



# Discussion Paper BRIEFS

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*Discussion Paper 89*

## **The Role of the State in Promoting Microfinance Institutions**

Cécile Lapenu

**M**icrofinance institutions (MFIs) allow millions of households, usually excluded from the banking sector, to access financial services. Yet, in view of the ambitious policy objectives fixed for MFIs, three main issues need further clarification. First, recent studies show that the presumed impact of access to financial services on household income and welfare may not materialize if complementary hard and soft infrastructures are not in place. Second, most of the MFIs still have to demonstrate that they are able to operate without subsidies. Finally, governments and donors have considerably increased their financial support for the promotion of MFIs so as to rapidly increase the number of clients. But rapid growth of clientele and the massive injection of external funds endanger the building of sound MFIs as it may increase loan defaults and management risks.

These issues raise several questions regarding the role of the state, namely, (1) the necessity of state-owned institutions, (2) the desirable level and nature of subsidization of the MFIs, (3) the choice for the state between alternative investments in financial institutions or complementary services, and (4) the necessary conditions for creating a favorable regulatory framework for microfinance.

### ***Model of Development of MFIs***

Diverse measures and reactions have been observed in the developing countries and have led to three different development models of MFIs vis-à-vis the state. In countries such as India or Viet Nam, a *model of integration* has been implemented where the state remains very present and most of the microfinance innovations are integrated within the public sector. In some countries, state and private sectors are complementary. Microfinance innovations may be adopted by private and public sectors. Indonesia is an interesting example of this *model of complementarity*. Finally, market and state failures to reach the poor and rural areas may be widely present. MFIs try to fill the gap, in a *model of alternative* to the deficient role of the state and the market, as in Madagascar or some West African countries. The analysis of the respective role of the state, the private sector, and the NGOs with different models of MFIs yields some conclusions for the state in increased outreach, impact, and sustainability.

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### ***Outreach of the MFIs and Innovation in the Different Models***

The model of integration of microfinance within the public sector allows high coverage of the rural population as can be seen in India, Viet Nam, or Thailand. The development of MFIs as an alternative to the deficient role of the state and the market incurs lots of constraints that may limit their outreach. Madagascar's MFIs for example, only reach 2 percent of the rural population. Instead, the role of the state can be to invest in network building: a minimum banking structure can facilitate the development of a rural financial system where complementarity between the institutions increases outreach and sustainability of microfinance.

In terms of depth of outreach, neither the integrated, complementary, or alternative model of microfinance vis-à-vis the public sector adequately reach the poorest of the poor. This may arise from the inherent limitations of microfinance as a tool to alleviate extreme poverty. In this case, financial interventions are just part of a range of choices for development assistance programs seeking to reduce poverty.

For the adoption of innovations, the model of integration of microfinance within the public sector can help support innovations as a public good. The innovative and self-sufficient network of the state-owned BRI in Indonesia is a good example.

The state could play a role in the implementation of innovations such as microfinance services to agriculture or insurance services. On the other hand, the slow restructuring of some public institutions like the Regional Rural Banks in India brings out the constraints to change that can also exist within the public financial institutions.

A balance of power must be created between the state, the local authorities and the financial institutions through external control to avoid political intrusion while ensuring a dynamic adoption of innovation and sound financial practices.

### ***Regulation of the MFIs***

With the development of MFIs, regulation becomes a necessity, in order to protect savers, to allow the MFIs to mobilize external resources, to offer them an official recognition against their informal, sometimes unfair, competitors. But regulations must be able to strengthen

the microfinance movement, and should not impede its development with rigid rules that can block innovation. Capped or subsidized interest rates observed in Viet Nam, China, or West Africa, impede the financial viability of the institutions and the future access to financial services by the rural poor. Innovation can and should be encouraged through a flexible regulation in terms of institutional forms. Compared to commercial banks, transparency in financial accounting and objectives of sustainability should be the same, but liquidity requirements, for example, may be more strict, given the seasonality of demand, the dependency on donors funds, or short-term liabilities. On the other hand, some rules may be more flexible such as the recognition of the concept of solidarity group as a guarantee, and the approval of uncollateralized loans. Finally, the regulation of MFIs requires specific skills and increased resources in order that traditional supervisory agencies can enforce prudential regulations. Governments in developing countries may have limited capacity to regulate mushrooming MFIs, and forms of self-regulation, apex institution or third-party involved in supervision should be considered.

#### ***Policy Implications***

- Where an extensive network of financial institutions already exists, the responsibility of the state may be to efficiently transform and restructure the public institutions to strengthen the structure of the financial system.
- When no rural banking network exists, there is an important public role in creating a minimum banking structure through the development of public branches or incentive for the commercial banks, where the private sector fails to adequately address the demands of specific poorer segments of the population.

- The success stories in microfinance show that subsidies remain necessary (1) for start-up investment and network building, (2) for the development of other innovations, in particular the development of insurance schemes.
- Extreme poverty requires complementary services (infrastructure, education, health) that can be offered for example through NGOs or state services, but independently from financial services. The NGOs should either respect the financial rules (nonsubsidized interest rates, strict enforcement of the repayment) or focus more on complementary services.
- To be developed on a safe and sustainable basis, microfinance institutions must have a specific regulatory framework. It can be defined step by step, and should remain flexible on its implementation in order to spur innovations. However, the states may be limited in their capacities to enforce the rules for an increasing number of MFIs.
- Efficient internal governance, with clear definition of the responsibilities, strict enforcement of the rules and circulation of the information, is necessary for all MFIs.

Microfinance can be a powerful tool for the economic development of the rural areas in the developing countries, but the rules should be clear, and the objectives must remain realistic.

**Keywords: microfinance, financial regulation, developing countries**

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## **FCND BRIEFS**



International  
Food  
Policy  
Research  
Institute

2033 K Street, N.W.  
Washington, D.C. 20006 U.S.A.

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