Regulating for development: the case of microfinance

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Abstract

The regulatory concerns of microfinance sector lies in the special nature of these institutions which caters the needs of those who have been marginalised from the formal financial sector. The paper underlines the importance of an appropriate regulatory framework to support sustainable delivery of diversified microfinance services such as savings and insurance. The paper explores the rationale for regulation in the microfinance sector, and followed by a review of major regulatory approaches and its impact on the microfinance sector. The sector-specific regulations along with prudential reforms may facilitate and environment, which allows microfinance institutions to mobilise savings and to reduce the problems in enforcing normal banking regulations. The paper also emphasises the need to incorporate the country specificities in the regulatory approach to encapsulate the specificities of macroeconomic environment and different stages of development.

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1. Introduction

In recent years, the discussion on regulation broadens our understanding on the extent to which the realities of the political economy influence the regulatory policy choices on different institutions. Traditionally, the need for regulation of economic activities is justified in the economics literature as a policy instrument to minimise the effects of market failures,
and gained substantial attention recently, particularly in the course of reform measures in developing countries (Armstrong, Cowan, & Vickers, 1994; Majone, 1996). In broader terms, regulation refers to a set of enforceable rules that restrict or direct the actions of participants and as a result alter the outcomes of this action (Chaves & Gonzalez-Vega, 1994). The financial crises in various countries have indeed brought the issue of regulation to the forefront of financial sector reforms, which is primarily about ensuring systemic stability and protecting depositors. Nevertheless, appropriate regulation of financial markets depends very much on the country-specific characteristics such as level of development and institutional capacities. Recently, the debates on regulatory policies are focusing on how to provide appropriate linkage between economic and social objectives on the one hand and the connection between the political and economic system (Cook & Minogue, 2003). In other words, regulation is seen more often as a set of rules of agreed to promote developmental objectives along with competitiveness and consumer interests.

This paper attempts to discuss regulatory issues in the microfinance sector, which caters the needs of those who have been excluded from the formal financial sector, largely through reviewing the sector specificities, and existing practices of regulation. Although no conclusive findings are available on how to regulate microfinance institutions, the answer to the regulatory concerns of microfinance sector lies in the special nature of these institutions which is explored in the next section. The paper then considers the main issues related with the existing regulatory approaches and its impact on the microfinance sector. After exploring the rationale for regulation in the microfinance sector, the paper elaborates on the nature of different types of regulation in this sector. Section 4 explores the role of state in the regulation of this sector while some conclusions are drawn in the final section.

2. Microfinance—salient features

During post-colonial period, subsidized agricultural credit had been considered as an appropriate development strategy to reach the poor. Most of the governments had followed this strategy with relaxed requirements for collateral and subsidized interest rates. Over the years, this particular approach seemed to be failing due to higher transaction costs, interest rate restrictions, corrupt practices and high default rates, which has resulted in the phenomenal growth of informal financial markets. The reasons for poor loan recovery are related to inappropriate design features, leading to incentive problems, and politicisation that made borrowers view credit as political largesse (Lipton, de Haan, & Yaqub, 1997).

The main providers of informal financial credit services are (i) lending by individuals on a non-profit (and often reciprocal) basis; (ii) direct but intermittent lending by individuals with a temporary surplus; (iii) lending by individuals specialised in lending, whether on the basis of their own funds or intermediated funds; (iv) individuals who collect deposits or ‘guard’ money; and (v) group finance (for a detailed discussion on these various categories see Matin et al., 2002). Informal providers are ready to accept collateral in different forms that are unacceptable to formal providers, and are part of a localised scale of financial intermediation which have much better information regarding the activities and characteristics of borrowers. The experience of formal and informal financial markets has highlighted the gap in terms of methodology and approach to reaching out to the poor, particularly in developing countries.
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