THE 9TH GLOBAL MICROFINANCE FORUM

Challenges of Institutional Diversity, Regulation and Supervision

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Presentation Summary

- Introduction
- Diversity challenges
- Legal Challenges
- Regulatory challenges
- Oparational Challenges
- Supervisory challenges
- Conclusion

1.0 Introduction

- Since the early 1970s, there have been many efforts from the international development community to understand the structure of social and economic relations which generate poverty as a by-product of the existing socio-economic and political systems (Umaru &Tende, 2011)

- According to a recent World Bank report (as of 8 October 2014), there were 2.2 billion people that lived on less than USD 2.00 per day (average poverty line in developing countries) in 2011, compared with 2.59 billion people who lived on the same amount in 1981

Introduction (Cont…)

650 million Muslims are living below average poverty line

- Although the number of people living below the average poverty line has gone down by 15% compared to 20 years ago, this number still makes up an alarming 30.6% of the current world population of 7.2 billion
- Out of those living below average poverty line, as reported by the Islamic Development Bank (IsDB), 850 million are Muslims
- As part of the initiatives addressing the poverty problem, many national and international institutions and movements have undertaken programs to help countries provide better job opportunities to the unemployed, and to microenterprises

Introduction (Contd...)

- The microfinance revolution, begun with independent initiatives in Latin America and South Asia starting in the 1970s, has allowed 65 million poor people around the world to receive small loans without collateral, build up assets, and buy insurance. (Divino, Maldonado, Mazali, & Tabak, 2015)

- The very idea of an Islamic microfinance programs came from Dr. Yunus who began a microfinance program among women in Bangladesh in 1976 through the University of Chittagong Gramen Bank

Introduction (Contd...)

- The latter, which was normally turned away by conventional financial institutions due to;-
  - lack of collaterals
  - high transaction costs
  - Lack of prudential and regulatory mechanisms, and
  - fragile legal enforcement mechanisms

- Has been served by microcredit and microfinance institutions (MFIs) since their inception in the 1970s with phenomenal success, though still there are many challenges out there

Kutayba Saccos, HQ-Dar es Salaam

Introduction (Contd…)

Tampro Saccos-Dar es Salaam

- From affordable loans and insurance products to safe places to save, microfinance services have been powerful weapons in the fight against poverty, especially in Latin America and South Asia (CGAP News, 2008)

- Among these organizations, Muslim micro-entrepreneurs turning to Islamic Microfinance Institutions (IMFIsIs) specifically for Shari`ah-compliant financing taking into consideration the faithful Muslims' adherence to their religious practice

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2.0 The Diversity of Islamic MFIs

- There are a number of reasons to expect that Islamic microfinance institutions do differ from their conventional counterparts and even among themselves

- According to institutional theory, three major forces cause organizations in any field to be more isomorphic, or similar (**DiMaggio & Powell, 1983**)

- **First**, important actors, on whom organizations depend, such as governments or other parties with resources, may impose regulations or policies that lead to isomorphism

- **Second**, organizations may mimic popular practices in other organizations, particularly in uncertain conditions

- **Finally**, Islamic and conventional MFIs are partly influenced by different isomorphic factors because they normally have different owners, often have different donors or funders, and depend on public funding to different degrees

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Diversity of Islamic MFIs (Contd...)

- IMFIsls in OIC Countries
- IMFIsls in Non-OIC Countries
- Bank-based IMFIsls
- Non-bank based IMFIsls
- Deposit based IMFIsls
- Non-Deposit based IMFIsls
- Waqf-based IMFIss
- Non-Waqf based IMFIss

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Institutional Diversity

- Islamic microfinance worldwide have been few compared to non-Islamic, scattered and of limited outreach
- Some have been mandated by the state, but lack popular demand, as in Iran
- other have emerged in response to popular demand, but lack regulatory support by the state, as in Tanzania and most Non-OIC or secular countries

Institutional Diversity (contd..)

- Islamic Microfinance goes hand in hand with Islamic Banking, without Islamic Banks Islamic MF will not thrive
- Unfortunately, Islamic banks have not yet successfully acquired the art of modern microfinance institutions and yet few of them even have microfinance divisions
- **Amana Bank in Tanzania launched a Microfinance division three years ago using group collateral and default RATE is almost ZERO%**

Institutional Diversity (Contd...)

- Islamic banks, mostly under state or corporate ownership, have failed to prove themselves as efficient and dynamic providers of microfinance services

- Islamic Microfinance, without strong institutional backing, like conventional ones, are an outright menace to their members, who risk loosing their savings (**The case of Kutayba Saccos in Tanzania**)

- There are two options of promoting Islamic microfinancing:
  - Assisting Islamic commercial banks to establish units with Islamic microfinance products;
  - Reassessing in a participatory process the challenges and realistic opportunities of Islamic rural banks and Microfinan

Institutional Diversity (Contd…)

- This should be done with a focus on;-
  - effective internal control
  - external supervision, and
  - the establishment of Islamic associations with apex services to their member institutions (e.g. **CIFCA in Tanzania**)
- Institutionally, there is not much difference between conventional and Islamic Microfinances
- ***Both suffer from the same legal; regulatory and supervisory neglect***
- This too, add to their institutional diversity

3. Legal, Regulatory, Operational and Supervisory Challenges (LROSPs)

The Challenge of Dual Nature of IMFIsIs

- Recent international financial crises have made it necessary that banks and microfinances be properly regulated and supervised to ensure the **safety and stability of the financial system**

- In addition to fulfilling **international regularity standards,** Islamic banks and Microfinances should also fulfill the ***Shari'a Standards for their authenticity***

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LROS Challenges (Contd...)

- **Robust Legal, Regulatory and Supervisory framework are instrumental towards ensuring sustainability of Islamic Microfinances development**

- **Any Legal, Supervisory & Regulatory framework for Islamic Microfinance has to:**
  - Offer those who use Islamic microfinances the same degree of protection and incentives offered to those who use conventional microfinances
  - Recognize the special features of Islamic microfinances; and
  - Find appropriate responses to them rather than simply applying solutions already devised for conventional microfinances
  - Target the unprivileged communities to alleviate their economic, social and educational problems

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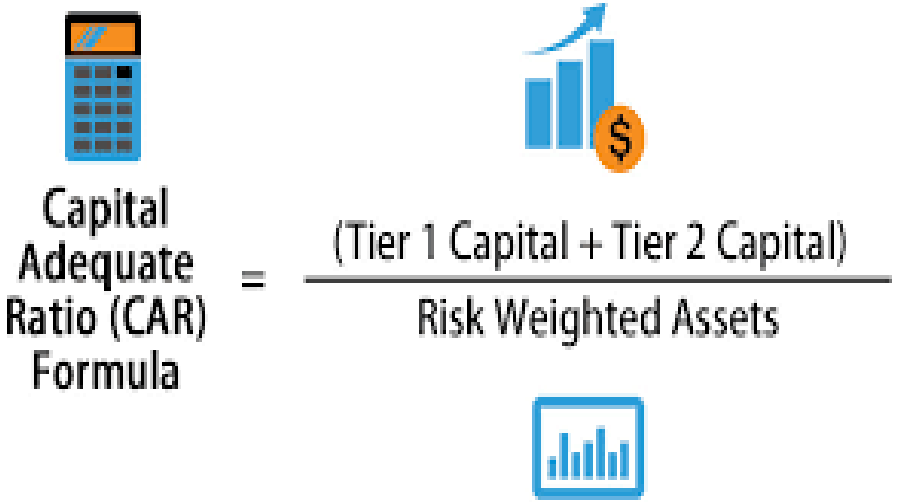
LROS Challenges(Contd...)

- Licensing Criteria – Policy Framework
- **Capital Adequacy regime**
  - total capital over risk weighted assets
  - a better measure of equity to assets ratio and meets Basel II requirements
- Statutory Liquidity Requirements
- Risk Management
- Prudential Regulations
- Internal Control Guidelines
- Disclosure requirements



Tier 1 capital : equity capital and disclosed reserves	*Tier 2 capital* is designated as supplementary *capital*

LROS Challenges (Contd...)

- Actually, Regulatory Framework for Islamic Microfinances goes hand in hand with Supervisory Framework
- The role of regulation extends beyond ensuring stability and confidence in Islamic microfinance, as it is also an ethical matter
- The laws, standards, and guidelines issued are instrumental in creating an incentive structure for market players to behave in certain ways
- Lack of proper legal, operational, regulatory and supervisory framework for Islamic microfinances results in;-
  - Poor services
  - Poor or inadequate product designs and development
  - Lack of innovations
- As a result, most of Islamic microfinance around the world to tend to replicate those in the conventional system

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LROS Challenges (Contd...)

- Five major issues can be highlighted while addressing the regulatory and supervisory issues within the *Islamic Microfinance industry;-*
  - Sharia'h GovernanceStandards
  - Financial and prudential regulations
  - Transparency, reporting and market conduct; and
  - The supervisory review processes

- The corporate governance structure of an IMFIs is as important as the corporate governance structure of any financial institution

- IMFIs are responsible for upholding not only their economic obligations to the participants, but also the principles of *Shari`ah*

- *In other words, IMFIs are not only an economic power house but also a means of showing the beauty and benefit of Islam to the people*

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LROS Challenges (Contd...)

- Regulatory and supervisory authorities of IMFIs play a key role in understanding the nature of *Microfinances participants prior to regulating the Microfinance industry*

- *Literacy level, financial availability and accessibility may be constraints on participation by the low-income population into IMFIs*

- This thorough understanding of factors affecting IMFIs, will facilitate the role of RSAs in helping to expand the scope of *Islamic finance coverage to the low-income population via Islamic Microfinance products*

- *Some of the areas in which RSAs may play a supporting role include:*

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LROS Challenges (Contd...)

- Introducing proportionate regulatory and supervisory requirements (which cover corporate governance, financial and prudential regulation, market conduct, and the supervisory review process) for both low- and high-risk *Microfinance participants*

- Providing an avenue for all stakeholders of *Islamic Microfinance to interact and understand their differing roles and functions*

- *These stakeholders include government agencies, Islamic charitable organisations, MPs, the central Shari`ah advisory board, intermediaries and potential participants*

- Providing accessible channels of communication/recourse for *Microfinance participants in cases of misrepresentation/fraud and mismanagement of funds*

- Ensuring that products developed by IMFIs actually address the needs of the low-income segment among the society

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LROS Challenges (Contd...)

- Ensuring that the IMFIs entering the market are there for the long term, and not for short-term gains, to demonstrate the value of *Islamic Microfinance*

- Understanding the demographic nature of Islamic *Microfinance participants through;-*
  - *Understanding the risks that revolve around them which may be uncommon among the population*
  - *Understanding the nature of occupation of these participants; and*
  - *assessing whether the barriers to their participation to IMFIs are real or arise from misperceptions of services and/or financial products offered*

- Outlining a different mechanism for monitoring Islamic Microfinances, which may include non-conventional mechanisms such as the use of Mosques, mobile-phone service providers etc

- Closely monitoring the financial condition of formal IMFIs to ensure that;-
  - the offerings of *Microfinance products are not made at the expense of the stability and soundness of the IMFIs, and that*
  - *any risks taken by IMFIs to include the high-risk, low-income population will not affect the IMFIs industry in the long run (Actuarization of IMFIs)*

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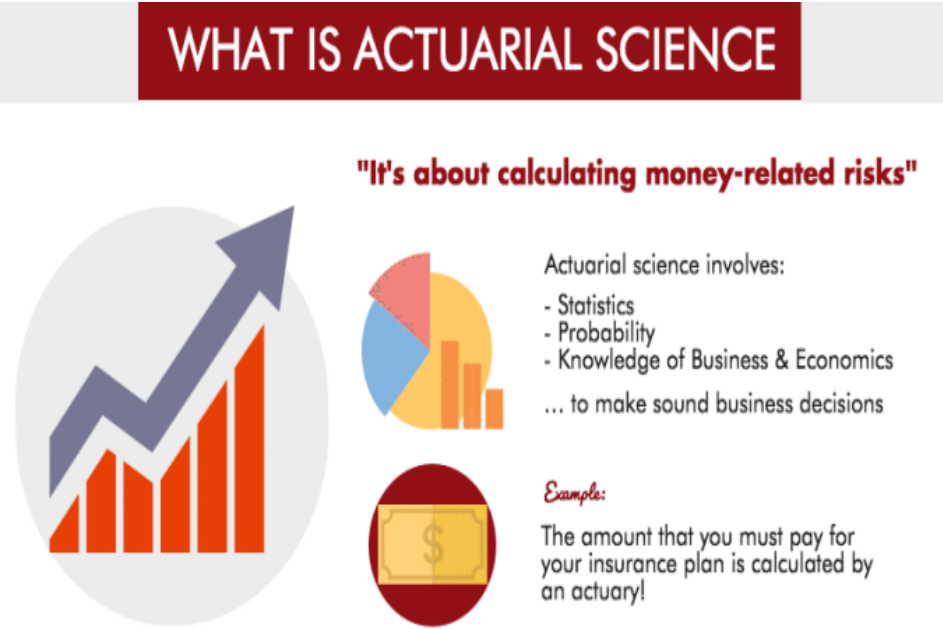
LROS Challenges (Contd...)

- Identifying the various types of Islamic Institutions that offer *Microfinances plans which may or may not be regulated by RSAs, for the purpose of understanding the risks that these IMFIs might pose to financial stability; and*

- Understanding the regulations of other jurisdictions that have been established for Microfinances *prior to coming up with its own regulations to suit the local requirements and adaptability*



Conclusions

- Generally, the outreach of Islamic Microfinances is almost negligible, and their overall performance poor:
- There is a lack of regulation, supervision and reliable reporting (transparency)
- The large majority of Islamic Microfinances is dormant or technically bankrupt;
- Their outreach is negligible, accounting for 7.2% of all microfinances globally but less than 1% of borrower outreach of the sector;
- Their loan portfolio (much of it overdue) accounts for 1,1% of the microfinance sector;
- Always the savings of the depositors are at great risk;
- Overall there is little difference in performance between conventional and Islamic Microfinances, the later having inherited most of their problems from the former;
- No remedy is in sight, except in the framework of a total overhaul of the IMFs system;
- Fresh money pumped into the sector without effective regulation and supervision will further aggravate their downfall, as has been historically the case of state-supported cooperative sectors
- There is a need to connect Zakah, Sadaqa and Waqf and IMFs for a better source of capital for IMFs

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