

**CURRENT TRENDS IN THE REGULATORY
FRAMEWORK OF MICROFINANCE**

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ABSTRACT

This paper covers the current trends and the embedded challenges of microfinance. Since the global financial crisis erupted in late 2007, it has affected the regulatory environment of microfinance, and the links between the economy and the performance of microfinance institutions. The paper observes the changes in the correlation between the microfinance industry and the international capital markets, changes in systematic risk of MFIs, and increased interest rates. Then, it presents how implementing the adequate regulations can effectively decrease those negative effects. Suggested regulatory frameworks and recommendations for further development of the global microfinance industry are brought to the fore.

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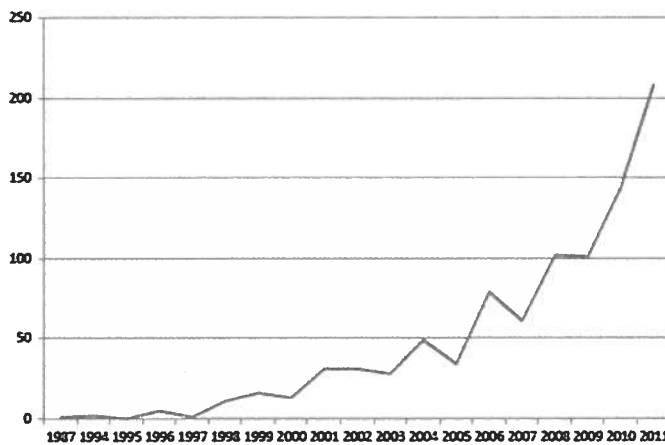
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1.0 Introduction

Microfinance, which entails the provision of financial services to micro-entrepreneurs, has demonstrated success as a poverty reduction strategy in a relatively short period of time. It has grown rapidly for the last two decades in developing countries and has become a global sector. As it expands, most countries have undertaken major financial regulatory reforms by adopting new banking laws and eliminating interest rate controls.

Figure 1. Revolution of Research on Microfinance
Number of scholarly abstracts available in EBSCO database



Source: Milana and Ashta, 2012

In recent years, issues regarding how the regulatory policy choices influence the growth of the microfinance industry have raised and gained substantial attention around the globe. The number of researches on this topic has accelerated (see Figure 1). Chaves and Gonzalez-Vega define

regulation as “a set of enforceable rules that restrict or direct the actions of participants and as a result alter the outcomes of this action” (Chaves and Gonzalez-Vega, 1992, p.2).

In traditional regulatory practices and policy reformations, the main purpose was to minimize the effect of market failures. However, in the microfinance industry the purpose is to provide an appropriate economic and social environment where microfinance institutions can develop further and achieve poverty alleviation.

This paper reviews the general impacts of regulation in the microfinance industry around the world, rather than focusing on a specific country. The preliminary section begins by uncovering the background of microfinance—its origin, objectives, distinctive features, and key principles. In the second part, the current state of development will be discussed in the order of current trends, challenges, and critics, followed by a review of how the financial crisis has affected the microfinance sector. The issues and challenges that arose during the financial crisis are identified, as they are closely intertwined with regulations and policies. Taking all these-- the nature of as well as the current state of microfinance-- into account, the following section analyzes the main pillars of regulatory frameworks that were recommended by the major international institutions. Those frameworks are elaborated into more details with respect to the current regulatory system. Then, the financial crisis is revisited and its impact on the regulatory environment is observed. In the Recommendations section, possible solutions to the current challenges and innovative models are presented in hopes of successful development of the microfinance industry. Lastly, the main points are revisited and unresolved issues are addressed for future research in the conclusion.

2.0 Microfinance Overview

It is crucial to keep in mind that microfinance institutions (MFIs) and traditional financial banks are different in their nature. A clear understanding of their differences is necessary for further discussions that will be provided in the subsequent sections.

2.1 Origin

The microcredit movement was initiated by an Economics professor at Chittagong University in Bangladesh, Muhammad Yunus, who made a loan of US \$27 out of his own pocket as start-up money to a group of 42 families in Bangladesh. He believed that helping people in poverty start their own businesses by providing small loans would foster business activities, reduce poverty and eventually develop the economy on the national level. He founded the very first microfinance organization called Grameen Bank on the principle of developmental idealism (Grameen Bank, 2013). It argues that small loans are better than charity donations in a way that these loans create opportunities for the poor to generate income by themselves. Ever since, this new approach has been extended to a greater success, and later obtained global attention. In the early 1970s, the microfinance industry was massively expanded as non-governmental organizations (NGOs) started to establish microfinance institutions in developing countries. NGOs replicated Grameen Bank's pioneering methodologies and deployed programs to make small loans of US\$100 to low-income rural households, who do not have access to the traditional banking system. These small-sized loans were made with no collateral as long as the borrowers were capable of repaying the loans as well as interest in a short period of

time. Extending the limit of access to capital to low-income clients, the programs rapidly unfolded. Microfinance is still expanding and advancing through learning by doing. The concept of microfinance is now well known and has reached most regions of the world. In fact, the United Nations declared 2005 as the International Year of Microcredit.

2.2 Objectives

The main objective of microfinance is to provide poor households, who are neglected by commercial banks, with ranges of financial services and to help them generate sustainable income, which will eventually lead them out of poverty. From a macroeconomic perspective, microfinance is seen as an innovative methodology that promotes economic development, employment and growth by supporting micro-entrepreneurs and small businesses (Milana and Ashta, 2012).

2.3 Distinctive Features

It is important to dissect the distinctive features of microfinance, in order to examine the current state of development, to analyze the effect of financial regulation on microfinance institutions, and to investigate the impact of the global crisis on the microcredit market.

The main difference between MFIs and other traditional banks is that microfinance is driven by a strong sense of developmental idealism, whereas traditional banks are profit-oriented. The main focus of MFIs is poverty reduction. MFIs strive to provide community-wide benefits, to empower women, to encourage entrepreneurship. Through

financial services and funds, MFIs not only bring financial benefits to individuals but also improve communities as a whole. Increases in incomes of community members can foster local businesses, which will create more jobs and new business ventures and will improve the communities' overall well-being. Moreover, in many developing countries, women have very limited or no access to financial services, and they are unable to participate in most economic activities (Jansson and Wenner, 1997). By providing them access to capital, MFIs empower women to take initiatives in entrepreneurships and encourage gender equality. Furthermore, poverty reduction can be achieved only if underprivileged people are able to generate personal sources of income and become economically independent. Most of them lack access to capital, education and training. MFIs can support potential entrepreneurs by providing access to financial and educational resources. These are the key to sustain and grow microenterprises (Chakrabarty and Bass, 2013).

On the other hand, traditional banks contribute to the economic cycle by keeping the money circulation among households, governments and corporations and by providing many financial services and products to all community levels. The table below lists key differences between traditional banks and emerging MFIs.

Table 1. Features of Traditional Banks and Microfinance Institutions

AREA	TRADITIONAL BANKS	MICROFINANCE INSTITUTIONS
Products	· Broad range of retail products of loans and deposits	· Specialize in credit
Procedures	· Multi-tired, record-oriented and resultantly lengthy at times	· Short and simple
Source of Funds	· Combination of owned and borrowed capital	· Borrowed fund
Cost of Capital	· Average of 8%	· Average of 14%
Lending Methodology	· Based on collateral · More documentation · Less labor intensive	· Based on character · Less documentation · More labor intensive
Loan Portfolio	· Fewer loans · Large amount of loans (USD 1000+) · Collateralized · Longer maturity · More stable delinquency	· More loans · Smaller amount of loans (USD10-300) · Uncollateralized · Shorter maturity · More volatile delinquency
Institutional Structure and Governance	· Profit maximizing institutional and individual shareholders · Creation by spin-off from existing regulated institution · Centralized organization with branch office located in cities	· Mainly non-profit institutional shareholders · Creation by conversion from NGO · Decentralized set of small units in areas with weak infrastructure
Risk Management	· Advanced risk management systems that are imposed as well as self-deserved	· Continuous contacts with the customer · Period re-training and performance incentives to customer and off-field staff

Source: Jansson and Wenner, 1997

2.4 Key Principles

The following eleven principles were developed by the World Bank-based Consultative Group to Assist the Poor (CGAP) and the G8 endorsed these principles to promote best practices in microfinance in developing countries (CGAP, 2004).

1. *The poor need a variety of financial services, not just loans.* The poor need more support (such as insurance) than just having access to capital to sustain their incomes. A wide range of financial products and services should be convenient, flexible, and reasonably priced.
2. *Microfinance is a powerful instrument against poverty.* It enables the poor to become financially independent and protect themselves from economic shocks. It can help the poor plan for the future.
3. *Microfinance means building financial systems that serve the poor.* Despite the fact that the majority of the populations in developing countries are poor, they still have no or little access to any type of financial services. In order to reach the full potential of microfinance, it needs to integrate with the financial sector.
4. *Financial sustainability is necessary to reach significant numbers of poor people.* By reducing transaction costs and interest rates, providing appropriate products and services, and reaching out to more prospective clients, MFIs can impact far beyond what donors can fund.
5. *Microfinance is about building permanent local financial institutions.* As the microfinance market and institutions mature and develop further, dependence on donors will diminish.
6. *Microcredit is not always the answer.* It is an innovative way of poverty alleviation, but certainly not appropriate for everyone in every situation.

7. *Interest rate ceiling can damage poor people's access to financial services.*
Generally making many small loans cost way more than making a few large loans, imposing interest rate ceiling by governments can be a threat to many MFIs.
8. *The government's role is as an enabler, not as a direct provider of financial services.* Governments should strive to maintain macroeconomic stability, smooth functioning of the financial market, and improve the business environment by implementing laws and policies.
9. *Donor subsidies should complement, not compete with private sector capital.*
Instead of building their own infrastructure to reach the poor, donor subsidies can integrate with financial institutions. This way, both parties will benefit from economic and operational efficiencies.
10. *The lack of institutional and human capacity is the key constraint.* From regulatory and supervisory bodies, government development agencies to financial institutions, capacity needs to be built at all levels.
11. *The importance of financial and outreach transparency.* Consumers need accurate, standardized and comparable information on the financial products as well as on the MFIs when they make financial decisions.

3.0 State of Development of Microfinance

3.1 Current Trends

The microfinance sector is becoming more transparent. CGAP regularly collects reports from more than 60 microfinance institutions around the globe, and analyzes the data to provide a firm foundation for the advancement of the microfinance industry. CGAP surveyed the 20 major MFIs in 2011; Symbiotics and MicroRate, also, provide extensive data on microfinance investment vehicles (MIVs). Based on the findings from the data and its analysis, this section describes global trends of microfinance in recent years (MicroNed, 2009).

3.1.1 Regulation of MFIs

MFIs are not viewed as unprofitable charity organizations anymore. More and more MFIs are empowered with new or reinforced regulations and legislations worldwide. For instance, South Africa and Kenya have formed a Microfinance Regulatory Council and a Microfinance Unit of Ministry of Finance, respectively, to regulate the microfinance sector (Finacle, 2013). In almost all other countries, MFIs are now regulated by their central banks, and over 50 countries are discussing or implementing comparable MFI regulations at the international level. The trend of building regulations shows how seriously each country perceives the microfinance industry. By far, the majority of government regulations are still at an early stage, but the issuance of regulations is recognized to have contributed to a sound development of the microfinance industry.

They provide suitable guidance and services to MFIs in managing risks, protecting clients and redirecting capital (Gallardo, 2001).

3.1.2 The New International Institutions

Not only social investors but also commercial investors are now drawn to microfinance. Funds from these commercial investors had sharply shrunk after the financial crisis; however, they are expected to grow at an even greater rate. New international funders such as the World Bank's International Finance Corporation (IFC), the German KfW, and the European Investment Bank have brought innovative strategies, put a pool of experts and various fields into play, and enabled MFIs to access international capital. Their capacity of support is far beyond what traditional and individual donors can offer.

The World Bank's IFC is currently the largest global development institution owned by the 184 member countries. For over 100 developing countries, IFC focuses on creating jobs, generating tax revenues, improving corporate governance and broadening access to finance for the poor. In 2013, IFC reported that it had contributed to support 2.7 million jobs, and provided more than \$265 billion in loans to micro, small and medium enterprises (IFC Annual Report, 2013).

The German KfW is committed to improve the economic and social conditions of the poor in developing countries by providing funds and advisory services. KfW has issued its first microfinance bond in 2010 and refinanced the proceeds into their microfinance projects, fully bearing the associated credit risks. It also has been actively participating in

joint financing operations with other international institutions in reducing poverty (KfW, 2013).

These international institutions can assess and address challenges and needs of institutions in the private sector, and bring together a variety of innovative solutions collectively.

3.1.3 Enhanced Use of Technology

Generally speaking, technology is indispensable for a sustainable growth in any sector. With an increase in the number of MFIs and the size of capital in the microfinance industry, leading MFIs have implemented software and hardware platforms that reduce operational time and cost. Incorporating new delivery channels such as ATM machines, and wireless technology on mobile phones and PCs can be extremely beneficial to both clients and MFIs (Kulik and Molinari, 2004). If simple transactions can be done through these mobile devices, clients who live in rural areas don't need to visit offices as much. Also, it will be a backdrop of cost effective operations as MFIs can reach potential clients without having local branches. These new types of technological infrastructures will play a very important role in reaching out to the poor living in remote or deserted rural areas (Frankiewicz, 2003).

3.1.4 Collaboration of Banks and MFIs

New types of ownership emerge as the development of microfinance matures. In the beginning, MFIs were typically formed as NGOs, but in recent years, there is a variety in the ownership types including social investors and commercial capital (Finacle, 2013). Banks specialize in managing accounts, and MFIs are responsible for managing customers. Collaboration between financial institutions and MFIs, and transformation of MFIs into more standardized structures blur the demarcation lines between the traditional financial institutions and the emerging market of the massive number of unregulated MFIs. As developing countries are becoming increasingly more interested in the issue of regulating the microfinance industry, a clear market segment is receding.

3.1.5 Wide Range of Products

Initially, MFIs have been mainly focused on credit products, but in recent years, they have broadened the range of products and services in response to an increasingly competitive environment. Innovative and adequate financial products are developed to satisfy customers' needs. Such products include insurance, savings, and money transfers. Since customers' needs and wants can significantly differ based on their demographic, geographic, financial or even cultural backgrounds, new products are carefully tailored to their specific needs (Anand and Khanna, 2011).

The microfinance sector has been pushing its frontier to expand financial services by regulating the MFIs, introducing major international organizations, engaging innovative technology, encouraging collaboration between institutions, and broadening the financial

products. In light of its fast shift along this road, the industry will likely continue to grow even faster. The following section introduces the accompanied challenges with these trends (Gonzalez-Vega, 1998).

3.2 Current Challenges

Reaching 130 million microfinance clients proves that there has been a rapid growth in the industry over the past decade (Zaman, 2004). Although microfinance has become a critical tool to reduce extreme poverty and has entered the financial mainstream, there are a number of key challenges that MFIs face throughout the world. These include barriers to reach the poor, lack of funds, institutional inefficiencies, financial illiteracy, and lack of regulation.

3.2.1 Reaching the Poor

Despite the successful track record of microfinance, the World Bank stated that it has a long way to go to meet the demand (IFC Annual Report, 2013). Microfinance can be a great tool to help five hundred million people living in poverty by giving them access to capital. Yet, only one-third of the world's population has bank accounts. The World Bank disclosed that the lack of access to any type of financial system is prominent among the poor in sub-Saharan Africa. It is estimated that only 10 percent of those who have a bank account have been reached by MFIs.

Dichter et al. (2007) illustrate that the main challenge of microfinance in the current period is reaching the poor to a greater extent. Out of three billion underprivileged people around the world, only 20 percent of the potential market has been reached. For instance, in Bangladesh, which is considered to have the most well developed microfinance market, microcredit services have reached only 18.4% of the poor (Cull et al., 2009). Hulme (2000) argues that providing financial services to the poor seems to have only a little impact on its primary objective that is poverty eradication. It is estimated that over 2.5 billion individuals worldwide still have no access to savings or credit. In most developing countries, central banks begin to ensure that the benefits of financial systems including microfinance products and services reach the poor.

3.2.2 Lack of Funds

One of the biggest challenges is lack of funds to increase the outreach. Loan manager Biplab Saharia, from Satra, a non-profit in the northeastern state of Assam, said, "Funding is the biggest problem. The cost of delivery is too high due to communication problems, and weekly repayment schedules" (Kotoky, 2011). In order to meet this scarcity, MFIs have to develop attractive deposit products and be able to bear the cost of capital.

3.2.3 Institutional Inefficiency

Some argue that the actual amount of funding is not the primary problem. There is sufficient funding but what lacks is the organizations that are capable of absorbing it.

Investment funds provide money for MFIs in developing countries, then, they make micro-loans to their local clients. For those loans that are too small, one line of credit from an investment fund can cover a great number of borrowers. However, the operational costs and management costs are too high for those small MFIs to afford. Since many MFIs began as NGOs with a social mission of reducing poverty, most of them do not have the firm management capacity in risk management, management information and internal control, marketing and customer responsiveness, and human resource development.

3.2.4 Lack of Education

In response to the increasing use of microfinance products and services by consumers in developing countries, governments and MFIs must take actions to improve overall financial literacy. Even if there are suitable microfinance products and services available, if consumers are not aware of what they are dealing with, uneducated low-income consumers have higher risk of not managing their finances and are likely to result in failures in the use of micro loans. Improved financial literacy will not only help clients to have better understanding of financial matters and improve their money management skills, but also allow MFIs to learn what their clients need and enable them to develop suitable products and services (MicroNed, 2009). The education should be focused on *knowledge*, an understanding of broader financial matters, *skills*, the ability to apply that financial knowledge when making financial decisions, *confidence*, having self-assurance, and *responsible financial decisions*, the ability to use the knowledge, skills and confidence appropriate to their own circumstances. Financial literacy is a shared

responsibility. Both governments and private MFIs must work independently and collaboratively in order to raise awareness and enhance financial literacy.

3.2.5 Lack of Regulation

Since the microfinance sector is a relatively new methodology in poverty-alleviation, lack of concrete regulations and policy structure is another main challenge to overcome. Although the current trend shows that more and more developing countries are keen on flourishing regulations over the microfinance sector, given that microfinance is mainly for developing countries, many countries are poorly equipped to regulate and supervise MFIs. Regulations should be established to provide the safety and soundness of financial institutions, while keeping the market competitive. Regulation will be revisited and discussed in detail in section 4.0 with its global trends and suggested regulatory framework.

3.3 Critics

Critics have brought to light the shortcomings of microfinance. Recent voices have risen to criticize about mission drifts of the microfinance industry. One example is from Sinclair's (2012) critique:

“Microfinance is now a \$70 billion industry and some investors and microfinance institutions enjoy eye-popping returns. The industry falls far short, however, of fulfilling its promise to end poverty. ... Many microcredit programs are nothing more than predatory lending schemes rebranded as socially responsible investment opportunities.” (p.10)

He criticizes how micro-lenders justify their high interest rates that it is necessary to keep the microfinance sector viable and sustainable when their administrative and operational costs are too high. In addition, critics claim that micro-lenders consider the microcredit system from the investors' point of view rather than their low-income customers' point of view.

Also, Bateman and Chang (2009) point out the following issues. First, it is rare that poor people can actually create wealth by themselves. Microfinance is conceived as a new innovative methodology of creating wealth through simply providing access to the credit market. This is a false premise; wealth creation is not a result of individuals' efforts. It requires collaboration of nations' effort and high level of skills and knowledge from the market participants in every aspect. Second, one of the most controversial issues in microfinance is its high interest rates. Without government subsidy or other funding, microfinance institutions must charge high interest rates in order to cover their high costs. Paradoxically, it obstructs the possibilities for borrowers to reinvest into themselves with profits; instead they have to pay a high portion of their profits to their lenders. Third, it was revealed that not all loans are used to create small businesses. Rather, it was made for consumption smoothing. Finally, Bateman and Chang doubt that microfinance would create prosperous small businesses in the long run. They point out that the clients would initially make attractive profits, but their income would drop dramatically due to limited technology improvement, and lack of skills and resources.

In addition, some researchers criticize on the matter of empowering women. While many MFIs focus on empowering women and provide loans solely to women, this has led to creating another form of risk to women. The Asian Development Bank (2007) found that the loans provided to women are redirected to their husbands or male relatives—indicating that these women are not the actual clients. Yet, they bear the liability for repayment of the loans. The problem and its resulting impact are difficult to measure or control. Under the pressure of repayment schedules, women utilize three strategies. First, they borrow from their neighbors, who are most likely to be in the same financial situations, or selling household goods. Circulating the funds within their social network or downsizing their original possessions are clearly not a solution to poverty alleviation. Second, they reduce the quantity and/or quality of their daily food consumption. Last, they work extra on the side in order to meet their short-term cash needs.

All together, these criticisms question the fundamental strategies and approaches of microfinance. It is very difficult to assess the impact of microfinance on its purpose of poverty alleviation. Conclusively, researches so far have accepted that microfinance could contribute to economic viability to some extent but it is still debatable whether it has a strong impact on poverty reduction in the long term. Many argue that microfinance is just yet another lending scheme generating high returns that is disguised as a new economically innovative way of poverty eradication.

3.4 Impact of the Global Financial Crisis

From a quantitative viewpoint, Di Bella (2011) gives a close examination of changes in correlation between the microfinance industry and the market, changes in systematic risk of MFIs, and increased interest rates. He also presents different views of researchers with regards to high interest rates.

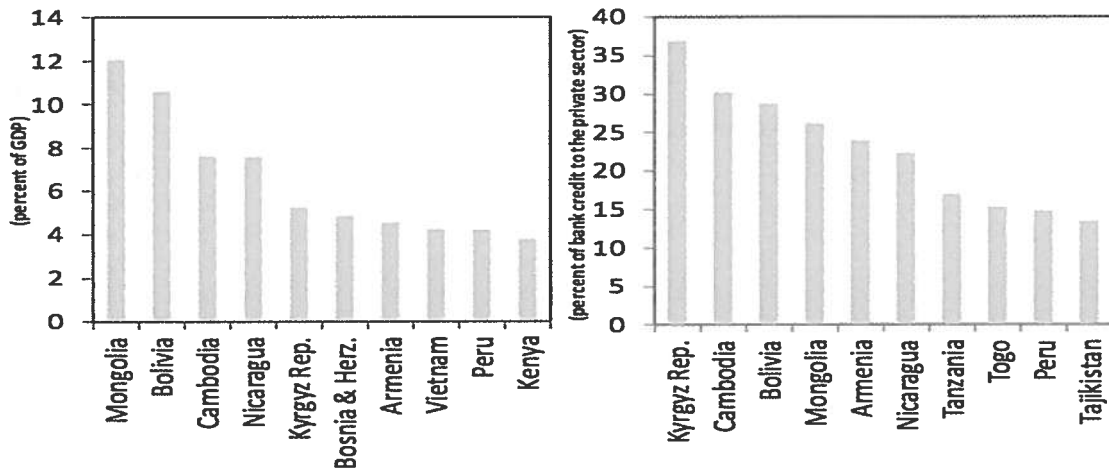
3.4.1 Increase in Correlation

Krauss and Walter specifically demonstrate a weak “correlation between performance of the microfinance industry and both international capital market development and macroeconomic conditions” (2009, p.87) prior to the global financial crisis in late 2007 (1998-2006). During this period, the microfinance industry has expanded roughly at an annual rate of 40%¹ with good asset quality and high profitability, regardless of institution type, location, purpose, age or legal status. Due to the low correlation between MFIs and economic conditions, this new type of asset, microcredit, was favorable to investors for insulating their portfolios from the market risk and extend the risk diversification even further. As investors provide MFIs with a greater pool of funds, the industry has grown enormously in a relatively short period of time. This boom has made microcredit more available to broaden their customer base in developing, transition and emerging economies. Figure 2 shows the share of microcredit in selected developing countries. From a macroeconomic perspective, one can suggest that microcredit has

¹ Low portfolio at risk (PAR-30); return on equity (ROE)≈10%.

become a significant share of those countries' gross domestic product (GDP), and a significant portion of the credit market in the private sector. Consequently, it has grown to be exposed to the volatility of general economic conditions.

Figure 2. Share of Microcredit in Selected Countries (2008-09)



Source: Gonzalez (2010)

During and after the global financial crisis when stock markets had fallen, large financial institutions also collapsed, and even the wealthy countries strived to bail out their financial systems. This global financial meltdown caused the MFIs to deteriorate. Illiquidity of fund providers and a rise in write-off rates have drastically impeded the growth rate in the microfinance industry. It was clear that the interrelationship between the microfinance industry and the global economic conditions has grown stronger.

3.4.2 Increase in Systematic Risk

In a macroeconomic perspective, the historical growth rate of microfinance has made microcredit a significant share of GDP in a great number of developing countries. Consequently, the stronger links between MFIs and the overall economy has increased the systematic risk² even more for two reasons:

- The rapid growth of MFIs in the two decades prior to the financial crisis had attracted high attention from investors around the globe, which improved its management practices, client base and information systems. As a result of the increase in its operational scale, innumerable non-profit NGOs have become regulated financial institutions.
- The fast growth of the industry has become a significant share of GDP in many countries (Gonzalez, 2010).

Di Bella (2011) shows that systematic risk seems to be higher in Central America, The Caribbean, Mexico and Europe compared with Asia Pacific, and South America. Also, from an institutional perspective, there is evidence that the systematic risk is higher for banks, for-profit and new MFIs than for NGOs, non-profit and mature MFIs.

² Systematic risk is defined as the risk inherent to the entire market that cannot be avoided through diversification. Also known as "un-diversifiable risk" or "market risk."

3.4.3 Increase in Interest Rate

Di Bella (2011) also points out that the interest rates charged by MFIs to their usual customers has increased, along with the increase in the correlation between microfinance and both international capital market and macroeconomic conditions, as well as the increase in the systematic risk of microcredit. The low-income customers of MFIs are now facing a higher burden in repaying their debts. Therefore, MFIs, nowadays, count more on the probability of repayment and write-off rates rather than their original mission of providing high-quality financial services to those who do not have access to the traditional banking system.

Cotler (2013) shows that MFI's age, productivity, and loan sizes altogether determine the interest rates. He suggests that MFIs at their mature/developed stage tend to operate productively and efficiently and charge lower interest rates. Moreover, MFIs who provide smaller loan sizes to a large number of customers are more likely to have higher operational and administrative expenses, which would result in higher interest rates.

The higher degree of political regulations and interventions has started to take its steps to prevent high interest rates. Di Bella (2011, p.32) suggests that the regulation should aim to:

- “Reduce interest rates.
- Create an enabling environment in which MFIs can operate.
- Test their lending technology.

- Introduce innovations allowing increases in productivity and efficiency.
- Promote competitions between MFIs.
- Protect customers' rights by ensuring transparency.”

While adequate regulations would keep the interest rates low and keep the profitability sustainable, inappropriate regulation is likely to cause investors to withdraw their funds, result in an increase in interest rates or bring losses in economic efficiency. Therefore, it is important to establish, review and reinforce legal frameworks in order to keep the interest rate low and to provide an advanced environment where the microfinance industry can grow further.

On the other hand, with an alternative view, Christen and Rosenberg argue that “microcredit can be sustainable only if the borrowers can be charged interest rates that are higher—usually much higher—than the rates that are customary in normal banking transactions” (2000, p.12). A sustainable MFI—that is, one that could cover the commercial cost for its funding without losing money—must therefore charge an interest rate that could sound obscene in the normal commercial-bank market or in the arena of political discussion.

4.0 Regulatory Framework of Microfinance

Over the past two decades, the microfinance industry has unfolded exponentially across the world. Due to this rapid growth, the operating scale of MFIs has increased, products,

services and funding structures are more diversified and strengthened, the client base has become stronger and a huge increase in the number of MFIs was witnessed. As the industry has become more mature, the industry is subjected to more regulation and supervision.

Nowadays, many MFIs that were initially founded as non-profit NGOs are turning into regulated financial institutions. This section will discuss how the performance of MFIs is measured, governments' roles in creating a safe and sound microfinance sector, the suggested regulatory framework and the impact of the recent financial crisis on regulation.

4.1 Performance Measurement Methodology

While measuring the performance of MFIs, researchers came up with different methods of assessing their performance and their influences. For example, Armendáriz and Morduch (2010) presented five financial ratios that are very useful to determine profitability and sustainability: Return on Asset, Return on Equity, Profit Margin, Debt to Equity, and Deposits to Asset. The only shortcoming is that they do not take efficiency into account, which is also an important element in assessing MFI performance. In Cull's recent empirical research (2009) on profitability and outreach, he measured how the operational and structural differences between commercial banks and NOGs can contribute to poverty alleviation at different levels. He found that non-profit organizations, which provide smaller loans to their low-income customers-- especially to female customers in areas where social discrimination against women is high-- have

higher chances of reducing poverty, compared with the commercial banks, which tend to offer larger-sized loans.

On the other hand, in terms of the effect of microcredit on nations' welfare, researchers have come to different conclusions. Gine (2003) points out that the numerous case studies suffer from self-selection biases. For example, in Indonesia, microfinance allows poor rural people to smooth their consumption in response to health shocks (Coleman, 1999), while it had little impact on welfare in Northeast Thailand.

However, through careful and detailed cross-sectional empirical examinations over the last decade, CGAP claims that microfinance has notably contributed to poverty reduction (Zaidi and Hubka, 2005, p.4):

“Microcredit enables borrowers to attain higher household incomes, increase savings rates, smooth consumption pattern over their lifetime and finally be able to diversify their sources of income generation. Access to financial services also translates into broader social benefits, including improved health, increased educational participation, and greater equality.”

4.2 Government's Role

From an economic perspective, the primary concerns and objectives of governments in developing countries are to eradicate extreme poverty. Governments must support and nourish the small-scale market entrants to settle until they can generate persistent incomes. This is why microfinance plays such a significant role in poverty reduction and governments need to promote the development of this industry. In fact, various empirical studies and researches on the impact of regulating microfinance have proven that

regulated MFIs have better performance results than the ones without regulations. As the importance of regulation has been highlighted, in recent years, government's role in building and implementing appropriate regulation and supervision has been brought to the centre of attention. Yet, there is no standardized regulation framework that is globally accepted. Hannig and Katimbo-Mugwanya (2000) emphasized that regulators should focus on protecting depositors (fund providers), and developing the microfinance industry.

Due to governments' lack of expertise and resources, they have put the burden of provisioning the microfinance services on the private sector such as commercial financial services firms and non-profit organizations. Hence, the primary objective of a government is rather to aim for macroeconomic stability, to provide a regulatory framework where the industry as a whole can grow and to establish an environment where the public can have confidence in the safety of the industry. A government must acknowledge that the purpose of regulation is to protect the small-scale depositors from facing risks from mismanagement. (Hubka and Zaidi, 2005).

When governments impose broad regulations on both traditional financial services firms and NGOs that do not distinguish the differences in their structures, inappropriate regulatory structures may have detrimental effects on the ability of the microfinance industry to grow (Ledgerwood, 1999).

Moreover, governments must realize the importance of policies and regulations. As

emphasized in the previous section, consumers with better financial literacy can understand the financial marketplace and use financial products and services best suited to their own needs, manage their personal finances and plan ahead, such as for retirement. Having the knowledge, skills and confidence to make responsible financial decisions is essential for financial well-being of developing countries. Governments need to develop and implement policies and programs that will improve financial literacy (Jansson and Wenner, 1997).

4.3 Regulatory Framework

The vast researches on microfinance have mainly focused on suggesting regulation frameworks. Governments need to be in charge of taking care of overall economic activities, effectively allocating resources, smoothing the functioning of financial markets, structuring a transparent financial system, maintaining the safety and soundness of financial institutions, and protecting consumers of financial products and services.

Based on the arguments made by a number of researchers, some significant elements that must be considered when structuring and conducting financial regulations have been extracted. Table 2 shows the six pillars for financial regulations.

In this vein, these six main elements of regulation are elaborated into seven different specified areas: entry requirements, capital adequacy standards, provisioning, collateral and joint liability groups, usury laws and interest rate ceilings, documentation requirements and operational restrictions.

Table 2. Six Pillars for Financial Regulation

Macroeconomic controls
<ul style="list-style-type: none">· reserve requirements· interest rate controls· restrictions on foreign investments
Allocative controls
<ul style="list-style-type: none">· selective credit programs· compulsory investment requirements· preferential interest rates
Structural controls
<ul style="list-style-type: none">· entry and merger controls· geographic restrictions· limits on the range of activities of different types of financial institutions
Prudential controls
<ul style="list-style-type: none">· minimum capital adequacy standards· limits on concentration of risk· reporting requirements· provisioning requirements
Organizational controls
<ul style="list-style-type: none">· rules of market making and participation· disclosure of market information· minimum technical standards
Protective controls
<ul style="list-style-type: none">· information disclosure to consumers· compensation funds· ombudsmen offices· interest rate ceilings

Source: Jansson and Wenner (1997)

4.3.1 Entry Requirements

It is suggested that the minimum capital requirements should be kept low. High minimum capital requirements will set a higher barrier for microfinance NGOs to transform themselves into regulated institutions. In addition, it is worth considering and allowing

NGOs to use the net present value of their loan portfolios to capitalize a new institution as opposed to the usual requirement of cash contributions. Having this flexibility will certainly open up more options for those well-managed MFIs to become regulated institutions (Christen, 1995).

In some countries, up until recently, foreigners and institutions were not allowed to have ownerships of the entities. As to the special nature of MFIs, ownership restrictions place a big hurdle in forming regulated MFIs.

4.3.2 Capital Adequacy Standards

According to the Bank for International Settlements (2005), a recommended standard for asset classification has been broadly accepted and the maximum risk-weighted asset-to-equity ratio is between 12.5 and 1. That is, a minimum capital adequacy ratio of 8%. Relatively higher capital adequacy is acceptable for MFIs since they are more exposed (higher market beta³) to the volatility of economic conditions.

4.3.3 Provisioning

Provisioning plays a significant role in determining potential losses from loan portfolios.

With an adequate provisioning, MFIs can keep their losses to a minimum. The specific provisions deal with non-payment risks including past repayment history, collateral, or

³ Market Beta is defined as a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. It measures a security's response to swings in the market in terms of its returns. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market.

guarantee, whereas the general provisions deal with overall credit risk of loans. With an absence of collateral for microenterprise loans, provisioning schedules that are not dependent on the existence of physical collateral would be desirable (Bascom, 1994). A provisioning rule solely based on payments in arrears is preferable in the current trend; however, it ignores customer's credit history and the overall performance of the loan portfolio.

4.3.4 Collateral and Joint Liability Group

Commonly, MFIs do not require physical collaterals from their borrowers. Thus, they arranged other ways to ensure repayments on time by assessing customers' repayment ability rather than the existence of physical collateral. One prominent concept is called joint liability group. By grouping borrowers, they lay peer pressure among the participants, so that if any member within the group defaults and cannot meet its obligation, then, other members will have to repay instead. Otherwise, the whole group will lose both money and future access to credit. This joint liability group method has proven to be effective in lowering delinquency.

4.3.5 Usury Laws and Interest Rate Ceilings

In addition to the increase in systematic risk of the microfinance industry, as mentioned earlier, the relatively high interest rates have attracted attention around the globe. This has brought many critics and skepticisms that MFIs charge their low-income clients inappropriately high interest rates. It was controversial among regulators and policy

makers. Regulations and policies that were built without taking these matters into account will create an environment where MFIs are difficult to grow in size or even survive in the long term.

Usury laws involve imposing interest rate ceilings primarily to protect customers. Contrary to their intention, they often bring negative effects on the development of microcredit, since they prevent MFIs from charging sufficient interest, which is high enough to cover their costs. As alternative methods to prevent usury, MFIs may charge closing fees, servicing fees, and discounts from face value of the debt instruments (Horne, 1990).

4.3.6 Documentation Requirements

Normally, financial institutions require loan documentation from borrowers in order to ensure the reliability of collateral and the financial stability of borrowers. Loan documents usually consist of the borrowers' identity, assets, credit history and financial status. These traditional regulatory practices would not be adequate for microenterprise loan borrowers, thus to make documentation more flexible, related laws and regulations must not specify the requirements. Rather, these documentation requirements should not lose their original objective of verifying payment capacity. In addition, notarization should be exempted and left to each MFI's own discretion (Zaidi and Hubka, 2005).

4.3.7 Operational Restrictions

Low-income customers are most likely limited in their flexibility with regards to traveling long distances or carrying out their transactions electronically. Considering these aspects, regulations should be flexible with branch operating hours and alternative methods for offering financial services to local customers. As has been pointed out already, high operational and administrative costs are unavoidable issues of microfinance. Thus, in order to reduce these costs, it is important to employ innovative and cost-effective credit delivery platforms instead of conventional branch offices. The following table provides examples of alternative methods implanted in the listed countries.

Table 3. Financial Service Delivery Systems

Country	Financial Service Delivery Systems
ARGENTINA	(1) Non-operative offices (basically for marketing purposes), (2) branch offices with limited range of services, (3) small branch
BRAZIL	Temporary offices which may be located in fairs for no more than 90 days
EL	
SALVADOR	Automated Teller Machines
GUYANA	Mobile deposit units
HONDURAS	Home visits
TRIN & TOB	Mobile office and limited service branch offices are permitted

Source: Jansson and Wenner (1997)

4.4 Impact of the Financial Crisis on Regulation

As the global financial crisis erupted in late 2007 and put the entire globe into financial turmoil, regulators in the financial sector around the world have begun imposing strict regulations and policies, and placed a higher degree of supervision over the financial industry. In addition to the findings on the post-financial crisis that the link between the

microfinance industry and both economic conditions and capital markets has increased, the fact that the financial turmoil has mainly resulted from flawed subprime lending models, the recent financial crisis has greatly affected the microfinance industry overall. MFIs are to be affected by the norm for disclosure; they would be required to provide more details on the features of their products and services. Due to the additional requirements and supervision costs, it is important to avoid over-regulation (Di Bella, 2011).

Moreover, as stated earlier, the financial crisis has imposed even higher interest rates and this has grabbed attentions in many countries. In order to reduce interest rates, regulations and policies aim to build a market structure where MFIs can operate with increased productivity and efficiency, improve infrastructures and introduce new products and services. This will allow MFIs to be more stable in terms of management, be able to reach their clients and meet their needs. The increase in the number of loans will reduce their average fixed costs and enable them to become more sustainable.

4.5 Road Ahead

From the beginning, MFIs have been on a rocky road with many critics and skeptics on their high interest rates, lack of funds, inability to reach the poor, and operational and economic inefficiencies. However, the visible improvement of their performance rating (Von Stauffenberg et al., 2013), integrating with government agencies, and implementing innovative technologies increase the potential of the microfinance industry to grow

further down the road. As to the goal, set by the UN, of reducing extreme poverty by half by year 2015, MFIs have played a focal role and have contributed beyond expectations.

The microfinance market is forecasted to grow at 16.61% annually over the period 2012-2016 (ResearchMoz, 2011). According to Brom (2012), a successful track record of the market and its vast client base will continue to attract politicians' attention. The formation of credit bureaus is likely to increase and the consumer credit information will be more transparent for the healthier future of the microfinance sector. Nowadays, it's the sustainability of MFIs that attracts funding rather than their social objectives. Appropriate regulation and supervision of the MFIs would play a vital role in attracting more funding, expanding the scale of MFIs, lowering average loan sizes, and increasing economic efficiency.

5.0 Recommendations

Based on SEEP Research's market outlook of the microfinance industry (Brom, 2012) as well as the policy trends presented by CGAP, I collected the following policy recommendations, organized and elaborated them further.

5.1 Branchless Banking Policy

Branchless banking is an innovative way to reach the poor, while lowering the operational costs by more than half. One suggested idea is that MFIs deliver their products and services to rural areas through existing retail agents. This would drop their costs enormously as MFIs do not need to build their own infrastructure. In addition, they

can incorporate mobile phones to process transactions, which will be convenient for their clients at the same time. A short history of branchless banking has shown positive feedbacks and results. Anticipating that it will increase dramatically over the next few years, precise policies and directions must be suggested (MicroNed, 2009).

There are three considerations to be wary when building branchless banking policies (Tarazi, 2013). One is giving an authorization to non-bank agents as customer service points who are in charge of managing cash transactions for the end users living in rural areas. The nonbank agents can provide various services such as transmitting and processing information, cash handling, and electronic funds transferred. The second point is the policies need to accommodate the fact that there is a relatively high potential of money laundering and financing terrorism in developing countries-- due to the low capability of the poor end users in providing required documents, and the low degree of supervision over the remote customer interface. The last point is that regulators must consider whether they will authorize nonbank retail agents to issue e-money. When permitting issuance of e-money by agents, additional requirements and documentations should be included according to the local characteristics of each rural area. Once the branchless banking policy enables MFIs to reach the poor more efficiently, consumer protection laws and regulations must come into play.

5.2 Consumer Protection Laws and Regulations

Consumer protection is one of the main issues for policy makers. In addition to existing financial consumers, consumer protection laws and regulations will protect and attract

potential consumers. They protect existing financial consumers and give confidence to potential consumers in the financial system. Because of the social objective of the microfinance industry and the growing number of low-income clients, it is even more crucial in this industry than in conventional banking. Low-income customers are often financially illiterate and have no or little experience with any type of financial system. These vulnerable consumers must be protected from buying any harmful or inappropriate products without recognizing their embedded high risks. McKee (2013) addressed three key consumer protection elements:

- Transparency – Customers should be able to easily compare the products they use with other similar products. They should be informed of the costs, risks, key features and terms of the products they use.
- Fair Treatment – Policies and laws must capture any misleading sales practices, aggressive collections and come up with the best practical actions against these mistreatments.
- Effective Recourse – Regulators need to ensure that there are effective and practical ways to resolve consumers' issues.

Consumer protection policies must entail firm insights into the lives of the poor. Precise researches must be conducted beforehand that trace how the poor behave towards their financial difficulties and interact with financial services. Recent researches on behavioral economics have shown that financial consumers, especially the ones with low education, “can behave in certain irrational ways, impacting consumers’ ability to make sound financial decisions” (McKee, 2013).

Regulators must take precautions to prevent designing and implementing inadequate laws and policies. Based on researches on the low-income consumers' behaviours, consumer protection tools, such as disclosure requirements, must be carefully developed and tested. To conduct consumer research, existing policies, laws and regulations need to be analyzed, as well as direct low-income consumer observations should be accompanied. Direct communications with those inexperienced and vulnerable consumers help policy makers identify and analyze urgent issues and take actions accordingly (Collins et al., 2011). Even with adequate consumer protections policies, if a market with a great number of low-income consumers has a limited supervisory capacity, policies would have no impact on the market. New approaches to supervision will be discussed in the following section.

5.3 Alternative Approaches to Supervision

In developing countries, many financial institutions have attempted to incorporate self-supervision, but results repeatedly turned out to be inefficient. One solution to this problem is forming federations. In Guatemala, for example, small groups of credit unions have formed federations and they are responsible for monitoring and creating prudential norms. The supervisory agencies still maintain legal authority and responsibility over the institutions but delegate day-to-day monitoring and regular inspections to those federations (Wydick et al., 2011). The federations' ability and reliability need be tested regularly. Another example is Bank Rakyat in Indonesia. It has rural branch officers who supervise a large number of small banks in rural areas. A federation of municipal banking institutions is responsible for monitoring over all transactions made with clients in rural

areas. It seems to work well so far as there have been no major problems and risks reported while witnessing their lending capacity grow (Patten et al., 2001).

6.0 Conclusion

For the last three decades, microfinance has attracted substantial attention from all around the world, and the number of researches and studies has increased exponentially. Microfinance is a new form of financial market, yet profoundly different from other financial services. It was pioneered mostly by NGOs in the early 1970s aiming to help the poor, especially women in rural areas, generate persistent income, which would lead them out of poverty.

This paper analyzed the emerging trends that helped boosting the growth of the microfinance sector. Today, hundreds of MFIs have strengthened and matured. They serve 75 million borrowers with outstanding loans of USD 38 billion (Finacle, 2013). More and more MFIs are transforming into regulated institutions. It is evident that the regulated institutions perform better and have a stronger sustainability. Although there are no globally accepted standards, many researchers have done empirical research on the impact of regulation on microfinance and they all come to an agreement that regulated microfinance institutions perform better than unregulated institutions. Thus, recently most countries have undertaken major financial regulatory reforms.

As the sector has matured, the international funders such as the World Bank have become major players in the market and are able to provide information at the global level. Also, the sector would greatly benefit from the enhanced use of technology, diversified products and the co-operation of commercial and non-profit institutions. They can

maximize the potential efficiencies in their specializations whether it is managing funds or carrying on their social works. MFIs, governments and the borrowers—they all need to be aware of the potential of the greater value in cooperation.

A strong and stable financial system depends on the ability of reaching the poor, meeting demand, operating efficiently and consumers' ability to make informed decisions. Financial literacy is an important life skill that empowers consumers to make the best financial decisions in their particular circumstances. With respect to all these, adequate policies and actions must be developed in order to improve overall conditions of the microfinance sector.

From a negative point of view, critics claim that it is difficult to assess the success of microfinance. The vast examinations and researches concluded that for the last two decades, microfinance has proven to improve economic viability and help poor people generate incomes. However, some argue that the mission of MFIs has drifted from helping the poor to making profits and that microcredit would have little or no impact on poverty eradication in the long run.

Furthermore, recent literatures have found that the global financial crisis influenced the microfinance industry. The correlation between the microcredit market and both international capital market development and macroeconomic conditions has increased. As the correlation increases, the systematic risk also increased. Moreover, researchers have found that the interest rate increased as a consequence of the crisis; however, they

have dropped following the introduction of new policies and regulations. These new laws and policies have imposed a stringent requirement of disclosure.

With respect to the regulatory reforms, governments need to maintain their power over economic activities, to control structure, safety, and smooth functioning of financial systems. Governments are taking initiatives to establish a safe and sound microfinance sector that accelerated rapid growth of the industry even more.

This paper explored how regulations and policies have been undertaken in the emerging microfinance sector. In light of the recent trend of reforms in the market, the groundwork for the newly issued laws and adaptation to the new regulatory environment is now in place around the globe. Alternative regulatory frameworks have been presented in this paper.

For the regulatory frameworks that were suggested by the literature, governments should consider the following: more flexibility in entry requirement, capital adequacy standards, collateral and documentation requirements, and revising provisions and usury laws, as well as alternative methods to reach the poor to overcome operational restrictions. Development and implementation of laws and policies are still at an embryonic stage.

In addition, the paper pinpoints specific areas that require laws and policies for the creation of transparent and healthy financial environment especially for low-income, low educated clients. These suggestions cover various sector-strengthening activities, which

include consumer protection policies, branchless banking policies and new ways of supervision. Since microfinance has only three decades of track record, many questions remain unanswered and along with the rapid growth of the industry, further exploration is needed.

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