

# DEVELOPMENT-ORIENTED FINANCIAL REGULATION<sup>1</sup>

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## Abstract

The main argument of this paper is that, in the context of Africa, the Basel III policy stance for financial regulation must focus more on the implications for financial development and inclusive economic growth. We summarise the key theoretical tenets that link financial regulation policies to financial development and inclusive economic growth, in a flow of funds framework. We then consider the transition to Basel III in Africa and emphasize the issue of microfinance regulation as social protection: among other findings of interest, we note that regulation and outreach in microfinance provision in Africa are strongly related, with the added benefit that outreach enhances the provision of financial and social protection for the poor.

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## 1. Introduction

Why should financial regulation be development – oriented? It may well be the case that we are stretching the role of financial regulation beyond the traditional boundaries of market failure, or even beyond the extreme bounds of regulatory failure. But, for many low income countries, especially in Africa, financial regulation policies constitute the foundation basis for the mechanisms through which financial development exerts a positive impact on economic growth and poverty reduction. The conventional financial intermediation story points to the benefits of enhanced savings, investment and economic growth. Further, while regulation of microfinance amounts to safeguarding the safety net of the poor, as we argue later, bank failure and bank fragility have serious negative implications for small and medium enterprises from which the majority of the population derive their livelihoods.

Indeed, the financial crises in Asia, Mexico, Russia, and the global financial crisis can be attributed not simply to monetary issues or subprime mortgages, but mainly to the spread of contagion effects exacerbated by weak regulatory environments (see Han, Lee and Suk, 2003; Sharma, 2001; Radelet et al., 1998; Brana and Lahet, 2009; Jackson, 1999; Sojli, 2007; Goodhart, 2008; and Mizen, 2008). Although the latest crisis affected banks globally more than any crisis in the past, the serial occurrence of these crises seems to suggest that regulators must do something fundamental to stop the recurring cycle of financial crises (see Brunnermeier et al., 2009), especially for developing economies which are most vulnerable to contagion but have no “voice” in the architecture of bank regulation. In addition, the financial crisis exposed the inadequacy of the Basel rules. As Kay (2009: 7) observed: “Basel capital adequacy rules proved worse than useless”. Globally, capital adequacy rules failed not only in their objectives, but also generated “regulatory arbitrage”, involving an explosion of asset securitization and the use of off-balance sheet vehicles (SIVs and conduits) intended to evade the rules. So, as argued by Murinde (2011), given the global financial crisis and some criticisms against Basel II, Africa is at the crossroads of bank regulation, contemplating how to embark on Basel III. As observed by Brownbridge and Kirkpatrick (2002), the key questions for policy makers are related to the specific methods of bank regulation and supervision that can work best in existing economic environments. This is the challenge for Africa today: trying to recover from the financial crisis, encumbered with Basel II that lost its credibility during the financial crisis, and aiming for regulation that will encompass specific features of banking such as microfinance institutions and credit to SMEs.

Importantly, the financial crisis has brought an unprecedented political awareness of the need to coordinate policy responses at the global level. The G20 Summit in Seoul in November 2010 emphasized the evolving international regulatory architecture in terms of Basel III. However, one key area that remains relatively neglected is to expand participation of low – income, especially African, countries in the Basel III rule-setting processes. The main idea is to ensure that the new international financial regulatory framework, as contained in Basel III, is particularly relevant to financial development and economic growth in Africa and other Low-Income Countries. The key aspects of Basel III, which are relevant for Africa include macroeconomic and micro-institutional regulation, risk-weighting of assets, and application to types of financing essential to Low-Income Country development, such as trade and project finance and microfinance institutions. Hence, it is crucial that these countries improve research, train analysts, strengthen their voice and engage with the Basel III architects, including the G20 and the Financial Stability Board.

Some initiatives have been launched to facilitate the participation of African countries in international regulatory reforms. For example, the African Economic Research Consortium (AERC), which coordinates economic policy research and training by Sub-

Saharan African universities and institutes, has worked with the African Development Bank on financial regulation, culminating in a March 2010 policy seminar on “Bank Regulatory Reforms in Africa: Enhancing Bank Competition and Intermediation Efficiency.” This highlighted the need to transmit African policy positions to the global level, and the African Economic Research Consortium partnered with New Rules in organizing the April 2010 African-U.S. meetings.

In general, three main considerations motivate this paper. The first is to contribute to the research and policy dialogue for a sounder regulatory framework in Basel III, underpinning global stability along with greater democratization of policy decisions that affect the broader society in developing countries, but with specific focus on Africa. The second consideration is to produce essential new policy positions and recommendations for reforming global financial regulation, specifically by adapting global financial regulation to financial development and economic growth in Africa and other Low-Income Countries. The third is to aim the message at key African policymaking forums on financial regulation, including the Committee of 10 (C-10), as well as its secretariat at the African Development Bank (AfDB); generally, to ensure that the African ideas on financial regulatory reform are effectively disseminated to the public and private political forums in Africa (e.g. a wide range of official, media, civil society and think tank organizations); the technical rule-making apparatus of the G20 and FSB (including the SSBs); the G20 political meetings at ministerial and summit level; and in other forums by the Commonwealth Secretariat, Korea Development Institute, and CIGI. The essence is to engage all actors in a debate on how best to promote global financial stability that supports equitable and sustainable economic growth.

Hence, this paper aims to recast the whole issue of regulation of banks, non-bank financial institutions (broadly to include microfinance, insurance, pensions, etc.), and capital markets (securities), in terms of financial regulation as a means of recovering from the global financial crisis, back on the path to sustainable economic growth and development. The methodology of the paper is to invoke relevant economic and finance theory, summarize insights from new literature on Basel III, analyse some key data and use some case studies to generate evidence on regulatory patterns in Africa. For example, one of the big issues is financial regulation as social protection. In addition, the paper should articulate findings and conclusions in terms of policy and topical concerns of the development implications of financial regulation.

In what follows, the remainder of this paper is structured into four sections. Section 2 summarises the key theoretical tenets that link financial regulation policies to financial development and economic growth, in the context of a flow of funds framework. The transition to Basel III in Africa is considered in Section 3, while the issue of microfinance regulation and social protection is given in Section 4. Section concludes.

## **2. What is “development oriented financial regulation”?**

In this paper the issue of “development oriented financial regulation” can be interpreted in at least two ways, which are not necessarily mutually exclusive. First, financial regulation in advanced economies, which is the major driver of global innovations such as the Basel Accords and BCPs, is primarily motivated by prudential concerns (for banks) and consumer/investor protection (for securities markets, insurance). For developing countries, economic and social development are much more important priorities than in advanced economies, so it is legitimate to ask whether financial regulation should not also contribute to developmental goals, in addition to prudential and consumer protection objectives. If so, what form should such financial regulation take; and are there trade offs between development and the other goals of financial regulation? One could argue, on the basis that separate

instruments are needed for separate targets, that the orthodox regulatory policies (capital adequacy, etc) should continue to be focussed on prudential objectives but that governments/central banks should use economic regulations to direct the allocation of financial resources towards developmental goals, as was the case in the 1960s and 1970s, with mixed success. The East Asian experience of economic regulations on the financial sector is more positive than that of Africa. Such regulations could include directed credit to favoured sectors, directions to open branches in rural areas, etc. This then raises the question of whether prudential and economic regulations might be in conflict, and if so, which should then take precedence? Can developing countries risk greater financial instability in order to achieve more rapid growth in intermediation, for example?

The second way of looking at the issue is to start from the premise that the objectives of financial regulation in developed economies are the same as in advanced economies, but that because of differences in economic and institutional characteristics, regulatory policies which are optimal in advanced countries are less applicable or less relevant in developing countries. Hence the standard global “best practise” regulatory policies need to be modified to make them more relevant to developing countries; for example by emphasising the regulation of sectors such as microfinance institutions. Regulation of mobile banking is another issue which has more relevance in developed economies than in advanced economies. This leads into the debate about the relevance of Basel rules for developing countries as prudential policies, leaving aside any other objectives of policy.

### **3. Financial Regulation and Economic Growth in a Flow of Funds Context**

The concept of development – oriented financial regulation derives from the argument that the role of financial regulation, in a flow-of-funds framework, is to ensure the functionality of banks and capital markets in relation to households, companies, the government and the external sector, in the sense that a “...main function of the flow of funds accounts is to reveal the sources and uses of funds that are needed for growth...” (Klein, 2000: ix). See also the surveys in Green, Kirkpatrick and Murinde (2005).

It is argued that financial regulation ensures timely and accurate information arrival and use in flow-of-funds transactions that take place in an economy, mainly involving exchanges of assets and liabilities. These transactions generate flows of funds from one agent to another and from one sector to another. In Table 1, flow-of-funds accounts show net transactions in financial instruments among the key economic sectors (Green and Murinde, 1998). When households and companies make consumption and investment decisions, changes in the stocks of assets and liabilities are tracked through identities, which state that the current stock is equal to the sum of the previous period’s stock, net flows into or out of the stock through transactions, changes in valuation (capital gains or losses), and depreciation of the pre-existing stock. Net flows into or out of a stock correspond to entries in the flow-of-funds account for any given sector. Entries for non-reproducible assets such as land reflect flows (purchases and sales) that do not enter into the current account. However, one sector may sell land to another to augment its funds in order to purchase other assets. Intangible assets are also included in any complete representation of flow of funds.

The behaviour of financial institutions and markets in response to a regulator, or any agent, may influence the portfolio behaviour of the household sector and the company sector, and the role of flow of funds in interest rate determination.<sup>2</sup> Hence, flow-of-funds models seek to explore why agents in a particular sector hold specific assets and why the agents choose to substitute assets in their portfolio. Also, as shown by Moore, Green and Murinde (2006a, 2006b), stochastic policy simulations within a flow-of-funds model can shed light on

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<sup>2</sup> See, in particular, Tobin and Brainard (1968), Green (1992), Green and Murinde (1998, 2004, 2005).

the type of banking sector reforms that influence outcomes for households, companies, banks and government.<sup>3</sup> As Fleming and Giugale (2000) emphasize, a key advantage of the flow of funds is that it imposes internal consistency on analyses and forecasts, and provides an exposition of the complete financial implications of policy or other changes. Hence, the framework in Table 1 revolves around the banking sector, but this sector can play its role only when it is well regulated and there is financial stability.

**Table 1: Financial regulation ensures functionality of flow of funds**

|  | <b>Household Sector</b> | <b>Company Sector</b> | <b>Banks Sector</b> | <b>Government Sector</b> | <b>Foreign Sector</b> |
|--|-------------------------|-----------------------|---------------------|--------------------------|-----------------------|
|  | <b>H</b>                | <b>P</b>              | <b>B</b>            | <b>G</b>                 | <b>F</b>              |
| <b>1. Income–expenditure</b>                                 |                         |                       |                     |                          |                       |
| 1.1 Income (Y)   | $Y^H$                   | $Y^P$                 |                     |                          |                       |
| 1.2 Taxes (T)  | $T^H$                   | $T^P$                 |                     | $T^G$                    |                       |
| 1.3 Consumption (C)  | $C^H$                   | $C^P$                 |                     | $C^G$                    | $C^F$                 |
| 1.4 Investment (I)   | $I^H$                   | $I^P$                 |                     | $I^G$                    | $I^F$                 |
|  |                         |                       |                     |                          |                       |
| <b>Net acquisitions (S)</b>                                  | $S^H$                   | $S^P$                 |                     | $S^G$                    | $S^F$                 |
|  |                         |                       |                     |                          |                       |
| <b>2. Assets and liabilities:<br/>Balance-sheet accounts</b> |                         |                       |                     |                          |                       |
| 2.1 Capital (K)  | $K^H$                   | $K^P$                 |                     | $K^G$                    | $K^F$                 |
| 2.2 Loans (L)  | $L^H$                   | $L^P$                 | $L^B$               | $L^G$                    |                       |
| 2.3 Domestic money (M)                                       | $M^H$                   | $M^P$                 | $M^B$               | $M^G$                    |                       |
| 2.4 Foreign money (R)  |                         |                       |                     | $R^G$                    | $R^F$                 |
|  |                         |                       |                     |                          |                       |
| <b>Net worth (W)</b>   | $W^H$                   | $W^P$                 | $W^B$               | $W^G$                    | $W^F$                 |

In the context of financial regulation, the flow of funds provides a holistic perspective on the implications of effective regulation and supervision. First, the framework underpins the sources and uses of funds between the household, company and banking sectors, on the one hand, and the foreign sector, on the other hand. The banks sector provides financial intermediation from the household sector to the company sector. Financial instruments (such as deposit and loan interest rates), financial reforms, and bank regulation influence the size of intermediation. Therefore, in a flow-of-funds context, the main implication for bank regulation is the centrality of the financial intermediation role, so that there must be a stable source of funding for all types of banks, including commercial banks and investment banks. For example, it is very important for banks to maintain capital ratios to avoid liquidity and solvency risks. If commercial banks ignore the basic principal of the deposits ratio and over-rely on money-market financing, liquidity crises may soon occur in banks once market confidence is lost. The crisis may be further complicated by the loss of market confidence through compounding liquidity problems, as in the recent financial crisis.

Also, the absence of efficient financial regulation may lead to vulnerability of the personal and business sectors to increases in borrowing rates, or to a significant rise in the spread between lending and borrowing rates for both producers and consumers.

Overall, in the holistic context of the flow of funds (Table 1) and the framework of financial regulation, it may be argued that if financial regulation is weak or poorly implemented, sectoral outcomes will suffer and economic growth may be seriously retarded.

<sup>3</sup> The implementation of flow-of-funds accounts in official statistics follows the UN System of National Accounts (United Nations, 1968 and 1993).

This is problematic in the sense that if African countries get financial regulation wrong, asset creation will suffer, intersectoral flows of funds will stagnate, savings and investments will slow down, the government sector may crowd out the private sector and, consequently, particularly financial development and economic growth will suffer.

#### **4. Transition to Basel III in Africa?**

Arguably, financial regulation in Africa has evolved through four overlapping phases. The first was the pre-1960s colonial phase. Colonies and territories were served by currency boards as precursors for central banks; for example, the East African Currency Board (1919–1966) and the West African Currency Board (1912–1968). Financial regulation was mainly controlled from abroad. Commercial banks were mainly foreign owned, and these banks were regulated by the home country (Kirkpatrick et al., 2008). On the whole, regulation did not address public interest issues. For example, there was widespread market failure and local entrepreneurs could not access bank credit. Rather, the type of bank regulation seems to have perpetuated the status quo, thus pointing to an aspect of regulatory failure in the context of bank intermediation among local entrepreneurs.

In the second phase, post-independence 1960s–1970s, national central banks replaced currency boards and assumed limited bank regulation, in addition to issuing national currencies and introducing monetary policy. Importantly, the new central banks intervened to address market failure by launching state-owned development banks (notably, agricultural development banks, industrial development banks, and cooperative banks) to finance specific sectors. At the pan-African level, the African Development Bank was established in 1964 to finance long-term developmental projects. Further, in the 1970s regulation was invoked to attain nationalization; some countries (e.g., Uganda and Tanzania) introduced state-owned commercial banks, mainly by nationalizing foreign banks. Governments used the banks to direct credit to local entrepreneurs (Brownbridge and Harvey, 1998). However, the banks experienced principal-agent problems, especially where managers were political protégés and credit was allocated through political peddling, testimony to the private interest view of bank regulation discussed in Section 2. Consequently, banks suffered bad loans from government-owned agricultural and manufacturing enterprises. In Ghana, for example, 47% of non-performing bank loans in 1977 were attributed to government enterprises (Brownbridge and Harvey, 1998: 64). Corruption and fraud contributed to banks' impaired loan portfolios. Although the state-owned banks were technically insolvent in some countries, there was no banking crisis in terms of banks closing down or depositor runs. These banks remained liquid and operational because they had a government guarantee.

The third phase, the Basel regime, includes the transition from Basel I to Basel II. When Basel I, also known as the 1988 Basel Accord, was initiated by the Basel Committee in 1988 and enforced by the Group of Ten (G-10) in 1992, the emphasis was on a set of minimal capital requirements for banks in order to address credit risk. Banks' assets were classified and grouped into five categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten, twenty, fifty, and up to one hundred percent. It was required that banks with an international presence hold capital equal to 8% of their risk-weighted assets. African countries were not among the architects of the Basel Accord but, like most other countries, they adopted, at least in name, the principles prescribed in Basel I. However, in general, the efficiency with which the Basel I principles were enforced in Africa, and even within nations of the Group of Ten, varied considerably.

The fourth phase includes the current transition to Basel III. Basel III rests on two main considerations. The first is an improvement in the quality of capital held by banks. This is inherited from Basel I and Basel II. The second is the emphasis on counter-cyclical

capital management. This is new, in which counter-cyclicality into the financial system is achieved through the creation of the counter-cyclical buffer, mainly through building stabilizers into the banking sector to counter-balance the effects of macroeconomic shocks. This requires that individual banks and the regulator have appropriate tools to measure and manage risk. Most banks in Africa and other low income countries use point-in-time models, such as credit-scoring models, in order to measure credit risk and the customer's probability of default for loans. The problem with point-in-time models is that they are inherently procyclical i.e. when the economy is doing well, credit scores tend to improve. Hence, the new emphasis on counter-cyclicality in Basel III will require forward – looking models that incorporate the probability of default associated with changes in the business cycle. These models are not yet in vogue in many African central banks or commercial banks.

Hence, Basel III is fundamentally different from Basel I and Basel II in two main aspects. The first one is that Basel III is more comprehensive in its scope than its predecessor codes. The second major difference is that, unlike Basel I and Basel II, Basel III combines micro- prudential and macro-prudential reforms to address institutional and system level risks, respectively. The main aspects of microprudential regulation include a significant increase in risk coverage, a fundamental tightening of the definition of capital, the introduction of a leverage ratio to serve as a backstop to the risk-based framework; the introduction of global liquidity standards to address short-term and long-term liquidity mismatches; and enhancements to Pillar 2's supervisory review process and Pillar 3's market discipline, particularly for trading and securitisation activities (Walter, 2011). The macroprudential regulation includes the build-up of capital buffers in good times, and the use of the leverage ratio to prevent excessive build-up of debt across the banking system during boom times (Walter, 2011).

The Basel III framework is the cornerstone of the G20 regulatory reform agenda, after process of coordination across 27 countries, including South Africa. Although SSA remains unrepresented, it may be argued that, similar to the previous case in Basel I and Basel II, the implementation of Basel III requires *minimum* standards and some countries may choose to implement higher standards if these are deemed necessary in the context of national economic strategies. However, in general, there are some challenges for Africa. First, asset valuation models and how these are used by central banks and /or regulators – this is important for ascertaining the capital ratios required. Second, the lack of harmonization of accounting practices in Africa, sometimes within the same country across domestic and foreign banks. Third, risk analysis and regulatory risk weightings is not well covered either by the ratings agencies or by independent analysts at central banks, hence the reports on credit quality are arbitrary. Fourth, a key challenge for many African countries is to address the financial system externalities that may arise from systemically important banks (SIBs), or the too-big-to-fail (TBTF) problem, especially if these are foreign banks with a high proportion of the total banking assets in the country. Finally, although Basel III adequately addresses banking regulation, the regulation of shadow banking remains incomplete. This is important for low income countries because during the global financial crisis, shadow banking provided the propagating mechanism for contagion effects, in particular, through SIVs, money market mutual funds, hedge funds, and securitisation. One proposal is to include off-balance sheet exposures in the Basel III leverage ratio. Further, the Basel III rule on trade finance has perverse implications for Africa and many low income countries, which rely on traditional trade finance for financing exports and imports. Basel III rules prescribe that banks have to provide reserves against trade credit advanced to customers that are equal to 100% of the outstanding amount, much higher than the 20% required under Basel II. This means shrinkage of trade finance in Africa, at a time when globalisation and the resulting growth in trade have led to worldwide prosperity for the last decade. Also, there are

problems related to recent changes in the structure of banking in Africa that make the regulatory crossroads very perplexing, for example the emergence of Islamic banking. As Murinde (2010) points out, the first modern experiment with Islamic banking in Africa was in Egypt in 1963, and by 1967 there were nine Islamic banks. Islamic banking assets in North Africa, West Africa, and East Africa grew rapidly in the 1980s-1990s, and in early 2010 Islamic banks were operating in 38 out of 53 African countries, while the banking system is almost wholly Islamized in the Sudan. Unlike conventional banks, which rely on interest rates for asset pricing, Islamic banks in Africa use some novel financial instruments in their operations, underpinned by Islamic law (*Shariah*) that prohibits the payment of interest on bank deposits or loans, which is regarded as usury. Also forbidden is investment in enterprises that produce alcohol, pork or gambling, which makes it akin to ethical investments (see Khalil, Rickwood and Murinde, 2002). Some of these instruments are tailored to fulfil risk management and monitoring roles, or even a poverty reduction role, as in Senegal. However, many central banks in Africa have yet to develop adequate capacity to supervise and regulate Islamic banking.

## **5. Regulation of Microfinance and Social Protection in Africa**

The regulatory concerns in the microfinance sector lie in the special nature of these institutions, mainly to address the needs of those who are not in the formal financial sector. Most of the microfinance clients are subjected to high levels of uncertainties in the sector, such as innovative procedures and high operating costs (Arun, 2005). The arguments for regulation in microfinance is primarily about ensuring systemic ability and protecting depositors.<sup>4</sup> The enhanced private investment in the sector has some benefits to the sector, but this also raises more challenges with regard to the regulatory practices in microfinance. In the context of recent financial crisis, many of respondents to the CGAP survey (2009) indicate that the liquidity drought is hurting, with smaller institutions suffering more acutely than their larger counterparts do. The financial failures in the sector could lead to a serious impact on the financial system by affecting the other financial institutions (who lends money to microfinance institutions) and the public confidence (*ibid.*, 350), and affecting the social protection fabric itself.

In general, the regulation of banking and other financial services in Africa is problematical. African countries have been in a transition process from Basel I to Basel II, but now, in the post-crisis era, Africa find itself at a crossroads (see Murinde, 2010). More so, regulating the microfinance industry remains a challenge for many countries (see Arun, 2005). Recently, WSBI (2008) has argued in a position paper that any type of regulatory practices in the microfinance sector needs to support the enlargement of access to finance, to guarantee a level playing-field between all microfinance providers and to protect customers. The challenge, however, lies not in the regulation, but in the need to differentiate the MFIs from formal sector banks. The aim of regulating microfinance is twofold (Arun 2005): to secure the interest of the vulnerable and uneducated consumers, and to ensure the smooth operation of the industry and thus safeguard the financial system as a whole. The regulation provides a secure climate to consumers. But there is also a danger of hampering the growth of microfinance; for example, if there is a cap on the interest rates charged by the MFIs, the consumer is protected from any unwarranted high rate. This also makes the operations of the MFIs impractical due to the low income and high costs of operating under the interest rate cap. This may have an adverse effect on the MFIs and would certainly stop growth.

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<sup>4</sup> The need for regulation of economic activities is justified in the economic literature as a policy instrument to minimize the effects of market failures, and the issue has gained substantial attention in the course of reform measures in developing countries (Armstrong, Cowan and Vickers, 1994; Majone 1996)

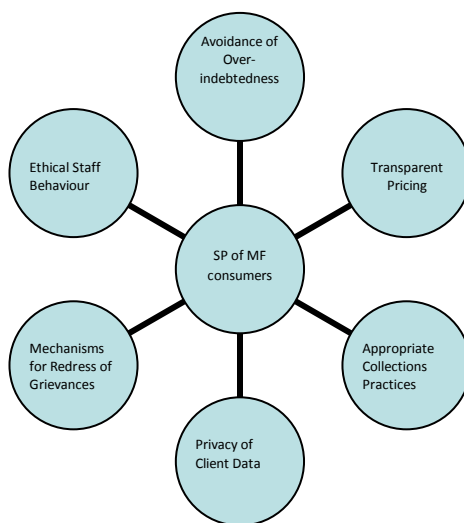
SSA also regards the regulation of MFIs as a serious task (see Christen, Lyman, Rosenberg, 2003). The policies on regulations are distinctly moving towards higher transparency, more rigorous standards and the adoption of a new law regulating MFIs in the West Africa Economic and Monetary Union (WAEMU)<sup>5</sup>. Except for three, all the countries in SSA have specific microfinance laws that cover the MFIs and financial co-operatives, but not the commercialised banks. Only Eritrea, Swaziland and the Seychelles do not have any legislation to cover microfinance. Table 4 highlights the current state of the regulatory framework of MFIs in the SSA countries.

**Table 2: Emerging Regulatory frameworks in Africa**

| Regulatory Frameworks                  | Countries  |  |
|--|--|--|
| E-Money Guidelines/<br>Laws (25)       | Botswana<br>CEMAC Countries (6)<br>DRC<br>Ghana<br>Mauritania<br>Namibia | Nigeria<br>Rwanda<br>South Africa<br>Tanzania<br>Uganda<br>WAEMU Countries (8)<br>Zimbabwe |
| M-Banking Guidelines/<br>Laws (7)      | Botswana<br>Ghana<br>Nigeria<br>South Africa                             | Tanzania<br>Uganda<br>Zimbabwe   |
| Use of Agents Guide-<br>lines/Law (18) | CEMAC Countries (6)<br>DRC<br>Ghana                                      | Kenya<br>South Africa<br>WAEMU Countries (8)   |

Source: 2009 Overview of Microfinance-Related Legal and Policy Reform in Sub-Saharan Africa, CGAP

**Figure 1: The social protection of microfinance consumers**



Source: Adapted from Forster, Lahaye, and McKee (2009)

In Africa, there are a large number of MFIs which operate without any kind of formal registrations and some are in a phase of expansion with specific licensing rules. Because of the large variety in the type of institutions, it has been suggested that institutions be fitted into a tiered structure that provides opportunities and incentives for MFIs to graduate between tiers, and creates the appropriate regulatory requirements for the different type of institutions (Meagher, 2002). This approach has benefited the development of sustainable microfinance

<sup>5</sup><http://www.themix.org/sites/default/files/2009-Africa-Microfinance-Analysi-Benchmarking-Report.pdf>.

in some countries - For instance, Susus of Ghana and SACCOs in East Africa both belong to both these categories according to their size of operations by clearly identifying pathways for MFIs to become legitimate institutions and to gain access to financial services from commercial markets.

Technological advances have brought in new challenges for the regulations to be as up to date as ever. With the emergence of branchless banking, real-time gross settlements and mobile banking, just like the commercial banks, the MFIs, too, need to have regulations in place. The authorities in SSA are gearing up to embrace these technological changes and have specific laws and regulations to tackle the potential threats posed by these new channels, as in Table 2. In the context of recent financial crisis, regulators have identified the need for the institutional strength of MFIs and their ability to get through the crisis.

The social protection trajectory of sub-Saharan Africa is heavily dependent on donor design and financing, in comparison to other regions in the World (Barrientos and Hulme, 2008). The social protection institutions are deeply embedded, informal systems of social protection, especially in rural areas (ibid, p.319). Broadly, microfinance regulations seem to be a public intervention measure to assist and protect individuals to manage risks and deposits better, and support the arguments regarding access to finance and development. The microfinance regulations seem to follow the social risk management framework that adds the issues of macro-economic stability and financial market development in addition to the social protection measures (Holzmann and Jørgensen, 2000).

Social Protection (SP) serves a dual purpose - one is of assisting the poor to survive in adverse conditions, and the other is that of promoting a better lifestyle for these consumers. The SP policies vary from region to region and are dependent on a range of factors such as the culture and needs of the local residents. These policies need to consider both the short-term and long-term impact of SP policies on targeted/general customers/programmes.<sup>6</sup> According to a consultative guide (Forster, Lahaye, and McKee, 2009), there are six principles that drive the SP of microfinance consumers, which are summarised in Figure 5.

- Avoidance of over-indebtedness: There could be two perspectives on this issue. On the one hand, the low-income borrowers will take on more credit and finally end up being over-indebted and unable to repay. On the other hand, due to competition in the market, the lenders may seek to increase the risk<sup>7</sup> at the cost of providing more credit than the borrowers are able to repay. The recent Microfinance Banana Skins (2009) has identified credit risk as the biggest risk faced by the MFIs globally. The African response precedes credit risk with institutional issues such as weakness in management, staffing and governance.
- Transparent pricing becomes a moral (and, in many cases, legal) responsibility of the MFIs to disclose the rates and all the costs explicitly since Microfinance is devised to protect the poor and vulnerable.<sup>8</sup> Until now, the consumer protection awareness in Africa is in its infancy, but is growing.<sup>9</sup>
- Appropriate collaborative practices: The guide proposes diligence and a risk-based approach in debt-collection practices.
- Ethical staff behaviour: The staffs of MF institutions are required to behave ethically and it is the responsibility of the managements of MFIs to ensure that adequate measures are taken to detect and to curb unethical and corrupt behaviour.
- It is imperative that MFIs have in place timely and responsive mechanisms for complaints and problem resolution for their clients. In Nigeria, the Consumer

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<sup>6</sup> Dag Ehrenpreis, UNDP 2006

<sup>7</sup> <http://www.cgap.org/gm/document1.9.35203/Microfinance%20Banana%20Skins%202009.pdf>.

<sup>8</sup> Protecting Low-Income Consumers: An interview with CGAP microfinance expert Kate McKee, July 15, 2008.

<sup>9</sup> CGAP <http://www.cgap.org/p/site/c/template.rc/1.26.4412/>.

Protection Council includes, amongst its core functions, a “speedy redress and awareness campaign” (see Access to finance in Nigeria, Isern *et al.*, 2009).

- There is a need to respect the privacy of client data and a need to require the permission of the consumer before using the data for any other purposes.

Overall, the regulations in the microfinance sector needs to be seen as a set of required “public actions to address vulnerability, risk and deprivation” (Conway, de Haan and Norton 2000), which clearly provides an argument for government to develop the regulations in a broader social protection framework.

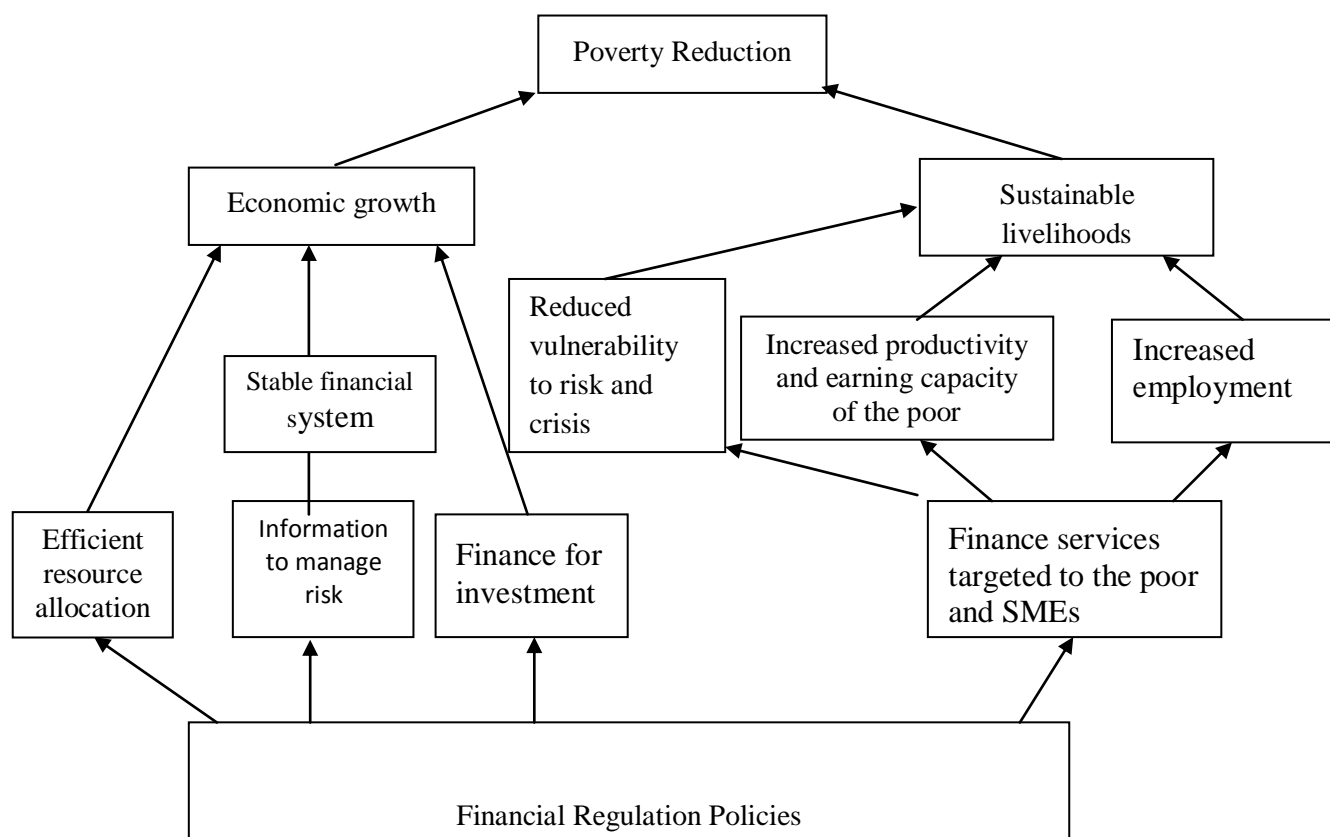
However, global experience shows that any single model of regulation is not an answer to the need for regulation in the sector. The sector specific regulations in the sector highlight the distinctiveness of the microfinance sector. These regulations may facilitate microfinance institutions to mobilise savings and grow with more linkages with formal sector. However, it is important to incorporate country specificities to make the regulatory practices practical. For instance, the experience in Ghana shows that through the “tiered approach”, microfinance institutions could grow into commercial markets to access finance. In reality, the nature of government regulations has varied impact on the MFI performance which depends on both institutional and country contexts. Usually, prudential regulations have a cost implication on the MFIs performance. At other times, an absence of regulations may hamper the growth of MFIs. The performance of MFIs depends largely on MFI regulations, which eventually affect social protection in several ways, mainly through their effectiveness and outreach. Governments need to consider the consequences of regulation in this sector beyond the formal approach, and to ensure closer engagement with microfinance institutions in developing the appropriate regulatory framework. In brief, the regulations play a vital role in the development of the microfinance sector and can determine the nature of the social protection provided by the sector.

## **6. Conclusion: Policy issues on development-oriented financial regulation**

In conclusion, we articulate findings and conclusions in terms of policy and topical concerns on the development implications of financial regulation. For the purposes of informing policy, the main stylized elements of the theory, evidence and case studies discussed in this paper are summarised in Figure 2. Specifically, it is shown that financial regulation policies drive the main linkages from finance to economic growth and poverty reduction; importantly, though, there is a multidimensional process of causal linkages.

We identify at least two main causal chains linking financial regulation policies, economic growth and poverty reduction. The first is the indirect link from the impact of financial regulation policies on economic growth and then on poverty. In this paper we have highlighted the important contribution that well-regulated financial systems can make to economic growth. Well-functioning financial systems mobilise savings and channel them to productive investment. They also improve the efficiency of resource allocation by screening projects and monitoring use of funds. The second link between financial regulation policies and poverty reduction is direct, from financial policy targeted at small enterprises or poor households that aim to improve access to financial services, including lending, borrowing and insurance services, and to reduce vulnerability to risk and financial crises.

**Figure 2: Causal chain linkages between financial regulation policies, economic growth and poverty reduction**



In conclusion, it is useful to highlight at least five main choices for African countries in the Basel III era. First, many African countries have transitioned their regulation from Basel I to Basel II, but post-crisis the countries are stuck at a crossroads. Going back to Basel I is not an option, and there is no point trying to maintain the status quo of Basel II when the quo no longer holds status; moving toward Basel III, albeit cautiously, is therefore the only option that remains. Second, the central banks of African countries must remember that because they were never involved actively in the architecture of Basel III and because Basel III is not a case of “one size fits all,” it is imperative to review the Basel III recommendations—primarily in order to decide on the key aspects that must be incorporated in their bank regulatory frameworks. Third, most of the emerging themes for Basel III are merely tangential to the concerns of developing economies. In particular, while there are real concerns with developing risk management frameworks for identifying, measuring, and mitigating potential risks, one key lesson from the failure of Basel I and Basel II in Africa and elsewhere is that the proposed Basel III regime must go beyond market risk concerns: it must represent development-enabling regulation.

Hence, in African countries, where microfinance and financing of small and medium enterprises are core activities in efforts to break away from poverty, simple regulatory tools for microfinance banking not only ensure banking stability but also reinforce social protection mechanisms for the poor and vulnerable in the process of economic growth. Fourth, an important cross-cutting element in Basel I, II, and III is capital adequacy. But it is useful to note that many African countries already have exceeded the Basel III enhanced capital requirements by building extra buffers to enable banks withstand financial stress. For

this matter, the regulators must observe the possible trade-off between capital adequacy and intermediation, so that any higher capital standards are not achieved at the expense of the lending ability of banks, given the role of loan creation in the growth process. The danger is that banks may move away from growth-enhancing portfolio decisions, such as making loans, to other earning assets, such as government securities. Fifth, African countries should buy into sharing of information and coordinated enforcement of rules to mitigate the specter of regulatory arbitrage—a major occurrence under Basel I and Basel II – and hence to be avoided in Basel III.

Further work is required in order to present a comprehensive and definitive analysis of how regulatory policies could contribute to sustainable growth and development. While the issues discussed are certainly the core ones (e.g. microfinance), future work should address the issue of long term financing for the corporate sector, which is surely the most important financial service needed for sustainable inclusive growth, and how regulatory policies might facilitate, or at least not impede, this objective.

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