The Regulation and Supervision of Microfinance Main Issues and Progress in Egypt

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Abstract

Responding to the rapid growth of microfinance institutions around the world, this paper attempts to explore the main aspects of the current debate on the regulation and supervision of microfinance in Egypt. This paper mainly argues that appropriate regulation and supervision of microfinance is critically important as there is broad awareness that poor people have different financial service needs. In order to reach its full potential and further grow as a credible development tool in Egypt, the microfinance industry must eventually be able to enter the area of licensed, supervised financial intermediation to be able to capture and minimize any financial crisis or crimes that may possibly occur. Having said this, microfinance regulation and supervision is complex and filled with challenges. Regulators will also have to weigh the potential costs of regulation and supervision to avoid consequences of regulation, particularly in regard to innovation and healthy competition meanwhile, preserve financial stability, resilience, integrity and consumer protection. The paper concludes with practicable suggestions to overcome the issues and challenges associated with microfinance in Egypt after analyzing the macroeconomic and policy environment, specific adjustments will be necessary to capture the specificities of microfinance activities along with amending the existing regulations or creating a new regulatory framework for microfinance. Finally, analysis is carried out that focuses on the key issues in the legal system and judicial processes, as well as on the regulatory and supervisory environment for microfinance which are being addressed in Egypt learning form successful microfinance movements in the Asian countries.

Key Words: microfinance, regulation, supervision, financial intermediation, development tool.
JEL Classification: E 31, E4, G38, G2, K 2, K42
1. Introduction

Microfinance refers to providing financial services to the poor. It is viewed as an innovative segment of the banking sector. Microfinance bridges the gap that commercial banking has not been able to fulfill and where philanthropy is unable to go beyond pilot approaches to reach meaningful scale. Microfinance is an income producing tool rather than a consumption aid. Meaning, microfinance and microcredit do not provide consumers with loans to simply increase their consumption; instead, they provide loans for the specific purposes of creating self-employment for the poor, thereby enabling the poor to build their own microenterprises and move themselves out of poverty. (Ledgerwood 1998, and Ledgerwood, Earne and Nelson 2013).

After years of successful development and increasing recognition as a development tool, microfinance has recently been hard hit by a series of crises that has led many critics to severely question the so-called “microfinance promise” (Morduch, 1999), namely the win–win rhetoric of “poverty alleviation with profit.” While some of these problems are inherent to any fast-growing sector, others—such as the repayment crises observed in various Latin American countries and, more recently again, in the South Indian state of Andra Pradesh—clearly point to deeper dysfunctions in the microfinance industry.

The blame for this unfortunate situation falls most squarely on the MFIs that failed to restrain aggressive growth even as the market became increasingly saturated. Investors must also swallow a big spoonful of blame. Because they paid dearly for shares in the MFIs, they need fast growth to make their investments pay off.

Given their critical impact on poor communities, they are serious enough to require a proper response by microfinance stakeholders and policy-makers. Today, there is a broad consensus among the microfinance community that the regulation and supervision of microfinance is critically important for its future development and its credibility as a development tool. However, how best to regulate and supervise microfinance remains a very challenging question (Anne Pouchous, 2012). A “one-size-fits-all” solution is therefore not possible, nor is it desirable. Any new regulatory and supervisory framework for microfinance will have to balance both the need for financial stability, resilience, integrity and consumer protection while, on the other hand, the need to preserve financial inclusion, innovation and healthy competition.

2. Background

The concept of microcredit was first introduced in Bangladesh by Nobel Peace Prize winner Muhammad Yunus. Professor Yunus started Grameen Bank (GB) more than 30 years ago with the aim of reducing poverty by providing small loans to the country’s rural poor (Yunus 1999). Microcredit has evolved over the years and does not only provide credit to the poor, but also now spans a myriad of other services including savings, insurance, remittances and non-
financial services such as financial literacy training and skills development programs; microcredit is now referred to as microfinance (Armendáriz de Aghion and Morduch 2005, 2010).

Micro financing is not a new concept. Small microcredit operations have existed since the mid-1700s. Also, the microfinance regulation is no longer a new field. Much has been written about it and even more has been done in terms of actually implementing new ideas. In a number of countries throughout the world, legal frameworks for microfinance have been amended or, in some cases, completely revised.

In the current environment, it is becoming difficult to stay abreast of new initiatives to regulate microfinance institutions (MFIs). The drafting of legal texts is an important step when setting up an appropriate legal framework for microfinance. It is neither the first step nor the last, but it is a crucial one. The elements of establishing a legal regime for microfinance can be distinguished. On the legal side, some kind of assessment of existing legislation should be conducted first. On the political side, new or amended legislation is only possible when sufficient political support exists. And, perhaps most importantly, on the institutional side, regulation will only be effective when institutional capacity and will are sufficiently strong.

Our method of analysis is first and foremost descriptive only concerned with the country in study. We do not assume that everything we came across is effective simply because it exists. Assessing the success of a regulatory framework is a difficult task, however, cautious has been taken to avoid and capture all the challenges related to regulation and supervision.

2.1 The Reason for Regulating and Supervising Microfinance

Achieving a conducive policy and legal framework is generally believed to be a better way to promote microfinance and increase the depth and breadth of access to financial services than for governments and central banks to directly participate in market transactions. It is further believed that a favorable policy environment is the prerequisite for the development of viable and sound financial institutions operating in an efficient financial system to serve the significant demand of various unbanked markets. Further, the need for regulation and supervision arises when MFIs take deposits from the public (Braun and Hannig 2006).

While it is the absence (or near absence) of formal regulation that has long given microfinance the necessary flexibility to develop as a successful financial inclusion tool, this situation has changed gradually over the recent decades. Indeed, as the sector matures, the arguments in favor of proper regulation (hard and soft) and oversight of microfinance are becoming increasingly more substantial. The academic literature provides a number of important justifications, including the following: (1) the protection of the country’s financial system and small depositors; (2) addressing the consequences of rapid growth and fast commercialization of the microfinance sector; (3) consumer protection and the fight against abusive interest rates; (4) the entry of new providers and credit delivery mechanisms in the
microfinance sector; (5) lessons from the recent financial crisis; and (6) fraud and financial crimes prevention. (Peck Christen and Rosenberg (1999) and Chen, Rasmussen, and Reille, (2010))

According to various Consultative Group to Assist the Poor (CGAP) reports and the Microfinance Information Exchange (MIX) (Littlefield and Kneiding (2009), CGAP (2009), and Gonzalez (2011)). MFIs have emerged relatively untouched from the financial crises of the past few decades when compared with commercial financial institutions. However, this situation is changing. Indeed, with the commercialization of the industry, microfinance institutions now have many more links to international financial markets than before (particularly those which have now become publicly traded institutions, such as Compartamos, SKS, and so on) and, as a result, are increasingly exposed to potential turbulences in global financial markets. As reported by CGAP, a number of MFIs in Latin American countries (e.g., in Nicaragua, Peru and Bolivia) and Eastern Europe were actually hard hit by the 2008 financial crisis, though in different ways. Looking at this evidence, microfinance experts generally agree that more mature MFIs, which derive an important part of their funding from international markets, would benefit from more rigorous prudential control and oversight. Such regulation would help them face two main types of risks: institutional refinancing risk (liquidity) and foreign currency dislocations.

As a result, financial services industry is the most heavily regulated industry due to the theoretical notion that financial sector is subject to market failures, which provides a rationale for government interventions in form of regulation. This is often known as the public interest view of regulation. (Lauer, K. and S. Staschen. 2012)

The objectives of regulation are either directly targeted at removing market failures by disclosure requirements that mitigate information problems or at alleviating negative consequences of market failures by protecting clients. In financial regulation the burden of proof should always be on the rule maker; regulatory intervention justified if there is a clear economic rationale for imposing regulation.

2.2 Regulating and Supervising Microfinance

2.2.1 Approaches to MFI Regulation

An optimal MFI regulatory environment should be designed to facilitate the objectives of these institutions (ADB 1990). This design may vary from country to country but the regulatory plan should be kept simple enough for the clients and authorities to work in harmony. They are classified here under three approaches:

2.2.1.1 Self-Regulation

The self-regulation concentrates this responsibility in the hands of the MFIs themselves without recourse to the government. So regulation and supervision is in the form of operational standards designed and enforced by an industry umbrella body or apex organization.
Supervision can be also conducted by a rating agency (Staschen 1999). This lack of government intervention can lead to reliability problems such as lack of depositor protection and even safeguarding of the financial system.

Although self-regulation may on the surface be preferable to no regulation or supervision, it is often difficult to establish a system that is free from influence and enforceable; that is, the regulator can enforce standards against one of the members, especially if such member is influential (Lauer and Staschen 2012).

2.2.1.2 Banking Law Regulation

Banking law regulation is the other extreme where MFIs are simply another form of financial institution and so regulated accordingly. This approach has had the advantage that a regulatory body already exists to enforce the related law. While some question whether the banking law is a good fit for MFI activities, Greuning, Gallardo and Randhawa (1999) show existing financial regulation can be modified to suit MFIs through tiered banking and graduated regulation.

Therefore, banks regulators can promote risk management under a statutory framework that allow MFIs systematically to develop and transform into more full service organization (Greuning et al 1999). There are already many such examples in Asia; Bank Rakyat Indonesia in Indonesia and the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, China, Philippine have are all nominated by their central banks as their interim MFIs regulator under the banking law. In Nepal microfinance development banks are now regulated under the ‘Bank and Financial Ordinance 2004’ and so they are subject to normal prudential regulation and supervision.

2.2.1.3 Special Law Regulation

The final possibility is to regulate MFIs under their own special legislation. This approach calls for enactment of MFIs specific special legislation with actual regulation and supervision conducted by the central bank or third party. This approach potentially offers lower barriers to entry and may best suit to MFIs’ need. It is also valid where there are several financially self-sufficient (or near to) MFIs (McGuire and Conroy 1999).

Special regulation may also lead to increased costs of supervision and political interference. In Pakistan, for example, its ‘Microfinance Institutions Ordinance’ allows microfinance banks to operate under their own specific MFI guideline. In Bangladesh the Grameen Bank is under special regulatory environment the ‘Grameen Bank Ordinance 1983’. The external, domestic and macroeconomic stability, good governance and policies would determine the continuity of this specialized of regulatory treatment approach.

In summary, each regulatory approach has its pros and cons; Experience in developing countries suggests self-regulation fails due to enforcement problems. A “one-size-fits-all” solution is therefore not possible, nor is it desirable.. The right choice will depend on any
country specific MFI issues, deficiencies in supervisory capabilities and knowledge, the time and ability of the MFIs to grasp the proposed regulatory environment.

2.2.2 What are the Major Regulatory Instruments?

The selection of regulatory instruments and tools for MFIs is not much different from that of traditional financial institutions. Legal provisions usually legislate for entry into the market, smooth operation and an orderly exit, either voluntarily or by order of the regulatory authority. Yet even when the instruments are the same, the specifications for MFIs are different. The most widely discussed types of regulation in microfinance are prudential regulation, which is about the safety and soundness of financial institutions, and conduct of business regulation, which focuses on how providers conduct business with their clients. The best-known example of this is the capital requirement for MFIs, which is generally much lower than for commercial banks. The following regulatory provisions are at the core of risk control in an MFI. (Stefan Staschen, 2003)

Minimum Capital Requirement

This represents the lowest amount of currency that investors can bring to the equity base of a financial institution seeking a banking license. Setting this ratio is particularly tricky for regulators. If, for example, the MCR is too high, many MFIs will be discouraged from entering the sector, and efforts to promote financial inclusion among poor communities will be severely constrained. If, on the contrary, it is too low, almost any deposit-taking institution would become eligible, challenging both the financial soundness of the system and its oversight capacity. It is important, therefore, that regulators opt for an MCR that will secure the resilience of the financial system while not discouraging micro-lending activity.

Capital adequacy

This ratio refers to the minimum amount of capital a financial institution should hold to avoid solvency problems. Microfinance professionals and regulators generally agree that MFIs should be subject to tighter capital adequacy requirements than standard banks (Peck Christen et al., 2011). The main reasons for this include the following: (1) MFIs’ portfolios tend to be more volatile than those of commercial banks, and, accordingly, can deteriorate with surprising speed. (2) Non-repayment events in MFIs, when they arise, tend to be more contagious than in a commercial bank. Many MFIs in Latin America (e.g., in Bolivia, Guatemala and Nicaragua) experienced this situation during the 1997–2000 downturns; and (3) Operational Risks in microfinance tend to be particularly high in microfinance. Because of the limited (and often ill-trained) human resources and infrastructure capacities. For all these reasons, therefore, specialized depository MFIs will typically require higher capital adequacy ratios than conventional banks.
Unsecured lending limits and loan loss provisions

Standard prudential regulation typically limits unsecured lending to some percentage of a bank’s equity base. However, none of these rules are adapted to microcredit portfolios. Indeed, most micro-lending is unsecured, and it is not possible for MFIs to automatically provision large portions of microcredit loans as soon as they are made. Some regulatory adjustments are thus necessary to accommodate for these specificities. CGAP experts have recommended that only delinquent loans be provisioned more aggressively than secured bank loans. Where possible, they also advise treating group guarantees as collateral.

Liquidity and Foreign Exchange Risks

These are two other areas where deposit-taking MFIs may require more conservative prudential requirements (depending, of course, on the degree of exposure of MFIs to domestic and foreign markets). Indeed, faced with liquidity problems, conventional banks can always reduce lending efforts for a while to replenish their cash reserves. In contrast, MFIs cannot stop lending without seriously disrupting the repayment of their outstanding loans. Furthermore, most MFIs do not have access to emergency liquidity from the central bank upon which standard banks typically rely. As a general principle, therefore, depository MFIs will need higher liquidity requirements than conventional banks. Regarding currency risks, MFIs often operate in countries where there is no proper instrument or knowledge on how to hedge efficiently against foreign exchange swings. It is important, therefore, that supervisors carefully check MFIs’ capacity to manage currency risk and impose clear limits if the MFI is not able to address these risks properly.

Asset Quality

For MFIs, the most important asset is their loan portfolio. Thus the classification of loans and the specification of provisioning requirements serve as important regulatory instruments. In general, provisioning requirements should be more conservative than for traditional banks, as microloans have more frequent payment installments than traditional loans.

Risk Concentration

Diversification of assets can reduce the overall risk of a financial institution. The most risky asset of an MFI is usually the loan portfolio. Restricting the loan exposure to single borrowers is a typical regulatory requirement for both traditional financial institutions and MFIs. Whereas a number of traditional banks in developing countries suffer from a high dependence on a small number of big borrowers, this is usually not the case for MFIs with a portfolio of many small loans. One way for a regulator to prevent risk concentration is to prescribe a certain risk-weighted capital adequacy ratio. Apart from loan portfolio, investments in other companies or fixed assets also play a role in the degree of risk diversification of a financial institution.
Insider Lending

According to the Glossary of the Microfinance Gateway, insider loans are “loans made to a person who is in a position of influence within the lending institution, or to someone else connected with such a person”. Insider lending has been a serious problem among many financial institutions in developing countries. Due to the inherent conflict of interest of such loans, they usually belong to the least-earning assets. In some cases, loan conditions are much more favorable than for external loans, in other cases it is simply much easier for borrowers to have their loans rescheduled or even forgiven.

One would think that insider lending is less of a problem in MFIs than in traditional banks, as the small loan size – especially when there is a strict ceiling on loan sizes – makes borrowing for the relatively better off insiders less attractive. Yet there is no any clear evidence of this.

Ownership Concentration

Another standard regulatory provision for all types of financial institutions is the stipulation of a maximum percentage of capital that can be held by a single owner. The rationale for such a requirement is to prevent a concentration of ownership, which could enable a single owner to take major policy decisions in his/her own interest without having to consult anyone else. Furthermore, the presence of a minimum number of owners facilitates a balanced representation of interests, which is particularly important for MFIs who face the potentially conflicting objectives of poverty alleviation and profit maximization.

Protection of Depositors

It is generally agreed that, if deposits in commercial banks are insured, deposits in other institutions prudentially licensed (including microfinance institutions) should also be insured. However, to the extent that the costs of such deposit guarantee schemes are very high and usually prohibitive for most MFIs, balanced funding solutions must be found to limit the negative impact of such protection schemes on microfinance institutions.

Sanctions and Corrective Actions

Sanctions and corrective actions have two main functions. Firstly, they should deter institutions from contravening regulatory requirements. Secondly, and this is where corrective actions are more important than sanctions, they should help to cure the problem which has been created by the violation of regulations. A serious problem with both sanctions and corrective actions is regulatory forbearance: as soon as deterrence has not worked, the regulator might choose not to make problems public, but to sweep them under the carpet. One way to preclude forbearance is to clearly spell out prompt corrective actions that must be taken as a response to clearly verifiable events (cf.Goodhart et al. 1998: 52ff.). It is difficult to say much about sanctions without looking deeper into supervisory practices. The final critical considerations concerns are reporting requirements and governance issues.
3. Methodology

3.1 Research Questions

As indicated in introduction, we have our major research question: how should MFIs be regulated and supervised in Egypt. The paper is viewed as a work in progress on which further adjustments could be made, based on analysis of the selected country experience from the field. We explore the main issues at stake in the regulation and supervision of microfinance by amending existing regulations or creating a new regulatory framework for microfinance in Egypt.

3.2 Data

Background on Microfinance in Egypt

3.2.1 Macroeconomic and Policy Environment

Egypt has a population of about 84.7 million, which has been growing at about 1.64% per year. Recent statistics (2014/2015) indicate that 64% of the population live in rural areas and 44% in urban areas.

Table 1: Population in Egypt

<table>
<thead>
<tr>
<th>Year</th>
<th>Population</th>
<th>Yearly % Change</th>
<th>Yearly Change</th>
<th>Migrants (net)</th>
<th>Median Age</th>
<th>Fertility Rate</th>
<th>Density (P/km²)</th>
<th>Urban Pop %</th>
<th>Urban Population</th>
<th>Country’s Share of World Pop</th>
<th>World Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>84,705,681</td>
<td>1.64%</td>
<td>1,325,595</td>
<td>-43,136</td>
<td>25.5</td>
<td>2.79</td>
<td>85</td>
<td>44%</td>
<td>37,433,982</td>
<td>1.16%</td>
<td>7,324,782,225</td>
</tr>
<tr>
<td>2014</td>
<td>83,386,739</td>
<td>1.62%</td>
<td>1,330,361</td>
<td>-47,438</td>
<td>25.5</td>
<td>2.82</td>
<td>83</td>
<td>44%</td>
<td>36,713,659</td>
<td>1.15%</td>
<td>7,243,784,121</td>
</tr>
</tbody>
</table>

Source: Worldometers (www.Worldometers.info)

Gross Domestic Product (GDP) stood at $271,972,822,883 US, with an annual growth rate of 2% in 2013. Inflation has been on a declining path recently following last July’s spike due to the adjustment of energy and tobacco prices. Headline inflation averaged 10.4% y-o-y during Q2 FY14/15, down from an average of 11.2% during the first quarter and 11.7% in the corresponding quarter of the previous year. The slowdown in inflation is even more visible in the core inflation trend, which excludes administratively regulated items as well as highly price-volatile food items: core inflation trended downwards to an average of 8.0% during Q2 FY14/15, down from 9.6% in the first quarter and 11.7% in the same quarter of FY13/14. (Egypt economic development conference, 2015)

Although, Egypt’s commitment to reform is complete, and its track record to date demonstrates its capacity and willingness to transform challenges to opportunities through proactive and far-reaching policies. Its financial structure is fairly shallow and vulnerable to external shocks.

Table 3: Sources of Financing and Indicators

<table>
<thead>
<tr>
<th>LE BILLION</th>
<th>FY08/09</th>
<th>FY09/10</th>
<th>FY10/11</th>
<th>FY11/12</th>
<th>FY12/13</th>
<th>FY13/14</th>
<th>Q1-FY14/15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Fiscal Deficit</td>
<td>71.8</td>
<td>98.0</td>
<td>134.5</td>
<td>166.7</td>
<td>239.7</td>
<td>253.4</td>
<td>65.8</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

3.2.2 Poverty in the Egyptian Context

Poverty in Egypt has increased from 21.6% in 2008-2009 to about 26.3% of the population in 2012-2013. Meanwhile, the unemployment rate is 13.4%. The increase in poverty levels have tended to be concentrated and in the rural areas. Poverty is highest among the self-employed households cultivating agricultural crops and has decreased only slightly, compared to the self-employed households engaged in export-crop agriculture and the wage employees in the public and private sectors.

3.2.3 Structure of the Microfinance Sector

Although deposit services are provided by all commercial and state-owned banks in Egypt, none of the Egyptian banks offering microcredit services have designed or marketed micro-saving products to their clients. For most part, microcredit in Egypt continues to be provided by non-governmental organizations (NGOs) though regulations prohibit this group from offering deposits to their clients. As a result, Egypt post continues to be the largest provider of saving products to the Egyptian micro entrepreneurs and lower income populations.
The Egyptian microfinance market has a limited product mix and has not diversified beyond credit. Microcredit in the form of commerce continues to be the largest product offering.

Microcredit
The vast majority of microfinance activity in Egypt is microcredit. Many MFIs in Egypt started out offering individual loans but have introduced group lending in recent years in order to improve portfolio quality. Recently, a few MFIs have begun to offer consumer credit products including housing and education loans. Other MFIs fear that the default rates on consumer loans will be higher than business loans and some MFIs are concerned that consumer loans are less “sharia’a compliant” than business loans. (Microfinance network of Arab countries, 2010)

Micro savings
While microsaving remain nonexistent in the Egyptian market due to the limiting legal status of MFIs as NGO and lack of interest on behalf of down scaling banks to provide tailored saving products to micro entrepreneurs. Egypt post has been historically a key provider of saving products to the Egyptian poor. Established in 1865, Egypt post has grown its network to reach 3700 branches all over the county and clientele base to over 17 million clients. (Microfinance network of Arab countries, 2010)

Micro-insurance
The Egyptian financial supervisory authority has taken lead in introducing micro insurance to the Egyptian market. While less than a handful of MFIs have introduced microinsurance products, several others are currently studing the product desings offered by insurance
companies and estimating possible demand to determine whether or not to include microinsurance in their product mix.

Finally the remittances and the non-financial services in which smaller MFIs have experimented services such as literacy and health training targeting women and youth enterprise but the area remains untapped. (Microfinance network of Arab countries, 2010)

3.2.4 Legal and Regulatory Framework for Microfinance

The Egyptian government has historically supported microfinance based on its development strategy which lists poverty reduction as one of its major focus in order to reduce poverty and to improve equity in the distribution of income. This ambitious program of economic, social and political transformation includes broad reform measures to restructure the financial sector and state – owned enterprises as well as policies aimed at improved allocation of public resources.

In 2004, the Central Bank of Egypt (CBE) under the Egyptian banking institution led a project of the development of the national strategy for Microfinance in Egypt with the support of USAID, UNDP and KfW. The objective of the strategy was to develop, within the next five years, a microfinance industry in which sustainable financial services for lower market segments are integrated into the overall development of a broad, inclusive and diverse financial sector. In Nov 14, 2014 Egypt has issued the country's first law regulating microfinance services. The law regulates microfinance funding by non-bank sources including companies and non-governmental organizations and puts them under the authority of the financial regulator, known as EFSA. Banks will continue to be regulated by the central bank.

Given the dynamic nature of its subject matter, we will briefly indicate how more in-depth assessments of legal frameworks for microfinance could appear. In the course of our work, a clearer picture of the main elements of legal frameworks for microfinance has emerged and to conduct comprehensive assessments of microfinance regulation in Egypt, one has to go a few steps further. The research went through the following steps to come up with this final, condensed version of a summary paper. Firstly, a country template was developed in the form of a table including the most important quantitative and qualitative regulatory requirements for MFIs. After collecting all the relevant legal texts, this table was filled out with the country case. This left us with a number of pages, which have been used to draft the analysis. They are not published in this research, but will be merged into soon to be launched.

First, the appropriateness of regulatory requirements in the relevant country context must be assessed. A list of the regulatory requirements which indicates why each requirement is of interest for regulating MFIs and what the rationale is for including such a provision.

The result of this first step provided a comprehensive overview of the existing legislation affecting the conducting of microfinance business that has been assessed in a number of pages in the form of schedules not published in this paper, moreover this was not sufficient in itself
to explain the strengths and weaknesses of a legal framework so the analysis continued to include the second step.

The second step is to look at the enforcement of legal provisions, i.e. at the supervisory practices. Here, a number of crucial elements for an effective regulatory requirement that was analyzed.

Capacity: A detailed analysis of supervisory practice can shed some light on this. Questions to be answered would be: how many people work in the supervision department; what is their background; which documents (e.g. supervision manuals) do they use and what is the quality of these documents; how do they follow up on identified problems; etc. On the other hand, do supervised institutions have sufficient capacity to comply with all relevant legal provisions? Since regulation of microfinance institutions is new in Egypt, therefore it is difficult to assess the way how regulators will deal with the problems and the measures of surveillance they will take to minimize the risk and improve the quality of supervision.

Incentives: Capacity alone is not sufficient, if the will is lacking. There must be strong incentives both for the regulator and for the regulated to enforce and to comply with legal requirements. The main incentive for the supervisory authority should be that it is accountable to the government for the soundness of the financial sector. A look at the historic performance of the regulator could give some indication of the appropriateness of incentives. A main incentive for the compliance of regulated institutions is that there is a high probability that a breach of law will be detected, followed-up and sanctioned.

Autonomy vs. Accountability: It is essential that the regulatory and supervisory authority is not subject to direct political intervention in its day-to-day operations. On the other hand, the regulator must be accountable for what it is doing. A mechanism must be in place to challenge regulatory decisions.

4. Results and Conclusion

From the schedules and drafts analyzed for Egypt’s case not published in this paper. The following results were reached.

Access to funds, whether through debt or equity, is considered as one of the major challenges for NGO-MFIs. Any funding from abroad requires the prior approval of the Ministry of Social Solidarity which is a lengthy and cumbersome process. This can be overcome through adopting a simplified and speedy approval process. The Ministry of Social Solidarity can put specific criteria to allow for quicker approval of funding through reputable international organizations.

Moreover, there are two main constraints connected with loans from banks (i), commercial banks are not motivated to lend to NGOs without the availability of minimum credit guarantees; and on the other hand, the NGOs cannot access private equity due to their nature as not-for-
profit entities. Banks remain reluctant to offer microcredit programs. (ii) Banks must get the approval of the Central Bank of Egypt (CBE) to extend credit facilities in Egyptian pound against deposit guarantees in foreign currency. In this regard, the CBE can prevent any delay by speeding its approval process and by issuing a decree to encourage the microfinance sector similar to the CBE’s Board Decree No. 2408/2008 with regards to "Encouraging Banks’ Financing of Small and Medium Enterprises”. This can be done directly by encouraging banks to downscale and provide microfinance services to their clients, or indirectly by encouraging banks to extend credit facilities to NGO-MFIs and MFCs based on the quality of the loan portfolios of these institutions and to benefit from their outreach and experience in microfinance.

The proposals at an international level to supplement risk-based measures with an internationally harmonized and appropriately calibrated leverage ratio are welcomed and could lead to its adoption by a wide range of countries in the future. The leverage ratio that microfinance companies’ in Egypt use cannot do the job alone; it needs to be complemented by other prudential tools or measures to ensure a comprehensive picture of the buildup of leverage in the financial system.

The Egyptian Financial Supervisory authority should arrange risk management training held by experts in such field. The risk management process begins with the board of directors and senior management, whose responsibility it is to identify all material risks and determine the organization’s risk appetite. The board and senior management are responsible for setting prudential limits and ensuring that the appropriate policies and procedures are in place to monitor and mitigate risk. They should establish reporting and early warning systems and contingency plans for stress events.

A sound risk management system should be supported by management information systems (MIS) that provide timely and pertinent information, as well as by comprehensive internal controls that reflect and reinforce the MFI’s risk policies and procedures. Ultimately, management needs to establish a “risk culture” throughout the entire organization by creating awareness of relevant risks amongst employees, encouraging adherence to sound procedures and controls, and creating mechanisms for reporting concerns and taking necessary action. By doing so, the laws and regulations then can be amended by reducing the minimum capital requirement for non-deposit taking MFIs who intend to engage in microcredit which could then be considered as an unnecessary entry barrier and the same goes to the loan loss provisioning.

If Egypt had a good risk management practices with well trained and experienced regulators, laws and regulations could be more flexible for non-deposit taking MFIs to increase the outreach and its benefits be widespread.

Moreover, Egypt lacks a thorough licensing process that includes a comprehensive business plan, appropriate management information systems along with satisfactory, verifiable and
acceptable evidence of payment by the proposed shareholders of the minimum capital requirement, including personal statement that capital does not originate from bank credit, any form of credit, questionable sources and any activity that relates to money laundering or any illicit activity. The quality of the license application tells much about the qualification of the future executives in the institution.

As a result Egypt’s legal structure and judicial system needs to be further modernized and upgraded to facilitate introduction of securitized financial instruments that can benefit microfinance development through better connection and linkages to formal sector institutions and financial markets. These modernizing improvements will be beneficial not just to the development of sustainable microfinance, but for the formal financial sectors as well.

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