Research Note N°4 on Microfinance Regulation

Learning from the analysis of *Loi N°2012-14* in Benin[1]

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How does regulation affect microfinance institutions (MFIs)? Research has addressed this question, but ambiguous results have been highlighted. Some studies argue that regulation favors both financial and social outcomes. Others argue that commercial stakes are adversely favored through regulatory pressures. Still others found that there is no clear link with performance. With different tools, this note summarizes an analysis of the outcomes of the *Loi N°2012-14* implemented in Benin and draws general conclusions on how to support microfinance via regulation.

Most countries developed some form of microfinance regulation, with usually two aims: fostering markets, to ensure that the access to financial services is as wide as possible, and protecting savers and stability. Still, studies remain ambiguous: while some argue that regulation supports both financial and social aspects, others identify that it favors the commercial mindset of MFIs, and still others find no direct effect on performance (Hartarska and Nadolnyak, 2007; Singhe and Louche, 2020).

Unfortunately, research has consisted mostly of broad cross-country studies, relying mainly on general conceptualization of regulation and broad comparisons between "regulated" and "unregulated" MFIs. Yet, regulatory frameworks are usually more complex than such a dichotomy. Moreover, regulatory outcomes are likely to depend on contextual conditions. Contributing to bridge this gap, this note analyzes the outcomes of the regulatory strengthening that occurred in Benin in 2012-2014, and which aimed to foster efficiency, protect clients, and diversify markets. Since many markets are not as regulated as Benin, this case is particularly relevant for policy markers – such as those considering strengthening their frameworks – to discuss potential externalities of their choices.

The Beninese (regulatory) context

For decades, the dominant paradigm has been to promote regulation as supporting markets and coping with market failures (Stigler, 1971). Microfinance has been no exception. In the West Africa Economic and Monetary Union (WAEMU), regulation has long been a preoccupation. In 1993, the PARMEC[2] Law was enacted, and ratified in Benin in 1997 (*Loi N°97-027*). This aimed to ensure stability, to protect depositors, and established full approvals for cooperative institutions, temporary agreements for non-cooperative MFIs, and simple recognitions for *caisses de base* (Acclassato, 2009).

After a decade of application, however, microfinance still faced important limitations: weak management information systems and governance, poor efficiency, and weak credit portfolio management (BCEAO, 2009; Kablan, 2014). The PARMEC Law also demonstrated limitations (Périlleux, 2013). Authorizations for non-cooperative MFIs were valid for five year only and generated long-term business planning difficulties, complexity and heterogeneity. Besides, the

[1] The views expressed in this note are those of the authors and not necessarily those of ADA. For more details on this research, please contact directly the corresponding author at tristan.caballero-montes@umons.ac.be.
[2] Projet d'Appui à la Réglementation des Mutuelles d'Épargne et de Crédit

requirements imposed on the quality and relevance of the data transmitted to supervisors were considered as too lax, resulting in non-compliance by quite a few MFIs (Kablan, 2014). Finally, prudential rules had to be reinforced (Setondji, 2018). In 2007, the Banque Centrale des États de l'Afrique de l'Ouest (BCEAO) thus announced the *Loi uniforme portant sur la réglementation des systèmes financiers décentralisés*, implemented in Benin five years later, via the *Loi N°2012-14*.

A specific regulatory strengthening[3]

Appendix 1 details the main changes and objectives of the law. Looking at these, it seems that the strengthening aimed to encourage formalization, performance, stricter supervision, and market diversification. The framework was implemented in a rather dynamic regional context. To begin with, the WAEMU economic growth remained steady: 4% in 2010 and 6.7% in 2017. Since 2012, inflation rate remained relatively low, going from 2.4% in 2012 to 0.8% in 2017. On the financial side, total credits and deposits steadily increased over the period, and located around 23,000 and 28,000 billion CFA, respectively, in 2019. Credits offered and deposits collected by microfinance operators have both represented around 7% of the total money lent or saved. Profitability has also shown positive trends, with increasing Net Banking Earnings (+11% in 2010; +12% in 2014; +11% in 2017). Still, it is important to note that portfolio quality corroborate figures observed for the Beninese microfinance, with a high *taux de dégradation du portefeuille,* around 13-15% in 2010-2017.

Overall, Benin followed the dynamics of the WAEMU. Still, Benin has been somewhat behind or above regional averages. For instance, in terms of economic growth, Benin remained close but below regional averages, going from 2.5% in 2010 to 5.6% in 2017. Inflation has also been higher in Benin and has located between 6% in 2012 and 3% in 2017. Some differences are noted between the Beninese evolution and regional evolutions, such as the steadiness of the contribution of domestic private sector credit to GDP, which remained around 16% between 2010 and 2017, while it increased in other WAEMU countries.

Finally, some regulatory adaptations which are not directly related to the 2012-14 framework also materialized. For instance, in September 2014, the Council of Ministers decided to guarantee minimal remuneration for savings products to attract savers and stimulate the mobilization of savings in the Union. Furthermore, the *Loi des Finances pour la Gestion 2015* promulgated in Benin implemented tax reliefs for financial operations between financial institutions, as well as the operations carried out by MFIs to offer credit and mobilize savings.

Analyzing regulatory outcomes in Benin: Mixed results

Our analysis is based on 2010-2017 data from the national supervision agency. It mobilizes graphical analyses, hypothesis testing, and a method inspired from event studies (D'Espallier et al., 2017). Doing so, it explores indicators of financial and social performance, and broad market dynamics.

- *Mitigated outcomes regarding self-sufficiency and portfolio quality*. Overall, MFIs could be considered as worse-off, since operational self-sufficiency deteriorated, and portfolio quality did not improve after the strengthening. The observed evolutions of operating costs and staff productivity tend to corroborate these arguments. Our findings support the conclusion that regulation did not help improve financial performance. These corroborate recent findings (Siwale and Okoye, 2017) arguing that regulation can fail to boost the emergence of viable MFIs. Regarding the invariable portfolio

[3] This section is based on BCEAO's annual reports and reports on the microfinance situation, as well as its Banking Commission's reports, which we consulted for the period of interest.

quality, we acknowledge that the regional banking environment in the WAEMU shows similar trends and levels. This may suggest the need for a more general approach to tackle this issue. Recent policies went in this sense, just like the promotion of Credit Information Bureaus (*Loi Uniforme Portant Réglementation des Bureaux d'Information de Crédit*).

- *Investors' and clients' confidence*. We observed reduced costs of funds after the *Loi N°2012-14*, indicating that regulation may be a signal favoring MFIs' credibility. Stricter regulations may provide incumbent funders with confidence and encourage new investors to step into the market, leading to reduced costs of funds. It may also strengthen clients' confidence, favoring savings and access to cheaper funds. This is supported by the reduction of the portfolio-to-savings ratio after the imposition of the new regulation.

- *Mitigated outcomes regarding social aspects*. Our analyses suggest that regulation induced no real social improvement. Although breadth increased, results suggest that this trend would have been similar had regulation not changed. This is in line with the steady trend of the number of clients at the regional level. Moreover, the typical indicators of depth suggest, at best, no improvement (average loan, percentage of portfolio dedicated to agricultural loans) and, at worst, deterioration (percentage of women clients). We also observed that the regulatory strengthening may have positively influenced the percentage of SMEs in MFIs' clientele. There is no consensus on the financing of which target group – micro-borrowers or SMEs – has the largest impact. Still, SMEs require larger loans than individual borrowers, potentially making them more profitable. Altogether with other results, this may be interpreted as a way for MFIs to attenuate the regulatory burden.

- *No market diversification*. Our findings suggest that the regulatory strengthening did not help diversify the Beninese market, neither regarding the distribution of MFIs, nor the market shares owned by different types of MFIs.

General conclusions and suggestions

The trends of the various indicators observed allowed to highlight general suggestions of interest to policy makers:

- *Our results stress the need to reflect on how to frame MFIs' practices while not overregulating the industry*. Especially, we argue for regulatory packages that have a general coherence, and which may not contain measures that could affect the financial sustainability of the industry.

- *Social outreach is not per se a constraint for financial performance*. All in all, our results tend to support that these are two sides of the same coin. Therefore, alongside financial preoccupations, regulators may consider social aspects when designing regulation.

- *Additional roles of MFIs may be acknowledged by regulators*, and therefore considered when designing or implementing regulations.

- *Innovative frameworks may opt for "more positive" or incentive-based mechanisms to complement constraint-based regulations*. If regulation is to support financial sustainability, regulators should accompany MFIs to face efficiency and compliance challenges.

- *Regulation should consider major industry-level changes*, such as the digitalization of financial services and its consequences for financial service providers and clients.

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Appendix 1. *Loi N°2012-14*: main changes

Main items	Objectives
Extension of regulation to MFIs of all legal forms, including *associations*, and *sociétés*, by creating a unique licensing regime (Art. 15).	Diversifying the market by integrating non-cooperative and/or profit-driven MFIs with other ownership structures into the legislation and facilitating their development to meet the demand and to attract investments.
Categorization of MFIs based on the outstanding loan portfolio and extension of BCEAO's control (Art. 44).	Allowing different regulatory features and supervision based on size: small MFIs are supervised by national ministries while larger ones, especially with outstanding credits or deposits > 2 billion CFA (≈ 3,6 million USD; 1 USD ≈ 550 CFA (www.bceao.int)), are also independently supervised by the Banking Commission of the WAEMU.
Introduction of microfinance-specific accounting standards; obligation of certification of financial statements; strengthened monitoring (Art. 49 to 55).	Enhancing control of financial statements, so far weakly reported. Additional data is now required including indicators related to performance and early signs of failure.
Creation of governance bodies: administration, credit, supervisory committees (defined in the application decreet No. 2012-410, enacted in November 2012).	Addressing governance laxity, unsolved by the previous law.
Strengthening of the former interest rate cap (27%) to 24% (implemented alongside the Law 2012-14, via the "Loi-cadre portant définition et répression de l'usure au Bénin", 1st January 2014).	Making sure MFIs provide credit to the poor at affordable prices.
Allowance of commitments by signature, alongside credit and savings services (Art. 4)	Extending the range of services allowed.