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**Paving the Way Forward for Rural Finance  
An International Conference on Best Practices**

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**Discussant Reaction Paper**

**Commentary and Reaction to Theme Paper**

Legal and Regulatory Requirements for Effective  
Rural Financial Markets

by Heywood W. Fleisig and Nuria de la Peña

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## 1. Introduction

Fleisig's and de la Peña's paper touches on a wide range of legal obstacles to the effective operation of rural financial markets. Its strength clearly lies in their detailed knowledge of legal problems in concluding secured transactions, which is enriched by numerous practical examples from all over the world. The scope of this short response does not allow me to address all of the obstacles mentioned. Based on the authors' approach to ranking legal reforms "in order of importance and ease", and taking into account my own background as an economist whose experience is predominantly in regulatory frameworks for microfinance institutions (MFIs), I briefly look at the following two fields:

- The legal framework for secured transactions (Ch. III) and
- The regulation of rural financial institutions (Ch. IV of the paper)

In my view, the most important **legal** obstacle to efficient rural financial markets is not shortcomings in the current system for secured transactions, but the lack of an appropriate regulatory and supervisory framework for rural financial institutions. This is because I expect more economic gains will be possible through reform in the field of financial regulation than through improving the legal system for secured transactions.

## 2. The Legal Framework for Secured Transactions

What are the benefits of a well-designed system for secured transactions? The main rationale for using collateral is to shield the lender from potential losses caused by the **inability** of the borrower to repay his/her debt. Yet inability to repay is only one element of credit risk. The other element is **unwillingness** to repay. My main argument is this: a well-designed rural financial system only very rarely takes recourse to collateral securities. The risk of a borrower being unable to repay is minimized through a thorough analysis of the creditworthiness of the lender, while there are better ways of dealing with unwillingness to repay than the use of traditional securities.

Collateral security is a means to an end, but not an end in itself. Its main benefit only becomes obvious in those cases, in which something has already gone wrong and therefore the debt is not served. In general, the seizure and sale of collateral by the lender is both socially undesirable and costly. For the lender, it creates transaction costs (Heywood and de la Peña illustrate the problems of enforcement associated with different types of security), which are - at the best - covered by the value of the collateral. For the borrower, he/she is in a difficult financial situation, which keeps him/her from paying back the debt in the first place. Furthermore, he/she now has to transfer the security pledged. This is particularly serious if the security is the very land which the borrower used to make a living from.

What has gone wrong? Admittedly, there are cases where the lender has done everything to assess the borrower's repayment capacity, and the borrower is still unable to repay his/her debt. After all, lending is a risky business. Yet experience from successful MFIs shows that these cases can be reduced to a minimum (and we will hear more about how to do this during the course of this conference). Another reason for non-repayment might be that the lending decision was not based on a careful analysis of the borrower's needs and his/her capacity to repay the loan. Interestingly, the better the legal framework for secured transactions is, the less incentive

the lender has to do a proper risk assessment. He/she can simply rely on the quality of the collateral instead.

Another scenario is that the borrower is perfectly able to pay back the loan, but he/she is simply not willing to do so. This is where we can most learn from successful microfinance lending technology. Many MFIs use collateral substitutes such as peer pressure in joint-liability lending or probation (e.g. access to larger loans or charging cheaper interest rates on consecutive loans). Typical for these collateral substitutes is that they are not enforceable through courts and that they have little market value. Others take some form of collateral (usually moveable property, business inventories, even personal property are more important than land titles), but it is rarely enforced.

To give an example: Centenary Rural Development Bank in Uganda does not look at the market value of securities, but at the “incentive value”. It is more important that the pledged items are of high personal value to the customers than that they can be easily seized and sold. This, of course, has also to do with the widespread problems of creating, establishing priority, registering and enforcing a security interest in many developing countries, which is the main topic of the theme paper. Yet my argument is that the reform of the system for security interests is neither a necessary nor a sufficient condition for effective rural financial markets.

One final concern is related to the question of whether a reformed system along Fleisig’s and de la Peña’s lines would in fact reduce the collateral constraint in rural areas. Balkenhol and Schütte list in their relevant study for the ILO two other causes for the collateral constraint, which are ‘suboptimal asset distribution’ and ‘uninformed banks’.<sup>1</sup> The first point very much depends on the segment of the market we are looking at. If we talk of microfinance in rural areas, it is characterised by a lack of conventional collateral and a change of the current asset distribution would be more important than the reform of collateral laws. If we talk of small and medium enterprises in rural areas, the concerns raised in the paper should be the focus of attention. The notion of ‘uninformed banks’ refers to the danger that, even in a reformed system, bank lending to the microfinance sector would not increase considerably because of the **perceived** high risk of this sector.

### **3. The Regulation of Rural Financial Institutions**

The theme paper includes a short section on this topic asking two main questions: who should be regulated and who should regulate? I do not agree with Fleisig’s and de la Peñas complaint that “donor-funded legal reform projects leave untouched the legal barriers facing microfinance”. My impression is that it is more the case that most donors see other legal obstacles as much more important than the lack of an efficient legal framework for secured transactions (the ILO publication confirms this view) – and I agree with them.

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<sup>1</sup> Balkenhol, Bernd, and Haje Schütte. 2001. *Collateral, Collateral Law and Collateral Substitutes*. 2nd ed, *Social Finance Programme Working Paper No. 26*. Geneva: International Labour Office. Available from <http://tinyurl.com/bhyu>.

Numerous studies have been undertaken about the appropriateness of existing regulatory frameworks for microfinance. Conferences have been held, consensus guidelines have been published<sup>2</sup> and, most importantly, lessons have been learned in the field.

Let me try to at least answer the two questions raised by the authors on the basis of my own experience. First, who should be regulated? Regulation has two main objectives, viz. to protect depositors and to safeguard the stability of the financial sector. These objectives are not only based on considerations of equity and fair treatment of small depositors, but can easily be justified by the analysis of incentive and information problems within financial markets. Neither objective calls for a regulation of all “those engaged in financial activities”. I fully agree with the authors when they say: “If they [non deposit-taking institutions] lend unwisely and lose their money, what is the bad consequence for the financial system?” I imagine that almost everyone agrees. I have not yet come across a case where a banking regulator has taken steps to bring non deposit-taking institutions under its system of **prudential** regulations (i.e. government regulation which takes on responsibility for the soundness of these institutions) – and I do not know of any donor agency promoting such an approach.

The second question is who is going to do the job. This is much more difficult to answer as it depends crucially on the country context. In my view, the preferable solution is to charge the existing superintendent of banks with this task. Yet a number of serious questions about the superintendent’s capacity, its political independence, and its specific knowledge about microfinance should be answered first. The problem is that even if the answers turn out to be negative, the alternatives might still be worse. The theme paper proposes to make internationally recognized NGOs such as WOCCU the supervisory agency. As with any proposal to delegate the task of supervision to another agency, one would have to look at ways to control the proper conduct of this agency (which would again be the job of the superintendent or of another government agency), its capacity and skills and ways to make it accountable for what it is doing. With the greatest respect to WOCCU, this proposal would not make the system any more efficient than one in which the superintendency would do the job itself. Other options might be self-regulation, which lacks enforcement power and suffers from regulatory capture (i.e. the regulated institutions ‘capturing’ the regulator for their own good), or delegation to an apex organization, which is subject to potential conflicts of interests between its different roles (as a lender, supervisor, sometimes also promoter of the industry). Ultimately, it will in many cases be easier to build capacity and educate the superintendent, so that it can also take over the role of regulating MFIs.

I have not talked about the regulation of rural financial institutions as opposed to other microfinance institutions. In my view, regulation of MFIs operating in rural areas should not be relaxed as a means of addressing the lack of rural outreach. Regulation is not the right instrument to promote rural finance. On the contrary, higher risks require stricter regulatory requirements. Therefore the best way to address this issue might be to adapt the financial technology of MFIs as to lower the risks involved in serving this market. We will hear more on this in the general session about ‘Innovation in Rural Finance’.

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<sup>2</sup> Consultative Group to Assist the Poorest. 2002. *Consensus Microfinance Policy Guidance: Regulation and Supervision*. Washington, DC: CGAP. Available from <http://tinyurl.com/anbm>.

To come back to my starting point: why do I think the ‘importance and ease’ of reforming financial regulation is higher than that of improving the system for secured transactions? From a better system of collateral, the authors of the theme paper expect “larger loans, at lower interest rates, repayable over longer periods of time”. I have my doubts that the effect would be very large, as I explained earlier. From a reformed regulatory system for microfinance, I expect a larger range of products offered (especially the introduction of savings products) and a higher number of customers served in a more sustainable manner. The legal system for secured transactions is important, but more so for SMEs than for microfinance and more as a second step than as the first.