Spotlight 2.1

Strengthening the regulation and supervision of microfinance institutions

Low-income households and micro-, small, and medium enterprises (MSMEs) in emerging economies often rely on microfinance institutions (MFIs) instead of conventional banks for financial services. The microfinance sector consists of a diverse group of regulated and unregulated financial service providers.[1]

Microfinance institutions are often the sole providers of financial services to vulnerable segments of a population. They play a critical role in local economies, household resilience, and women's financial inclusion. One source suggests that up to 80 percent of MFI borrowers in emerging economies are female, and 65 percent are located in rural areas.[2] MFIs rarely become large enough to threaten the stability of the financial system when they are in financial distress. But because many MSMEs and low-income households, including very poor, hard-to-reach populations, depend on MFIs as a source of credit and as a custodian of their financial assets, the safety and soundness of the microfinance sector are critical for this population.

Effects of the pandemic on MFIs and the policy and regulatory responses

MSMEs and low-income households were affected disproportionately by the COVID-19 (coronavirus) pandemic and the ensuing containment measures. Many MFI clients, suffering significant income losses, were unable to pay loan installments. Meanwhile, some clients had no way to make payments in person during lockdowns and lacked digital payment alternatives. Moratoria were introduced to give MFI clients breathing room, while avoiding steep increases in capital buffers for MFIs, which would constrain lending.[3] At the same time, credit moratoria delayed borrower payments, which

meant MFIs had less liquidity. However, this problem was to some extent mitigated by a slowdown in new disbursements on the back of weakening demand. On the whole, then, these liquidity pressures were short-lived.

Policy makers and regulators responded to the pandemic with support measures, which varied across countries and markets. Although unregulated nongovernmental organizations only benefited from broader policy measures such as fiscal support, regulated MFIs received support similar to that offered to commercial banks:[4]

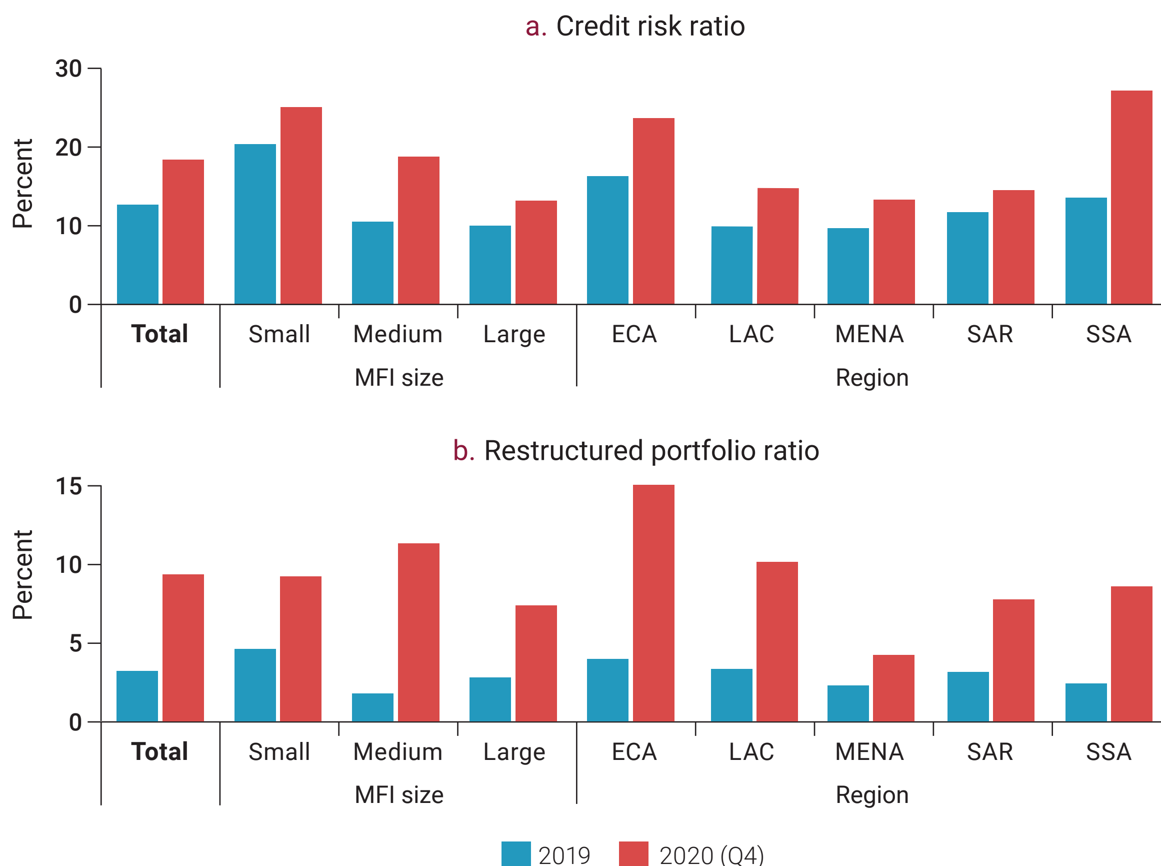
- *Relief for MFI clients*, such as mandated credit moratoria or permission for MFIs to offer credit moratoria, with or without prior consent of customers; easing of loan restructuring requirements; and protection of borrowers' credit histories.
- *Relief for MFIs, lending support, and capital conservation*, such as direct liquidity support for MFIs or indirect support via creditor banks (for example, guarantee schemes); temporary changes in prudential standards, including reduction of collateral, provisioning, and risk-weighted capital requirements for small and medium enterprises (SMEs) or microfinance loans; reduction of the capital adequacy ratio, reserve requirement, liquidity ratio, leverage ratio, and minimum paid up capital; deferment or suspension of supervisory activities (MFIs have been subject to enhanced reporting of priority data); and suspension of discretionary payments (such as dividends) aimed at conserving capital.

The general thrust of these measures was to boost the sector's resilience and avoid liquidity and capital constraints that would limit MFI lending. But the measures did not always achieve those goals because support measures largely mirrored those for conventional banks and were not customized for the distinct features of microfinance portfolios[5] and the realities of microfinance clients.[6] In some instances, measures arrived too late in view of the short-term nature of microfinance loans and the early impacts of the pandemic on low-income customers and MSMEs. Similarly, some central bank liquidity facilities that targeted MFIs imposed eligibility or collateral requirements that could not be met by MFIs.

The credit moratoria also raised consumer protection issues that may resurface as prudential challenges in the future. In many cases, missing or inadequate regulatory guidance for the use of moratoria saddled borrowers with additional debt burdens through fees and compounded interest that they did not always understand. In addition, when moratoria were lifted some deferred payments came due as a lump-sum payment that borrowers struggled to repay.[7] Some MFIs were also unprepared to follow up with each borrower and process a sudden increase in requests for loan restructuring. This led to blanket moratoria with automatic opt-ins without borrower consent and without considering the potential negative effects on borrowers, including on their credit history. Furthermore, in some cases weaknesses in internal controls led to the embezzlement of unsolicited loan disbursements by MFI staff. Finally, there was a spike in disbursements of high-cost, short-term loans by lightly regulated or unregulated lenders—loans sought by low-income clients who were unable to meet their need for immediate cash by borrowing from regulated MFIs.

The limited data and anecdotal evidence available indicate that at the onset of the pandemic there was a short-lived but dramatic drop in loan repayments and disbursements. Disbursements were made only to the best clients, or in some cases were halted altogether. Subsequently, in July 2020 reported NPLs began to increase as broad-based credit moratoria were phased out or replaced with more targeted borrower support measures (that often provided MFIs with greater discretion in

Figure S2.1.1 **Credit risk ratio and restructured portfolio ratio, by size of microfinance institution and World Bank region, 2019 and 2020**



Source: CGAP and MFR 2021. Data from MicroFinanza Rating, Atlas (dashboard), https://www.atlasdata.org/; Consultative Group to Assist the Poor, CGAP Global Pulse Survey of Microfinance Institutions (dashboard), https://www.cgap.org/pulse.

Note: Panel a: 2019 data, 375 microfinance institutions (MFIs); 2020 (Q4) data, 152 MFIs. Panel b: 2019 data, 457 MFIs; 2020 (Q4) data, 158 MFIs. The sample includes only MFIs that entered the pandemic with an above-average portfolio-at-risk 30 ratio (PAR 30—loans overdue more than 30 days) of more than 8.5 percent. The credit risk ratio is calculated as the mean of the sum of write-offs, restructured loans, and PAR 30, all divided by the average gross outstanding portfolio. ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SAR = South Asia Region; SSA = Sub-Saharan Africa.

terms of debtor selection and types of support measures offered).[8] The combination of slowing disbursements, rising provisioning expenditures, and ongoing fixed operational expenditures (including salaries) translated into pressures on profitability.

Figure S2.1.1 compares the credit risk ratio (panel a) and the restructured portfolio ratio (panel b) for 2019 with that for the fourth quarter of 2020 by size of MFI and by World Bank region. As economies reopened, MFIs and their clients opted for loan restructuring or new disbursements rather than moratoria extensions. The portion of the MFI portfolio under moratoria declined from over 90 percent in March/April 2020 to around 20 percent by December 2020.[9] Although MFIs have so far weathered the pandemic better than initially expected, the situation is still fluid, and pressures on asset quality—which so far have been relatively stable—may increase as moratoria are fully lifted

and restructured loans begin coming due. This may happen in the context of the continuing global impact of the pandemic and a generally uncertain economic outlook.

Regulation and supervision of MFIs

During the pandemic, the prospect of growing pressure on asset quality and solvency put a spotlight on the long-standing weaknesses in microfinance regulation and supervision. For example, large nonprofit MFIs, including deposit-takers, do not always fall within the regulatory perimeter, and they are not required to transform into companies whose ownership is organized via shares. Moreover, regulatory, resolution, and consumer protection frameworks in emerging economies are often inadequate and accompanied by under-resourced supervisory functions that lack microfinance expertise and reliable data. Some of these weaknesses are rooted in the origins and structure of the microfinance sector, which is often challenging to regulate and supervise because of the sheer number of entities, their legal status, often remote locations, and underdeveloped information systems. Reforms have been overdue, and it is now time to prioritize the reform of microfinance regulation, beginning by widening the regulatory perimeter; strengthening regulatory, resolution, and consumer protection frameworks;[10] and improving supervisory capacity and data collection systems. There are also important lessons to learn from the pandemic on how to be better prepared for the next crisis by tailoring response measures such as credit moratoria to the specific needs of MFIs and their clients.

Notes

1. CGAP (2020c).
2. Convergences (2018).
3. CGAP (2020b).
4. CGAP and MFR (2021); Dias (2021).
5. BCBS (2016).
6. Dias (2021).
7. CGAP (2020a); Dias (2021).
8. CGAP and Symbiotics (2020).
9. CGAP and Symbiotics (2020).
10. A recent example is a consultative document released by the Reserve Bank of India in June 2021, which advocates harmonizing microfinance regulation for all regulated entities (RBI 2021). It also proposes revising the definition of microfinance loans and the limits applicable to such loans.

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