

The Government sees its role as that of creating an enabling environment for MFIs to achieve significant outreach on a sustainable basis. For this, it is important to have a framework that encourages MFIs to meet minimum performance and reporting standards to improve performance over time, especially if MFIs are going to take savings from the poor so that this money can be safeguarded (BOZ/P/3: 3). It believes it can do this through microfinance specific regulations.

Further, as the supervisory authority responsible for FIs, BOZ sees it as its responsibility to regulate and supervise the microfinance sector. "MFIs were brought under BOZ supervision

[144] Times of Zambia, Monday, March 11, 2002, "BOZ to introduce new bank supervision style".

following the amendments to the Banking and Financial Services Act in the year 2000" (MOF, 2004: 21), a view shared by the majority of stakeholders.

8.3 CONSULTATION

As stated in chapter 4, the purpose of consultation is to gather evidence for the RIA and serves as an important source of information. Those consulted, i.e. the stakeholders, act as 'experts' and may possibly provide valuable information on whether the proposals are workable and proportionate, whether there have been any significant omissions by policy makers, the practical implications for those being regulated, and unintended consequences (NAO, 2004: 21). Although policy makers may be knowledgeable in their field, this type of information can often only be provided by those affected by the proposals.

Thus, various stakeholder views were sought as to whether the microfinance sector should be regulated as noted in Chapters 4 and 5. Consultation within Government was made up of interviews with Bank of Zambia officials, Ministry of Finance officials, the Registrar of Banks and Financial Institutions, and other Registrars. Public consultation was conducted via FGDs, questionnaires and interviews. The results of this process were presented in Chapter 6.

8.3.1 Within government

Those interviewed within Government felt that it was necessary to regulate and supervise the microfinance sector otherwise there would be 'lawlessness and anarchy'. Regulation would provide the ground rules for the orderly conduct of business, set minimum standards, improving performance and strengthening MFIs. The introduction of regulations would also give the microfinance sector credibility and legitimacy. Financial system stability would be enhanced and depositors protected.

Interviewees indicated that BOZ was the most appropriate supervisory authority, as it was responsible for supervising the financial sector, was already in existence and, therefore, avoided the costs of setting up another supervisory authority. It also had the relevant expertise. There were concerns raised by some of the interviewees, however, that BOZ would face capacity constraints and the supervision of MFIs at the lower end of the spectrum should be supervised by another body, possibly AMIZ.

BOZ also anticipated a number of challenges in supervising the sector. These included, firstly, ensuring compliance by MFIs that have not had to adhere to high standards of financial and

management operations that would be set by regulation. Regulation may prove costly for MFIs as they would have to have frequent staff and management training programmes, establish internal control mechanisms, have external audits and provide periodic reports to BOZ. Secondly, as the regulation of microfinance was a relatively new area, there were no established standards for regulators. Thirdly, as the market was made up of a variety of institutions covering a dispersed geographic area, traditional forms of supervision would not be practical, financially or in terms of human resources. Therefore ways of dealing with the diversity would need to be developed (Nyirongo, 2001: 7).

8.3.2 Public consultation

The results of the consultation process revealed that the majority of stakeholders felt that the microfinance sector should be regulated, as regulation would protect depositors, enhance the credibility of the microfinance sector, increase investor confidence and provide checks and balances. Other reasons cited were that it would facilitate the mainstreaming of microfinance, data collection and the monitoring of developments in the sector. Regulations were needed to ensure that the public was not exploited and in this respect, some of the FGD participants felt it was necessary to regulate interest rates. Through regulation it would be possible to set up a debtors register and prevent over indebtedness. Customers would also be able to seek recourse.

However, regulation needed to take into account the distinctive characteristics of microfinance, the different types of MFIs and their size. Although BOZ was identified as the most appropriate supervisor, there was consensus that BOZ did not need to supervise credit only MFIs. In addition, there were concerns raised about BOZ supervising the microfinance sector in that it was felt that BOZ did not understand the peculiarities of microfinance and would simply apply regulations and practices more suited to the commercial banking sector. This would undermine the development of the microfinance sector. It was also pointed out that BOZ did not have the capacity to supervise all MFIs and, therefore, this function should be delegated to another body, such as AMIZ, but overseen by BOZ. Thus, NDT MFIs and the smaller ones that posed no systemic threat to the financial sector should not be supervised directly by BOZ.

Concerns were also raised in relation to the DMFRs. The regulations were considered too restrictive, especially in relation to ownership and governance, the treatment of forced savings and reporting requirements. "He (Mate) explained that the difficulty with microfinance

regulation was that regulators, usually central banks, wanted to apply existing banking and financial services regulations on microfinance and that this tended to stifle the development of microfinance. Mate noted that while microfinance used forced savings for collateral, typical banking regulations did not recognize the forced savings and insisted on treating them as normal depositors' funds and that this had prudential implications for microfinance institutions"[145]. This is despite the Government's assertion that "The intention is not to restrict microfinance business, but we would like to see the orderly development of the industry based on sound business principles and industry best practices"[146].

8.3.3 Risks of not having regulations

According to BOZ, microfinance services in Zambia are currently being provided without regulation or supervision. "Significant amounts of money are being channelled into a sector without rules. This lack of a legal and supervisory framework for MFIs means that the sector's stability is not guaranteed. Therefore, regulation of this sector should be seen under the overall goal of maintaining financial market stability, encouraging responsible growth, and deepening financial services available to Zambians" (BOZ/P/3: 3). "The lack of a regulatory and supervisory structure for MFIs means that checks on MFI operations or legitimacy are absent. The result is a risky, rapidly growing, ungoverned sector with significant gaps in accountability, transparency, stability and efficiency. It therefore follows that if MFIs are to operate efficiently in the market, it will be necessary to apply some form of supervision, depending on the circumstances of the institution" (BOZ/P/3: 3).

It is evident from the quote above that BOZ believes that the risks of not introducing the regulations are that the reasons for regulating the sector as outlined in section 8.2 would not be met. Therefore, "The Bank of Zambia proposes to regulate MFIs if they pose an element of risk, such as when they mobilise savings from the public, and when good standards of practice are absent in the institution. MFIs should be regulated when they grow to a stage when their failure would impact negatively on the MFI sector or the whole financial system. The different sources and types of institutional funding and the corresponding risks that have to be managed also reinforce the need for regulation" (Nyirongo, 2001: 4). This is a view echoed by a number of the interviewees, questionnaire respondents and FGD participants.

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[145] Kelvin Chambwa, The Post, Wednesday May 26, 2004, "AMIZ calls for effective microfinancing to stimulate emergence of microenterprises".
[146] Kingsley Kaswende, The Post, No. 2762, Monday May 10, 2004, "Microfinance institutions vital in achieving MDGs – Magande".

8.4 OPTIONS

There are two options under consideration. The first option, option 1, is to leave the regulatory and supervisory environment as it is, i.e. 'do nothing'. With this option, it is assumed that the microfinance sector will continue to develop and evolve as it has done in the past. It will respond to changes in the economic, political and social environment in a similar and consistent manner. In other words, if the events that happened in the past were to happen again in the future, the microfinance sector would respond in exactly the same way, all things being equal.

The second option, option 2, is 'the introduction of the draft Microfinance Regulations (DMFRs) with the Bank of Zambia as the supervisory authority'. Under this 'business as usual' scenario, a variable, the draft Microfinance Regulations, is being introduced and the impact of this change is assessed to determine whether the outcome, in terms of the development of the microfinance sector, would be any different, all other things being equal. Simply put, this can be restated as:

Option 2 = Option 1 + DMFRs

Conclusions can then be drawn about the outcomes of the two scenarios and the *difference*, if any, would be the potential impact of the draft Microfinance Regulations on the microfinance sector.

8.4.1 Option 1: Maintain the current regulatory framework

Under this scenario, the regulatory environment remains the same and the regulations are not passed. Thus MFIs would be regulated as NBFIs under the BFSA 2000. There would be no provisions that take into consideration the specific characteristics of MFIs. The registrar has 180 days to determine an application. The capital requirement for DT NBFIs is K2 billion and K25 million for NDT FIs. Licences permit FIs to provide a wide range of financial services, unless the institution is specifically prohibited or restricted from doing so by the Registrar. FIs can take any legal form whether they accept deposits or not. So although trusts are not allowed to own shares, there are no limitations for shareholders in terms of ownership or control for NBFIs, unless the MFI is a company. In this case, ownership and control is limited to a maximum of 25% per shareholder and the board must have a minimum of five members. FIs are required to submit prudential reports on a monthly basis and, as licensed institutions, they are inspected by BOZ at least once a year.

However, maintaining the status quo means that the ambiguity and confusion in the current regulatory and supervisory environment remains. MFIs can opt to obtain a licence or continue to operate without one. Even for those that do obtain licences, there is no clarity as to the treatment of forced savings. This would result in fragmentation of the industry with similar institutions operating under different rules, depending on whether they had obtained a licence from BOZ or not.

8.4.2 Option 2: Introduction of the draft regulations with the Bank of Zambia as the supervisory authority

Under this scenario, the DMFRs are passed into law. MFIs would have to apply for a licence within one month of the regulations being passed and commence operations within 3 months of obtaining a licence[147]. It would be a criminal offence to provide microfinance services without a licence. This would resolve the ambiguity in the current regulatory environment in which MFIs may opt to apply for a licence. Forced savings would be classified as deposits. There would be consistency in BOZ's approach to all MFIs sending a clear signal to the industry.

The registrar would still have 180 days to evaluate a licence application. In making his or her decision, the Registrar would have to take into consideration the financial sustainability of FI. The minimum capital requirement for a DT MFI would be K250 million[148] and K25 million for a NDT MFI[149]. The services and products offered under the Regulations would be restricted to the provision of credit facilities, linkage banking, in country transfers and compulsory savings for DT MFIs. NDT MFIs would only be allowed to provide credit facilities. DT MFIs would have to be limited companies with a minimum of 4 shareholders and 3 board members[150]. However, trusts are still not permitted to own shares or control MFIs. Both DT MFIs and NDT MFIs would be required to submit prudential reports to BOZ on a monthly and quarterly basis respectively. As licensed institutions, MFIs would be inspected by the BOZ at least once a year[151].

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[147] Under option 1, should an MFI obtain a licence, it has one year to commence operations.
[148] Lower than the requirement under option 1.
[149] The same as for option 1.
[150] Whereas under option 1, they can have any legal form.
[151] See appendix 15 for a more detailed appraisal of the DMFRs.

8.5 BENEFITS AND COSTS

8.5.1 Sectors and groups affected

The DMFRs are targeted to those providing microfinance services. The case studies illustrate how the sector would be affected by the passing of the DMFRs. The results are summarised below.

Firstly, MFIs that use forced savings as part of the lending methodology, like MFI 1 and MFI 2, would be classified as DT MFIs and would have to meet the minimum capital requirement of K250 million. NDT MFIs, like MFI 3, would have to comply with the minimum capital requirement of K25 million. All the MFIs in the case studies had to increase their capital levels. Therefore, the overall impact would be for MFIs in Zambia to increase their capital levels. However, considering that most MFIs require forced savings, they would have to raise their capital levels to K250 million which is considered too high by the industry, especially for the smaller MFIs. This provision may force many MFIs to go out of business.

Secondly, DT MFIs would have to be limited liability companies registered with the Registrar of Companies with a minimum of 4 shareholders, with shareholdings and or control not exceeding 25% each, and a board of directors with a minimum of 3 members. Trusts would not be permitted to own shares. A significant number of MFIs in Zambia are funded by donors whose preferred vehicle of investment is a trust. The impact of the provisions therefore is likely to be a reorganisation of governance structures in some MFIs as was the case for MFI 2 and MFI 3.

Thirdly the provision of services and products would be restricted to the provision of credit facilities, linkage banking, money transfer facilities, and compulsory savings for DT MFIs and credit facilities only for NDT MFIs. MFIs would have to submit prudential reports to BOZ on a monthly basis for DT MFIs and quarterly for NDT MFIs. All MFIs would be affected as they would have to apply for a licence or risk being prosecuted if they continued to operate without one. Smaller MFIs would be affected more as the costs of compliance would be proportionately higher for them than for the larger MFIs. The three MFIs did not have problems with complying with the reporting requirements. However, they are relatively large compared to other MFIs in Zambia. The compliance costs would most probably be passed onto customers through increased fees and interest rates.

Thus, the second group that would be affected by the passing of the DMFRs are customers. On the negative side, in addition to the increased fees and charges, customers would have less choice and reduced access to financial services resulting from fewer MFIs operating in the sector. On the positive side, they would have access to more information because MFIs would be obliged to publish their financial statements, as well as disclose the terms, including the total costs, of the services and products that they provide. MFIs would also be obliged to have complaints procedures in place and this would provide some form of recourse to customers.

The third group that would be affected are investors. As for customers, investors would have more access to information on the microfinance sector enabling them to make informed decisions. Additionally, they would also be affected by the ownership and governance provisions of the DMFRs.

The last group identified is the supervisory authority, BOZ. They would have the task of implementing and enforcing the Microfinance Regulations.

8.5.2 Benefits and costs of option 1

Benefits

The main benefit of maintaining the status quo is that the industry would grow with the establishment of more MFIs, as has happened since liberalisation, and flourish, as has happened in other parts of the world where microfinance remains unregulated. There are very few restrictions under the current regulatory framework. Because MFIs are not compelled to obtain a licence, they would be able to enter the market freely and offer a range of services. Even if MFIs did decide to obtain licences, the requirements under the BFSA are relatively more relaxed than the provisions under the DMFRs.

In this respect, more MFIs would most likely enter the market. Because there would be more MFIs operating in the sector, this would lead to increased competition, thus benefiting customers. Competition would force down prices, both in relation to fees charged to the customers and the interest rates. A larger proportion of the population would have access to financial services. Increased competition would result in greater options for customers.

If MFIs did decide to obtain licences, then capital levels in the industry would rise as shown by the case studies. Higher capital levels would mean a larger cushion to absorb losses and cover risk, hence a lower probability of failure and increased stability in the financial sector.

Costs

The main cost under this option, is the ambiguity and confusion that exists in the current regulatory and supervisory framework. BOZ has not been insistent that MFIs obtain licences, even though MFIs can apply for non-bank financial institution licences. Therefore, an MFI may apply for a licence or not, as it sees fit. This is exemplified by the MFI 2 case study. MFI 2 surrendered its licence to BOZ and yet it was still allowed to carry on operating. This is likely to result in a '2 tier' system with institutions that are licensed, regulated and supervised and those that are not, although for all intents and purposes, there would be no distinction, either in the organisation or the services and the products being offered by these MFIs.

Under this scenario, the classification of forced savings would remain unclear and the uncertainty exacerbated by BOZ's reluctance to make a decision in the absence of Microfinance Regulations. In both case studies where the MFIs were collecting forced savings, they were deemed not to be accepting deposits, in MFI 2's case because the savings were not available for use by either the savers or the MFI. This confusion is not conducive to encouraging investment in what is an already difficult industry. Thus, the microfinance sector may not flourish as much as anticipated.

Compliance costs

The other costs relate mainly to compliance costs should an MFI decide to obtain a licence. Firstly, there is the cost of obtaining the licence and covers both the time involved in making the application, i.e. the administrative cost, and the application fee. The second cost is the annual licence fee that has to be met. The third cost relates to meeting the capital requirements. The minimum for a DT MFI is K2 billion[152] which is considered too high for MFIs in Zambia. For NDT MFIs it is K25 million which is still considered too high as revealed by public consultation. Having to meet this requirement would result in MFIs having to close, a reduction of MFIs operating in the sector and less competition. On the other hand, there is the advantage that higher capital levels bring in terms of reducing the probability of failure, thus, increasing financial stability.

[152] The same for banks.

If the MFI is registered as a limited company, then it must have a minimum of 4 shareholders and 5 board members, both requirements which may prove to be a challenge to meet. Reporting requirements are onerous for FIs as they do not differ from those required for banks and prudential reports have to be submitted on a monthly basis regardless of whether the FI accepts deposits or not. This is costly both in terms of time, effort and resources. This is especially applicable to the smaller MFIs, they may have to improve their MIS in order to meet the reporting requirements which could prove to be a considerable expense.

The licensed MFIs would be subject to annual inspections. Again these involve costs in terms of time and resources required to prepare for the inspection, assist the inspectors during the inspection, as well as the disruption caused to the business whilst the inspection is being carried out. This would not be helped by the fact that there is no distinction in BOZ's supervisory approach to DT and NDT FIs. Thus, being a regulated FI would entail significant costs, proportionately more so for smaller MFIs. These costs would have to be passed on to the customers, through increased fees and interest rates. These results are summarised in Table 8.1.

Table 8.1: Benefits and costs of option 1

Benefits	Costs
• Growth of the microfinance sector • Increased competition • Access to financial services • Lower charges and interest rates • Provisions of the BFSA 2000 not as strict as those of the DMFRs	• Ambiguous regulatory environment • 2 tier system with some MFIs obtaining licences and others choosing not to • Customer exploitation • Compliance costs, but these are avoidable in that MFIs do not have to be licensed

8.5.3 Benefits and costs of option 2

The reasons set out for regulating the microfinance sector, and hence passing the DMFRs, have been set out in section 8.2 above. The attainment of these objectives would constitute the benefits under option 2, as presumably they are not being met under option 1, hence the need to introduce regulations specifically targeted to the microfinance sector.

The first objective of passing the draft regulations is to maintain financial stability. However, the microfinance sector in Zambia is very small compared to the banking sector. Therefore the failure of an MFI would not have a significant impact on the financial sector. This was evident when MFI 1 went into voluntary liquidation. Combined with the fact that MFIs are

not part of the payment system, are not used in the implementation of monetary policy, and do not play a pivotal role in the economy, means that they do not pose any systemic risk. Therefore, having this as an objective for regulating the microfinance sector is questionable.

The second objective is the protection of depositors. As illustrated by the case study of MFI 1, depositor funds were not protected despite the fact that the institution was being regulated and supervised by BOZ. The outcome would not have been any different under the DMFRs as they do not specifically or directly address the issue of protecting depositors' funds. All things being equal, MFIs would still fail because passing the draft regulations would not necessarily result in a change in attitude in the supervisory approach, especially with regard to enforcement. This highlights the need to have an alternative safety net mechanism in place, such as prohibiting MFIs from using the forced savings for on-lending and requiring them to be deposited in a regulated FI such as a commercial bank, having an explicit deposit insurance scheme or private insurance, if available.

The third objective is that of investor protection. However, as for depositors, investors would not necessarily be protected for the reasons outlined above. Regulation and supervision do not guarantee that an institution will not fail. With respect to ensuring that public resources and donor funds are used effectively, this issue is not addressed by the DMFRs and, therefore, this objective would not be met.

The fourth objective is that it would improve the integrity and credibility of MFIs that are licensed. Licensing implies that the supervisory authority is vouching for, or is prepared to, assume the responsibility for the financial soundness of the regulated FI which the public may be dealing with (Christen and Rosenberg, 2000; Gallardo, 2001; Druschel, 2005). This in turn means that there would be more confidence in the microfinance sector. However, as illustrated by the case study of MFI 1, this is not necessarily true. On the other hand, as MFIs would have to obtain a licence, entrants would be vetted. This would make it more difficult for unscrupulous individuals to own and manage MFIs, reducing the probability of criminal and fraudulent activity. In this respect, the integrity and credibility of MFIs would be improved.

The fifth objective relates to draft regulations setting minimum performance standards and reporting requirements. As illustrated by the MFI 1 case study, and to some extent the MFI 2

case study, the draft regulations did not ensure that MFIs performed to a minimum standard. Both MFIs performed poorly despite the fact that they were being supervised. The DMFRs, as they stand, do not specifically address this matter. Therefore there would be no change in the outcome in this respect. Despite weaknesses having been notified to the management of MFI 1, nothing was done to rectify them and no action was taken against the MFI by BOZ consequently. Thus, being regulated and supervised would not necessarily result in improved performance. On the contrary, where enforcement is weak, regulation and supervision have no impact.

The case studies showed that donors were willing to invest in the microfinance sector even in the absence of microfinance specific regulations. The question then arises as to whether this funding would increase with the implementation of the DMFRs. Judging from the two case studies of MFI 1 and MFI 2, one can conclude that passing of the DMFRs is not likely to have much of an impact, as the two MFIs were able to obtain significant amounts of donor funding even though they were not licensed by BOZ. If anything, in light of the comments made by the donor community noted in Chapter 6, it may be concluded that the DMFRs would serve to impede donor flows as donors see the DMFRs as being too restrictive and more likely to stifle the microfinance sector than to encourage its growth. This is in complete contrast to the views expressed by BOZ which believes that DMFRs are needed to promote the industry and encourage growth, thus increasing access to financial services by the majority of the population which is not banked. Overall, the evidence suggests that the DMFRs would have very limited impact in meeting the stated objectives.

Benefits

The main benefit of passing the DMFRs would be that it would reduce the ambiguity and confusion that currently exists, thus sending a clear signal to all participants in the microfinance sector, specifically MFIs, investors and, to some extent, customers about where they stand legally. This would level the playing field because all MFIs would have to apply for a licence or risk prosecution. There would be no choice involved and there would be consistency in BOZ's approach to regulating FIs in the sector. Thus, all those MFIs that charge 'loan insurance fees' or require 'forced savings' as collateral would be deemed to be accepting deposits, and treated as DT MFIs for regulatory and supervisory purposes.

Other benefits of passing the DMFRs are that more information would be readily available to the public. MFIs would have to publish their financial statements on a quarterly basis. Additionally, MFIs would be required to clearly spell out their charges and interest rates in relation to the services and products being offered. The DMFRs would also require that MFIs have in place clear procedures for dealing with complaints. However, the draft regulations are not specific as to how disputes would be resolved. Therefore, the issue of redress would not have been entirely dealt with. Passing the draft regulations would also benefit BOZ in that it would facilitate and make it easier to collect data on the microfinance industry and monitor developments.

The benefit of having BOZ as supervisor is that it exists and, therefore, avoids the costs of establishing another supervisory authority, it is the supervisory authority with the most relevant expertise as a financial sector supervisor, and it has got the legal authority conferred to it by the BOZ Act and the BFSA 2000.

Capital levels in the industry would be raised. This would increase the likelihood of financial sustainability, reduce the probability of failure, thus fostering financial system stability. Because the capital requirement for a DT MFI is lower under option 2 than option 1, it would be easier for MFIs that provide voluntary savings facility to enter the sector.

Licensed MFIs would have increased access to funding, as they would be permitted to mobilise deposits legally. However, in relation to obtaining funding from other sources, such as the capital market, this would still be limited due to the broader constraints affecting the microfinance industry noted in Chapter 5, as well as the fact that the capital market in Zambia is still in its infancy and not well developed.

Costs

The requirement for all MFIs to obtain a licence, however, would result in fewer MFIs in operation for a number of reasons. Firstly, MFIs would have to meet the higher capital requirements. MFIs in Zambia are relatively small. This was acknowledged by BOZ when, in its preliminary study, it only identified four MFIs that would possibly qualify for licensing. Secondly, BOZ would not be able to licence MFIs that are not financially sustainable, as the Registrar has to take into consideration the financial viability of the business when evaluating a licence application. Most MFIs would fail this requirement as they are heavily dependent on donor funding and are not financially self-sustainable.

Thirdly, a number of MFIs would not be able to comply with the ownership provisions which limit shareholding and prohibit trusts from owning shares. Considering the relatively poor performance of the sector, the high level of risks involved, the thin capital/equity markets in Zambia, and numerous other constraints in this sector, finding investors would probably not be an easy task. As noted by Mate, "Microfinance was not a very profitable business into which private investors could put their money and hope for a good return. It would thus be difficult to expect MFIs to comply with the restriction on the extent of ownership by one shareholder in a financial institution at least in the short to medium term"[153]. A significant portion of MFIs in Zambia are funded by donors whose preferred vehicle of investment is a trust. The impact of this is likely to be a reorganisation of governance structures in some MFIs, as was the case for MFI 1 and MFI 3. For other MFIs that are funded by donors and government agencies, the change may not be easy to implement, as in MFI 2's case. Where the changes are difficult to implement, MFIs would have to cease operating. If the DMFRs did become law, then MFIs would have to apply for a licence within one month and will not have the option of operating without one, as MFI 2 is doing now, as this would constitute an offence. The overall impact, therefore, of prohibiting trust ownership on the microfinance sector would most likely be negative.

Fewer MFIs would mean less competition. There would be less choice for customers and reduced access to financial services. This would be compounded by the restrictions placed on the services that could be provided by MFIs under the DMFRs.

Compliance costs

As for those MFIs that opted to be licensed under option 1, MFIs would incur compliance costs. Specifically, MFIs would incur the costs of obtaining a licence and the annual licence fee. They would have to raise their capital levels. In addition to these costs, DT MFIs would incur the costs of converting into a limited company and having an annual audit, institutions with microfinance units would incur the costs of registering these units as separate legal entities, and MFIs would have to pay a fee for every new branch opened.

DT MFIs would have to submit reports to BOZ on a monthly basis and NDT MFIs, quarterly. All MFIs would have to publish their financial statements on a quarterly basis.

[153] Kelvin Chambwa, The Post, Wednesday May 26, 2004.

Reporting requirements would be onerous and costly, in terms of time, effort and resources, especially for smaller MFIs and those located in rural areas which may have to upgrade and improve their MIS in order to meet the reporting requirements.

MFIs would be subject to annual inspections by BOZ. Inspections would increase the costs of MFIs, in terms of both time and resources associated with preparing for the inspection, assisting inspectors during the inspection, and the disruption caused to the business as a result.

MFIs would incur increased staff costs associated with training and the additional cost of having two different individuals to cover the posts of CEO and CFO, regardless of the size of the institution. On an ongoing basis, MFIs would have to pay an annual supervision fee. And lastly, there is the opportunity cost of having to hold liquid non-interest earning assets in order to comply with the liquid assets ratio[154]. An increase in costs in a sector whose financial performance is already poor would most likely result in the closure of MFIs. Table 8.2 summarises the compliance costs that would be incurred by MFIs.

Table 8.2: Compliance and supervision costs

MFI Compliance Costs	
Initial costs	**Annual costs**
• Licence application • Meeting the capital requirement • Converting into a limited company for DT MFIs • Costs of registering as a separate legal entity for microfinance units • Branch fees • Training • Upgrading MIS	• Licence fee • Supervision fee for DT MFIs • Audits for DT MFIs • Meeting regulatory capital requirements • CEO and CFO salaries • Submission of prudential reports • Publication of financial statements • Annual on-site inspections • Opportunity cost of having to hold non-interest bearing liquid assets
Bank of Zambia Supervisory Costs	
Initial costs	**Annual costs**
• Licensing MFIs • Training and capacity building • Establishment of the regulations • Revising the supervisory framework	• Licensing and licence renewals • Conducting on-site inspections • Off-site monitoring

Supervision costs

BOZ would also incur additional costs in carrying out its obligations. Initial costs include establishing the regulatory and supervisory framework which cover, amongst others: (1) the drafting of the regulations and the work associated with this task and revising the supervisory

[154] This ratio has not yet been prescribed by BOZ.

arrangements of BOZ once the DMFRs have been passed; (2) training personnel; and (3) licensing the MFIs. On an on-going basis, BOZ would incur costs in relation to on-site inspections and off-site monitoring, including licence renewals. The costs that would be incurred by BOZ are summarised in Table 8.2.

The main benefit of option 2, therefore, is that it would clear up the ambiguity in the current legislative environment. However, most of the objectives cited for passing the DMFRs would not be met. Additionally, there are a number of costs associated with this option. There would most likely be fewer MFIs in operation under this option leading to less competition, and therefore, less choice for consumers and reduced access to financial services. Compliance costs are significant. These would most probably be passed onto customers. BOZ would also incur costs in supervising the sector, especially taking into consideration the geographical dispersion of MFIs, in addition to those already incurred in establishing the regulatory framework. From this analysis, the evidence suggests that the costs of passing the DMFRs would far exceed the benefits that would be gained. The results are summarised in Table 8.3.

Table 8.3: Benefits and costs of option 2

Benefits	Costs
• Reduces ambiguity in the regulatory environment • Higher capital levels • Availability of information • Increased consumer protection • Increased access to funding for MFIs	• Does not meet stated objectives • Less competition • Reduced access to financial services • Fewer services • Significant compliance costs for MFIs • Higher charges and interest rates • BOZ supervisory costs and costs incurred in establishing the regulatory framework

8.6 SMALL FIRMS IMPACT TEST

The passing of the DMFRs would have the greatest impact on smaller MFIs. Firstly, the smaller MFIs would not likely be able to meet the licensing criteria, both in terms of capital requirements and financial sustainability. Secondly, meeting the costs of compliance, especially the reporting requirements, would be the most onerous for small MFIs and those located in rural areas. It is the smaller MFIs that would most likely have to upgrade their MIS. Complying with this requirement would also be difficult taking into account the poor infrastructure in areas outside of the urban capitals. Although all 3 MFIs in the case studies did not have any problems complying with the reporting requirements, this would not be true for the smaller ones. All studies of the MFIs, including that undertaken during this research, shows that MFIs in Zambia have poor accounting records and weak internal controls. Thus,

the increased costs could result in a significant proportion of the smaller MFIs having to cease operating.

8.7 COMPETITION ASSESSMENT

As noted above, the passing of the DMFRs would significantly affect competition. On the positive side, option 2 would level the playing field by requiring all MFIs to obtain a licence and subjecting them to the same rules. The 2 tier system, therefore, would not arise. On the negative side, the licensing criteria, albeit it unintentionally, would act as barriers to entry, thereby reducing the (potential) level of competition. The increased costs of compliance would affect smaller MFIs more than larger ones, resulting in some of them going out of business. The higher capital levels would also have a greater impact on the smaller MFIs. Thus, the structure of the industry would change in terms of both the size and number of MFIs in operation.

8.8 ENFORCEMENT, SANCTIONS AND MONITORING

There are provisions in the DMFRS that empower BOZ to take corrective action in cases of non-compliance. BOZ also has in place monitoring systems and through off-site and on-site inspections, it is able to monitor compliance and performance on an on-going basis. However, for the DMFRs to achieve the objectives identified after they are introduced, they have to be enforced. Simply passing them into law is not enough. As noted in the literature, it is better to not have regulations than introduce regulations which are then not enforced (Christen and Rosenberg, 2000). This can negatively affect the supervisory authority's credibility and undermine the purpose of introducing the regulations in the first place. The case study of MFI 1 highlights BOZ's ineffectiveness in ensuring that the MFI complied with the legal provisions (section 7.3). Despite the same issues having been highlighted by successive inspections and notified to management, no action was taken by MFI 1 management to rectify the situation; neither did BOZ utilise any of the sanctions available to it under the law to compel compliance.

Passing the DMFRs into law would not necessarily result in a change to BOZ's supervisory approach. Attitudes and practices are not automatically altered by the introduction of new laws. The study by Maimbo (2001: 308) in relation to BOZ's supervisory practices found that the "process of implementing the corrective action took an excessively long period, not only because of political and economic concerns but also because of the exhausting administrative

policies and procedures, which had evolved in the department out of tradition and precedent, rather than deliberate administrative design" and "These regulatory processes were further complicated by the decentralised responsibility structure in existence at the BOZ operating within a highly-centralised decision-making environment" (Maimbo, 2001: 310). Therefore, in addition to introducing the regulations, a concerted effort would have to be made by BOZ to address the weaknesses identified by Maimbo and reflected in the case study analysis.

8.9 SUMMARY AND CONCLUSION

This chapter analysed the impact of the proposal to introduce microfinance specific regulation in Zambia using RIA. The field work results were analysed within this framework and sought to address the research objective of assessing the potential impact of regulating and supervising the microfinance sector. Two options were considered. The first option, option 1, was 'do nothing' i.e. maintain the status quo. Under this scenario, it was assumed that the microfinance sector would evolve and develop as it has done in the past. The second option, option 2, was to 'introduce the draft microfinance regulations with BOZ as the supervisory authority'. Under this scenario, a variable, the draft Microfinance Regulations (DMFRs), was introduced and the outcome of this change assessed to determine the potential impact of regulation on the microfinance sector. The results are summarised in Table 8.4[155].

Table 8.4: Summary of results

	Option 1	**Option 2**
Benefits	• Growth of the microfinance sector • Increased competition • Access to financial services • Lower charges and interest rates • Provisions of the BFSA not as strict as those of the DMFRs	• Clears up ambiguity in regulatory environment • Higher capital levels • Availability of information • Increased consumer protection • Increased access to funding for MFIs
Costs	• Ambiguous regulatory environment • 2 tier system • Customer exploitation	• Does not meet stated objectives • Less competition • Reduced access to financial services • Fewer services • Significant compliance costs for MFIs • Higher charges and interest rates • BOZ supervisory costs and costs incurred in establishing the regulatory framework
Net benefit	**High**	**Low**

[155] The benefits and costs were not quantifiable due to the fact that values were subjective and the non-availability of data.

The main benefit of option 1 is that the microfinance sector is more likely to flourish under this scenario. There are very few regulatory restrictions to entry, if any. This means there would be increased numbers of MFIs operating in the sector and, therefore, increased competition resulting in increased access to financial services, more choice for customers, and lower charges and interest rates. However, not passing the DMFRS would mean that the regulatory environment would remain unclear, which may serve to discourage investment. Customer protection would not be as high, especially as unscrupulous individuals who might have been screened out by the vetting process would be able to own and manage MFIs. The direct costs associated with this option are very low as they are avoidable in the sense that MFIs do not have to obtain a licence if they do not wish to do so without any repercussions. This could result in a fragmented 2 tier system.

As noted in Table 8.4, the net benefit of this option has been ranked as high. This ranking was reached taking into account the following factors. Firstly, the microfinance sector in Zambia is relatively small. Secondly, the ambiguous regulatory framework has not prevented the establishment of MFIs in the past, therefore, there is no need to believe that it will in the future. Thirdly, there are alternative ways in which customers can be protected, for example, ring fencing compulsory deposits and a simple registration procedure for MFIs that would facilitate the vetting of entrants. The fourth factor is that the provisions of the BFSA 2000 are adequate, especially in light of the fact that the DMFRs do not radically modify the provisions of the main Act and in most cases only serve to reiterate them. Lastly, the '2 tier' system that might evolve may be used as an opportunity for BOZ to build up its expertise and capacity before it is overwhelmed with having to regulate a large number of MFIs. The costs associated with this option are very low, especially as getting a licence is voluntary and compliance costs are avoidable. Thus, the net benefit of maintaining the status quo has been ranked high.

With option 2, the main benefit is that it would resolve the ambiguity that currently exists in the regulatory and supervisory environment. All MFIs would have to apply for a licence. This would level the playing field. Forced savings would be classified as deposits. Customers and investors would have access to information on MFI performance, as well as their products and charges. Capital levels in the industry would be raised, reducing the probability of failure, increasing the likelihood of financial sustainability and enhancing financial system stability. The vetting of entrants would reduce the probability of criminal and fraudulent activity, increasing the integrity and credibility of the microfinance sector, hence confidence.

However, the objectives of depositor and investor protection, setting minimum performance standards, acting as a signal to potential investors that MFIs are financially sound, thus encouraging investment, are not likely to be met. Licensing requirements would serve as a barrier to entry as the majority of MFIs would not be able to meet the licensing criteria. This would mean fewer MFIs operating in the sector, leading to less access to financial services and less choice for customers. Compliance costs would be significant for MFIs, unavoidable and would affect the number of MFIs that remained in operation. These costs would most likely be passed onto customers through increased charges and interest rates. In addition to the compliance costs faced by MFIs, BOZ would incur additional costs in relation to having to carry out its statutory obligations under the Regulations. As pointed out above, the costs of passing the DMFRs far exceed the benefits that would be derived.

Thus, as a result of the analysis, the net benefit of option 2 has been ranked low for the following reasons. Firstly, it would not achieve all the stated objectives. The level of customer protection that would be achieved as a result is low compared to the cost of the loss of access to financial services and choice that it would entail as a consequence of fewer MFIs operating in the sector. As already stated, there are cheaper and more effective methods of protecting depositors, such as ring fencing deposits. Compliance costs are significant taking into consideration the size of institutions to be regulated and of the microfinance sector as a whole. Even if BOZ did not establish a separate unit for microfinance, it would have to employ additional staff if it was to regulate the microfinance sector effectively. These costs are not proportional to the potential benefits for either customers, or the industry[156]. These costs far outweigh the benefits of an unambiguous regulatory environment, increased availability of information, increased access to funding by MFIs, increased customer protection and higher capital levels. Thus, the net benefit of passing the DMFRs has been ranked low.

The conclusion drawn, therefore, is that the status quo should be maintained and the draft Microfinance Regulations should not be passed.

[156] To put this into perspective, when MFI 1 went into voluntary liquidation, it had forced savings of approximately K15 million in total. The basic gross salary, excluding allowances and benefits, of a senior inspector in the Supervision Department is K19.8 million per month!

9 CONCLUSIONS AND RECOMMENDATIONS

9.1 INTRODUCTION

The last twenty years have seen increasing interest in microfinance with enthusiasts advocating its adoption as a tool in the alleviation of poverty. With this increased interest, there has been growing debate about the regulation and supervision of MFIs, with countries all around the world considering the establishment of regulatory and supervisory frameworks where none exist. A number of reasons have been out forward for regulating and supervising the sector. This study aimed to assess the potential impact of regulation and supervision on the microfinance sector in Zambia. It aimed to do this at two levels; firstly at the micro level using case studies of MFIs that were licensed and supervised. The analysis was then extended to the sector level using RIA.

In order to meet the broader research objective of assessing the potential impact of regulation and supervision on the microfinance sector, two further research objectives were identified. The first was to obtain an understanding of the microfinance sector to which the regulatory and supervisory framework was being targeted and the second, to develop an understanding of the existing regulatory and supervisory arrangements, in order to determine the extent to which the proposed change would change the status quo. This chapter is organised as follows. The next section summarises the main findings of the study, followed by a discussion of their implications for theory and further research in section 9.3. Section 9.4 considers the policy implications resulting from the research. The chapter concludes with a discussion of applicability of the study findings to the regulation of microfinance more generally.

9.2 SUMMARY OF MAIN FINDINGS

9.2.1 The microfinance sector in Zambia

The findings of the study were that the microfinance sector in Zambia was relatively new with most of the MFIs surveyed having been established after 1995. The sector was served by a diverse spectrum of organisations with different legal forms. The majority of these institutions were funded by donors and developmental organisations. However, this sector was miniscule when compared to the banking sector and most of their operations were

concentrated in urban areas. Outreach was low, with microfinance providers focusing on the provision of microcredit rather than a range of financial services.

The study sought to determine the definition of microfinance in the Zambian context, as it would affect the targeting of the regulations. However, it was not conclusive which served to illustrate the complexity involved in defining microfinance. What was clear, was that microfinance was predominantly associated with the provision of microcredit, characterised by frequent loan repayments, to small or micro enterprises and low income households. The study also raised issues as to whether regulations should focus on regulating microfinance activity as opposed to the institution; whether there should be any regulation at all in light of the ownership and funding structures of MFIs, and lastly the desirability of regulating an industry that is stagnating and performing poorly.

A number of constraints, at both the institutional and industry level, as well as the macro level, to the development of the microfinance sector were identified. At the institutional and industry level, these included the lack of capital; poor internal controls and the absence of industry standards; high dropout rates and inappropriate lending methodologies. At the macro level, these included the poor credit and savings culture; poor infrastructure; the inefficient legal system; the unstable macroeconomic environment; the absence of income generating opportunities; and the low population density. The constraints identified raised doubt as to whether the objective of promoting the industry through the introduction of a regulatory framework specifically for the microfinance sector would be met. The development of a vibrant microfinance sector is dependent on a number of contextual factors including high population densities; the presence of quality physical infrastructure; a stable macroeconomic environment; monetisation; and opportunities for income generating activity, factors which can be not addressed through the introduction of a regulatory and supervisory framework alone.

9.2.2 The existing regulatory and supervisory environment

The principal Act governing the financial sector, including MFIs, is the BFSA 2000. The supervisory authority is the central bank, the Bank of Zambia. As noted, the microfinance sector is served by a diverse spectrum of organisations with different legal forms, registered under different Acts and supervised by different agencies. With the exception of the banks, MFIs are not supervised for the provision of financial services. Consequently, the legal

framework for microfinance is fragmented. With the exception of the banks that were involved in the provision of microfinance services, it was found that large numbers of MFIs were 'unregulated' and 'unsupervised'.

The main weakness with the existing legal environment was the lack of clarity, with microfinance providers unsure as to their legal status regarding the provision of financial services. This was also reflected by BOZ's reluctance to enforce the provisions of the BFSA 2000 in the absence of microfinance specific regulations, despite the Act's applicability to NBFIs, including MFIs. Therefore, other than the banks, only three MFIs had obtained licences. The uncertainty extended to the treatment of forced savings and whether they qualified as deposits. The other major weakness identified was the long and cumbersome process involved in recovering loans, rendering this an unviable option for loan recovery by MFIs.

The study results were not conclusive with regard to the impact that the existing regulatory framework has had on the microfinance sector. On the one hand, the lack of regulatory and supervisory attention may have resulted in the growth of the microfinance sector which might not have happened if this sector had been regulated as per option 2 from the start. On the other hand, the growth of the industry may have been due to the change in government policy and/or the increased interest by the donor community and developmental agencies in funding microfinance, rather than any absence of regulatory and supervisory attention. Different country experiences do not shed much light on this matter as microfinance has flourished under both scenarios.

9.2.3 The potential impact of regulation and supervision on the microfinance sector

With the introduction and effective implementation of microfinance specific regulations, all MFIs would be required to obtain a licence and would be supervised by BOZ. It would harmonise the regulation and supervision of all MFIs for the provision of financial services, regardless of their legal form or organisational structure. The introduction of the DMFRs would address the ambiguity that exists in the current regulatory and supervisory environment and clarify their legal position, thereby enhancing the credibility and legitimacy of MFIs.

The study found that the objectives for regulating and supervising the microfinance sector, as advocated in the literature and reflected in the research findings, were not likely to be met by

the proposed change. Firstly, considering the size of MFIs in Zambia, and the microfinance sector as a whole, the objective of maintaining financial system stability should not really be an objective. The failure of an MFI, even a relatively large one, with the possible exception of the banks which are already regulated and supervised by BOZ, would not destabilise the financial system. Because MFIs typically are not connected to each other in the same way that banking institutions are through the inter-bank markets and payment clearing systems, the failure of an MFI is not likely to negatively affect other FIs and precipitate a collapse in the financial system. Moreover, because the majority of MFIs in Zambia, with the exception of banks, do not offer savings or deposit facilities, the loss of confidence is not likely to result in a loss of confidence in the entire financial sector.

Thus, concerns in relation to issues of financial system stability are unfounded. Furthermore, as experience in the banking sector has shown, and the research findings in relation to the case study of MFI 1, regulation and supervision does not prevent the failure of a FI. Therefore, in the Zambian context, where the microfinance sector is miniscule in relation to the financial sector, MFIs are not part of the payment clearing system and do not provide deposit facilities, microfinance specific regulations should not be introduced on this basis.

Depositor funds would not be 'safeguarded' by the introduction of the DMFRs. As stated above, MFIs are still likely to fail even when regulated and supervised. Even after the introduction of the DMFRs, depositors would still rank in the same way as other ordinary creditors in order of priority for liquidation. Thus, other mechanisms would need to be put in place to meet this objective. In the banking sector, prudential regulation is often accompanied by depositor protection schemes to safeguard depositors' funds. This is justified mainly to instil confidence and minimise the probability of bank runs, hence systemic risk. It also serves to reduce the loss and inconvenience suffered by depositors when an institution fails. Considering the fact that most MFIs in Zambia do not provide savings or deposit facilities, this objective should not rank very high as a basis for introducing the draft regulations. In addition, as regulation and supervision do not necessarily prevent failure, this objective is not likely to be met in any event. Therefore, the draft regulations should not be introduced on this basis.

In the same vein, the objective of protecting investors would not be met. Furthermore, there is consensus in the literature that investors are capable of monitoring and supervising their

institutions and this function need not be delegated to a government supervisory agency. This is another objective, therefore, which does not warrant the passing of the draft regulations.

Licensed MFIs would be legally permitted to mobilise deposits. Thus, the objective of increasing access to funding would be met to some extent. However, this assumes that MFIs do wish to provide deposit and savings facilities which may not necessarily be the case. As one microfinance practitioner pointed out, the provision of savings can be very costly. With regard to raising funds in the Zambian capital/equity market, this would not be easy. Microfinance is not a profitable business in Zambia which is an important reason why the banking sector has been reluctant to invest in microfinance, especially in rural areas. As shown by the study, access to funding was not dependent on being licensed by the central bank. Investment in microfinance, at least by private investors, is more likely to be determined by considerations of profitability.

The objective of customer protection would be met to some extent through increased information disclosure requirements. However, as customer protection is not a legal mandate of the central bank, it may be best left to an alternative agency to deal with. As highlighted in the literature, the failure to distinguish between prudential and code of conduct business regulation results in regulation that is restrictive and unmanageable. A steady increase in regulatory objectives leads to over regulation and regulatory complexity which firms may find difficult to meet. Likewise, regulators with too many responsibilities will not be able to regulate effectively. Similarly, by placing large numbers of diverse microfinance providers under their responsibility for the purpose of collecting data in a sector that is insignificant and inconsequential in relation to the financial sector makes the problem more acute in jurisdictions where supervisors already face capacity constraints dealing with the banking sector alone. This would either undermine efforts to regulate the more important sectors, or result in the microfinance sector being totally ignored.

In addition to the objectives not being met, the study concluded that the introduction of the draft regulations would have a detrimental effect on the development of the microfinance sector. The licensing requirements and high costs of compliance would result in fewer MFIs, leading to decreased access to financial services, less choice for customers and increased charges and interest rates. In addition to the compliance costs faced by the MFIs, BOZ would

incur additional costs in regulating and supervising the microfinance sector. Using the RIA approach, the study found that the potential benefits of passing the DMFRs would not outweigh the additional costs.

9.3 IMPLICATIONS FOR THEORY AND DIRECTIONS FOR FURTHER RESEARCH

The public interest view of regulation did not hold for the microfinance sector in Zambia. The findings of the study - specifically that the objectives of regulating the microfinance sector in the manner proposed would not be met, that it would not correct market failures, and would lead to decreased access to financial services for MFI clients, less choice in terms of services and products on offer, and increased charges and interest rates - did not support the public interest theory of regulation. The study confirmed earlier empirical studies that found that regulation failed to achieve the results that the public interest theory implied, namely the correction of market imperfections so as to simulate the welfare maximising conditions of perfect competition and consumer protection.

The private interest view, on the other hand, postulates that the government regulates the financial sector to maximise the welfare and influence of politicians and bureaucrats, even when nobler public interest goals are the purported goal. So, although there may be significant market failure in the microfinance sector, the private interest view cautions against an approach to regulation dependent on a powerful regulatory agency, such as the central bank. Although, the study findings did not support the public interest theory of regulation, it was not conclusive as to whether the regulatory decision making process had been subject to regulatory capture, and more specifically, political capture. It has been suggested in the literature that regulatory authorities in some countries may have been positively influenced to support modern prudential regulation and supervision to enhance their budgets and perquisites.

The study lends support to the ineffective hand view of regulation. The ineffective hand view does not question the existence of market failure or the intentions of government and regulatory agencies, but states that official government regulation may prove ineffective due to ambitious mandates, inadequate skills and meagre resources resulting in a regulatory environment that does not meet its objectives. The findings of the study found that in cases where MFIs had been regulated and supervised, their regulation and supervision had been ineffective in improving their performance. Furthermore, stakeholders, including BOZ

officials, expressed reservations about the central bank's ability to effectively supervise the microfinance sector.

The public interest view assumes that regulators are 'disinterested' parties in the regulatory process, an assumption disputed by the private interest view. If, in fact, regulators are not 'disinterested' parties, and are subject to capture, then an area for further research would be to establish whether the regulatory decision making process had been subject to regulatory capture and by whom; determine which interest group had significant power to affect regulatory policy; and assess the impact of the regulatory capture on the design of the regulatory and supervisory environment for microfinance.

9.4 POLICY IMPLICATIONS

The study has shown that the proposal to regulate the microfinance sector was designed to achieve a multitude of objectives. The underlying assumption was that these objectives would be met with the introduction of the DMFRs. However, the study did not validate this assumption, but rather, drew attention to the fact that the extent to which regulation and supervision can correct market failure and meet the stated objectives is limited. Therefore, in carrying out an assessment of a regulatory proposal, an evaluation of the impact of regulatory failure also needs to be considered, as regulatory failure may prove more costly than no intervention at all.

Because numerous objectives for regulating and supervising the sector were identified, there was a lack of focus. Focus is important to ensure that regulation and supervision is appropriately targeted, increasing the likelihood of success. It also makes it easier to assess whether the intended proposal is the most appropriate, or whether alternatives should be considered. This presents a case for Zambia adopting the RIA approach to developing and implementing new legislation. RIA encourages a structured examination of the objectives and impacts of regulating. In particular, it results in clearer and more explicit consideration of the objectives behind regulations. RIA helps governments design efficient regulations that address market failures and result in the optimisation of social welfare by highlighting aspects of regulation which limit consumer choice and the level of competition in an economy, thus ensuring that regulations do not impose disproportionate costs and unintended impacts on business or society at large. RIAs help governments strike the right balance between the need

to provide investors and citizens with protection and confidence without regulation being unnecessarily burdensome.

Moreover, the adoption of too many regulatory objectives may result in 'over-regulation'. This clouds the issues and makes it difficult to assess the appropriateness of a proposal and the central bank as a supervisory authority. As mentioned above, the RIA may mitigate against this. This 'over-regulation' may lead to regulatory complexity which MFIs may have problems meeting and supervisory agencies with too many responsibilities that they are unable to regulate effectively. Linked to this, the study highlighted the need to take contextual factors into account. Thus, some of the objectives, such as increasing access to funding from sources such as the capital markets and credit lines from donors and government, would not be applicable in the Zambian context. Policy makers need to take these factors into account and desist from blindly adopting such objectives which may be more applicable in other jurisdictions. Furthermore, regulation in itself would not be sufficient to address the institutional and macro level constraints identified. Alternative policy solutions would be needed to address these deficiencies. For example, regulation can not deal with the problem of poor infrastructure.

According to the study, it would appear that BOZ was identified as the most appropriate supervisor because it was responsible for the financial sector, it was already in existence and had the most 'relevant' expertise. However, these considerations failed to take into account the effect that the added responsibility would have on BOZ's ability to effectively supervise the banking sector and concentrate on its more pressing mandates of maintaining price stability and financial system stability. Considering the capacity constraints faced by BOZ and the number of MFIs that would be regulated, there is the risk that regulations would be introduced that BOZ would not be in a position to enforce. This would negatively affect its credibility. It is better to have no regulations, than to introduce regulations that can not be enforced.

The study found that the introduction of regulations alone would not be sufficient to achieve the objectives identified for encouraging the development of the microfinance sector. What was of greater importance was the effective implementation of regulatory and supervisory policy and procedures. Thus, the fact that an MFI obtained a licence did not automatically translate into it being effectively supervised. The introduction of microfinance specific

regulations would not necessarily result in a change in attitudes and procedures by the supervisory authority as illustrated by the experience after the BFSA amendments and what Maimbo (2001: 324) refers to as 'bureaucratically institutionalised regulatory forbearance'.

Lastly, for regulations to be beneficial, they would have to take industry structure into account, especially in relation to regulatory capital requirements, ownership and governance structure, size and lending methodologies. As shown in Chapters 7 and 8, the impact of regulation on the microfinance sector is directly affected by the specific provisions contained in the DMFRs. Therefore, the impact of regulation on microfinance can be manipulated by the details of the provisions contained in the legislation. The research findings also imply that the stage of development of the microfinance sector needs to be taken into account in establishing the regulatory framework. Thus regulation may not be appropriate when the industry is still in its nascent stage.

9.5 CONCLUDING REMARKS

Although the study was carried out in Zambia, the research findings did have more general relevance to the regulation of microfinance in other countries, particularly in sub-Saharan Africa. The public interest theory assumes that regulation by a government supervisory agency (usually the central bank) will result in maximising social welfare. In a number of sub-Saharan African countries, this would not be the case for the same reasons it was not applicable in the Zambian context (i.e. the objectives would not be met and market failure would not be corrected). The 'ineffective hand' view would most likely dominate as most supervisory agencies have a tendency to adopt overly ambitious mandates, lack appropriate skills and have insufficient resources.

Secondly, the adoption of RIA would be beneficial for all countries in so far as an empirical method of decision making encourages a structured examination of the objectives and impacts of regulating. RIAs also help governments design efficient regulations that are better able to address market failure and result in the optimisation of social welfare, as well as minimise the risks of over-regulation. Because the objectives of regulating the microfinance sector are unlikely to be met, and the costs of compliance high, regulatory failure is a real possibility. Thus, an evaluation of regulatory failure must also be incorporated into the analysis when considering the policy proposals.

Thirdly, the introduction of well designed and effectively implemented microfinance regulation alone is not sufficient to promote growth and produce viable sustainable MFIs. Other policy considerations are needed that will strengthen the supporting institutional infrastructure (e.g. the judicial system, accounting and auditing standards, etc), improve the physical infrastructure (roads, telecommunications), and promote macroeconomic stability.

Lastly, the introduction of microfinance legislation must be accompanied by the effective implementation of regulatory and supervisory policies for it to have any impact. Therefore, capacity building has an important role to play in ensuring the effective enforcement, sanctions, and monitoring of regulation.

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Appendix 1: History of microfinance

Since the beginning of time…
Informal savings and credit groups have operated for centuries across the developing world.

Middle Ages
In Europe an Italian monk created the first official **pawn shop** in 1462 to counter usury practices. In 1515 Pope Leon X authorized pawn shops to charge interest to cover their operating costs.

1700s
Jonathan Swift initiates the **Irish Loan Fund System**, which provides small loans to poor farmers who have no collateral. At its peak, it is lending to 20 percent of all Irish households annually.

1800s
The concept of **the financial cooperative** is developed by Friedrich Wilhelm Raiffeisen and his supporters in Germany. From 1865, the cooperative movement expands rapidly within Germany and other countries in Europe, North America, and eventually developing countries.

Early 1900s
Adaptations of these models begin to appear in parts of **rural Latin America**.

1950–1970
Efforts to expand access to agricultural credit use **state-owned development finance institutions**, or farmers' cooperatives, to channel concessional loans and on-lend to customers at below-market interest rates. These development banks lose most or all of their capital because their subsidized lending rates cannot cover their costs, including the cost of massive default.

Early 1970s
Experimental programs extend tiny loans to groups of poor women to invest in micro-businesses, and **microcredit** is born. Early pioneers include Grameen Bank in Bangladesh; ACCION International, which started out in Latin America; and the Self-Employed Women's Association Bank in India.

1980s
Microcredit programs throughout the world improve on original methodologies. Microlenders, such as Bank Rakayat Indonesia, defy conventional wisdom about financing the poor. **Cost-recovery interest rates and high repayment** permit them to achieve long-term sustainability and reach large numbers of clients.

Early 1990s
The term "microcredit" begins to be replaced by "**microfinance**," which includes not only credit, but also savings and other services, such as insurance and money transfers.

Today
The borders between traditional microfinance and the larger financial system are starting to blur. In some countries, banks and other commercial actors are entering microfinance. Increasing emphasis is placed on building entire financial systems that work for the poor.

Source: Helms (2006: 3)

Appendix 2: Innovations in microfinance

Group lending

The first innovation, group lending, generally works as follows. Individuals, typically with no collateral, form groups to obtain loans. Loans are made individually to group members, but each borrower is jointly and severally liable for the debts of the other members. If any one of the members fails to repay their loan, other members of the group can not receive a loan until the defaulting borrower's debt is repaid. After the first round of loans, members are entitled to another loan for a higher amount. Screening costs for the MFI are lowered because they are passed on to self-selecting groups that are responsible for each others debt. Similarly, transaction costs of debt collection are lowered because peer pressure is exerted on members by fellow members to repay their loans (Roth, 2002). Therefore, clients have strong incentives to select responsible partners when forming groups, monitor them and repay promptly.

Frequent repayments

Loan repayments are made in small instalments, start soon after the initial disbursement, and continue weekly after that. The small weekly repayments allow borrowers to repay the loan in manageable amounts. By having repayments start so soon after the initial disbursement, MFIs pick borrowers who are more likely to be able to repay their loans even if the investments fail as borrowers must have other sources of income to meet the early instalments and, therefore, are less risky. Thus, repayment schedules closely match borrowers' income streams. In this way, the loan products become more like savings products (Armendáriz de Aghion and Morduch, 2005). Another advantage of frequent repayments is that it provides an early warning system facilitating prompt corrective action if needed. Regular meetings enable the establishment of personalised relationships and provide opportunities for monitoring. Frequent repayments are also an advantage to clients that have problems holding onto income and saving, thus counteracting the perceived increased transaction costs for borrowers imposed by the frequency of the meetings.

Public meetings

Some MFIs require repayments to be made at public meetings. The advantages of this approach are, firstly, the possibility of stigma arsing from non-payment acts as a strong incentive for borrowers to repay their loans. Secondly, meeting a large number of borrowers at the same time in a specified location reduces the lender's transactions costs. Thirdly, the group often acts as a source of information on errant borrowers. Fourthly, the group meetings facilitate education and training for those schemes that offer complementary services. Fifthly, it is thought that the experience of approaching a FI for those with no prior experience is less daunting if they are able to do so with their friends or neighbours. Lastly, by keeping transactions in the open, public repayments can help enhance internal control for the MFI and reduce opportunities for fraud.

Progress lending

After the first round of loans, customers are typically entitled to another loan for a higher amount. Progressive lending allows for the screening of clients before expanding the loan scale by increasing the opportunity cost of non-repayment, thereby discouraging 'strategic' default and increasing repayment rates. Additionally, the average cost of lending for the MFI decreases as clients graduate to larger loans. This is because the cost of servicing a loan of $400, for example, is not twice as expensive as servicing a loan of $200.

Non-traditional collateral

Although microfinance loans are secured through non-traditional means like group lending, some MFIs, like BRI, do require collateral, but are flexible with regard to what they will accept. What is important is the 'notional' value placed on the pledged asset by the borrower, which would make it difficult for them to give it up. So, for example, household items may be accepted even if they are 'worthless' to the MFI. Another solution that addresses the problem of the lack of collateral is the requirement for borrowers to have 'forced' savings. The ability to save demonstrates characteristics like discipline and money management skills that correlate with being a good borrower. Savings also mean deposits in the bank that can be used directly as security for loans.

Targeting of women

To many, microfinance is about banking for women. Microfinance is about small businesses which often involve self-employment in the informal sector, of which women make up a large and growing segment. MFIs target women as women seem to be more reliable than men when it comes to repaying their loans because they are more cautious than men. They tend to work close to home, making them easy to find and cheaper to monitor than men (Armendáriz de Aghion and Morduch, 2005). Serving women seems to meet the two objectives of maintaining high repayment rates and meeting social goals as proxied by higher household expenditures. Women tend to be more concerned about children's health and education than men.

Lastly, unlike traditional FIs, MFI loan officers spend considerable time talking to prospective borrowers' neighbours and friends when making lending decisions. Gathering information can be helpful at many stages in the loan process and not just at the application stage. This information helps MFIs assess the risk profiles of their borrowers more accurately, thus, mitigating the problems of information asymmetry.

Appendix 3: Regulatory frameworks for South Africa, Tanzania and Ethiopia

South Africa				
Regulated MFIs	Microlenders registered with the MicroFinance Regulatory Council (MFRC), savings and credit cooperatives (SACCOs), and banks with microlending activities.			
Non-regulated sources of microfinance	Unregistered microlenders; consumer sales credit; moneylenders			
Definitions of microfinance or microcredit	For the purpose of exemption from the Usury Act, loans under approx. US $1,200 (7,955 ZAR), payable within 36 months			
NGO microfinance provider formalization or transformation issues	NGOs may register with the Micro Finance Regulatory Council (MFRC), enabling them to engage in money lending while being exempt from the Usury Act. The MFRC is not a prudential regulator. The NGO must be licensed as a bank or mutual bank and regulated by the Central Bank to take deposits. Cooperatives exclusively concluding transactions with members are temporarily exempted from the requirements of the Banks Act and may mobilize deposits from their members up to a certain amount, but only if they maintain a business relationship with a formal bank. "Mutual banks" were created in 1993 to provide a second-tier deposit-taking institution, but due to high minimum capital requirements, they do not play a significant role in the microfinance market.			
General approach to regulating	**Legal basis for regulating**	**Definition or description of institution**	**Regulator(s) and role of regulator(s)**	**Activity that determines required regulatory status**
Banks	Banks Act (1990, as amended) and Usury Act, 1968	Universal banks as well as specialized institutions	Reserve Bank of South Africa	Offering deposit products to the general public, outside exemption rules.
Microlenders	Usury Act (No. 73 of 1968), Notice 713 of 1999 in terms of Section 15A of the Usury Act (referred to as the Exemption Notice) Banks Act (No. 94 of 1990) Rules of the MFRC (as effective from 1 July 2002, referred to as Rules) and MFRC Circulars	Credit-only MFIs who are members of MFRC and comply with their rules	Microfinance Regulatory Council (MFRC) or other authorized regulatory institution for all MFIs within Usury Act exemption	All MFIs; Money lending transactions of various institutions falling within the scope of the Usury Act Exemption Notice (defined as a type of business, not an institutional type); Small informals not regulated in practice; in order to charge higher interest rates than the Usury Act allows, registration with authorized regulatory institution (e.g. MFRC) required.

South Africa				
Savings and Credit Cooperative Societies	Notice 1422 of 2000 (referred to as Exemption Notice) in connection with Banks Act (No. 94 of 1990) Cooperatives Act, 1981 (Act No. 91 of 1981)	Closed co-operatives, i.e. financial co-operatives carrying on business with members only	A SACCO must be a member of a self-regulatory body approved by the Registrar of Banks, the Savings and Credit Cooperative League of South Africa (SACCOL)	SACCOs must comply with the requirements of the exemption notice, if not, their deposit-taking business falls under the definition of a business of a bank and they therefore must apply for a banking license
Organisational Registration	**Laws and regulations governing registration**	**Agency administering registration**	**Required legal form of organization**	**Restrictions on ownership**
Commercial Banks	Banks Act 1990	Registrar of Banks at the South African Reserve Bank; NBFIs are registered by the Financial Services Authority.	Public company registered as a bank	No person shall hold more than 15% of controlling shares unless permission is given by the Registrar of Banks.
Microlenders	Any natural or legal person can be a microlender, hence no specific rules apply.	MFRC can give provisional registration	Private or public company, close corporation cooperative, trust, NGO, mutual bank, or bank. (Almost 80% of registered lenders are close corporations.)	Determined by the law governing each organizational structure
Savings and Credit Cooperative Societies	Co-operatives Act of 1981	SACCOL and Registrar of Cooperatives in the Department of Agriculture	Incorporation as a trading co-operative	Members only may hold shares, and membership is limited by "common bond rules," i.e., available only to individuals related through neighbourhood residence or workplace commonality.
Supervision	**Supervision method**		**Depositor protection mechanisms (e.g., deposit insurance or lender of last resort)**	
Commercial Banks	Offsite inspection of statements; on-site inspection		Loan insurance exists, although the system is near collapse because of the strain the HIV/AIDS epidemic has put on the insurance industry	
Microlenders	MFRC supervises MFI adherence to standards of management & consumer protection, deals with complaints, gathers & publishes information on the industry, makes annual report to Department of Trade & Industry (DTI); MFRC performs inspections using outside auditors and can inspect with or without notice.		None reported	
Savings and Credit Cooperative Societies	Self-supervision by trade association, but supervision is mostly ineffective.		Central Finance Facility helps with short-term liquidity constraints. SACCOs must pay a one-time entrance fee (US $13 [86 ZAR] plus US $0.13 [0.86 ZAR] per member), purchase shares equal to 1% of the SACCOs' total assets each financial year, and mandatory deposits of 9% of total assets each financial year. All SACCOs are required to have loan insurance, which can be purchased from SACCOL (although this mechanism may be dropped in the future because of the effect the HIV/AIDS epidemic has had on the system).	

Tanzania				
Ownership structure of banks and FIs	Banks (commercial, regional, and rural), NBFIs, and savings and credit cooperatives			
Regulated MFIs	Banks (commercial, regional, and rural), NBFIs, and savings and credit cooperatives			
Non-regulated sources of microfinance	NGOs			
Definitions of microfinance or microcredit	Microcredit means a credit whose security may include non-traditional collateral, granted to a natural person, individually or in a group, whose income depends on her own business or economic activity and who may lack formal financial statements or other accounting and operational records. (See Microfinance Companies and Micro Credit Activities Regulations of 2004)			
NGO microfinance provider formalization or transformation issues	None reported			
General approach to regulating	**Legal basis for regulating**	**Definition or description of institution**	**Regulator(s) and role of regulator(s)**	**Activity that determines required regulatory status**
Banks	Banking and Financial Institutions Act of 1991	A bank is a financial institution authorized to receive money on current account subject to withdrawal by check. (See section 3 of 1991 Act.) Only three regional banks have so far been established and the indications are that these banks have been established principally to address the requirements for banking services of community-based MFIs and organizations, the SACCOs and other non-financial primary cooperative societies. (See Randhawa and Gallardo 2003)	Bank of Tanzania	Accepting and collecting of deposits from the public and using such funds to make loans, advances, or investments
Microfinance company (MFI)	Microfinance Companies and Micro Credit Activities Regulations of 2004: These regulations shall apply to financial institutions licensed by the Bank of Tanzania as Microfinance Companies under the MFIs charter provided in section 3 of the Banking and Financial Institutions Act, 1991	A financial institution licensed by the Bank of Tanzania as a MFI under section 3 of the Act to undertake banking business mainly with individuals, groups and micro enterprises in the rural or urban area of Tanzania Mainland and Tanzania Zanzibar.	Bank of Tanzania	Financial institution with lower minimum capital requirements that can only provide services that constitute microfinance.

Tanzania				
Non-bank Financial Institution	Banking and Financial Institutions Act, 1991	A NBFI is any person authorized by law or the Bank to engage in banking business not involving the receipt of money on current account subject to withdrawal by check. NBFIs can be either deposit-taking or non-deposit taking. (See section 3 of 1991 Act.)	Bank of Tanzania	Accepting and collecting of deposits from the public and using such funds to make loans, advances, or investments under certain conditions (e.g. unable to hold checking accounts for its clients.) Regional financial institutions have lower minimum capital requirements and must operate within confined geographical areas.
Savings and Credit Cooperative Societies	Savings and Credit Cooperative Societies Regulations, 2004 Financial Cooperative Societies Regulations 2004 These regulations shall apply to societies incorporated under the Cooperative Societies Act No. 4 of 1986.	Legal entity established by the voluntary membership of private or public persons for the purpose of depositing their savings and providing credits to its members (See Savings and Credit Cooperative Societies Regulations, 2004, art. 9)	Bank of Tanzania	Providing financial intermediation to members only.
Organisational Registration	**Laws and regulations governing registration**	**Agency administering registration**	**Required legal form of organization**	**Restrictions on ownership**
Commercial Banks	Banking and Financial Institutions Regulations, 1997; Company Law	Bank of Tanzania	Stock corporation. (See section 33 of 1997 Regulations)	No person or group may own more than 20% of the core capital of any bank or financial institution. (See section 36 of 1997 Regulations)
Microfinance Companies	Banking and Financial Institutions Regulations, 1997; Company Law	Bank of Tanzania	Companies limited by shares	An organization with a proven track record in lending may own up to 66% of the share capital of the microfinance company
Non-bank Financial Institution	Banking and Financial Institutions Regulations, 1997; Company Law	Stock corporation. (See section 33 of 1997 Regulations)	No person or group may own more than 20% of the core capital of any bank or financial institution. (See section 36 of 1997 Regulations)	Application cost of US $1802. Bank of Tanzania will accept or reject an application within 90 days of receiving it. (See section 20 of 1997 Regulations)
Savings and Credit Cooperative Societies	Savings and Credit Cooperative Societies Regulations, 2004 Financial Cooperative Societies Regulations 2004	Bank of Tanzania	Cooperative Society	

Tanzania		
Supervision	**Supervision methods**	**Depositor protection mechanisms (e.g., deposit insurance or lender of last resort)**
Commercial Banks	On-site surveillance by Bank of Tanzania staff approximately once a year at the head office of each bank. (See Randhawa and Gallardo 2003.)	Deposit Insurance Fund controlled by a Deposit Insurance Board. Bank of Tanzania determines amount to be contributed but it must be not less than 1% of the average of the bank or financial institution's total deposit liabilities for the preceding 12 mos. (See section 25(4) of 1991 Act.)
Microfinance Companies	On-site surveillance by Bank of Tanzania staff approximately once a year at the head office of each bank. (See Randhawa and Gallardo 2003.)	Deposit Insurance Fund controlled by a Deposit Insurance Board. Bank of Tanzania determines amount to be contributed but it must be not less than 1% of the average of the bank or financial institution's total deposit liabilities for the preceding 12 mos. (See section 25(4) of 1991 Act.)
Non-bank Financial Institution	On-site surveillance by Bank of Tanzania staff approximately once a year at the head office of each bank	Deposit Insurance Fund controlled by a Deposit Insurance Board. Bank of Tanzania determines amount to be contributed but it must be not less than 1% of the average of the bank or financial institution's total deposit liabilities for the preceding 12 mos. (See section 25(4) of 1991 Act.)
Savings and Credit Cooperative Societies	Field inspection and examination of individual SACCOs by district cooperative officers and examination of externally-audited financial accounts by the Registrar of Cooperatives. (See Randhawa and Gallardo 2003.)	None reported

Ethiopia				
Ownership structure of banks and FIs	Regional governments hold equity in five of Ethiopia's 16 MFIs; associations and NGOs hold equity in 13 MFIs and represent the majority shareholder in eight of these. Individuals hold equity in 13 MFIs, represent the majority shareholders in three, and hold 100% of shares in another three. (Shiferaw and Amha 2001)			
Regulated MFIs	Commercial banks; savings and credit cooperatives; and MFIs			
Definitions of microfinance or microcredit	Legal duty to give preference to marginal farmers; loan ceiling = US $625 (5320 ETB) Proclamation 40/1996 defines microcredit as, "an activity of expending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs."			
NGO microfinance provider formalization or transformation issues	Legislation attempts to tier MFIs by requiring MFIs with deposits over 1 million ETB to re-register. However, inadequate capacity of National Bank of Ethiopia has prevented implementation.			
General approach to regulating	**Legal basis for regulating**	**Definition or description of institution**	**Regulator(s) and role of regulator(s)**	**Activity that determines required regulatory status**
Banks	Monetary and Banking Proclamation (Proclamation No.83/1994) Licensing and Supervision of Banks and Insurance Companies (Proclamation No.84/1994) Proclamation 97/1998	Provide financial services	NBE, Ministry of Finance	

Ethiopia				
MFIs	Licensing and Supervision of the Business of Micro-financing Institutions Proclamation No.40/1996 Proclamation 83/1994 12 Directives of the National Bank of Ethiopia (NBE)	Extend credit, in cash or in kind, to peasant farmers or urban small entrepreneurs, the loan size of which shall be fixed by the Bank (40/1996, Sec 2)	NBE, Ministry of Finance. NBE provides licensing requirements and also is tasked with promoting the microfinance industry by training MFIs, promoting investment, and encouraging banks to engage in microfinance.	All MFIs to register with NBE as unlicensed microfinance activity is illegal; re-registration required when savings equals 1 million ETB (although not enforced)
Savings and Credit Cooperative Societies	Cooperative Societies Proclamation No.147/1998 in 1998	Minimum of 20 members with common occupation or residence per cooperative; established by individuals on voluntary basis to collectively solve and manage their economic and social problems (147/1998)	Federal, Regional or City governments (depending on the size and area of the SCCS)	Mobilize savings and provide credit to members
Organisational Registration	**Laws and regulations governing registration**	**Agency administering registration**	**Required legal form of organization**	**Restrictions on ownership**
Commercial Banks	Monetary and Banking Proclamation (Proclamation No.83/1994) Licensing and Supervision of Banks and Insurance Companies (Proclamation No.84/1994) Proclamation 97/1998	NBE		No foreign ownership
MFIs	Licensing and Supervision of the Business of Micro-Financing Institutions, Proclamation No. 40/1996 (40/1996) 12 Directives of the National Bank of Ethiopia (NBE)		Share company, 100% Ethiopian-owned (Article 304 of the Commercial Code	No foreign ownership (84/1994); no individual may own more than 20% of the MFI (84/1994)
Savings and Credit Cooperative Societies	Cooperative Societies Proclamation No.147/1998 in 1998		Limited Liability Society	Foreigners allowed to own shares
Supervision	**Supervision methods**		**Depositor protection mechanisms (e.g., deposit insurance or lender of last resort)**	
Commercial Banks	None reported		None reported	
MFIs	Annual external audit, regular on-site inspections, follow-up on quarterly reports. (Only five inspections took place between 1996 and 2001)		None for MFIs	
Savings and Credit Cooperative Societies	Audit and inspection		None reported	

Appendix 4: Familiarisation of the RIA process

<u>Workshops attended</u>

26.11.03 – 27.11.03 **Regulatory Impact Assessment: Strengthening Regulation Policy and Practice** organized by the Centre on Regulation and Policy, Manchester, UK

24.11.03 – 25.11.03 **New Directions in Impact Assessment for Development: Methods and Practice** organized by the Centre on Regulation and Policy, Manchester, UK

26.06.03 – 27.06.03 **Risk Regulation, Accountability and Development Workshop** organized by the Centre for Analysis of Risk and Regulation (CARR), the Centre on Regulation and Competition (CRC) and Aston Business School, Manchester, UK

<u>Interviews held</u>

Cabinet Office Regulatory Impact Unit
Scrutiny (DU200) (16 December, 2003)
<u>Director</u>
Karen Hill
<u>Finance and Cross Cutting</u>
Marie-Anne Mackenzie
<u>Employment/Trade</u>
Ashley Holt

Public Sector (DU800) (16 December, 2003)
<u>Local Authorities, Procurement</u>
Fiona Macaulay

HM Treasury Office (17 December, 2003)
Ashley Bennett, Competition Regulation and Energy Team

Small Business Services (17 December, 2003)
Debbie Akinfe

Home Office (15 January, 2004)
Graeme McCabe, Better Government Team
Bruce Bebbington
Jacob Hawkins
Jill Wanliss

Financial Services Authority (3 February, 2004)
Isaac Alfon, Financial Economist, Regulatory Strategy and Risk Division
Grazia Rapisarda

Appendix 5: District profiles

District	Province	Population	Population density per sq.km	Poverty levels	Unemployment levels	Economic activity	Natural resources	Accessibility	Financial Institutions
Chadiza	Eastern	83,981	17.9-47.4	80%	84.8%	Agriculture (cotton and tobacco, maize and groundnuts, cattle)	Arable land	Gravel road from Chipata	1 bank (ZNCB - mobile unit once a week, Wednesdays)
Chingola	Copperbelt	172,026	47.5-3013.1	65%	24.4%	Copper mining Agriculture	Copper, cobalt and arable land	Road and rail	7 banks (IZB, SB, ZNCB, BBZ, NSCB, FB and CCB) MFIs (including CETZAM, BAYPORT, Pride Zambia and KADENE
Chipata	Eastern	367,539	47.5-3013.1	80%	4.8%	Agriculture (maize and groundnuts, tobacco and cotton, cattle), food processing and cotton ginning		Road	5 banks (ZNCB, BBZ, FB, NSCB) 1 building society (ZNBS) MFIs (including Pride)
Choma	Southern	204,898	17.9-47.4	76%	16.1 %	Agriculture (maize and sweet potatoes, livestock) Trading	Arable land Water	Road and rail	4 banks (BBZ, SCB, ZNCB, FB) and MFI (Pride)
Kabwe	Copperbelt	176,758	47.5-3013.1	77%	12.1%	Agriculture (maize and livestock) Forestry Small scale gem mining	Arable land Gem stones	Road and rail	4 Banks (ZNCB, BBZ, NSCB, IZB) 2 MFIs (FINCA and Micro Bankers Trust)
Kalomo	Southern	169,503	7.1-13.1	76%	16.1 %	Agriculture (maize and livestock) Gem stone mining		Road and rail	3 banks (SCB, BBZ, FB)
Kaoma	Western	162,568	5.0 to 7.0	89%	5.1%	Agriculture (maize and cassava) trading	Arable land	Road	1 bank (FB)
Kapiri Mposhi	Central	194 752	7.1-13.1	77%	12%	Agriculture (maize and livestock) Fishing (on a small scale) Small scale gem mining	Arable land Gem stones	Road	1 bank (ZNCB)
Kasama	Northern	170,929	13.2 to 17.8	81%	6.2%	Agriculture (coffee and cassava, sweet potatoes and groundnuts) Food processing	Arable land Chishimba waterfalls	Road and air	4 banks (SCB, ZNCB, FB, NSCB) 1 building society (ZNBS)
Kawambwa	Luapula	102,503	7.1-13.1	81%	6.7%	Agriculture (cassava, groundnuts coffee and tea and livestock)	Arable land Water Fish	Road	1 bank (ZNCB)
Kitwe	Copperbelt	376,124	47.5-3013.1	65%	24.4%	Agriculture (maize and livestock) Mining Trading and construction	Copper Arable land	Road Rail and Air	8 banks (IZB, SB, ZNCB, BBZ, NSCB, IBZ, SCB, FAB) 1 building society (ZNBS) MFIs (including CETZAM, BAYPORT, MICROFIN, and Pride)

District	Province	Population	Population density per sq.km	Poverty levels	Unemployment levels	Economic activity	Natural resources	Accessibility	Financial Institutions
Livingstone	Southern	103,288	17.9-47.4	76%	16.1 %	Tourism	Victoria Falls Water Game	Road Rail Air	5 banks (BBZ, FB, SCB, ZNCB, NSCB) MFIs (including Pride)
Lundazi	Eastern	236,833	13.2-17.8	80%	4.8%	Agriculture (maize, rice, groundnuts and soy beans, tobacco and cotton. livestock) Small scale gem mining	Arable land Mica Gemstones	Road	1 bank (ZNCB)
Mansa	Luapula	179,749	17.9-47.4	81%	6.7%	Agriculture (groundnuts and sweet potatoes, livestock) Fishing Food processing Light engineering Trading	Arable land Water Fish	Road	3 banks (BBZ, ZNCB, NSCB) 1 building society (ZNBS)
Mazabuka	Southern	203,219	17.9-47.4	76%	16.1 %	Agriculture (maize and livestock) Trading Food processing	Arable land water	Road Rail	3 banks (BBZ, SCB, ZNCB)
Mbala	Northern	149,634	17.9-47.4	81%	6.2%	Agriculture (cassava, maize, beans, sweet potatoes and millet)	Arable land waterfalls	Road	2 banks (FB, CCB)
Mkushi	Northern	107,438	7.1-13.1	77%	12.1%	Agriculture (tobacco barley) Fishing Mining	Arable land Copper, gold and Manganese	Road rail	2 banks (SB and ZNCB)
Mongu	Western	162,002	13.2-17.8	89%	5.1%	Agriculture (maize, cassava and rice) Food processing Trading		Road	4 banks (NSCB, ZNCB, SB) 1 building society (ZNBS)
Mpika	Northern	146,196	2.1-4.9	81%	6.2%	Agriculture (tobacco) Fishing	Arable land Water Game	Road Rail	3 banks (ZNCB, FB, ZNBS)
Mwinilunga	North Western	117 505	5.0-7.0	76%	7.3%.	Agriculture (maize, cassava, sweet potatoes) Mining Trading Food processing (honey production)	Arable land Precious metals Copper	Road	1 bank (FB)
Nakonde	Northern	75,135	17.9-47.4	81%	6.2%	Agriculture Trading Mining	Arable land	Road	1 bank (FB)

District	Province	Population	Population density per sq.km	Poverty levels	Unemployment levels	Economic activity	Natural resources	Accessibility	Financial Institutions
Ndola	Copperbelt	374,757	47.5-3013.1	65%	24.4%	Agriculture (maize and groundnuts, livestock) manufacturing	Arable land Lime	Road Rail Air	8 banks (ZNCB, IZB, SB, CB, BBZ, NSCB, SCB, CCB) 1 building society (ZNBS) MFIs (CETZAM, Pride, Microfin) Finance Leasing Companies
Petauke	Eastern	235,879	17.9-47.4	80%	4.8%	Agriculture (cotton and tobacco) Ginning	Arable land Phosphates Copper	Road	2 banks (ZNCB, NSCB)
Sesheke	Western	78,169	2.1-4.9	68%	5.1%	Agriculture (maize cassava and millet) fishing	Arable land Water	Road	1 bank (FB)
Sinazongwe	Southern	80,455	13.2-17.8	76%	4.8%	Agriculture (cotton) Mining Fishing Crocodile farming	Arable land Coal Mica	Road	None (the nearest is bank, ZNCB, located in mining township of Maamba)
Solwezi	North Western	203,797	5.0-7.0	76%	7.3%.	Agriculture (maize and sweet potato) Mining Trading	Arable land Precious metals Copper	Road	4 banks (ZNCB, NSCB, BBZ, IZB)

BBZ = Barclays Bank, CB = Citibank, CCB = Cavmont Capital Bank, CETZAM = Christian Enterprise Trust of Zambia, FAB = First Alliance Bank, FB = Finance Bank, FINCA = Foundation for International Community Assistance, IZB = Indo-Zambia Bank, SB = Stanbic Bank, SCB = Standard Chartered Bank, ZNCB = Zambia National Commercial Bank

Appendix 6: Focus Group Discussions

Date	Time	Province	District	Comment (where applicable)
14/04/04	Morning	Lusaka	Kafue	BOZ sensitisation programme, distribution of questionnaires.
15/04/04	Morning	Lusaka	Chirundu	BOZ sensitisation program. The meeting did not take place due to low attendance. No questionnaires were distributed.
16/04/04	Morning	Southern	Siavonga	BOZ sensitisation program, distribution of questionnaire.
07/05/04	All day	Lusaka	Lusaka	AMIZ AGM - was attended by members of AMIZ.
21/05/04	Morning	Central	Kapiri Mposhi	FGD and distribution of questionnaires.
24/05/04	Morning	North Western	Mwinilunga	FGD and distribution of questionnaires.
26/05/04	Morning	North Western	Solwezi	The FGD did not take place due to low attendance. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
27/05/04	Afternoon	Copperbelt	Chingola	The FGD did not take place due to low attendance. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
28/05/04	Morning	Copperbelt	Kitwe	The FGD did not take place due to low attendance. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
28/05/04	Afternoon	Copperbelt	Ndola	FGD and distribution of questionnaires.
02/06/04	Morning	Copperbelt	Kabwe	The FGD did not take place due to low attendance, no distribution of questionnaires.
07/06/04	Morning	Eastern	Lundazi	FGD and distribution of questionnaires.
08/06/04	Morning	Eastern	Chipata	FGD and distribution of questionnaires.
09/06/04	Morning	Eastern	Chadiza	FGD and distribution of questionnaires.
10/06/04	Morning	Eastern	Petauke	The FGD did not take place due to low attendance, no distribution of questionnaires.
16/06/04	Morning	Southern	Mazabuka	The FGD did not take place due to low attendance. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
17/06/04	Morning	Southern	Choma	FGD and distribution of questionnaires.
18/06/04	Morning	Southern	Livingstone	FGD and distribution of questionnaires.
21/06/04	Morning	Western	Sesheke	The FGD did not take place. The DC's office never received the correspondence so no arrangements were made. However, the DC did indicate that there were no MFIs in the District.
22/06/04	Afternoon	Southern	Kalomo	FGD and distribution of questionnaires.

Date	Time	Province	District	Comment (where applicable)
23/06/04	Afternoon	Southern	Sinazongwe	FGD and distribution of questionnaires.
14/07/04	Afternoon	Luapula	Kawambwa	FGD and distribution of questionnaires.
15/07/04	Afternoon	Luapula	Mansa	FGD and the distribution of questionnaires.
16/07/04	Afternoon	Northern	Mpika	FGD and the distribution of questionnaires.
19/07/04	Morning	Northern	Nakonde	FGD and the distribution of questionnaires
20/07/04	Morning	Northern	Mbala	The FGD did not take place as no arrangements had been made. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
21/07/04	Afternoon	Northern	Kasama	FGD and the distribution of questionnaires.
23/07/04	Morning	Northern	Mkushi	The FGD did not take due to low attendance. Distribution of questionnaires.
28/07/04	Morning	Western	Mongu	The FGD did not take place as no arrangements had been made. However, questionnaires were distributed by the researcher to institutions identified by the DC's office as offering microfinance services.
29/07/04	Morning	Western	Kaoma	The FGD did not take place. No arrangements had been made as a new DC had just been appointed. However, 5 questionnaires were left with his office for distribution. The lack of appropriate transport meant it was not possible for the researcher to distribute the questionnaires herself.
16/08/04	Morning	Northern	Mpika	Meeting held with Luangwa North Wildlife and Chibansa, one of the village banks.

Appendix 7: Interview guide

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1. What is your understanding of microfinance? How would you define it in the Zambian context?

2. Do you think microfinance is different from banking?

3. Do you think microfinance should be regulated?

4. What do you mean by regulation?

5. What risks do you think would be addressed by regulation?

6. What are the benefits of regualtion?

7. Do you think there is a need to distinguish between the different types of MFIs for regualtion depending on their objective, ie the alleviation of poverty or profit maximisation?

8. What role do you think microfinance plays in the Zambian economy?

9. Who do you think should regulate the microfinance sector? Why?

Appendix 8: Interviewees

Date	Name	Title	Institution
	Ministry of Finance		
10 Oct 04	1. Mr Felix Mutati	Deputy Minister	MOF
10 Jun 04	2. Mr S Musokotwane	Secretary to the Treasury	MOF
	Regulators		
21 Sep 04	3. Dr D Kalyalya	Registrar of Banks and Financial Institutions	BOZ
17 May 04	4. Mr Chibiya	Registrar of Pensions and Insurance	MOF
03 Jun 04	5. Mr Mwansa	Registrar of Cooperatives	MACO
13 May 04	6. Mrs Sakala	Registrar of Societies	Ministry of Home Affairs
	Bank of Zambia		
04 Oct 04	7. Mrs E Mudenda	Director-Non Bank Financial Institutions Supervision	BOZ
31 Aug 04	8. Mr C Mwanakatwe	Director-Bank Supervision	BOZ
03 Sep 04	9. Mr G Simwaka	Executive Assistant	BOZ
	Donors		
12 May 04	10. Mr John Hansell	Private Sector Advisor	DFID
12 May 04	11. Ms C Mulenga		DFID
14 May 04	12. Mr Dan Griffith	Economic Growth Team Leader	USAID
18 Mar 04	13. Ms T Cook	Microfinance analyst	CGAP
18 Mar 04	14. Mr M Holtman	Lead microfinance specialist	CGAP
	Associations		
16 Sep 04	15. Mrs Sherry Thole	Acting Chairperson	BAZ
23 Sep 04	16. Mr Webby Mate	CEO	AMIZ
16 Sep 04	17. Mrs Chansa		AMIZ
	MFIs		
26 Aug 04	18. Mrs Irene Mutalima	Acting CEO	CETZAM
17 Sep 04	19. Mr Kawana	General Manager	Pride
02 Sep 04	20. Mr Birchard	Managing Director	FINCA
16 Sep 04	21. Ms Mary Nandazi	CEO	MBT
	Banking Sector		
26 Sep 04	22. Mrs M Chibesakunda		SCB plc
04 Aug 04	23. Mr N Mutasaa	Head of Retail	BBZ plc
04 Aug 04	24. Mr H Chipuka	Senior Manager – Branch Operations and Card Centre	ZNCB
03 Aug 04	25. Mr E Bwalya	Head of Retail	SB
04 Aug 04	26. Mr S Simaataa	Director – Operations and Risk Management	FB
11 Aug 04	27. Mr Malunda	CEO	CCB
09 Aug 04	28. Mr R Mfula	CEO	NSCB
	Consultants		
12 May 04	29. Mr Musona	CEO	M & N Associates
02 Sep 04	30. Mr Mbulo	Director	MM & Associates Limited
16 Sep 04	31. Ms N Machila	CEO	Epsilom Consulting

Appendix 9: Working schedule

Date	Document Type	To	From	Title
16 Feb 1998	Memo	AD RP and FA	Inspector FA	MFI 2
8 Sept 1998	Memo	Acting AD RP and FA	Inspector FA	MFI 2
9 Oct 1998	Memo	Inspector FA	Senior Inspector RP	MFI 2
6 Nov 1998	Memo	Senior inspector RP	Inspector FA	MFI 2
8 Nov 2000	Letter	Acting Director BS	Board Chairman	Amendments to the Banking and Financial Services Act Section 24A(1)
13 Dec 2000	Letter	Acting Director BS	CEO	
21 Sep 2001	Letter	Director FSS	Board Development Officer	Board Members
2 Oct 2001	Letter	Director NBFI	CEO	Submission of Audited Accounts, Auditors Report and Compliance Certificate
6 Nov 2001	Letter	Director NBFI	CEO	
7 Nov 2001	Letter	CEO	Director NBFI	Deposit Mobilisation from the Public
1 Feb 2002	Letter	Director NBFI	CEO	Exposure to Konkola Copper Mines and Mopani Copper Mines
7 Aug 2002	Letter	Director NBFI	CEO	MFI 2
26 Aug 2002	Letter	Director NBFI	CEO	Invitation to opening of Lusaka Branch
3 Sep 2002	Letter	Director NBFI	CEO	Transfer of Licence
9 Sep 2002	Letter	CEO	Director NBFI	Transfer of Licence
12 Sep 2002	Letter	CEO	Director NBFI	Change of Name
17 Sept 2002	Letter	CEO	Director NBFI	MFI 2 Limited
8 Apr 2003	Letter	Director NBFI	Board Chairperson	CEO MFI 2
14 Apr 2003	Letter	Board Chairman	Director NBFI	CEO MFI 2
6 June 2003	Letter	Interim CEO	MFI 2 Board Member and MFI 2 Chairperson	Attachment to MFI 2 in position of interim CEO
9 June 2003	Letter	Director NBFI	Board Chairperson	Various issues pertaining to MFI 2 Limited

AD = Assistant Director, BS = Bank Supervision, FA = Financial Analysis, RP = Regulatory Policy

Appendix 10: The UK RIA framework

RIA Template

Sections 1-8

1. **Title of proposal**
2. **Purpose and intended effect**
   - **Objectives**
   - **Background**
   - **Rationale for government intervention.**
3. **Consultation**
   - **Within government.**
   - **Public consultation.**
4. **Options**
5. **Costs and benefits**
   - **Sectors and groups affected.**
   - **Benefits.**
   - **Costs.**
6. **Small Firms Impact Test**
7. **Competition assessment.**
8. **Enforcement, sanctions and monitoring**

Sections 9-12

9. **Implementation and delivery plan.**
10. **Post-implementation review.**
11. **Summary and recommendation**
12. **Declaration and publication**

Source: http://www.cabinetoffice.gov.uk/regulation/ria/documents/word/ria_template.doc

The UK framework is divided into 12 sections as shown in Figure 2. Section 1 of the RIA contains the proposal title including any document reference. This is followed by section 2, 'Purpose and Intended Effect', in which the objectives of the measure are spelt out, clearly, concisely and as specifically as possible, the background to the problem is set out, in brief, and the consequences if there is no government action.

Section 3 covers consultation. Consultation is an essential component of the RIA, thus forming an integral part of the process[1]. As such, consultation, whether formal or informal, continues throughout and facilitates the gathering of information about the policy proposal, including the options available, potential costs and benefits, and the likely risks involved[2]. Consultation should be done both within government and with the public and cover as large a cross section of stakeholders as possible, including other policymakers and specialists (e.g. economists, statisticians, social researchers, etc). Consultation methods include meetings and interviews, listening events, public surveys and FGDs. Consultation is a cost effective source of data on matters such as the acceptability of a policy, essential information in determining

[1] The RIA guidance given by Cabinet Office recommends that a minimum of 12 weeks be allowed for the consultation process.

[2] There are a number of advantages to consultation. Firstly, it may highlight unintended consequences of the policy proposal. Secondly, greater public participation leads to greater 'public buy-in' to the proposal. Lastly, it provides the public with an opportunity to contribute towards policy development (Cabinet Office guidance notes on Consultation).

the practicability of a regulation and designing compliance and enforcement strategies (Rodrigo, 2005).

The different options, including 'do nothing' and alternatives to government regulation, are listed in section 4[3]. In addition, this section also covers the advantages and disadvantages of each option. Section 5, "forms the main analytical component of the RIA" and provides "evidence to support *the* final recommendation and … determine whether the benefits from the policy options justify the costs"[4]. Although it is often very difficult to quantify the benefits, it can not be automatically assumed that the benefits outweigh the costs and, thus, do not need to be valued. An assessment of the expected benefits is, therefore, one of the most essential and challenging aspects of an RIA. Although the monetisation of benefits may not always be possible, a structured analysis of benefits facilitates a more robust comparison between options (Department of the Taoiseach, 2005: 23). To determine whether the proposals are genuinely more beneficial, only additional costs and benefits to those which would have been incurred if no action were taken are included when making the assessment. Where it is not possible to quantify costs and benefits, a detailed qualitative description of those elements that can not be quantified are given[5].

Section 6 of the RIA covers the Small Firms Impact Test (SFIT) and is a consideration of the impact the proposals will have on small firms followed by the competition assessment[6] in section 7 of which there are 2 stages. The first stage involves the application of the competition filter test to the policy proposal. This stage helps identify any effects, good or bad, on competition and determines whether a simple or detailed assessment will be needed to be carried out in stage 2.

Section 8 of the RIA covers issues of enforcement, sanctions and monitoring. To be effective the policy proposal needs to be enforceable. Some considerations in relation to enforcement are "how the regulations will be enforced, whether different policy options require different enforcement regimes, how different enforcement regimes would affect compliance and costs, how patterns of compliance affect costs and benefits, and the sanctions that would apply in

---

[3] The 'do nothing' option provides a reference point for the assessment of all other options and an opportunity to consider whether the policy objective(s) can be achieved using existing powers. Alternatives to government regulation include self regulation, co-regulation, information and education campaigns, codes of practice, other mechanisms (e.g. public information registers, mandatory audits and quality assurance schemes), just to mention a few (Better Regulation Task Force Report, Alternatives to Regulation).

[4] Cabinet Office RIA Guidance notes, http://www.cabinetoffice.gov.uk/regulation/ria/documents/word/ria_template.doc

[5] " Although often used colloquially to simply refer to the identification of costs and benefits, CBA, in the sense in which it is formally used, refers to a rigorous and technical analytical process where all costs and benefits, both market and non-market, are identified, quantified and evaluated on a common monetary scale to assess whether benefits of a proposal/project exceed costs" (Department of the Taoiseach, 2005: 22)

[6] Competition refers to the ability of firms within a sector to compete with each other and the consequences of this for microfinance clients (as opposed to competitiveness – the ability of all firms within a sector to compete with equivalent firms in a similar sector elsewhere). Regulations can prevent markets from working well when they impact adversely on competition. For example a regulation that deters potential new entrants into a market, introduces distortions between existing competitors, reduces innovation, or changes firm's behaviour in other related activities may lead to higher prices and reduced choice for the consumer. Regulations can impact on competition in a number of ways, for example by:

- directly affecting firms' costs, availability of resources or requirements of customers, e.g. by changing cost structures;
- directly specifying what product or service must be produced, e.g. by specifying a minimum standard for a product; and
- directly impacting in how firms compete in a market, e.g. by preventing new firms from entering a market. (Cabinet Office Guidance notes).

the event of non-compliance" (NAO, 2004: 7). The RIA should also cover "how the regulation and its effects are to be measured and monitored, and describe the reviews and evaluations which will be used to judge how far the regulation is achieving defined objectives" (NAO, 2004: 7). Section 9 covers the implementation and delivery plan and details how the policy proposal will be implemented[7], the time frame for implementation, and the body responsible for implementation, with consideration of resource requirements and costs for all parties directly affected, the activities to be undertaken by those affected, and how compliance will be checked and monitored. Section 10, Post-Implementation Review, outlines how the policy proposal will be reviewed and when. At the RIA stage, this section simply provides the plan for how this review will be done and sets out the criteria to be used for the assessment. The evidence and analysis discussed in earlier sections of the RIA are summarised in Section 11. It is in this section that the recommendation with justification is made and an explanation provided of why the other options were not chosen. Section 12 contains the Ministerial Declaration[8].

[7] In the UK, there is a 12 week implementation period for all new regulations to give reasonable time to those affected to prepare for any changes between guidance being issued and proposals taking effect (Cabinet Office RIA Guidance notes).

[8] The 'responsible' Minister signs off the RIA making it final. The final RIA is then published on the Department's website in a central place where it is easy to find and copies placed with both Houses of Parliament (Cabinet Office Guidelines notes).

Microfinance Survey 2004

Institutional details

1. Institution name…………………..…………………………………………………
2. Physical Address of head office…...……………..……………………..………….
3. P O Box…..……………………..………………………………………..………...
4. Tel……………………………..………………………………………………….
5. Fax……………………………...………………………………………………
6. Email…………………………..……………………………………..……………
7. Date of creation/formation……………………….………………………………

8. Is your organisation registered? Yes ( ) No ( )
9. If yes, what is it registered as:
   Society ( )
   Cooperative ( )
   Limited company ( )
   Sole proprietorship/partnership ( )
   Other (please specify)……………………………………………..…………….
10. Date registered……………………………………………………………………

11. For institutions not solely dedicated to the provision of microfinance services, % of portfolio dedicated to microfinance…………………………………………………

12. Areas of operation:

Current/previous/ future*	City/town	Province	Number of branches

* planned within the next 3 years

13. Is your organisation a non-profit making organisation? Yes ( ) No ( )

Regulation of MFIs

14. Does the agency with which you are registered require any reporting?

    Yes ( )   No ( )

15. If yes, what information are you required to report? To whom? Please indicate frequency (daily, monthly, yearly, etc).

	To whom	Frequency
Financial statements		
Audited accounts		
Cashflow projections		
Donor inflows/statements		
Operation manuals		
Other (please specify)		

16. Is your organisation currently supervised by any agency for the delivery of financial services? Yes ( )   No ( )

17. If yes, which one?
    Bank of Zambia ( )
    Registrar of cooperatives ( )
    Registrar of societies ( )

    Other (please specify)……………………………………………………………..

18. When was the last time the agency contacted you?
    Within the last month ( )
    Within the last quarter ( )
    Within the last six months ( )
    Within the last year ( )

    Other (please specify)……………………………………………………………….

19. When was the last time the agency visited you?
    Within the last month ( )
    Within the last quarter ( )
    Within the last six months ( )
    Within the last year ( )

    Other (please specify)……………………………………………………………..

20. When was the last time the agency asked you for information?
    Within the last month ( )
    Within the last quarter ( )
    Within the last six months ( )
    Within the last year ( )

    Other (please specify)……………………………………………………………..

21. What information was requested?
    Financial statements ( )
    Audited accounts ( )
    Cashflow projections ( )
    Donor inflows/statements ( )
    Organisational operations manuals ( )

    Other (please specify)……………………………………………………………..

22. Do you think the microfinance industry should be regulated?

    Yes ( ) No ( )

23. Please explain you answer……………………………………………..……………

…………………………………………………………………………………………………

…………………………………………………………………………………………………

…………………………………………………………………………………………………

………………………………………………………………………………

If you answered no to question 22, please go to question 32.

24. Who should the regulator be?
    Bank of Zambia ( )
    Registrar of cooperatives ( )
    Registrar of societies ( )
    Registrar of corporations ( )
    Ministry of finance ( )
    Donors ( )

    Other (please specify)……………………………………………………………..

25. How often should the regulator visit you?
    Every month ( )
    Every quarter ( )
    Every year ( )

    Other……………………………………………………………………………..

26. What information should you provide the regulator with?
    Financial statements ( )
    Audited accounts ( )
    Cashflow projections ( )
    Donor inflows/investments ( )
    Organisational operation manuals ( )

    Other (please specify)…………………………………………………………..

27. How often should you report to the regulator?
    Every month ( )
    Every quarter ( )
    Every six months ( )
    Every year ( )

    Other (please specify)…………………………………………………………..

If the spaces provided are insufficient for your responses, please use a separate sheet of paper(s) and attach it to the questionnaire.

28. From your institution's experience, what are the major regulatory and supervisory related obstacles for providing financial services? ....

    …………………………………………………………………………………………
    …………………………………………………………………………………………
    …………………………………………………………………………………………
    …………………………………………………………………………………………
    ……………………………………………………………………..……………

29. What the major non regulatory and supervisory obstacles faced by your institution in the provision of financial services? …………………………..……………………

    …………………………………………………………………………………………
    …………………………………………………………………………………………
    …………………………………………………………………………………………
    …………………………………………………………………………………………
    …………………………………………………………………

30. What do you think are the likely benefits to the following of the having the microfinance industry regulated

Government……………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
………………………………………………………………

Microfinance institutions……………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
…………………..……………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………

Clients…………………………………………………………………………………
……………………………………………………………………………………………
……………..………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………..

Investors………………………………………………………………………………
……………………………………………………………………………………..…
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
………………………………………………………………

31. Do you plan to license your organisation after the draft Microfinance Regulations are passed? Yes ( ) No ( )

Please give reasons…………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………………………
……………………………………………………………………………

Ownership and governance

32. Who are the owners of the organisation?

NGO	( )
Members	( )
Company	( )
Individuals	( )
Other	( )

33. What are your funding sources? Please indicate percentages.

Donor funds	( )	…………………
Deposits	( )	…………………
Commercial loans	( )	…………………
Government	( )	…………………
Equity	( )	…………………
Other (please specify)	( )	…………………

Management and staffing

34. What is the percentage of staff dedicated to the provision of:

Financial services……………………………...………………….

Social services……………………………………………………….

Other services (please specify)………………………………………

35. Size of the institution

	2003	2002	2001	2000	1999
Total no. of staff					
No. of loan officers					
No. of borrowers					
Total no. of loans outstanding					
Total value of loans outstanding					
Portfolio at risk					
Repayment rate					
Total assets					
No. of savers					
Value of savings					
Profit/loss					
Shareholders/members' equity					
Liabilities					
Retained earnings					

If information is available for previous years, please provide it as well.

36. Total number of loans disbursed to date………………………………..

Client profile

37. Total number of active clients ………………….

38. Clientele (percentage of total):

Female …………..………

Urban ….….…………….

39. How do you select your clients?
    Poverty levels ( )
    Gender ( )
    Locality ( )
    Interest in the program ( )
    Prior experience in business ( )

    Other (please describe)…………………………………………………………..

40. To select clients, is information from the following sources used?
    Financial statements ( )
    Credit histories ( )
    Village/community leaders ( )
    Friends/relatives ( )
    Employers/business people ( )
    Credit group selection of eligible members ( )

    Other (please specify)…………………………………………………………..

Services

41. What loan products does your institution offer?
    Agricultural loans ( )
    Manufacturing loans ( )
    Housing loans ( )
    Trade/commercial loans ( )
    Consumption loans ( )
    Loans to repay existing loans ( )

    Other (please specify)……………………………………………………………

42. What other financial services does your institution provide?
    Savings ( )
    Money transmission ( )
    Insurance ( )
    Purchase/sale of foreign currency ( )

    Other (please specify)……………………………………………………………

43. Is there any training prior to lending? Yes ( ) Duration…………………
    No ( )

Loan Characteristics

44. Lending methodology

    Group ( ) Average group size: min…….. max……. avg……

    Individual ( )

    Other (please specify)……………………………………………………………….

45. What is the period between a client joining and their first loan?

    min …..…. max …..… average …..….

46. Do you require collateral? Yes ( ) No ( )

47. If yes, what collateral do you accept?
    Forced savings ( )
    Vehicles ( )
    Land ( )
    Animals ( )
    Household goods/furniture ( )
    Personal guarantees ( )
    Group guarantees ( )

    Other (please specify)…………………………...………………………………

48. Is there a waiting period between repayment and the disbursement of a subsequent loan?
    Yes ( ) No ( )

49. Loan activity

	Number	Outstanding balances
Total		
Individual		
group		

50. Loan characteristics

	minimum	maximum	average
Loan size			
Annual interest rates (for 2003)			
Loan terms (duration-indicate days, months or years)			
Repayment frequency			

51. Do you give loans to:
    Staff ( )
    Board ( )
    Their relatives ( )

52. Current loans with late repayment (at least 30 days late?)

	Number	Balance
Total		
Individual		
Group		

53. When do you classify a loan as delinquent?..
    ………………………………………………………………………………………………
    ………………………………………………………...…………………….

54. Are there any penalties for the early payment or prepayment of loans?
    Yes ( ) No ( )

Deposit characteristics

55. Deposit accounts

	Number	Balance
Compulsory		
Voluntary		

56. Annual interest rate on deposit accounts

Minimum………………… Maximum…….…….……. Average………..……….

57. Are clients required to make forced savings? Yes ( ) No ( )

58. How much is a client required to save before a loan is disbursed?...........................

59. Where are clients' savings kept? ……………………………………………….…...

60. Can clients withdraw their forced savings? Yes ( ) No ( )

61. If yes, under what circumstances?

Family emergency ( )

Invest in business ( )

No specific reason ( )

Other (please specify)………………………………………………………………

62. Are savings/deposits used for onward lending? Yes ( ) No ( )

Respondent details

In order to enable the researcher follow up on some of the responses, kindly complete the section below. This is optional and entirely for research purposes only.

Name of respondent…………………………………………………………………….

Position………………………………………………………………………………….

Tel/fax…………………………………………………………………………….......

Email……………………………………………………………………………………

Appendix 12: Zambia's main economic policy regimes, 1964 – 2002

Zambia's policy regimes can be divided into four main periods.

Free market policies (1964-72). During this period political and economic policies were liberal, with little or no state controls and a focus on providing infrastructure and services. High and rising export receipts from copper enabled a spectacular build-up of the economy's capital stock.

State control (1973-84). By the mid-1970's, Zambia had become a classic public sector-led economy with excessive controls, parastatal monopolies, and a pro-urban, anti-agricultural bias. The government created a large number of parastatals in mining, telecommunications, energy, finance, and agri-business, which together produced about 80% of Zambia's GDP and employed about 140,000 workers in 1991. The Government actively supported industrialisation by maintaining an overvalued exchange rate to promote imports of capital equipment and intermediate goods and by protecting local producers with high tariffs on finished goods. In 1974-75, the Government began subsidising maize, a practice that continued until the early 1990s, with increasingly negative effects on the fiscal balance. The Government dramatically increased its foreign borrowing to compensate for the steep decline in the international purchasing power of copper since 1975.

Economic transition (1985-90). This period was characterised by the introduction of unsustained stabilisation and structural adjustment policies. Significant measures were undertaken in 1985-88. In May 1987, however, the Government abandoned earlier agreements with the International Monetary Fund (IMF) and the World Bank and reimposed numerous controls, after political discontent resulted in food riots in the Copperbelt. In June 1989 the Government decontrolled all consumer goods prices except the price of maize. However, the Government's commitment to reforms was compromised by printing money to fund civil service pay increases and the election campaign.

Stabilisation and structural adjustment (1991-2002). During this period the Government actively pursued policies that facilitated private sector growth, including price, trade, exchange, and interest rate policies; financial sector liberalisation; and more responsible fiscal and monetary policies. Agriculture output and input markets were liberalised, significant privatisation and other institutional reforms were undertaken.

Source: WB (2004: 3)

Appendix 13: Conditions for opening a savings account with major financial institutions

Institution	Minimum balance	Bank charges	Documentation
African Banking Corporation	K20,000	2% of interest per year.	• Application letter • 2 passport size photos • Proof of identity (e.g. national registration card (NRC), passport, driver's licence, etc) • Proof of source of funds (e.g. payslip, bank statement, etc) • Proof of residence(e.g. utility bill, lease agreement) • Reference (e.g. from existing account holder, management, employers, current banker, etc)
Bank of China	K1 million	K25,000 per month as ledger fee	• Application letter • 2 passport size photos • Proof of identity • Proof of source of funds • Proof of residence • Reference from business partners, management, employers, person of high repute, current banker, etc
Barclays Bank	K750,000	No bank charges	• 2 passport size photos • Reference letter from account holder • Letter of application • Identity i.e. NRC/passport • Water, phone or electricity bill (proof of residence)
Cavmont Capital Bank	K200,000	K5,000 per month	• Application Letter • 2 passport size photos • 2 references • Proof of identity • Proof of residence
Finance Bank	K100,000	K5,000 per month	• Application Letter • 2 colour passport size photos • 2 references • Proof of identity
Finance Building Society	K50,000	K7,500 per month	• Application Letter • 1 passport size photo • Proof of identity
Indo Zambia Bank	K250,000	No bank charges but K10,000 is charged per month on overdrawn accounts	• Application Letter • 2 passport size photos • Reference • Proof of identity • Proof of residence

Institution	Minimum balance	Bank charges	Documentation
Intermarket Discount House	K1 million	No bank charges	• Application Letter • 2 passport size photos • Proof of identity • Proof of source of funds • Proof of residence • Reference
Investrust Bank	K150,000	No bank charges	• Application Letter • 2 passport size photos • Reference letter • Proof of identity • Proof of residence
National Savings And Credit Bank	K50,000	K7,500 per month	• Application Letter • 2 passport size photos • 2 reference letters • Proof of identity
Pan African Building Society	K100,000	K10,000 per month	• Application Letter • 1 passport size photo • Proof of identity
Stanbic Bank	K300,000	No bank charges but K20,000 is charged per month on overdrawn accounts	• Application Letter • 2 passport size photos • Reference letters • Proof of identity • Proof of residence
Standard Chartered Bank	K750,000	Ranges between K10,000 and K100,000 depending on activity of account	• Application Letter • 3 passport size photos • 2 reference letters • Proof of identity • Proof of residence
Zambia National Building Society	K100,000	K7,500 per month	• Application Letter • 2 passport size photos • Reference letter • Proof of Identity
Zambia National Commercial Bank	K200,000	K,5000 per month	• Application Letter • 2 passport size photos • 2 reference letters • Proof of identity • Proof of residence

Source: Field work, September 2004
Note: Citibank and the First Alliance Bank do not provide retail banking

Appendix 14: Definitions of microfinance in selected countries

Africa
Ethiopia Proclamation 40/1996 defines microcredit as "an activity of expending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs."
Kenya Providing loans to micro or small enterprises and low-income households; receiving deposits for on-lending. Small loans are equivalent to GDP per capita to a single end borrower (Microfinance Bill 2002).
Tanzania Microcredit means a credit whose security may include non-traditional collateral, granted to a natural person, individually or in a group, whose income depends on her own business or economic activity and who may lack formal financial statements or other accounting and operational records (Microfinance Companies and Micro Credit Activities Regulations of 2004).
Uganda Principal business: Accept deposits and employ such deposits by lending, including the provision of short-term loans to micro-enterprises & low-income households, usually characterized by the use of collateral substitutes. Short-term loans are defined as those with less than a two-year maturity, and small loans are constituted as less than 1% of core capital for individual borrowers and less than 5% of core capital for group borrowers (MDI Act, Section 2).
Asia
Bangladesh Any loan for less than US $171 (10,000 BDT) and repayable within less than 12 months, regardless of the name given to the loan (see BRPD Circular No. 16 dated December 06, 1998 effective from January 01.1999).
Indonesia Generally defined by loan amount ceilings and self-selected clientele. Not explicitly defined in legal text.
India Providing small amounts of thrift, credit, and other financial services and products to the poor in rural, semi-urban or urban areas for income generation
Philippines Central Bank of the Philippines Circular No. 272 (2001) defines microfinance as small loans given to the poor and low-income houses to raise income levels and living standards. Loans are unsecured and based on cash flow analysis and do not exceed US $2,667 (150,000 PHP). The schedule of loan amortizations and the terms and conditions of the loan should take the borrower's projected cash flow into consideration. Hence, microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis.
Latin America
Bolivia Microcredit: All loans granted to a borrower or group of borrowers that uses a solidarity guarantee for financing productive activities.
Columbia Financing provided to microenterprises (i.e. with 10 or less employees and total assets of less than 501 minimum monthly wages; currently: US S67,635). If such financing is provided by any financial intermediary or any organization specialized in microcredit, and the maximum credit per customer is equal to or less than 25 minimum wages (US $3,375), the law authorizes charging fees (deemed technical assistance cost) and commissions (deemed as cost of credit review and loan collection cost) that are not considered as interest. Interest on other loans outside this category is limited by the usury laws (Commercial Code, Art.884). Same ability to charge fees is applicable to Real Estate Microcredit, i.e. mortgage financing less than 25 minimum wages, with less than five year terms and a social housing soft interest rate (Financial System Organic Statute (Decree 663 of 1993) and Financial Reform Law 795 of 2003)
Peru Banking Supervision (SBS) defines micro assets and credits as less than $30,000 (Resolution 808-2003). CMACs: Financial services for persons and enterprises without access to formal financial intermediaries.
Mexico According to the Office of the Secretary for the Economy, microfinance provides small loans (microcredits) to the poorest families, in order to support them economically in productive activities (business, self-employment).

Source: http://microfinancegateway.org/resource_centers/reg_sup/micro_reg/country (accessed Wednesday, 15 April 2006, 21.00 hours)

Appendix 15: Analysis of the Draft Microfinance Regulations

Overview

Overall, the DMFRs do not contain any provisions that radically modify the requirements of the principal Act, the BFSA 2000, and, more often than not, serve to reiterate them. Where the DMFRs are silent on a particular matter, the provisions of the principal Act apply. The salient features of the DMFRs are described below and summarised in the table.

Licensing

Sustainability

The DMFRS do not outline the criteria that the Registrar shall take into consideration when evaluating a licence application. Therefore, the provisions of the principal Act apply and include assessing the sustainability of the financial institution[9]. MFIs will have one month to apply for a licence after the DMFRs come into effect[10]. Most MFIs are heavily reliant on donor grants or loans at interest rates that are generally lower than ruling market rates, and even then, most are not financially viable. Those institutions that will not be financially self sustainable in a 'reasonable' period would have to cease operating, as they would not be granted a licence. Therefore, enforcement of the law would result in a number of MFIs going out of business.

Commencement of operations

MFIs are required to commence operations within 3 months of being granted a licence, 9 months less than for financial institutions licensed directly under the BFSA 2000. Thus the DMFRs are stricter in this respect, and may have a negative impact on the microfinance sector[11].

Permissible services

Deposit taking MFIs are restricted to providing credit facilities, linkage banking, in-country transfers and compulsory savings. Although there is provision for BOZ to prescribe other services that MFIs may provide, no proposals had been made at the time of writing. NDT MFIs may only provide credit facilities. The range of services that can be provided under the DMFRs is narrower than that provided for under the BFSA 2000. The provisions of the DMFRs severely constrain service provision by MFIs and will most likely stifle growth. Overall the impact is likely to be negative.

---

[9] Section 7(e) states that "in deciding whether or not to grant a *financial institution's* licence, …, the Registrar shall have regard to – (e) the prospects for profitable operation of that business."

[10] Regulation 54(1).

[11] It is not clear if applicants would have to submit another licence application if operations did not start within the legislated timeframe.

Classification of forced savings as deposits

Other than shortening the definition, the DMFRs make no variation to the definition contained in the principal Act[12] and the wording is practically identical. Cash received as collateral, whether it is referred to as 'forced savings', 'compulsory savings' or 'loan insurance fee', is classified as deposit. So although there is no difference to the status quo, it is felt that the Regulations will clarify the treatment of 'cash collateral'[13].

Capital requirements

Minimum capital requirement

The amount proposed, as indicated in Form MF7 of the DMFRs, is K250 million for deposit taking MFIs and K25 million for NDT MFIs.[14] This was confirmed by various discussions with BOZ officials. Under the principal Act, DT financial institutions are required to have a minimum (regulatory) capital of K2,000 million, leasing companies, K250 million and other NBFIs, K25 million.

The lowering of the capital requirement should have a positive impact on the microfinance sector compared to the status quo. More organisations should be able to satisfy the lower capital requirement resulting in fewer closures due to insufficient capital levels and a higher number of MFIs entering the market than would be the case otherwise.

Ownership and control

Legal form and controlling interest

The DMFRs make a distinction between DT and NDT MFIs. Deposit taking MFIs must be companies[15] and voting control is limited to a maximum of 25% per shareholder unless Bank of Zambia approval is obtained to control more[16].

NDT MFIs are permitted to have a number of different legal forms. They can be companies, NGOs registered with the Registrar of Societies, or cooperatives[17]. However, if the MFI is registered as a company, then voting control is limited to 50% per shareholder unless BOZ approval is obtained to control more[18].

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[12] Regulation 2 of the DMFRs defines a deposit as "an amount of money paid to a microfinance institution in respect of which; (1) an equal amount or any part thereof is conditionally or unconditionally repayable …".

[13] At the moment, BOZ is unsure of how to treat cash collateral as revealed by the case studies. However, through discussions with BOZ officials, it was clear that they felt this uncertainty would be removed with the DMFRs coming into effect.

[14] Regulation 29 which relates to capital adequacy states that "the Bank shall prescribe the primary and regulatory capital of a microfinance institution." At the time of writing, BOZ did not have a draft prescription ready prepared but the proposed amounts were reflected on the attached schedules to the DMFRs.

[15] Regulation 39(1).

[16] Regulation 39(2) states that "a person shall not, without prior approval in writing from the Bank of Zambia; (a) acquire a beneficial interest in the voting shares of a deposit taking microfinance institution; or (b) enter into any voting trust or other agreement, that would enable that person or another person to control more than 25% of the total votes that could be cast on any general resolution at a general or special meeting of a deposit taking microfinance institution".

[17] Regulation 39(3).

[18] Regulation 39(4) states that "a person shall not, without the prior approval in writing of the Bank of Zambia (a) acquire a beneficial interest in the voting shares of a deposit taking microfinance institution; or (b) enter into

Furthermore, the DMFRs are silent on matters of controlling interest in MFIs with a legal form other than that of a company. Under the principal Act, NBFIs, regardless of whether they provide deposit facilities, may take any legal form, including sole proprietorship. So, in relation to matters regarding the ownership and governance structure of MFIs, the DMFRs are stricter.

Trust ownership

The DMFRs are silent on the issue of whether trusts can own shares or have any beneficial interest in the MFIs. This means, that the provisions of the principal Act apply. This provision will have a negative impact on the industry as trusts are the preferred investment vehicle for most donors as noted in the previous chapter.

Board of directors and senior management

The main differences between the DMFRs and the BFSA are that under the DMFRs, the governing body must have a minimum of 3 members compared to 5, the appointment of the members must be approved by BOZ, and the governing body must meet at least 4 times a year. Thus, in relation to the number of members in the governing body, the DMFRs are more lenient but stricter with regards to other provisions. There is still a requirement to have separate individuals as the CEO and CFO.

Reporting requirements

The proposed reporting schedules under the DMFRs are listed in Box 1[19]. Although the reporting frequency has not been indicated on the schedules, BOZ proposes to have DT MFIs submit reports on a monthly basis and quarterly for NDT MFIs. The number of reports is fewer than those that are required to be submitted under the BFSA 2000 and not as detailed in some cases. However, reporting requirements are still considered onerous, especially for the smaller MFIs.

Box 1: On going reporting schedules

Balance sheet
Income statement

Schedule 1	Distribution of loans and advances
Schedule 2	Classification and provisioning of loans and advances
Schedule 3	Insider lending exposures
Schedule 4	Calculation of risk weighted assets
Schedule 5	Computation of capital position
Schedule 6	Large loan exposures
Schedule 7	20 largest loans and advances

any voting trust or other agreement, that would enable that person or another person to control more than 50% of the total votes…".

[19] The relevant provision is regulation 42 which states that "the Bank of Zambia shall prescribe the reporting formats and frequency of reporting for microfinance institutions, …".

Table: Salient features of the Law

BFSA 2000	Draft Microfinance Regulations	Comment
Definitions *Financial institution* • A person other than a bank conducting a financial service business. Financial service includes any of the following: • Commercial or consumer financing services; • Credit reference services; • Deposit brokering; • Factoring with or without recourse; • Financial or finance leasing; • Financing of commercial transactions; • The issue and administration of credit cards, travellers cheques or bankers drafts; • Issue of guarantees, performance bonds or letters of credit; • Lending on security of or dealing in mortgages or any interest in real property; • Merchant banking services; • Money transfer or transmission services or the payment of cheques other than demand payment orders drawn or issued by customers and payable from deposits held by the payer; • Purchase and sale of foreign exchange; • Issuance of debentures and money market instruments and the acceptance of …term deposits, other than current accounts and chequing deposits; • Issuance of building society and mutual society shares, having characteristics similar or identical to that of deposits; • Venture capital funding; • Secured or unsecured credit services; • Any other service as BOZ may designate	**Definitions** *MFI* • A person who as part of its business advances micro credit facilities. Micro credit • A credit facility that is not more than 5% of the primary capital of a licensed MFI as prescribed by BOZ or 111 fee units whichever is lower. Microfinance service • The provision of services primarily to small or micro enterprises and/or low income customers and includes (a) the provision of credit facilities usually characterised by frequent repayments and (b) the acceptance of remittances and any other services that BOZ may designate Low income customer • Economically active low income persons who generally do not have access to formal financial institutions. Compulsory savings • A sum of money provided by the borrower for a period of the loan as partial guarantee or as a precondition of the loan. DT MFIs may provide any of the following services: • Credit facilities; • Linkage banking; • In-country transfer; • Compulsory savings; and • Any other service BOZ may prescribe. NDT MFIS may only provide credit facilities.	The DMFRs are more restrictive as NBFIs are permitted to provide a wider range of financial services than MFIs.
Deposit • (a) "An amount of money paid to a bank or FI in respect of which (i) an equal amount or part thereof is conditionally or unconditionally repayable with or without a premium…". • (c) "money received or held by a bank or FI … in the usual course of	*Deposit* • "An amount of money paid to a MFI in respect of which (1) an equal amount or any part thereof is conditionally or unconditionally repayable …"	The DMFRs does not make any change to the definition.

BFSA 2000	Draft Microfinance Regulations	Comment
business for a special or specific purpose … including (i) escrow funds and funds held as security for an obligation due to the bank or financial institution".		
Licensing • 180 days for Registrar to determine the application. • Registrar must consult the Minister of Finance in determining the application. • Non-transferable. • May be revoked if FI does not commence operations within 12 months of being granted the licence. • Must display statement of licensed status.	**Licensing** • 180 days for Registrar to determine the application. • No requirement to consult the Minister. • Non-transferable. • May be revoked if MFI does not commence operations within 3 months. • Copy of the licence must be displayed in every place of business.	The DMFRs are more restrictive as MFIs are required to start operations within 3 months of being granted a licence compared to 12 months for NBFIs.
Capital requirements • Minimum capital requirements for: ➢ DT FIs = K2,000m ➢ NDT FIs = K25m ➢ Leasing companies K250m • Tier 1 capital = or > 5% • Total Regulatory capital = or > 10%	**Capital requirements** • Minimum capital requirements for: ➢ DT FIs = K250m ➢ NDT FIs = K25m[20] • Tier 1 capital = or > 5% • Total Regulatory capital = or > 15%	The DMFRs are more lenient as the minimum capital requirement is lower but more restrictive as the minimum regulatory capital requirement is higher.
Ownership and control • Any legal form permitted whether the FI accepts deposits or not. • If it's a company, 25% limit on share ownership. • Trusts not permitted to own shares.	**Ownership and control** • DT MFIs must be a company with controlling interest limited to 25% per shareholder. • NDT MFIs may be a company, NGO[21], or cooperative. • For DT MFIs that are companies, the controlling limit is 50% per shareholder. • A "person" may not control more than one MFI.	The DMFRs are more restrictive in terms of legal form and ownership structure for financial institutions which accept deposits. The BFSA is silent as to whether a person can 'own' more than one FI.
Board of directors and senior management • Minimum of 5 directors, the majority of whom are non-executive directors. • Must have a CEO and CFO who are separate individuals. • May only be a director of one FI.	**Board of directors and senior management** • Minimum of 3 directors. • The board must meet at least 4 times a year. • Must have a CEO and CFO who are separate individuals. • Must obtain BOZ approval for appointments to the board and senior management.	The DMFRs are more lenient in relation to the number of directors but stricter in relation to other requirements.
Branching • FIs may operate anywhere in the Republic. • 14 days notice required to open a branch. • 60 days notice required to close a	**Branching** • MFIs may operate anywhere in the Republic. • 14 days notice required to open a branch. • 60 days notice required to close a	Under the DMFRs, it is more expensive for MFIs to open a branch.

[20] The minimum capital and regulatory capital are to be prescribed by BOZ. The proposed amounts are contained in the attachments to the DMFRs.
[21] Registered with the Registrar of Societies.

BFSA 2000	Draft Microfinance Regulations	Comment
branch. • No fees to open a branch.	branch. • Payment of fee for each additional branch to be opened.	
Customer rights • Must have procedures in place for customer complaints.	**Customer rights** • Must display in all places of business, customers' rights and responsibilities.	The DMFRs are more onerous.
Disclosure • Must disclose interest rates and charges for both deposit accounts and credit facilities[22].	**Disclosure** • Must disclose the cost of borrowing on prescribed MFI Form 5. • Clear, simple summary of the MFI's business. • Financial products on offer and the terms under which they are offered.	The DMFRs are more onerous as more disclosure is required and the provisions are more prescriptive.
Reporting requirements • Submit monthly reports to BOZ. • Publish quarterly financial statements in a paper of general circulation • Quarterly financial statements to be displayed in every branch. • Financial statements to be sent to every shareholder and BOZ every quarter. • Submit audited financial statements to BOZ and shareholders within 3 months of the financial year end.	**Reporting requirements** • Submit monthly reports for DT MFIs, quarterly reports for NDT MFIs, to the BOZ. • MFIs to submit audited FS or management accounts to the BOZ, shareholders and 'interested parties'. • Disclose intentions to enter into any significant arrangement 30 days prior to the proposed arrangement. • Display balance sheet and income statement on business premises.	The DMFRs are slightly more lenient in terms of the amount of detail required and frequency of reporting. However, the DMFRs are more onerous in relation to the disclosure of 'significant arrangements'.
Reserves • FIs required to transfer specified amounts to reserves before payouts to shareholders. • Maintenance of special reserve or liability insurance.	**Reserves** • No provisions[23]	No change.
Liquidity • Maintenance of minimum liquid assets as prescribed by the BOZ[24]. • Maintenance of prudential liquidity ratio.	**Liquidity** • Maintenance of minimum liquid assets as prescribed by the BOZ[25].	None
Large loan exposures • Limited to 25% of regulatory capital.	**Large loan exposures** • Limited to 5% of paid up capital, whichever is lower.	The DMFRs are more restrictive as the limit is lower.

[22] SI No. 179, the Cost of Borrowing Regulations and SI No. 183, the Disclosure of Deposit Charges and Interest Regulations.
[23] Where the regulations are silent, the provisions of the principal Act apply.
[24] No minimum has been prescribed as yet.
[25] No minimum has been prescribed as yet.

Appendix 16: The cooperative sector in Zambia

Cooperatives have not played a significant role in the development of microfinance in Zambia. This has been due to the fact that, historically, cooperatives were used by Government as vehicles for development in rural areas, mainly in agriculture. Secondly, after the changes in government policy in the early 1990's, most cooperatives failed to adjust to the new political and economic environment, resulting in a number of cooperatives becoming defunct. Those that 'survived' have inappropriate corporate structures and culture, are in poor financial condition, and lack adequate skilled personnel.

Background

The first cooperative[26] in Zambia was established in 1914. After independence in 1964, Government viewed cooperatives as a way to stimulate rural development and "not necessarily as economic institutions fulfilling member needs" (SCC, 2002: 5). Cooperatives were incorporated in national development plans and used by Government and donors as vehicles for development in rural areas. This position was consolidated with the enactment of the Cooperatives Societies Act of 1972 which gave extensive powers to the Registrar of Cooperatives and emphasised their social role. This served, however, to "undermine their cooperative identity and resulted in their being perceived, both by their members and the general public, as part of the government sector" (SCC, 2002: 6).

With the Government and donor support that was made available, primary societies mushroomed, increasing from approximately 500 prior to independence to over 1,000 by 1973. In April 1973, Government formed an apex body, the Zambia Cooperative Federation Limited (ZCF), to coordinate the development of the cooperative sector. As part of Government policy, provincial cooperative unions were formed in 1984. Their main function was to carry out agricultural marketing.

Thus, the cooperative sector during the second republic was characterised by: (1) the formation of cooperatives based on government incentives rather than a genuinely felt common need; (2) the lack of autonomy with cooperatives having to consult Government on matters which should have been decided by the Board of Directors; and (3) poor management, as most cooperatives operated as extended arms of Government, resulting in financial and operational mismanagement, insufficient capital, and overdependence on Government support and protection.

1991 onwards

With the change in Government in 1991, the era of Government sponsored and controlled cooperatives came to an end and Government's role shifted from direct involvement in the day-to-day activities of the cooperatives to providing an enabling environment for a market economy (MACO, 2002b). Preferential treatment and support was withdrawn. This contributed to the collapse of the cooperative sector which had failed to adjust to the new political and economic environment. Whereas, previously, Government had provided

[26] The International Cooperative Alliance (ICA) defines a cooperative as "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise" (http://www.coop.org). ICA is the international apex organisation established in 1895 to represent the interests of cooperatives globally.

financial aid, its role was now "restricted to creating an enabling environment for cooperative development through capacity building in the form of extension services and cooperative training and education" (President's speech in MACOa, 2002: 50 – 51). A new Cooperative Act was passed in October 1998, emphasising the autonomy of the cooperative sector and encouraging the formation of single purpose specialised apex organisations.

According to the baseline survey conducted in 2002-2003[27], cooperatives had a total membership of approximately 124,177, of which 66% were male and 34%, female. However, only 73,741 (59%) were active members as measured by those that were up to date with their membership subscriptions. The majority of cooperatives are involved in agricultural production and marketing (71%). Few are involved in non-agricultural activity. The services offered to members are the provision of technical (55%) and marketing information (39%), credit facilities (48%), and inputs (50%). Other services provided include extension services (39) and training (32%).

The cooperative sector is characterised by a lack of skills and expertise in the management of their activities. 42% of cooperatives reported that their accounts were not up to date at the time of the survey, making it difficult to interpret the data collected on their financial position. Based on data collected through documentary review, FGDs, interviews and various discussions with informants, particularly those involved in the cooperative sector[28], it is evident that most cooperatives are in poor financial condition, a situation exacerbated by institutional capacity problems such as: (1) poorly qualified personnel, both professional and support staff; (2) the lack of appropriate strategic planning on the part of cooperatives; (3) government interference in management; (4) inadequate capital; and (5) inappropriate corporate structures and culture. Moreover, it is also apparent that the cooperative sector is not actively involved in the provision of microfinance services. This may be due to a number of reasons. Firstly, historically, the focus of the cooperative sector has been on the provision of agricultural inputs and marketing of agricultural produce [DCO/M/2 (89-92), OSH/M/5 (27-29)]. Secondly, with the change in government, a substantial number of cooperatives became defunct [FG/D/24 (84-86), FG/D/24 (91-94), FG/D/24 (187-188)]. Lastly, those that are still in operation are severely cash constrained [DCO/M/9 (19)]. These factors have meant that the cooperatives have not played a significant role in the emergence of the microfinance sector.

[27] 2,244 cooperatives responded to the survey. However, responses from Northern Province went missing and, therefore, have not been included in the analysis.

[28] In addition to the interviews with the Registrar and Deputy Registrar of Cooperatives, informants included Mr Chirwa (ZCF), Ms P Mukumbuta (Country Coordinator, SCC), Mr M Lwaisha (Marketing and Cooperatives Officer, MACO, Mwinilunga), Mr D Sibakanya (District Agricultural Officer, MACO, Kawambwa), Mr S Kyanguba (Chairman, District Cooperative Union, Solwezi) and Mr Mutokolo (Manager, Mongu's Teachers Credit Union).

Appendix 17: The regulation and supervision of banking institutions

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The general model of bank regulation and supervision involves a set of detailed rules, usually set out in banking law, based on the framework set out in the Basle Committee's Core Principles for Effective Banking Supervision[29], in which bank supervisors evaluate a financial institution according to its capital, asset quality, management, earnings and liquidity (CAMEL).

Thus, banking institutions are required to maintain adequate capital levels which act as a cushion against losses. Capital adequacy is computed with reference to the risk profile of the banking institution's asset base in accordance with, at a minimum, the rules set out in the Basle Capital Accord, the minimum capital adequacy ratio being 4% for tier 1 capital and 8% for total capital[30]. The Capital Accord also sets out what 'form' of capital qualifies and is acceptable for inclusion in the computation.

Limits are placed on the maximum shareholding of any one individual and ownership is subject to a minimum number of shareholders in order to limit undue influence by dominant shareholders. In some countries, there are also legal restrictions on who is eligible to own financial institutions. So for instance, in some countries, NGOs can not be owners of financial institutions. With regard to management, regulations often stipulate minimum qualifications, both for senior management and the board of directors, and a separation of duties between the CEO and CFO.

The regulations of banking institutions often limit what can be lent out unsecured and in extreme cases, there is a requirement to make a 100% provision for unsecured loans, even before they become non-performing. Loans are deemed to be non-performing if a scheduled repayment of either principal or interest has not been received within 90 days. The definition of acceptable security is often limited and that which is deemed acceptable for microfinance (such as group guarantees) would not be considered acceptable security for a traditional banking institution. Loan documentation requirements for banking institutions, such as collateral registration, financial statements, evidence that the business (where applicable) is formally registered, are detailed and voluminous (and may prove practically impossible and expensive for microfinance clients to produce).

Supervisory tools often employed for banking institutions include capital calls and cease and desist orders. Capital calls relate to the requirement for shareholders to inject additional capital into the financial institutions during times of distress as directed by the supervisory authority. Therefore shareholders must have the capacity to be able to inject additional capital into a distressed institution in a timely manner for this measure to be effective. Cease and desist orders refer to directives to the financial institution to stop accepting deposits or stop giving new credit or both, in order to reduce risk and minimise losses to depositors should the institution fail.

Additionally, banking institutions are required to have minimum security infrastructure in place, such as vaults and security guards (which may prove very costly for microfinance institutions) and are often subject to restrictions with regard to branching and opening hours.

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[29] http://www.bis.org/publ/bcbs30a.pdf, accessed Sunday, October 08, 2006.

[30] http://www.bis.org/publ/bcbsca03.pdf#search=%22%20%22basel%20capital%20accord%22%22, accessed Sunday, October 08, 2006.