Regulation of the micro-finance sector in Moldova

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1. Economic significance of the microfinance sector

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The rationale for microfinance

- "MFIs provide financial services to low-income, economically active borrowers who seek relatively small amounts to finance business, manage emergencies, acquire assets, or smooth consumption" (CGAP).
- Barriers to lending by established banks lie in information asymmetries and lack of collateral that result in excessive risk.
- Also, borrowers are unable to accumulate cash over longer periods. Frequent repayments are used as a commitment device.
- These business models result in much higher effective interest rates.

- MFIs traditionally seemed insulated from international capital markets, given large dependence on donor funds.
- The 2008-09 financial crisis exposed a much larger vulnerability to capital flow reversals than previously thought, as abrupt declines in lending growth resulted.

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Why MFI lending is important in Moldova

- The recent strong growth in MFI lending has to some extent compensated for the contraction in bank retail lending due to tighter underwriting standards and income documentation requirements.
- Lending techniques by MFIs make financial access for low-income borrowers commercially viable.
- Empirical studies show strong growth benefits from credit to micro-entrepreneurs (which may be hard to distinguish from household credit).
- ‘Financial deepening’ is beneficial for the economy as it improves capital allocation and credit constraints are overcome, allowing entry into the labour market.

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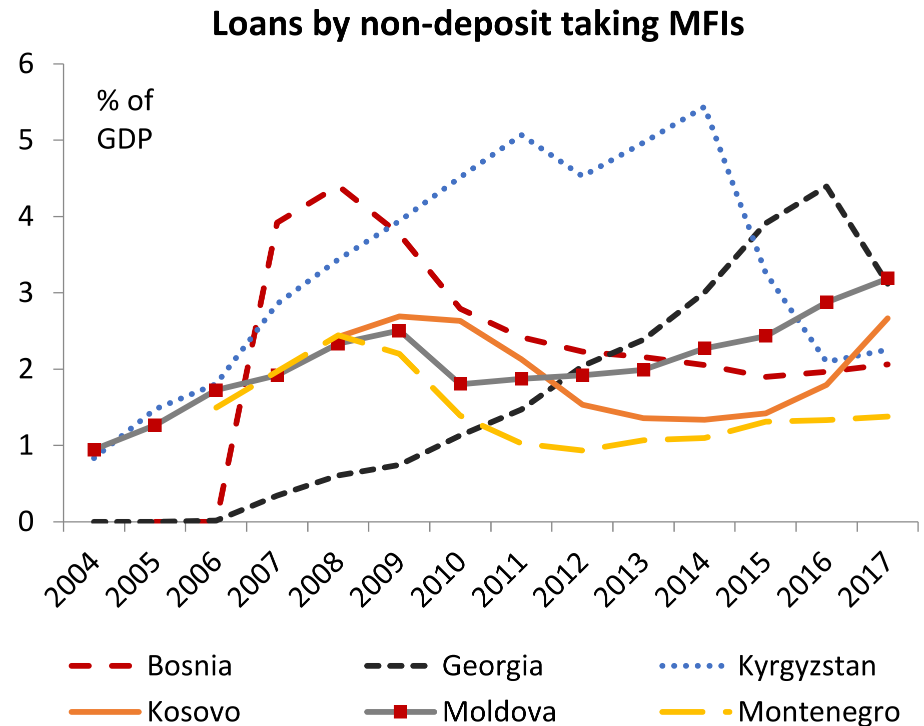
MFI sectors have grown strongly in emerging Europe, though can be volatile

- Information sharing platforms and credit bureaus often poorly functioning.
- Foreign owned bank subsidiaries offer only more formal credit products.
- Rapid inflow of donor funds to NGO-led and IFI supported MFIs until 2008.



Source: FRED, from International Financial Statistics.

2. Best practice in regulation

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Non-deposit taking MFIs traditionally not the subject of prudential regulation – which is concerned with liquidity and solvency of institutions. Capital regulation has the primary purpose of limiting entry.

The objective of conduct regulation is:

- To ensure adequate oversight of management, also by including high quality local owners or IFI investors.
- To minimize operational risks. Decentralized operations are more prone to fraud, and a strong internal audit is required.

Objectives of consumer protection:

- disclosure of interest rates and fees, which should be clear, simple, easy to understand, and comparable;
- prohibitions of business practices that are unfair, abusive, or deceptive;
- recourse mechanisms that are efficient and easy to use.

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Empirical findings on the impact of tighter MFI regulation

- More rigorous and regular supervision does not seem to impact profitability (it is often associated with ability to collect deposits, or accessing cheaper and more stable sources of capital). But:
  - Head office staff and capital becomes larger relative to branch network.
  - Adverse impact on outreach. Results in larger average loan sizes, and less lending to marginal groups.
  - High supervision costs induce a shift away from cost-intensive segments of the population.

World Bank (2015).

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Poor MFI regulation can create risks for the financial system

- Deposit taking by MFIs (‘regulatory arbitrage’)
- Banks may take excessive exposures to the sector
- Client over-indebtedness through multiple loans. Household insolvency and cross-defaults to banks, tax authorities or utility providers.
- Increased use of collateral and abusive collection practices.
- Adverse selection: investors cannot observe quality/business models of MFIs. Risky institutions (‘light risk management/high default/high loan rates) may then crowd out more prudent lenders. Any of the above risks will be further aggravated.

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Example of a poorly regulated MFI sector: Bosnia and Herzegovina 2008

- MFI boom in late 1990s funded by local commercial banks (mostly foreign-owned), and cross-border investment funds.
- By 2008, 28 per cent of households were in excess debt, of which about 60 per cent with monthly repayment obligations in excess of income.
- Default also migrated to guarantors among friends and family.
- Rapidly higher rates of entry and exit of micro-enterprises.
- Problems caused by:
  - Concentrated lending, and multiple borrowing (58 per cent of borrowers had accumulated loans from several microlenders).
  - Overstretched MFI capacity (inexperienced staff as hiring accelerated).
  - Widening product offering and loan limits;
  - Loss of credit discipline (aggressive sales techniques, lack of client interaction, and poor monitoring).
- credit information bureaus did not become operational ahead of the crisis.

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3. Priorities and further options to stem household debt distress from MFI lending in Moldova

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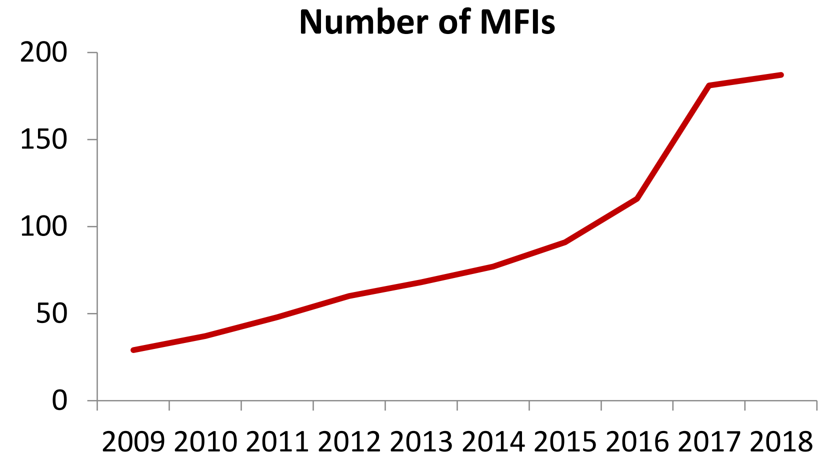
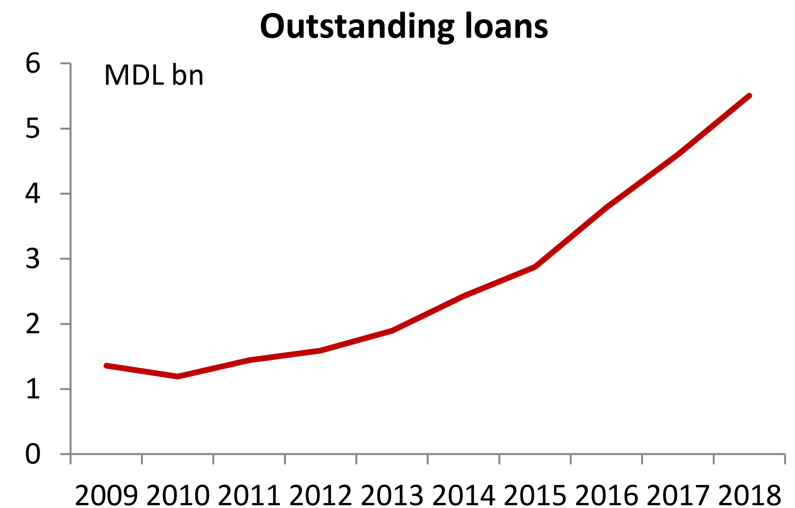
Risks from microlending in Moldova

- Also a rapid surge of entry into the sector to almost 200 MFIs at end-2018.
- Share of MFIs in total consumer loans rose rapidly to almost 40 per cent in early 2018
- IMF (June 2018): "Underdeveloped prudential framework, and less developed oversight, and scope for regulatory arbitrage". But all MFIs need to re-register by end-March 2019, based on the October 2018 Law on non-bank credit organizations.
- Total household debt in Moldova seems modest, but there is evidence of repeated default of households, and non-cooperative enforcement benefiting the most aggressive lenders.





Source: National Commission for Financial Markets

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The legal and regulatory context

- Law on non-bank credit organizations (valid since 2018).
  - Minimum internal regulations on services, customer complaints etc.;
  - Permissible and prohibited activities (with limited exemptions for deposits);
  - Registration and capital requirements also require disclosure of ultimate beneficial owners;
  - Clarifies role of the National Commission as supervisor, though provisions on reorganisation and liquidation or de-registration seem vague.
- Law about credit agreements (2013).
  - Based on EU directive 2008/48/EC, but no specific provisions that go beyond that
  - Lenders need to provide pre-contractual information, adequate explanations of all costs, and assess the consumer's credit worthiness
- Law on credit bureau (2008)
  - Not designed for the rapid rise of the MFI industry.

Priority I: strengthen consumer protection

- The law is adequate, though in the context of limited financial literacy more specific provisions could further raise visibility of APRs, written disclosure in understandable format etc, and quality of pre-contractual information.
- The **Consumer Protection Agency** needs to more strictly enforce that charges, effective interest rates, and future payments are clearly stated. This should also include charges on overdue payments (as stipulated in the law). Lei loans indexed to foreign currency should be banned.
- Violations of the law should be more effectively sanctioned. Enforcement actions could include:
  - Requiring MFIs to refund excess charges;
  - withdraw misleading advertisements;
  - and ultimately withdrawal of the license to operate.
- There should be standards in secondary regulation on complaints resolution, and recourse to mediation (e.g. a financial ombudsman).

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A tool to bring about sector consolidation: raise capital requirements

- The nearly 200 MFIs represent excess competition and fragmentation of the sector, given proliferation of products, duplication of certain services, and constrained supervisory capacity.
- The Oct. 2018 Law non-bank credit organisations puts in place a re-registration process, based on capital requirements (of 300,000 lei, and 5 per cent capital coverage), but also disclosure of beneficial owners.
- If consolidation does not happen, a further tightening of capital requirements should be considered.
- This could result in higher lending costs, reduced access (higher loan sizes) and reduced coverage of lower-income groups, though such adverse impacts are not likely to be significant.

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A more intrusive option: interest rate caps

- Often used with the objective of protecting consumers from ‘usury’, and to limit access to credit where it could do ‘social harm’.
- Could be coupled with limits on additional fees and charges on borrowers in default, eg as a multiple of outstanding principal.
- Adverse effects: reduced transparency and product diversity. Formal and semi-formal micro-lenders cannot cover their costs, driving them out of the market.
  - Poor clients are either left with no access to financial services or must revert to informal credit markets (such as local moneylenders), which are even more expensive.
- Implementation problems: interest rate caps and outright bans on usury have “proven to be unsustainable and difficult to enforce.” CGAP/World Bank, Financial Access Report 2010 at p. 23.

- **Interest rate caps results in many distortions.**
- **They are nevertheless quite common in both eastern Europe, and even in some EU countries, e.g. in Germany, Italy, or Poland.**
- **To be effective they require very strong powers in supervision.**
- **The cap should be relative to a benchmark, rather than an absolute rate.**

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Debt service to income (DSTI) caps are not necessary

- A debtor's DSTI is an important predictor of its probability of default
- Such limits are typically a 'macro-prudential' measure, aimed at financial system instability, for instance due to a property market boom.
- Usually DSTI limits are based on complex income verification:
  - Payroll data from bank statements or tax records;
  - Individual entrepreneurs' income verified through financial analysis by the lender, possibly by an on-site visit.
- Likely impact:
  - Reduced operational efficiency among lenders; higher loan charges;
  - Reduced access, in particular where informal income needs to be documented;
  - Circumvention through over-declaration of income.

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Experience in stemming micro-lending: Georgia

- Household credit growth at over 20 per cent, much of it in mortgages.
- About 650,000 households in long-term default at end-2018, and household debt rose to about 34 % of GDP, which is above the regional average.
- Measures up to 2018 included:
  - A limit on the annual effective interest rate at 100%, and at 50% since Sept. 2018;
  - Higher capital requirements on bank loans to borrowers without verifiable income;
  - Tighter real estate appraisal standards;
  - Fees and penalties cannot exceed a certain multiple of outstanding principal;
  - MFIs came under central bank supervision.
- Since January 2019, ‘responsible lending standards’:
  - LTV and DSTI limits differentiated by borrower income and loan currency, based on detailed verification of borrower income and repayment capacity
- Ad-hoc write down of defaulted household debt, following purchase of loans by a private foundation close to the government

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Experience in stemming micro-lending: Romania

- Lending to low-income households increasing rapidly (total retail lending up by 27 per cent in 2017).
- NBR regulation of Oct. 2017 aims at improved risk management and reducing regulatory arbitrage.
- NBFIs in the NBR's Special Register are subject to on-site inspections, and to additional prudential requirements regarding:
  - Quality of significant shareholders;
  - Adequacy of the framework for internal control, audit, and management of significant risks;
  - Capital requirements;
  - Exposure to counterparties;
  - Reporting to central credit registry.
- Law adopted in December 2018 which caps interest rates
  - Consumer loans above 3,000 Euro: 18%
  - Consumer loans below 3,000 Euro: 50%
  - Mortgage loans: Policy rate + 3 percentage points

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4. Other reforms that underpin good MFI regulation

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Strengthening the Moldovan credit history bureaus

- Credit history bureaus provide critical information on borrowers' exposures and repayment records. They are essential to limit multiple borrowing relationships, and excessive lending, but the value of information will depend on the extent of participation by financial institutions.
- Unlike banks, Moldovan MFIs are not required to report, and fixed costs or high charges limit incentives to obtain information.

- ➢ **Information reporting and credit bureau consultation should be made mandatory for MFI loans above a certain size;**
- ➢ **Incentives should be given for coordination and information exchange between the two existing bureaus.**
- ➢ **Licensing of an additional credit bureau should be conditional on such an information exchange.**

Debt restructuring and insolvency for households and entrepreneurs

- Orderly discharge of excessive personal debt needs to be predictable and balance the interests of creditors (credit discipline) and borrowers (allowing a ‘fresh start’).
- A credible framework protects the sector against ad-hoc political interventions, or the need for state-supported private debt restructuring.
- A number of countries in emerging Europe revised their personal insolvency laws in the wake of the financial crisis: Estonia, Latvia, Lithuania, Poland. For Moldova much remains to be done.
- Good elements are:
  - Following a discharge period, individuals need to be allowed a ’fresh start’;
  - Repayment terms need to reflect debtors’ capacity to repay;
  - Transparent filing criteria need to make insolvency accessible, and minimize abuse;
  - Special legislation for e.g. mortgages need to minimize ’moral hazard’ (strategic defaults).
- A well-defined court process encourages predictable private (‘out-of-court’) restructuring principles for borrowers in distress, as agreed with the industry.

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Debt collection and enforcement

- The work of the court—appointed executors seems to be well regulated.
- But abusive collection practices may arise from high-pressure selling, and the emergence of households in excess debt.
- Scrutiny of collection practices is hence integral for consumer protection.

- **Enforcement measures need to be clearly spelled out in pre-contractual phase, and in loan documents.**
- **Debt servicing and collection agents should be licensed by the Commission.**
- **They should report to the credit history bureau to minimize data gaps.**

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5. Policy recommendations

- Microfinance plays a key role in fostering financial access for low-income households and micro-entrepreneurs. But the recent rapid growth of MFIs in Moldova could become a concern for financial system stability, in particular due to cross-defaults from excess household debt.
- These risks should be monitored, including within the new Committee on Financial Stability. Enforcement of existing provisions should be better resourced, and stepped, existing laws could be tightened, and further regulation considered:

1. A key priority is to **strengthen the enforcement of consumer protection** through better capacity in the relevant agencies, and complementary provisions on sanctions and recourse to mediation.
2. Unless re-registration of MFIs under the October 2018 Law lead to a sector consolidation, higher **capital requirements** should be imposed.
3. More drastic options such as limits on interest rates and debt-service-to-income are not needed for now.

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Policy recommendations

4. A strengthening of **credit history bureaus** is essential given proliferating borrowing relationships and complex borrower histories.
5. Such greater transparency will also necessitate an improved **insolvency code** that covers households and micro-entrepreneurs. On that basis more predictable and cooperative private restructuring solutions will emerge.
6. The evolving risks should be monitored within the new Financial Stability Committee, and publicly disclosed.

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