Regulating Innovation in Microfinance

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Abstract

Microfinance is a socio-financial innovation which has increased financial inclusion in majority countries for the past three decades. However, changing technology and demographics mean that the future of microfinance depends on innovation by Microfinance Institutions (MFI’s) in product design, application processes and financial operation. This paper applies the results from interviews with stakeholders in Pakistan, India and Bangladesh to understand how microfinance regulation directly impacts on MFI innovation and thus on the sustainability of financial inclusion in majority countries. We propose that microfinance regulation can support long-term financial inclusion via microfinance innovation through allowing MFI’s to access: equity partnerships; diversified capital sources; and leverage opportunities derived from the mobile banking revolution for loan repayments. These findings have direct relevance for policy makers, and contribute to the literature regarding the future of financial inclusion.

Key words: Innovation, Policy, Microfinance, Microfinance Innovation, Microfinance Policy

JEL Codes: G21

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1. Introduction

Innovation is as important for governments as it is for business, for, through regulation, governments are able to leverage off the private sector to achieve the goals they so ardently desire. This is particularly true when it comes to financial inclusion. Majority world\(^1\) governments seek financial inclusion as a tool for long-term economic growth, and Microfinance Institution (MFI) regulation is one method to achieve financial inclusion. However, the needs of consumers in majority countries change just as rapidly as the needs of those in developed countries (Batra, Ramaswamy, Alden, Steenkamp, & Ramachander, 2014; Hwang, Wu, & Yu, 2016; Popkin, Adair, & Ng, 2012). Thus, MFI’s must continuously innovate to maintain relevance for their borrowers, and to ensure their business operations are financially self-sustainable. However, the innovations of MFI’s greatly depend on the regulation under which they are governed. For example, consider Bangladesh, the birthplace of modern microfinance, yet the country with the least amount of microfinance innovation. This presents a great risk for long-term financial inclusion in Bangladesh, because it indicates MFI’s have not adapted to the changing needs of their borrowers in the last 30 years, and that their outdated model will lose still more relevance over the next 30 years. Hence, the risk of not innovating is putting the long-term economic growth of Bangladesh at risk. On the other hand, the amount of innovation by MFI’s in Pakistan covers all aspects of business operations, and is facilitated by regulation. This paper focusses on the regulation of three key countries, Pakistan, Bangladesh, and India, and how it affects innovation by MFI’s. This topic has not been considered by the literature to date, despite the fact that innovation by MFI’s will shape the future of microfinance, financial inclusion, and economic growth in majority countries.

Microfinance Institutions can innovate in one of four ways: product design; product delivery; product approval; and, access to credit. Innovations in product design may include an allowance for loans to be secured by gold jewellery. Innovations in product delivery could be in the form of mobile phone disbursement of loans or applications. Innovations in product approval may take the form of fingerprint readers to identify borrowers who are not in possession of an identity card. Innovations in access to credit may take the form of securitisation of loans, or accessing the capital markets. These innovations are all critical for

\(^1\) Majority world is a term used to refer to those countries which are still developing, and which comprise the majority of the world in which we live in the current era. This term has been used widely in the sociology literature and is aligned with the socioeconomic outcomes of microfinance (Punch, 2003).
MFI’s seeking to adapt to the changing financial inclusion landscape, and regulation holds the key as to whether MFI’s are able to innovate.

Financial inclusion through microfinance reflects a trend in economic development which aims to leverage the financial system to create widespread opportunities for the vulnerable in society, generating general and long-lasting changes in prosperity. These changes in prosperity will come from millions of people having access to financial services, enabling them to save, borrow, and insure in a way which allows for wealth creation and wealth protection. However, the sustainable provision of financial inclusion requires consistent innovation by the firms which provide access to financial services. This paper considers the role regulation plays in enabling or crippling innovation in Microfinance Institutions (MFI’s). It will be argued that the effect of regulation on MFI innovation will ultimately determine the continued financial inclusion of a majority of people in the world.

The economic benefits of financial inclusion generally relate to microenterprise creation and expansion, which is implemented through microfinance. Although research to date has found that the economic benefits of microfinance are lower than previously expected (Aggarwal, Klapper, & Singer, 2012; Ahlin & Jiang, 2008), there is consensus that the initiative is likely to have greater benefits than disadvantages, costing governments relatively little to support (Hunt, 2013). The social benefits of microfinance have been well established in the literature to date (Hossain & Knight, 2008; Molyneux, Hutchison, Chuma, & Gilson, 2007; Roper, 2005), with MFI’s seeking to extend financial inclusion to the most vulnerable in society. The targeted users for MFI’s are usually rural–located, illiterate women in majority countries – a segment of society whose vulnerability to financial exclusion is matched only by the cost of extending financial services to (Cull, Demirgüç-Kunt, & Morduch, 2010; Woller, 2002).

Microfinance is a financial innovation, and MFI’s are specialised providers of financial services who have innovated business models, products, and access to credit in order to extend financial services to those previously excluded from them. Historically many MFI’s have relied on international donations, and there has been a trend in recent years for MFI’s to seek operational self-sustainability. The potential long-term security of microfinance for more than

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2 Microfinance is the provision of small loans of generally less than US$1,000 to individuals utilising social rather than physical collateral (references from community members) and with no financial recourse for unpaid loan amounts (Sharma, 2005). The aim of microfinance is threefold: providing access to credit; shifting household bargaining power; and providing incentives to change the way people decide on ‘temptation expenditure’ and ‘efficient expenditure’ (Banerjee, Duflo, Glennerster, & Kinnan, 2009) (pp. 11).
100 million borrowers (Armendáriz & Morduch, 2010) comes from the ability of MFI’s to respond to the changing needs of their clients through innovation.

The regulatory environment in which MFI’s function determines the ability of an MFI to innovate. This is an important topic of research for the literature and also for policy, given the significant positive impact⁴ that microfinance has in majority world countries. Additionally, without regulatory measures which allow innovation, the ability of MFI’s to provide financial inclusion to vulnerable populations will be hindered. Some of the key aspects of organisational innovation are found in the development of income streams, capital raising, and expense minimisation; these characteristics are illustrated in MFI’s which are financially self-sustainable. The financial self-sustainability of MFI’s is a topic covered in the literature, generally relating to the impact on the borrowers. This paper takes an alternative perspective, by linking MFI financial self-sustainability to their ability to innovate, which is ultimately affected by regulation.

Financially self-sustainable MFI’s contribute to ensuring long-term financial inclusion (Haq, Skully, & Pathan, 2010). At the heart of the research question for this paper is the discussion of why MFI’s should be operationally self-sustainable and innovative. A report by the IMF explained how MFI’s which rely on donations are restricted by limited resources (Sarr, 2006). Indeed, this report goes on to say that subsidised lending by NGO’s may actually have adverse effects on the operations of MFI’s (Sarr, 2006). If MFI’s are not financially sustainable (or otherwise unable to access sources of sustainable capital (Al-Azzam, Mimouni, & Ali, 2012)) they must primarily rely on other funding sources, either from NGO’s or subsidised credit from governments (Di Bella, 2011). This may result in the ongoing attainment of the social benefits derived from microfinance, however the continuation of these benefits relies on a cycle of charitably motivated funding. A financial model which relies on donor funding when a self-

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⁴ The literature is comprehensive in regards to the impact assessment of microfinance, such as the positive effect on consumption, poverty, employment, education and social status (Torkestani & Pari, 2008). However, there is a general lack of data on microfinance borrowers, their characteristics, contextual influences and success rates (Emeni & Kehinde, 2008; Weiss, Montgomery, & Kurmanalieva, 2003). Further, the research to date has focussed on microfinance as a socio-economic mechanism rather than as a tool to promote latent entrepreneurship and economic growth (Affleck & Mellor, 2006). Considering the fact that microfinance emerged as a tool to fight poverty, this is not surprising. However, microfinance allows self-employment, which requires a whole new set of skills to overcome difficulties at every stage of operation (Felsenstein & Schwartz, 1993). Microfinance leads to entrepreneurship (Emeni & Kehinde, 2008) and limited access to capital has been found to be a contributing factor in the poor economic growth of many majority world countries (Collier & Dasgupta, 2007). Authors have supported the economic effects of microfinance at a macro and also at a local level (Buera, Kaboski, & Shin, 2012) and on the quality of life (Eichner, 2012).
sustaining model is available may put MFI’s under unnecessary risk, because if there is a change in the financial stability or focus of their sponsors, MFI’s may be left without funding. However, it is the legislation governing MFI’s which potentially influences whether they are regulated to a financially stable level where they can receive deposits and also whether international and credit market funding sources are available.

1.1 Theoretical framework

The literature on microfinance consistently mentions four areas of MFI operations where innovation is vital: product design; product delivery; product approval; and, access to credit. The current paper considers innovation in microfinance in each of these four fields, with a view as to how regulation can influence them, and how vital innovation in these areas is to MFI’s in a diverse range of countries.

The specific aspects of MFI operations that regulation can affect are: product design (such as accepted collateral of gold or social collateral); product delivery (such as mobile phone repayments); product approval (such as identification of borrowers using fingerprint technology); and, MFI processes and access to credit. This paper considers and compares the impact of MFI innovation across these areas.

2. Methodology

The current paper focusses on how regulation is affecting the future of microfinance via innovation by MFI’s. In order to consider the topic more thoroughly, it presents the findings of three methodological perspectives which focus on the countries of interest by comparing relevant regulation documentation, statistical considerations, and interview results.

By utilising a strategy of methodology that relies on both quantitative and qualitative methods of data collection, this paper uniquely positions itself within analyses unexplored in literature to date, while providing a level of validity not achievable from focussing on one methodological approach.

The methodological processes of this paper represent an innovative strategy for considering the future of financial inclusion. The innovative approach taken by this paper is driven by a lack of published research on this topic and hence the requirement to provide a foundation paper which considers different possible perspectives regarding the influence of regulation on financial inclusion. When one considers the lack of research on this topic it is clear that initial
research in this field needs to establish a range of potential conclusions about the current state of play. Future research regarding innovation in microfinance will only have the ability to delve into specific methodologies once the literature establishes a baseline, by reflecting the current state of play.

2.1 Country selection

In a strategic sense, there are two main perspectives on how to identify countries which yield meaningful comparisons. Some authors, such as Marr and Tubaro (2013) who intentionally chose to compare Peru, Tanzania and the Indian state of Tamil Nadu, have indicated that the most beneficial comparison of legal issues can be made between countries which have large contextual differences. On the other hand, authors have attempted to compare similar countries, such as Beck and Levine (2005) in their paper on the role of private investor protection on financial development.

Both perspectives are important for establishing a sound empirical methodology for the current research, however three similar countries (Pakistan, India and Bangladesh) have been chosen for a number of reasons. Firstly, they are relatively comparable in terms of cultural factors which might otherwise distort the results. Indeed, these three countries have a shared history and, until 1947, were one original country.

Secondly, they are the most similar three separate countries which have available industry and regulatory data on microfinance. Therefore, for the purposes of determining the effect of regulation on innovation in microfinance, these three countries are the most appropriate.

2.2 Interview Methodology

To determine the effect of regulation in a meaningful way requires a broader range of data and a richer consideration than a purely statistical approach. Hence, semi-structured interviews have been undertaken with stakeholders in the microfinance sector in Pakistan, Bangladesh, and India. The technique of interviewing has long been established as a method of gaining in-depth and personal information which is critical for certain research fields (DiCicco-Bloom & Crabtree, 2006). Qualitative research faces similar methodological considerations to quantitative research (Creswell, 2012). For both methodological perspectives the most
important aspect is the overall strategy and logic of the analysis, and the second most important aspect is the quality of data input\(^4\); thus quality interviews were sought.

2.2.1 Interviewee Selection

Interviews were conducted with Chief Executive Officers (CEO’s), Managing Directors (MD’s) and Chief Financial Officers (CFO’s) of MFI’s, NGO’s and self-regulatory bodies in the countries of interest. In addition, high-level officials in the State Bank of Pakistan, Reserve Bank of India, and Microfinance Regulatory Authority (Bangladesh) were interviewed. Previous research has indicated that six interviews are generally sufficient, and that data saturation occurs after 12 interviews (Guest, Bunce, & Johnson, 2006). Hence, a minimum of six interviews was achieved for each country.

2.2.2 Interview Questions

The interviews were semi-structured, meaning that the questions were used as a guide for the discussions. Indeed, given the inherent nature of qualitative research of this kind, the direction of the interviews individually evolved depending on the particular interest, experience, and perspective of the interviewee. Further, in order to ensure that the interviews proceeded in a free-flowing manner and yielded the maximum possible information, a formal interview technique (which can make subjects suspicious and defensive (Britten, 1995)) was avoided.

2.2.3 Process

Interviews were conducted in the countries where interviewees were located, namely Pakistan, India, and Bangladesh. Interviews were primarily conducted in the offices of the interviewees or suitable nearby locations. The discussions with interviewees were recorded electronically as well as the responses being either typed or hand-written during the interview\(^5\).

2.3 Regulation Comparison Methodology

The methodology for conducting the comparative analysis of regulations between the three countries of interest is based on the criteria broadly identified in The Law and Economics of Microfinance by Hunt (2014). In that paper a law and economics analysis identified different aspects of regulation which can theoretically have an impact on MFI innovation (Hunt, 2014).

\(^4\) IT specialists refer to this phenomenon as GIGO, or ‘garbage in, garbage out’.

\(^5\) Full interview transcripts and list of interviewees is available by emailing the author.
In this way, the current paper is a test of the theory as to which aspects of microfinance regulation have a potential impact on MFI innovation, which in turn has potential flow-through effects on long-term financial inclusion. In particular, Hunt (2014) identified that regulation which promoted the use of microfinance would potentially contribute to the financial sustainability of MFI’s through innovation. The methodology of comparative analysis was chosen for the current study because it provides a direct examination of the differences between countries, which directly assists comparisons of differences in MFI financial sustainability.

The current paper identifies aspects of regulation which are relevant to innovation in microfinance, and presents a summarised discussion on the findings of the regulatory comparison based on the regulations specific to microfinance in the countries of focus.

3. **Results**

The current paper seeks to determine the effect of regulation on innovation in microfinance in the countries of interest. Despite the plethora of research which has found that innovation is closely tied to long-term outcomes in a variety of societies (Ford, 2013; Langlois, 1992; Potts, 2009), this theory has not been directly applied to microfinance. This is surprising given that the long-term sustainability of microfinance may potentially have some of the strongest and most long-lasting effects of any financial initiative in majority world countries. The focus of this paper is to identify the link between regulation and innovation in microfinance. As such, results will be presented with this purpose in mind.

3.1 **Legal Comparison**

For the current paper, the level and degree of regulatory control functioning in each of the countries studied was established by examining the original pieces of regulation. The regulatory comparison indicated that despite the Bangladeshi microfinance regulator\(^6\) functioning in a paper-based system inherently a year out of date, there are very high written controls regarding the freedoms accorded to MFI’s. For example, in Bangladesh MFI’s are required to check with the government regarding all cash flow activities, even if through generation of capital surplus they wish to use funds for charitable purposes. Consequently, the Bangladeshi MFI’s spend a large amount of time completing paper-based submissions and

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\(^6\) Microfinance Regulatory Authority (MRA)
incurring a high level of administrative costs associated with regulation. This naturally has an impact on the capital available for innovating, and ultimately on the development of products designed to reach those financially excluded. This micro-managing approach of the Bangladeshi regulator is in contrast to the never-ending submission process of the Indian government, with regulation drafted in 2012 still not passed by the parliament.

Regulatory analyses for Pakistan revealed the potential for regulation to effect the types of microfinance loans developed. For example, the regulations provide a waiver for the general provisions of assets to be held against loans which hold gold as security for the loan\(^7\). This has the potential to encourage the functional use of gold held by households, so long as MFI’s develop products which leverage off this asset class.

Although the regulations in Pakistan have some aspects which seem to potentially increase financial inclusion (the gold waiver, for example), other requirements on MFI’s may result in less freedom for MFI’s to innovate. For example, the regulations in Pakistan require that MFI’s establish the ‘repayment capacity’ of the borrower\(^8\). This regulation has the potential to restrict the provision of loans only to those who have the documented ability to repay the loan. Given that microfinance and other financial inclusion initiatives have been developed to provide an alternative source of symmetric information (i.e. social collateral and community references), this regulation has the potential to restrict access to credit to the middle classes who have documented income. The regulation is drafted in a way which reflects the intention for consumer protection, and as such may reflect an overall aversion to over-indebtedness since the 2009 crisis in neighbouring India.

Overall, the regulations in the three countries of interest contain enough differences to illustrate that different countries require different outcomes from their regulatory initiatives. Despite this, the regulations currently in place in the countries of interest have resulted in differences in innovation within MFI’s. Bangladeshi regulation restricts innovation by creating a high paper-based administrative burden and creating a climate of subsistence in that MFI’s are not allowed to even donate money without government approval. On the other hand, Indian MFI’s are able to innovate in some ways, such as through access to credit via securitisation of loans, but not in other ways such as through product design, approval or distribution. At the other extreme,

\(^7\) Regulation R-14, Prudential Regulations for Consumer Financing, State Bank of Pakistan 2011.
\(^8\) Regulation R-15, Prudential Regulations for Consumer Financing, State Bank of Pakistan 2011.
the regulations in Pakistan greatly assist MFI’s through encouraging equity partnerships, innovation in collateral requirements, and innovation in technological leverage to expand microfinance services to the most remote communities. However, even the example of regulation in Pakistan leads to questions regarding why more MFI’s in Pakistan do not seek the kind of innovation that companies such as Tameer do.\(^9\)

4. **Interview Results**

The interviews were conducted across MFI’s large and small, self-regulatory institutions, ratings agencies, NGO’s, and the regulators.\(^10\) Despite the diversity of perspectives, consistency can be seen in the results in most cases. The trends in the effects of the law on MFI operations are understood by all players, and so the results of the interviews were simpler to compile than if each perspective presented a different opinion. This section presents a summary of the results of the interviews.

4.1 **Bangladesh**

Interviews in Bangladesh provided a contrast to the other countries examined because the motivation of the regulator is completely different. Unlike Pakistan, where the regulator seeks long-term financial inclusion through a variety of strategies, in Bangladesh the regulator primarily seeks consumer protection from rogue microfinance firms, and the regulations are a direct reflection of this focus. This highlights the fact that the overall strategic perspective of the regulator has a great effect on MFI innovation, and ultimately on financial inclusion through microfinance.

The interviews in Bangladesh revealed that, although it is the birthplace of modern microfinance, Bangladesh hasn’t innovated in product design, product delivery or credit source for three decades. The result is that despite the world’s highest per capita outreach (13% of the population has a microfinance loan (MIX, 2015)), products for financial inclusion have not adapted to changing market conditions or consumer attitudes. Interviews revealed a large

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\(^9\) Tameer Microfinance Bank is the leader in innovation of products, delivery, processing, technological leverage, and access to credit: [http://www.tameerbank.com/](http://www.tameerbank.com/)

\(^10\) The regulators in question are the State Bank of Pakistan, the Reserve Bank of India, and the Microfinance Regulatory Authority in Bangladesh.
disconnection between the innovations that MFI’s would have liked to make, and the role that the regulator saw MFI’s playing in financial inclusion.

Bangladesh is where the joint-liability group-loan originated. As such, the trend away from this well-ingrained system has been much slower than in other countries. Although there has been a trend away from group-loans by the large MFI’s, the core products are still loan products without any kind of specialisation or flexibility of loan terms. Most MFI savings accounts are still effectively unavailable to depositors, except with BURO. Interviews with BURO and other MFI’s revealed that BURO is the only MFI which has managed to maintain financial sustainability through integrating microsavings as a source of capital. However, interviews with the regulator revealed that the cap for savings has been set at 25% of capitalisation to protect consumers from financial loss, and there is no intention to adapt these regulations to a changing capital funding structure for financial inclusion institutions.

One of the key issues in Bangladesh is the need for diversification of capital sources. At the current time the regulator says there are no issues in the sector. On the other hand, MFI’s say they need to be able to mobilise more savings than just 25-50% of capitalisation\textsuperscript{11}. Regulation in Bangladesh effectively ensures that most MFI’s rely on donations for their establishment, operations, and expansion. This is because MFI’s are unable to access capital from the capital markets, unable to undertake equity partnerships, and unable to mobilise large amounts of microsavings. Given these restrictions, MFI’s operate reliant on hand-outs from PKSF and other donors. When MFI’s are reliant on donations for the achievement of their organisational goals (i.e. financial inclusion), it is intuitive that their behaviour is tuned to maximising the donations they receive. This system stifles MFI innovation, because it is natural that donors support MFI’s who achieve financial inclusion to the most vulnerable in society, and don’t necessarily support the kind of investment in technology, infrastructure and human resources that innovation requires.

Two of the key issues in Bangladesh are that regulation has not supported the creation of a Credit Information Bureau, nor allowed for dialogue through a self-regulatory organisation.

\textsuperscript{11} The regulations currently allow MFI’s to mobilise only 25% of savings to fund business operations as per MRA Act (2007). Grameen Bank can take deposits, and in 2009 had a ratio of 142% for client savings to loan portfolio. Total deposit balance does not exceed 80% of total loans outstanding at any time. There are conditions which need to be followed in order to receive voluntary deposits (including that they cannot exceed 25% of the total capitalisation of the organisation). Detail is given about how to administer deposits and the conditions to follow.
Interviews revealed that the regulator has no intention of supporting a Credit Information Bureau, and that MFI’s view the idea as one which will increase competition and customer stealing. As such, there is consensus in Bangladesh that a Credit Information Bureau is not going to be initiated, despite great success with the same system in neighbouring Pakistan and more recently in India. In addition, the lack of a strong self-regulatory body means that there is no dialogue between the regulator and the MFI’s, and this has direct, flow-through effects on regulation which supports consumer protection at the expense of financial inclusion. However, it is clear that consumer protection cannot be had without the presence of financially independent and strong MFI’s who seek to provide financial inclusion. In this way, regulation which is focussed solely on the end-goal loses sight of the means to achieve the goal.

Interviews in Bangladesh revealed a strong disconnection between the regulator’s perceptions (that the industry is fine, and that consumers must be protected at all costs), and the perceptions of MFI’s (that they want to be able to innovate yet the regulation doesn’t allow them to). Based on the interviews conducted as part of the current study, it can be clearly seen that regulation in Bangladesh has a direct impact on MFI innovation, and is stifling an industry which seeks to adapt to the changing financial inclusion landscape. In addition, interviews revealed that regulation ensures that microfinance in Bangladesh is completely reliant on donations, which means that a change in donor priorities is all that is needed for the financial inclusion of millions of people to disappear.

4.2 India

The Indian microfinance environment has been shaped by the increasing dialogue between the regulator and the self-regulatory institution, Microfinance Institutions Network (MFIN). As a result, current regulations more closely reflect the requirements of MFI’s than they did previously. However, there is still disagreement between the regulator and MFI’s in terms of how MFI’s should function within the space of financial inclusion, and this is reflected in discrepancies raised in the interviews.

There is ongoing dialogue between the RBI\textsuperscript{12} and MFIN\textsuperscript{13} which enables regulation to reflect some of the needs of the industry, such as achieving their financial inclusion goals. However, despite some regulations adjusted through industry dialogue, many regulations which would

\textsuperscript{12} Reserve Bank of India

\textsuperscript{13} Microfinance Industry Network, the self-regulatory body in India.
facilitate future innovation in product design and delivery, such as mobile banking, have been flatly refused by the regulator. Hence, the situation in India is one where regulation permits innovation in some ways, while restricting it in other ways which hamper long-term financial inclusion.

One of the key innovations which allows MFIs’s greater diversification in credit sources is the possibility for the securitisation of microfinance loans. The challenges associated with this initiative differ from those faced when loans in developed countries are securitised and re-sold. One of these issues is the difference in maturity between the three year securitised loan portfolios and the one year microfinance loans. In developed countries this hasn’t stopped the securitisation of credit card debt, which indicates that there might be a possibility for 12 month microfinance loans as well. Large MFI’s in India are developing securitisation products which they can sell to the market to fund operations and share the risk of the loan portfolios. There are strong innovations in this area, because most microfinance loans are only a 12 month term while the securitised products are for 3 years, requiring some inspired financial engineering to fix the maturity disparity and ensure they are marketable products.

Despite the move towards innovation in establishing diversified options for credit, MFIs are restricted from making a profit unless they are able to keep operating costs below 10%. Hence, there is limited strategic investment in MFIs from domestic and international companies as MFIs are rarely able to prove that they are financially viable businesses worth investing in or partnering with. There is currently a margin cap of 12%. Interviews with the MFIN indicated that 1% was required to cover bad loans and 1% for possible profit. That only leaves a 10% margin for operating costs, an unachievable task considering the costs of servicing the target market. MFIs say this is leading to mission drift, however interviews with

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14 Interviews with the RBI found that they perceive the idea of mobile phone banking with an attitude that it will simply result in the creation of an unregulated 'eMoney' as happened in Kenya. Other countries have been proactive about ensuring this doesn’t happen, but the RBI has indicated that they will avoid that trend. Time will tell whether this proves to be true.

15 Given that microfinance borrowers are often ruralily dispersed, illiterate women in majority countries, the cost of providing financial services to this sector is relatively more costly than to a comparative group of urban middle class in the same countries. If MFIs are seeking to keep costs below 10% it is very difficult for them to provide loans to the target market as they are so costly to service. Ordinarily, the costs are able to be passed on to the end-users, who are willing and able to pay for the cost of financial services (Aggarwal et al., 2012). However, if the margins are restricted to 10%, MFIs are incentivised to provide loans to those less costly to serve – namely, the middle class. The term used to describe this trend is mission drift and it has been applied to situations of regulated interest rate and margin caps, and widely covered in the academic literature in papers by Brau and Woller (2004) and Kiweu (2011) to name a few.
the RBI\textsuperscript{16} indicated that from their perspective, the 12% margin is enough for MFI’s to run efficient businesses and serve the poor. Hence, dialogue between the industry and regulator are ongoing, with outcomes which suit all stakeholders remaining the long-term goal.

The interview with the regulator in India revealed that it has no intention to allow mobile-phone repayments or branchless banking, because it does not want to create unregulated ‘eMoney’. However, it also has no intention of considering the way Pakistan is developing a system to allow for regulated eMoney, despite the countries being neighbours. The regulator wants to avoid the creation of ‘eMoney’, as happened in Kenya as a result of the mobile phone money transfer system. Hence, there are regulatory restrictions on operating in a ‘cashless’ way. The result is that MFI’s can only increase outreach through the traditional model of branches and loan officers, which is naturally more expensive than operations which can use technology in a systematic way.

Interviews with MFI’s indicated that they believe they are not able to develop products which leverage off technology because of restrictive regulation, and this is a big limitation in product innovation. It is intuitive that if the regulator declines to nurture a system of branchless banking, then MFI’s aren’t able to develop the infrastructure or product design to implement such innovation. Interviews with the regulator indicated that it sees no reason to support branchless banking when all it illustrates is a divergence from what MFI’s should be doing, which is providing loans to the poor. Naturally, with such different perspectives on the role of branchless banking in financial inclusion, it is no wonder that the regulators and the industry are at odds over this matter.

The current government of India has put in place the Sampurna Vittiya Samaveshan (Total Financial Inclusion) program which is designed to extend low-cost bank accounts to an additional 200 million under-served women. Access to a bank account is a key first step in financial inclusion, and although it doesn’t allow the potential business benefits that microfinance does, it does provide a framework from which customers can become active financial members of society. Despite the continued interest rate cap for microfinance loans, MFI’s in India have bounced back from the regulatory and sector crisis of 2009 and seem to be gathering momentum for long-term financial inclusion.

\textsuperscript{16} Reserve Bank of India
4.3 Pakistan

The microfinance sector in Pakistan has been shaped by the adapting regulation which helped to establish the first formal MFI’s in 2007. Since the first microfinance regulation, the industry and regulator have had a relationship of dialogue and negotiation. With both the regulator and MFI’s on the same wavelength regarding financial inclusion, the industry has gone from strength to strength.

A significant initiative by the government which has encouraged diversification of funding for MFI’s is the allocation of funding from DIFID to an account managed by the regulator to act as security for capital market loans entered into by MFI’s. This enables MFI’s which are able to show operational efficiency to seek capital from a variety of sources. Interviews revealed that the SBP\textsuperscript{17} is of the opinion MFI’s don’t operate efficiently enough, and haven’t taken advantage of this generous security arrangement which allows them to access capital. The capital provided by the SBP results in a greater amount of capital available for MFI’s, as lenders have security in knowing their money will be repaid regardless of future MFI performance. This initiative illustrates the ability of the regulator to encourage MFI’s to seek diverse sources of capital, a reform which has potential flow-through effects on innovation as MFI’s seek to develop products which provide reliable income and serve the target market, the poor.

However, interviews with MFI’s indicated that the money set aside to provide security for capital market loans was not enough to help them access the capital. The reasons for this are that providing loans to the poor is costly, and keeping financial indicators within a range which illustrates financial efficiency is a task which most MFI’s fail to achieve. MFI’s which have achieved financial efficiency and obtained loans on the capital markets have often had to focus on a segment of society which is less costly to service, namely the middle classes\textsuperscript{18}. Interviews with stakeholders in Pakistan indicated that there are a number of target markets for different MFI’s which offer different levels of profitability.

MFI’s in Pakistan explained in the interviews that they are not restricted by regulation, and are able to innovate in products, delivery, and capital access. Interviews with MFI’s found that they were able to innovate in diversifying their income streams through different products such

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\textsuperscript{17} State Bank of Pakistan

\textsuperscript{18} This trend in loan provision is called ‘mission drift’ because MFI’s are going against their mission of serving the poorest in society in order to achieve financial efficiency.
as remittances. In addition, MFI’s are investing in mobile banking, and this is supported by equity partnerships with foreign telecommunications companies which provide the necessary capital and expertise to establish the technological infrastructure to support mobile banking. Telco’s are investing in MFI’s in a strategic way because the innovations in branchless banking mean that the poor are now a potential market for financial services. These investments in MFI’s are profit motivated, in terms of increasing the potential market for Telco products and services. However, the result of the poor being treated as a market is that there will certainly be increased financial inclusion through MFI growth and an increase in outreach as a result. However, some MFI’s informed the research that they were focussing their future strategy on branch expansion, rather than through mobile banking.

Interviews in Pakistan revealed the potential for a significant impact from an individual piece of regulation. MFI’s have illustrated their capacity to innovate in terms of what they accept as collateral, with regulation allowing waivers of the ‘general provisions’ for capital requirements for loans secured against gold. This means that loans secured by gold have less impact on the Profit and Loss statement, freeing up capital for productive use in other loans.

The Pakistani perspective is that allowing MFI’s to leverage off technology will result in financial services reaching a greater number of people, which is aligned with the social goals of the government. Further, the government of Pakistan advised me that the overall aim of their regulation is financial inclusion, and microfinance is just one of the initiatives they are promoting to achieve that. They are also building financial system stability and other associated factors.

The interviews in Pakistan with leading MFI ‘Tameer’ illustrated how MFI regulation directly affects their business operations and model. In terms of capital, Tameer have an equity partner in TeleNor (a Norwegian telecommunications company) which allows the MFI to increase outreach using phone banking for certain services, as well as providing capital to invest in innovative infrastructure and market research. In addition, this equity partnership provides TeleNor with an entry point into the Pakistani mobile phone sector, which is one of the most innovative and progressive of majority world countries. This equity partnership is directly supported by regulation which allows for this relationship to take place, unlike in India and Bangladesh where regulation explicitly denies equity partnerships of this nature. Tameer is well known in Pakistan for its ‘gold-backed’ microfinance loans which, despite only serving those with some gold investments, do allow a flexibility of collateral which enables the firm to
have 100% repayment of loans. Interviews with both Tameer and the State Bank of Pakistan revealed that the gold-backed products are a direct result of regulations which provide a waiver for the ‘general conditions’ for gold-backed loans. In effect, this means that gold-backed loans don’t require the large amount of capital reserves that unsecured loans require (to ensure MFI financial stability in the case of mass-default). Hence, the regulations have directly affected not only the operations and products offered by Tameer, but also allowed greater financial inclusion to those who aren’t able to enter the formal financial system.

5. **Challenges for Innovation**

MFI’s are inherently innovative institutions in their approach toward extending financial services to the poor in that their model of social collateral and home visits to receive repayments goes beyond the services offered by the traditional financial system. However, the ability of MFI’s to become complacent and reliant on a never-ending inflow of donations has been repeatedly documented (Hudon, 2008). The results of the interviews showed a range of perspectives regarding challenges ranging from access to capital to savings mobilisation. In all three countries the results consistently showed that access to capital was a pervasive challenge for MFI’s, and a challenge that regulators either accepted and addressed (such as in Pakistan), or denied and ignored (such as in Bangladesh).

6. **Limitations of the Research**

The current research presents important and practical results which contribute to the gap in the literature and inform policy makers. However, there are limitations to this research which restrict the generalisability of results and call into question their significance. Limitations for the current research relate to: the limited number of countries analysed; the unexamined perspective of the relevant governments; methodological issues inherent to semi-structured interviews; the grouping of MFI’s as one segment; and the inherent bias of interviewees.

The current research considered only three countries, all of which are arguably too similar or too different to compare, depending on the perspective taken. The small number of countries considered limits the practicality of the research. In addition, the current research relies heavily on the perspective of the three governments, particularly relating to the goal of regulation. Given that regulation is drafted with a particular goal in mind, it is not surprising that different countries have different regulations stemming from government perspectives.
Methodological issues in the current research relate specifically to the inherent problems of semi-structured interviews which allow the interviewee a large amount of control over the direction of discussion. Combine this issue with the vested interests inherent to all interviewees and it can be seen that this naturally results in a significant amount of bias in the responses. These different perspectives have been highlighted in the diversity of the perspectives given by the stakeholders interviewed. However, it is also important to note that despite the variety of factors which affect the impact of microfinance regulation, the perspectives of the interviewees are inherently biased towards how they envisage the future success of microfinance. If this research were so broad to have considered the perspectives of funding bodies such as DIFID and USAID, the results may have been different.

An additional limitation of the current research is that MFI’s are grouped and referred to as one type of financial institution. This is inherently incorrect as MFI’s can operate as NGO-MFI’s reliant on donations for all costs, as profit-seeking MFI’s innovating in equity partnerships, or as co-operative based community savings and loans groups. The diversity among MFI’s and the inability of the current research to differentiate between them in a systematic way limits the scope of the research.

Despite the limitations of the research, this paper presents results which fill a large gap in the literature regarding the effect of regulation on innovation in microfinance. Limitations of the results will always be present in empirical research which examines complex and important areas of study as the current paper does.

7. **Conclusion**

The current paper has illustrated identifiable and concrete examples of how regulation is directly affecting innovation in MFI’s in Pakistan, Bangladesh, and India. It has contributed to the literature by illustrating the ways in which MFI innovation can occur through products, product delivery, and access to credit. These core avenues for innovation are those which have the greatest potential impact on long-term financial inclusion as these are the areas which will increase the amount and type of financial services extended to those currently excluded from the financial system.

Despite the intuitive importance of creating and maintaining MFI’s which are sustainable in the long term, little research has focussed on the top-down mechanisms which may allow this to happen. Much of the literature has considered the effects of microfinance on borrowers, with
consensus regarding positive social effects (Molyneux et al., 2007; Roper, 2005; Steele, Amin, & Naved, 2001). Further, research has considered the role of regulation in microfinance, particularly relating to the financial self-sustainability of microfinance (Hunt, 2014). However, the ways in which regulation can impact the innovation of MFI’s has not previously been considered. The current paper has addressed this topic and provides a foundation of analysis from which future studies can build. It has been found that, despite discrepancies between opinions of the regulators and other stakeholders, regulation certainly affects a number of areas of MFI functioning which are inherently tied to the future of microfinance.

The future of microfinance relies on products and delivery methods which adapt to the changing needs of those financially excluded. Although microfinance has worked well for the last three decades, the needs of borrowers have changed. Indeed, one could argue that the needs of microfinance borrowers have changed at a rate significantly greater than the rate of those in minority developed countries. This is because the change at a societal level regarding access to health, education, and technology has changed little in minority developed countries. On the other hand, the trends in majority world countries have resulted in billions of people gaining access to healthcare, education, and financial services, all in the last three decades. The startling fact is that microfinance hasn’t changed at a rate which reflects the momentous and widespread changes which have occurred in the lives of the poor.

Many of the reasons for lack of innovation in microfinance stem from the inability to meet demand for services. Interviews with MFI’s revealed that there is very little perceived competition, and MFI’s feel as though they are restricted only by their access to capital in extending outreach of financial services to more and more borrowers. Another reason for the lack of innovation over the last three decades may be due to donor complacency. With MFI’s reporting consistent outreach to those otherwise financially excluded, donors may be reluctant to encourage change or innovation which may have a negative impact. Regardless of the actual reasons behind the lack of innovation in the last three decades, it is sure that the next three decades require innovation at an exponential rate to keep up with the changing nature of microfinance borrowers. This is particularly true when it comes to branchless and mobile banking, a technological trend which is important for financial inclusion as it is well-insulated from external shocks (Dash & Tech, 2014). Results from this study reveal that MFI’s which don’t leverage off trends in their target market of borrowers are likely to be left behind by donors and face an uphill battle trying to rekindle connection with their borrowers. With foresight and regulatory support this is a situation which is less likely to occur.
The challenges faced by MFI’s are inherently linked to the innovation they are capable of. As the English proverb says: necessity is the mother of invention. Interviews with MFI’s illustrated that although they have the overarching goal of providing financial access to people who are otherwise excluded from the financial system, they feel they are unable to do that in a manner which is financially self-sustainable. For example, Tameer in Pakistan expressed the frustration that it was required to establish on paper the ability of borrowers to repay loans. This limits the potential clients of MFI’s in Pakistan to those who have documented income, clearly a small segment of the population and one which is not the target market for MFI’s in general. However, the regulations in Pakistan provided a concession that loans which hold gold as a security are exempt from the general loss provisions. This regulatory tweak allowed Tameer to develop a particular gold-backed loan product unseen anywhere else in the world. This type of innovation is driven by the need to service a certain group of clients, and the flexibility of regulation reflects the needs of the MFI’s it affects.

The effect of regulation will depend on the regulatory history in each country, relative to the maturity of the microfinance market. This is particularly poignant in the countries of interest, where microfinance regulations have been brought in at different stages: 2001 in Pakistan; 2008 in India; and 2007 in Bangladesh. Considering this, it is particularly relevant that the microfinance market in Pakistan is even now still in its infancy (despite an established law), and yet the Bangladeshi market has been well established over the last 30 years. Hence, there is not necessarily an established microfinance sector which leads to a supportive regulatory environment for MFI’s to operate under.

In addition to the history of regulation, the effect of that regulation depends on the MFI’s themselves, and enforcement of the regulation. MFI’s in different countries have different management goals (eg. profit versus serving the poorest), and different organisational origin, either evolving from an NGO or from a strategic financial company. It can be easily understood how the characteristics of MFI’s affect the overall impact of regulation on MFI innovation. For example, MFI’s which are in essence NGO’s are less likely to be negatively affected by restrictions on savings mobilisation and capital requirements than are financially viable MFI’s seeking to maintain profitability, as the sources of capital are completely different. Hence, regulation applied to different management goals produces a range of differing incentives to innovate.
The success seen by microfinance over the previous three decades illustrates the innovation inherent in the initiative, and suggests that future innovation is critical to unlock further markets and continue to increase financial inclusion. Considering the importance of innovation in the microfinance sector in achieving financial inclusion, it is surprising that the regulators in India and Bangladesh seek to restrict innovation, rather than support it. Regulation in these countries discourages MFI’s from innovating in product design (such as with collateral options) as happens in Pakistan, and limits their access to the capital markets. In addition, in interviews with the Indian government they explicitly communicated that they wanted to avoid the use of mobile phones in banking, to avoid the creation of ‘eMoney’ outside fiscal control.

The interviews have shown the different ways regulation can affect MFI financial self-sustainability. Although the results have not highlighted the way one particular law can make or break a microfinance sector, the combination of the regulations, along with the regulatory and market history of each country plays a role. The results have indicated that governments have the ability to allow innovation in microfinance to support long-term financial inclusion. Indeed, the results of the interviews have illustrated repeatedly that the fate of MFI’s in the countries of interest are in the hands of their regulators. That is, regulation has direct and measurable influence on the actual practices of MFI’s and hence on financial inclusion. With such power to guide and control an industry as important as microfinance, research on this topic is increasingly important.

Government support for innovation through regulation has direct flow-through effects on MFI operations and subsequently on financial inclusion in each country. Interviews have shown that regulation has the ability to allow companies to form equity partnerships with international firms to share knowledge, to create innovative products, or to seek to leverage off technology in increasing outreach to the poorest. The current research has illustrated the directly measurable effects of regulation on MFI innovation. Indeed, the interviews have shown that stakeholders in the microfinance sector have a vested interest in communication between the regulator and MFI’s and that this is a healthy relationship.

The current research has the potential to inform microfinance policy, particularly where the regulator is interested in the sustainability of microfinance. The cross-country comparison detailed in the current paper adds a new dimension to the literature of finance which has not previously discussed innovation in microfinance from an empirical perspective. This paper fills this gap and provides a foundation for study from which future research can build.
References


