LEGAL AND REGULATORY REFORM FOR ACCESS TO FINANCE: A POLICY AND PROGRAMMING TOOL

TRAINING MODULE

microREPORT #48

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LEGAL AND REGULATORY REFORM FOR ACCESS TO FINANCE: A POLICY AND PROGRAMMING TOOL

TRAINING MODULE

Accelerated Microenterprise Advancement Project (AMAP) Financial Services
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OVERVIEW OF THE TRAINING MODULE

TRAINING OBJECTIVES

By the end of this training, participants will:

1. Understand the term "access to finance" and the possible policy interventions that correspond to this term.

2. Know the basics of microfinance regulation best practice.

3. Be familiar with the Policy and Programming Tool and its use in analyzing programmatic options.

4. Learn how to gather and analyze materials relevant to the tool.

5. Learn how to contract outside expertise.

TRAINING PARTICIPANTS

Participants in this training should already have experience in or understanding of:

1. Have a basic understanding of financial systems and how they work.

2. Have a basic understanding of microfinance and how microfinance programs are implemented.

3. Have a basic understanding of the goals and tools of financial regulation.

MATERIALS AND EQUIPMENT

- PowerPoint presentation
- Handout 1: Examples of "Access to Finance" Related Strategic Objectives
- Handout 2: Regulation in the Philippines

- Handout 3: Excerpts from Zambia's Microfinance Regulations, 2006
- Handout 4: The Case of ExampleLand
- Handout 5: Example of a Step One Matrix
- Handout 6: Financial Services in the Lorax Republic
- Handout 7: The Financial Regulatory Framework in the Lorax Republic
- Handout 8: The Capacity of the Lorax Republic's Regulator
- Handout 9: The Lorax Republic's Potential Advocates
- Handout 10: USAID's Opportunity to Effect Change
- Flip-chart 1: Blank Step One Matrix (3 copies)
- Flip-chart 2: Blank Decision Roadmap
- Index Cards for each participant (1)
- Copies of CGAP's Donor Guidelines, Consensus Guidelines, and IDB's Principles of Microfinance Regulation

OUTLINE OF THE TRAINING MODULE

Timing	Session Content	Training Techniques and Activities	Materials
8:30 – 8:45 am **(15 minutes)**	1. Introduction Introduction of trainers and participants Training objectives Training content		Binder with toolkit Slides 1-2
8:45 – 9:00 am **(15 minutes)**	2. What is access to finance and why is it important? What strategic objectives does it help us achieve?	Plenary Brainstorming and Mini-Lecture	Slide 3 Handout 1: Examples of "Access to Finance" related Strategic Objectives.
9:00 – 9:15 am **(15 minutes)**	3. How do we program "access to finance"? What are common interventions? What things have participants done? Introduce Donor Guidelines and "micro, meso, macro" framework	Plenary Brainstorming (small groups if number of participants exceeds 15)	Slides 4-5
9:15-10:30 am **(75 minutes)**	4. What is microfinance regulation? Review purpose of financial regulation Introduce CGAP Consensus Guidelines ideas Prudential vs. non-prudential regulation Comparative approaches	Utilize existing CGAP training Examine a sample MF law (handout)	Slides 6-12 Handout 2: Regulation in the Philippines Handout 3: Excerpts from Zambia's Microfinance Regulations, 2006
10:30 – 10:45 am **(15 minutes)**	Break		
10:45 – 11:15 am **(30 minutes)**	5. Can policy interventions always solve this issue?	Individual reading of a failed policy intervention case study. Plenary brainstorming identifying the reasons for failure.	Handout 4: The Case of ExampleLand Slides 13-14
11:15 – 11:30 am **(15 minutes)**	6. Introducing the tool Why it was developed? What it will help you do? What it isn't meant to do for you/ limitations? Overview of the three components	Lecture	Slides 15-21
11:30 – 12:30 am **(60 minutes)**	7. Step One: Assessing the situation Objective of Step One	Lecture	Slides 22-23; Handout 5: Example of a Step One Matrix; Toolkit pp 9-14 for

	Resources required to complete Introduction to the Step One matrix	Three small groups: Fictional Country X's financial services market. Each group assesses one aspect (credit, deposit, transfers) and fills in the matrix. Plenary: Present findings. Plenary group decision on whether each aspect represents a lack of access.	further resources Handout 6: Financial Services in the Lorax Republic Flip-chart 1: Blank matrix on flip-chart paper to fill in (3 copies) Index Cards
12:30 – 1:30 pm	Lunch Break		
1:30 pm – 1:50 pm **(20 minutes)**	8. Step Two: Analyze conditions for reform Objective of Step Two What are the four factors How to assess each factor and resources required	Lecture with plenary brainstorming on types of resources required to assess	Slides 22-33; Toolkit pp 15-23 for further resources
1:40 – 2:50 pm **(60 minutes)**	9. Using Step Two Employ factor analysis in Fictional Country X	Four small groups: The Lorax Republic's conditions for reform. Break into four groups, each to assess one factor using resources provided.	Handouts 7-10: Case study information for each factor
2:50 – 3:15 pm **(25 minutes)**	10. Debrief Step Two What did they learn? What surprised them?	Convene as a group to provide findings and discuss whether yes/no determination is correct. Plenary brainstorming	
3:15 – 3:30 pm	Break		
3:30 – 3:45 pm **(15 minutes)**	11. Step Three: Focus your Efforts Introduce the Decision Roadmap	Lecture on Decision Roadmap and how to use it; skim through a few scenarios, but not all Plenary discussion on other scenarios in the tool	Slides 34-44; Toolkit pp 24-32 for further resources
4:00 – 4:45 pm **(45 minutes)**	12. Step Three: Decisions for the Lorax Republic Apply Decision Roadmap to the Lorax Republic Introduce the other scenarios and corresponding recommendations. Is it what was expected? Identify discrepancies between expectations and recommendations in the tool and discuss.	Plenary Discussion: Are the recommendations for the Lorax Republic feasible? Is it a different outcome than you expected?	Flip-chart 2: Flip-chart paper with blank table to fill in with answers Index Cards
4:45 – 5:00 pm **(15 minutes)**	13. Debrief Tool Highlight all available resources for users of the tool. Spend time discussing the TOR that is available	Show all available resources for tool users, including TOR. Provide links to guidelines on implementing LRFAF projects (CGAP, IDB, etc.)	Slides 45-49 Handouts of relevant documents (e.g., copies of Donor Guidelines, Consensus Guidelines and IDB Guidelines)
5:00 – 5:15 pm **(15 minutes)**	14. Closing Summary	Have several participants provide their own summaries	Handout of all slides to be put in binders.

SESSION 1: INTRODUCTION

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: By the end of session 1, participants should be aware of what will be accomplished during the course of the day, what is expected of them, and who their fellow participants are. It should be stressed that basic knowledge about the financial sector, microfinance, and financial regulation are assumed in the course of this training.

SESSION CONTENT:

1. **(2 minutes)** Trainer(s) should do self-introduction, including their background relating to microfinance legal and regulatory reform.

2. **(7 minutes)** Ask participants to state their names, organizations, countries, and why they may be interested in using this tool. Other ice-breaking exercises may be organized.

3. **(1 minute)** Ask two participants to volunteer to provide a summary of the morning and afternoon sessions at the end of the day (respectively).

4. **(2 minutes)** Pass out binders if they haven't been already given to participants. Turn to **Slide 2** and introduce the training objectives, which are:

    1. By the end of this training, participants will
    2. Understand the term "access to finance" and the possible policy interventions that correspond to this term.
    3. Know the basics of microfinance regulation best practice
    4. Be familiar with the Policy and Programming Tool and its use in analyzing programmatic options.
    5. Learn how to gather and analyze materials relevant to the tool.
    6. Learn how to contract outside expertise.

Ask the participants if they have any other objectives they would like to add to this list. Answer each one directly, saying whether they can or can not be accommodated in the course of the day's training.

5. **(3 minutes)** Go over the content of the training with participants. Tell participants we will begin by discussing the topic of "access to finance" - what it means and how donors program it. We will then explore the place policy interventions hold in solving access to finance issues and will ask to draw upon their own experiences in doing so. This will help to introduce the Policy and Programming Tool, which we will clearly explain. We will also utilize extensive case study material to employ the tool, using it to determine the best course of action in the case study country. There will be a good deal of small group work, brainstorming, and discussion, and we hope to have everyone's full participation. At the end of the day we will also provide further information and resources that will be useful in implementing the tool.

SESSION 2: WHAT IS ACCESS TO FINANCE AND WHY IS IT IMPORTANT?

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: Access to finance includes the ideas that all people should have the opportunity to access a range of financial services – not only credit but also savings, transfers, and insurance. Access includes the ideas of affordability and transparency. Countries with deeper financial systems (greater access) are more developed and show less incidence of poverty – working on these issues can often help in achieving a number of economic growth and poverty reduction related strategic objectives.

SESSION CONTENT: DISTRIBUTE HANDOUT 1

1. **(8 minutes).** Plenary brainstorming. Show **Slide 3.** Pose the question "What is access to finance?" and ask the participants to brainstorm possible responses. List responses on a flipchart. (Responses might include: "using credit," "having a deposit account," "having a bank account," "sending or receiving remittances," etc.) Tie the responses together with a general definition of access to finance such as, "Access to a range of financial services – including credit, deposit, and transfer services – from a variety of financial services providers – including banks, credit unions, and non-bank financial institutions. Access to such services should be done in a safe manner and with full information disclosure." Other points to include:

- Microfinance means financial services for the poor. It is about diverse institutions providing permanent access to a broad range of financial services for a broad range of clients.

- All poor people, not just entrepreneurs, use and need financial services beyond working-capital loans, such as savings, credit, insurance, and money transfer services.

- Institutions with large existing infrastructures, such as commercial banks, state-owned banks, credit union networks, financial cooperatives, and even retail chains, could play a significant role in scaling up financial services for the poor.

- Large-scale sustainable microfinance can be achieved only if financial services for the poor are not viewed as a humanitarian effort isolated from national financial system. In order to reach millions of poor people, microfinance will need to be housed within institutions that are licensed to capture deposits from the public and other commercial sources.

2. **(7 minutes)** Plenary brainstorming. Pose the question, "If that's what access to finance means, what strategic objectives does addressing this question help us to achieve?" List responses on a flipchart. (NOTE: This is specific to a USAID audience.)

SESSION 3: HOW DO WE PROGRAM "ACCESS TO FINANCE"?

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: Programming for access to finance can occur on three levels (micro, meso, and macro). Each level is important in building a more inclusive financial sector.

SESSION CONTENT:
1. **(7 minutes)**. Plenary Brainstorming. Turn to **Slide 4** and click once. Ask the participants how they would program "access to finance" objectives – what are the types of interventions they would initiate (or have initiated) to achieve such a goal? List responses on a flipchart. (Note: If the group exceeds 15 people, informally break into smaller groups of 5-7 people. This may facilitate more learning between groups.) Emphasize things they may have already done in this area. Click again to show other examples.

2. **(8 minutes)**. Mini-Lecture. Look at the examples provided by participants and remark that these could be grouped into three levels of activities: micro, meso, and macro. Explain that the Consultative Group to Assist the Poor (CGAP) has recently surveyed their 30+ member donor institutions and created a document called "Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance" which outlines such a matrix for determining which level of donor activities are important. Turn to **Slide 5** and explain the following concepts:[1]

- **Inclusive Financial Systems:** The new vision for donor activities in microfinance recognizes that large-scale sustainable microfinance can be achieved only if financial services for poor households are integrated into all three levels of a financial system: micro, meso, and macro. In general, integration allows

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1 Adapted from CGAP's "Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance" explanatory PowerPoint presentation, available at http://www.cgap.org/direct/policy/donorguidelines.php.

greater access to capital on the part of institutions serving poor households, better protection of poor people's savings and increased legitimacy and professionalization of the sector. Ultimately, integration into the financial system could open financial markets to the majority of people living in developing countries, including poorer and more geographically remote clients.

- **Micro-level:** Success in building inclusive financial systems hinges on the contributions of a wide range of actors and their ability to work together effectively. In addition, financial systems for poor households depend on existing conditions, such as infrastructure, access to markets, production technology, and availability of information to mitigate risk. The backbone of financial systems remains retail institutions that provide services directly to clients (micro-level).

- **Meso-level:** In addition, a supporting infrastructure comprising quality auditors, rating agencies, professional networks, trade associations, credit bureaus, transfer and payments systems, information technology, technical service providers, and trainers is required to reduce transactions costs, increase outreach, build capacity, and foster transparency among retail institutions. This infrastructure, known as the "meso-level," can transcend national boundaries and include regional or global actors.

- **Macro-level:** Finally, a conducive and stable macroeconomic and policy environment is necessary to underpin a pro-poor financial system. Central banks, ministries of finance, and other national government entities constitute the primary "macro-level" players.

SESSION 4: WHAT IS MICROFINANCE REGULATION?

SESSION LENGTH: 95 MINUTES

KEY MESSAGES: The regulation of microfinance should be clearly defined and participants should understand that an enabling environment for microfinance is one that takes away the obstacles for financial services to be provided to the poor from a variety of providers. The activities should help participants further understand exactly how this occurs in real-life situations.

SESSION CONTENT: DISTRIBUTE HANDOUT 2 AND 3

1. **(2 minutes)** Explain that to start with that it is important to understand the terminology so that we can work together as a group with the same understanding of core principles. Show **Slide 6** and explain:

- *"Regulation" refers to the set of government rules that apply to financial services. It aims to protect the financial soundness of licensed intermediaries' business in order to prevent financial system instability and losses to depositors.*

- *"Supervision" is the process of enforcing compliance with those rules.*

2. **(5 minutes)** Plenary Brainstorming. Ask participants what they would consider "appropriate" policies for increasing access to finance, or that are particularly conducive to microfinance.

3. **(5 minutes)** Mini-Lecture. Show **Slide 7**, which discusses the salient features of an appropriate policy environment. Emphasize these points:

- ***Allows credit institutions to charge sustainable interest rates.*** Because microfinance is more costly than traditional, mainstream finance, microfinance providers must be able to charge a higher, cost-recovering interest rate from their customers. Some countries have usury laws in place that place a ceiling on the interest rate that can be charged which is lower than a microfinance provider's cost recovery rate. Experience has shown that this leads to credit rationing – fewer resources going to the poor – which is a far worse outcome than paying a higher price for the service. In addition, research has also shown that the poor have a high price tolerance, particularly when there are no other available services, and that greater competition between microfinance providers will create greater efficiencies and lower prices.

- ***Removes policy barriers to the profitable provision of loans, savings, insurance and transfer services to the poor.*** These policy barriers can come in many forms in addition to the interest rate restrictions. For example, some countries have ID or minimum balance requirements in order to open a savings account that restrict access to the very poor who do not have such IDs or can't maintain the minimum balance. Who can legally act as an agent for insurance or transfer services will affect whether the poor can access such services.

- ***Adjusts banking requirements that would impede profitable provision of microfinance services.*** Traditional banking regulations often need modified in order to support the very different risk profile presented by a microfinance portfolio. This includes changes in the way minimum capital, capital adequacy, loan loss provisioning, and other items are formulated.

- ***Integrates microfinance into the financial sector by allowing competent providers access to commercial funding sources.*** Microfinance providers can not survive in the long-term on limited donor funding. They must be able to access a range of private capital sources, including commercial debt and various forms of equity, and, where the provider is competent enough to do so, deposits.

- ***Protects the soundness of microfinance providers who take deposits.*** When a financial institution is entrusted with the public's money (in the form of deposits), it must be regulated in such a way that ensures the sound use of these funds when they are intermediated. This involves the use of prudential regulation, which we'll turn to next.

4. **(3 minutes)** Show **Slide 8** and explain the following concepts:

- ***Prudential regulation*** is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions. When a deposit-taking institution becomes insolvent, it cannot repay its depositors, and, if it is a large institution, its failure can undermine confidence enough so that the banking system suffers a run on deposits. Prudential regulation mandates such things as capital-adequacy requirements and rules for provisioning loan losses, which almost always require a specialized financial authority for their implementation. Prudential regulation is relatively difficult, intrusive, and expensive because it involves understanding and protecting the core health of an institution.

- ***"Non-prudential" regulation*** tends to be easier to administer because government authorities do not have to take responsibility for the financial soundness of the organization. "Non-prudential" rules, e.g., screening out unsuitable managers or requiring transparent reporting and disclosure, are appropriate for microfinance providers that do not take deposits. These rules may often be largely self-executing and can often be dealt with by agencies outside the central bank or finance ministry.

- ***An important general principle*** is to avoid using burdensome prudential regulation for non-prudential purposes—that is, purposes other than protecting depositors' safety and the soundness of the financial sector as a whole. For instance, if the concern is only to keep persons with bad records from owning or controlling MFIs, the central bank does not have to control the financial soundness of MFIs. Such non-prudential regulation can often be accomplished under general commercial laws, and administered by whatever organs of government implement those laws.

Solicit and respond to any questions related to these definitions. Ask participants to focus their questions on these definitions, avoiding in-depth discussion on whether microfinance should be regulated or not, which will be covered in the next session.

6. **(20 minutes)** Guided Plenary Discussion.

7. **(5 minutes)** Distribute **Handout 2** (Mindanao Times Press Release) to all participants. Ask participants to take 5 minutes to read the press release.

8. **(5 minutes)** Ask: How is microfinance different from "regular" banking from a regulation standpoint? Take a few suggestions before showing **Slide 9** to review reasons why microfinance may need different treatment than regular banking.

9. **(10 minutes)** Now, let's see how these kinds of issues affect standard banking regulations when they are applied to microfinance. Show **Slide 10** and go through the issues one by one. Encourage questions and discussion. Ensure the following information is covered-
Typical regulations that may need to be changed for microfinance portfolios:

- ***Capital adequacy ratios may need to be higher due to risk*:** A number of factors support mandating tighter capital adequacy requirements for specialized MFIs than the requirements applied to commercial banks: Well-managed MFIs maintain excellent repayment performance, with delinquency typically lower than in commercial banks. However, MFI portfolios tend to be more volatile than commercial bank portfolios, and can deteriorate rapidly because they are usually unsecured. The borrower's main incentive to repay a microloan is the expectation of access to future loans. Thus, outbreaks of delinquency in an MFI can be contagious. The incentive of borrowers to continue paying declines because it is less likely that the MFI will be able to reward them with future loans. In addition, an MFI's costs are usually much higher than a commercial bank's costs per unit lent, so that a given level of delinquency will decapitalize an MFI much more quickly than it would decapitalize a typical bank.

- ***Minimal capital requirements: there may be a need to ration the number of licenses that need supervision.*** There is a direct trade-off between the number of new institutions licensed and the likely effectiveness of the supervision they will receive. The most common tool for drawing this balance is minimum capital. Supervisors who will have to take responsibility for the financial soundness of new institutions tend to favor higher capital requirements, because they know there are limits on the number of institutions they can supervise effectively.

- ***Limits on unsecured lending*** as a percentage of the bank's equity capital or total assets often make character-based microfinance impractical.

- ***Provisioning a high percentage*** of unsecured lending will be impractical for most microfinance providers.

- ***Full registration of collateral*** costs too much to be used with tiny loans. Many MFIs use partial registration techniques that are both effective and affordable.

- ***Requirements for branches*** such as security standards, working hours, daily clearing of accounts, or limitations on location, can interfere unnecessarily with innovations that reduce costs and bring more convenient service to clients.

- ***Standard loan documentation requirements*** are too expensive and time-consuming for good micro-lending, especially when they rely heavily on group guarantees.

- ***Limits on guarantors or co-debtors***, if interpreted strictly, would not allow group loan methods where members are both debtors and guarantors.

10. **(5 minutes)** Ask: ***Where do you think supervisory responsibility for microfinance should be located? What options are you familiar with?*** (Possible answers: central bank, delegated supervision, self-supervision) Take a few answers and Show **Slide 11**, highlighting the following information:

- ***The supervisory body responsible for commercial banks is usually, though not always, the most appropriate supervisory body for depository microfinance***. Using this agency takes advantage of existing skills and lowers the incentive for regulatory arbitrage. Whether or not to create a separate department of that agency will vary from country to country, but at a minimum specially trained supervisory staff are needed, given the differing risk characteristics of microfinance portfolios.

- ***Delegated supervision:*** *Occasionally central banks have successfully delegated some supervision to third parties, while retaining authority and oversight.* This seems to have worked in some cases where the government financial supervisor closely monitored the quality of the delegated supervisor's work. Where this model is being considered, it is important to clarify: 1) who will pay the substantial costs of the delegated supervision, 2) a realistic fallback option available if the delegated supervisor proves unreliable, and 3) which body will have the authority and ability to clean up the situation if a supervised institution fails. Because many MFIs are relatively small, some think that their supervision can be safely delegated to external audit firms. Unfortunately, experience has been that external audits of MFIs, even by international audit firms, very seldom include testing that is adequate to provide a reasonable assurance as to the soundness of the MFI's loan assets. If reliance is placed on auditors, the supervisor should require microfinance-specific audit protocols and regularly test the auditors' work.

- ***Self-supervision:*** Sometimes regulators decide that it is not cost-effective for the government financial supervisor to provide direct oversight of large numbers of MFIs. However, self-supervision by bodies controlled by the supervised institutions has virtually never been effective in developing countries.

- ***Prudential supervision of savings and loan cooperatives****:* *Prudential supervision of savings and loan cooperatives should be done by a specialized financial authority, not by the government agency responsible for all cooperatives.* In most developing countries, supervision of financial cooperatives is assigned to the government agency responsible for cooperatives generally. These agencies are often charged with promotion of the cooperative movement, a mission not always consistent with financial regulation and supervision of cooperatives. Such agencies tend to be politicized, and almost never have the financial expertise needed to supervise financial intermediaries.

11. **(5 minutes)** Show Slide 12 and walk participants through the various options for regulating and supervising microfinance, showcasing the choices other countries have made. Points to emphasize include:

- There was a time in the 1990s when the trend was towards creating microfinance specific licenses regulated by the banking regulatory, which is why you see a large number of countries mentioned here. The sample from which this table is taken, however, (CGAP Regulation Resource Center), is not world-wide. There have been increasing trends lately to regulate microfinance within the existing regulatory framework.

- Many of these choices are contextual, given the nature of the existing regulatory framework, the capacity of the supervisor, the existing microfinance market at the time of regulation, the stakeholders involved in the process, and the prevailing political attitudes towards microfinance.

- Explain what "Tiered" regulation is – offering various options that range from a non-profit, credit only option to a for-profit, deposit-taking option, each with varying levels of oversight, access to commercial finance, and regulatory requirements.

12. **(5 minutes)** Provide participants with Handout 3: Excerpts from Zambian Microfinance Regulations and ask them to take five minute to read the regulations.

13. **(5 minutes)** Ask participants what was interesting about these regulations – what did they find the most interesting?

14. **(20 minutes)** Lead participants in a discussion of a few crucial points:

- In our comparative approaches table, where would you put the Zambian laws? Does it adapt an existing framework or does it create a whole new license for microfinance? Does it allow deposit-taking? Who is the regulator?

- What activities can a deposit-taking MFI versus a non-deposit taking MFI engage in? Why do you think the BoZ made these distinctions? Is the BoZ providing prudential regulation of non-deposit taking institutions? Should it be prudentially regulating its deposit-taking institutions? (Remember, the definition of "savings" in the law is very important.)

- What does the law say about governance of the institution and about internal controls? Does this fall under prudential or non-prudential regulation? Does it help the BoZ to mitigate risk? How?

(Note: this should lead into questions about whether or not such a policy would actually help to increase access to finance, which is the topic of the next session.)

15 minutes Break

SESSION 5: CAN POLICY INTERVENTIONS ALWAYS SOLVE THIS ISSUE?

SESSION LENGTH: 30 MINUTES

KEY MESSAGES: Policy interventions do not automatically create access. In addition, they are often influenced by political forces which can mitigate their effectiveness in automatically creating greater access.

SESSION CONTENT: DISTRIBUTE HANDOUT 4

1. **(5 minutes)** Distribute **Handout 4** (The Case of ExampleLand) to all participants. Ask participants to take 15 minutes to read the document and the following questions.

2. **(10 minutes)** Turn to **Slide 13** and click once. Ask: Do we consider this policy intervention "successful"? Why or why not? Gather some responses, and probe to find out what participants consider a "successful" policy intervention.

3. **(10 minutes)** Click again on Slide 13. Ask: What were the main factors that prevented NGOs from achieving their goal? Write responses on a flip chart.

4. **(5 minutes)** Go to **Slide 14.** Explain that in the course of over 10 years of microfinance legal and regulatory reform, patterns have emerged that tell us when a microfinance legal and regulatory reform project will be more or less "successful" or when it may backfire. Depending on how much of this was brought up in the previous discussion, make sure that these four points are covered:

- ***Identify the real constraints: Is it the regulatory environment?*** The first thing to know is whether or not it truly is the regulatory environment that is causing the constraint to growth of financial services. If it is, then you will see the following situation: Legal and regulatory considerations (such as capital adequacy requirements, inability to accept suitable collateral) inappropriately inhibit larger-scale commercial financial institutions from reaching micro and small enterprises or from providing financial services to poor households; and regulatory considerations inappropriately impede small financial institutions (such as unregulated NGOs) from growing larger, attracting greater and more diverse sources of private capital, and providing a wider array of financial services. If it isn't the regulations, then the real bottleneck comes in the capacity of the existing financial institutions, the lack of market demand, or a more simple lack of access to capital.

- ***Understand the existing capacity of the regulator.*** The second thing to know is what the existing capacity and workload of the regulatory body is. This will affect their ability to implement any potential reform to increase access to financial services in terms of resources and staffing. Two situations may seriously impede the success of a LRFAF project: 1) If the regulator is not able to fully meet its current responsibilities and faces shortcomings in its current staffing and resources, any additional work would be overly burdensome, and any regulatory development affecting access to finance could not be carried out in a sufficient manner to achieve any level of success. Capacity building is required. 2) If the regulator demonstrates the wrong incentives for reform - if staff is not motivated to participate in reform initiatives, due to either influence from government-related banks or other financial institutions, lack of motivational incentives to participate, or other corruptive influences, this will derail any reform initiative that is implemented.

- ***Know beforehand whether you have the 'right' advocate(s).*** This "champion" should understand the important facets of how to increase access to financial services and be willing to push reform measures onto the national agenda. The champion(s)—who can come from the private or public sector—should wield significant moral or political authority and/or assume a high level of responsibility within the public authorities dealing with financial sector issues. It is critical that this person or organization understand fundamental principles of microfinance; namely concepts such as sustainability (and the ability to charge cost-recovering interest rates) and when prudential regulation is necessary. The champion should also have a willingness to learn from international experience to draw from in advocacy efforts. Without this, the reform proposal will fall flat.

- ***Know your own limitations: Can USAID make a difference?*** A successful reform project depends on USAID's ability to understand what is needed to increase access to financial services through legal and regulatory reform, USAID's positioning within the country, the available resources, and the actions other donors are taking.

SESSION 6: INTRODUCING THE TOOL

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: The LRFAF toolkit will help to examine the major factors that will create success in a regulatory reform project, and was created out of a growing need to identify these factors in advance of getting involved in regulatory reform work. The toolkit will help the user to analyze the current situation in a given country and how best to proceed. It is composed of three steps: an overview of the financial services sector; an analysis of the conditions for reform; and a roadmap for deciding what action steps to take.

SESSION CONTENT:

1. **(5 minutes)** Show **Slide 16** and explain the following.

Over the last thirty years, the development of a variety of innovative mechanisms for lending, savings, insurance, and transfer instruments in developing and transition economies have shown impressive results as tools for delivery of financial services to poor households. Simultaneously, financial and technical support for the development of inclusive financial sectors is rapidly becoming a central element of donor development strategies. Such assistance takes many forms, from the provision of credit for on-lending to technical and financial training, and has been targeted at commercial banks, non-bank financial institutions (NBFIs), credit unions and non-governmental organizations (NGOs). This support has contributed significantly to the development of institutions that better serve poor households, and whose operations are focused on the twin objectives of organizational outreach and self-efficiency.

These operations, however, often take place within institutional and legal environments that are not designed to support the expansion and sustainability of microfinance services. In the absence of available information on institutional reform options, especially for those non-licensed organizations offering microfinance, the regulators' reactions have taken three basic forms: i) disinterest ("benign neglect"), ii) direct intervention in the microfinance providers' management using existing interventionist legislation, and iii) enactment of ad-hoc legal adjustments including special laws for microfinance. In most countries in Asia and Central America, neglect has enabled some growth but has resulted in insufficient attention to critically needed savings services. In

Russia, public interventions using existing legislation have prevented growth of many institutions that provide microfinance. In West Africa, the installation of ad-hoc rules forcing cooperative structures on all MFIs has hindered private investment and stifled innovation in developing alternative institutional models.

These approaches have not helped investors, MFIs or their clients. In some cases, laws have directly obstructed the implementation of international financial best practices among microfinance providers. Financial investors are hesitant to partner with or invest in MFIs because of uncertainty about the legal status of the organization or the legality of the investment. Finally, the lack of supportive policies, laws and regulations hinder MFIs' ability to offer – and clients to access - dependable savings, transfer and insurance products. As a result, MFIs remain largely dependent on various forms of financial support from donors, are not legally allowed to mobilize deposits, and face little incentive to transform themselves into viable and independent institutions that are integrated into national financial structures. Many governments were taken by surprise by the emergence of microfinance, in particular in countries where NGO activities were looked upon with skepticism. Governments originally saw little need to devote scarce fiscal resources to supervising these activities, and MFIs were satisfied to be able to grow without public oversight. Over time, however, both microfinance providers and regulators recognized a need to reach a level of regulation and supervision that did not tax further already overstretched regulatory authorities, while providing some modicum of legal recognition to growing MFIs eager to access formal sources of funding. Concurrently, formal financial institutions have begun to engage in these types of lending practices, diversifying the range of activities that regulators must oversee.

There is a growing realization that a transparent microfinance policy environment, supported by a flexible set of laws and regulations, will discourage fraud, improve the quality of investments in MFIs, ensure operational transparency and forge critical links to the broader financial market. In the medium to long run, if microfinance is to be fully integrated within the formal financial sector, supportive legal and regulatory frameworks are necessary.

2. **(2 minutes)** Show **Slide 17**. Explain the following:
The extent, nature, and reach of this optimal level of public oversight, however, depends on the combination of many factors, such as size of the market, scale of savings mobilization and regulatory capacity. In some countries, the level of development of the microfinance market —especially if it features substantial savings mobilization or affects market stability—may merit public oversight. In other countries, the microfinance market may be too small or underdeveloped to justify the costs of developing a full legal and regulatory apparatus to supervise the industry. In yet other countries, although the need may be clearly identified, the government may be aware of its own limitations in exercising regulation and supervision in an effective manner. The issues at hand in making these judgments are numerous and complex. They

include the country's stage of economic and microfinance development, the regulator's implementation capacity, concerns about innovation and client welfare, and macroeconomic variables. Many countries lack the instruments to determine whether the development of their microfinance market warrants higher public scrutiny, and whether they have access to the tools necessary to exercise this scrutiny. In addition, the lack of widely available evidence about the value of different approaches to regulation and supervision of microfinance makes it particularly difficult for governments to set priorities for public oversight. Therefore, this tool was developed by the IRIS Center to help guide USAID Missions to answer some of these questions – when are the conditions ripe for reform, and how to best spend scarce resources?

3. **(2 minutes)** Show **Slide 18**. Explain the following:
The toolkit builds on a growing body of resources for those interested in legal and regulatory reforms that would increase access to finance. Some of you may be familiar already with the CGAP Consensus Guidelines on appropriate regulatory considerations for microfinance. The World Bank Institute has also produced a training toolkit that addresses these issues. In addition, CGAP and IRIS have produced the Microfinance Regulation and Supervision Resource Center at http://www.cgap.org/regulation – where you can see 50 different profiles of regulatory environments in various countries around the world, read opinions on the impact of such regulatory choices, catch up on the latest news in regulatory reform, and browse recommended documents on best practice in this area.

In building this tool, however, we faced a dilemma: How do people look at this mountain of resources and come to decision about where to spend their resources and design reform programs that achieve some level of success? I think you've already seen this morning in our earlier discussions the complexity of doing just this.

4. **(1 minute)** Show **Slide 19**. Explain the following:
Therefore, we set out to achieve the goal of assisting USAID Mission staff and their country counterparts to identify the conditions under which such legal and regulatory reform may be warranted—and the circumstances under which is not recommended—and to suggest various programmatic options.

5. **(5 minutes)** Move to **Slide 21.** Explain the following:
The LRFAF tool consists of three fundamental steps: an assessment of the country's existing financial services market; an analysis of the country's readiness for legal and regulatory reform for access to finance, and an identification of the possible policy and programming options.

Step 1: Assess the situation. The first step is to understand the environment in which you operate. You will be asked to document the existing financial services market, looking specifically at ways poor households already access credit, savings, and transfer services.

Suggestions will be made for how to gather this information. This market assessment will help focus your efforts as you proceed.

Step 2: Analyze conditions for reform. In step 2, you will be provided with a list of four factors for which you will be asked to gather information. The toolkit will help you to determine what data sources to consult. You will also be given guidelines in how to assess each of the factors, which are:

- Characteristics of the financial regulatory framework
- Capacity of the financial regulator
- Existence of a public advocate for access to finance
- Opportunity for USAID to effect change

Step 3: Focus your efforts and determine what is feasible for your country. These four factors are plugged into a "decision roadmap" that helps you to see what types of interventions may be needed in your country and what other interventions should be added to create an optimal project. Case studies of countries that have faced comparable situations are offered as examples.

An Annex provides useful links, references of relevant documents, and selected USAID projects with a LRFAF component. Finally, a worksheet is attached for you to fill in throughout the process of using the tool to document the resources you consult and decisions that are made. This worksheet should be stored appropriately in several different locations, in an effort to avoid duplication of efforts in the future (when new FSNs come in, for example).

SESSION 7: STEP ONE: ASSESSING THE SITUATION

SESSION LENGTH: 60 MINUTES

KEY MESSAGES: The first step of the tool helps the user to more accurately pinpoint when "access" is constrained for deposits, credit, or transfer services.

SESSION CONTENT: DISTRIBUTE HANDOUT 5 AND 6
1. **(5 minutes)** Show **Slide 22.** Explain that we are going to begin using a fictional case study as we go through each step of the tool, starting with step one. First, spend some time explaining all the features of step one, including:

The first step is to understand whether low-income households and micro-entrepreneurs currently have access to affordable and reliable financial services, based on what current providers say and future trends show. This includes whether changes afoot in the financial sector will mean an increase in supply of financial services, or whether the current lack of financial services will not be solved in the future.

In evaluating all of this information, you are trying to answer a three-part question: Do low-income households and micro entrepreneurs face a significant lack of access, now and in the future, to safe and affordable

- *Credit?*
- *Deposit services?*
- *Transfer services (sending and receiving remittances)?*

Types of information to gather (more specific advice given in the toolkit itself):

- Determine who provides financial services. Examine NGOs, credit unions, NBFIs, and commercial banks. Document all the types of financial services they can or could provide (credit, deposit, and transfers).

- Talk to the existing MFIs about any demand studies or market research they've done on unmet demand for financial services.

- Talk to commercial bankers or a bankers' association about existing bank downscaling projects or interest from commercial banks in downscaling to lower-income retail or SME markets.

- Talk to other grassroots NGOs in the community about their perceptions regarding demand for financial services.

- Check out documents from the World Bank, IMF, the Economist, and others. Do a literature search for other academic papers on the subject in your country.

- Discuss with other donors what their understanding of demand and supply of financial services looks like.

2. **(5 minutes)** Show **Slide 23**. Explain that as you gather the information above, you should start to fill in a matrix that helps you to analyze it according to who the providers are, what services they are providing now and in the future, unmet demand estimates, and where the gaps between supply and demand might be. Pass out **Handout 5** and give participants a few minutes to look at a filled-in matrix.

3. **(30 minutes)** Break the participants into three groups. Explain that we are going to look at the fictional country of The Lorax Republic today in implementing the tool. Each small group will be given information about one type of financial service in The Lorax Republic. Group 1 will look at deposits, Group 2 will look at credit, and Group 3 will look at transfer services. Give each group a copy of **Handout 6** as well as a copy of **Flipchart 1**. Tell the participants to spend 30 minutes reading over the case study materials and filling in the matrix for each type of financial service they are responsible for.

Flipchart 1 (Change the column heading to reflect each group's mandate)

	(Deposits, Credit, or Transfer Services)
Providers	
Services currently provided	
Potential future services	
Estimates of unmet demand (saturation, some demand, major unmet demand)	
Lack of Access?	

4. (**10 minutes)** Re-convene the small groups and have each group nominate one participant to present their findings.

5. (**5 minutes)** Lead a discussion of these findings. Do the other groups agree with the final assessment of whether or not there is a "lack of access" of this type of material? Why or why not? What additional resources might they have turned to in order to find additional information on the demand or supply for their type of financial service? Write the list of resources on a flip chart. Explain that participants should remember to turn over every possible corner in trying to find this information – talking to only two or three stakeholders will ultimately bias the analysis.

6. **(5 minutes)** Pass out **index cards**. Ask each participant to write down the three things they think a project in The Lorax Republic should address that would increase access to finance. Ask them to put the index cards away; we will use them later.

Lunch Break 1 hour

SESSION 8: STEP TWO: ANALYZE CONDITIONS FOR REFORM

SESSION LENGTH: 20 MINUTES

KEY MESSAGES: Step Two analyzes four conditions for reform: the characteristics of the regulatory framework, the capacity of the regulatory, the existence of an influential public advocate, and the opportunity for USAID to effect change. Each is vitally important in determining how to construct a regulatory reform project and information is given for how to assess each factor.

SESSION CONTENT:

1. **(2 minutes)** Turn to **Slide 24**. Explain that in step two, you begin to look at four specific conditions for reform – these should look very familiar based on our discussion this morning about important success factors. They are:

- Characteristics of the financial regulatory framework
- Capacity of the financial regulator
- Existence of an influential public advocate
- Opportunity for USAID to effect change

For each factor, the tool provides a very specific question which you are required to answer "yes" or "no" – these answers will be used in the analysis in step 3. The tool points out the types of resources to consult and what the characteristics of a "yes" or "no" look like. For now, let's look at each one of these in turn before we go back to small groups and utilize the methodology.

2. (**5 minutes)** Turn to **Slide 25**. Explain that the first factor is to determine the characteristics of the regulatory framework and answer the question, "Does the financial regulatory framework inappropriately inhibit access to finance among poor households?" This will be, arguably, the hardest question to answer. In addition to gathering the relevant laws and regulations, potential resources to consult include

CGAP Regulation and Supervision Resource Center (http://www.cgap.org/regulation), FIRST Initiative website (http://www.firstinitiative.org/), discussion with all types of providers about problems with the regulatory environment, including a review of allowability of using movables or intangible property as collateral, and World Council of Credit Unions (www.woccu.org). Ask participants what other resources they might consult.

Turn to **Slide 26**. Explain that a "yes" answer to this question implies that regulatory considerations (such as capital adequacy requirements, inability to accept suitable collateral) inhibit larger-scale commercial financial institutions from reaching micro and small enterprises or from providing financial services to poor households; and regulatory considerations impede small financial institutions (such as unregulated NGOs) from growing larger, attracting greater and more diverse sources of private capital, and providing a wider array of financial services. A "no" answer to this question implies that any reason that a financial institution has not to grow into an institution serving poor households at scale and sustainably (either a small institution growing larger or a large institution opening into a new market) is related to issues of capacity building, access to capital, or lack of market demand rather than the regulatory framework in which this occurs.

3. **(5 minutes)** Turn to **Slide 27**. Explain that the second factor is to determine the characteristics of the regulatory framework and answer the question "does the financial regulator(s) have the potential capacity to undertake new responsibilities that would increase access to finance?" Potential resources to consult include eStandards Forum (http://estandardsforum.com) (collects information on compliance with international standards in macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision), FIRST Initiative, and to visit Central Bank, identify staffing needs, gauge application of supervision and regulation, as well as knowledge of unregulated providers. Ask participants what other resources they might consult.

Turn to **Slide 28**. Explain that a "yes" answer to this question implies that the regulator has a strong grasp of its responsibilities in overseeing the existing financial system and has the resources and technical capacity to undertake potential new responsibilities to overcome regulatory obstacles to access to finance. A "no" answer to this question implies that the regulator is not able to fully meet its current responsibilities and faces shortcomings in its current staffing and resources. Any additional work would be overly burdensome, and any regulatory development affecting access to finance could not be carried out in a sufficient manner to achieve any level of success. Capacity building is required. If time permits, ask the participants if they can give examples of "yes" or "no" in their own countries.

4. **(3 minutes)** Turn to **Slide 29**. Explain that the third question requires an answer to the question, is there an influential public or private advocate who will push the reform agenda in order to make it successful? Is it the "right" advocate? For example, in gathering the above information, has Mission staff met someone particularly interested in pursuing this topic? Participants should meet further with potential candidates to gauge whether they would be willing to support a potential USAID project on this topic. Has Mission staff worked with parliamentarians particularly interested in microfinance who would be willing to help push any legal reforms required through the parliamentary process? How successful is that parliamentarian likely to be, given local politics, and how willing is USAID to forge a partnership with that person? Ask participants to give examples of local advocates in their countries.

Turn to **Slide 30**. Explain that a "yes" answer to this question implies that one or more public advocates exist who could successfully push a reform agenda forward; these advocates are 'microfinance-savvy' and would not simultaneously push for such damaging efforts as interest rate caps or the prudential regulation of small credit-only institutions; these public advocates could also push for any new legislation required to be put before Parliament in a timely manner and could help shepherd such legislation through the parliamentary process. A "no" answer to this question implies that there is no one willing to support such a reform effort to increase access to financial services; or the persons willing to do so do not have the necessary understanding of what it takes to provide sustainable financial services on a large scale to poor households, and their involvement in the process might lead to further regulatory obstacles rather than breaking down of regulatory obstacles.

5. **(5 minutes)** Show **Slide 31**. Explain that the final question asks "is there an opportunity for USAID to make a difference in improving the legal and regulatory framework for poor household's access to financial services?" Assessing this factor requires the user to look both inward and outward. Looking inward involves analyzing the user's own experience with financial sector development, microfinance, and issues around increasing access to finance, and project leadership. You should ask what resources are available for the project, and compare this to other USAID microenterprise programs that have included LRFAF components. Ask who else in the Mission supports such an endeavor? How does it fit in with the overall strategy of the Mission? Are there available resources for the project? Looking outward requires knowing what the other donors in the country are doing and how USAID activities would compete with or complement such activities. Ask participants to share experiences of times they've tried to go ahead with projects when the Mission Director didn't buy in or when other donors were working the same area. What happened?

Show **Slide 32**. Explain that a "yes" answer to this question implies that the knowledge and resources you possess should lead to a successful project, you have support from within the Mission, and other donors are either not working in this area or are willing to partner with you in their own efforts. A "no" answer to this question implies that there are not enough resources available to create a successful project, or other donors are heavily involved in this activity and a USAID project would crowd these efforts too much to achieve any success.

SESSION 9: USING STEP TWO

SESSION LENGTH: 60 MINUTES

KEY MESSAGES: The analysis for each factor is not difficult; but requires a lot of informational inputs. Participants should learn-by-doing in this exercise.

SESSION CONTENT: DISTRIBUTE HANDOUTS 7-10

1. **(5 minutes)** Show **Slide 33**. To review, remind the participants what was discussed before the lunch break and ask if there are any questions about this. Once participants have refreshed their memories, say that it is time to break into four separate groups, each of whom will receive information on one of these factors for The Lorax Republic.

2. **(5 minutes)** Break the room into four small groups. Give Group 1 a copy of **Handout 7**, give Group 2 a copy of **Handout 8**, give Group 3 a copy of **Handout 9**, and give Group 4 a copy of **Handout 10**.

3. **(50 minutes)** Give participants 50 minutes to read the case study information and discuss. Ask each of them to use the worksheet at the end of the handout to record their discussions and make a determination on whether each factor is a "yes" or a "no." Remind participants that they can consult the binder with the tool for further information on how to assess each factor.

*Note: If the number of participants is fewer than 12, you may want to break them into three groups, and give Group 3 both Handout 7 and Handout 8.

*Note: Some of the groups may finish before others. Walk through their findings with them to see if you find any holes. If time permits, give them another handout to assess one of the other factors.

SESSION 10: STEP TWO: DEBRIEF

SESSION LENGTH: 25 MINUTES

KEY MESSAGES: This session should help participants to recognize what was learned during the process; what resources were available to conduct this analysis; and how the tool helped them think through critical issues.

SESSION CONTENT:
1. **(15 minutes)** Have each group send a representative to the front of the room and give them 3-4 minutes each to present the information they were given and the decisions they made. Ask the other participants whether they would have made the same decisions. Probe on some of the particularly conflicting evidence.

2. **(10 minutes)** Lead the group in a discussion of the process. What types of information do they wish they had in making these decisions? Were they surprised at some of the decisions they made? What was particularly difficult? Summarize people's opinions, making the point that it is often not easy to make such yes or no decisions, but that exploring all angles of these factors will be crucial as we move forward.

*Note: Make a note to yourself as the participants give their decisions what "option" this would be in the Decision Roadmap. You will need to know this in preparation for the next two sessions.

Break 15 minutes

SESSION 11: STEP THREE: FOCUS YOUR EFFORTS

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: The decisions from step two can be combined in a number of ways to help the user make decisions.

SESSION CONTENT:

1. **(2 minutes)** Show **Slide 34.** Explain to the participants that now that they have been able to make some determinations about the environment in which financial services operate, it's time to come to some decisions about what this means for a potential legal and regulatory reform project in your country. In a broad sense, if all four factors point to "yes" you probably should consider implementing a project to reform the legal and regulatory environment for access to finance. There will only be a few cases where this is true, however, and an array of possibilities is outlined below with some corresponding ideas for the types of likely interventions. In evaluating each option, a number of potential policy interventions will be discussed. Keep in mind the "micro, meso, macro" framework we discussed earlier.

2. **(5 minutes)** Explain to the participants that the "yes/no" answers they created in Step Two are at this point plugged into a "Decision Roadmap." Show **Slide 35**. Explain that of all the possible combinations, these are the 9 possible real world scenarios we have divined. In the first two we determined, that if the regulations were not the thing inhibiting access, it might be interesting to ascertain regulatory capacity, but that the other factors would no longer matter, as the suggestion would not be to spend scarce resources on reforming something that is not a constraint. Explain that in the tool, you will see that each scenario comes with accompanying text discussing the best programming options as well as some information on a country that faced a similar situation.

3. **(8 minutes)** Take some time to flip through 2-3 scenarios from **Slides 36-44** carefully avoiding the scenario they created in The Lorax Republic example (which you noted earlier). For each scenario, discuss what might have led to this scenario and what the policy and programming suggestions are. Mention the case study country whose experience corresponds to it, and discuss with participants whether they have experienced something similar.

SESSION 12: STEP FOUR: DECISIONS FOR THE LORAX REPUBLIC

SESSION LENGTH: 45 MINUTES

KEY MESSAGES: Here, participants should apply the decision roadmap to their work on the case study for the Lorax Republic and consider the recommendations the tool makes based on these decisions.

SESSION CONTENT:

1. (**5 minutes)** Show **Flipchart 2** and return to **Slide 35**. With the participants, fill in the Decision Roadmap to see what scenario they have predicted for The Lorax Republic.

Flipchart 2

Scenario	Financial regulatory framework inhibits access?	Regulatory capacity?	Public advocate?	USAID opportunities?

2. **(10 minutes)** Once the flipchart is filled in, match it up with the scenario on the Decision Roadmap. Go to the appropriate Slide in the presentation and debrief the programming options suggested there.

3. **(30 minutes)** Guided Discussion. What do they think about the recommendations the tool gives for The Lorax Republic? Ask participants to refer to the index cards they wrote after reading Handout 6. How do these differ with the recommendations given in the tool? Ask participants to share their insights. Ask participants what they would do from here – how would they use the analysis and what kind of project would they design?

SESSION 13: DEBRIEF TOOL

SESSION LENGTH: 15 MINUTES

KEY MESSAGES: Participants recognize the resources required in using this tool and where to find all of them.

SESSION CONTENT: HANDOUTS OF RELEVANT DOCUMENTS (E.G. OF DONOR GUIDELINES)

1. (**10 minutes)** In order to do this session well, participants will need to access a number of important resources. Show **Slide 45**. Briefly explain how these websites help to provide useful information. Show **Slide 46**. Discuss the importance of these publications. **Show Slide 47**. Here, emphasize the importance of talking to as many different people as possible, including all banks and MFIs, and the importance your own local networks in-country may play in helping you to understand all angles and opinions. Remember that USAID internally has a great team of people able to help you, and USAID belongs to CGAP where another great team of people could help you as well.

2. **(5 minutes)** Show **Slide 48.** Explain that we understand all of this might be quite overwhelming and that they are all very busy people. This assessment could take many hours to complete. Therefore, the toolkit comes with a full Terms of Reference (TOR) to use to hire someone to do it for you. All you need to do is plug in a few pieces of information about your country, and you'll have one international and one local consultant to conduct the assessment, for 24 total days of LOE (12 per person). In addition, the TOR is modular enough that it can be modified if you only want to hire someone to do a piece of the assessment.

SESSION 14: CLOSING SUMMARY

SESSION LENGTH: 15 MINUTES

1. **(15 minutes)** Ask the two volunteers to provide summaries of what was learned in the morning and afternoon sessions, respectively. Pass out a copy of the Power Point slides used in the session. Show **Slide 49** and thank the participants for coming. Conclude the session.

LEGAL AND REGULATORY REFORM FOR ACCESS TO FINANCE: A POLICY AND PROGRAMMING TOOL

TRAINING HANDOUTS

May, 2006

This publication was produced for review by the United States Agency for International Development. It was prepared by Kate Druschel, Thierry van Bastelaer, and Patrick Meagher, all of the IRIS Center at the University of Maryland, and Chemonics International. This publication is suitable for a day-long training in the use of "Legal and Regulatory Frameworks for Access to Finance: A Policy and Programming Tool."

LEGAL AND REGULATORY REFORM FOR ACCESS TO FINANCE: A POLICY AND PROGRAMMING TOOL

TRAINING HANDOUTS

Accelerated Microenterprise Advancement Project (AMAP) Financial Services
Contract: GEG-1-00-02-00013-00, Task Order #01
AMAP FS IQC, Knowledge Generation

Handout 1: Examples of "Access to Finance" related Strategic Objectives

- Increased Rural Incomes
- Improved Livelihoods in Selected Areas
- Increased Transparency and Efficiency in the Allocation and Mobilization of Resources in Selected States
- Rapid Rural Income Growth Sustained in Target Areas
- Labor-Intensive Exports Increased
- Increased private sector competitiveness in agriculture and natural resources
- Expanded Sustainable Economic Opportunities for Rural Sector Growth
- Accelerated Economic Growth

Handout 2: The Case of ExampleLand

ExampleLand is a small country in the Eastern Europe and Central Asia region. It is rich with natural, mineral resources. After the country claimed independence in the 1990s, the Russian centralized economy collapsed and many employees of state-owned enterprises and government workers lost their jobs. Many turned to trading and other types of small businesses and were badly in need of capital. At that time, the existing financial system was weak and so the donor community and international NGOs operating in the country turned to microcredit to help foster economic development.

A number of small NGOs cropped up and began conducting more and more business. Donors poured in more money, and the government began to get interested in what was happening in this sector. Some microfinance institutions and donors began to push for regulatory reform that would allow these NGOs to operate on a sounder legal basis, as it was unclear whether NGOs were legally allowed to conduct this on-lending business.

At the same time, the government and other donors expended resources on building the financial sector. Commercial banks learned how to operate on a commercially sustainable basis and the central bank received extensive technical assistance in regulating and supervising such banks and bringing their practices up to the standards of the Basel Core Principles. For the most part, however, these efforts existed separately from the development of the microfinance industry.

The government was also getting on its feet at this time, instilling principles of good governance, rule of law, and trying to rid the country of corruption. Successful elections were held, and as time went on, political parties strengthened. Two constant political topics were building the economy and helping to ease the burden of poor households. Microfinance, because of its ability to help achieve both goals, was encouraged – however, there were some in the government that felt it was only helpful as a poverty alleviation strategy and should remain in the hands of the NGOs.

In the midst of this, the NGOs came together to pursue legal and regulatory reform. They felt the need to draft a law that would govern their activities, a law that would allow for a tiered system, whereby they could enter the market as non-profit entities providing credit-only services and eventually move up the ladder, transforming from non-profit to for-profit, and eventually expand the scope of allowed activities to include deposit and transfer services. They looked at several other countries to see how they had written such a thing into law; donors helped them by supplying legal expertise and analysis, and eventually a draft law was produced.

At this point, however, they faced a challenge as no parliamentarians seemed willing to enter the bill before ExampleLand Parliament without substantial changes to it. For example, one person wanted to add interest rate caps to the bill. The central bank opposed the bill because it called for them to be the regulator and supervisor of the for-profit microfinance institution forms, and they did not want this responsibility, especially on top of all the other reforms they were involved in. The Ministry of Finance was torn, as some staff were behind the bill and others felt that the Ministry of Finance should maintain control over these institutions, not the central bank. The Ministry of Justice, which had been administering the non-profit institutions, became aware through this process that the microcredit non-profits were earning a profit on the loans they distributed and opposed the ability for these institutions to maintain non-profit status.

Eventually, however, compromise was reached on all sides, and a revised bill was introduced that allowed for one form of MFI: a for-profit, credit-only institution with minimal reporting requirements to the central bank. The central bank receives the reports but does not read them. The MFIs can only conduct credit services and are now facing a challenge as donors funds move on to other areas, and their portfolio base is not diversified. Outside sources of capital are slim. The central bank has since reformed the financial system, and strong commercial banks are beginning to go into the microfinance sector. Through these reforms, a non-bank financial institutional type was created, but the entry and reporting requirements are too stringent for MFIs to reach.

Questions:

Do we consider this policy intervention "successful"? Why or why not?

What were the main factors that prevented NGOs from achieving their goal?

Handout 3: Example of Step One Matrix

	Credit	Deposits	Transfers
Providers	Moneylenders, ROSCAs, friends and family, NGOs	ROSCAs; credit unions	Western Union storefronts
Services currently provided	Short-term credit	Current accounts at credit union only	High-cost transfer service; can't always afford to use it
Potential future services	NGOs will start doing some longer-term agricultural loans	Banks are starting to open more rural branches; ATMs moving into poorer urban areas	Credit unions negotiating with MTC to provide more affordable services
Estimates of unmet demand (saturation, some demand, major unmet demand)	NGOs only work in a few areas and don't have a lot of capital – other sources very expensive – lots of unmet demand	Poor don't trust banks yet and would prefer to work with the NGOs they already know; credit unions not a big business; some unmet demand	As banks and ATMS expand, and as credit unions get going, there will be more sources. There is also not a lot of migration, so demand is not great.
Lack of Access?	Yes	Yes	No

Handout 4: Financial Services in ExampleLand

ExampleLand is a large country that is currently undergoing a rapid economic development. This rapid economic development has meant a decline in the absolute level of poverty, yet a worsening in income inequalities, especially between urban and rural populations. Approximately 12% of the population lives below the international poverty line of $1/day (PPP); however, most of these are concentrated in rural areas. The country's manufacturing sector has seen recent, substantial growth

The government of ExampleLand has a stated commitment to poverty reduction which has, in the past, impacted the financial services sector. The government is slowly growing out of the philosophy of state-owned banks dominating the sector and has started to private its assets in the financial sector. There are three national state-owned banks, one of which is mandated with working purely in rural areas (the Agricultural Bank). In addition, there are a number of local government-owned financial institutions at the provincial and city level. All of these institutions are offering savings accounts and lending activities, although most of the lending activity is geared towards large enterprises, especially manufacturing and agro-processing. Lending is collateral-based, mostly utilizing real estate (both commercial and residential). Wire transfers between branches of the same bank are possible, although exorbitant fees are imposed to transfer money from one bank branch to another. ATMs only exist in cities and the largest rural towns, and some of the smallest bank branches are still paper-based. Western Union has arrived in the large cities, but has not made any inroads to the rural towns, although more and more out-migration from the rural areas is starting to occur.

These state-owned financial institutions, however, are plagued by crony-ism and lending based on relationships. Most face liquidity shortages as the government slowly takes away their financial subsidies, and their personnel are ill-equipped to manage a commercially sustainable institution. However, this wide network of government-owned institutions means that bank branches exist in all cities and large rural towns, and about 10% of these institutions show promise, including a willingness to reach out to new client populations, especially MSMEs and poorer households. The more prosperous rural villages may also have a bank branch, although usually only from one bank, operating without competition.

There are a few private sector banks that have entered the market, although these have concentrated in large urban areas and spend most of their investment in the burgeoning urban private sector. There are a good number of cooperatives as well, in both urban and rural areas, however these operate mostly for the middle-class and are also plagued by poor management and, power relationships that dictate where funds go. These cooperatives are not linked together in any fashion to move excess funds between them nor to move transfers between different cooperative members, although there are discussions to begin linking up cooperatives within each province.

The postal system does exist in every city, town, and village, and savings accounts are available at every local post office. In addition, the post office will send funds from anywhere to anywhere in its system around the country. This payment system is not, however, linked to the commercial banks or to any international network.

In addition, there are a number of domestic and international NGOs that have employed the Grameen Bank lending methodology. Approximately three NGOs have been able to reach greater than 7,000 clients, and the remaining ten reach about 2,000 clients each. All of them operate within small areas and most of them lend only to rural or peri-urban customers. They only participate in lending activities, and operate mainly on donor funds which, due to the rapid economic development in most of the country, are quickly starting to dry up.

Handout 5: The Financial and Regulatory Framework in ExampleLand

As you learned earlier, the types of financial institutions in ExampleLand include private and public banks, cooperatives, the postal savings system, and the microcredit NGOs. Below you will find some information about the financial regulatory framework. Read this and discuss with your other group members, and use it to fill in the worksheet you will find attached here.

Laws and Regulations

You have consulted the relevant laws and regulations in your country as well as some other analyses of the regulatory environment and found the following:

Types of Institutions	Banks	Cooperatives	NGOs
General Approach to Regulating			
Legal basis for regulating (Law)	Law on Banks	Cooperative Act	Law on Foundations.
Regulator(s) and role of regulator(s), supervisor(s)	Central Bank; regulates and supervises	Central Bank; regulates, but does not actively supervise	Ministry of Justice for registration purposes, only.
Required legal form of organization	Company	Cooperative – member owned and governed; provides serves to members only	Foundation
Ownership restrictions	No person or group of related persons may hold more than 45% of shares; persons holding more than 5% of shares must be fit and proper. No majority foreign ownership.	Owners must be individuals and must be members of the cooperative.	Foundations are not "owned" by individuals. No foreign founders.
Source of Funds (what's required or prohibited)	No restrictions	Members' shares.	
Capital and Reserves			
Minimum capital	US$2.5 million	Minimum capital requirements are determined by multiplying the number of members by US $25.	N/A
Capital adequacy/ gearing ratios	Core capital: 8% of risk weighted assets; Total capital: 12% of risk-weighted assets.		
Forms of capital recognized	Core capital refers to shareholders equity in the form of fully paid-up shares plus reserves. Supplementary capital refers to general provisions, revaluation reserves, and any other capital.	Capital consists of issued capital (members shares), additional monetary contributions, monetary donations, retained earnings and financial year's earnings.	
Risk-weighting of assets	Follow risk weighting concepts as given in Basle Agreement.	Cooperatives shall classify their assets in accordance with written policies and procedures approved by their management and	

		maintained in their credit files.	
Loan loss provisioning, write-off	• General provision of 1% • Substandard: 180-365 days, 20% • Doubtful: 1-2 years, 50% • Loss: more than 2 years, 100% • Write-off within three months of being identified as loss	• Standard Loans: 2% • Watch Loans: 10% • Doubtful Loans: 70% • Loss Loans: 100% A credit union can classify a loan as partially "Watch," "Doubtful" or "Loss" in cases where the loan is partially secured.	
Reserves, **Liquidity requirements**	Liquidity Ratio: Liquid assets max 30% of demand and time liabilities; liquid assets include cash, government T-Bills and securities, net deposits in domestic banks or the central bank, demand deposits at foreign banks, promissory notes.	Reserve accounts for losses should be maintained in local currency. They should be reviewed and adjusted on a monthly basis.	
Risk Management Guidelines			
Guidelines on business activities			
Financial Services	Permitted: All financial activities except the following: Prohibited activities: Lending using financial institution's own shares or capital as security; engaging in trade, commerce, industry, insurance or agriculture, make capital investments in excess of 25% of core capital; investments in immovable property only up to 100% of core capital and only for the purpose of conducting the financial business; underwriting of shares and securities brokerage; restrictions on foreign exchange business as prescribed in rules published by the central bank, the same applies to net open positions in any foreign currency.	Permitted: Attract deposits from members; extend loans to members; engage in limited investment activities; provide services related to the above.	May conduct lending activities.
Consumer protection	Must meet truth-in-lending requirements in loan documentation.		
Interest rate restrictions	None.	Rates can float up to 25% around a base rate set by the central bank.	Interest rates are subject to negotiation with the government.
Other operational rules	New branch openings or changes in location require central bank approval; branch closure requires Bank of Uganda notification.		
Concentration of risk	Loan to a single borrower or related borrowers max. 25% of total capital (core capital plus supplemental capital), under certain circumstances up to 50%. Prohibition against large exposures which exceed 800% of total capital.		
Connected/ **insider business**	Use of non-preferential terms for loans to insiders prohibited; maximum limit for these loans (in the aggregate) is 20 percent of core capital; market value of securities has to be at	Members of the Executive Committee, Supervisory Council or Credit Committee may not provide a warranty or act as a	

	least 120% of outstanding loan amount; max. loan size to employees is equivalent of two years' salary (except for mortgage lending, which has a cap of three years' salary); max. loan size to non-executives is 2.5% of core capital; and other, strictly defined limits for insider lending.	guarantor for any loan.	
Reporting and Supervision			
Supervision methods	On-Site: Periodic on-site inspections or at its own discretion either by an officer of the central bank or another appointed person; more frequent visits as part of prompt, mandatory corrective actions.	The central bank supervises the activities of the cooperatives and on-site inspections are carried out once a year.	No on-site inspections.
Supervision costs and fees	Annual fee, penalty fee in case of late payment.		
Disclosure and reporting requirements	Annually: Audited financial statements All information including periodic returns, balance sheet and profit and loss; also the same information of subsidiaries, affiliates, associates or holding companies; frequency to be determined by central bank except reports on insider loans, which have to be submitted monthly. Return for net open position in foreign currencies daily, weekly or monthly.	Quarterly reports, which include assets classification and possible loss reserves. Annual external audits are also required, and all reports must be maintained according to procedures established by the central bank.	The Ministry of Justice requires annual audited financial statements.
Depositor protection mechanisms (e.g., deposit insurance or lender of last resort)	The Deposit Protection Fund is managed and controlled by the central bank; every financial institution must contribute no less than 0.2% of average weighted deposit liabilities with increased charges for those institutions found not to be acting in the best interests of depositors.	The Deposit Protection Fund is managed and controlled by the central bank; every financial institution must contribute no less than 0.2% of average weighted deposit liabilities with increased charges for those institutions found not to be acting in the best interests of depositors.	N/A

You gathered the following insights on the regulatory environment from interviews with the following stakeholders:

Banking Association: Banks tend to have a good relationship with the regulatory authority. The only trouble is the restrictions on ownership which sometimes limit potential investors from starting new banks. It is acknowledged that most of the state-owned banks do not meet these requirements, although the banking regulator has started to toughen and will soon be stricter with these banks.

Cooperatives: Most cooperative managers you met with seemed not to be aware of the appropriate regulations they should be adhering to and have not seen a regulatory inspection recently. Some have, however, heard talk that the regulator is going to toughen up and they are starting to read up on what they should be doing. Some believe that adhering to such rules will cause a great burden and they aren't sure if they will be able to maintain their business.

Microfinance Association: All the MFIs are registered as NGOs and they say it is a joke to what extent they are regulated. The three strong MFIs express a desire to begin taking deposits. They have approached the central bank to try to transform into regulated financial institutions, but the central bank was not interested in trying to accommodate them; none could meet the US$2 million minimum capital requirement for banks, anyway. They most likely would not be able to find a group of investors all willing to take a minority share, either. As cooperatives, they don't think they would meet their goals given the state of regulation of the cooperative sector and besides, none of them operate as member-based institutions.

***Central Bank*:** It is struggling to meet Basel requirements and knows it must do something about the cooperative sector. It believes there may be room to create a separate non-bank financial institution into which some of the healthier cooperatives could convert, and some of the ailing banks could downgrade into NBFIs. It does not believe microfinance should fall into its purview as the size of the sector is so small, it does not pose any risk to the financial system.

Worksheet: As you assess each of the four factors, write down all sources consulted, a brief synopsis of the findings, and whether you determine the answer is 'yes' or 'no.'

Factor 1: Characteristics of the Financial Regulatory Framework

Does the financial regulatory framework inappropriately inhibit access to finance among poor households?

<u>Consulted Resources</u>

People:____
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Publications:____
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Websites:____
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<u>Synopsis of Findings</u>

Does the financial regulatory framework inappropriately inhibit access to finance among poor households?

YES NO

Handout 6: The Capacity of the ExampleLand's Regulator

As you learned earlier, the types of financial institutions in ExampleLand include private and public banks, cooperatives, the postal savings system, and the microcredit NGOs. Here you will find some information you gathered about the capacity of the ExampleLand's regulator.

From the eStandards Forum, you learned that ExampleLand's regulator acts as an independent banking watchdog, supervising and regulating banks, asset management companies, trust and investment companies, and deposit-taking institutions. Two years ago, it conducted a review of past supervisory experiences. Based on the results, the management set out four objectives for banking regulation, which include the protection of consumers and maintenance of stability in the banking system. The management also formulated a set of principles to assess the result of our supervisory activities. These include among others, maintaining systemic stability, enhancing banks competitiveness and encouraging competition. ExampleLand's regulator has also declared its intent to become compliant with Basel Core Principles. To do so, it established a Council of International Advisers to assist it in benchmarking its activities to international best practices. It states that ExampleLand will make supervision of the domestic banking sector compliant with international standards within five years. By next year, a platform for effective banking supervision is to be established and two-thirds of ExampleLand's regulating measures are to meet the standards outlined in the core principles. In five years, all banking supervision laws and measures will be implemented effectively and will meet core principle standards.

At the FIRST Initiative, you learned that there are a number of donor projects aimed at financial sector strengthening, including strengthening the securities market, building up the capacity of the insurance supervisor, reforming and privatizing the banking sector, and that one donor has placed an international advisor at the banking regulator to move towards Basel Core Principles compliance.

You gathered the following insights on the regulatory environment from interviews with the following stakeholders:

Banking Association: Banks tend to have a good relationship with the regulatory authority. The only trouble is the restrictions on ownership which sometimes limit potential investors from starting new banks. It is acknowledged that most of the state-owned banks do not meet these requirements, although the banking regulator has started to toughen and will soon be stricter with these banks, especially as they begin to privatize.

Cooperatives: Most cooperative managers you met with seemed not to be aware of the appropriate regulations they should be adhering to and have not seen a regulatory inspection recently. Some have, however, heard talk that the regulator is going to toughen up and they are starting to read up on what they should be doing. Some believe that adhering to such rules will cause a great burden and they aren't sure if they will be able to maintain their business.

Microfinance Association: All the MFIs are registered as NGOs and they say it is a joke to what extent they are regulated. The three strong MFIs express a desire to begin taking deposits. They have approached the central bank to try to transform into regulated financial institutions, but the central bank was not interested in trying to accommodate them; none could meet the US$2 million minimum capital requirement for banks, anyway. They most likely would not be able to find a group of investors all willing to take a minority share, either.

Central Bank: It is struggling to meet Basel requirements and knows it must do something about the cooperative sector. It believes there may be room to create a separate non-bank financial institution into which some of the healthier cooperatives could convert, and some of the ailing banks could downgrade into NBFIs. It does not believe microfinance should fall into its purview as the size of the sector is so small, it does not pose any risk to the financial system. It does not quite understand what microfinance is or how it works.

Worksheet: As you assess each of the four factors, write down all sources consulted, a brief synopsis of the findings, and whether you determine the answer is 'yes' or 'no.'

Factor 2: Capacity of the Financial Regulator

Does the financial regulator have the potential capacity to undertake new responsibilities that would increase access to finance?

<u>Consulted Resources</u>

People:____

Publications:____

Websites:____

<u>Synopsis of Findings</u>

Does the financial regulator have the potential capacity to undertake new responsibilities that would increase access to finance?

YES NO

Handout 7: ExampleLand's Potential Advocates

As you learned earlier, the types of financial institutions in ExampleLand include private and public banks, cooperatives, the postal savings system, and the microcredit NGOs. Here you will find some information you gathered from interviews with many different stakeholders.

Banking Association: Banks tend to have a good relationship with the regulatory authority. The only trouble is the restrictions on ownership which sometimes limit potential investors from starting new banks. Banks under the existing regulations could conduct any type of financial service and so do not see a need for any types of reforms, especially those that might induce greater competition in their markets.

Cooperatives: Cooperatives will struggle to meet requirements as the regulator continues to toughen and require these institutions to reduce costs and operate commercially. To do so, they will need to continue expanding their market share and moving into new territories – and may not welcome any competition in doing this.

Microfinance Association: The three largest MFIs largely run the Microfinance Association, and these three want to begin taking deposits. They are very keen to start a dialogue around regulatory reform that would achieve this goal.

***Central Bank*:** It is struggling to meet Basel requirements and knows it must do something about the cooperative sector. It believes there may be room to create a separate non-bank financial institution into which some of the healthier cooperatives could convert, and some of the ailing banks could downgrade into NBFIs. It does not believe microfinance should fall into its purview as the size of the sector is so small, it does not pose any risk to the financial system. It does not quite understand what microfinance is or how it works.

Ministry of Finance: The Ministry of Finance has maintained a watchful eye as banks privatize and the banking regulator implements the Basel Core Principles. It is slowly taking away its subsidies of these banks. It also realizes the potential poverty reduction powers that microfinance brings, and the greater potential that comes when these institutions are allowed to operate commercially.

***Parliamentarian A*:** This person helped to found the Microfinance Association and often meets with representatives of some of the international NGOs working with the MFIs. He has worked to allow foundations to conduct lending activities, and is fully behind bringing microfinance into the financial sector.

***Parliamentarian B*:** This person was elected to her seat after running on a "pro-poor" platform that included ending the practice of high interest rate lending (such as moneylenders). She has recently become aware of the high interest rates that microfinance institutions charge and is not keen on legally sanctioning this practice.

Worksheet: As you assess each of the four factors, write down all sources consulted, a brief synopsis of the findings, and whether you determine the answer is 'yes' or 'no.'

Factor 3: Existence of an Influential Public or Private Advocate

Is there an influential public advocate who will push the reform agenda in order to make it successful? Is it the right advocate to address the problem?

<u>Consulted Resources</u>

People:____

Publications:____

Websites:____

<u>Synopsis of Findings</u>

Is there an influential public advocate who will push the reform agenda in order to make it successful? Is it the right advocate to address the problem?

YES NO

Handout 8: USAID's Opportunity to Effect Change

As you learned earlier, the types of financial institutions in ExampleLand include private and public banks, cooperatives, the postal savings system, and the microcredit NGOs. Here you will find need to look both inward and outward to determine if there is an opportunity for USAID to effect change.

Looking inward:

You, the proposed project officer, have a background in private sector development and previously ran a microfinance capacity building project at your last post. You will be in this post for another 2.5 years and have about $3 million to spend on a new activity. The Mission Strategy for this five-year period includes a strategic objective to "Increase Rural Incomes," and the Mission Director has a penchant for rural and agricultural based economic activities.

Looking outward:

At the FIRST Initiative, you learned that there are a number of donor projects aimed at financial sector strengthening, including strengthening the securities market, building up the capacity of the insurance supervisor, reforming and privatizing the banking sector, and that one donor has placed an international advisor at the banking regulator to move towards Basel Core Principles compliance. Two other donors support microfinance initiatives directly, and USAID is already providing some small support to the Microfinance Association. USAID has a rocky relationship with the central bank, however, and does not often collaborate with the donor who has placed an advisor at the central bank.

Worksheet: As you assess each of the four factors, write down all sources consulted, a brief synopsis of the findings, and whether you determine the answer is 'yes' or 'no.'

Factor 4: Opportunity for USAID to Effect Change

Is there an opportunity for USAID to make a difference in improving the legal and regulatory environment for access to financial services?

Consulted Resources

People:____
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Publications:____
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Websites:____
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Synopsis of Findings

Is there an opportunity for USAID to make a difference in improving the legal and regulatory environment for access to financial services?

YES NO

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