The Role of Regulation in the Development of the Trinidad & Tobago Microfinance Sector

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Abstract

In the Trinidad & Tobago (T&T) microfinance is limited to the provision of microcredit services to small and micro enterprises (SMEs). The microfinance sector exists on a limited scale with microfinance institutions (MFIs) unable to attain financial sustainability and wide outreach. Growth in the microfinance sector requires an expansion in the range of MFIs’ products and services. To enable this transformation supporting regulation governing the industry is necessary. In this paper, global approaches to microfinance regulation were critically studied in order to formulate policy recommendations for the enhancement of microfinance regulation in T&T. The paper seeks to emphasize the need for an appropriate regulatory framework; to support the stable expansion of the country’s microfinance industry, to protect the potentially vulnerable client base and to enable the industry to deliver on the social and economic benefits promised. The findings of this study can aid in policy formulation to transform this country’s lagging microfinance sector by introducing enabling regulation that can grow the sector from its static embryonic stage of development.

Keywords: microcredit, microfinance, microfinance institution (MFI), regulation, small and micro enterprise (SME), Trinidad & Tobago

INTRODUCTION

The microfinance industry started in the 1970’s as a philanthropic movement with a primary focus on alleviating the conditions of the poor. It did not, however, take the industry players long to realize that the marginalized and under-served poor formed a lucrative market that could be profitably served by microfinancing. The practice of commercial microfinance has enabled significant growth in the microfinance industry over the last two decades. The Microcredit Summit Report of 2011 stated that to the end of December 2009, 3589 microcredit institutions servicing 190.1 million clients reported into the submit (Reed, 2011). To fund this expansion many Microfinance Institutions (MFIs) have tapped into commercial sources of finance and the MicroBanking Bulletin (2008) reports that from the year 2004 to 2006, commercial financing sources on MFIs’ balance sheets almost tripled.

The expansion of microfinance services during the 1990’s raised concerns on the part of financial regulators, donors and microfinance gurus (Wright, 2000). These interested parties saw the need to offer protection to depositors especially in instances where deposits were being used by MFIs for on-lending. During the 1990’s many Latin American countries were among the first to begin regularizing the microfinance sector. This early experiment with regulation boasted of much success (Rhyne, 2002). It was found that a sound micro-financing regulatory framework acted as a key contributor to attaining financial sustainability for MFIs, which fostered further industry growth and outreach.

The success of the microfinance revolution globally has not been favourably reflected in the Trinidad and Tobago, hereafter referred to as T&T, and the Caribbean region as a whole. The industry described as immature when compared to Asia and Latin America, suffers from substandard financial performance and lacks outreach into the microenterprise sector (Wenner and Chalmers, 2001). The industry suffers from deficiencies in basic institutional structures and operates on a very small scale, experiencing great difficulty with loan recovery and lacking sustainability. These assertions find support in the findings of a 2012 study conducted by the Economist which ranked fifty-five countries worldwide based on each country’s regulatory framework, supporting institutional framework and overall stability for microfinance (Economist Intelligence Unit, 2012). While T&T ranked 7 for stability, for supporting institutional framework and regulatory framework the rankings were 54 and 55 respectively.

This paper starts by examining a number of theoretical considerations in microfinance regulation. It builds the case for increased regulation for the microfinancing sector, and seeks to offer guidelines to local policy makers on the introduction of micro-financing regulations. In forming recommendations
the paper draws on successful experiences of nations across the globe.

Conceptual Framework for Implementing Microfinance Regulation
To aid the regulation of microfinance operations the Consultative Group to Assist the Poor (CGAP) in 2003 published guidelines on regulation and supervision of microfinance. These guidelines have been used to build the framework for discussions in this study and are summarized in Figure 1. Figure 1 presents the major approaches to microfinance regulation and summarizes some tools used to deliver on these.

Wright (2000) espouses the three main approaches to microfinance regulation shown on Figure 1: no regulation as is the case of T&T, self regulation and a blended approach. The blended approach is often criticized for extensive government manipulation, as the supervisory apex bodies are usually state appointed and funded. In practice the reviews are mixed. In India for example the operations of the supervisory body, National Bank for Agriculture and Rural Development (NABARD) is subject to much state interference, while in Bangladesh the domestic apex organization Palli Karma Shahayak Foundation (PKSF) has been able to execute its functions autonomously (Haq et al., 2008).

While self regulation is put forward as a viable option for microfinance regulation, it has been found that self regulation does little more than improve the financial reporting and internal controls in the organization. Karnani (2009) argues that MFI responses to self-regulate have at best been ‘naively optimistic’, and highlights that the USA is on the path to greater government regulation after the failure of that country’s experiment with self-regulation.

If developed economies such as America have failed at self regulation, there is little reason to expect self regulation alone to work for the microcredit industry in developing countries like T&T which face less competition and scrutiny.

Prudential regulation or supervision, governs the financial soundness of licensed intermediaries’ businesses in order to prevent financial system instability and losses to small, unsophisticated depositors. Such external regulation can be implemented through the existing regulatory and legal framework. Christen et al. (2003) suggest that this approach better promotes integration of the license MFI into the overall financial system and increases the likelihood that the regulatory changes are properly harmonized within the existing regulatory landscape. In Asia countries such as; Bangladesh, China, Philippine and Vietnam have all nominated their central banks as their interim MFI

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1 CGAP is an independent policy and research centre dedicated to advancing financial access for the world’s poor. It is supported by over 30 development agencies and private foundations. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, microfinance providers, donors, and investors (CGAP 2011)
regulator under existing banking law, and so they are subject to normal prudential regulation and supervision (Haq et al., 2008). BancoSol in Bolivia was the first MFI to be registered in 1992 as a bank under existing banking regulations.

Regulation can also be achieved through MFI-specific regulation: some countries such as Bolivia, Peru, Mozambique and Uganda have created a distinct legal-status and regulation for non-bank MFIs. This approach can be appropriate when there is a 'critical mass of qualifying institutions' ready to transform from NGO MFIs to deposit-taking status (Christen et al., 2003). Developing MFI specific regulation is time-consuming and expensive and so should only be undertaken when the costs can exceed the benefits. The Grameen Bank in Bangladesh was incorporated by special regulation.

The success of any regulatory framework depends more on its content than whether it was implemented as special regulations or within existing regulations. In determining the appropriate regulatory content any number of suitable prudential and non-prudential instruments can be employed.

**Why Regulation for Microfinancing?**

The Basel Committee (2010) acknowledged the fundamental differences between microfinancing and the traditional banking sector and the need to have microfinance specific regulation.

- **Product design, client profile and labour-intensive underwriting methodologies give microcredit a unique risk profile.** Effective credit risk management thus requires different tools and analyses than for conventional retail lending (Basel Committee 2010).

The benefits to be had from operating as a regulated MFI as opposed to an un-regulated NGO are detailed by Hishiguren (2006) as follows:

**Access to Additional Commercial Sources of Funds:** NGOs' sources of funds are limited to donations, income from lending and subsidized loans. Regulated MFIs can access commercial sources of funds for both equity and debt (Rhyne, 2002). The MicroBanking Bulletin (2007) reported that in 2005 MFIs held US$1billion more in commercial borrowings than two years prior and that nearly one half of this went to regulated MFIs.

**Wider Range of Financial Services:** Regulation prevents un-regulated, non-profit MFIs from mobilizing savings. Transforming to a regulated financial institution enables the MFI to offer a wider range of financial services including but not limited to savings. Savings mobilization gives the MFI access to a stable source of local resources, and enables expanded outreach. Depositors' savings need to be protected from financial intermediaries who may take excessive risks in investing and loaning out these funds. Prudential regulation to protect depositors and guard against moral hazard2 is critical.

**Self Sustainability and Profitability:** The basic premise behind commercial microfinance is profitability and self sustainability. Robinson (2005), and transformation is viewed as the only means to achieve this. There is however an on-going debate on profit-maximisation goals benefitting MFIs and investors at the expense of financially illiterate and needy clients. Karnani (2009) cites the example of Compartamos in Mexico, which started as an NGO and went public in April 2007; initial investors earned a return of roughly 100 percent per annum by charging interest rates in excess of 100 percent per year on loans to the poor.

To enable sustained growth many MFIs sought to transform their legal structures, the Microfinance Information Exchange (MIX) reports on MFIs by institution type and this data for the years 2000 and 2009 is presented in Figure 2.

Figure 1 - Percentage Composition of MFIs by Institution type as at Dec 31st 2000 and Dec 31st 2009

Source: Microfinance Information Exchange (2011)

Figure 2 shows that while NGOs and NBFIs continue to dominate the microfinance landscape, by 2009 NGOs accounted for a smaller proportion of institution type, falling from 43 percent in 2000 to 38 percent in 2009. NBFIs have however become the more popular of the two, increasing from 30 percent in 2000 to 36 percent in 2009. Such transformations have occurred across the globe, but have been most pronounced in Latin America this is shown on Table 1 which reports on MFIs transformed from NGOs to regulated financial institutions as at March 2006.

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2 Moral hazard is the incentive for someone who holds an asset belonging to another person to risk the value of that asset because the person holding the asset does not bear the full consequence of any loss (Wright 2000).
The case study attempted to determine financial viability of the MFI operating within the microfinance sector. The operational self sufficiency ratio which measures whether the MFI can meet its direct costs from the revenue earned is a simple and reliable measure of this (Barres et al., 2005 and Ledgerwood, 1999). For the years 2004 to 2008 only the NGO studied scored above the breakeven point of 100 percent. Table 1 gives ratio values for 2008 for the three MFI. This finding asserts earlier studies on Caribbean microfinance which found the sector to be financially unsustainable and dependant on government or donor-supported funding (Westley, 2005 and Wenner and Chalmers, 2001).

Table 2 - Key Financial Ratios for 2008 for three T&T MFIs

<table>
<thead>
<tr>
<th>Institution</th>
<th>2008 – Operational Self Sufficiency</th>
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<tr>
<td>Private MFI</td>
<td>83.88%</td>
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<tr>
<td>State Funded MFI</td>
<td>26%</td>
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<tr>
<td>NGO</td>
<td>157.5%</td>
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The operation of the T&T microfinance sector operates on a limited scale and presents no risk to the stability of the country’s financial system. The insignificance of the microfinance sector in T&T is highlighted by the fact that in 2008 the total dollar value of loans advanced by this sector accounted for only 0.15% of the total loans outstanding for commercial banks.

Once registered as a lending agency the MFI in T&T operate in a largely un-regulated environment. The only regulatory stipulation which affects their operations is the ceiling on lending rates. These rates are set too low to allow MFIs to profitably cover their high operating costs or to take advantage of their clients’ willingness to pay higher than market rates. This latter assertion is supported by the thriving informal money lending industry which charges significantly higher than market interest rates.

State owned and funded MFIs use state funds to compete with well-established private MFIs that fund their operations from commercial sources. This perverts the operation of free market forces in the supply of microfinancing and operates to the disadvantage of the private MFIs. Meagher et al. (2006) in a study of microfinance regulation in Ghana, noted that the Ghanaian government’s focus over the period 2002-3 to expand directly subsidized credit programs was not consistent with best practices in microfinance and worked to undermine the development of the microfinance industry. This problem is further complicated by the shifting priorities on policies such as microcredit funding as government regimes change.

Many government initiatives designed to ease the conditions of the poor sometimes take the form of financial handouts. Such policies create a dependency...
syndrome that can suppress entrepreneurial spirit among those for whom microfinance is available. This limits the potential client base available to MFIs.

The present state of the Trinidad and Tobago microfinance sector mirrors Zeller and Meyer’s (2002) description of the state of the global industry in the 1970’s:

......the operations were generally limited, with few locations and undiversified portfolios, dependent on donor and government funding.....

PROBLEM STATEMENT

Strong positive linkages have been established between commercial microfinance and financial sustainability. Commercial microfinance can only thrive in a regulated microfinance industry. If this sector is to develop in T&T the MFIs operating it must be transformed into commercially funded institutions. Where no microfinance regulation exists, there is no change of commercialization of the sector. Presently, the government of T&T looks toward the microfinance sector to aid in economic diversification and alleviation of unemployment and poverty. As a result, fifty percent of the MFIs are state funded programs. As none of these institutions are financially sustainable they present a permanent drain on the government’s purse. The high level of state interference in the microfinance sector also perverts the operation of free market forces. Instituting a regulatory framework for microfinance can bear promise of enabling the state to more efficiently develop the industry by re-directing the allocation of state funds from patrimony to industry building and sustaining policies.

RECOMMENDATIONS

The first step in regularizing the unregulated microfinance industry in T&T is gaining an in depth understanding of its’ present state. A comprehensive study of all institutions that purport to offer microfinance services is needed to determine their financial sustainability, sources of funding, risk to the stability of the financial system and readiness and desider to operate in a regulated environment. Presently among the eight MFIs operating in T&T there is not one qualifying institution ready to transform from NGO MFIs to deposit-taking status. Unless an MFI can demonstrate an ability to operate profitably it should not be considered a candidate for regulation.

Government needs to chart the strategic focus for microfinancing in the country and exhibit commitment to the effort. The role of the government must be clearly defined and understood by all parties. The creation of such a framework will rely on close co-operation between the regulators and the regulated, and if done correctly can enhance and support the dynamic nature of microfinancing by enabling MFIs to be responsive, versatile, flexible and sustainable (Counts and Sobhan, 2002).

The differences between microfinancing and traditional banking imply that pre-existing regulations for the formal banking sector should not be applied to the microfinance industry. MFI regulation must depart from the traditional requirement of 100 percent provision on all unsecured lending for loan loss. Loan loss provisioning should instead be based on the institution’s lending, tracking and collection procedures. Once balances become past due however these must be provided for more aggressively by the MFI than the commercial banks. In Cambodia which was ranked eight for it overall microfinance business environment in the 2012 Economist study, MFI loans are classified into four types; standard, sub-standard, doubtful and loss, depending on the financial situation of the borrowers and the timeliness of principal and interest payments and loan loss provided for as follows: standard 0 percent, sub-standard 10 percent, doubtful 30 percent and loss 100 percent (Vada, 2010). At present in T&T there is no standard policy for loan loss provisioning, while the privately funded MFI follows the rules of the International Financial Reporting Standards (IFRS) in providing for loan loss, the state funded programs are grossly under-providing for this item.

In determining interest rate policies for MFIs it can be argued that the imposition of interest rate caps obstructs the operation of a free market and ultimately reduces the supply of microfinancing to the poor (Christen et al., 2003). In practice however there is no consensus on how regulators have treated with this issue. Many regulated MFIs are presented with either interest rate ceilings or flexibility to set interest rates within a stipulated range, while a lesser portion are given full freedom to set interest rates on microlending. A best practice policy guideline for interest rates can be drawn from Cambodia. Here the National Bank of Cambodia has issued regulation of no interest rate cap on microfinance operators; however the Bank stipulates that the method of interest rate calculation must be on a ‘declining-balance method.’ Additionally all licensed MFIs have joined the Cambodian Microfinance Association which embraces as one of its aims the principle of not using interest rates as a competitive tool to attract customers (Vada, 2010).

The following safeguards should be observed in charting the microfinance regulatory framework for T&T. Sensible cost benefit analysis should be undertaken in determining levels of regulation as the already high operating costs of microfinancing are increased by satisfying regulatory requirements. Christen et al. (2003) estimates the cost of
compliance at 5 percent of total costs during the initial year and 1 percent thereafter. For the recommendations to succeed the regulatory process should be an inclusive one. A cautious approach, resisting the temptation to copy what other nations have done should be adopted. Microfinance in all its facets has shown that local conditions must be embraced for success. Over-regulation must be guarded against as this can shut down rather than promote development in the sector. Realism must be maintained at all times, and policy framers must not lose sight of the fact that we in T&T are now attempting to enter the commercial microfinance arena, one in which most players have been building their positions over the last three decades.

CONTRIBUTION AND LIMITATIONS OF STUDY
Although this paper draws on existing literature to formulate an approach to microfinance regulation for T&T the recommendations forwarded are globally transferable. While policy on microfinance must be tailored to domestic circumstance, there is much benefit to be had from learning from best practices and mistakes of regions which have advanced their microfinance sector to financial and operational sustainability. The role of government, the state of the existing sector as well as careful cost benefit analysis must be completed by any country attempting to regulate microfinancing. Only when these are understood can details on the approaches to employ, tools to be used and supervisory authorities be decided upon. While in microfinance there is no ‘one size fits all’ approach the basic framework can be built using shared best practice as presented in this paper. This study presents a comprehensive checklist for any country to use in attempting to build its microfinance regulatory framework.

This study was conducted as an initial review to determine whether regulation of the T&T microfinance sector could in any way act as an impetus for transformation in the lagging industry. This scope limits the findings to this country and the recommendations to address only regulation. It is acknowledged that there are other critical policy interventions which may have a greater impact in positively stimulating the industry which will need to the focus of future studies.

CONCLUSION
The approach to regulation adopted by any nation must ultimately depend on its local conditions. Given that the risks to either the financial system or its clients are minimal considerable extensive prudential regulation may not be the best approach given its cost and complexity. The goal of microfinance regulation in T&T should be less focussed on the protection of the vulnerable microfinance clients and stability of the financial systems, and more concentrated on building an enabling environment to encourage sector growth. A microfinance regulatory framework built on non-prudential regulations is found to work well when the goal is to enable MFIs to extend credit but not take deposits. Given the current state of the local microfinance sector it is recommended that options to regulate the microfinance industry first focus on enabling policies through non-prudential measures. Regulation must be enacted together with other enabling policies such as institutional rationalization and development if it is to promote development and growth of this industry.

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