CGAP

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Helping to Improve Donor Effectiveness in Microfinance

THE ROLE OF GOVERNMENTS IN MICROFINANCE

Historically, governments have used credit schemes as a way to transfer resources to specific target populations. The negative impact of most of these schemes has led many donors and experts to advocate for national governments to disengage from microfinance. This approach has not always produced the desired effect: some government programs still undermine microfinance markets. However, there is increasing clarity that governments do have a constructive role in building financial systems that work for the poor. Experienced donors can support governments to focus on developing sound policy frameworks and encouraging vibrant and competitive microfinance, rather than directly providing financial services.

How can governments support an inclusive financial sector?

Governments (at both national and local levels) can create a legal and regulatory environment that encourages market entry and competition in microfinance. To do this, finance ministries, central banks, and other government bodies should recognize microfinance as a legitimate financial activity within the financial system, rather than a marginal sector or a resource transfer mechanism.

- The most important contribution governments can make to microfinance is to *maintain macroeconomic stability* through appropriate monetary and fiscal policies. In the 1990s, volatile inflation in Lao PDR often reached three digits. The resulting need for frequent price changes disrupted microfinance institutions (MFIs) and confused their clients.
- Governments can *involve the private sector in formulating poverty reduction strategies*, and explicitly recognize its leading role in financial sector development, including microfinance. The active participation of the private sector should help to embed microfinance firmly within financial systems, with private and non-governmental actors taking the lead (as opposed to government bodies, such as ministries of agriculture and health, and local authorities).
- If and when needed, governments should *adjust regulatory frameworks* to permit all types of financial institutions to offer services to poor people. Premature or restrictive regulations can stifle innovation. For example, the “Loi PARMEC” in francophone West Africa favors the cooperative model, to the detriment of others. This limits poor people’s choices and access to services. The introduction of prudential regulation is generally only warranted when a critical mass exists of institutions that are strong enough to obtain licenses to mobilize deposits from the public.
- Governments should *invest in supervisory capacity.* In many developing countries, bank supervision capacity is limited. There is no point in licensing institutions that cannot be effectively supervised.

What kinds of government interventions harm the development of microfinance?

- *Interest rate ceilings.* Interest rate ceilings undermine the ability of MFIs to cover their costs. They generally hurt the poor by making it hard for new MFIs to emerge and for existing ones to stay in business. Faced with interest rate ceilings, MFIs often withdraw from markets, grow more slowly, become less transparent about total loan costs, and/or reduce their work in rural and other costly markets.
- *Provision of credit at the retail level*. Governments (including local authorities, development funds, line ministries, and other public institutions) should not be directly involved in credit delivery or the management of microfinance initiatives. Government ministries and project management units usually lack the technical skills and political independence needed to manage microcredit programs.

- *Subsidized lending programs*. Subsidized lending is usually associated with high default levels. It absorbs scarce public resources that need constant replenishment. It distorts markets, hampering the development of sustainable lenders, and can encourage rent-seeking behavior. In the 1980s, the Indian government introduced several subsidized targeted lending programs including the Integrated Rural Development Program (IRDP). Studies show that IRDP has a loan recovery rate of 10–55 percent and has tended to benefit better off segments of the rural population, rather than poorer groups.
- *Political interference.* Government interference in governance or management of private institutions can threaten their sustainable development. Such interference can force managers to lend to unfit clients or lower interest rates, ultimately decreasing the number of poor who access services.

How can donors support governments to play a constructive role?

Donors can help governments at both national and local levels facilitate the emergence of a strong pro-poor financial system and avoid actions that restrict private sector-led initiatives.

- *Collaborate according to respective strengths.* Effective policy work requires donor agencies that have a mix of experience and skills. Deep technical skills in finance, hands-on experience supporting retail-level institutions, and the ability to truly influence governments are all key. Only donors who have these characteristics should work at the policy level. (Few donors do). Donors should leverage each others' strengths when designing programs in this area.
- *Provide technical inputs to poverty reduction strategy papers (PRSPs)* that advance pro-poor financial sector development**,** for example, supporting better policies and encouraging governments to withdraw from direct financial services delivery.

> After the failures of the Entendikwa small loan program in 1997 and the highly subsidized Uganda Cooperative Bank in 1998, the government of Uganda (GOU) decided that its proper role was oversight, not the direct provision of credit. The GOU learned that government credit programs are often politicized, that clients may not feel obligated to repay subsidized credits, and also that it lacked the human resources to run loan programs. The GOU has since focused on building a regulatory framework for microfinance. In 1999, the Bank of Uganda issued a Policy Statement on Microfinance Regulation that explicitly recognized "microfinance as a line of business" and identified the "sustainability of the microfinance sector" as one of its major concerns. The Bank of Uganda understood that microfinance is best managed as a private sector activity, with interest rates set at market levels.

- *Foster strong networks* and empower other local stakeholders capable of engaging with governments in policy dialogue. In Mali, GTZ, USAID, and the World Bank promoted the emergence of an association of MFIs, APIM, that serves as a conduit for MFIs to contribute to the formulation of national policies.
- *Support interest rate liberalization.* Donors can provide information on the rationale for microcredit interest rates that cover costs and document the adverse effects of interest rate ceilings on poor people.
- *Where circumstances call for it, provide technical support to help governments adjust the regulatory and supervisory framework*. For instance, donors can build capacity of key government staff in ministries of finance and central banks. Donors can also showcase examples of successful regulatory and supervisory frameworks, both related to the content and process of reform.
- *Invest in public retail lenders and apexes only* when they are independent from government and demonstrate a clear capacity and commitment to perform sustainably. Donors should exercise caution about funding apex institutions. They should analyze whether a critical mass of viable MFIs exists, and avoid creating disbursement pressure that compromises quality standards.

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