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Regulation and supervision of microfinance in Albania

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This paper describes important regulation issues that concern microfinance. It starts by considering literature on how and why to regulate and supervise microfinance. Considering the specific case of microfinance in Albania, it analyzes the context of this industry and some particular issues that might influence its growth. Related regulation in Albania seems to be not activity-oriented since a real definition of microfinance is lacking in the Albanian law. Therefore, Albanian microfinance sector needs, first of all, a microcredit and microfinance definition to implement the right development policies and avoid confusion and license misuse. Moreover, the regulatory framework seems to be too restrictive for institutions supposed to be engaged in microfinance example high capital requirement and provisioning. Possible interventions can be in lowering minimum capital requirements for NBFIs to improve entrance, simplifying procedures, documentation and harmonization of the taxation treatment of institutions to enhance development, encourage access and avoid market distortions. There is the need to implement regulation considering microfinance as an activity, and develop a regulatory framework to induce commercial banks integrate downward into the microfinance market and help informal start-ups institutions develop and get formalized.

JEL Classifications: G21, G28, K23

Keywords: Microfinance institution, regulation, supervision, credit union, non-bank financial institution.

Introduction

Nowadays, microfinance is demonstrating a great expansion specifically in poor developing countries. The financial intermediaries, microfinance institutions (MFIs), represent a large range of institutions with different characteristics and ownership structures. Moreover, they increasingly are trying to offer additional services to forefront the progressive rise in demand of non-banked customers, substituting in some way the bank institutions. The shift towards offering bank services and higher risks held by their assets, justify the increasing attention by the regulatory and supervision authority.

This short paper will provide an overview of the literature on regulation and supervision of Microfinance answering some basic questions such as: why and how to regulate Microfinance? Some deeper insights will involve issues on which advocates have not unanimous consensus such as: specialized microfinance institution licenses or incorporation of microfinance activity in the existing law framework. The second part concerns the specific legal, regulatory and supervisory framework of MFIs and credit unions in Albania. The short analysis is focused on prudential regulation and supervision and provides an overview on characteristics of Albanian microfinance sector and some development issues.

Why regulate the microfinance sector?

Generally, the main justifications of regulatory interventions are market imperfections. Concerning the financial market, imperfections are identified essentially by "adverse selection" and "moral hazard" behaviour as a result of asymmetric distribution of information between the parts. Microfinance institutions and their activities, as a relatively

new part of the financial system, represent a set of particular characteristics that enhance the need for regulation and supervision even further.

Regulation is defined by Rosenberg et al. (2003) as “the set of binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations)” In addition, the government might not be the only possible regulatory institution, denoting with the term also the self-regulation of groups of institutions via associations or networks as well (Chavez et al., 1993).

Supervision, in contrast, refers to the external oversight aimed at determining and enforcing compliance with regulation. It is implemented through examination practices and monitoring mechanisms which determine the real risks faced by the financial intermediary. Indeed, regulation and supervision are complementary. A clear message emerges for situations where regulators are not able to supervise all regulated financial institutions: It is better not to regulate what you can not effectively supervise (Valenzuela et al., 1999).

Regarding regulation, Medgher (2002) asserts the fact that the Microfinance expansion needs a strong structure of rules able to deal with efficiency in the mobilization of funds, ensure suitable risk management and customer protection as a first objective. In terms of funds mobilization, deposit taking activity seems to be the main reason for Microfinance regulation. This source of funding appears to be cheaper than commercial loans and provides decision-making freedom, attracting a huge number of institutions. It also allows economies of scope between lending and deposits mobilization (Vogel et al., 2000). However, taking deposits from the general public embodies additional risk in the Microfinance activity. The risk faced by small and uninformed depositors which might lose their savings because of bad management decisions. The soundness of the overall national payment system, in the case of small asset microfinance institutions, in most of the cases is not directly affected as may be from the failure of an important commercial bank (Rosenberg et al., 2003). Although, a size of deposits or assets sufficient to trigger regulation can be evaluated considering the overall size of the market and the institutional landscape in a country specific (Valenzuela et al., 1999).

Moreover, regulation is considered very important for MFI's which want to expand their founding sources and improve their appearance in front of donors and institutional investors. Regulated institutions are viewed as trustworthy activities where to invest money, and furthermore, donors prefer to allocate funds in licensed and supervised institutions where at least fraud and illegal use of money are prohibited and monitored (Meagher, 2002). In addition, supervision is required from MFI's in order to promote their self through rating from private agencies and disclosure through dissemination of their performance indicators, social values and outreach.

Another motivation for an adequate regulatory framework is the impact in supporting the creation of new MFI's or improving the performance of the existing institutions. Providing an individual regulatory framework for Microfinance activity may well have the effect of increasing the volume of financial services delivered and the number of clients served. It is recommended not to over-specify this structure since it may have a negative effect on innovation and competition (Rosenberg et al., 2003) and can lead to regulatory fragmentation (Valenzuela et al., 1999).

How to regulate microfinance?

Before starting the analysis of different issues which are taken into account for implementing a good regulatory structure, it is important to make a distinction between prudential and non-prudential regulation. Regulation is prudential when it governs the financial soundness of licensed intermediaries' businesses, in order to prevent financial-system instability and losses to small, unsophisticated depositors. Although, this paper focuses on prudential regulation, it is important to state that not all regulatory objectives need a prudential treatment. Indeed, non-prudential regulatory issues include consumer

protection; fraud and financial crime prevention; interest rates policies; permission to land; tax and accounting discipline (Rosenberg et al., 2003). Non-prudential regulation is an accessory to prudential regulation but not less important especially for the Microfinance sector which is very sensible to consumer protection and interest rates policies because it deals generally with low-income people.

Institution or activity? General approaches to regulation

The answer of how to regulate Microfinance needs to consider the institutional context of the industry. Microfinance services are offered by a large variety of institutions that range from commercial banks with microfinance portfolios to socially oriented NGO's without a clear ownership structure. The most controversial point in discussion consists in how to consider Microfinance under the regulatory approach, as an institution or an activity.

Advocates of specialized microfinance institution licences argue that there is the need to group all microfinance regulatory necessities into a specific framework that allows industry development.

These licenses should require low capital investment to improve entrance and specifically enable NGO's to transform into regulated institutions. There is the need to compensate what bank institutions are not offering to poor depositors and micro entrepreneurs.

Instead of structuring regulation and supervision around a single institutional approach, allowing only a defined type of Microfinance institution provide services, is better to regulate the activity (Valenzuela et al., 1999). From this viewpoint, regulation and supervision should be based on risk characteristics, services and product development procedures of the institutions with microcredit portfolio. It is argued that integration of microfinance is important and the existent regulatory framework should be reviewed to accommodate its activities into the financial services sector. In countries with a developed financial sector, regulation should be used as a leverage to induce banks and financial institutions to integrate downward into the microfinance market. Some financial institutions have created specialized microfinance divisions within their institutions, for example Banco Económico in Bolivia, Banco de Desarrollo in Chile. This shift naturally will extract microfinance activities from the stricter bank regulatory framework and might promote through incentives¹ the enlargement of microfinance market.

In the case of poorly developed markets where MFI's generally start as informal institutions, regulation approach should provide phased assistance in each of these stages to help them consolidate, get formalized and finally be regulated. Although, it is ambiguous and still under discussion if a specialized microfinance institution licence is the best solution (Meagher, 2002).

Rosenberg et al. (2003) cite the case where, in some countries, the special regulatory window for microfinance is misused from financial institutions. Their activities are far from the socially-oriented ones such as consumer lending, because of the less severe practices on capital requirement and other prudential regulation constraints. Although, there are pro and counter regarding specialized licences use. Country experiences are showing that no option is standard and before implementing a regulatory framework a country assessment is needed (Valenzuela et al., 1999).

Van Greuning et al. (1999) propose an approach which can accommodate both country scenarios. This regulation approach is related to the structure of the liabilities which highlights the principal founding source for the MFI's. They argue for different regulation disciplines when funds derive from donor sources or commercial loans, from members' savings or deposits collected from the general public. Different sources of funding and the corresponding risk that must be managed triggers the need for different levels of

¹ In my opinion incentives might be for example, tax exemption for profit from microfinance activity or other facilities like easier bureaucratic procedures for licensing or flexible contracts for employees, in order to lower operational costs.

regulation. When the institution, in fund mobilization, pass a certain defined threshold with a wider field of activity and risk, a more stringent regulation and supervision is applied. Graduation to higher tiers would require MFIs to strengthen their operations, reach significant scope, and achieve financial self-sufficiency.

The basic of this reasoning is that institutions which do not mobilize deposits from the general public¹ should not be regulated and supervised from the government authority. Other types of regulation and supervision can be employed such as self-regulation or delegated supervision from a third party institution, though less restrictive. However, most MFIs are simply financial institutions which are not likely to be involved in sophisticated instruments and risks. The adoption and observance by non-regulated MFIs to risk management principles and practices upon which prudential regulation are based can lead to a better performing Microfinance market. Regulators ensure prudent risk management by prescribing risk-based capital adequacy requirements for supervised intermediaries. By specifying the limits to the relationship between risk assets and the amount of qualifying capital adequate to safeguard solvency and liquidity, they determine the overall size of risk-oriented business and deposit-based funding that a regulated institution can carry out. Because of the institutional structure of MFIs and the nature of the microfinance business, the categories of risk that are most relevant to MFIs are balance sheet structure, profitability, capital adequacy, credit risk, liquidity and operational risk. A better description of these risk categories and regulatory limits are described in the following case of the Albanian regulation.

Microfinance in Albania

Microfinance begins its activity in Albania in the early 1990s with donor support and government commitment to develop and consolidate it into a financial market. The growing performances showed by these institutions and the role played in the financial sector development have highlighted the need to improve the impact on the economy and poverty alleviation. At the same time, the microfinance sector evolution in terms of scale and complexity requires policies and concrete actions targeted beyond the mere strengthening of individual microfinance institutions.

Currently, Albania's MFI landscape is composed of two SCA's Union,² five NGOs, two licensed as non-bank financial institutions (NBFI) and three licensed as commercial banks mainly oriented towards micro loans. Microfinance actually has reached over 2.4% of the population and roughly 80% of the geographical area.³

Albanian regulation and supervision context

The first steps of microfinance regulation in Albania were made in 1998, trying to develop a legislative framework able to accommodate the World Bank Micro Credit Project (World Bank 2005). The authority, after the collapse of the pyramidal savings schemes in 1997⁴ understandably follows a severe regulation and supervision campaign even for small financial institutions. This concern is still apparent today.

SCAs and their Union regulation and supervision

¹ The general public deposits do not include member's deposits (ex. in the case of Credit Unions) or mandatory savings requested for getting a loan.

² Credit Unions in Albania are known as Savings and Credit Associations and their Unions, (SCAs) Union.

³ Source the Mix Market

⁴ In this period Albania descended into anarchy because roughly 50 percent of the population lose their savings.

On the basis of a solid “stand alone” Law¹ for SCAs, the authority² issued Licensing and Supervisory Regulations for SCAs in 2002, allowing rapid growth. A specific law for SCAs is justified by the fact that only SCAs and their Unions are allowed to take and mobilize deposits. Indeed, the member’s deposit mobilizing is not a compulsory issue for triggering prudential regulation, at least not such as general public savings. In general, the Albanian law is based on the current recognized standards set for Credit Unions³ about membership, services offered, member’s rights and non-profit activity. The role of the Union is to promote and coordinate the SCAs activity, offering at the same time financial services, management consultancy and training (Colleye, 2005). Another important task assigned to the Union is the delegated supervision of the member SCAs. Through frequent inspections and off-site supervision the Union provides to BOA the necessary information about SCAs activity and the risks they are facing. In fact, there isn’t another way to allow BOA monitors small SCAs with its limited structure and funds.

Prudential regulation is considered very severe concerning provisioning. The loan loss provision is higher than the one set for banks⁴ hindering thus, together with high limits on non secured lending, the growth of capital and loan portfolios of SCAs.

Furthermore, currently SCAs and their CUs are not authorized to invest funds exceeding the lending activity in securities, obligations or other safe instruments guaranteed from the government. This restriction is not justified and hinders income generating capacity for the institutions and self sufficiency.

Concerning the liquidity requirements, standards are set lower than the liquidity ratio recommended by WOCCU for Credit Unions. Liquid assets (those with no maturity or a maturity of less than 1 month)/ (total deposits of maximum 6 months maturity)⁵ must not be less than 10% compared with 15% of WOCCU and the 20% recommended by the World Bank (World Bank, 2008).

The start up of new SCAs improves through very low capitalization requirements, only 8% of capital to lending is necessary. Member’s capital contribution is modest; ranging from 2% to 4% of the loan the member seeks (Gannon, 2005).

From the activity developing prospect, regulation should allow SCAs and their CUs offer a variety of other services. The possibility to be involved in activities such as money transfer and foreign exchange can help capture the flow of remittances to Albania, increasing their deposits and the base for lending. Since SCAs operate primarily in rural areas micro leasing can be used to finance machinery equipment.

MFIs and Non Bank Financial Institutions regulation and supervision

The current regulatory framework of the Albanian Microfinance sector has been tailored to allow MFIs, except SCAs and their Unions, offer lending activity only under the license of Non-Bank Financial Institutions⁶. These entities are subject to prudential regulation and supervision by BOA even though they cannot collect deposits from the public. The decision to prudentially regulate these institutions that don’t take and mobilize deposits, in any case is considered too restrictive from the moment that they are not big enough to jeopardise the overall financial system. Moreover owners hold all the risks themselves.

First of all, the key absence in current legal and regulatory framework is the definition of “microfinance” and, the more basic one, the lack of “microcredit” definition even as a

¹ Law on “Credit Savings Associations and Their Unions” Republic of Albania law no. 8782

² BOA (Bank of Albania)

³ See WOCCU (Credit Union regulation and supervision)

⁴ See Regulation on the supervision of Credit Savings Associations and Their Unions decision no.67 2002 and Banking law of Republic of Albania no. 8365

⁵ Regulation on the supervision of Credit Savings Associations and Their Unions decision no.67 2002 (art. 8.1)

⁶ Law no.9662 (2006) “On Banks in the Republic of Albania”

quantitative reference. If the authority aims to create an environment where low income people are supplied with financial services, a difference should be made between institution's nature and scope of their activity. MFIs can be defined as a financial institution whose loan portfolio must contain a predominant percentage of loans not larger than a certain amount defined microcredit¹.

Thus, the compliance of such requirements should differentiate MFIs from other NBFIs, applying a preferential regulatory discipline more focused on non-prudential regulation.

Another worrying point is the high capital needed to be engaged in this activity. Previously these MFIs, mainly of the NGOs type, were authorized to engage in this activity by the civil code. Now they must have a minimum capital of 1.2 million USD to take the license. The capital requirement, which is 5 times the capital required to NBFIs that does not lend to clients, is considered to high compared to other countries without capital requirements (World Bank, 2008). Although, Gannon (2005) considers the high minimum capital requirement as a good barrier to ensure the entry of only well financed institutions that are healthy for the finance sector.

Regarding capital adequacy, it is set according to the fact that microfinance portfolio is more volatile than the commercial bank one (CGAP, 2003). Indeed, the lack of collateral makes the microfinance loans more unsecured. The capital to total assets ratio is set at 10% instead of 8% required for bank entities. Even though the requirement is for 100% capital coverage on total risky loans regulation imposes a stricter ratio. Risky loans to total loans ratio set at 8% must not be used for prudential purposes as stated in the regulatory framework².

Key issues of non-prudential regulation are loan documentation, taxation, consumer protection and internal control and audit. Loan documentation, given the small size of the loan and the nature of clients, should be smaller because it engraves on procedure simplicity and administrative costs.

The formal documentation required for microcredit loans should be minimal and focus on information that attests to the client's identity and place of residence.

Taxation highlights the need for considering microfinance as an activity. Even though it appears to be a consensus among advocates that MFIs should not be taxed due to their social objectives, different taxation treatments are in act actually. SCAs and their Unions are tax exempt due to their non-profit nature but commercial banks engaged in microfinance activities pay 10% on profits.

Alternatives to level the playing field somewhat in this regard include:

- Allowing banks and non-bank institutions to create wholly owned subsidiaries engaged in microfinance that are tax exempt;
- Allowing banks and non-bank institutions to deduct interest revenue earned from microcredit from taxable income.

Well defining the microfinance activity will enable a more equal treatment of different institutions engaged in microfinance. Taxation preferential discipline of microfinance activity will induce institutions to get involved and have a larger availability of funds.

Regarding supervision, NBFI should report to BOA on a quarterly basis³. The low risk of non-deposit taking institutions, as discussed above, should induce BOA to keep its prudential requirements and supervision reasonably light in order to discourage development of the sector and focus its limited resources where they are needed the most.

¹ Instead of imposing a fixed amount, currently is in use a microcredit definition expressed in percentage of GDP/capita (CGAP 2003).

² Article 5.1 of the "Regulation on the Granting of License to Non-Bank Financial Subjects"

³ Bank of Albania, 2005. "Regulation on Supervision Norms of Non-Bank Financial entities". Art.8.1

Conclusion

The microfinance sector is having a great expansion, performing quite well in almost the entire developing world. This expansion in scale and services increases the need for regulation and supervision. The concern of the regulatory authority is the security of the people's deposits and the soundness of the financial market.

Hence, prudential regulation and supervision should be applied to microfinance when:

- MFIs collect and mobilize deposits from the general public.
- The scale of their activity is large enough to jeopardise the overall financial system.

From the moment that a large part of MFIs do not have the previously mentioned characteristics, refereeing to the Albanian case, non-prudential regulation should be applied to care more on lending efficiency, consumer protection and sector development.

The Albanian microfinance sector needs, first of all, a microcredit and microfinance definition to implement the right development policies and avoid confusion and license misuse.

Some other possible interventions can be in lowering minimum capital requirements for NBFIs to improve entrance, simplifying procedures, documentation and harmonization of the taxation treatment of institutions to enhance development, encourage access and avoid market distortions.

There is the need to implement regulation considering microfinance as an activity, and develop a regulatory framework to induce commercial banks integrate downward into the microfinance market and help informal start-ups institutions develop and get formalized.

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