Improving regulatory environment for MFBs and NB MFIs in Rwanda

Microfinance plays a pivotal role in enhancing access to finance and financial inclusion for the people of Rwanda. For this very purpose, a series of interviews with stakeholders have been conducted and a concept note has been prepared for the legislative and regulatory stakeholders to consider taking actions. This project has been sponsored by Access to Finance Rwanda (AFR) and carried out in close cooperation with Association of Microfinancial Institutions of Rwanda (AMIR), Rwanda Bankers Association (RBA), Ministry of Finance and Economic Planning (MINECOFIN) and National Bank of Rwanda (BNR).

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I. Acknowledgements

The publication of this report has been made possible thanks, first, to the sponsorship of Access to Finance Rwanda.

Also, there were many stakeholders of the microfinance industry in Rwanda, who graciously spared their time to meet with the consultant to share their views on several issues. They include the managing directors/CEOs of all microfinance banks and several non-bank MFIs, and representatives of the Ministry of Finance and Economic Planning, National Bank of Rwanda (BNR), Access to Finance Rwanda (AFR) and Association of Microfinance Institutions of Rwanda (AMIR).

Special thanks are due to Tim Lyman, Special Policy Advisor at Consultative Group to Assist the Poor (CGAP) of World Bank, who spared his time to respond to several questions on the phone.

II. Project Description

The project is composed of two phases:

First, micro finance banks, hereinafter called MFBs, have expressed several issues related to regulatory framework, which are not conducive to microfinance (MF). The consultant collected these issues and validated their legitimacy through secondary research on current banking law and regulations, as well as other relevant resources in the global MF industry. After comparative analysis, the consultant created a concept note that documents recommendations to be considered towards achieving improvements in regulatory framework for MFBs.

Second, the consultant collected issues from non-bank microfinance institutions, hereinafter called NB MFIs, and proceeded to validate them through reviews of current law and regulations and other relevant resources as well. After comparative analysis, the consultant presented a concept note that documents recommendations to be considered for achieving improvements in regulatory framework for NB MFIs.

The project was completed on September 12, 2014.

III. Approaches

To carry out the project effectively, a 4 R approach has been adopted involving Review, Research, Report, and Recommendations.

Review includes the review of the current laws and regulations that pertain to MF activities. New banking laws in progress have also been reviewed for possible change before they are enacted.

Research includes primary research through interviews with stakeholders and secondary research on global resources that are relevant to MF. The interviews were conducted with all MFB managing directors/CEOs and managing directors of eight selected NB MFIs. Interviews were also carried out with Director General of Financial Sector Development at MINECOFIN, Director of Bank Supervision, Director of MF Supervision, Executive Secretary of AMIR, Executive Secretary of RBA, Chairman of RBA, Technical Director of AFR.

The main resources that were used for secondary research were:

- "Microfinance Activities and Core Principles" (2010) by the Basel Committee on Banking Supervision (BCBS)
- "A Guide to Regulation and Supervision of Microfinance" (2012) Consultative Group to Assist the Poor (CGAP)

All other resources that were used for research and analysis are listed in the "References" attached hereto.

Report represents this report containing the issues raised and analyses conducted using global resources. A preliminary report was submitted to AFR, the project sponsor, for review. Furthermore, it was shared with key stakeholders for validation.

All abbreviations and professional vocabularies used in this report are described in the "Glossary" attached hereto.

Recommendations are included in this report and have been converted into a concept note that is presented to the regulatory and supervisory body for their consideration.

IV. Limitations

This report has limitations in the quantitative data analysis on the impact that each of the issues raised has on the MFBs and/or NB MFIs. However, the qualitative evidences and analysis seem sufficient to support most of the issues. If a quantitative analysis is necessary for the regulatory authority to make a decision, it should be carried out as a separate project.

Additionally, it is premature to offer specific criteria and standards to assess the soundness of MFBs in Rwanda due to most of their relatively short periods of operations as MFBs. While UOB that has been operating as an MFB for the past seven years, similar experiences of MFBs elsewhere in the world may also provide solid guidance to making appropriate changes in the current laws and regulations applicable to MFBs to be more conducive for promoting access to finance and financial inclusion.

Lastly, this report does not cover issues of smaller Savings and Credit Associations (SACCOs), including Umurenge SACCOs. However, to address this, there have been separate studies conducted for these entities.

V. Executive Summary

Without a doubt, microfinance (MF) plays a significant role in advancing financial inclusion, particularly in low-income countries. By improving access to finance, it also improves income through enhanced economic activities.

MF has evolved over time from offering only microcredit to providing a variety of financial services, including microcredit, microsavings, microinsurance and remittances. As the scope of MF has expanded, the need for regulatory supervision has also increased, particularly to protect the interests of depositors.

However, prudentially regulating small MFIs with limited activities is costly and time-consuming for both the supervisory authority and the MFIs. This challenge has induced many scholars and practitioners alike to evaluate the costs and benefits of optimal MFI regulation.

According to *The Economist*'s 2013 Global Microscope on MF, Rwanda was ranked 22nd in external business environment on microfinance, including regulatory framework. It slid five places down from its 2012 ranking; moreover, Rwanda trailed Kenya (5th) and Uganda (10th).

In this context, microfinance institutions, both banks and non-banks alike, have expressed their challenges related to the regulation and supervision on their operations.

These issues included: pressure on interest rates charged for microcredits, pressure to lower the loan-to-deposit ratio, supervision fee imposed as a percentage of revenues despite the high operating expenses incurred, heavy reporting requirements, high compliance costs, inconsistency in supervisory guidance, dual systems for agents, as well as a few other issues related to the supervisory authority.

Extensive secondary research has revealed that many of these claims are valid and relevant. Thus, a concept note has been prepared and presented to the central bank, National Bank of Rwanda, and the policy-making government body, Directorate General of Financial Sector Development at Ministry of Finance and Economic Planning.

The concept note includes: a few general principles to be adopted, analysis of the claims made by MFBs and NB MFIs and resulting recommendations, as well as suggested adjustments to CAMELS rating components applied to

MFBs. There were a few other issues that were also discussed outside the regulatory and supervisory framework for information and appropriate action, if circumstances allow.

The general principles included a clear definition of microfinance, a clarified definition of microfinance institution, clarifications of permissible activities, existing regulation and supervision for MF activities, as well as proportionality and rewards for each type of MF activity.

The recommendations for adjustments to CAMELS rating components were made on capital adequacy, asset quality, management capacity, earnings, liquidity adequacy, and sensitivity to market risk. As lending practices differ widely between regular commercial banking and microfinance banking, special attention has been given to asset quality.

Other recommendations made outside the regulatory framework pertained to trade association membership issues and over-indebtedness. The latter issue has potential to become grave in Rwanda unless timely preventive measures are taken industrywide.

Non-bank MFIs had different issues from microfinance banks, which included access to the payment system, stop-lending notice, the clarification on definition of microfinance, collateral registration and recovery issues, regulation on insider lending and reporting templates.

But, the most significant issue of all was their desire to access the payment system. Due to its importance, heavy emphasis was placed on access to the payment system. Because the issue is quite complex, however, the payment system in Rwanda was analyzed by segments and specific recommendations were made for each segment: checks, cards, interbank payments and mobile payments.

All in all, the major claims collected from the interviews with MFBs and NB MFIs and the recommendations made in reference to each of the major claims were summarized in tables for each reference, placed after the main body of this report.

VI. Background Information

Note: MFI refers to the overall industry or any financial institution engaged in microfinance activities. Commercial banks that are engaged in microfinance are excluded from this report's coverage. More details are explained in the "Glossary" attached hereto, but for the purpose of this report, please note these abbreviations.

The Association of Microfinance Institutions in Rwanda (AMIR) held a meeting with National Bank of Rwanda (BNR) on April 2, 2014, conveying the industry's overall concerns about rigid regulatory framework and making a request for reconsidering certain regulatory measures imposed upon the microfinance industry at large, both microfinance banks (MFBs) and non-bank microfinance institutions (NB MFIs). BNR instructed AMIR to conduct a review of the current laws and regulations, and come up with recommendation for changes to be considered.

AFR agreed to sponsor this project, titled "Improving Regulatory Environment for MFBs and NB MFIs." The underlying purpose is to enhance access to finance and financial inclusion, particularly for the underprivileged people of Rwanda.

The project has been carried out in two phases. Phase I focused on MFBs and Phase II on NB MFIs. This report covers two separate reports for these two phases.

i. Defining Microfinance

Microfinance is a word that has evolved over time and thus implies various meanings to different people. Rwanda's Establishing the Organization of Microfinance Activities Law (No. 40/2008) defines microfinance as follows:

> *Activities that are characterized by at least one of the following operations:*
>
> a. *Extending loans to a clientele that is not able to have access to loans offered by the banks;*
>
> b. *Accepting saving deposits from a clientele not usually served by banks and ordinary financial institutions;*

c. Extending loans or accepting saving deposits from a clientele not usually served by banks and ordinary financial institutions.

In 2010, the Basel Committee on Banking Supervision (BCBS) issued a paper that documents "Microfinance Activities and Core Principles for Effective Banking Supervision" (hereinafter called "BCBS Core Principles on MF"). This paper was issued to aid the supervision of all deposit-taking institutions, including banks and non-bank depository institutions, which are engaged in microfinance activities. "BCBS Core Principles on MF" provides the following definition of microfinance:

> *The provision of financial services in limited amounts to low-income persons and small, informal businesses.*

BCBS has issued this paper because microfinance *is increasingly being offered by a variety of formal financial institutions, including banks and non-banks, either as their core business or part of a diversified portfolio.*

Meanwhile, the Consultative Group to Assist the Poor (CGAP), an arm of World Bank, synthesized these definitions in their 2012 publication "A Guide to Regulation and Supervision of Microfinance – Consensus Guidelines" ("CGAP Guide on MF") with the following definition:

> *The provision of formal financial services to poor and low-income people and those systemically excluded from the formal financial system.*

Microfinance is broader than microcredit or microlending: it generally also includes microsavings, microinsurance, and affordable remittances. Therefore, the microfinance institution has similarly been defined in a various ways.

According to both "BCBS Core Principles on MF" and "CGAP Guide on MF," the term MFI refers to any formal entity, registered or licensed, that is engaged in microfinance activities, whether it is a bank, a finance company, a finance cooperative or a non-government organization (NGO).

Rwanda's Law on Microfinance uses the following definition:

> *Any organization that exercises microfinance activities regardless of its legal status, including savings and credit cooperatives.*

Literally, MFI should include banks in Rwanda. However, in reality, MFI means a non-bank MFI in Rwanda. Any institution that carries a word "bank" is not considered an MFI, thus not subject to the Law on Microfinance.

For the purpose of this report, therefore, three different words are used to distinguish their differences as defined in the Glossary: MFI for all types of microfinance institutions, MFB for microfinance banks, and NB MFI for all other MFIs other than MFBs.

ii. The Impact of Microfinance

The official use of the word "microfinance" dates back to 40 some years ago. However, the practices of microfinance began when human beings started using monetary currencies, not excluding informal financial services that were carried out among neighbors in villages.

In this context, microfinance has been a longstanding part of human life, particularly for those with low incomes and small businesses almost everywhere in the world.

Yet microcredit's impact is controversial. It was widely known for its significant economic impact for a few decades, but its effect was strongly challenged in the aftermath of suicide cases in India several years ago, attributed primarily to high interest rates and harsh collection practices. Later, people realized a hidden risk behind these incidents: over-indebtedness. The "Microfinance Banana Skins" report, a regular report on risks for the microfinance industry, identified over-indebtedness as the greatest threat to the industry in 2012 and 2014, two publications in a row.

Despite some challenges issued specifically against the effect of microcredit, it is generally accepted overall that microfinance is beneficial to low-income workers and small businesses, improving their access to finance and financial inclusion.

One of "CGAP's Key Principles of Microfinance" well summarizes the impact of microfinance:

> *Microfinance is a powerful instrument against poverty. Access to sustainable financial services enables the poor to increase incomes, build assets, and reduce their vulnerability to external shocks. Microfinance allows poor households to move from everyday survival to planning for the future, investing in better nutrition, improved living conditions, and children's health and education*

Moreover, in contrast to the situation a decade ago, most stakeholders involved in microfinance now appreciate that the poor, like the rest of us, need a variety of basic financial services, not just credit.

In this context, the ability of the market to respond to this demand depends not only on providers developing sustainable and affordable ways to provide such services, but also on having an enabling policy and regulatory environment.

Therefore, it is critical to establish an appropriate regulation framework on financial service providers in bringing to poor and low-income people the financial services they need.

iii. Global Standards on Regulatory Frameworks for MF

In general, most regulators of financial institutions, including MFIs, take the position of ensuring financial stability. In this context, it is difficult for the regulators to take a position of promoting a particular industry or a sector. This type of promotion could render significant downside risk: a conflict of interest between financial stability and product promotion.

As a result, usually a department or unit of the government is mandated to develop policies and programs to support supervisory approaches to enhancing access to finance and financial inclusion.

Supervision plays a significant role in empowering and regulating the MFI industry. Over-regulation, however, may result in repression, limiting the efficiency of financial intermediation and eventually increasing costs for consumers. The growing research and literature on microfinance regulation highlight the importance of a clear regulatory framework to support sustainable microfinance, and call attention to some important considerations especially regarding timing and phasing.

Regulation of microfinance can be a double-edged sword. When properly conceived and implemented, laws and supervisory structures can provide the stability, predictability, and support that MFIs need to thrive and that are necessary to protect the savings of the poor. However, inappropriate systems – those that are not adapted to or aligned with the local realities of the microfinance industry – will not foster MFI growth.

The Basel Committee of Banking Supervision (BCBS) is the global standard setting body on bank supervision. In 1997, BCBS, in cooperation with supervisors from member and nonmember countries and other international standard-setting bodies (SSBs), identified "25 Core Principles for Effective Banking Supervision" that set forth the de facto standard in banking regulation. The principles were revised in 2006 to reflect important changes in banking regulation worldwide, and again in 2012 to address post-crisis lessons.

BCBS issued "Microfinance Activities and Core Principles on Effective Banking Supervision" in 2010, hereinafter called "Core Principles on MF," which documents standards to be applied to financial institutions, banks or not, that are engaged in microfinance. Based on global, industry-wide collaboration through the Microfinance Workstream task force of the BCBS, these principles were devised to assist countries in developing a coherent approach to regulating and supervising microfinance. It was developed on the basis of the 2006 "Core Principles on Effective Banking Supervision." It indicates the importance of the need to adjust the application of "Core Principles on Effective Banking Supervision" if a regulated institution, particularly deposit-taking institution, is engaged in microfinance – whether it is a bank, a non-bank finance company, or a financial cooperative.

The Microfinance Workstream is working on an updated version of "Core Principles on MF" based on the 2012 version and the current proposed revisions highlight the *principle of proportionality*.

These "Core Principles on MF" clearly explain that among "25 Core Principles on Effective Banking Supervision" a certain number of Principles are universally applicable (Principles 1, 4, 5, 12, 24 and 25), but most of them require adjustments to financial institutions engaged in microfinance activities.

A summary of key points included in these "Core Principles on MF" is as follows:

1. Core Principles that apply to institutions engaged in microfinance are:
    a. Principle 1 (Objectives, independence, powers, transparency and cooperation),
    b. Principle 4 (Transfer of significant ownership),
    c. Principle 5 (Major acquisitions).
    d. Principle 12 (Country and transfer risk);

   e. Principle 24 (Consolidated supervision); and
   f. Principle 25 (Home-host relationships).

   Principles 12, 24 and 25 may not have wide implication to MFIs.

2. All other Core Principles require a tailored approach in their implementation compared to conventional retail banking.
3. The Core Principles are applicable to all deposit-taking MFIs, whether banks or non-banks.
4. These Core Principles on MF highlight the key differences between the application of each Core Principle to conventional retail banking and microfinance in banks and nonbanks, pointing out areas that may require tailoring.
5. Four recommendations for regulatory authorities to implement the Core Principles are:
   a. Allocate supervisory resources efficiently, especially where depository microfinance does not necessarily represent a large portion of the financial system but rather comprises a large number of small institutions;
   b. Develop specialized knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly microlending;
   c. Recognize proven control and managerial practices that may differ from conventional retail banking but may suit the microfinance business both in small and large institutions, specialized or not in microfinance;
   d. Clarify regulations in regard to microfinance activities, particularly the definition of microcredit, and specify which activities are permitted to different institutional types while retaining some level of flexibility to deal with individual cases.
6. A clear regulatory definition of microcredit distinguishing it from other loan types is necessary for adequate oversight of credit risk. It is particularly true that the regulators need to know the characteristics of heavily labor-intensive microlending methodologies to maintain an appropriate degree of flexibility to assess asset quality and risk. Appropriate loan documentation for microlending is a good example.
7. Differences between microfinance and commercial banking should be understood and considered when assessing risk management processes and techniques. Specifically regarding MFIs, the loan portfolio is their

primary asset so supervisors should particularly focus on credit risk and should have specialized knowledge of the labor-intensive microlending methodology.

8. Provisioning and reserves for microloans should be tailored rather than grouped with other loan categories.
9. Both bank and non-bank MFIs should be subject to regulation and supervision commensurate to the type, complexity, and size of their transactions. The need to protect depositor funds should be harmonized with the need to enhance access to financial services. This would require increasing public confidence in microfinance providers, improving their operational standards, and setting a level playing field for both banks and non-banks. However, compliance with prudential rules and other requirements can be costly for both supervised institutions and supervisors, in relation to the risks posed by this line of business. Thus, microfinance oversight, whether over banks or non-bank MFIs, should weigh the risks posed by this line of business against the supervisory efforts necessary to monitor and control those risks versus the role of microfinance in fostering financial inclusion. This calls for a coherent regulatory and supervisory approach, tailored to the unique features of microfinance as compared with conventional retail banking, in particular the distinctiveness of microlending and microfinance institutions.
10. Microfinance activities that banks and NB MFIs are permitted to conduct should be clearly defined in regulations, including the array of products permitted, such as microsavings and perhaps other products such as microinsurance. Of particular importance is the definition of microcredit, which may include loan amount, term, frequency of payments, underwriting methodology, and other criteria.

Consultative Group to Assist the Poor (CGAP) is an arm of World Bank that is mandated to provide consultant assistance for the microfinance industry in helping the poor people around the world. Their primary work is publishing guidelines, brief notes, position papers, and research papers on various topics that pertain to the microfinance industry. In other words, it is the de facto authority on microfinance.

CGAP published "A Guide to Regulation and Supervision of Microfinance" as consensus guidelines in 2012. This Guide was published for the purpose of providing clarity for supervisors developing country-appropriate supervisory frameworks for the microfinance industry. It was developed in tandem with an update to the "BCBS Core Principles on MF" and includes guidance on many specific issues that supplement the "BCBS Core Principles on MF."

The following is the summary of key points for general principles included in this Guide:

1. To craft and enforce appropriate regulation with a financial inclusion objective, regulators need to understand the distinctive characteristics of microfinance, including clients and their needs, products and services, and the institutions providing them.
2. Problems often arise due to inadequate coordination among financial regulators and other government agencies whose responsibilities may affect institutions delivering microfinance.
3. Regulation creates costs for both the regulated institutions and the supervisor. These costs should be *proportionate* to the risks involved.
4. To the extent possible, regulation should aim to be *institution-neutral* (supporting an activity-based regulatory approach), both to create a level playing field that fosters competition and to reduce risk of regulatory arbitrage.
5. In creating new windows for microfinance, regulators need to be alert to the possibility of *regulatory arbitrage*. Some countries create special microfinance windows with one sort of activity in mind, and then they are surprised to find that the window is also being used for other activities that the regulators might not have been so keen to promote.

Of particular interest is the guidance for adjustments to prudential standards for microfinance.

1. Some prudential norms developed for conventional banking don't fit well with the risks and requirements of microfinance, which involves different products and services.
2. Many of the adjustments relate to distinctive features of microlending, reflecting the fact that microfinance differs from conventional banking more on the credit side than on the deposit side.
3. There are strong arguments and recent experiences that support the imposition of higher capital adequacy standards for specialized depository MFIs than for banks.
4. A microloan portfolio should not be limited to a specified percentage of the lender's equity nor burdened with a high general provision

requirement simply because the loans are not conventionally collateralized.

5. Excepting special circumstances, performing microloans should have the same provision requirement as other loan categories that are not particularly risky. However, the provisioning schedule for delinquent microloans that are uncollateralized should be more aggressive than the provisioning schedule for secured bank loans.
6. Boards of deposit-taking MFIs should be independent of management and should include members with experience in finance and banking, as well as members who understand clients well.
7. Specialized MFIs may need higher, rather than lower, liquidity requirements.
8. MFIs should not borrow or transact in foreign currency without having the capacity to assess and manage currency risk.
9. Given the size of microloans and the nature of the borrowers, loan documentation requirements need to be lighter for microcredit than for conventional bank lending.
10. The content and frequency of reports should enable supervisors to conduct the analyses needed for effective supervision of a depository MFI. However, regulation must also consider the circumstances of its supervised institutions, which may not be able to comply with some requirements applicable to banks.
11. Regulation—including any proposed new regulation that provides for depository microfinance—should clearly define the types of permissible activities in which a prudentially regulated institution may engage.

These two documents are excellent sources that will help form a regulatory and supervisory framework that is sufficiently conducive to the MF industry.

iv. The Rwandan Context

In Rwanda, the MFI industry consists of two segments: microfinance banks (MFBs) and non-bank MFIs.

MFBs are licensed by law with the minimum capital of RWF 1.5 billion, which is lower than minimum capital requirements for other types of banks: RWF 5 billion for commercial banks and RWF 3 billion for development banks. Other than minimum capital requirement, there are no other distinctions. MFBs are supervised by the Director of Bank Supervision and subject to various regulations pertaining to all institutions that carry the word "bank." CAMELS rating is applied to all without any consideration or adjustment for microfinance banks, at least in appearance.

NB MFIs consist of four categories as described in the Microfinance Law, which are briefly summarized as follows:

a. Category 1: information MFIs. No need for a license, but required to register with the local administrative cells.

b. Category 2: SACCOs with deposits of less than RWF 20 million. Only one office allowed. Minimum capital of RWF 5 million.

c. Category 3: Deposits of more than RWF 20 million. The entity could be corporation, limited liability company, or savings and credit cooperative as a licensed MFI. Equity investment allowed up to 15% of net worth or 20% of the invested entity, whichever is lower, not exceeding 40% of the net worth. Minimum equity ratio of 15% and minimum capital of RWF 300 million.

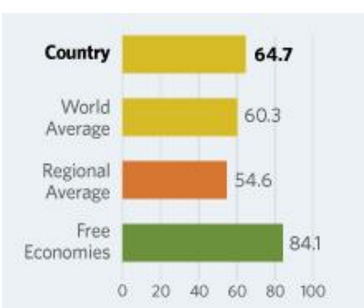
d. Category 4: Credit-only MFI. No deposit taking from the public. An LLC or limited company.

NB MFIs, except Category 1, are under the supervision of the Director of Microfinance at BNR, subject to microfinance law and regulation.

Overall, Rwanda's regulatory framework for microfinance seems reasonably well established. But compared to neighboring countries, particularly Kenya and Uganda, it has room for improvement as explained further below.

Let us begin with an overall business environment for Rwanda.

Economic Freedom Index



The Heritage Foundation, in partnership with *The Wall Street Journal*, issued the 2014 "Index of Economic Freedom." In this report, Rwanda's freedom score was 64.7, ranking its economy in 65th place as most free. Its score is 0.6 points better than last year, reflecting improvements in the management of government spending, business freedom, and labor freedom. Rwanda's score exceeds the world average and is ranked 4th out of 46 countries in the Sub-Saharan Africa region, behind

Mauritius, Botswana and Cape Verde. Rwanda's score of 64.7 compares favorably to Uganda's 59.9 and Kenya's 57.1.

Over the index's 20-year history, Rwanda's economic freedom score has improved by 26.4 points, the fifth largest increase of any country. Demonstrating score improvements in nine of the 10 economic freedoms, Rwanda has advanced from the economic repression it experienced 20 years ago to a "moderately free" economy today.

Nonetheless, substantial challenges remain, particularly in implementing deeper institutional and systemic reforms that are critical to strengthening the foundations of economic freedom. While security is more stable, the absence of a well-functioning legal system undermines property protection rights as well as efforts to eradicate corruption, according to the report.

The report revealed that the financial sector is small but growing. Despite progress, the high costs of financing and limited access to credit remain serious challenges for entrepreneurs.

Business Environment for Microfinance

While Rwanda's overall economic freedom rank was better than Kenya and Uganda as stated above, its business environment for microfinance lagged behind the two countries.

In the *The Economist*'s 2013 global microscope on the microfinance business environment, Rwanda's overall ranking was 22nd out of 55 countries, significantly behind Kenya (5th) and Uganda (8th). Moreover, Rwanda's ranking declined by five places from 17th in 2012, while Kenya remained unchanged and Uganda showed an improvement of six places.

This overall ranking is comprised of sub-rankings of regulatory and supporting institutional frameworks, with consideration for political stability.

Rwanda's regulatory framework was ranked 10th, behind Kenya (3rd) and Uganda (5th). Its supporting institutional framework, at 28th, fell short to Kenya's 8th as well, while ahead of Uganda's 34th. The political stability of these three countries were ranked as follows: Rwanda at 30th, Kenya at 44th, and Uganda at 20th.

Rwanda's overall regulatory framework was favorable with the 10th rank, but it is noteworthy that regulatory framework for MF deposit-taking and supervisory capacity were ranked only neutral. In these areas, Rwanda trailed neighboring countries Kenya and Uganda, indicating room for improvement.

This somewhat favorable rank in regulatory framework was weighed down by Rwanda's lack of accounting transparency and lack of client protection – particularly transparency in pricing, both of which were rated weak.

The following page features a table that shows the rankings of all 55 countries. In light of the external perspective on Rwanda's regulatory framework, a further study has been conducted separately for MFBs (Part I) and NB MFIs (Part II).

Overall microfinance business environment rankings

Weighted sum of category scores (0-100 where 100=most favourable)

Rank	Country	2013 Score	Change
1	Peru	82.5	+2.7
2	Bolivia	69.8	-2.0
3	Pakistan	69.7	+2.3
4	Philippines	67.9	+4.6
5	Kenya	61.1	-1.7
6	Cambodia	60.3	+4.6
7	Colombia	58.5	+2.5
=8	El Salvador	53.8	-2.5
=8	Uganda	53.8	+2.2
10	Dominican Republic	53.6	+7.5
=11	Panama	53.5	-0.1
=11	Paraguay	53.5	+1.5
13	Ghana	53.3	+2.3
14	Nicaragua	52.9	+9.0
15	Azerbaijan	52.4	+14.0
16	India	52.0	+6.3
17	Uruguay	51.5	+7.3
18	Mexico	51.1	-2.5
19	Chile	49.9	-1.9
20	Brazil	49.1	-0.1
21	Mongolia	48.9	+4.7
22	Rwanda	48.4	-0.2
23	Ecuador	48.3	-4.3
24	Nigeria	48.2	+4.8
25	Tanzania	47.9	+1.4
26	Armenia	47.4	-
27	Honduras	47.2	+0.9
28	Indonesia	46.5	+2.2
29	Bosnia and Herzegovina	45.2	-0.1
30	Mozambique	44.0	-
31	Georgia	43.4	+9.7
32	Costa Rica	42.1	+2.4
33	Guatemala	41.4	-
34	China	39.1	+4.7
35	Morocco	38.3	+4.6
36	Tajikistan	36.0	-0.3
37	Madagascar	35.9	-
38	Kyrgyz Republic	35.1	-7.0
39	Senegal	34.4	+0.3
40	Lebanon	33.3	-0.2
41	Bangladesh	32.8	-
42	Jamaica	31.8	+0.3
43	Cameroon	31.7	+0.1
44	Yemen	31.0	+0.6
45	Argentina	28.8	-
46	Dem. Rep. of Congo	28.4	-0.1
47	Nepal	28.3	-3.0
48	Thailand	27.6	+2.2
49	Egypt	27.3	-0.1
=50	Trinidad and Tobago	26.5	+2.4
=50	Sri Lanka	26.5	-1.7
=50	Turkey	26.5	-0.1
53	Venezuela	26.1	+0.9
54	Haiti	25.8	-3.3
55	Vietnam	25.6	+4.1

VII. Part I: Microfinance Banks (MFBs)

As explained earlier, other than the difference in minimum capital requirement, MFBs are subject to all laws and regulations devised for commercial and development banks.

Permitted activities for MFBs are not explicitly specified or documented, thus, MFBs can technically be engaged in all activities that commercial banks are permitted to do. Informally, however, MFBs have been instructed not to engage in international correspondent banking and operations.

History of MFBs

Initially licensed as a commercial bank in 2006, UOB was licensed as the first Rwandan MFB in 2007. After the license was issued in 2006, the BNR raised the minimum capital for all banks to RWF 5 billion. After UOB shareholders appealed that microfinance in Rwanda would not require such a high level of capital, the BNR established another category for MFBs, with a lower capital requirement of RWF 1.5 billion.

UOB was the only MFB until 2010, when two local non-bank MFIs were licensed: Unguka Bank and Agaseke Bank. They began operating as MFBs in 2011. Later in 2013, a greenfield microfinance bank was licensed as well. Named AB Bank, a subsidiary of Access Microfinance Holdings headquartered in Berlin, Germany, this latest entrant rendered a total of four MFBs currently operating in Rwanda.

MFB is a bank

Like all banks, MFBs would be subject to risks of public concern that justify government supervision by the central banking authority, including:

- Bank runs and liquidity crises caused by loss of public confidence.
- Negative externalities (contagion) of other bank failures and a possible systemic collapse.
- Vulnerability to market failures caused by asymmetries of information by both the bank in terms of the creditworthiness of its borrowers, and the bank's customers in terms of the bank's soundness.

Though it appears the central bank would prudentially regulate MFBs, a question remains: "What special characteristics of microfinance banks might justify adjustments in the way the BNR carries out its regulatory responsibilities?" In light of global standards for institutions engaged in microfinance activities – "BCBS Core Principles on MF" and "CGAP Guide on Regulation and Supervision of MF" discussed above – this inquiry is clearly valid.

MFB is also an MFI

A case study from Harvard University, "Microfinance Development in Kenya" by Jay K. Rosengard, Ashok S. Rai, Aleke Dondo, and Henry O. Oketch (2000), examining an NGO-turned-microfinance bank in Kenya identifies six key features of MFBs that might warrant adjustments to the application of bank regulations and supervisory guidelines. These are as follows:

1. *Client Base*: Borrowers are low-income entrepreneurs working in the informal sector, rather than those running traditional, registered businesses.
2. *Lending Methodology*: Loan decisions are based on character and backed by little if any conventional collateral, rather than the result of sophisticated analysis of financial statements supported by pledges of formal security.
3. *Cost of Lending*: Transaction costs of lending are relatively high, somewhere between traditional bank lending and informal credit markets.
4. *Loan Portfolio Composition*: Credit is comprised of a high volume of small, short-term loans with strong geographic concentrations, in contrast to a standard retail banking loan portfolio profile.
5. *Funding Base*: Deposits are largely from community-based savers, rather than from highly mobile and somewhat speculative short-term investors.
6. *Structure and Governance*: Bringing banking services to a widely dispersed, relatively remote clientele usually results in a decentralized structure and weak institutional infrastructure, rather than the centralized structure and bureaucratic governance of most retail branch banking.

The BNR's addressing of these distinctive traits can be accomplished in a variety of ways, such as general philosophy, regulatory and supervisory principles, and practical implementation. For example, the adaptation could be made to the six components of the BNR's CAMELS bank oversight rating: capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk. These will be discussed more in detail later in this report.

While a bank is indeed a bank, whether small or big, simple or complex, some adaptations of current practices might be necessary for the BNR to fulfill its mission without incurring exorbitant costs itself or imposing unreasonable burdens on MFBs. The guiding principle should be flexibility, not leniency. In other words, the BNR should identify different but equally rigorous criteria and standards for measuring a common performance objective. Without these adjustments, MFBs face challenges in their operations.

i. Issues for MFBs in Rwanda

To identify the challenges that MFBs face in their operations, a total of six stakeholders have been interviewed who are directly or indirectly involved in MFB operations. These stakeholders included MDs/CEOs of all four MFBs, as well as a couple of other stakeholders who are well experienced in Rwandan microfinance. The issues raised were listed in the order of significance, from most to least significant, as measured by frequency. A detailed analysis of each issue follows this summary table.

Issues Raised	Frequency
Pressure to lower the interest rate to an unsustainable level	6
Pressure to lower Loan-to-Deposit Ratio to 80%	6
Unreasonable level of bank supervision fee without regard for the nature of MF	5
Inconsistency in regulatory guideline	3
Reporting burden	3
Dual membership cost for trade association	2
Heavy compliance cost	2
Insider lending exposure	1
Cost compared to PSP agents	1

iii. Research and Analyses

To validate if these issues are legitimate and to see how serious they are, an extensive research has been conducted for an analysis purpose. The following discusses each topic based on external data, guidelines and practices.

Interest Rate

MFB Claim: MFBs have claimed that they have received persistent pressure to lower their lending interest rates based on average banking industry lending rates. Commercial banks, which make up more than 75% of the banking industry, charge lower interest rates than MFBs on smaller loans. Even if commercial banks charge higher rates on smaller loans, similar to the profile of loans that MFBs make, they represent only a fraction of their portfolio and their high rates are not reflected in their average pricing.

It is of paramount importance that MFBs, like all other types of financial institutions, operate with self-sufficiency and reasonable profitability that satisfies investor expectations and thus provides capital for future growth. Otherwise, they can hardly become sustainable enterprises.

One of "CGAP's Key Principles of Microfinance" reads:

> *Financial sustainability is necessary to reach significant numbers of poor people. Most poor people are not able to access financial services because of the lack of strong retail financial intermediaries. Building financially sustainable institutions is not an end in itself. It is the only way to reach significant scale and impact far beyond what donor agencies can fund. Sustainability is the ability of a microfinance provider to cover all of its costs. It allows the continued operation of the microfinance provider and the ongoing provision of financial services to the poor. Achieving financial sustainability means reducing transaction costs, offering better products and services that meet client needs, and finding new ways to reach the unbanked poor.*

The World Bank views that improving access to basic financial services for low-income producers is an important ingredient of its efforts to promote economic growth and reduce poverty. It emphasizes a market-driven approach in which the sustainability of financial intermediaries becomes paramount.

Interest income from a loan portfolio is normally the major income source for any financial institution. It is even more so for microfinance banks mainly because MFBs have limited sources of other income, such as fee income from FX, operations or financial transactions, compared to commercial banks.

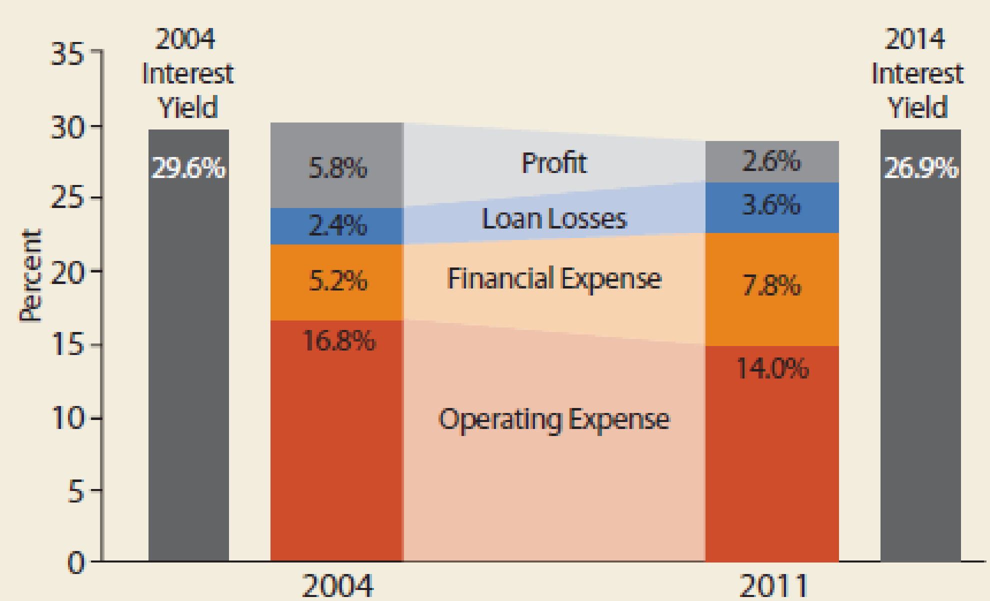
Thus, the regulator should ensure that MFIs recover their operating expenses sufficiently through sources of income that are derived from their normal course of operations. Surely, the supervisor should monitor closely if an MFI is at or close to an optimal level of operating efficiency, but the MFI's income source should not be arbitrarily restricted.

The most common way of putting these restrictions is capping the maximum interest rate that an MFI can charge on its loans and/or pressuring the MFI to lower the interest rate, formally or informally, to an unsustainable level without convincing evidence.

CGAP's Guide documents that it usually results in adverse effects to cap the MFI's interest rates.

Unlike commercial banks, MFI's most significant component of its cost structure is operating expenses. Operating expenses account for more than 50% of total costs, and it is not uncommon to see this percentage climb up to 75%. One can easily imagine that it would be more costly to make 1,000 loans of RWF 100,000 than just one RWF 100 million loan. If an MFI is engaged in group lending, the percentage of operating expenses to total costs will be even higher.

Drivers of Interest Yields, as % of Yield, 2004–2011



Note: All data as percentage of average GLP, weighted by GLP.

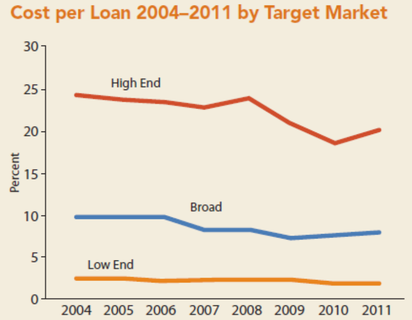
CGAP conducted a survey and published a report documenting microcredit interest rates and their determinants in June 2013. This report covered a period from 2004 to 2011. The table above shows the composition of cost structure on an average of all MFIs surveyed, numbering more than 6,000 MFIs of all types scattered around the globe.

This table shows that operating expenses accounted for 52% of interest yield in 2011, down from 56.7% in 2004 but still significant factor in total costs. Also noteworthy is that MFIs tend to use more borrowed funds to finance their loan portfolio than their counterparts in commercial banking. In 2011, financial expenses were 7.8% of the average yield of 26.9%, or 29% of the total, a significant factor.

The following lists key observations on the component of operating expenses:

1. Operating costs are the largest determinant of interest rate levels.
2. The decline of average operating expenses (i.e. improvement in efficiency) has slowed recently, though trends differ by region.
3. Operating costs as a percentage of interest rate levels have remained flat over the past few years. It could be the bottoming out of the learning curve.
4. Cost per dollar outstanding is the prevalent measure of operating efficiency, but it can be very misleading in terms of measuring effectiveness at controlling costs if used to compare different microlenders.
5. Average loan size trends do not support a hypothesis of mission drift in commercialized microlenders: over the observed period, average loan sizes dropped much more among for-profit microlenders and regulated microlenders than among non-profit and unregulated microlenders.
7. Not surprisingly, low-end microborrowers have considerably less access to savings services than high-end microlenders.

Cost per Loan 2004–2011 by Target Market



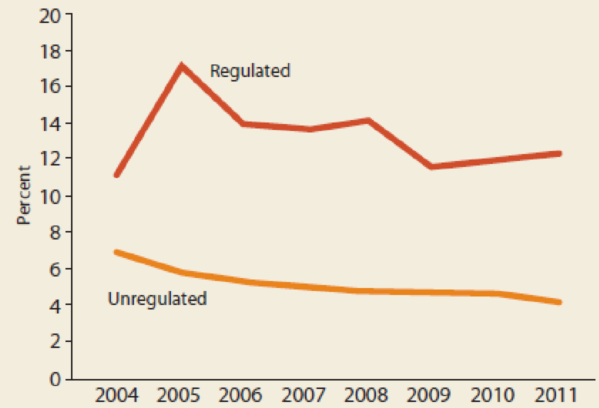
Note: Operating costs/number of active loans averaged over the year and expressed as % of per capita gross national income.

The graph on the left illustrates the average operating cost per loan in percentage. Broadly, it averages around 10%, but it could be in the range of 20-25% at high end.

Thus, if a regulator caps the maximum interest rate or pressures MFIs to lower the interest rate to an unsustainable level, they will tend to shy away from making small loans and end up neglecting the low end of the economic pyramid. If this happens, the government's goal to enhance the financial inclusion and access to finance will naturally fail to materialize, but quietly.

If an MFI is regulated, its cost will be higher than that of an unregulated institution. The graph to the right also shows the higher cost per loan for regulated MFIs compared to unregulated MFIs.

Cost per Loan by Regulatory Status, 2004–2011



Note: Operating costs/number of active loans averaged over the year and expressed as % of per capita gross national income.

Let us take a look at some examples in other countries.

In the liberalization process, interest rates were fully deregulated in Bolivia and Mexico, but not in Colombia. Many regulatory authorities retain interest rate caps today, under the compelling argument that poor people should not have to pay more than the rich. However, it does not fully factor how much return a micro enterprise with the microloan can generate with the micro loans borrowed and how much more it costs MFIs to service small loans. Also, this argument ignores the fact that "access matters more than cost of funding" in the microenterprise world.

In Bolivia, when microfinance began in the early 1990s, interest rates were high – around 80 percent per year on average. The competition resulting from the entry of new players and the growth of the microfinance industry has now pushed interest rates down to levels between 22 and 30 percent. This drop in interest rates took place without regulatory pressure from the banking authorities and without unsustainable subsidization of interest rates by the public sector.

In Colombia, by contrast, interest rate caps have caused microfinance institutions to hide charges as fees, reducing pricing transparency to the customer. This lack of pricing transparency is not only damaging to microfinance customers, but it hinders competitors from entering the market. More important, they have kept NGOs from joining the financial mainstream as a means of avoiding interest rate controls. In short, interest rate restrictions have retarded the growth of microfinance in Colombia.

Another example: *The Economist* writes that in Senegal the lowering of interest-rate caps in 2014 could limit the growth of small and medium MFIs. The rate cap for MFIs will be reduced from 27% to 24%. Not all MFIs respect the current 27% limit due to high costs of operation in challenging areas, and small and medium MFIs will face difficulties operating at the 24% cap.

Group Loans

Known as village banking, community banking, trust group, or solidarity group, microcredit can be based on a group-lending model. Being a methodology usually employed for very poor clients, it involves payment frequencies that are weekly or bi-weekly, thus causing loan officers to visit and meet with the groups more often than individual loans. These frequent meetings naturally cause a high level of operating costs, time, and transportation costs, to say the least. Without being adequately covered by appropriate income, MFIs making group loans will have to phase out of this group lending, thus leaving the poor people unserved. Some countries, mostly in low-income countries, have regulatory provisions for group microcredit methodologies applied by banks or other MFIs. In such cases, existing lending limits are either not applicable or higher than for individual loans. A few countries have developed supervisory programs that deal specifically with group lending. (There was only one MFB that was engaged in group lending as of this report. There was one additional MFB that was considering group lending once its system is put in place.)

In theory, interest rate caps could be set at a level that permits sustainable microfinance operations while eliminating excessive profits. But achieving that balance can be politically difficult for the government agency that has to identify (and implicitly sanction) a particular rate. Most people do not understand why tiny loans require high interest rates, so it tends to shock the public conscience when MFIs are allowed to charge very high rates to poor borrowers. Furthermore, there may not be one interest rate that makes all MFIs sustainable.

It is noteworthy that, even in the absence of interest rate controls, rates have been dropping in most microcredit markets over time, as illustrated in the CGAP report on interest rate determinants.

In summary, it is not considered prudent to pressure MFBs to lower their interest rates without looking into their optimal cost structure, solely on the basis of the average of the industry-lending rate, which is predominately determined by commercial banks.

"CGAP Guide on MF" points out that interest rate caps can restrict access by making it impossible to serve small or remote borrowers. It also points out that it may be politically difficult to set a cap that is high enough to cover the unavoidable costs of microlending and a profit margin high enough to attract capital to low-income financial services.

Here is CGAP's 7th Key Principle of Microfinance:

> *Interest rate ceilings can damage poor people's access to financial services. It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs, and their growth and sustainability will be limited by the scarce and uncertain supply of subsidized funding. When governments regulate interest rates, they usually set them at levels too low to permit sustainable microcredit. At the same time, microlenders should not pass on operational inefficiencies to clients in the form of prices (interest rates and other fees) that are far higher than they need to be.*

A reasonable alternative to interest rate caps is effective disclosure combined with steps to help consumers understand the product and pricing. This—together with additional efforts to publish comparative prices among lenders—has served in some markets to bring down interest rates, spurring more effective competition among MFIs and other financial service providers.

Loan-to-Deposit Ratio

MFB Claim: MFBs have claimed that it is unfair and inappropriate that the BNR expects MFBs to comply with the so-called industry best practice guideline of 80% loan-to-deposit ratio. This claim is based on an argument that it is common for an MFI to use borrowed funds to finance part of its loan portfolio, in addition to deposits. Also, many MFIs have institutional or international NGO shareholders that are willing to lend money in the form of a debt to finance loan portfolio growth.

Loan-to-Deposit Ratio, or LTD Ratio, is one of the most frequently used tools used by bankers and investment analysts to measure a financial institution's liquidity.

When banks used solely deposits for their lending, it was a prudent practice that the use of deposits for loans was limited to 70-75%. Over time, however, the financial market has changed. The development of capital markets facilitated the availability of alternative borrowed funds to financial institutions. The use of alternate debt financing for loan portfolio has naturally resulted in a higher loan-to-deposit ratio for the entire industry. Thus, it has become imprudent to use the LTD ratio as a reliable indicator of liquidity, but to use it as a baseline followed by more in-depth analysis to understand the true liquidity of an institution.

A practical way of using the LTD ratio is as follows:

- If the LTD ratio is higher than a certain benchmark, say 80%, then it is considered relatively high. But, it should not be viewed as the de factor indicator of liquidity.
- It should be reviewed along with other liquidity indicators, such as liquidity ratio, a legitimate regulatory tool. In other words, if an institution shows a high LTD ratio, but maintains a high level of liquidity ratio, then the institution's liquidity position should be considered adequate and normal despite a seemingly high LTD ratio.
- Also, if an institution with a higher LTD ratio maintains ample lines of credit committed to drawing at any time, it is a significant mitigating factor of the seemingly high LTD ratio.
- Also, if an institution maintains a high LTD ratio, its loan asset mix and deposit mix should be analyzed more closely. For example, a short duration of loans is a plus factor, as is a stable deposit mix.

The following table illustrates several characteristics of 64 financially self-sufficient MFIs. One is use of external funds as a percentage of loan portfolio, indicated in the far right column. Banks engaged in MF showed 167%, more than twice as high as the so-called best practice guideline of 80%.

Table 1. Selected Characteristics of 64 Financially Self-sufficient MFIs (In %)

Organizational formats	*Capital/assets*	*Operating self-sufficiency*	*Dollar average loan*	*Depth**	*External funds/ loans F*
Bank	21.0	118.6	527	62.5	166.6
Non-bank	27.4	110.4	958	62.4	70.3
Credit union	42.1	122.5	1,306	91.6	88.6
NGO	58.5	130.8	490	38.8	26.6

* Depth = Average loan balance per borrower/GNP per capita.

F External funds/loans = Borrowed funds @ commercial rates/average loan portfolio.

Source: The MicroBanking Bulletin, Issue No. 6 (April 2001), Tables C and D.

It is a common practice that MFIs use borrowed funds to finance their loan portfolio. Thus, their LTD ratios tend to be greater than 80%, frequently exceeding 100%, while they maintain an adequate liquidity position. But, in this case, the loans that are financed by borrowed funds should be subtracted from the loan portfolio to calculate the institution's effective loan-to-deposit ratio, comparing the deposit level against the loans that are financed by deposits.

This pressure for MFBs to lower the LTR ratio to 80% seems inconsistent with the "transformation ratio" allowed for and applied to NB MFIs in which all capital resources, including capital, borrowed funds, subsidies and deposits, may be transformed into loans up to 80%. (Microfinance Regulation Article 61)

An inquiry to a Senior Policy Advisor at CGAP, Tim Lyman, who co-authored "CGAP's Guide on MF" and also serves the Microfinance Workstream at BCBS, said that he has not seen any similar cases in other countries, stating it was "odd and very rare."

Supervision Fee

MFB Claim: MFBs have claimed that it is unfair for the BNR to charge MFBs in the same manner as commercial banks without consideration for unique characteristics of microfinance activities.

It takes costs to supervise financial institutions. So it is only natural that a supervisory authority collects fees from those being regulated. The question is how much is adequate to cover costs without creating excessive burden on the supervised institutions.

"BCBS Core Principles on MF" and "CGAP Guide on MF" are both silent on this topic. And no empirical data has been found.

But, one argument for MFBs can hardly be ignored.

As both documents point out and as discussed earlier in this report, it is true that microlending needs proportionally higher operating costs than commercial lending. This translates to an argument that it is not fair to MFBs to be charged the supervision fee solely based on the revenues without considering the proportionally higher level of operating expenses that were spent to generate such revenues. In other words, relatively higher interest rates must be charged on microloans to recover the proportionally higher operating expenses, but the supervision fee is levied on all banks regardless of the cost structure.

An adjustment is necessary to avoid this inequity based on the common spirit of the BCBS's Principles and the CGAP's Guide that regulation and supervision should be applied *proportionally* to the type, size and capacity of the MFIs. The remaining question is how to define the eligible MFIs to benefit from presumably lower supervision fee or a uniquely designed fee schedule. This discussion is covered in the Recommendations section later in this report.

Inconsistency in Supervisory Guidance

MFB Claim: MFBs claim that they have experienced inconsistency and lack of clarity in supervisory guidance in several situations.

Analysis indicates that this claim centers on the fact that the BNR has no regulatory framework that is applicable to MFBs. An-depth discussion of this topic is also included in the Recommendations section later in this report.

Reporting Requirement

MFB Claim: MFBs claim that the BNR's reporting requirements are burdensome and excessive. Some claim that the BNR does not ever review them for any constructive purpose. This claim was louder with the reporting requirement on group loans.

Principle 21 of "BCBS Core Principles on MF" clearly suggests that a reporting requirement for MFIs should be tailored in a manner that is commensurate with the type and size of their transactions. This applies to banks engaged in microfinance as well. The intent is to uphold requirements that do not unduly increase costs of microfinance activities in both institutional types.

CGAP's Guide also points out that the content and frequency of reports should enable supervisors to conduct the analyses needed for effective supervision of a depository MFI. However, regulations must also consider the circumstances of its supervised institutions, which may not be able to comply with some requirements applicable to banks.

Reporting to a supervisor can add substantially to the administrative costs of an intermediary, especially one that specializes in very small transactions. In addition, some requirements may not be feasible—for instance, transportation and communication conditions can sometimes make daily reporting virtually impossible. It is a common practice in many countries that such reporting requirements are simpler for depository MFIs and microfinance programs than for conventional retail banking operations.

Compliance Costs

MFB Claim: MFBs claimed that the compliance costs have risen to be a burden to the bank's operational sustainability. No quantitative data has been made available.

It is important to consider the benefits versus the costs associated with establishing and implementing a regulatory framework for microfinance. Regulation and supervision entail costs, not only for the regulator but also for the regulated institution. For instance, BancoSol's (in Bolivia) management estimates that complying with the bank superintendency's reporting requirements during its first year of operations generated a cost equivalent to 5% of the loan portfolio, even though this had subsequently declined over time.

One MFB in Rwanda claimed that the bank's overhead doubled over the past three years mainly because of greater compliance costs.

It is inevitable that MFIs have to upgrade their organizational capacity to a higher level to be called a "bank." The question is "To what extent should MFBs be required to comply with the standards for commercial banks?" and "How soon?" The timing is more for those NB MFIs transform into MFBs from NB MFIs. In this case, it is necessary for a regulator to assess an institution's capacity and willingness to comply with the requirement within a reasonable grace period, established in advance before a license is issued.

Insider lending

MFB Claim: Banking regulations limit the insider lending three ways; one borrower limit at 5%, staff loans at 15%, and all insider loans at 25%. To a certain MFB, this is an unreasonable burden to comply with because of its previous ownership history. It was more an isolated case.

An issue raised by one of the MFBs was related to the maximum exposure for all insider lending, including loans to directors, management, staff and shareholders. This case pertains more to loans to shareholders, rather than anything else.

CGAP's Guide maintains a position that insider lending should not be allowed except certain welfare loans to staff, except for MFIs that are cooperatively owned.

The analysis indicates that this case has become problematic because the insider lending included all loans to shareholders.

If a bank is a publicly owned entity, it would be an ideal situation that a shareholder also becomes a client because he or she will be loyal to the bank.

It appears to be somewhat unusual to include all loans to all shareholders as insider loans. What matters to the supervisor should be an excessive lending to major shareholders with concessionary terms, thereby possibly threatening the safety of depositor funds, not loans made to small shareholders.

It is recommended considering the re-definition of insider loan: to exclude loans to small shareholders who owns less than 5% for example, as long as the loans are made in line with the general terms and conditions applicable to other borrowers of similar qualification. This way, this institution may not be in violation of the regulation while not compromising its relationships with these shareholder clients.

Loans that help insiders purchase shares in an MFI raise both conflict of interest and capitalization issues. Some countries prohibit such lending, or allow it only if the capital/asset ratio is above a specified percentage. This is not considered a desirable practice.

Dual Schemes for Branchless Banking between Bank Agents and Payment Service Provider Agents

MFB Claim: One MFB claims it is unfair that banks have to obtain approval for all agents and have to pay a fee for each agent, while payment service *providers (MNOs) can easily expand their agent network. This dual framework creates competitive disadvantage for banks that want to promote rural outreach through more aggressive agent network development.*

The claim seems to bear merit in terms of unfairness between the payment service provider agents and bank agents, while their functions are pretty much identical.

Branchless banking is believed to hold the promise of significantly expanding financial access by lowering transaction costs for the lender and improving convenience for the customer, according to "CGAP Guide on MF."

This topic is an enormous one that requires an in-depth study to effectively implement it, but here are a few points that are included in CGAP's Guide, which are relevant to this particular claim:

1. A suitable regulatory framework for branchless banking should include (i) conditions for banks' and nonbanks' use of agents or other third parties as a customer interface; (ii) a flexible, risk-based AML/CFT regime; (iii) a clear regulatory regime for nonbanks to issue electronically stored value; (iv) consumer protection tailored to the branchless context; and (v) payments system regulation that allows (at least in the long term) broad interoperability and interconnection.
2. Limitations on the nature and qualifications of agents and other third parties need to be crafted carefully to avoid limiting outreach to target clients.
3. Regulation should be clear about the financial service provider's liability for the acts of its third-party contractors.
4. Nonbank e-money issuers should be subject to appropriate regulation and supervision, including liquidity and solvency-related requirements.
5. Regulation of access to payment systems needs to balance promotion of competition against the risk of discouraging innovation.

It is recommended that the BNR consider finding a way to reconcile these differences between two types of agents to create a level playing field.

iii. General Regulatory Recommendations

MF helps enhance access to finance and financial inclusion. Rwanda achieved a remarkable improvement in financial inclusion over the 2008 – 2012 period from 48% to 72%. As Rwanda plans to improve *formal financial inclusion* significantly further over the next three years, from 40% to 80%, as reported in the Newtimes in conjunction with the Financial Inclusion Global Summit that took place in Kigali in July 2014, it is necessary to improve the regulatory framework for formal financial institutions engaged in microfinance activities while continuing to help formalize informal financial institutions.

Microfinance Definition

The current legislative definition of microfinance needs to be expanded and clarified. MF is currently confined to lending and savings that are not serviced by banks and ordinary financial institutions. It is unclear what ordinary financial institutions represent. Also, the current definition ignores the fact that even some banks are engaged in microfinance activities based on the industry definition. Moreover, microfinance now includes other financial services, beyond credit and savings, such as microinsurance and remittances.

As the BCBS's core Principles and the CGAP's Guide both clearly point out, microcredit needs to be more accurately and specifically defined to avoid confusion. Furthermore, the definition of MFI needs to be clarified more in line with the global industry definition.

In this context, all types of financial institutions, whether banks, finance companies or even financial cooperatives, should be considered MFIs, if their primary business activities are *microfinance activities* as defined by the BNR with further clarity.

For example, the CGAP's Guide explains that an African banking regulator requires that microloans represent at least 70% of the loan portfolio of deposit-taking MFIs. This percentage may be adjusted to whatever is deemed reasonable.

Here is another example for an MFB. To illustrate how these entities may be defined, a microfinance bank in a South Asian country is defined as a "deposit-taking institution regulated separately from commercial banks with different standards for licensing and supervision, whose principal business is to provide microfinancing and related banking services to the poor and underserved segment of the society." In this country, at least 80% of the total portfolio of microfinance banks must consist of loans that do not exceed US $1,800.

Permissible Activities

Once microfinance is defined, its permissible activities should also be clearly articulated, particularly for prudentially regulated institutions.

Regulation may permit certain institutions to engage only in lending and deposit-taking (or initially only lending, with deposit-taking being permitted later subject to supervisory approval). Other institutions may be allowed to provide money transfer or foreign exchange services. Limitations on permitted activities will significantly affect prudential requirements, including in particular capital and liquidity rules. Regulation may also limit an institution's scope of activities by defining and restricting the concept of "microcredit."

Managers of newly licensed MFIs may not have much experience with managing the full range of banking activities and risks (e.g., retail savings delivery and asset and liability management). Permission to engage in sophisticated activities usually should be based on management capacity and institutional experience. For instance, depository microfinance providers may be well-equipped to serve as microinsurance agents, but are unlikely to be well-positioned to underwrite insurance risk.

Regulation by Activity

Since MF activities may be carried out by all types of institutions–from financial cooperatives to non-bank financial companies to microfinance banks even to commercial banks–it is important to create a supervisory framework that oversees microfinance activities in a manner that is neutral to the type of institution.

The CGAP's Guide suggests "regulation and supervision by activity" rather than "by type of institution." This way, a level playing field is established for all those who wish to engage in microfinance. The following are excerpts from "CGAP Guide on MF:"

> *To advance financial inclusion while promoting a level playing field, similar activities should be subject as much as possible to*

similar regulation, regardless of the institution being regulated. The ability to regulate activities similarly will depend on both the specific regulatory issue being addressed as well as how the different institutions are regulated (i.e., under one or many laws) and supervised (i.e., by one or many regulators). There are various approaches. Under a "functional" approach, supervision is determined by activity. A unified or "integrated" approach combines prudential and non-prudential regulation and supervision under one roof. The "twin peaks" approach uses separate structures for prudential and non-prudential issues. In many countries that use a unified or twin-peaks approach, non-depository institutions fall outside of the supervisory regime.

It is well established that any financial institution that wants to engage in insurance needs to obtain a separate license from an insurance-governing body and consequently, to be subject to all regulations for insurance activities.

By the same token, any financial institution that wants to engage in microfinance needs to obtain a separate license or permit before it begins engaging in MF, regardless of the type of financial institution. This way, the regulatory authority can pre-screen the institution's readiness and capacity in microfinance in advance. So long as this institution participates in microfinance, such activities will be subject to regular supervision by microfinance specialists in addition to the standard supervision for the institution type.

An example: if a commercial bank wants to begin offering microfinance, it needs to obtain a permit in advance. Once received, this microfinance activity would be subject to on-going supervision from microfinance specialists, as well as the CAMELS rating for its general commercial banking activities.

Rewards for Financial Inclusion Activity

Since MFIs help enhance the beneficial social goal of financial inclusion, they deserve incentives. Regulation should promote microfinance activities through enabling institutions that offer microfinance, thus helping the country work toward better access to finance.

For this to be feasible, a clear policy needs to be established as to what microfinance activities play a role in financial inclusion, and how those engaged in these activities should receive benefits at the government level.

Again, these rewards should be applied based on the defined activities, regardless of the types of institutions. Such incentives and benefits could include tax benefits, allocation of public funds at low cost, public recognition, etc. Another example: the government may offer favorable transaction tax treatment based on the type of activity, regardless of the nature of the institution and whether it is prudentially licensed or not. [*More in-depth study is necessary for this project and is beyond the scope of this project.]*

Proportionality: An improved regulatory framework needs to maintain balance between financial stability and proportional supervision– commensurate with the type, capacity, and size of the institutions, as emphasized by both the BCBS's core principles and the CGAP's Guide. It is costly to supervise financial institutions for both the supervisory authority and the financial institutions.

iv. CAMELS Rating Recommendations

CAMELS rating is used primarily for commercial banks. As the BCBS's core principles suggest, these rating components be adjusted proportionally to MFBs. Here is the list of suggestions made to consider in making adjustments to each of the CAMELS rating components in light of the issues identified.

Capital Adequacy

Currently, the BNR requires a relatively high level of capital from all banks at 15%. This level of capital is deemed to provide adequate cushion for volatility in microfinance activity and subsequent capital erosion. However, if the current capital requirement changes to be lower according to the Basel II/III, MFIs–whether MFBs or NB MFIs–should be required to maintain a higher level than that of commercial banks. The microfinance market can be much more volatile than traditional banking markets, and there are many examples of loan portfolios that have deteriorated with alarming speed when there were significant changes in the external environment or internal systems began to break down.

Asset Quality

This component can be discussed in a few topics since it is one of the greatest differences to note between commercial and microfinance banking. Practically speaking, many individual loans being made by MFBs mimic SME loans being provided by commercial banks. So this section focuses more on the differences between group lending and individual lending being made by commercial banks.

Underwriting: Underwriting for group lending is completely different from commercial loan underwriting. The typical 5 C's or RAMPS (repayment sources, amount, maturity, purpose, secondary source of repayment) approaches cannot be applied to group loans. This is mainly because group loans are based on the self-selection of members, self-governance of members and social guarantee, none of which is applicable to commercial or individual loans. An uneducated bank examiner, for instance, may criticize an institution offering group lending with a comment that it is made without proper analysis of individual group members.

Additionally, the alternate source of repayment for group loans is partially social guarantee and partially group savings taken as group collateral. Microinsurance coverage for credit life could also be the alternate source of repayment.

Loan Documentation: The BCBS's core principles and the CGAP's Guide are both clear on this point. Based on the principle of proportionality, loan documentation requirements should be adjusted.

Past Due Status: For commercial banks, the primary ratio that the bank supervisors watch is non-performing loans (NPLs). NPLs are loans past due longer than 90 days. Since most of commercial loans are structured with monthly payment schedule, 90 days past due loans would have missed three payments. But if a group loan in microfinance is structured with a weekly payment schedule, in 90 days, the loans would have missed 12 payments. In other words, it is far too late to take action on NPLs as defined by the regulatory and supervisory guideline for past due loans, particularly group loans. Thus, the guidelines specified for the microfinance regulation of portfolio at risk (PAR) or any other relevant industry terminology should be used to monitor and evaluate the performance of microcredit portfolio, banks and NB MFIs alike.

Collateral Coverage: Because of the nature of microfinance loans, many may not be adequately collateralized. In particular, group loans are completely unsecured although among members they may collect collateral formally or informally. Therefore, there should be a separate guideline used for different types of microcredits, again regardless of the type of financial institutions.

Loan Loss Provisioning: Since the risks of microcredits vary significantly from those of commercial loans, loan loss provisioning should also be different. The provisioning should be appropriately established based on the institution's risk profile and the type of microcredit it extends.

Write-off: Since group loans have shorter maturity and more frequent payment schedules, the write-off requirement should also be properly established. The write-off requirement should be shorter than commercial or individual loans that are structured with monthly payment schedule.

Management

Personnel: Many central banks have mandatory organizational structures and staffing requirements that are inappropriate for microfinance banks. These tend to be overly complex, highly centralized, and bureaucratic structures, while a key to the success of microfinance banks is organizational and operational simplicity to maximize the quality of service to their customers and ensure the financial viability of their bank. Based on the principle of proportionality, the BNR should require a minimal organizational structure that separates key functions for internal control, but not require overly complex organizational structures or top-heavy staffing regimes for MFBs.

Reporting Requirements: The same holds true for reporting requirements as discussed earlier. Standard statistical reports are usually designed for banks with a wide variety of sophisticated services, while most microfinance banks offer a limited range of simple products. Thus, many reporting categories either do not apply to MFBs, or are irrelevant for ensuring the quality of a MFB's management. The BNR's reporting requirements for microfinance banks should cover the same basic categories as those provided by commercial banks, but adapted to the products and operations of microfinance banks. Loan documentation requirements should also be simplified, given the high volume and small value of individual microfinance loans.

Earnings

If microfinance banks are free to set their interest rates to cover all costs (funds, operations, losses), then standard indicators of profitability such as return on assets and return on equity should also be appropriate for microfinance banks. The BNR should allow all institutions engaging in regulation-defined microfinance activities to set their interest rates at levels sufficient to ensure financial viability and long-term sustainability, and then measure profitability as it would for any other bank. Too much profitability from microfinance activities and any operating inefficiency should also be challenged.

Liquidity

Microfinance banks that are not part of a larger commercial bank may face challenges in asset-liability management, especially regarding exposure to a relatively high level of seasonal liquidity risk. These stand-alone microfinance banks normally have no immediately accessible "lifeline" of liquidity credit. Moreover, loss of savings for the low-income clientele of microfinance banks is calamitous for poor families in the absence of any publicly-funded social safety net.

At a minimum, MFBs should be subject to the same reserve and liquidity requirements as commercial banks. The BNR might also consider making these requirements even more stringent for MFBs, given their relatively greater exposure to liquidity risk and their more limited access to possible sources of quick liquidity injections. This is entirely within the BNR's critical responsibility to protect savings mobilized from the public at large.

However, as discussed before, it is not considered prudent to require MFBs to bring down and maintain the loan-to-deposit ratio to the so-called industry best practice guideline of 80% as they may finance a significant portion of their loan portfolio with borrowed funds.

Sensitivity to Market Risk

Microfinance activities normally involve minimum market risks. But, microfinance banks may be exposed to FX exposure if they depend heavily on foreign currency-denominated debts to finance their loan growth. This FX exposure is tightly controlled by the BNR's net FX exposure limit of 10% of capital in either a long or short position.

MFIs should not borrow or transact in foreign currency without having the capacity to assess and manage currency risk. The BNR's usual proper and fit test for the senior management should be applied to MFBs that want to borrow debt denominated in foreign currency.

Microfinance activities may also be subject to interest rate risk if there is a significant mismatch in interest rate types between assets and liabilities. But typically a short duration of loan assets minimizes this exposure.

v. Broader Industry Recommendations

Stakeholders raised a few other issues unrelated to an improved regulatory framework. The two below deserve discussion.

Trade Association Membership

There are two issues in this topic. The first is the dual membership that MFBs maintain, the Rwanda Bankers Association (RBA) and Association of Microfinance Institutions of Rwanda (AMIR). Having neither the size nor the resources, MFBs are almost required to maintain both memberships. They pay the highest fee schedule at AMIR and pay the same fees as commercial banks.

Two possible recommendations to address this issue:

1. For the RBA, secure a collective AMIR or MFB membership for one fee. Delegate a representative of MFBs to attend the meeting and then circulate the issues discussed and actions taken. This representative may be rotated among the MFBs. In this proposal, MFBs may be able to reduce their membership fee to 25% without losing the benefit of the membership. MFBs may also opt to be a full-fledged member if they so choose.
2. The RBA adjusts the membership fee structure to be more in line with global standards and practices. Bankers trade associations commonly run on resources provided by members. For example, the Kenya Bankers Association has a membership fee structure as follows:
    a. One third of the annual budget is composed of equal contributions from all members. It represents the basic membership fee.

b. Another third of the annual budget is composed of contributions from all members, but scaled according to the assets of member banks. This is dependent on their resources.
c. The last third of the annual budget is calculated based on the member's number of employees. This factors in the magnitude of the membership's beneficiaries.

Adoptions of these reforms would enable RBA membership to be not only voluntary but also to have a more equitable fee structure.

Over-indebtedness

There is no simple, commonly accepted definition of the term "over-indebtedness." Some associate it with borrowers who can't repay their loans. Others would include borrowers who can repay, but only at the expense of sacrificing basic household consumption needs. Clients with multiple outstanding loans are not necessarily over-indebted, although this behavior is statistically correlated with higher delinquency in most of the empirical studies to date.

As the supply of MF credits continues to increase and the types of the suppliers continue to diversify, MF clients worldwide have easier and better access to financing. Easy access to abundant capital could naturally result in over-indebtedness. In July 2014, the Centre for the Study of Financial Innovation (CSFI) published its 18-month cycle "Microfinance Banana Skins" report. Unchanged from the 2012 publication, the greatest concern of more than 300 MF regulators, investors, practitioners, and scholars in 70 countries was, again, over-indebtedness. This was selected among 19 risks that the industry specialists have identified in the MF industry.

Those who are over-indebted have the potential to ruin their financial and family lives. If this over-indebtedness occurs to the poor, the consequences are significantly worse, and many times disastrous: they can easily un-do any prior economic development, struggling and suffering once more in chronic poverty.

It is the general consensus that many MFIs are conducting their business without clear strategy to cope with this potentially disastrous phenomenon.

It is strongly suggested that the BNR and other MF stakeholders take all necessary preventive measures to detect, identify, and mitigate the causes of over-indebtedness.

VIII. Part II: Non-Bank Microfinance Institutions (NB MFIs)

In addition to MFBs, Rwanda's microfinance institutions are largely comprised of informal savings groups, financial savings and credit cooperatives (SACCOs), and finance companies. As discussed earlier in this report, the Rwandan Law on Microfinance categorizes them as follows:

a. Category 1: Informal MFIs. No need for a license, but required to register with their local administrative cells.

b. Category 2: SACCOs with deposits of less than RWF 20 million. Only one office is allowed, and minimum capital of RWF 5 million is required. Often, several SACCOs form a union, or a growing SACCO establishes a union to effectively create its branches as different SACCOs. The union then functions as a head office or a platform for external transactions on behalf of the member SACCOs.

c. Category 3: Deposits of more than RWF 20 million. The entity could be corporation, limited liability company, or savings and credit cooperative as a licensed MFI. Equity investment is allowed up to 15% of net worth or 20% of the invested entity, whichever is lower, so long as it does not exceed 40% of net worth. The minimum equity ratio is 15%, and the minimum capital required is RWF 300 million. The majority of significant MFIs in Rwanda fall into this category.

d. Category 4: Credit-only MFI. No deposit taking from the public is permitted, and it can be an LLC or limited company. Formerly, there was one MFI that belonged to this category, but it was converted into Category 3 MFI in 2013.

With the exception of Category 1, NB MFIs are under the supervision of the Director of Microfinance at BNR, and are subject to microfinance law and regulation. Category 1 is excluded from discussion in this report.

If an MFI is a SACCO, it is also subject to the laws and regulations that govern the SACCOs, regardless of the size and complexity of the institution, thus complicating the regulatory supervision.

i. NB MFIs Issues

To identify what issues NB MFIs may face during regulatory supervision, AMIR was consulted to select a certain number of MFIs to interview. AMIR selected eight MFIs accordingly, and the consultant subsequently interviewed all the selected subjects.

The interview consisted of several questions, including those that required ratings from 1 to 5. The ratings were described as follows:

- Rating 1 Completely unsatisfactory; needs significant change.
- Rating 2 Generally unsatisfactory; needs change.
- Rating 3 Partially satisfactory; some need for improvement.
- Rating 4 Generally satisfactory; areas for minor improvement.
- Rating 5 Excellent; no need for improvements.

The following table summarizes three primary questions from the interviews:

Questions MFIs	A	B	C	D	E	F	G	H	Total	Avg.
What is your rating of the current regulatory framework, such as MF law and regulations? (1 being the lowest and 5 being the highest)	4	3	4	4	5	3	4	3	30	3.75
What is your rating of the approval process for branches and/or new product and services?	3	2	4	5	4	4	4	4	30	3.75
What is your rating of the supervisory procedures and processes currently put in place?	4	2	4	3	4	4	4	4	29	3.625

As indicated in the table, interviewees overall expressed satisfactory experiences with the regulatory and supervisory body of BNR. In general, they commended the BNR for their regulatory framework, their availability, and their guidance.

The participating MFIs assigned an average of 3.75 to the current regulatory and supervisory framework, with a consistent ratings distribution among all MFIs. This suggests an overall satisfaction, with need for some minor changes.

Looking at the second question, the participating MFIs assigned also an average of 3.75 to the current regulatory and supervisory approval process. Although the rating is the same as the overall regulatory framework, the distribution of the ratings was somewhat skewed because one institution assigned a 2 rating, but this appears to be an isolated case.

As for the last question, participating MFIs assigned an average of 3.625 to current supervisory procedures, such as on-site or off-site supervisory meetings. Despite being slightly lower than the previous two questions, this rating is also fairly strong.

However, interviewees requested that the BNR address a few issues to make the regulatory environment more conducive to the MFI industry. The following summarizes these findings, voiced mostly by MDs/CEOs:

Issues Raised	Frequency
Access to the Payment System	8
Stop-Lending Notice	5
Clarification on Definition of Microfinance	3
Collateral Registration and Recovery Issues	3
Regulation on Insider Lending	2
Reporting Templates	2

Access to the payment system was the one issue that every interviewee claimed needed improvement. However, each interviewee addressed the issue from a few different perspectives. There are other issues, but none are as complex as the issue of access to the payment system.

The next section will thus describe each of the issues raised from the interviews as well as research-based analyses, with a heavy emphasis on access to the payment system.

ii. Research and Analyses

Extensive research has been conducted for the purpose of validating the legitimacy and seriousness of these issues. The following discusses each topic based on external data, guidelines, and practices.

Access to the Payment System

MFI Claim: NB MFIs interviewed had a variety of issues with this claim. Some talked about access to check clearing; others talked about access to mobile banking. One MFI specifically talked about access to ATM networks. But the strongest complaint was about not being able to receive salary payments directly. Most claims were addressed from the standpoint of competitive disadvantage, institutional reputation, and operational inefficiency, which will be elaborated on below.

Rwanda's current payment system works with the BNR at the center: the BNR recently launched the Rwanda Integrated Payment Processing System, or RIPPS. RIPPS includes Automated Clearing House (ACH), Real Time Gross Settlement (RTGS) and Central Securities Depository (CSD).

While ACH handles high volume retail payments, RTGS handles high value and time sensitive payments, in real time. CSD, on the other hand, handles all securities transactions, including the storage of financial instruments.

Primarily, ACH is the system most applicable to NB MFIs, due to the fact that NB MFIs mostly handle retail transactions with small amounts. Even for NB MFIs, access to the payment system is complex, but can be categorized into the following components:

1. Checks
2. Cards
3. Interbank payments
4. Mobile payments

<u>1. Checks</u>:

There are two aspects to checks: issuance and collection.

Issuance: A few MFIs indicated their plans to issue checks once they were allowed access to the check clearing system. When asked how many clients of their institutions would want their checks, however, most revealed that the number would not be significant. It seems that the primary reasons for wanting to issue checks were to bolster institutional reputation and competitiveness against commercial banks.

It is apparent that most MFIs underestimate the costs and overestimate the benefits of issuing checks. The costs of fraud have been historically substantial, and this risk remains high to this day. Upon successful implementation, the BNR-led effort to standardize checks, truncate physical checks, and exchange digital images instead would reduce the fraud cases. However, any institution that wants to issue checks must make significant initial capital investments and bear operating costs.

Collection: Currently, a few MFIs receive checks from their clients and deposit them with their banks for collection. One MFI claimed that in the past two weeks alone, it lost two of its best clients to a competing bank because it did not have direct access to check clearing. This particular MFI issues checks through its correspondent banks, and it identified its lost clients based on the amounts and payees of issued checks. Commercial banks are likewise able to identify the size of MFI clients based on the check amounts and who the issuers are. This particular MFI, therefore, aims to become an MFB in two years, when it has hopefully built up its staff and institutional capacity. However, it would be beneficial to have access to check clearing at least for collection even before it becomes an MFB.

2. Cards

The world of card payments is also quite complex, but the following discussion will focus on three elements: a) types of cards, b) scope of card services and c) activities on cards.

a) Types of Cards

Credit Card: Allows the client to pay merchants for purchases by extending secured or unsecured credit. The credit card is fairly new in Rwanda and only offered by a few commercial banks. It is thus not applicable to NB MFIs in Rwanda.

Debit Card: Allows a client to access his or her account with an institution directly through instant electronic payments. The rest of discussion about cards will focus on debit cards.

b) Scope of Card Services

International: Rwanda's market currently offers VISA and MasterCard. The focus of NB MFIs is primarily on debit cards. But even to be able to issue international debit cards, they need a significant initial investment and sponsorship from a principal member. Thus, it is unrealistic to expect NB MFIs to achieve benefits that exceed overall costs.

Also, an MFI that wants to issue international debit cards will eventually have to comply with the international security standard, Payment Card Industry Data Security Standard (PCI DSS), a significant challenge for even commercial banks in Rwanda.

VISA has a national settlement center in Rwanda, which allows for settling transactions, including card and mobile payments. However, VISA's national settlement center can handle only VISA transactions.

An informal source revealed that MasterCard also plans to establish a national settlement center in Rwanda in the foreseeable future. This would facilitate further use of their electronic payment system in Rwanda.

Whether at an ATM or point of sale (POS), in order for MFIs to handle transactions both on-us (due from the card issuing institution) and off-us (due from institutions other than the issuing one), they would need a RIPPS settlement account with the BNR. A detailed solution for this is discussed in the recommendations section below.

Without a settlement account with the BNR, however, NB MFIs will still be able to handle on-us e-payment transactions through RSwitch. RSwitch is a payment switch in Rwanda. RSwitch is interoperable with all financial institutions that hold a RIPPS settlement with the BNR, but offers only a closed loop solution without interoperability with other financial institutions if an institution does not have the RIPPS settlement account.. This could be a limited alternative option for electronic payments.

Domestic: All financial institutions currently settle proprietary card transactions through RSwitch, which provides an interoperable e-payment solution under the brand name of Smart Cash. This is likely the most viable card solution for all NB MFIs that are interested in issuing debit cards to their clients. But the same challenge—a RIPPS settlement account with the

BNR—remains. Without a RIPPS settlement account, an MFI can handle only its own on-us transactions, quite a significant limitation.

c) Activities on Cards

Issuance: An institution that desires to expand its delivery channel usually considers ATMs or POS devices as the first channel for electronic payments. For both channels, a card is necessary to perform any transaction. Currently, NB MFIs can only issue cards through banks. In this case, clearing and settlements would then be made between the bank and an MFI. But if issuing banks require their bank names to be placed on these cards, it may create confusion about the identity of MFIs.

On the other hand, with a BNR settlement account, NB MFIs would also be able to issue proprietary cards to their clients without this identity confusion and to settle transactions directly through RSwitch.

Acquisition: An institution that desires to acquire transactions should purchase or lease ATMs and/or POS devices. This would enable acquisition of transactions from not only the institution's own clients but also clients of other institutions. With sufficient business volume, an institution may be able to make profit from this acquisition business, in addition to providing expanded access points for its own clients. But it would take substantial resources and technical competency to take this on, and there are only a few commercial banks in Rwanda that are active in the business of acquisition. Thus, this approach seems inappropriate and inapplicable to NB MFIs at present.

If RSwitch or any other switch chooses to run its own ATMs and/or POS network, it would be easier for an NB MFI to participate in this electronic card payment system. It is evident that it is becoming easier to perform POS transactions through mobile phones, which works with a small card reader connected to a phone. Currently, mobile POS transactions require smart phones, but technology is reportedly being developed to work with lower quality USSD phones.

3. Interbank Payments

Interbank payments can be made internationally or domestically. International ones should be based on global SWIFT (Society for Worldwide Interbank Financial Telecommunication), and for this to be possible, an institution is required to open a deposit account with an international money center bank, typically in New York, for settlement. It is extremely difficult even for banks to open this international account for various reasons. Thus, they are deemed inapplicable to NB MFIs, and the following discussion focuses on domestic interbank payments.

In Rwanda, all domestic interbank payments are made and settled through the BNR's RIPPS, specifically ACH for retail payments. Under this structure, NB MFIs can handle domestic interbank payments in two different ways: a) directly through RIPPS/ACH or b) indirectly through correspondent banks.

a) RIPPS

RIPPS is an electronic payment system that the BNR operates to clear all types of electronic payments, regardless of the amount, between financial institutions. To date, only banks are allowed to open RIPPS settlement accounts with the BNR and to participate in this payment system. In addition to opening a settlement account, an institution that desires to participate in the system has to develop an interface between its core banking system and the BNR, which would require a strong IT infrastructure and a competent staff to make this possible.

Reportedly, one SACCO MFI already has an account with BNR and is now being tested to access RIPPS directly for both payments and receipts. This may provide a framework for other MFIs to do so as well: further discussion is in the recommendations section below.

b) Correspondent Banks

NB MFIs maintain accounts with several commercial banks primarily for operational purposes. Through these accounts, NB MFIs can handle both outgoing and incoming interbank payments, but with different characteristics discussed below:

Outgoing Interbank Payments: These can be handled without direct participation in RIPPS and without having to disclose to their clients how such interbank payments are handled. Nevertheless, a certain type of inconvenience persists.

One NB MFI complained about the inconvenience that some of its clients suffer. These clients registered with the Rwanda Revenue Authority (RRA) as encouraged by the Rwandan government and as a result, had to open a redundant account with a commercial bank to make their tax payments. This was because the RRA prefers to receive payments from taxpayers electronically, and businesses have no way of making tax payments electronically at their NB MFIs at present. This case seems somewhat isolated and not as severe as other issues, but it remains a competitive disadvantage for the NB MFIs.

Incoming Interbank Payments: NB MFIs interviewed claimed this to be the most serious challenge. All NB MFIs interviewed make salary loans that are to be repaid with salaries. Thus, they require salaries to be directed to the borrower's account with the NB MFIs. For this purpose, they have to use commercial banks, giving rise to several issues summarized below:

- When funds are received, a client's salary often comingles with other salaries, particularly when the same employer sends multiple salaries to an NB MFI. This costs the NB MFI time and money to reconcile them.
- Almost every day, MFIs have to make physical trips to collect bank statements that provide supporting data for all incoming interbank payments. Moreover, such bank statements are often incomplete and inaccurate, worsening the reconciliation challenge discussed above.
- If incoming payments are processed late due to reconciliation issues, some loans go into default and cause disputes between the borrower and the NB MFIs. This creates reputational issues for NB MFIs, often resulting in the loss of clients. At the very least, MFIs have to reverse the late fee and default interest, causing additional work.

4. Mobile Payments

Mobile banking is relatively new in Rwanda, but rapidly expanding. An institution may establish its mobile payments system through one of three solutions: a) Institution-led Solution, b) Mobile Network Operator (MNO)-led Solution, or c) Switch-led Solution.

a) Institution-led Solution: For an institution to establish a mobile payment system on its own, it needs to purchase a software application and develop an interface with telecommunication companies. This solution is a closed-loop: it allows the institution's clients to perform transactions with the institution's other clients only. Moreover, it requires significant initial financial investment, a strong IT infrastructure, and a competent staff to offer a working mobile solution. Overall, it is not considered a viable option for NB MFIs.

This institution-led solution, however, may become a viable option if it takes the interoperable route. Currently, this interoperability may only be offered through mVISA, VISA's mobile banking solution for emerging markets.

There are two aspects to interoperability. One is interoperability for agents and the other is for MNOs. The former is made possible because mVISA operates a switch that allows participating institutions to clear and settle mutually on transactions made at each other's agents. In other words, an mVISA participating institution's clients can go to other participating institution's agents to perform transactions, and these transactions are then settled through mVISA's switch in Rwanda. At present, Bank of Kigali and UOB are a part of the mVISA network, with a few other banks also planning to join. The second aspect of interoperability, for MNOs, is made possible because mVISA has developed connectivity with all telecommunication companies. This allows transactions to take place between clients of different telecom companies.

An informal source indicated that RSwitch is also planning to offer interoperable mobile payment solutions to institutions in the near future. Furthermore, MasterCard is planning to introduce its own interoperable mobile payment solution for institutions as well. Once they are available, these two additional providers would offer more options and help to expedite interoperability. Further discussion continues below.

b) MNO-led Solution: An institution that desires to introduce its clients to mobile payments may partner with MNOs that offer mobile money services. All three major mobile network operators, MTN, Tigo, and Airtel, currently offer mobile money services. Techno Mobile is a new entrant to the telecom industry in Rwanda, but does not offer the mobile money service at present.

The MNOs establish and manage their own agents, which an institution's clients can use to perform financial transactions. The institution must choose one or more MNOs and develop a system that allows them to perform and settle transactions together. Despite having immediate access to a great number of agents, the financial institution neither has to make initial financial investments, nor maintain the system or the agents. This solution is typically the most viable option for smaller institutions.

This solution is not without drawbacks, however. They include:

- An institution's clients may send or receive money from those who may not be the clients of the institution, but it is a closed-loop for only clients of the MNO: in other words, the institution's clients are limited to performing transactions with only those who are within the MNO. This limitation may be resolved when the BNR secures interoperability among MNOs, tentatively scheduled for 2015.
- An institution has no control over the product features and functions of the MNO's mobile payment solution. Thus, an MNO's solution may not be customized to meet the unique needs of an institution.

c) Switch-led Solution: As briefly discussed above, institutions can offer interoperable mobile payment solutions to their clients in partnership with switches. Currently this is offered exclusively by mVISA, though it may potentially expand with RSwitch and MasterCard's mobile solution.

These switches are defined as the third party companies that offer clearing and settlement services for electronic payment transactions, in this case mobile payments. They also assist institutions in developing and marketing mobile payment services. Under this interoperable, institution-led solution, the institution is required to establish and maintain its agent network, but in compliance with the switch's brand and marketing standards to ensure consistency.

A new potential service that may be made available for NB MFIs is called a switch-led mobile solution. It is similar in most aspects to the interoperable, institution-led solution discussed above, but fundamentally different in one aspect. The institution-led solution requires the institutions to develop and own an agent network. However, under the switch-led solution, the switch is responsible for establishing and maintaining the agent network. Thus, an institution may just join the switch to provide the mobile payment services for its clients, at a fee.

According to an informal source, RSwitch is planning to offer these turnkey electronic payment services to smaller institutions, via both ATMs and mobile payments, as early as 2015. If this were made possible, institutions would be able to offer mobile payment services even without a RIPPS settlement account with the BNR: transactions would instead be settled through the switch's RIPPS settlement account.

Our research indicates that Kenya has recently allowed NB MFIs to access clearing functions through Kenya Bankers Association that accepted MFIs as associate members. (2013) In fact, the research has found that Kenya was the only country to do so, although the details on the exact functions allowed have not been made available. Many countries limit access to the payment system to banks only.

In light of Rwanda's overall propensity to be flexible and proactive with a legislative, regulatory, and supervisory framework that promotes financial inclusion, it is feasible that the BNR may consider taking a few actions without compromising on its prudential supervisory mission.

Stop-Lending Notice

MFI Claim: Five out of eight MFIs interviewed claimed that supervisory action has produced slight to significant adverse effects, such as rising defaults, excessive liquidity, and loss of good clients. If a rumor spreads that an institution has been stopped from lending, clients may not make agreed-upon payments. Frequently the institution's loan portfolio quality worsens, rather than improves, at least on a short term.

The BCBS and CGAP Guidelines both state that such stop-lending notices are not effective. In many situations, it causes a "borrower-run," compared to the "depositor-run" that occurs when a deposit-taking institution becomes known to fail or have liquidity problems. When an institution is known to have received a stop-lending notice from the central bank, even good borrowers stop making their loan payments and start looking for another institution.

The current Microfinance Regulation Article 61 describes the BNR's right on this issue as follows:

> *A loan with at least one installment in arrears for at least 365 days is deemed non-recoverable.*
>
> *This is also applicable to an overdraft or credit facility not reimbursed after 180 days. A loan considered non-recoverable shall be written off.*

> *When a microfinance institution has reached a rate of non-recoverable loans of 10%, it is no longer authorized to grant new loans and must focus its activities on recovering non-performing loans.*

According to this provision, the 10% rule is applicable to non-recoverable loans, not non-performing loans. This translates to a significant difference. If an institution's non-recoverable loans reach 10% of the total portfolio, it is a significant risk, compared to the lesser threat of non-performing loans reaching 10%. There may be a misunderstanding of this issue on part of NB MFIs, in which case, a general education may be required. If there is a misapplication of the provision on the BNR's part, this also should be corrected.

There is one point to clarify on this provision. If an NB MFI is served with this notice, it is required to stop granting *new* loans, not all loans. In this case, it would be necessary to define and clarify what new loans represent. In the microfinance, renewal loans are quite common due to their short maturity. These renewal loans should not be considered new loans; however, any increase in the amount of renewal loans may be considered to be new loans.

Scheduled Dialogue with Regulatory Supervisors

MFI Claim: Almost all MFIs expressed their satisfaction with the ready availability of BNR supervisory officials, as well as the quality of the guidance received from the BNR's on-site supervision or any special meetings held between institutions and supervisors. Several NB MFIs expressed their desire, however, that the BNR hold a regular, at least annual, meeting or forum. Regardless of whether it was held collectively or individually, such an event would allow NB MFIs to discuss any changes in laws or regulations, and new trends that may be relevant to the MFI industry.

One NB MFI said that they received an on-site examination in 2013 and previously in 2009 with no meeting in between. No communication from the supervisor appears to be a sign of comfort and satisfaction with the institution from the BNR's perspective; however, there is a possibility that this institution may face significant challenges later on if it fails to keep abreast with all changes in laws, regulations, and practices.

The request for regularly scheduled dialogue seems quite reasonable.

Clarification on Definition of Microfinance Clients

MFI Claim: Three out of eight MFIs interviewed requested clarification on the definition of microfinance clients. The way the current Law on Microfinance defines microfinance activities somewhat undermines the quality of MF clients. Also, microfinance activities include more than loans and savings.

The current law defines microfinance activities as one or more of the three activities as explained earlier: i.e. provision of loans, savings or loans/savings that are not readily available from banks or ordinary financial institutions. This definition must indeed be clarified, as discussed extensively above.

Article 9 of the microfinance law adds "Similar Activities and Services to the Public" to the list of potential MFI activities. The article reads:

> *Authorised microfinance institutions may perform the following activities accepted by the Central Bank:*
>
> *1. Delivery of remunerated services providing advice and training to members or clients;*
>
> *2. Microinsurance operations;*
>
> *3. Transfer of funds operations for client accounts made within the same institution or network;*
>
> *4. External transfer of funds operations, not denominated in foreign currency, with banks and other registered financial institutions;*
>
> *5. Purchase and sale of currencies;*

If these activities are permissible, the definition of microfinance activities should be expanded to include or refer to these activities as well.

Reporting Templates

MFI Claim: Two out of eight MFIs interviewed requested that the templates used for monthly reports be refined to suit all loan types. For example, the current reporting templates do not seem suitable for group loans, yet seven out of eight MFIs interviewed are currently providing group loans.

It seems unreasonable to require MFIs to report group loans according to a template designed primarily for individual loans. Either the report should be refined to accommodate all major types of loans, or a simplified format should be devised to alleviate the burden of reporting group loans.

Regulation on Insider Lending

MFI Claim: The current law and regulations seem to impose strict limitations on the insider lending limits.

Please refer to the discussion of this issue under the section for MFBs.

Cumbersome Process for Collateral Registration and Recovery

MFI Claim: The current cost for registering collateral is burdensome to the borrowers of small loans, mostly MF clients, and the recovery process is cumbersome. For example, the auction process is too long and costly, resulting in excessive burden to clients who are already in financial hardship.

This issue is not directly related to the regulatory and supervisory body of the BNR. Nonetheless, it is an important issue to NB MFIs. This topic is thus addressed below in the section, "Broader Industry Recommendations."

iii. General Regulatory Recommendations

Access to the Payment System

Access to the payment system is a complex issue and has multiple aspects to consider, in terms of costs and benefits. The following recommendations are made from the standpoint of promoting financial inclusion and access to finance for Rwandans, but without compromising on the BNR's prudential supervisory mandate.

In the context of enhancing financial inclusion, there is no doubt about the necessity to expand the window of payment system access to additional financial institutions such as NB MFIs. A nation's payment system, however, is critical to the nation's security and financial stability, and should be maintained with safety and soundness. It is essential, therefore, to expand access to the payment system only to the extent that such security and stability are not compromised. The access to payment system should thus be made available only to NB MFIs that meet a certain qualification criteria.

The qualifications that NB MFIs must meet should include the following:

- *Strong management and staff capacity*. At a minimum, NB MFIs that should be allowed to access the payment system should maintain the BNR's supervisory rating of "Satisfactory" or better. For this purpose, the BNR should pay attention to the management and staff capacity dealing with access to the payment system.
- *Strong MIS and data processing capacity*. This capacity pertains to the overall health of the payment system in Rwanda. The BNR should determine if an NB MFI is qualified based on the assessment of its IT and payment teams.
- *Strong IT infrastructure*. This capacity is necessary to ensure timely interface development and adequate maintenance. This qualification should be based on the assessment of the BNR's IT team.
- *Financial Strength*. Access to the payment system requires substantial financial investments and any interested NB MFI should have a minimum equity base to be able to absorb the financial investments and potential initial operating losses from accessing the payment system. The BNR should establish the minimum net worth at a reasonable level in light of the minimum capital requirement of Rwf1.5 billion for MFBs and Rwf300,000 for NB MFIs.

MFIs that meet the qualification thresholds and desire to access the payment system will be referred to as "Prepared MFIs" for the rest of this report. These Prepared MFIs should be allowed to open an RIPPS settlement account with the BNR, to be used for various purposes as described below:

Checks: Prepared MFIs should be allowed to deposit their client checks into RIPPS accounts for direct clearing and settlement with other banks. Issuance of checks should be limited to banks, including MFBs, in light of the high risks and costs, which require strong management competency and adequate infrastructure. Possible exceptions may be made available to certain NB MFIs for check issuance, if circumstances dictate, subject to the BNR's approval.

Cards: Prepared MFIs should be allowed to issue proprietary cards through RSwitch and settle on-us and off-us transactions through RSwitch, using their RIPPS settlement accounts with the BNR. However, it is still deemed premature and too costly for MFIs to issue international cards.

Prepared MFIs should also be allowed to install ATMs and handle both on-us and off-us transactions, as long as the MFIs demonstrate their competency in both IT/MIS systems and staff/management as discussed earlier.

If a switch is willing and able to offer a turnkey service to NB MFIs, it would be much easier for NB MFIs to implement this service for their clients, enhancing financial inclusion significantly.

Interbank Payments: Prepared MFIs should be allowed to receive the incoming payments directly from banks or other financial institutions through their RIPPS settlement accounts with the BNR. This requires an interface between MFIs and BNR on RIPPS, one reason why the MIS/IT capacity of NB MFIs should be an important factor for the BNR's approval. Initiating and sending payments through RIPPS may also be allowed once receiving functions work successfully and seamlessly.

Mobile Payments: Prepared MFIs should be allowed to introduce a mobile payment system, though again strongly subject to their MIS/IT and staff capacity. It is recommended that any Prepared MFI interested in offering mobile payments present to the BNR a cost-benefit analysis and a business plan that includes a plan for implementation.

It is recommended that Prepared MFIs be encouraged to pursue an interoperable solution, whether institution-led, MNO-led, or switch-led, for the purpose of achieving the government's goals and expediting financial inclusion.

Stop-Lending Notice

The current regulatory provision related to this issue seems reasonable, but it appears that there have been misunderstandings about this issue. Clarification through education and training would ensure clear understanding on the BNR's intent and practice.

Reporting Template

It is beyond the scope of this assignment to identify specific items in the reporting template to be refined or corrected. To do so, it is recommended that the BNR hold a meeting with the key stakeholders among NB MFIs to collect specific feedback. This would be a good opportunity for the regulatory supervisor and the regulated institutions to collaborate.

Definition of MF and MF Activities

Please refer to the recommendations made in the section for MFBs above. One clarification that may be added is the following sentence after the definition of microfinance activities:

> *Microfinance activities may also include the additional activities listed in Microfinance Law Article 9, subject to the Central Bank's approval on each activity.*

Scheduled Dialogue with NB MFIs:

This seems to be a low-hanging fruit for the BNR to implement. After the BNR identifies a group of target MFIs that require special attention by their size or complexity, it may plan to hold an annual workshop or forum where mutual dialogue may take place. The BNR could delegate the dialogue platform to AMIR for the MFIs that do not meet the threshold, requiring AMIR to write a report on the activities and outcome.

iv. Broader Industry Recommendations

Collateral Registration

This issue would require collaboration and coordination among the Rwanda Development Board and Ministry of Justice, but it is recommended that a specific guideline be established for microfinance loans that meet a certain criteria. The criteria for these microfinance activities are:

- All loans of RWF 5 million or lower, regardless of the loan-granting institution
- All loans made to specific government-supported growth industries, such as agriculture

Loans that meet these criteria may be subject to special process for collateral registration, recommended as follows:

- A simplified appraisal by an external appraiser as determined by institutions engaged in microfinance activities, as opposed to an appraiser from the RDB-approved list
- A nominal flat fee for notarization, regardless of the number of documents to be notarized. (E.g. RWF 1,000.)

Collateral Recovery Process

This issue has been raised in the past and is related to the entire financial services industry. The Rwandan government has been working hard to improve this collateral recovery process in many different ways. I trust the government's effort will continue, and no further recommendations are made in this report.

IX. Summary Tables of Major Claims and Recommendations

I. Microfinance Banks

Major Claims	Issues Raised/Observed	Recommendations
Pressure to lower the interest rates is unreasonable	• Since MFBs are treated as commercial banks, the interest rates are likewise compared to the industry average that is mainly derived from commercial banks. • This is regardless of the types of operations that result in different operating costs. • To be fair, equitable guidelines should be established and applied, in light of the type of operations. • This would require the application of the *principle of proportionality* and the *regulation by activity*.	• Once an institution is considered an MFI under the new definition, an average should be calculated out of the newly defined MFI industry, separate from the commercial banking industry. • Any MFI that charges higher interest rates than the MFI industry average should be given an opportunity to explain why its interest rate is higher than the MFI industry. • Any MFI whose interest rate is higher than the industry average without justifiable reasons should be requested to present a plan to take corrective actions and a target date for compliance.
Pressure to lower the loan-to-deposit ratio to 80% is inappropriate	• This issue creates a gap between supervisory guidelines for NB MFIs and MFBs • LTD ratio is not a supervisory guideline, but a treasury management guideline. • Even if it may be applicable to commercial banks, it is not appropriate to expect compliance from MFBs.	• It is recommended establishing a guideline for a maximum limit in converting defined sources of funding, including but not limited to deposits. This would be established in a similar manner to the transformation rate applied to NB MFIs. • If LTD ratio has to be used, then it should be used only as a preliminary screening tool for liquidity, and the final liquidity position should be evaluated and determined by the regulatory liquidity ratios. • One could alternatively calculate a more relevant LTD ratio after deducting all loans supported by loans and subsidies.
Supervision fee is burdensome and unfair to MFBs	• Currently, a set percentage is being applied to each bank's adjusted gross revenue of the previous year. • This uniform guideline creates a disadvantage for	Once an institution is identified as an MFI according to the new definition, it should be applied a different rate in light of its tendency to have a higher operating expense ratio.

	MFBs whose operating costs are proportionally higher than commercial banks and hence yield higher revenues. • The application of *regulation by activity* will allow all institutions engaged in microfinance to identify such operations. • An adjusted rate for supervision fees should be applied to the newly defined MF activities.	
Inconsistency in regulation	• The dual regulation for MFBs and NB MFIs is the foundation for inconsistency in regulation. • Actions must be taken to mitigate these differences.	• As recommended by the Basel Committee on Bank Supervision and the CGAP's Policy Committee, the BNR should implement the following fundamental changes: 1. Change from *regulation by type of institution* to *regulation by activity* 2. Application of the *principle of proportionality*.
Regulation by type of institution	• All MFBs are considered to be banks; thus, all laws and regulations are the same as those that are applicable to commercial banks. • The only regulatory difference between MFBs and commercial banks is the required capital size (RWF 1.5B for MFBs vs. RWF 5.0B for commercial banks). • Microfinance activities are quite different from commercial banking and require alternative consideration and treatment.	• Change the current approach to *regulation by activity*. • Treat all financial institutions that desire to engage in microfinance activity on equal footing through the issuance of a permit or a license. This may be implemented in the same way as insurance licenses, and achieved one of the following ways: 1. Amend the current Microfinance Law to be inclusive of all financial institutions engaged in microfinance activity; or 2. As Kenya did, establish a Microfinance Amendment Act to bridge the gap between the current and desired regulatory framework. 3. Alternatively, establish new regulations for MF activities under the new Banking Law. This regulation should operate in tandem with the laws and regulations on microfinance applicable to NB MFIs.
Definition of microfinance	• MF activities are defined by the Microfinance Law,	Refine the definition in light of Basel Commission on Bank Supervision

activities is unclear	thus not applicable to MFBs but only NB MFIs. • NB MFIs that desire to become MFBs face significant challenges in meeting heavy compliance requirements and costs, as well as overcoming significant differences between separate supervisory guidelines. • The current law limits MF activities to making loans, collecting savings, or doing both activities when they are not readily available from banks or ordinary financial institutions. • The current MF Regulation includes a few additional activities that may be allowed to NB MFIs, subject to the BNR's prior approval.	and/or CGAP Guideline on Regulation and Supervision of Microfinance.
Definition of microfinance institution is unclear	• Globally, an MFI is referred to as an institution, regardless of its legal or regulatory status. But in Rwanda, MFI is referred only to non-bank MFI, not MFBs, although the Law refers to *any organization*. • This may create confusion about the scope of MF activities being done in Rwanda since all MF activities performed by MFBs or commercial banks are excluded from relevant statistics.	• Amend the legal definition to include any financial institution that is engaged *primarily* in MF activities. *Primarily* could be defined as deriving more than 50% of the revenues from MF activities. • Once an MFI is defined, different consideration should be given to promote financial inclusion and access to finance for the underprivileged people in Rwanda. • If it is a bank, then special consideration should be given on all CAMELS components.
Differences between regulations for bank agents and payment service provider (PSP) agents are unfair and unreasonable	• Agent can be compared to an ATM operated by a human. Like an ATM, an agent may be owned or contracted to third parties. • The difference between the roles of bank agents and PSP agents is minimal. • But the regulatory process for each is quite different and disadvantageous for bank agents.	• This difference should be addressed. Combine two laws and/or regulations into one that covers both agent types while indicating differences when necessary. • This combination would not only expedite financial inclusion and access to finance in rural areas, but also mitigate regulatory inconsistency.

II. Non-Bank MFIs

Major Claims	Issues Raised/Observed	Recommendations
Access to the payment system should be allowed for NB MFIs.	• Only banks are allowed to access the payment system, with the exception of one NB MFI that has been allowed to open a RIPPS settlement account. • Lack of access to the payment system by NB MFIs has created several issues, such as competitive disadvantage, increased time and financial costs for reconciliation, reputational risk associated with delayed process, as well as operational inefficiency. • NB MFIs desire to access the payment system, but their needs vary. • For financial inclusion, it is desirable to allow NB MFIs to access the payment system, but without compromising on the security of the national payment system and financial stability. • The payment system is complex and access for NB MFIs should be granted only to those that qualify by passing guidelines that demonstrate institutional competency.	• The BNR should establish guidelines that allow qualified NB MFIs to access the payment system. • Qualification guidelines should assess financial strength (minimal equity capital at a reasonable level), management competency (supervisory rating of *satisfactory* or better), strong IT infrastructure (as determined by the BNR IT team), and strong MIS and data processing capacity (as determined by the BNR IT and Payment teams). NB MFIs that meet these qualifications should be considered to be *Prepared MFIs*. • *Prepared MFIs* should be allowed to open RIPPS settlement accounts with the BNR and access the payment system as follows: 1. Checks – Receipts/collections only with possible exceptions subject to the BNR's approval 2. Cards – Proprietary cards only to be cleared through RSwitch, for both issuance and acquisition 3. Interbank Payments – For both receiving and sending, settled through RIPPS account 4. Mobile Payments – Interoperable institution-led or switch-led solutions should be allowed when available. (Certain features of mobile payment are already available to NB MFIs without having to be qualified for the Prepared MFIs)
Definition of microfinance clients needs reconsideration	The current definition derived from MF activities seems to undermine the quality of MF clients.	The new definition of MF should resolve this issue. Please refer to the issue summary under MFBs.

X. Glossary

Varying terminology used in the discussion of microfinance regulation sometimes leads to confusion. This report primarily used the glossary included in the CGAP's "Consensus Guideline for Supervision and Regulation of Microfinance" (2012). Relevant terms are listed below.

Association of Microfinance Institutions of Rwanda (AMIR)*:* The trade association for all financial institutions that are engaged in microfinance. Its membership is primarily comprised of non-bank microfinance institutions.

Anti-money laundering and combating the financing of terrorism (AML/CFT)**:** Legal requirements, controls, and practices designed to detect and prevent money laundering, the financing of terrorism, and other illicit activities.

Automated Clearing House (ACH): A payment system that is owned and operated by the BNR, which covers large volume retail payments, whether checks or electronic payments, under the Rwanda Integrated Payment Processing System (RIPPS).

Automated Teller Machine (ATM): An electronic telecommunications device that enables the customers of a financial institution to perform financial transactions without the need for a human cashier, clerk or bank teller.

Branchless banking*:* The delivery of financial services outside conventional bank branches, often using third parties (such as small retailers) and relying on information and communications technologies (such as card readers, point-of-sale terminals, and mobile phones).

Common microlending methodology*:* Lending approaches applied over the past four decades involving most, but not necessarily all, of the following:

- The lender's personal contact with the borrower
- Group lending or individual lending based on an analysis of the borrower's (or borrower's household) cash flow as opposed to scoring
- Low initial loan sizes, with gradually larger amounts available in subsequent loans
- An understanding that borrowers who repay their loans faithfully will have prompt access to follow-up loans
- A "compulsory savings" requirement that must be satisfied by the borrower before receiving the loan to demonstrate the borrower's willingness and ability to make payments and/or to provide a partial "cash collateral" for the loan

Compulsory savings: also referred to as forced savings, obligatory savings, or compensating balances. Savings that many microfinance institutions (often lending-only institutions) require of their borrowers, both to demonstrate the borrower's ability to make payments and to serve as partial security for the repayment of the loan. The cash is posted by the borrower with the microfinance institution and sometimes deposited by the microfinance institution at a commercial bank in an account (sometimes a trust account). If the funds are held in trust, they cannot be intermediated. If the savings are intermingled with the microfinance institution's funds, then the microfinance institution effectively uses the funds for its lending operations.

Credit bureau: A private agency or firm, established either as a profit-making venture by individual entrepreneurs or as a cooperative association by a group of lenders, that gathers and provides consumer credit information. This information can be used to assess an individual's creditworthiness and other factors important to a lender when determining whether to grant a loan. The term "credit bureau" can also be used to refer to a public credit registry (defined below). In Rwanda, the private credit bureau is called CRB Africa.

Credit registry: A database maintained by a government agency (e.g., the central bank) to which regulated financial institutions are typically required to submit loan and repayment information. In many countries, only regulated financial institutions can access information from a public credit registry.

Customer due diligence (CDD): Requirements imposed on banks and other financial institutions by regulation. FATF has a specific Recommendation on CDD setting forth what financial institutions should be required by regulation to do (subject to the risk-based approach), including (*i*) identifying the customer and verifying that customer's identity, (*ii*) identifying the beneficial owner, (*iii*) understanding the nature of the business relationship, and (*iv*) conducting ongoing due diligence on the business relationship. Similar (and sometimes identical) to "know-your-customer" requirements (see definition below).

Delegated regulation/supervision: Supervision that is outsourced by a primary prudential regulatory body to another, such as a federation of retail institutions. Typically, the delegating body retains responsibility for the performance of the body to which regulation or supervision is delegated.

E-money: Monetary value represented by a claim on the issuer that is (*i*) stored on an electronic device, (*ii*) issued on receipt of funds of an amount not less in value than the monetary value issued, (*iii*) accepted as a means of payment by parties other than the issuer, and (*iv*) convertible into cash. In practice, the customer exchanges cash at a retail agent in return for an electronic record of value.

Financial cooperative: A member-owned financial intermediary, such as a savings and credit cooperative, credit union, or cooperative bank. Members share an economic stake in the outcome of a cooperative's operations and govern by a "one member, one vote" principle—that is, each member of a financial co-op has an equal voice regardless of the amount of money that he or she has invested. Financial cooperatives typically engage in both lending and deposit-taking, with members' money (from membership shares and deposits) typically funding all or most of the co-op's lending activity. Financial cooperatives can be "stand alone" financial institutions or can be organized into federations, with the federation often exercising critical functions, such as liquidity management on behalf of its members.

Financial intermediation: The process of accepting repayable funds (such as funds from deposits or other borrowing) and using these to make loans or similar investments.

Fit and proper: Specifically in the context of financial regulation, a minimum set of requirements and/or competencies applicable to those individuals with a controlling interest in a financial institution, as well as members of its senior management and governing board. Requirements often include the absence of a criminal record and personal bankruptcy, as well as prior professional experience with a depository institution (particularly for senior management and board members).

***Greenfield institution*:** A newly established institution.

Know your customer (KYC): Due diligence, sometimes referred to as customer due diligence (CDD), that banks are typically required by prudential requirements, AML/CFT requirements, and also internal guidelines to perform on potential customers. Common KYC requirements include the provision of national identification cards and documentary proof of home address and employment.

Microcredit: Small-scale credit typically provided to self-employed or informally employed poor, low-income individuals, and microenterprises. Other common features of microcredit include a lending methodology characterized by familiarity with the borrower, lack of collateral, expectation of a follow-up loan, and very small loan amounts (although the size of microcredit loans varies from country to country.) See "Common microlending methodology."

Microfinance: The provision of formal financial services to poor, low-income people, and those systemically excluded from the formal financial system. This definition differs from Rwanda's legal definition.

Microfinance bank (MFB): Banks that are licensed by the central bank in Rwanda with a lower level of minimal capital (RWF 1.5 billion) compared to that of commercial banks (RWF 5 billion) and of development banks (RWF 3 billion).

Microfinance institution (MFI): A formal (i.e., legally registered) entity whose primary activity is microfinance. This generic definition differs slightly from non-bank MFIs in the Rwandan context; see "Non-bank microfinance institutions" below.

Ministry of Finance and Economic Planning (MINECOFIN): The ministry of the Rwandan government that is responsible for all matters related to the country's finance and economic affairs. MINECOFIN is responsible for the country's fiscal policy and remotely oversees the central bank in Rwanda.

National Bank of Rwanda (BNR): The central bank of Rwanda that regulates and supervises all types of financial institutions that require registration. The BNR oversees not only banks, but also MFIs, as well as insurance and capital market activities. The BNR is responsible for the country's monetary policy and financial stability.

National payments system: A country's institutional and infrastructure processes for making payments, specifically by commercial banks and the central bank. The central bank runs Rwanda Integrated Payment Processing System (RIPPS). Please refer to the definition of RIPPS.

Non-bank micro financial institutions (NB MFI): In Rwanda, MFI means non-bank MFIs. Microfinance banks are considered banks. Hence, this distinction.

Non-governmental organization (NGO): An institution that does not have "owners" in the sense of parties with an economic stake in the outcome of the entity's operations. Furthermore, an NGO has one or more enumerated public benefit purposes, as stated in its constituent documents and often as required by law. Because there are no owners to elect it, an NGO's governing body may be self-perpetuating (i.e., the body chooses its own successors) or may be chosen by third parties, such as a general assembly of members or founders. The capital structure of an NGO is distinguishable from other institutional types because an NGO's initial equity base is typically grant-funded, and it can't raise additional equity by issuing shares or otherwise bringing in new owners. The only means of raising funds is through borrowings, grants, donations, and retained earnings. In most regulatory systems, NGO MFIs are not permitted to mobilize voluntary savings from retail customers, so an overwhelming majority are microlending-only organizations.

Over-indebtedness: There is no single, commonly agreed definition for over-indebtedness. Some of the more widely accepted indicators of over-indebtedness include consistently poor repayment rates over a period of time (generally a lagging indicator), high ratios of debt-service-to-income or debt-to-assets, and inability to make loan payments without extreme personal hardship.

Payment Card Industry Data Security Standard (PCI DSS): An actionable framework for developing a robust payment card data security process -- including prevention, detection and appropriate reaction to security incidents for the payment card industry. All major international payment card issuers, such as VISA, MasterCard, American Express Card, require their members to comply with this standard.

Payment on Sale (POS): A point where a sale transaction is made. The seller offers a variety of options with which for the buyer to make payment for the purchase. It is also referred to as a type of device that allows the buyer to make payment for the purchase, typically electronic payment. Upon successful completion of a transaction, money transfers from the buyer's account to the seller's account electronically without actual movement of cash. A merchant or an agent keeps a device that allows for electronic payment.

Payment system: A funds transfer system with formal, standardized arrangements and rules for processing, clearing, and/or settling payment transactions.

Proportionate approach: An approach to regulation and supervision in which the costs should not be excessive when measured against the risks being addressed and the proposed benefits.

Prudential (regulation or supervision): Governing the financial soundness of licensed intermediaries' businesses, with intention to prevent instability in the financial system and losses to small, unsophisticated depositors.

Real Time Gross Settlement (RTGS): A system that the BNR operates to effect real time settlements for large value and time-critical financial transactions. This system covers both checks and electronic payments as part of the BNR's RIPPS.

Regulation: Binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations).

Regulations: The subset of regulation adopted by an executive body, such as a ministry or a central bank.

Retail payment system: A system that processes retail payment instruments, such as an automated clearing house or a payment card scheme.

Rwanda Bankers Association (RBA): The trade association for all types of banks in Rwanda.

Rwanda Switch (RSwitch): A private company in Rwanda that has been licensed by the BNR to switch electronic payments for financial institutions. It is not limited from expanding its operations beyond Rwanda.

Supervision: External oversight and engagement aimed at determining and enforcing compliance with regulation.

Society for Worldwide Interbank Financial Telecommunication (SWIFT): SWIFT is a network that enables financial institutions worldwide to send and receive information about financial transactions in a secure, standardized and reliable environment. Most of international financial institutions use SWIFT as a means to communicate financial transactions. At present, more than 9,000 financial institutions in more than 200 countries use SWIFT.

Transformation: A change of an MFI's business from one organizational type to another. The most common type of transformation is from an NGO MFI into a new or previously existing shareholder- or member-owned company (Newco). Such a transformation is typically implemented via the transfer by the NGO of all or part of its loan portfolio and other assets, liabilities, and employees to Newco. In exchange, the former NGO receives either shares in Newco or payment by its shareholders or founders in the form of cash, debt, or a combination thereof. In some instances, Newco may be a bank or other form of depository MFI. Other types of transformation include (*i*) a for-profit lender becoming a deposit-taking institution, (*ii*) a member-based organization transferring its assets to a licensed financial institution (with a similar exchange as noted), and (*iii*) an NGO transforming into a member-based organization.

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