

Overcoming Regulatory and Legal Constraints to Savings Mobilization

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Introduction

This paper provides a brief overview of savings mobilization within the context of the microfinance industry, focusing on the regulatory and legal constraints microfinance providers face in providing savings services to the poor. It first provides an overview of the ways in which poor populations save around the world. It then broadly highlights the principles of financial regulation as they relate to deposit-taking, and then outlines the regulatory restrictions various microfinance providers face in offering such deposit services, focusing on banks, non-bank financial institutions, and non-profit organizations. I conclude with a discussion of how to overcome three types of obstacles: regulatory constraints, capacity constraints, and cost constraints.

How Savings Occur: An Overview

There is an increasing array of literature proving that poor people can and do save in a variety of ways. Not unlike any other person in society, poor people value access to these savings when needed, they need them to be kept safe and secure, and they want to earn a return on their money. (Hirschland 2003). Generally, poor people will save in a range of informal, semi-formal, and formal institutions.

Informal Institutions

Informal institutions for savings abound in every culture around the world. Called *tontines*, *susus*, *hui*, ROSCAs, ASCAs, these informal institutions provide informal ways to collect deposits either through a voluntarily formed group or by a village savings collector. The money is returned to the

depositor, usually at a future time, almost always with some rate of return. Outside of these loose affiliations, poor people will also use excess liquidity to purchase assets such as livestock that are easily converted back to cash when the need arises. Finally, there is also the storing of cash within the home (the proverbial money-under-the-mattress), arguably the least safe, riskiest form of savings employed by any individual.

Semi-formal Institutions

Semi-formal institutions can be defined as those institutions that may be formally organized, but without full legal ability to accept and intermediate deposits. These include the village savings and loans being organized by CARE, Oxfam, and other NGOs, Village Banks, self-help groups in India, or simply the member savings being taken by a variety of microcredit NGOs around the world (also called compulsory savings). Some of these institutions borrow liberally from the indigenous informal forms of savings mentioned above. The act of depositing savings occurs in or near the home or business, or during the course of interactions with the NGO representatives.

Formal Institutions

There are several different institutional types that can formally accept savings and intermediate these savings in a productive fashion. These are banks, deposit-taking non-bank financial institutions (NBFIs) and cooperatives.

For these institutions, savings mobilization can occur at a branch location of the institution, or in any numerous forms of "branchless banking" locations that have emerged in recent years.¹ Making deposits and withdrawals in the context of the branch occurs in the same way it does around the world any

¹ I use the term "branchless banking" as defined by CGAP: the delivery of financial services outside traditional bank premises, usually by taking advantage of information and communications technologies such as POS or RTS devices, ATMs, cell phones, smart cards, or pre-paid cards.

day. ATMs are also being employed in greater number. "Branchless" banking employs new technologies, where making deposits can be as simple as a saver going into the local grocery store, convenient store, lottery kiosk, etc., giving the cashier some money, and receiving proof of payment generated by a remote transaction or point of sale device showing that the money has been deposited into an account. Withdrawals occur in the same way. Deposit-taking could also involve someone from a local institution coming to meet depositors in the market, taking the deposits and recording it using a remote transaction device that accesses each person's account by reading personal smart cards. Technology innovations abound that will bring formal types of savings accounts to more informal settings.

General Principles of Financial Regulation

To understand existing legal and regulatory constraints to savings mobilization, it is important to understand why institutions take savings in the first place, and how regulators approach the collection and use of deposits.

Institutions take savings primarily for two inter-related reasons. First, it is a source of funds for the institution. Some argue that it is the cheapest source of funds available to most institutions, although this is dependent on the calculation of the true cost of collecting savings (regulatory compliance, staff training, liquidity and capital requirements, etc.) and the market for other sources of funds in the relevant country. Second, it is a service that entices the client to enter into the financial system and utilize other financial services for which the provider would earn a fee.

This creates a situation whereby the depositor is in fact an investor in the financial institution. Because most of these investors are doing so out of their own personal interest (putting their money in a safe place where it will

earn a small return), there exist significant information asymmetries regarding the use of these funds. This means that because depositors often do not spend extensive time and energy in investigating the investments a bank is making, they may blindly trust the money is safe, while the bank – whose incentive is to earn a return on this investment higher than the interest rate being paid to the depositor – may be utilizing these funds in risky investments that may result in losing the money entrusted to them. Regulators, then play a role in ensuring that incentives exist for the banks to weigh the trade-offs between earning a return on the deposited money with wisely using these funds and not taking excessive risks, so that depositors will not lose their money.²

Financial regulatory systems, therefore, are generally set up with a goal to protect the safety and soundness of the financial system. Regulations and supervisory techniques help regulators understand the risks a financial institution is taking and signal the need for intervention when the risks outweigh the management's ability to adequately mitigate against loss. When it comes to addressing very small deposits, the goal is to protect the depositor who has limited information and time. The regulator may also be calculating any additional burden created by supervising new institutions about which it has little knowledge, for which the regulator may have few resources to adequately supervise.

² Other actors are helping to correct these information asymmetries, namely institutional investors, raters, and auditors, all of whom create greater transparency around which banks are well-performing and therefore engender more trust for depositors. There is also a wide literature around the use of deposit insurance and whether it serves to mitigate risk or to heighten risk tolerance it by creating such a safety net. (See World Bank Finance Research Department, sub-topic on Deposit Insurance on <http://www.worldbank.org>.)

Microfinance Providers and Deposit-taking: Legal and Regulatory Considerations

In a general way, microfinance providers can take three distinct forms³: banks, non-bank financial institutions, and non-profit organizations. Legal and regulatory effects on savings mobilization are distinct depending on the type of provider.

Banks

Banks by nature are allowed to offer deposit-taking services, generally in a variety of ways (current and term accounts, use of ATMs, etc.). However, there can be detailed requirements that impede a bank's ability to offer flexible savings services to poorer populations. These include:

- *Minimum deposit requirements.* Some regulatory environments will require a minimum balance in a deposit account that may be too high for poorer populations to achieve.
- *Identification requirements.* In some places, requirements for identification (or multiple forms of identification) will impede poorer populations from opening accounts. These requirements may be intensified in the future as anti-money laundering and combating the financing of terrorism (AML/CFT) rules take effect. (Isern, et al. 2005)
- *Branching requirements.* Often, commercial banks must meet certain requirements in opening a branch such as security measures (bank halls, type of vaults), hours of operation, and location. These can sometimes make it too costly to open branches in remote areas where poorer populations reside. Similarly, ATMs might need to be located near branch locations or require certain amounts of security which would limit the ability to place ATMs in remoter locations.

³ This paper does not touch on the fourth provider of microfinance, cooperatives, which pose distinct regulatory challenges separate from other organization forms. Readers interested in cooperatives should consult the World Council of Credit Union's *Guide to International Credit Union Legislation* and other literature available on the WOCCU website (<http://www.woccu.org>).

Non-bank Financial Institutions

The second type of potential microfinance provider, non-bank financial institution, can take a generic form such as finance company (such as Bolivia's FFPs), or more specifically designated microfinance institution (such as microcredit organizations in Kazakhstan or Bosnia). In some cases they are allowed to take deposits and in other cases they are not allowed to take deposits, each of which face different obstacles to savings mobilization.

For NBFIs that are allowed to take deposits, there can be similar obstacles as are in place for banks in reaching deposit-taking services to the poor, as discussed above. In addition, such NBFIs may also be restricted in the types of deposits they can take. For example, an NBFIs may be limited to accepting term deposits that can only be withdrawn at specified intervals. Poorer populations, on the other hand, are generally more likely to need current accounts that offer the flexibility to deposit and withdraw money as required rather than at specific timed intervals.⁴ Under such rules, the NBFIs is not able to offer competitive services to the poor; from the regulator's viewpoint, however, it requires less resources – human and financial – to effectively supervise these institutions.

For non-deposit taking NBFIs the issue is their inability to take deposits. These institutions are organized similarly to for-profit companies, either with limited liability or as share companies and governed by the national Companies Law. Therefore, the organization may have the corporate governance in place that allows prudent stewardship of deposits. For some reason, the regulator has decided to not allow deposits to be taken, which may be correlated to a) the capacity of the regulator to adequately supervise

⁴ This stems from the use of savings as a risk mitigation and income smoothing strategy for the poor rather than as an investment strategy. (Robinson 2004 provides an overview of how and why people save, including a discussion on the need for flexibility in accounts.)

more deposit-taking institutions; b) the overall development of the financial system in the country; as well as c) the capacity of the institution.

Non-profit institution

Non-profit providers are generally regulated only minimally under the relevant law on NGOs, although a few countries have placed non-profit microcredit providers under Central Bank regulation with limited supervision (e.g., Brazil). In general the furthest these institutions will go towards offering deposit services is requiring compulsory savings in the context of taking a loan. In this situation, MFIs often take the view that clients are “net borrowers” (are liable to the institution for more money than they have saved in the institution), and the institution is not intermediating the savings it collects. The legal framework generally bars these institutions from mobilizing any other types of savings or intermediating what compulsory savings it may be involved in gathering. In some cases, this practice is not addressed in law and regulators are taking a laissez-faire attitude, allowing the practice. When not intermediated, the collection of such savings is a service to clients more than a source of funds for the institution. (There are exceptions to these trends where institutions do in fact intermediate the compulsory savings, or where non-borrowing clients still hold their compulsory savings accounts in the institution, making them “net savers”.)

Discussion: Understanding Legal and Regulatory Effects on Savings Mobilization

In general, for microfinance providers to move towards savings mobilization will require an understanding of three types of constraints: regulatory constraints; capacity constraints; and cost constraints. Below, each of these is outlined with examples of how this is being addressed in various countries.

Regulatory Constraints

As was highlighted above, rules written in law can sometimes prohibit an institution either from taking deposits outright or inhibit an institution's ability to offer small accounts that are accessible to the poor. The enforcement of the law, i.e., when regulators enforce laws in a different manner in which they are written, can sometimes affect an institution's ability to offer savings services as well.

There are three broad ways in which institutions are addressing such regulatory circumstances: 1) by lobbying for changes in the regulatory framework such that their institution can offer small deposits to the poor; 2) through institutional transformation into an organization that can offer deposits; 3) through partnerships and alliances with deposit-taking institutions. Examples of each of these are offered below.

Box 1: Brazil's red tape solutions

The government of Brazil has tried several tactics to increase the provision of financial services to the poor. What is being battled in Brazil, however, is bureaucratic red tape restricting financial services. For example, businesses must formally register in order to access financial services, since banks are prohibited from lending on the basis of unrecorded cash flow or income. Formal registration of the business implies tax liabilities, and Brazil's tax structure is expensive and complicated.

Brazil has, however, realized the problems such restrictions pose for the poor and two innovative solutions address such red-tape. Recently, banks have been allowed to set up 'banking correspondents' as their points of service. These 'correspondents' act almost like branch licenses, where retail locations — particularly shops and lottery ticket sale stations — are given a franchise to provide electronic access to the national payments system through an arrangement with the parent bank. Clients can open accounts, pay utility bills, send and receive money, check account balances, draw on credit lines and repay loans, often using a simple terminal machine similar to an ATM. The franchisees are paid a fee per transaction.

In addition, "simplified accounts" were allowed by banking authorities for accounts with less than R\$1,000 (US\$345) turnover per month. Unlike standard accounts, opening simplified accounts does not require proof of income and residence. Clients not yet in possession of a tax identification number are assigned one by the account-holding bank. This does not imply a tax obligation, but tax numbers are used for identifying individuals and companies in financial databases.

(From Druschel, van Bastelaer, and Meagher 2005)

Regulatory Reform

Regulatory reform to change the framework under which financial services can be provided is happening all over the world. In some countries, new laws accommodate specialized microfinance institutions that can take deposits (such as Uganda and Pakistan). Other countries have reformed

existing regulations for second-tier financial institutions (e.g., finance companies) so that they can better accommodate microfinance (including deposit taking), such as Bolivia Private Financial Funds (FFPs). Some countries have relaxed regulations regarding deposit-taking to create more conducive environments for providing services to the poor while simultaneously allowing new information technologies such as point of sale devices to be involved in the deposit-taking process. The best examples of this are in Brazil and South Africa (see Box 1).⁵ Table 1, adapted from the CGAP/IRIS Microfinance Regulation Resource Center (<http://www.cgap.org/regulation>), shows the different ways various countries have reformed the regulatory environment.

Table 1: Examples of Regulatory Reform

Regulatory Reform	Example Countries
Regulate microfinance activity, regardless of provider	<ul style="list-style-type: none"> • Under central bank supervision: Colombia, Philippines • Under a hybrid, delegated regulator: South Africa (credit only)
Reformed an existing NBF regulatory framework to accommodate microfinance	<ul style="list-style-type: none"> • Under central bank supervision: Ghana, Indonesia (both utilizing rural banks) • Using delegated supervision: Mexico
Reformed deposit laws for banks to facilitate deposit services to the poor	<ul style="list-style-type: none"> • Relaxed ID requirements and minimum deposit requirements: Brazil and South Africa
Created a new financial license for microfinance	<ul style="list-style-type: none"> • Tiered system (organizations can range from non profit and credit only to for profit and deposit taking): Kyrgyzstan, Tajikistan • Deposit-taking: West African Monetary Union, Peru (rural and municipal banks), Bolivia, Kenya, Pakistan, Uganda • Non-Deposit-taking: Bosnia, Brazil, Peru (NGO-MFIs), Nicaragua, Nepal

⁵ The development of Uganda’s Law on Micro Deposit-Taking Institutions (MDIs) is outlined in Ledgerwood, Braun, and Burand 2002. Bolivia’s story is detailed in Rhyne 2001. A great overview of Brazil’s financial services industry as it relates to access issues is in World Bank 2004. Information on the evolution of South Africa’s microfinance market is ably represented in ECIAfrica and IRIS Center 2005.

Transformation

Other organizations have instead chosen to transform their legal status into an entity already allowed to take deposits in their country. The first case of an NGO transformation was BancoSol in Bolivia, which worked directly with Bolivia's central bank to tailor the normal banking licensing requirements to accommodate BancoSol's unique portfolio (Rhyne 2001). Other institutions have followed and transformed into banks and deposit-taking NBFIs in order to begin taking savings; in some of these cases this was done entirely under an existing legal framework where no additional accommodation was made for the unique microfinance portfolio.

Partnership Models

A third way is for MFIs to partner with deposit-taking institutions so that deposit services can be provided to their clients, although the account lies in the books of the bank. This is sometimes called a service-agent or partnership model. Usually, the MFI will continue to function as the public face to the client, utilizing the same loan officers in the same manner. The bank trusts the MFI to make lending decisions and to offer deposit accounts to these customers based on its successes with the business model, and agrees to hold the loans and deposits on its books while financing the portfolio. The bank charges a fee for the capital, but the MFI may charge a fee for the service of finding and servicing clients. The client may or may not know that it is dealing with the bank, depending on the arrangement worked out between the MFI and the bank. ICICI Bank partners with Cashpor Financial and Technical Services in India under this model, and ACCION affiliates in Haiti and Ecuador have similar arrangements with other banks; numerous examples are emerging as this model proves its success. (Bell 2005; Lopez and Rhyne 2003)

Capacity Constraints

Capacity constraints affect two actors: regulators and MFIs. When considering lobbying for regulatory reform, the capacity of the regulator is a crucial factor, as the reform will generally require that it take on new responsibilities. (Druschel, van Bastelaer, and Meagher 2005) These new responsibilities require resources and capacity – including human know-how – to adequately supervise microfinance. MFI capacity is a similar stumbling block. Deposit-taking requires a new set of skills within the institution to deal with liquidity management and cash handling. It requires an institutional mind-set shift for the staff of the institution, as well as new incentives for bonus and promotion schemes for staff.

Regulatory capacity

Addressing regulatory capacity constraints is often the domain of donors, who will train regulatory staff in the business of microfinance and appropriate supervisory practices for microfinance. A look at the FIRST Initiative website (<http://www.firstinitiative.org>), which compiles information on financial sector strengthening projects funded by various donors, shows that in May 2006, there were 530 active financial sector related development projects across the globe, 163 of them related to strengthening or reforming financial sector regulatory frameworks or adjusting the financial system; 112 of the 530 active projects are classified as microfinance or access to finance-related.

USAID and GTZ have been the major funders of such initiatives as they relate to microfinance. Early in the reform process in Uganda, GTZ placed a resident advisor directly in the Central Bank of Uganda to work with the regulators there, training them in the business of microfinance from a regulator's perspective. In Ecuador, a USAID project worked in a similar way to train the staff of the central bank, increasing the important placed on supervising microfinance within that institution.

Institutional capacity

Overcoming institutional capacity often requires serious change management. The Savings Information Resource Center has been following the process taken by several MFIs in implementing deposit-taking, most notably Compartamos. See http://microfinancegateway.org/resource_centers/savings/changemakers for more information.

Cost Constraints

While it may be the cheapest source of funds available to many institutions, there is a cost involved in building a deposit-taking business, particularly if an institution's target clientele still deposits and withdraws in very small amounts, in remote, often rural, locations.

Overcoming such cost constraints can be done by either limiting the location and times when such deposits are made, or by offering them flexibly through cheaper technologies or within an existing infrastructure. This is where the latest innovations in information and communications technology are changing the way we think about offering financial services to the poor. While signing up for the account may need to be done in a bank branch, subsequent business can be done through an ATM, point of sale or remote transaction device in a local store, and increasingly through mobile phones. Alternatively, some organizations are equipping loan officers with remote transaction devices that utilize smart card technology – the loan officer quickly records the transaction using the device and stores the information on the client's smart card. Hewlett Packard has teamed up with three MFIs in Uganda and a variety of technical service suppliers, microfinance technical assistance providers, and other stakeholders to introduce such remote transaction systems in that country. (Hewlett-Packard) In the Philippines, rural banks are working with Globe Telecom to integrate "G-Cash" technology into loan repayments, so clients can use any G-Cash operator to repay their

loans. All of these technologies require a supportive regulatory infrastructure that ensures the risk for fraud within the system is minimized and client's deposits are still safeguarded; we are still learning how to best accomplish these goals within this new technological era.

Conclusion

Today, in many countries, creating greater opportunity for safe savings accounts to be offered to poor populations no longer requires an MFI to transform into a bank with high minimum capital requirements and to be supervised by a central bank that does not understand microfinance. With increased knowledge about how and when poor people want access to safe and flexible savings services, both institutions and regulators are responding. Traditional financial institutions are reaching into this market with relaxed regulatory requirements and impressive new technologies. Regulators are working with the microfinance community to better accommodate this business within the existing regulatory framework. Stakeholders on all sides are beginning to understand how capacity constraints – for both regulators and financial institutions – affect these choices. There is increasing opportunity for more and more of the world's poor to access deposit services, and for microfinance providers to utilize this source of funds to grow their portfolios and reach a growing number of people with financial services.

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