

Housing Finance for the Poor Policy & Regulation

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Acronyms

ANC- African National Congress
BANSEFI- Organic Law of the National Savings and Financial Services Bank
BI- Bank of Indonesia
BKDs-Village Banks
BKK- Badan Kredit Kecamatan: Subdistrict Credit Organization
BPD- Regional Development Banks
BPR- Bank Perkreditan Rakyat (People's Credit Bank)
BPRD- Banking Policy & Regulation Department
BRI- Bank Rakyat Indonesia
CNBV- National Banking and Securities Commission
COFOPRI- Comision de Formalizacion de la Propiedad Informal
CRA- Community Reinvestment Act
DFG- Development Finance Group
DTI- Department of Trade and Industry
EDPYME- Entities for the Development of the Small and Microenterprise
GoP- Government of Peru
HBMEs- Household-based Microenterprises
ILD- Instituto Libertad y Democracia
KUDs- Village Cooperatives
KUK- Small-scale Businesses
KUT- Subsidized Farming Credit Program
LACP- Microbanking Law
LDKPs- Non-bank Non-cooperative MFIs
MFI- Microfinance Institution
MFP- Microfinance Provider
MFRC- Micro Finance Regulatory Council
MSLI- Municipal Savings and Loan Institutions (MSLI -also known as CMAC)
MSME- Micro-small-medium Enterprises
NABARD- National Bank of Agriculture and Rural Development
NBFC- Non-banking Financial Corporation
NGO- Non-governmental Organization
NHFC- Khula Trust and National Housing Finance Corporation
NPL- Non-performing Loan
PRs- Prudential Regulations
RBI- Reserve Bank of India
RSLI- Rural Savings and Loan Institutions (RSLI - also known as CRAC)

SBP- State Bank of Pakistan
SHG- Self Help Group
SMMEs- Micro-small-medium Enterprises

DRAFT

DIG is engaged in a concerted and comprehensive effort to research and provide guidelines on the optimal mix of policies and regulations that can support sustained access to housing finance for the poor. We are researching and documenting such guidelines, while suggesting best approaches to enact them; and we are outlining the role donors, governments, practitioners and other stakeholders can play.

Introduction

Because of its apparent social and political importance, housing finance for the poor seems an area ripe for policy and regulatory intervention by most governments. However, a survey of both developing and developed nations demonstrates that there is no clear model of an enabling policy and regulatory environment that sufficiently promotes equitable access to housing finance while policing practices. In fact, virtually no common—let alone, “best”—practices exist with regard to the policies and regulations that govern housing finance for the poor. While some regulatory changes in the past decade (particularly with regard to general microfinance fiduciary regulation and land title regularization programs) are beginning to change this, the vast majority of the world’s poor still have limited access to housing finance and their nations’ policy and regulatory environments do little to correct for this. The condition holds true for three interconnected reasons.

First, these policies cover a wide terrain of public policy (and politics) that includes overall macroeconomic strategy, regulations of banking institutions and products (including microfinance regulations, if they exist), home purchasing and transfer requirements, public housing programs, and even local land use and building codes. All of these governmental decisions affect either the cost of purchasing or improving a home, or of finding appropriate private financing for it. Yet, these are obviously vastly different areas of technical expertise and governance. Second, the resulting likelihood of there being special policies focused on housing finance as a separate and unique social concern are high; in fact, many nations have created special housing finance institutions or policies and regulations that promote, restrict, or protect households from entering into financial relationships relating to homes. Of course, the majority of these special policies and regulations focus on the access to and practice of mortgage finance—a financial product that is unfeasible and impractical for most of the world’s poor. Third, policies and regulations related exclusively to housing finance for the poor are usually non-existent.

This begs several questions, not the least of which is “how can this situation change?” :

- To what extent does general fiduciary policy and regulation of financial institutions affect the poor and, more accurately, their use of housing finance? Have the microfinance regulations that have sprouted over the last decade helped or hindered the poor's use of and access to housing finance?
- To what extent do special housing finance policies and regulations help the poor globally?
- How do non-financial housing policies and regulations indirectly, but just as significantly, affect the access to and practice of housing finance?
- What is the status of these environments globally? Are there any successful models of enabling environments? If so, how do these function and what were their political origins?

Rather than begin in the order posed above, we will start to answer these questions by looking at some case studies. These will demonstrate both the scattered nature of policies and regulations across the world, as well as suggest some recommendations.

Case Studies

Because of most nations' focus on mortgage finance when considering housing finance policies and regulations, and mortgages often fail to reach the poor, the case studies will look only at microfinance environments. For that reason, we look at cases where 1) microfinance is thriving (as in Peru); 2) where it is deficient or declining (as in Indonesia); and 3) where special experiments in housing microfinance are currently being undertaken (including India, Pakistan, Mexico, and South Africa). Since much has been written on microfinance policies and regulations in general, we will limit this discussion to those that disproportionately affect housing microfinance beyond traditional microfinance.¹

Mixed Environment 1: India

After years of Gandhian Socialism, the Reserve Bank of India (RBI) emerged in the 1980s as a national financial network desperate for an improved and liberalized regulatory environment. Despite this, the RBI has repeatedly stated that it informally regards both the lending and deposit-taking activities of microfinance institutions as extra-legal.² However,

¹ For excellent reviews of how financial policy and regulations affect the general microfinance climate, see: Christen et al, *Guiding Principles on Regulation and Supervision of Microfinance* (CGAP: Washington, DC, 2003) and CGAP's *Building Inclusive Financial Systems: Donor Guidelines on Good Practice Microfinance* (2006).

² Much of this discussion is adopted from or directly taken from Sanjay Sinha, "Microfinance Regulation for Financial Inclusion: The 'street child' needs nurturing..." Essay No. 22 — Microfinance Regulation for

since banks and other formal institutions have failed to provide financial services to the poor in any meaningful way, the RBI has contended that attempting to terminate these activities would not be socially responsible. Nevertheless, the RBI has consistently fended off requests for the development of an enabling regulatory framework for MFIs, largely because it lacked the necessary supervisory capacity until 2006 (discussed further below).

Similarly, the approach of the Ministry of Finance to microfinance has also been one of benign neglect. In recent years, however (partly for populist reasons), the federal Government of India has started to grant grudging recognition to microfinance due to the ongoing insistence of national and international microfinance advocates. These efforts have stimulated some action, including changes in public rhetoric, steps towards financial governance of microfinance institutions, and even a fund of \$21 million established in 2000 for the promotion of microfinance activities. The earliest steps towards enabling microfinance in India included (i) exempting non-profits from Non-Banking Financial Corporations (NBFCs) registration requirements (1996), (ii) allowing NBFCs engaged in microfinance to access foreign investments and commercial borrowing, and (iii) promoting funds and technical assistance through the National Bank for Agriculture and Rural Development (NBARD) (which, incidentally, partially explains the disproportionate representation of MFIs in rural versus urban India). In the early 2000s, the RBI declared that lending by banks to MFIs qualifies for classification as 'priority sector' lending under its directed credit requirements, doubling financial grants to MFIs, and further expanding the allowed investments in the equity of NBFCs. These measures have provided some minor impetus for the microfinance sector.

The most significant change has been the allowance of the transformation of NGO-MFIs into for-profit NBFCs, which occurred largely in order to take advantage of the market-oriented capital structure enabled by this institutional form. This benefits MFIs in two ways: it facilitates the raising of equity capital from social investors or institutional funds; and, in doing so, it facilitates the flow of debt capital to the MFIs, since lenders prefer to limit the debt-to-equity ratios of their borrowers. This process is, of course, reinforced by the comfort factor stemming from the transparency and range of strategic ideas that result from the participation of a wider set of equity investors in a for-profit MFI's governance. In addition, the RBI's decision to credit bank lending to MFIs towards the 'priority sector' lending requirements was a critical factor in the development of linkages

between commercial banks and MFIs over the past 3-4 years. Similarly, down-scaling by commercial NBFCs to cater to the microfinance market has been stimulated by the advent of social investors into microfinance and reinforced by the 'priority sector' qualification for bank lending to MFIs.

More recently, a new issue emerged that led to significant reactionary regulation against MFIs. Beginning in early 2006, MFIs in some states were characterized as 'exploiters of the poor,' and every aspect of their operations fell under scrutiny. This started with action taken by a district administrator in the state of Andhra Pradesh against two MFIs in response to reported coercion of MFI clients who were unable to repay their loans. The two MFIs in question were in extreme competition with each other, and their management was being pushed by their commercial banks lenders to "overlend" in order to increase their gross loan portfolios and numbers of clients. Many of these banks, incidentally, had received significant bad press for being insensitive to the plight of the poor.

The state government of Andhra Pradesh pressured the two MFIs into reducing their interest rates to the unrealistic level of 15%, and ensuing pressure has been placed upon others to follow suit. Bureaucrats and politicians in other states have also jumped on the bandwagon: similar action was taken against an MFI in the state of Karnataka, and the Orissa government questioned the interest rates charged by MFIs operating in its state. Throughout this, however, the national regulatory environment maintained appropriate controls and guidance. The RBI itself defended the MFIs' right to charge cost-covering interest rates, while decrying overzealous collection practices. The RBI also clarified that as NBFCs are regulated by the central bank, state-level laws on money lending do not apply to them.

While concurrently addressing the consumer protection issues in microfinance discussed earlier, the RBI (with encouragement from the government) has been exploring other ideas for promoting financial inclusion. In January 2006, the RBI officially approved the use of "business correspondents" by the banking sector in India for the purpose of disbursal and recovery of "small value credit;" collection of small deposits; offering of microinsurance and pension products; and provision of remittances and other payment instruments. The circular specifically lists NGOs and MFIs (among others) as entities that may act as business correspondents on behalf of banks, and it provides for the banks to pay a 'reasonable' fee to these entities, while prohibiting the correspondents themselves from charging any fees directly to the customers for services rendered. In some

countries, this approach is reported to have considerably expanded the outreach of financial services to poor and underserved households.

The banking correspondent model mitigates the argument for regulation to officially permit deposit collection by MFIs, because it will facilitate the provision of small deposit-taking services – particularly passbook savings accounts – and microcredit and other microfinance services directly from banks (through their MFI business correspondents, who act on the banks' behalf). In practice, however, it is taking some time to develop a successful business model for banking through correspondents, because the level of fees and a series of rules governing such operations have yet to be determined. Even more importantly, the cost of compensating banking correspondents would substantially increase the banks' operating expenses, and due to interest rate restrictions on small loans, banks already lose money on small accounts. Indeed, there is no reason to expect that the banks' cost of delivering financial services to low-income clients will be any lower through the banking correspondent model than it is through the Self Help Group (SHG)-bank linkage model. On the contrary, to the extent that group liability and transparency of operations are significant risk-mitigating factors in the SHG-bank linkage model, their potential absence in the business correspondent model could become an important impediment to the latter's growth.

In 2007, however, new regulations established by RBI for microfinance institutions further attested to the importance of the sector (while liberalizing its regulation).³ The government approved legislation known as the "Micro Finance Sector (Development & Regulation) Bill" that established norms for self-help groups (SHGs) and microfinance institutions (MFIs) to lend and collect money. Prior to this, only those entities registered with RBI were allowed to raise deposits, putting SHGs and MFIs at risk of having their activities restricted by authorities. An official release stated that the bill had been approved by cabinet and would also seek to designate NABARD (National Bank for Agriculture and Rural Development) as the regulator for the sector and provide differentiation between microfinance institutions that collect deposits and those that are engaged only in lending activities.

Mixed Environment 2: Pakistan

Pakistan's government promulgated the Microfinance Institutions Ordinance (MFI Ordinance) in October 2001, making Pakistan one of the first countries in South Asia to introduce a comprehensive regulatory

³ "New regulations for microfinance soon" *Times of India*, (December 8, 2006).

framework for microfinance.⁴ The Ordinance was enacted when the microfinance industry in Pakistan was still in its infancy. At the time, the sector was characterized by limited outreach and was dominated by a small number of multi-dimensional non-governmental organizations (NGOs) that were simultaneously involved in non-microfinance development activities. Accordingly, the formal financial sector—including the primary financial sector regulatory body, the State Bank of Pakistan (SBP)—viewed microfinance as a poverty-alleviating tool rather than as a core financial sector concern. As a result, the early regulatory structure, characteristic of most regulators' preliminary forays into regulating microfinance, was premised on the perception of the sector and its role.

Since then, however, the sector has witnessed rapid growth. The most visible growth has been in terms of active microcredit clients: the number grew tenfold between 2001 and 2006. Another area for growth has been the institutional front: since 2000, the SBP has licensed six microfinance banks (MFIs). These private sector entities, exclusively established with a view to enhance and deepen the financial penetration of the banking sector, are directly supervised by the SBP. By March 2007, SBP-regulated MFIs accounted for approximately 35 percent of total microcredit outreach.

Since the enactment of the MFI Ordinance in 2001, SBP has carried the dual responsibility of supervision and promotion of microfinance in Pakistan. To effectively perform the task as catalyst while simultaneously inculcating good practices within microfinance providers (MFPs), the SBP has undertaken several steps to both build its own capacity with regard to microfinance, and streamline processes and assign areas of responsibility between departments.

The SBP, pursuant to its restructuring and the creation of a separate Development Finance Group (DFG), has assigned the regulation and supervision of MFIs to its Banking Policy & Regulation Department (BPRD). Earlier, with the exception of onsite inspection, the work related to regulation and off-site surveillance was done at the Micro Finance Division in the SMED (Small and Medium Enterprises Department of the State Bank of Pakistan). This division is now primarily involved in the promotion of the

⁴ Much of this discussion is adopted from or directly taken from S. Ahmed & M. Shah, "Amendments to the Microfinance Institutions Ordinance, 2001 - Implications for the Sector" Essay No. 25 — Microfinance Regulation for Financial Inclusion; Microfinance Regulation and Supervision Resource Center (College Park: U Maryland, 2007).

sector. Since the promulgation of the Ordinance, the SBP has also introduced a number of supporting regulations for the sector:

1. Prudential Regulations for Micro Finance Banks (2003).
2. Guidelines for Mobile Banking Operations (2003).
3. Guidelines for NGOs Transformation (2005).
4. Fit and Proper Criteria for CEO/members of Boards of MFIs (2005).
5. Prudential Regulations for Commercial Banks to Undertake Micro Finance Business (June 2006).
6. Guidelines for Commercial Banks to Undertake Micro Finance Business (June 2006).

Since 2001, a number of amendments to the Ordinance and the Prudential Regulations (PRs) for MFIs have been recommended by the MFCG, including:

- Definitions of Microfinance and Microfinance Institution amended.
- Definition of "poor person" altered.
- Investment options for MFIs increased (GoP Securities PLUS).
- Regional MFI tier created.
- Maximum tenure of external auditors extended.
- Increased flexibility in timeline for publication of annual audited accounts.
- SBP authorized to manage Liquidity and Cash Reserve.
- SBP oversight with regard to governance and management of MFIs introduced.
- Secrecy and fidelity of records and information required.
- Writing off non-performing loans and provisioning.

This amendment was particularly controversial, as it dictated that all non-performing loans be written off one month after the loan was classified as a "loss". As a result of this amendment, MFIs are required to maintain a higher amount of capital for every rupee lent out, relative to a commercial bank (for unsecured lending).

According to most MFIs, given the nature of microfinance, this will present a stumbling block in growth for MFIs, especially when there is a market event (elections, strikes, floods, etc.) and a larger portion of the portfolio is affected. Some MFIs further state that if forcing MFIs to recognize a decline in portfolio quality within 30 days could result in increasingly adversarial interactions between lenders and borrowers.

- Truth-in-lending and promotion of consumer protection philosophy.

Still, there are many further steps that remain to be taken in Pakistan's policy and regulatory environment. For example, the Ordinance does not

allow MFIs to use their receivables as collateral to raise debt. This reduces an MFI's capacity to leverage its balance sheet for growth.

Another restriction is the loan loss provision; even though the general provisioning requirement has been reduced from two percent to 1.5 percent, in other comparable cases like Bolivia and Ghana, general provisioning is one percent. As discussed earlier, higher provisioning for delinquent loans means higher levels of capitalization relative to commercial banks as a result. According to some MFIs, approximately 60% of the microfinance customers are self-curing (i.e. they deposit installments on their own), 20% need up to two visits, and the remaining 20% remain delinquent due to temporary liquidity mismatches. This becomes an even larger stumbling block to the growth of MFIs when there is a market event (elections, strikes, floods, etc.) and a larger portion of the portfolio becomes affected. The requirement to recognize non-performing loans (NPLs) after only 30 days means that there is no safety margin for the MFI. This could also have a spillover effect on client relations and create adversarial relations. In banks, if there are "ability to pay" problems, it takes a certain timeframe to turn things around, thus the 90-day period before the decline in quality is recognized. If MFIs are forced to recognize a decline in quality within 30 days, their behavior towards the customer will lead to increasingly adversarial interactions.

Pakistan also caps the loan size of microfinance—a regulation that could severely impede housing microfinance in more expensive areas like Karachi and Lahore. The caps were designed to ensure that investors do not use microfinance as a back channel for conducting commercial banking. At the same time, some MFIs strongly feel that capping loans creates the most significant impediment to financial sustainability. Their argument is based on the fact that there is a sizeable gap between what commercial banks will lend without collateral and the current limit for microfinance (Rs. 150,000, or approx. USD 2,500), as determined by the Ordinance. As a result, this limitation is likely to prevent an MFI from continuing to serve its clients through an ever-increasing loan size which would lead to poverty alleviation and stronger financial institutions. Consequently this policy creates a 'missing middle' in the market. More relevantly, this dramatically limits the expansion of housing microfinance.

Difficult Environment 1: Indonesia

In Indonesia, microfinance is the modern term for what used to be the "Volkscredietwezen" (popular credit system) established at the end of the

19th century under Dutch colonial rule.⁵ The actual landscape of current microfinance in the country is divided into formal, semi-formal and informal sectors; the formal sector's contribution to microfinancial services is outperforming the semi-formal and informal sectors in terms of loans outstanding and savings as well as in number of clients.

A variety of old and new MFIs exist in Indonesia, including:

1. BRI Units;
2. BPRs (Bank Perkreditan Rakyat (People's Credit Bank))⁶, consisting of BKDs (village banks) and non-BKDs ("new" BPRs and old MFIs that have converted to BPR status);
3. non-bank, non-cooperative MFIs (LDKPs, sub-district and village-level MFIs founded by provincial/district governments);
4. cooperatives (credit cooperatives and saving and loan units, including credit unions and BMTs); and
5. Grameen Bank replicators (mostly unlicensed), and some NGOs (most of which have a foundation license).

As of mid-2005, there were over 54,000 outlets for microfinance, serving over 29 million borrowers (13% of the population) and more than 43 million depositors (19% of the population).

The Bank of Indonesia (BI) is encouraging commercial banks to lend to micro-small-medium enterprises (MSME) through self-determined targets in their business plans. BI has also defined micro-credit broadly to include loans up to Rp 50 million (approx. USD 5,450). Under this broad definition, commercial banks dominate "micro-credit", serving 48% of total borrowers with loans totaling 82.8% of the aggregate outstanding microfinance loan portfolio. BRI Units, which number nearly half of total commercial banks' outlets, account for 10.8% of borrowers and 12.6% of outstanding micro-loans. The average micro-loan size of commercial banks is USD 983.50 (around 85% of income per capita), as compared to USD 53 for BKDs (approximately 5% of per capita income).

Generally, all public deposit taking MFIs in Indonesia are regulated under the banking act and have to fulfill the criteria of a BPR, or MFI. Indonesia has not promulgated a special MFI law, but has adjusted its banking act

⁵ Much of this discussion is adopted from or directly taken from Sumantoro Martowijoyo, "Indonesia Microfinance at the Crossroads: Caught Between Popular and Populist Policies" Essay No. 23 — Microfinance Regulation for Financial Inclusion; Microfinance Regulation and Supervision Resource Center (College Park: U Maryland, 2007), and Bank Indonesia and GTZ's Project ProFI (Promotion of Small Financial Institutions) essay titled "Legislation, Regulation, and Supervision of Microfinance Institutions in Indonesia" (January 2000).

⁶ rural banks, smallholder credit banks

to accommodate a certain type of MFI. Out of 13,740 microbanks, Bank Indonesia (BI, is overseeing directly some 2,420 BPR. The central bank has concluded special arrangements with other institutions to supervise on BI's behalf. Bank Rakyat Indonesia (BRI) is supervising 5,345 credit-only BKDs (village credit boards) on behalf of BI and is reimbursed for this task. The regional governments and the regional development banks (BPDs) are supervising 2,272 LDKP (rural fund and credit institution), some of which are limited deposit-taking MFIs.

In June 1983, the first banking reform was enacted, which abolished restrictions on interest rates and ceilings on credit expansion. In October 1988, a decline in oil revenue led to the enactment of the next banking reform, Pakto 88, which liberalized rules governing the establishment of new banks as well as new branch offices of the existing banks to tap domestic savings and to expand loan facilities. These two successive reforms succeeded in boosting not only the number of bank offices, but also expanded savings mobilization and credit at remarkable rates that had never been achieved before. The next step in the reforms, Pakjan 1990, took place in January 1990. Pakjan 1990 was intended to gradually reduce subsidized Central Bank credit, leaving only those subsidized loans that promoted self-sufficiency of rice production, designated to procure food stock, assisted the development of cooperatives, or boosted investment in the eastern part of Indonesia. At the same time, Pakjan 1990 also required commercial banks to lend at least 20% of their portfolios to small-scale businesses (KUK). In retrospect, BI was not fully successful in reducing the amount of subsidized financing due to pressure from the government, especially those ministries that were noted as long-time promoters of subsidized credits.

BI's microfinance advisory team, Pro-Fi, disseminated a 'blue book' in 2003 on the development of microfinance. The 'blue book' advised the government to lift all constraints on microfinance and set up policies conducive to the development of microfinance, including: phasing out subsidized loan programs and legalizing non-bank, non-cooperative MFIs and allowing them to mobilize savings in a limited area and up to a certain threshold. The transfer of banking supervisory authority from BI to a new financial supervisory body, which was supposed to be done by 2002, has been postponed by the Parliament until 2010. As a result, BI still retains both regulatory and supervisory duties for all licensed banks. To reduce its supervisory burden, BI is financing BRI to perform the supervision of village banks (BKDs) on its behalf. Based on the Central Bank's philosophy of "the bigger, the stronger," the BKDs are not rural banks that fit its BPR concept, so it has focused almost all of its attention on the "new" BPRs rather than the BKDs. BI has given BKDs until 2010 to prepare before becoming

'orphaned,' as the new supervisory body will likely require them to comply with its regulations and will charge a supervision fee. Nevertheless, less attention from BI and BRI has already affected the sustainability of BKDs, as witnessed by the decrease in the number of active BKDs year by year.

To meet minimum capital requirements, and to reduce the number of institutions (in accordance with another popular prescription for the banking sector), BKKs have been undergoing a merging process aimed at leaving only one licensed BKK in each district. The most financially healthy licensed BKK in a district will be designated as the head office. All other BKKs in the same district will be reclassified as branch offices of that BKK. Enforcement of BPR rules has also led to the termination of a 35-year paternalistic apex relationship between the Central Java Provincial Development Bank (BPD) and the BKKs. As a BKK has to become a licensed rural bank (BPR), the BKK's supervisor at the BPD's branch office will no longer be allowed to audit it, since this authority has shifted to the Board of Supervisors, which is led by the head of a district or the mayor of a municipality. Licensed BKKs also are not free to invest their liquidity in the BPD, because such a placement is now subject to legal lending limits for related parties. For these reasons, the BPD is seriously considering selling its ownership shares in BKKs.

So, while consumer protection is the ultimate rationale of regulation and supervision for commercial banks as well as for MFIs, in practice the apparent clear-cut distinction between deposit taking and non-deposit taking MFIs is difficult to make in Indonesia. The government has chosen a multi-agency and tiered regulatory framework for MFIs and a so-called hybrid approach to MFI supervision that is based on the size and type of MFI's deposit taking activities.

To make matters even more complicated, as an ongoing result of the 1997 monetary crisis, loan subsidization has returned to the mainstream. The government implemented a large number of new loan programs and other social safety net schemes, crowding the market with cheap and uncontrolled credit. A new subsidized farming credit program (KUT) was launched after the original KUT was informally suspended due to high arrearage of participating village cooperatives (KUDs). The new KUT was intended to eliminate the weaknesses of the former KUT by allowing NGOs to participate as another loan channel. However, this KUT scheme has followed the same path, but with NGOs as the new defaulters.

BI, which has had experience in managing microfinance projects, is acting tactically for the banking sector by defining micro-credit to include loans up to Rp 50 million (approximately USD 5,400). Its policy has created

more confusion regarding the role of microfinance as a means for poverty alleviation, and it has diverted attention away from the importance of real pro-poor microfinance. The enforcement of the BPR system with respect to the existing traditional MFIs – such as village banks (BKDs) and non-bank, non-cooperative MFIs (LDKPs) – has left them with an unclear status and a bleak future. In the second stage, the decision of the Central Bank to follow popular policy prescriptions has resulted in the destruction of the original BKK system and the termination of the BKKs' long-time apex relationship with the Central Java BPD. Microfinance in Indonesia is thus at a crossroads of two unsupportive and contradictory policies: the enforcement of the BPR system by the Central Bank, which requires a complete transformation of the nature and culture of the original system; and the forthcoming waves of subsidized loan programs from the government that will crowd out the market with cheap credit. Either road will severely threaten the sustainability of commercial microfinance. If BKDs and LDKPs are still surviving ten years from now, that would be the real triumph of microfinance.

Enabling Environment 1: Mexico

Financial services in Mexico are provided by a diverse set of financial intermediaries through a pyramidal structure which attends to different market niches. The government's current strategic approach is to promote the development of social banking with the purpose of increasing the depth and outreach of the financial system.⁷

Because of the need to order, regulate and promote the microfinance system, the legislature approved the microbanking law (LACP, for its acronym in Spanish) and the Organic Law of the National Savings and Financial Services Bank (BANSEFI, for its acronym in Spanish), on April, 30, 2001. The objective of the LACP is to provide security for the savings of the population participating in the system, and to provide that population with a stable funding source. Additionally LACP promotes the development of the microfinance, in an ordered way to allow:

- An important source of financing for micro- and small enterprises, and for housing.
- The provision of formal financial services for the sectors and regions that is currently underserved, incorporating them into the formal financial system and the main economic flows.

⁷ See Aarón Silva “Regulation, Development, and Perspectives of the Microbanking Sector in Mexico” A Presentation to the Interamerican Forum on Microenterprise (2002) and Jansson et al, *Principios y prácticas para la regulación y supervisión de las microfinanzas* (IDB: Washington DC, 2003).

Only those intermediaries that prove their financial viability will be integrated into the new legal framework. The LACP is a “functional” law whereby all of the intermediaries that perform the same functions will have to comply with the same rules and adopt one of the two allowed legal forms, either as a savings and loan cooperative or a popular financial partnership. LACP differentiates according to the individual development level of the intermediaries, with four levels, defined according to:

- Assets and liabilities;
- Number of partners or clients;
- Number of branches;
- Geographical niche; and
- Technical and operational capacities.

As the development level increases, the intermediaries will be allowed to become involved in more operations; as the complexity of the operations increases, a higher level of regulation will apply.

The LACP is supported in an “auxiliary supervision scheme.” The National Banking and Securities Commission (CNBV, for its acronym in Spanish) maintains its supervisory authority over the intermediaries. Under this scheme, federations have the task of enforcing the legal framework and performing their auxiliary supervision and oversight faculties over the intermediaries through a supervision committee authorized by the CNBV. The law established a two year transition period so that the CNBV could issue the prudential regulations according to LACP and intermediaries could adjust their operations to fully comply with the law. This period ended in June, 2003.

The enforcement of the Microbanking Law initiated a consolidation process. There were intermediaries which were able to adjust their operations without problems to comply with requirements of the law. Other intermediaries required support in order to adjust their operations to the requirements of law, and had to merge or even exit the system and stop offering microfinance products and services.

In Mexico, thus, the creation of new regulations has formed part of a larger effort to both consolidate the number of financial institutions that currently exist as well as to diversify their products and services. This has increased the availability of microfinance in general and housing microfinance in particular (especially given that housing finance has been the sole province of a limited number of financial institutions).

Enabling Environment 2: Peru

In contrast, microfinance institutions in Peru are composed of municipal savings and loan institutions (MSLIs -also known as CMACs), rural savings and loan institutions (RSLIs - also known as CRACs) and entities for the development of the small and microenterprise (EDPYME).⁸ MSLIs started their operations in the early 1980s, and were created with the cooperation of the German government to replicate the success of the German Sparkassen. They are owned by local governments and operate in provinces, helping small business to expand their services by offering financial products from funds collected in the communities. RSLIs were created in early the 1990s, after the Agrarian Bank was closed due to the 1992 financial reforms. They are owned by local private entrepreneurs, and operate mainly in rural areas with significant exposure in the agriculture and livestock sectors. EDPYMEs were created in the mid-1990s to formalize those NGOs that were granting loans to microentrepreneurs; this formalization became more important by the end of the 1990s when a law was passed which required NGOs to pay value-added tax on all interest from loans. Since NGOs did not have experience collecting deposits from the public, EDPYMEs were created as credit-only institutions.

Microfinance institutions and their operations are regulated under the same norms as banking and other financial institutions in Peru, with some differences in the minimum capital requirements and the number of operations allowed. For example, microfinance loans can only be given to individuals who are unsalaried, though the same institutions can offer different loans—i.e., consumer loans—with similar terms to salaried individuals.

Solvency is regulated and supervised by establishing and monitoring minimum capital requirements by institution type. These are readjusted each trimester according to wholesale inflation in the period. For all MFIs, the minimum capitalization requirement is kept at US\$275,100, and adjusts upwardly according to inflation. Peruvian regulations define four types of loans: (i) commercial and (ii) microenterprise loans to firms and individuals to finance their economic activities(microenterprise loans have a cap of US\$30,000); (iii)consumer loans to individuals for consumption purposes; and (iv) mortgage loans to build, modify or buy housing, using the property as collateral. While the risk categories of microenterprise, consumer and mortgage loans is determined solely by the number of

⁸ See Alfredo Ebentreich, “Microfinance Regulation in Peru: Current State, Lessons Learned and Prospects for the Future” Essay No. 5 —Microfinance Regulation for Financial Inclusion; Microfinance Regulation and Supervision Resource Center (College Park: U Maryland, 2005).

days a loan is past-due, the risk evaluation of commercial loans requires a further financial assessment of the client.

Since microenterprise and consumer loans are granted with shorter terms than commercial and mortgage loans, they move into default sooner. Establishing additional requirements to evaluate microenterprise and consumer loans would have made them burdensome, since it is not only hard to evaluate the financial situation of a microenterprise or of a person, but also because these loans have higher administrative costs than commercial loans. Thus, lower regulatory requirements for these loans have had a positive impact on microfinance institutions, since microenterprise and consumer loans are their biggest products, representing 53.7% and 25.2%, respectively, of the total loan portfolio as of December 2004. All financial institutions report their clients to the Superintendency, which consolidates the information and shares it, through its credit bureau, to all financial institutions. This is beneficial as many clients have debts with more than one financial institution.

However, a single client cannot have several risk categories, since the client represents the same risk. Therefore, through the credit bureau, financial institutions can see the risk category of shared clients, and must change their risk assessment according to the risk category assigned by any financial institution which has lent a significant portion (at least 20%) of the total debt to these clients. This prevents debtors from borrowing with several financial institutions and repaying only to those they choose.

The main standard for liquidity risk is the minimum liquidity ratio, both in local and foreign currency. The liquidity ratio is defined as the ratio of liquid assets over short-term obligations. Since Peru is a highly dollarized economy, and local currency generally devalues with respect to the US dollar, the minimum liquidity ratio in foreign currency was set at 20% and the liquidity ratio in local currency at 8%, so that financial institutions can cope better with runs on foreign currency due to sudden changes in the exchange rate with US dollars. These liquidity requirements are easily met by most MFIs, since deposits from the public are usually long term. Apart from having liquid assets to meet short-term obligations, MFIs also keep liquid assets to increase their supply of loan products.

The principal risk faced by MFIs is foreign exchange risk. Limits are set as follows: for assets greater than liabilities in foreign currency, the risk of exposure is 100% of regulatory capital; for liabilities greater than assets, the risk is 5% of the regulatory capital. In the case of banks, additional capital must be made for 9.1% of the exposure of foreign exchange risk. MFIs, due to the market niche they serve, operate mostly in local currency.

However, since some of them receive external financing in foreign currency, many have open positions, more liabilities than assets in foreign currency.

The most frequent reason for MFI closures has been losses larger than 50% of their regulatory capital. This can result from a low capital requirement, losses coming mostly from the loan portfolio of these institutions, or because of both factors. Minimum regulatory capital of roughly USD 250,000 has proven to be a very low requirement, not just in comparison with minimum capital in other countries for MFIs, but also for any new MFI to sustain its initial losses while a minimum loan portfolio is built to support its expenses, and cover start-up costs. In fact, not a single license application for an MFI has been authorized if its equity equals the minimum regulatory capital, and all operating MFIs have equity higher than USD 400,000. In practice, it is accepted that a higher minimum capital is required.

In traditional onsite supervision, a sample of credit files is selected to review the classification of the clients to determine whether the financial institution adequately provisions for loan losses according to the risk level of its client. However, in the case of MFI loan portfolios, composed mostly of microenterprise and consumer loans, selecting a useful sample would require reviewing a large number of files. It would also require the institution to have more information about its clients, which would be problematic when many clients do not have financial statements, and MFIs instead rely on estimates prepared by the credit analyst.

Onsite inspections at MFIs now involve a review of the entire database of all microenterprise and consumer loans, and a selected sample of commercial loans, which are very few, to determine the need for additional provisions. Relevant to provisioning is the fact that many MFIs grant additional loans to clients in financial trouble, so that they can repay their former loans, and no additional provisions are made for these refinanced loans (also called reprogrammed loans). This has brought attention to the issue of refinanced loans, and regulators have started to develop a process to review this issue during onsite inspections.

Another reason for closure of MFIs was a failure in the internal control system to detect irregularities and the deterioration of the loan portfolio. Initially MFIs were only required to have internal auditors who report to their board of directors, but due to the growing size of their loan portfolio, it became necessary to require these institutions to establish a department in charge of risk evaluation, especially credit risk, to permanently oversee compliance with limits and internal norms regarding

risk management. This became especially salient as the number of regulated MFIs grew over the past few years and the supervisory agency could not perform frequent onsite inspections. There are plans to require MSLIs, which have three major management positions (loan, finance and administration) to add an additional manager to deal with risk evaluation.

South Africa

As South Africa made the transition to majority rule in the early to mid-1990s, it had address the need for a parallel transition in its economic institutions. Since then, South Africa has made significant strides toward improving the national policy and legal environment for more equitable economic growth – including small-scale finance. As part of the process of deepening the financial sector, the Micro Finance Regulatory Council (MFRC) was established in 1999, under an exemption to the Usury Act. The MFRC's purpose is to supervise the operations of those institutions lending under its unrestricted interest rate window, and to provide for effective consumer protection and regularization of micro-lender operations in a growing market. Having served this role for over five years, the MFRC is soon to be absorbed into a larger regulatory structure, as part of a new generation of financial reforms.⁹

An early step, as the apartheid government was nearing its end, was to create the Usury Act Exemption of 1992. The stated policy goal here was to spur growth in lending to micro-, small, and medium sized enterprises (SMMEs). The exemption allowed lenders to charge unregulated interest rates on loans under RAD 6,000 (USD 937) and for a term of less than 36 months. What actually emerged was a booming micro-loan sector, dominated by payroll and cash-based lending mostly to formally employed, largely urban individuals. The exemption essentially licensed micro-lenders to create a separate, largely unregulated tier of credit provision to people on the fringes of the banking system. The Exemption did not have an immediate impact, but a few pioneering lenders started implementing a new approach that showed the potential of the 30-day cash loan market. Based on this demonstration effect, the market expanded rapidly.

By many accounts, the 1992 Exemption Notice created a “disaster” by dividing the market and thereby fencing lower income people off from the banking sector and formal credit options. Interest controls were

⁹ See Patrick Meagher, “Microfinance Regulation and Supervision in South Africa” Essay No. 6 — Microfinance Regulation for Financial Inclusion; Microfinance Regulation and Supervision Resource Center (College Park: U Maryland, 2005) and Ted Baumann, “The Pro-Poor Microfinance Sector in South Africa” An unpublished monograph for FinMark Trust (January 2007).

removed without other constraints (such as debt recovery and capital access) being addressed. As a result, full conditions for the development of an efficient market (including regulatory oversight and consumer credit protections) did not exist at a time when the market was growing very quickly. A further problem, exacerbated by the exemption, was the general legislative fragmentation created by the different rules applicable to each form of credit. The exemption also did not address the restrictive framework that impeded entry of competitors into the banking sector. Last, this arrangement seemed to create a small universe of profitable and exploitative informal lending – which, in the absence of an incentive framework for developmental lending, seemed to discourage SMME financing.

By the mid-1990s, the advent of the first ANC government raised expectations and created increasing pressure for policies that would extend the benefits of credit liberalization to all – and create rules of conduct that would protect borrowers from exploitative practices. The government decided that the best approach would not be through changes in legislation and regulations (i.e. a market development approach), but rather through wholesale-level intervention in the markets. An early government response was the establishment of parastatal development finance wholesalers (Khula Trust and National Housing Finance Corporation or NHFC) to serve NGO-based microfinance institutions. This reflected the view that micro-lenders were inherently exploiting the poor and therefore could not be used as a tool to deliver finance to SMMEs.

The 1999 Exemption Notice made it a condition of micro-lender operations (i.e. extending credits up to a new maximum of R10, 000 [USD1,562] at rates above the statutory interest rate cap) that each institution register with a new regulatory agency that would be legally constituted. Thus, the MFRC came into being as a non-profit company carrying out delegated regulatory functions within the market niche carved out by the new exemption notice. MFRC is a functional regulator – it focuses on a set of activities that it licenses and supervises, regardless of the organizational form of or financial license held by the lender. The key elements of MFRC's mandate boil down to these: (i) formalize the micro-lending sector, (ii) provide consumer protection, and (iii) improve information and understanding on the sector. Further, MFRC strategically expanded its mandate to address glaring deficiencies in financial sector development, which may have strictly fallen outside of its mandate, but clearly impeded or undermined its core responsibilities.

What have been the outcomes of the system just described? MFRC has played an important role in the emergence of a RAN 17 billion market (from less than RAN 1 billion [USUSD156.3 million] in 1992, and around R10 billion [USD 1.6 billion] in 1999, at the time of MFRC's inception). There is evidence that nearly 30% of this consumer credit has been used for developmental purposes (i.e. enterprise, housing, and education). Other evidence suggests that the MFRC has helped create access for an estimated three million people who did not have access to formal finance before. These other broad impacts are apparent:

- Major changes in micro-lender behavior towards more responsible lending practices and concern for lenders' reputations.
- The influx of banks into the sector, which appears to be driven in part by the reduction in reputational risk.
- A quantum leap in information and understanding with respect to the sector.

One clear outcome of these experiences has been the testing of an innovative model for microfinance regulation. The MFRC is an example of hybrid or delegated regulation. Here, political influences are counterbalanced by the pressures inherent in all forms of self-regulation. At the extreme of self-regulation, i.e. voluntary industry codes of conduct, the government is kept at arm's length and the industry determines the mode of policing, which may be more or less robust depending on the outside pressure that the industry faces. The opposite end of the self-regulation spectrum is closer to classic governmental regulation, but with some public-private division of labor. Here, there are a few variants. The form typically associated with the professions is for legislated standards to be enforced by industry associations, and for certification procedures to reinforce professional standards and public confidence. Another variant, involving greater involvement by government, is used in some stock exchanges. The exchanges police member behavior according to well-established industry rules, under continuous oversight by government regulatory, investigative, and judicial authorities. MFRC combines aspects of these models. Several microfinance industry representatives in South Africa have complained about the MFRC's intrusiveness, and the fact that it does not behave the way a member-based industry promotion organization should. On the other hand, consumer advocates have complained that it has been too lenient with the industry on rates, disclosure, and over-indebtedness. It is precisely because the MFRC was set up as a hybrid, not an arm of government, that it has been able to encourage voluntary compliance by the industry, as a self-regulatory body, at the same time as it wielded investigatory powers and official sanctions. Its position outside the government hierarchy (along with astute

appointments), has enabled MFRC to resist political pressures to become a draconian enforcer.

Looking forward from that point, as the situation develops in South Africa, a number of critical issues remain to be addressed:

- The need for a more unified, less fragmented, structure for credit regulation.
- Incentives to expand development finance top-down for banks and bottom-up for MFIs.
- The efficiency of commercial credit transactions and information infrastructures, such as title and collateral registries.
- The need for savings, insurance, other vehicles.
- The heavy burden of "red tape" on SMMEs.
- The need to expand credit access, and especially to develop the embryonic township and moderate-income housing markets.

Responses to several of these issues have been formulated and are being discussed. The key initiatives are described below. However, there has not yet been an adequate response to the question of developmental, or SMME, finance. The market for small and micro-enterprise finance has developed only modestly since the early 1990s. It is hard to make a profit in it, hence the massive entry into consumer credit, which now relies almost exclusively on either bank account deduction (debit order-based) or, to a lesser extent, payroll-based repayment mechanisms, neither of which are available to enterprise lenders. The development of financial products (particularly credit) has, to date, appeared to have largely been dictated by the collection mechanisms available to lenders, as only a handful of NGO MFIs make loans to non-salaried people, even though some financial institutions, including at least one bank, have begun to develop and pilot products that would better serve this market.

A complex array of problems, unrelated to the governance of the financial sector per se, weighs down the development finance market. First among these are labor regulations and land titling. The former appears to have a severe dampening effect on the growth of small firms, and consequently the demand for SME credit. A regulatory impact study estimated the overall costs of inappropriate regulation in South Africa at RAN 89 billion (USD 13.9 billion). Land titling issues make it extremely difficult for lenders to efficiently leverage collateral in the form of real property. Apparently, title registries in low-income areas such as townships cannot keep up-to-date records of transfers, because so many of these

happen informally. Related to this is a lack of supportive economic infrastructure in the townships, which the government is now trying to address. This has led many to the conclusion that there is as of yet no real moderate-income housing market in South Africa.

The culmination of the changes since the end of the MFRC led to the National Credit Act of 2005-2006 which addressed the majority of the previous concerns already addressed by the MFRC's work. There was much talk of the burden that South Africa's banking laws place on the microfinance sector. This discussion is framed in terms of the difficulty that microlenders have in raising loan capital, since they are not allowed to accept retail or wholesale deposits. It is important that current efforts to develop a more adequate regulatory definition and treatment of institutions providing microfinancial services to the poor expand beyond the present dichotomy of microenterprise, microcredit and co-operative banking. Integrated microfinancial services for the poor involve both microcredit and microfinancial services, but it is clear that neither the microcredit nor the savings and credit subsectors in South Africa on their own have sufficient experience and methods to develop approaches that would apply uniformly across the country. A more holistic, inclusionary approach is needed, one that can formulate appropriate microfinance services out of the full range of options available in South Africa and abroad.

Finally, another general issue arising is that the public policy environment for the pro-poor microfinancial services sector is fragmented and dysfunctional:

- The Department of Trade and Industry (DTI) is concerned almost exclusively with microenterprise credit and has little appreciation of microfinancial services appropriate to the livelihood strategies of the poorest of the poor. Although the DTI has supported efforts to establish a new apex microcredit institution catering to HBMEs (household-based microenterprises), it does not appear to be developing a more comprehensive approach to 'lifeline' microfinancial services, including savings and non-enterprise microcredit.
- The SA Reserve Bank sees its role as defining the limits of its responsibilities under existing regulation and excludes non-bank microfinancial service institutions from its regulatory ambit, rather than exploring ways in which it can contribute to the development of the pro-poor microfinancial services sector.
- The Department of Social Development (DSD) is not competent in microfinancial services for the poor and has

achieved little through its hosting of the Social Finance Programme since 1999. This is due to lack of focus and staff consistency at DSD, and to the unsuitability of the technical support provided to the department by the Social Finance Unit of the ILO.

There is a need to investigate and appreciate the types and experience of existing pro-poor MFIs in South Africa more carefully than at present. Regardless, South Africa still appears to be an example for advanced enabling policy and regulatory environments.

From this additional analysis comparative patterns can be drawn from the country cases.

Financial Regulation of Housing Microfinance

Financial policy regulations, in general, are meant to protect the overall economic well-being of a country on the one hand by ensuring safe and fair practices among financial institutions (loosely, “prudential” regulation), and protecting individual consumers from those same practices on the other (or, “non-prudential” regulation). Too often, though, governments place restrictions that are either excessive, or do not achieve either of the desired protections. When it comes to lending to the poor, all of these issues are exaggerated because of perceptions of risky practices in this market.

Further, when it comes to housing finance for the poor, there is additional complexity because housing finance is such a guarded, monitored, and overall unique financial animal. For example, some nations have very strict requirements as to what kinds of institutions can offer mortgage finance in particular (or, any housing-related finance, for that matter, such as in Brazil and Ecuador and formerly in Peru and Mexico)—making it difficult for either mortgage lenders or microfinance institutions to offer housing microfinance products.

In those environments with strict, ineffective, or irrational regulations, many governments have attempted to either change existing rules to allow for alternative financial products (including housing microfinance) or create special windows for microfinance that enable these alternatives without jeopardizing either consumers or overall financial stability. These have included explicitly allowing non-bank microfinance institutions and/or non-bank financial retail intermediaries without requiring new prudential regulation and supervision. Unfortunately, these have often been abused (such as when consumer lenders for salaried employees acquire

microfinance banking licenses rather than traditional banking licenses because of the decreased requirements involved)—leading to more regulation in the end.

The following analysis briefly reviews prudential and non-prudential regulations as well as enforcement issues that are critical to housing finance for the poor—and to housing microfinance in particular. A brief review of regulations' effects on microfinance is provided. However, the focus here is on whether the regulations disproportionately impact housing microfinance.

Prudential Regulation of Microfinance

Prudential regulation is generally much more complex, difficult, and expensive than most types of non-prudential regulation. Prudential regulations (for instance, capital adequacy norms or reserve and liquidity requirements) almost always require a specialized financial authority for their implementation, whereas non-prudential regulation (for instance, disclosure of effective interest rates or of the individuals controlling a company) may often be largely self-executed and can often be dealt with without involving the financial authorities. Much of the microfinance regulation being proposed today is enabling—that is, it designed to allow MFIs to take deposits and thereby require them to be financially solvent. These require prudential regulations.

Housing microfinance often requires slightly higher loan values than other microfinance products which, in turn, create an asset-liability mismatch. In those instances, lenders may need to raise minimum capital and capital adequacy requirements. When collateral requirements are slightly more rigid (rare for housing microfinance but sometimes in effect when the loans are of a higher value), deposits are required that would seem to make some additional prudential regulation necessary. However, there is sufficient evidence that housing microfinance has a higher repayment rate when compared to other kinds of microfinance products. Similarly, despite the unsecured nature of the housing microfinance loan, there appears to be a stronger social desire to repay because of the permanence and security of the home itself. In general, though, it would seem that there is nothing particular about housing microfinance products that would require additional or less prudential regulation in these areas (minimum capital or capital adequacy requirements, unsecured lending limits, and loan-loss provisions). Other areas that appear to affect housing microfinance in the same manner as other microfinance products and services include restrictions on co-signers as borrowers, the physical security and operation of branches, or reserves and ownership requirements.

Two areas of prudential regulation that are likely distinctions are those of loan documentation and reporting. For the former, generally speaking, it would be excessive or impossible to require MFIs to generate the same loan documentation as commercial banks. This is particularly true when title or other deed is required for any kind of housing finance product in a country when title is not a readily available document or where special titling programs have not been instituted. The fact that title could be a prudential requirement for a housing loan would prevent many of the poor from accessing housing microfinance and, for this reason, title security is viewed as sufficient—and a collateral or documentation requirement that is unique to housing. This is further discussed below.

For loan reporting regulations, reporting requirements ideally should be simpler for microfinance institutions or programs than for normal commercial bank operations. For housing microfinance providers, however, this requirement may be slightly higher given the size of the loan (assuming the loan is higher than microenterprise loans) and the creation and/or improvement of the physical asset that is being financed. Though this reporting would likely be an unnecessary hindrance, there is some evidence that this has occurred in some countries due to other non-financial policy requirements (namely, housing subsidy provisions or local housing requirements).

Non-Prudential Regulation of Microfinance

As opposed to prudential regulation (where there are depositors to protect), non-prudential regulation enables certain institutions to conduct a lending business legally. This essentially can be used, then, to promote microfinance or any other kind of financial instrument for that matter, without putting any depositors or the overall institution or economic well-being of the country at risk. These are likely to be more distinct when looking at housing microfinance.

A few other areas of non-prudential regulation do not impact housing microfinance disproportionately (like fraud prevention, consumer credit references, ownership requirements, taxation, and legal structure)—unless there are specific prohibitions for housing finance institutions within these regulations. In this case, special windows should be created for housing microfinance in particular and for microfinance in general.

One relevant area of non-prudential regulation, however, is whether the basic permission to lend for a housing-related purpose (even when the loan is small) is allowed. Legal systems around the world treat this issue in three ways. In some legal systems, any activity that is not prohibited is

implicitly permissible. In these countries, an NGO or other unlicensed entity is implicitly authorized to lend as long as there is no specific legal prohibition to the contrary. In other legal systems, especially in formerly-socialist, transitional countries, an institution's power to lend—at least as a primary business—is ambiguous unless there is an explicit legal authorization for it to conduct such a business (this ambiguity is particularly common in the case of NGOs). In yet other legal systems, only prudentially licensed and regulated institutions are permitted to lend, even if no deposit taking is involved. This is true of many countries with regard to housing. In such cases (for example, Mexico was before changes over the last decade in financial regulations), modification of the general legislation governing microfinance may be needed.

Consumer protection is another area in which housing microfinance distinguishes itself, mainly because collections from poorly-paying clients cannot necessarily result in the acquisition of the asset. Not only are foreclosures of homes unlikely in these contexts (and usually unenforceable even if foreclosure laws are on the books), it is unlikely that a lender can repossess a new roof or other home improvement from a client very easily.

The security of transactions, a non-prudential activity related to the prudential regulation of loan documentation, is also more relevant to housing microfinance. Here, title security and other forms of documentation could be viewed as critical to offering a loan despite the fact that there are constraints that make it hard for lower-income people to use their homes and land as collateral. Legal and judicial reform centered on the commercial and judicial laws can support secured transactions more than changes to the banking law (as previously described).

Lastly, two key areas of non-prudential regulation are of critical importance: interest rate caps and loan value caps. Interest rate caps are relevant especially where housing microfinance requires significant additional costs to the institutions engaged in lending beyond what is usually undertaken for microfinance (for example, for construction technical assistance). Quite simply, MFIs cannot continue to provide tiny loans unless their loan charges are considerably higher in percentage terms than normal bank rates. Interest rate caps, where they are enforced, almost always hurt the poor—by limiting services—far more than they help the poor by lowering rates. Recently, there have been backlashes in many countries (such as the case in India above). This could disproportionately affect housing microfinance.

When it comes to caps, housing microfinance is adversely shaped. Housing microfinance loans tend to be larger than traditional microfinance products and have longer terms. Any restriction posed on the product itself or any microfinance product (for example, the overall microfinance loan cap restrictions in Pakistan) will limit the feasible housing microfinance offerings.

Supervision and Enforcement of Microfinance

Microfinance as an industry can never reach its full potential until it is able to move into the sphere of prudentially regulated institutions, where it will have to be prudentially supervised. While prudential regulation and supervision is inevitable for microfinance, there are choices to be made and balances to be drawn in deciding when, and how, this development takes place. Those conclusions are likely to be drawn in the right place only if supervisory capability, costs, and consequences are examined earlier and more carefully than is sometimes the case in present regulatory discussions.

In fact, in some cases the special windows for MFIs created by regulatory institutions have resulted in a proliferation of underperforming institutions, and a supervisory responsibility that cannot be met. Yet, self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in ensuring the soundness of the regulated organizations. As such, some special consideration must be made for supervising housing microfinance products. This begs the question of whether existing regulatory institutions themselves have special requirements when it comes to housing finance in particular.

Housing Finance Regulation

Again, most housing finance regulation globally focuses on access to and offering of mortgage finance. This is less relevant to the poor than housing microfinance. However, in some instances we have seen that any housing finance could be subject to many if not all of the mortgage finance requirements which makes housing microfinance virtually impossible to carry out.¹⁰ This was true previously in Mexico.

In general, as mortgage markets develop, more institutions are created for which regulations are made, such as mortgage design rules, capital rules, disclosures, and registration requirements—all for housing financiers only. Combined with other housing policies, these have often led to massive regulatory “special windows.” When mortgage markets have

¹⁰ See William Britt Gwinner, "Housing Finance Regulation" A presentation delivered at the World Bank Group conference on Housing Finance in Emerging Markets (Washington DC, March 15-17, 2006).

taken off, regulatory responses are often reactionary, including restrictions on loan-to-value ratios, product designs, origination, and documentation monitoring, among others. These more restrictive actions have often been balanced with business-friendly policies, such as mortgage insurance requirements, securitization opportunities, and advanced foreclosure laws.

In most countries, again, policies have been restricted to the mortgage market. Where these are conflated with other housing-finance products (particularly when these products feasibly compete with mortgages or public subsidies), there is some question as to how regulatory institutions will respond. To date, the primary effect of housing finance windows on housing microfinance can be felt in terms of:

- Permission to lend (where certain institutions are prohibited).
- Loan terms (particularly interest rates and loan value caps).
- Collateral (especially with regard to title requirements).
- Construction quality (where some inspection or assessment is necessary, though this is often arbitrarily enforced among poor communities).

In all cases, there are numerous potential pitfalls in these areas that require "special windows" for housing microfinance.

Examples

Despite this, there are numerous examples of how thoughtful and appropriate legislation can actually help with creating options in housing finance for the poor. Some of these deal exclusively with advancing credit of all kinds to the poor, while others are non-financial policies such as land use reform that affect housing finance. Examples of "special window" regulations exclusively for housing microfinance include:

- **USA's Community Reinvestment Act**
The Community Reinvestment Act, passed into law by the U.S. Congress in 1977, requires all banks and other financial institutions to provide credit and services throughout the areas they serve while prohibiting them from disregarding poorer neighborhoods, or "red-lining." The act requires regular evaluation of all institutions in meeting credit equity goals and reviewing applications and registrations.
- **Peru's Land Legalization Policies**
Peruvian Economist Hernando de Soto postulates that in developing countries such as Peru, vast amounts of this informal property means billions of dollars of potential capital resources are financially and

commercially invisible, and thus cannot be transformed into money to improve the productivity of society. Reforms influenced by his organization, *Instituto Libertad y Democracia* (ILD), changed the property system in Peru significantly in the 1990s, creating thousands of newly titled properties.

In Peru, like many other countries in Latin America, only 20% of land originally had a clear title. Years of agrarian land reform have resulted in further land titling but this still only covers an additional 15% of program beneficiaries receiving titles, although those beneficiaries received 53% of parceled land. In response to these inefficiencies and in order to make millions dollars of wealth visible, Hernando de Soto and the ILD drafted reforms of 175 laws and 2,000 regulations affecting the property formalization process in the mid-1980s. These property reforms, called PROFORM, established possession rights and new registration procedures, legalized mortgages based on possession rights and authorized insurance companies to grant credit insurance. With strong influence from the ILD, a series of the laws in the 1990s changed the way Peru looked at property rights, affecting informal properties in both urban and rural areas. In 1990, Peru created a new property registration system, *Registro Predial*, to register informal settlements in urban areas which, in 1996, became the *Comisión de Formalización de la Propiedad Informal* (COFOPRI).

- Colombia's Housing Microfinance Regulatory "Special Window" Based on the poor performance of a housing subsidy in the early 2000s, the Colombian government has been working on reforming financial regulations to improve indirect assistance to the low-income population's housing needs. In addition to some funding of MFIs, Colombia has begun introducing laws at the behest of the Superintendent of Banks, the Superintendent of Subsidies, the Ministry of Finance, and the judiciary for setting prudential norms for housing microfinance, including reconciling regulations and supervisory practices between the banking and housing officials, adopting best practices, and drafting new regulations that support an active housing microfinance market with training for MFIs.

A series of decrees in 2003 established procedures for finance companies to obtain financing from commercial banks so as to increase housing microfinance and to increase access of the unbanked to housing microfinance. For Colombia, these policy reforms are significant given that heretofore loans that traditionally fell under the rubric of "housing" were subject to interest rate ceilings that

made the housing microfinance products financially unattractive, thus forcing MFIs to use microenterprise loans for housing ends.¹¹

Guidelines for Assessing the Housing Finance Policy Environment

As has been seen here, there are a variety of factors that a financial institution or housing-related organization needs to consider in the earliest steps of planning a housing financial product for the poor—particularly housing microfinance. These issues could ultimately limit or even prohibit some the core design and implementation activities. So, they should be carefully considered before any other steps are taken. Most microfinance institutions will be cognizant of these issues, but even a slightly more thorough investigation can yield some surprises that might shape an institution's product design.

Ideally, there should be a variety of housing finance options for the poor that take into account their repayment capacity, their housing needs, and the legal structures for their homes. This means that financial institutions should also be able to offer profitable products that target as wide a population as possible, easily and flexibly, while ensuring the financial safety of clients and investors. This also means that housing subsidy and property policies should support both improvements in the living conditions of its poorer citizens, and private sector interventions to accomplish these improvements. From these three areas (financial regulations, housing subsidies, and property laws), the items in the following checklist constitute guidelines for reviewing the environment for developing private housing finance products for the poor.

Financial Regulations

Financial institutions should be able to offer a wide variety of products at interest rates and terms that are appropriate to each client, both flexibly and easily. The financial environment should be such that it removes the barriers to this occurring, and possibly even promotes it. Some items to consider are listed here:

1. General Banking Regulations

General and necessary regulations for ensuring overall, prudential soundness of the banking sector need to be in place but should not inhibit competition and growth, such as:

- Simplified licensing of non-bank lending institutions.

¹¹ Nino Mesarina and Christy Stickney, "Getting to Scale in Housing Microfinance" A monograph published by ACCION (Number 21 May 2007).

- Adequate consumer protections against abuse, including truth-in-lending requirements.
- The existence of credit agencies or bureaus.
- Equitable and appropriate taxation policies for different financial institutions.
- Adequate prudential regulations applied to appropriate financial institutions like banks but not necessarily microfinance lenders.

2. Microfinance Regulations

Check to see if current laws either directly permit microfinance lending in some form or do not explicitly prohibit it. Either may be the case through regulating the institutions (through new financial institution licenses or existing ones) or oversight of the institution's activities, or a combination thereof. If the opposite is true, there is almost no point in pursuing a private housing finance solution. Also, check to see that there are no restrictions that indirectly limit microfinance institutions or their products, including:

- Interest rate caps.
- Minimum capital holdings or reserves requirements for financial institutions.
- Blanket depositor protections on all financial institutions, even for non-deposit taking lenders like most microfinance institutions.
- Any limits on unsecured lending which is what most microfinance institutions practice.
- Restrictions on bank branch or office operations, such as working hours or locations that prohibit traditional microfinance lending practices.
- Required registration of collateral where most microfinance institutions do not or only partially register collateral.
- Extensive loan documentation and reporting requirements that are cost prohibitive for most microfinance institutions.
- Restrictions on ownership, management or investor structure that prohibit foreign or non-traditional involvement, if and when the MFI might have such involvement.

3. Housing Microfinance Regulations

Microfinance allowances in commercial and banking laws sometimes do not permit loans being used for non-enterprise purposes. Likewise, some housing policies restrict which institutions can offer financial products in the field. An institution exploring this area should check:

- That microfinance laws allow for housing-related microfinance products, or are not restricted to enterprise loans alone.
- How financial, banking, or housing laws specify which institutions provide housing-related financial products (including mortgages, if applicable).

4. Housing Subsidies

Public subsidies often compete directly with private financial services among the segments of the population that might feasibly be covered by the private sector. Even more often, they do so in a way that does not promote good financial behavior and subsequent access to the private financial sector. So, before beginning, it is important to gauge the quality, target, and structure of current subsidies since these will likely affect the choices from which your target clients will be selecting.

Public Subsidy Design

Subsidies come in different forms, and certain ones are more likely to shape a potential client's decision to take out a loan than others. A financial institution should be aware of subsidies that:

- Involve extensive direct construction of housing for the poor (or extensive construction loans to developers who build housing for the poor) since these are likely to be given to just a small population.
- Involve subsidized interest rates for housing loans since these often result in default and make it worse for private financial institutions later.
- Are targeted towards their primary segment (lower-income salaried and self-employed), especially those that subsidize full house purchases or construction in ways that prevent later progressive or incremental housing that would be funded by private housing microfinance.

Public Subsidy Effectiveness and Efficiency

Of course, even if the subsidy appears more attractive in the short-term to a potential borrower, there might not be (and likely are not) sufficient public funds to cover everyone in the target population. It is also possible that the funds are not being efficiently deployed to cover everyone. Ironically, the less effective and efficient a subsidy is, the more likely that private housing finance is needed. So, institutions looking to offer housing financial products (especially housing microfinance) should be especially aware of these. In all cases, the financial institution should check to see:

- What the target population for a subsidy is and whether that crowds out potential private finance products.
- How much of the target population has received the subsidy, if any have actually received it, what they did with it (including whether they stopped rent payment or payment on government loans).
- Whether there is long history of ineffective or inefficient subsidies that have either ignored or left untouched the real housing demands of the poor or have created false expectations of free housing or bad financial behavior among the poor.

5. Property Laws

A final area to consider when developing housing finance products for the poor are the corollary property policies, laws, and local norms that might shape whether a financial institution can offer a loan to a poor borrower, and what the borrower can do with it. In particular:

- **Ownership Laws**

Foreclosure, eviction, lien laws and all other regulations over financial obligations must be strong in order for a private financial institution to be able to make loans. If there is no threat of losing possession for non-payment, it will be difficult to justify any product, let alone maintain it.

- **Title and Registration Laws**

There are often financial regulations and housing subsidies that require clear title and registration of land and property. This might limit the spectrum of uses for loans that a financial institution could provide. A financial institution might decide whether its products are contingent on this kind of security, or whether its products can lead to future granting of it.

- **Construction and Land Use Regulations**

There are occasionally restrictions on construction and home improvements that may affect what a household can do. These are usually not enforced or are arbitrarily enforced in poor areas, but can become a problem if they are. Building codes and zoning laws have not been a barrier to most current housing microfinance programs, though.

Conclusion

In all cases, it is useful to review these various policies and regulations to assess their potential to enable, limit, or even prohibit housing finance for the poor. Ultimately, a flexible policy environment that takes into account the reality of housing conditions will produce better results than strict enforcement of high minimum standards. Rigid housing and

financing laws that establish high minimum standards that are unachievable for the poor will reduce rather than increase the quality and volume of available housing. Instituting regulations that reflect how the poor build can encourage lenders to develop innovative products, improve the quality of the guarantees taken by these institutions and allow the poor to improve their living conditions.

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