# Responsible regulation for innovation in microfinance

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In faithful reflection of its original aims, this fourth number of the online publication *Progreso* preserves its focus on (i) the evolution of the legal framework of regulation and supervision, with which diverse authorities constrain the undertakings of microfinance institutions, and (ii) the evolution of the structures of corporate governance, with which these organizations define their own course of action and the incentives that motivate the participants in their efforts. Jointly, the legal framework and the structures of governance are a determining factor in the performance of these organizations and in the achievement of the objectives mandated by their mission.

In its fight against financial exclusion, with the aim of promoting the inclusive and sustainable economic and social development of disadvantaged populations, the BBVA Microfinance Foundation has adopted its own approach of a responsible supply of financial services for productive activities. The achievement of this goal requires, however, the existence of an equivalently responsible regulatory framework. In this respect, however, recent years have witnessed, in Latin America, both major advances and relevant reversions. This publication attempts to report on trends that influence the evolution of this framework, to support better-informed decisions and facilitate the debate.

A view of microfinance from a perspective of legal systems will be critical in successfully addressing the challenges emerging both from the increasing maturity, complexity, and competition in the sector and from the risks resulting from varied, fast and unpredictable changes in the environment. In turn, a correct understanding of the true nature of microfinance should guide future regulatory interventions in this sector. What today we know as microfinance has been the outcome of a series of remarkable innovations in the production and the delivery of various types of financial services to populations that had not previously had access to institutional finance.

Actually, the essence of microfinance has neither been so much the very small size of the transactions nor the fact that the clients are poor. Rather, its essence has been the development and implementation of innovations in financial technologies (for lending and for deposit mobilization) that have made it possible to prudently manage the risks associated with the target clienteles, among the poor, and to lower the costs associated with very small transactions.

In these production functions for financial services, modern information and communication tools will increasingly be key inputs, but the critical components of microlending technologies have been: (i) the collection in the field, interpretation, and use-in-decisions of personalized information (both to design services that match diverse client demands and that lead to positive impacts in their lives and to determine the ability and willingness to repay of loan applicants) and (ii) the design and enforcement of contracts (in order to secure the sustainability of client relationships and create robust incentives to repay).

A critical dimension of success has been the signal that a loan is a contract and that, as in any contractual relationship, it creates rights and responsibilities for *both* parties. This notion of microcredit as a contract emerged in sharp contrast with the earlier notion of credit as policy tool, which easily became an electoral instrument. When viewed as a public policy tool, credit was a top-down intervention (not client-centric), with the authorities either granting a favour (transferring a subsidy) or mandating a behaviour (conditioning the use of the funds). This perspective destroyed the culture of repayment, an important dimension of a country´s social capital.

If, in contrast, a microloan is viewed as a contract, then the borrower commits to its repayment as agreed and, at the same time, she acquires rights, in terms of the suitable quality of the service, the transparency in the revelation of the actual terms of the obligation, and the expectation of improved conditions in future interactions with the institution. In turn, the institution acquires the right to receive repayment as promised, in order to protect its equity, but it also incurs the obligation of delivering services appropriate to the client´s conditions and of protecting its own sustainability, in order to be available when the client may require its services in the future. This is what responsible and sustainable finance is about. The interaction of these rights and obligations, of both the client and the institution, determines the quality of the relationship.

Claudio González Vega during a meeting in Bancamia (Colombia) in 2014

The core of the new lending technologies developed by microfinance institutions has been the creation, *in situ*, of credible relationships that are mutually valuable. Indeed, these relationships constitute explicit or implicit long-term contracts, which create structures of incentives that influence the behaviour of the parties in the contract. In turn, these structures of compatible incentives encourage investment, by both parties, in the continuation and deepening of the relationships. Indeed, the present value of these future relationships, for either one of the parties, has been the element of the lending technologies that has nurtured the astounding repayment performance of microfinance borrowers and the exponential growth of these institutions.

These relationships have been more valuable when attractive productive opportunities have been available to the borrowers (which allows them to fulfil their repayment obligations without being impoverished and to benefit from a positive impact from the relationship), when the services delivered have matched the demands and financial strategies of the client households, and when the institution has been perceived as sustainable. The value of the relationships has lowered the costs and the risks faced by the microfinance institution which, in turn, has made the expanded breadth and depth of outreach of its services possible.

Similarly, the expansion of the dimension of deposit facilities of microfinance institutions has reflected key innovations in savings mobilization, with the development of new products (such as debit cards with biometric identification) and the broadening of delivery channels, both through the expansion of the branching network and the use of branchless mechanisms, that go beyond, such as networks of correspondents and the use of cellular phones and online banking, thus allowing a more accessible service, appropriate to the client´s circumstances. This progress has been facilitated by the development of more flexible prudential norms (such as the authorization of basic accounts, with simplified procedures), better-adapted to modern technologies. These norms have attempted to optimally combine, on the one hand, concerns for the safety of the depositor´s savings and the need to cultivate the public´s trust and, on the other hand, an acknowledgement of the unique challenges of expanding deposit services towards marginal areas and populations.

Thus, the strength of contractual relationships has been at the roots of the success and has constituted the essence of the innovations that have characterized the microfinance revolution. Therefore, as the regulation of financial systems will evolve in the future and as new efforts to create legal environments appropriate for microfinance will emerge, it will be critically important that a responsible regulation makes sure that these contractual relationships continue to be protected rather than being degraded. Given increasing political pressures on the authorities, this will be a formidable responsibility.

The task faced by a responsible regulator is not easy and, after the international financial crisis, the challenge has become even more complex. At the most basic level, the prudential regulator must achieve an optimal combination of at least two objectives: (i) to ensure the stability of the financial system, by promoting the trust of the public and by constraining the opportunistic behaviour of the various actors (in order to avoid the emergence of systemic crisis) and (ii) to promote both financial deepening (namely, the contributions of the financial system to increases in productivity and of the rate of growth of the economy) as well as financial inclusion (namely, the access and greater use of high quality financial services, at a reasonable cost, by broad sectors of the population. With increasing emphasis, in addition to these objectives, the protection of the consumers of all types of financial services, and not just of depositors, has become another goal of the authorities.

The reasonable achievement of these objectives is a complex task, which must avoid several types of mistakes. First, a basic obligation of a responsible regulator is to clearly define the rules of the game and to not arbitrarily modify them. When this is not the case, regulation no longer is an effective instrument to contain systemic risk and, instead, regulatory uncertainty becomes an additional source of risk for financial intermediaries and other market participants. Second, in any case, regulation and supervision are inevitably costly for all market participants. Beyond operational costs, both for the regulator and for the regulated and its clients, there are the opportunity costs that emerge from unnecessary restrictions on entry and unjustified prohibitions on the development of new products and procedures. These types of norms represent an important damper on innovation. Third, in the worst of cases, repressive regulation introduces distortions in the nature of the transactions and the role of the market, leading to serious inefficiencies and inequities.

In conclusion, the essence of microfinance has been the innovation in the delivery of financial services of small size, to poor clienteles. Its continued progress will depend on how the authorities face the need for innovation in their own regulation and supervision technologies, for a virtuous matching of the characteristics of the sector and the intervention of the authorities to emerge. Thus, the microfinance revolution must be accompanied by a responsible regulatory revolution, in which interventions are consistent with the true nature of the microfinance sector.