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MICROFINANCE REGULATION IN GHANA: LESSONS LEARNT

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ABSTRACT

A well-functioning and regulated financial system is vital for businesses, consumers and the economy. Therefore, regulating microfinance activities is crucial to ensure institutional sustainability and customer protection. We explore the consequences of microfinance regulation in Ghana using the desk review approach to document lessons that could be learnt. Our preliminary findings suggest that there are some learning opportunities. These are regulatory methodology mismatch, mission drift tension, and the collapse of potentially rescuable institutions. Additional lessons include a need for better governance, implementation of complementary laws and inadequate regulatory capacity. The paper offers policy recommendations for future regulatory architecture and design.

Keywords: Microfinance regulation, Ghana, Financial services, Bank of Ghana, Microfinance institutions

INTRODUCTION

Financial sector regulation originates from microeconomic concerns over financial institutions' capacity to monitor lending risks and ensure effective governance to promote financial sustainability. Therefore, financial laws and rules exist to minimise the risks. In the banking sector, laws are provided to safeguard depositors' monies and bank assets. For example, historical antecedents suggest that financial regulation was dramatically overhauled during the Great Depression in the 1930s. Consequently, the chaos associated with bank runs, and the numerous bank failures spurred numerous policy actions to prevent a recurrence.

Around the world, financial regulators strengthened the laws that govern banking institutions in response to the financial crisis. Like traditional banking institutions, non-bank financial institutions (NBFIs) play a significant role in the

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financial sector and also need to be regulated. At the Managed Funds Association (MFA) Global Summit held in May 2023, the Chair emphasised the need for NBFI regulators to have information that facilitates risk detection and robust intervention.[4] In Ghana, there are risk variations within non-bank financial activities, particularly those involving capital market transactions and services that target the informal economy such as microfinance institutions (MFIs). These inherent variations also require appropriate regulatory mechanisms.

Globally, MFIs have been subjected to regulation with rules, guidelines, and laws because they are a segment of the financial system. They collect deposits; therefore, their risks could cascade to the traditional banking sector, and their failure may be contagious. Any disruption could affect the livelihoods of most of their clients, who have small-scale businesses in the informal sector. As depicted by the global financial crisis, the assumption that markets are self-correcting might not always hold; hence, the need for government intervention to reduce risks and instability.

Regulation improves efficiency, reduces costs, creates innovation, and promotes development. Like other financial institutions, MFIs are generally subject to two forms of regulation: prudential regulation reinforces financial soundness, and non-prudential regulation serves other purposes, such as consumer protection—governments have a duty to protect innocent customers from losing their hard-earned deposits. Regulation is also a public policy requirement, which the government must address to avoid political instability. Therefore, if well executed, regulating microfinance activities could produce more gains than losses.

In most African countries, MFIs are regulated by different bodies. In this section, we draw on a few examples of the various modus operandi from selected African countries. These countries were selected based on the unique nature of their regulatory system. In South Africa, MFIs are regulated by the Microfinance Regulatory Council (MFRC),[5] which was established in 1999 under an Exemption Notice. The initial attempt at the reformation was implemented by the 1992 Usury Act Exemption (1992 to 1999 covers the 1st Exemption Notice).

Since 1999, the MFRC has been mandated to formalise micro-lending, ensure consumer protection, improve information delivery and educate the people about microfinance business. In 2003, the Usury Act was amended (Usury Amendment Act 10 of 2003). The amendment significantly enhanced the MFRC's authority

[4] https://www.fca.org.uk/news/speeches/drive-data-non-bank-financial-intermediation-nbfi.
[5] The MFRC was mandated to inspect unregistered and registered lenders using external inspectors and submit questions to the High Court for declaratory order.

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and empowered it to act on behalf of the government.[6] The MFRC's wider regulatory powers, effectively backed by law, have supported the smooth functioning of microfinance activities.

The Kenyan government passed an Act of Parliament (the Microfinance Act, 2006[7]) to ensure the licensing, regulation, and supervision of microfinance businesses and related activities. The Act covers supervision by the Central Bank, licensing, governance and deposit protection. The Microfinance (Amendment) Act of 2013 augments the initial instrument. The interesting aspect of the Kenyan case is that parliament has taken steps to enact laws to enforce microfinance regulation. As an Act of Parliament, it gives the regulators *teeth* to bite and the *cane* to whip. Unfortunately, this is not the case in Ghana and most African countries.

Morocco's Central Bank is primarily responsible for regulating the microfinance industry. However, the bank has a dedicated division that has a direct supervisory responsibility. The 'Office of Bank Supervision' is a subsidiary of the Department of Oversight of Financial Institutions. A law enacted in 1999 (No. 18-97) brought MFIs under a legal operational framework. Subsequently, the sector experienced rapid and significant growth until 2006, when problems began to unfold. The historic low rates of non-performing loans (NPLs) rose significantly over an extended period. It was observed that a lack of effective and efficient governance contributed to the MFI challenges. This prompted the Central Bank, the *Bank Al-Maghrib,* to actively intervene in an industry that had been lightly regulated. Consequently, new regulations were issued through the *'Directive on the Governance of Microfinance Associations'*, enacted in September 2009. The directive was to enforce effective corporate governance in the industry.

In Central Africa, microfinance is regulated by an apex body called the Central African Banking Commission (COBAC). The commission regulates microfinance in Cameroon, Central African Republic, Gabon, Chad, Congo and Equatorial Guinea. Gabon was the first country to regulate its microfinance activities in 2003 with an oversight unit within the Ministry of Finance. In the Congo-Brazzaville, the government created the first microfinance network, while some member countries, such as Cameroon, had embryos of legislation that

[6] Patrick Meagher, 'Microfinance regulation and supervision in South Africa' (2005) CGAP and IRIS Centre

[7] See The Microfinance Act, 2006 No. 19 of 2006 as evidence of a devoted microfinance regulatory instrument.

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sought to regulate microfinance.

Microfinance was placed under the tutorship of the Ministries of both Agriculture and Finance because it was initially identified as essentially suited for promoting rural and agricultural development.[8] One unique aspect of microfinance regulation in Central Africa is that individual central banks are not responsible for general oversight. The regional centralised supervision could be problematic because of the differences in economic and cultural characteristics that regulation must consider.

The country-specific cases highlighted suggest that microfinance regulation is distinct from banking regulation. Having dedicated supervisory entities propped by legal instruments can significantly engender the smooth functioning of the microfinance sector and the financial system. These entities can either be a specialised agency with ample regulatory powers or a fully resourced and dedicated unit of a Central Bank that can effectively execute its mandate. However, the problems experienced in Morocco suggest that supervisory presence and legal reinforcement may be inadequate. Without sufficient rigour, regulation may still be superficial with attendant consequences; hence, more robust intervention would be required to strengthen supervisory oversight.

In 2011, the Central Bank implemented microfinance regulation in Ghana. Among other initiatives, the regulator categorised providers based on their functions and services. The regulation formalised microfinance operations to improve accountability and ensure financial stability. Despite the positive outcomes, several issues have occurred, including licence revocations, reported customer defrauding, difficulty paying deposits, and the collapse of MFIs. Therefore, there is an urgent need to examine and document some lessons from the regulation activities to inform policy.

So far, the literature lacks a policy-oriented study that critically examines the post-regulatory environment to offer lessons to regulators, policymakers, and all stakeholders. Apart from the paper by Gallardo and others[9] on lessons from microfinance regulation in Benin, Ghana, and Tanzania, we are not aware of any study that has taken stock of lessons from microfinance regulation in Ghana. This review is especially pertinent given the recent banking crisis, which has

[8] Anne Claude Creusot, 'L'état des lieux de la microfinance au Cameroun' (2006) BIM n° - 09 mai 2006, http://www.lamicrofinance.org/resource_centers/profilcameroun/

[9] Joselito Gallardo and Korotoumou Ouattara and Bikki Randhawa and William Steel, 'Microfinance regulation: Lessons from Benin, Ghana and Tanzania' (2005) 85-96 Savings and Development.

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implications for the conduct of both banking and NBFIs.

This paper examines the effectiveness of microfinance regulation in Ghana to offer lessons that can inform policy. First, it reviews the genesis and post-regulatory environment of microfinance operations in Ghana. Second, it gathers the lessons to be learnt and proposes recommendations for policy actions. The paper contributes to the literature on Ghanaian microfinance regulation with insights on effectiveness and delivery. It fills the gap between microfinance regulation and its outcomes by highlighting lessons and implications that can inform the regulatory agenda. Additionally, it contributes to the design and architecture of future regulation of microfinance activities in Ghana.

The paper is organised as follows: the next section presents the methodology followed by the economics and law of microfinance regulation. Section 4 presents the inception and post-regulation environment of microfinance activities in Ghana. Section 5 documents the lessons learnt and Section 6 provides the conclusions, policy implications and recommendations.

METHODOLOGY

This paper adopted the desk review approach to examine secondary documents on microfinance regulation in Ghana. These documents include microfinance acts, operational rules, guidelines and notices issued by the Bank of Ghana, and laws and guidelines on microfinance regulation in some selected African countries. We also accessed academic publications on microfinance delivery in Ghana and related documents. In addition, we retrieved a notice published by the Bank of Ghana to collate data on the reasons for the revocation of licences of insolvent Savings and Loans and Finance Houses in 2019. The data was analysed using simple percentages.

THE ECONOMICS AND LAW OF MICROFINANCE REGULATION

The primary purpose of prudential regulation is to ensure that MFIs (especially deposit-taking institutions) retain sufficient liquidity to meet any reduction in redeposits and to discourage such a reduction in the first place. This critical oversight is to avoid the risk of failure. When financial institutions focus on ensuring a healthy balance sheet, depositors can also be assured of the safety of their deposits. This win-win situation should ensure the overall health of the financial system. Uncertainty is, therefore, the key economic justification for regulation.[10] Alternatively, when depositors lose trust in the financial system, it

[10] David Aikman and Mirta Galesic and Gerd Gigerenzer and Kapadia Sujit and Konstantinos

could spark a withdrawal that can collapse the financial entity. Any contagion can also ripple through the entire financial sector.

Another theoretical argument for microfinance regulation lies in its ability to increase the wealth of low-income clients through capital mobilised for entrepreneurial and investment opportunities.[11] This individual wealth creation is critical for institutional sustainability and its subsequent impact on economic development. In case of failure, the risks can be very high for depositors and the wider integrity of the financial system. Therefore, there is a need to establish a well-structured contractual architecture which should safeguard benefits for both parties.

Uncertainty and risk set into motion the idea of contract law, which has several implications for regulation and supervision. Contract law may be assessed economically and culturally. In *An Economic Analysis of Law,* Judge Richard A. Posner (a former University of Chicago law professor) suggests that contract law performs three significant economic functions. First, it incentivises individuals to exchange goods and services efficiently. Second, it reduces transaction costs because its very existence implies that the parties can avoid the trouble of negotiating a variety of rules and terms already spelt out (for instance, as in a loan agreement). Third, the contract law alerts parties to troubles that have arisen in the past, thus making it easier to plan the transactions more intelligently to avoid potential crises. Regulation, therefore, supports contracts to be sufficient, ceteris paribus.

Regulation ensures the principal party to a contract does not harm the *minor.* In this case, the MFI and the depositor. Regulation exists to provide an avenue for the poor depositor to survive the unforeseen behaviour of the MFIs that might dissipate any accrued wealth. Rules and laws in the regulatory document may prevent any potential breach. Therefore, the legal system supports contracts, which are vital to ensure effective interaction between the principal and the minor. According to the law of tort, if a party owes a duty of care to another and breaches, then the party (that breached the contract) will be liable for any losses.

Katsikopoulos and Amit Kothiyal and Emma Murphy and Tobias Neumann, 'Taking Uncertainty Seriously: Simplicity Versus Complexity in Financial Regulation' (2021) 317-345 Industrial and Corporate Change.
Maurizio Trapanese, 'Regulatory Complexity, Uncertainty, and Systemic Risk' (2022) 689 Bank of Italy Occasional Paper.
[11] Emilio Marti and Georg Scherer Andreas, 'Financial regulation and social welfare: The critical contribution of management theory' (2016) 298-323 Academy of Management Review 41(2).

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In a contract, a party is required to deliver the service to the extent of the agreed scope, with reasonable skill and care. When providing financial services to their customers, MFIs owe their clients a duty of care, especially regarding their savings and deposits. Due to competing interests, the Bank of Ghana is tasked by law to superintend over all financial institutions' operations, including MFIs. The reason is that any breach of contract between customers and the MFIs will constitute economic loss and further legal implications. Thus, on economic and legal grounds, regulation is essential as it caters for uncertainty and minimises potential breaches that could result in court cases.

MICROFINANCE REGULATION IN GHANA

The Genesis

The Bank of Ghana legally draws its mandate from the Constitution of Ghana[12] and the Bank of Ghana Act, 2002 (Act 612) as amended. It has overall supervisory and regulatory authority in all matters relating to deposit-taking, non-depositing business, payments, as well as clearing and settlement systems. Arun and Murunde[13] contend that microfinance provides social protection for the vulnerable by enabling them to access finance, create assets and avoid slipping into poverty traps. There was, therefore, an imperative for the Central Bank to regulate the ever-increasing number of MFIs. In 2011, the Central Bank of Ghana initiated the first steps to regulate microfinance activities. MFIs were to register with the Office of the Registrar General to obtain a business certificate.

The Bank took the bold steps for the following reasons: first, since some categories of MFIs take deposits, there is the need to protect depositors' hard-earned funds. Second, the regulation seeks to address the needs of those in the informal financial sector since most clients are subjected to high uncertainties that require innovative procedures and high operating costs.[14] Third, financial sector development also implies more sophisticated regulation and supervision of financial institutions, which may also help improve the efficiency of MFIs[15]. Therefore, regulation is beneficial for enhancing the efficiency of all stakeholders in the financial market.

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[12] Article 183 of the 1992 Constitution establishes all the powers of the Bank of Ghana.

[13] Arun Thankom, 'Regulating for Development: The Case of Microfinance' (2005) 346-357 The Quarterly Review of Economics and Finance.

[14] Arun Thankom, 'Regulating for Development: The Case of Microfinance' (2005) 346-357 The Quarterly Review of Economics and Finance.

[15] Shakil Quayes, 'Depth of Outreach and Financial Sustainability of Microfinance Institutions' (2012) 3421–3433 Applied Economics.

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Like many other developing countries, Ghana transformed its unregulated microfinance into a regulated one. It took this step to respond to public outcry and the frequent loss of deposits. Therefore, the main objective of the regulation was to protect depositors and ensure sound financial operations within the microfinance sector. In July 2011, the Bank of Ghana issued the Microfinance Institutions (Operation Rules and Guidelines) Notice No.BG/GOV/SEC/2011/04 which specified the various categories and operational activities of each category of microfinance tiers.

The tiered structure represented a reasonable classification of different types of institutions in terms of size and risk to financial stability. Four categories were outlined, and the structure prescribed different levels of capital requirements for each category. Tier 1 comprises Rural and Community Banks, Finance Houses, and Savings and Loans Companies. Tier 2 includes Susu companies and deposit and profit-making Financial Non-Governmental Organisations (FNGOs). Money lenders and non-deposit taking FNGOs are in the Tier 3 category, while Susu collectors and Individual money lenders come under Tier 4.

The new regulatory guidelines (Business Rules and Sanctions for Microfinance Institutions -Tiers 2, 3, and 4) consolidated all previous guidelines issued since July 2011. In addition to the previous guidelines and notices, the current microfinance laws included issues from existing laws such as Non-Bank Financial Institutions Law (NBFI Law) 2008 Act 774 and the Banking Act 2004 (Act 673 as amended). In 2016, these laws were replaced by the Banks and Specialised Deposit-Taking Institutions Act, 2016 (Act 930). The act covers finance houses, remittance companies, savings and loans companies, and leasing companies, among others. It is important to recognise and appreciate the importance and essence of the regulatory instruments.

Under the Banks and Specialised Deposit-Taking Institutions Act, 2016 (Act 930), the Bank of Ghana finalised a full-fledged regulation document for all categories of MFIs in Ghana.[16] Among the tools for regulating MFIs are licensing and supervision, capital adequacy and solvency requirements, reporting requirements, sanctions, remedial measures and administrative penalties.[17] These tools are to promote soundness and enhance the liquidity. They are also to ensure that MFIs operate under good corporate governance. Yet, regulation seems disproportionately centred on minimum capital prescription than other facets that

[16] https://www.bog.gov.gh/wp-content/uploads/2019/09/banks-and-specialised-deposit-act-2016.pdf.
[17] Ibid.

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may pose risks. For instance, between 2003 and 2014, the Bank of Ghana prescribed five capital requirements (from 2.5 million Ghana cedis to 400 million Ghana cedis) for commercial banks and MFIs alike. Therefore, capital adequacy requirements dominated other supervisory tools outlined in the regulatory document. Nonetheless, the current legal regime does not adequately address regulatory issues for MFIs.

Post-Regulation Environment

In behavioural economics, trust is important in explaining the relationship between an institution and its clients. Trust affects an individual's willingness to use a particular financial institution based on their subjective assessment of its reliability. In any economic transaction, one party's lack of trust in the other is an implicit cost due to moral hazard. This mistrust can either increase monitoring and enforcement costs or lead to unconsummated transactions. Therefore, trust is a key ingredient for the survival of financial institutions.

Prior to the regulation of microfinance activities, the banking sector in Ghana was experiencing some misalignments with due diligence, which subsequently cascaded to the microfinance sector. Consequently, the post-regulatory period presented more challenging scenarios. For example, the quality of bank assets has been deteriorating since 2002. According to Ackah and Asiamah.[18] this trend continued till 2013 when the country witnessed an escalation in threats to its financial system from both external and domestic sources. Despite the regulatory reinforcements, the weaknesses in the banking sector threatened the survival of MFIs. High-risk lending was an important factor that led to the crisis because most MFIs could not implement strong risk management practices to enhance loan quality. Bank of Ghana confirmed that non-performing loans and poor credit/loan underwriting were key factors which led to the subsequent withdrawal of some licences.

Revocation of licences of Microfinance Companies

Microfinance Companies fall under the second tier of the microfinance categorisation in Ghana. These are companies limited by shares but not listed on the Ghana Stock Exchange (GSE). In 2019, the Bank of Ghana prescribed a minimum capital of two million Ghana cedis (equivalent to USD 400,000). A significant number of institutions were unable to comply. Consequently, the revocation of licences started with Microfinance Companies on Friday, May 31

[18] Charles Ackah and Johnson Asiamah, 'Financial Regulation in Ghana: Balancing Inclusive Growth with Financial Stability' (2014) Working Paper / Overseas Development Institute.

2019, following an announcement that 347 MFCs were insolvent.[19] The Bank of Ghana explained that it took action under section 123 (1) of the Banks and Specialised Deposit-Taking Institutions Act, 2016 (Act 930). The Act requires the Central Bank to revoke the licence of a bank or Specialised Deposit-Taking Institution (SDI) where the regulator determines that the institution is insolvent or is likely to become insolvent within the next 60 days. Unfortunately, most of the affected institutions had been insolvent for more than the legal 60 days.

It must be emphasised that many of these MFCs could not meet their minimum capital for an extended period before the revocation. This presupposes that capital adequacy-based bank regulation may be ineffective in Ghana, but guidance may yield positive effects. Moreover, it could also be asserted that the Central Bank had not been proactive enough in collaborating with institutions to manage their strategy to comply with the requirement. Most importantly, the sudden nature of the news release into the public domain may not have helped prudential regulation. Some depositors may have misinterpreted the requirement as a looming problem to spark a panic withdrawal, further deteriorating the capital requirement and facilitating their imminent closures.

To correct this 'market distortion', the government decided to bail out affected institutions by paying customers about 900 million Ghana cedis (equivalent to US$ 196 million). This was a loan contracted by the Ghana Government from the World Bank to clean up the sector. Many have argued that the bail-out process was imprudent because the funds could have been used to resuscitate the affected institutions. This option would keep them in business to avoid job losses and a dissipation of public confidence. In some countries where banking crises have occurred, the institutions are revamped rather than paying monies directly to customers.

During the global financial crisis of 2007/08, the United Kingdom government decided to inject £137 billion to rescue some ailing banks and to stabilise the financial system.[20] Although the bailout included a component to compensate depositors, it largely consisted of support schemes such as credit guarantees, special liquidity, and asset protection schemes. In Ghana, the absolute closures

[19] https://www.bog.gov.gh/wp-content/uploads/2019/07/notice-of-revocation-of-licences-of-insolvent-microfinance-companies-and-appointment-of-receiver.pdf. The list of institutions is provided online at https://www.graphic.com.gh/business/business-news/full-list-of-347-microfinance-companies-whose-licences-have-been-revoked.html

[20] Federico Mor, 'Bank Rescues of 2007-09: Outcomes and Cost' (2018) 5748 House of Commons Briefing Paper, Retrieved from https://researchbriefings.files.parliament.uk/documents/SN05748/SN05748.pdf

agitated political debates in the media waves even though the government proceeded to instruct the receiver to pay customers.

Revocation of licences of some NBFIs

Savings and Loans Companies (S&Ls) and Finance Houses are regulated by the NBFI Law 1998 (Act 774) and classified as Tier One MFIs. After revoking the licences of 347 MFCs, the Bank of Ghana targeted the Savings and Loans Companies and Finance Houses. On 16th August 2019, the Bank of Ghana issued a notice revoking the licence of 23 Savings and Loans Companies and Finance Houses[21] in compliance with Section 123 (1) of the Banks and Specialised Deposit-Taking Institutions Act, 2016 (Act 930). The notice provides the reasons for revoking each institution's licence. The main reason offered by the regulator was that the level of capital held by some of these institutions violated the minimum regulatory capital required by Act 930. Low liquidity heightens the precarity of these institutions to continue their deposit-taking services due to the direct or indirect risks they pose to their depositors and other counterparties.

Among the reasons cited were:

1. Excessive risk-taking without the required risk management functions to manage associated exposures;
2. The use of depositors' funds to finance personal or related-party transactions or businesses on terms that were not commercial, leading to little or no income accruing to the relevant institutions and thereby compounding their liquidity challenges;
3. Corporate governance weaknesses (weak board oversight, poor accountability, and override of internal controls);
4. Creative accounting practices and under-provisioning for impaired assets, thereby misrepresenting their true financial condition to the regulator and other stakeholders; and,
5. Persistent regulatory breaches, involving non-compliance with the Bank of Ghana's prudential rules, and failure to implement on-site examination recommendation.

Table 1 summarises the reasons identified by the Bank of Ghana across the 23 institutions listed. Twenty-one (21) separate issues were uncovered. The four prevailing issues include negative capital adequacy ratio, negative net worth, serious liquidity challenges and violation of regulatory limits to related companies.

[21] https://www.bog.gov.gh/wp-content/uploads/2019/08/Revocation-of-Licenses-of-SDIs-16.8.19.pdf

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Table 1: Reasons for licence revocation of S&Ls and Finance Houses

S/N	Reasons	No. of Institutions	%
1	Negative net worth	22	95.3
2	Negative capital adequacy ratio	23	100.0
3	Serious liquidity challenges	15	65.2
4	No supporting and concealing documentations	2	8.7
5	Non-performing loans	10	43.8
6	Misrepresentation of the institution's true financial condition	4	17.4
7	Corporate governance weaknesses	5	21.7
8	Engaging in non-permissible activities	2	8.7
9	Breach of minimum cash reserve ratio	12	52.2
10	High management fee paid	1	4.3
11	Weakness in board and senior management oversight	3	13.3
12	Poor credit, loan underwriting and risk management function	5	21.7
13	Window dressing of accounts	5	21.7
14	Violation of regulatory limits to related companies	15	65.2
15	Failure to implement Bank of Ghana on-site recommendations	9	39.1
16	Ceased operation and closed offices	5	21.7
17	Change of name and relocation without approval	1	4.3
18	Failure to sell repossessed collaterals	1	4.3
19	Failure to submit and publish audited financial statements	6	26.1
20	Loans without proper documentations	1	4.3
21	High rent expenses	1	4.3
	Total	23	-

Source: Data obtained from Bank of Ghana, 2019[22]

There is a tendency to suggest that the failures may not have occurred if the regulatory requirements had been explicit on the breaches enumerated in Table 1. While some issues are fully explicated in the guidelines and sanctions document, others are either partially indicated or unclear. It is worth noting that some of the issues raised by the regulator did not happen in one day, signalling an oversight omission. For instance, liquidity challenges may have accumulated in many MFIs for years, causing the liquidity crunch. It is worrisome that currently, the regulator applies the NBFI Act, 2008 to all non-deposit-taking MFIs contrary to the

[22] The data was collated from the Bank of Ghana's publication on 16th August 2019. https://www.bog.gov.gh/wp-content/uploads/2019/08/Revocation-of-Licenses-of-SDIs-16.8.19.pdf

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provisions of the Act.

So far, the regulator is weathering the storm in the microfinance sector. However, there is an urgent need to think through the lessons learnt for policy purposes. A National Microfinance Policy[23] is being drafted to provide a fresh direction for the sector. This policy document is not meant for regulatory purposes but to ensure that the sector continues to provide the much-needed services to underserved communities and small businesses. The national policy has come at the right time to inject a new wave of energy and promise into a frail sector. One important lesson is that without regulation, it is easy to fall into unlawful practices that create an environment of mistrust between financial institutions and clients. Despite the challenges, the regulator continues to play an important role in defining and enforcing vital rules and regulations such as KYC (know your customer) policy,[24] AML (anti-money laundering) and CFT (combating the finance of terrorism). Having effective and robust regulations can also help build trust among MFI clients.

LESSONS LEARNT

This section focuses on the lessons learned so far from microfinance regulation in Ghana. Market distortions from information asymmetries and externalities require robust regulations. In Ghana, MFI regulation has taken three main forms: simple registration as a legal entity; non-prudential regulations (provides standards of business operations and oversight, such as submitting operating and financial reports); and full prudential supervision. MFIs in Ghana are supposed to graduate from the simple to the complex requirements. While regulation has sanitised the sector by expunging unscrupulous institutions, it has also resulted in some negative consequences from which lessons must be learned. The following lessons have been gleaned from the study:

Regulation without recourse to MFI methodology

In the Ghanaian context, microfinance regulation has produced limited benefits because commercial banking standards are applied to MFIs without adequate

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[23] The policy is set to replace existing regulatory frameworks that are considered inadequate and not responsive to needs of Microfinance Institutions (MFI) in Ghana. It will focus on re-emphasizing the social mission of the industry while creating the conditions for its supervisory framework to function.

[24] In its paper on 'Customer Due Diligence for Banks' published in October 2001, the Basel Committee on Banking Supervision issued guidelines for implementing customer due diligence. The document would assist banks to recognise the importance of instituting adequate controls and procedures to know and protect their customers.

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consideration of microfinance methodologies. Using traditional banking approaches to regulate MFIs has not helped the sector due to the methodological difference between microfinance delivery and traditional banking. It is also important to note that MFI clients are not just micro-entrepreneurs seeking to finance their businesses but the whole range of poor clients who also use financial services to manage emergencies, acquire household assets, improve their homes, smooth consumption, and fund social obligations.[25] In most cases, the regulating team may not appreciate microfinance delivery models and adopted operations.

From the regulator's perspective, there could be misconceptions and assumptions that microfinance is similar to universal banking because of their predominant familiarity with traditional banking activities: granting loans and accepting deposits. For instance, the emphasis has always been on capital requirements, which is positive. However, capital adequacy does not entirely mitigate risks, such as irrational MFI runs. Using traditional banking tenets, principles, and practices with no distinctive criteria for regulating microfinance could be confusing and problematic.

Mission drift?

Regulation is expected to keep institutions afloat, but the unintended consequence may cause mission drift. Due to the tension between the welfare objective and financial sustainability, MFIs will have to present themselves as focusing on clients' economic and social welfare while operating on a commercial and sustainable basis. This institutional transformation, coupled with the demands of both prudential and non-prudential regulation, has unintentionally shifted their balance in favour of commercialisation.[26] Data collected in 2015 revealed that profit-maximising institutions granted over three-quarters of microloans (76%).[27] Given the extent of their operations, regulatory requirements may have compounded operational costs and widened the mission drift. The profit motive and additional regulatory burden have shifted attention from the poor to the non-poor.

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[25] Robert Perk Christen and Timothy Layman and Richard Rosenberg, 'Guiding principles on regulation and supervision of microfinance', International Monetary Fund. accessed 10 August

[26] Enrico Bellazzecca and Olga Biosca, 'Intended and unintended effects of specialised regulation on microfinance institutions' double-bottom line management' (2022) 977-999, Annals of Public Cooperative Economics, 93(4).

[27] Rural and Agricultural Finance Programme (RAFiP), 'Poverty outreach and impact of rural and microfinance institutions and government credit programmes in Ghana' (2016) Ministry of Finance and Economic Planning.

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The mass exodus of MFIs

Commercialisation of the microfinance sector led to rapid growth in the industry, especially after the 2011 regulatory intervention. According to Ewusie and others,[28] profit-oriented microfinance companies topped the league table of microfinance institutions in 2015. The study revealed that Rural and Community Banks (RCBs) had been relegated to second place by the commercial MFCs, which had a market share of 22.3 per cent. Even though RCBs were initially granting subsidised loans to promote small-scale agriculture, they formed 21.4 per cent of microfinance operations, followed by Credit Unions (17.1%), Savings and Loans Companies (15.7%), Susu Collectors (12.7%), Money Lenders (9.2%) and Financial Non-Governmental Organisations (1.6%). In a rapidly growing pro-poor financial market overtaken by profit-seeking entities, financial system soundness may be compromised by sporadic and unregulated institutions. This necessitates the need for rigorous intervention.

In doing so, the tendency to weed out some viable institutions may be high. During the clean-up campaign conducted by the Bank of Ghana, over 400 MFIs had their licences revoked for insolvency. The figure includes licences revoked for MFCs, Microcredit Credit Companies (MCCs) and Savings and Loans Companies (S&Ls).[29] This action was pursuant to section 123 (1) of the Banks and Specialized Deposit-Taking Institutions Act, 2016 (Act 930). By 2015, the regulator had issued licences to about 484 MFCs.[30] Following the clean-up, the number of deposit-taking microfinance institutions has fallen to 133.[31]

Undoubtedly, the regulator took positive steps to safeguard financial stability. Nonetheless, the exodus has implications for providing financial services to the underserved in hard-to-reach areas. Instead of strengthening the base and operations of MFIs, a significant number of institutions have folded up. The clean-up has succeeded in protecting clients from predatory institutions. However, the risk of taking down some potentially viable institutions could have been high. One lesson that needs to be learnt is that the soundness of the financial system is not mainly about capital adequacy. There is a fundamental need for a holistic approach towards regulation.

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[28] Ewura-Adwoa Ewusie and Samuel Kobina Annim and William Brafu-Insaidoo, 'The density of microfinance institutions and multiple borrowing in Ghana: Are rural borrowers vulnerable?' (2021) 1217-1237, Journal of International Development, 33(8).
[29] https://www.mofep.gov.gh/sites/default/files/adverts/ToR-for-Tech%20-Assistance-to-Strenthen-SDI-Subsector.pdf
[30] https://www.bog.gov.gh/wp-content/uploads/2019/07/notice-of-revocation-of-licences-of-insolvent-microfinance-companies-and-appointment-of-receiver.pdf
[31] https://www.bog.gov.gh/supervision-regulation/ofisd/list-of-ofis/. This figure is not disaggregated to indicate the number for MFCs, S&Ls and CUs.

Regulation without good governance

Regulation without good governance provides numerous avenues for the breaches cited by the Central Bank. Good governance rules should focus on the structures and processes fit for microfinance functions. They require boards to have an adequate number of independent members from sufficiently diverse and appropriate backgrounds who have been given proper induction and can regularly evaluate institutional performance. Over the years, the regulator has not been entirely robust regarding the governance of MFI structures as compared to the banking sector. More attention has been given to the traditional banks.

Even though the guidelines for regulating tier 2, 3, and 4 MFIs sufficiently document some form of governance structures, the enforcement has been weak. The clean-up clearly shows that most MFIs lack corporate culture and values, which suggests that loyalty principles and the duty of care are missing. No matter the regulatory tools applied, institutions will continue to fail if the governance systems are weak and ineffective.

Insurance against risks of losses on deposits

MFIs fragility, combined with the important functions they perform, engenders a belief that they need to be regulated and also required to offer insurance to depositors against the risks of failures. Unfortunately, not much emphasis has been given to the concept of deposit insurance until after the enactment of the Banks and Specialised Deposit-Taking Institutions Act, 2016 (Act 930) and the Ghana Deposit Protection Act, 2016 (Act 931). The latter was amended in 2018. The Ghana Deposit Protection (Amendment) Act, 2018 (Act 968) is to be implemented in conjunction with the initial Act. Nevertheless, it is not just about the promulgation of the Act; it is also about its enforcement. Good as it may be, an Act cannot promote accountability or improve lives if it is not rigorously enforced. In the past, a number of laws have been passed but the enforcement has been less potent.

Another issue is whether the Deposit Protection Act extends to MFIs. It is apparent that the universal banks have fully embraced it. However, the challenge is with the MFIs due to weak enforcement. In safeguarding deposits, a critical problem that the regulator has not been able to address is that of unscrupulous and unidentifiable institutions that engage in microfinance. They mobilise deposits but are unable to pay customers upon maturity. The regulations do not seem to consider the threat posed by clandestine institutions that emerge and operate below the radar. Therefore, enforcing complementary laws such as the Deposit Protection Act and swiftly identifying unregistered institutions would go a long way to mitigate risks

for depositors.

Regulatory Capacity

There is no doubt that the regulator is capable of regulating MFIs in Ghana. Nonetheless, the Bank alone cannot tackle the magnitude of the oversight required. It must also be noted that good laws and regulations are only partially adequate. They require a regulatory cadre that is well-staffed, well-trained, and well-paid. The scattered nature of MFIs nationwide requires extra intervention and competent personnel to reach out. The Ghana Microfinance Institutions Network (GHAMFIN) is the apex body of Microfinance Associations in Ghana. It evolved from the Ghana MFI Action Research Network (GAMFIARN), established in 1996. Under the regulatory framework, the Microfinance Associations were empowered to supervise their members. However, their supervisory powers are not explicitly stated in any of the laws that regulate MFIs, thus weakening their capacity to enforce rules and guidelines. Even where it is stated, it does not empower the Associations to sanction the defaulting members.

Summary of Lessons Learnt

The events of the microfinance sector in Ghana demonstrate that the existing regulatory frameworks are not responsive to MFIs' needs. One important insight from microfinance regulation in Ghana is that without regulation, it is easy to fall into irrefutable practices and create an environment of mistrust between service providers, financial institutions, and clients. On a positive note, microfinance regulation in Ghana has contributed to some extent in strengthening staff capacity and weeding out an appreciable number of unscrupulous institutions. However, the regulation has also unravelled issues with learning opportunities.

We identified six lessons that could inform decision-making and future policy actions on microfinance regulation. These include regulatory methodology mismatch, mission drift tension, the collapse of potentially rescuable institutions, lack of good governance, implementation of complementary laws and inadequate regulatory capacity. These lessons suggest that regulatory efforts in Ghana would benefit from a critical review to strengthen the industry and promote effective financial inclusion.

This study adopted a desk review approach to examine microfinance regulation from its inception to the post-regulatory environment. Future research can use primary data to examine institutional challenges and expert opinions on how regulation impacts the operational flexibility and financial soundness of MFIs.

CONCLUSION AND POLICY IMPLICATIONS

This paper examined microfinance regulation in Ghana to gather lessons that could be learnt to inform policy decisions. Our analysis suggests that there are crucial lessons that can inform best practices. These are regulatory methodology mismatch, mission drift tension, the collapse of potentially rescuable institutions, lack of good governance, implementation of complementary laws and inadequate regulatory capacity. These lessons have various implications for the industry, its smooth functioning and the stability of the financial sector.

The review suggests that microfinance regulation has been conducted without recourse to typical microfinance delivery methodology. Traditional tools for regulating commercial banks have been adopted for MFIs with adverse consequences. For effective regulation, there should be a clear working definition of microfinance in the Ghanaian context. Other non-bank financial institutions should also be distinguished from microfinance institutions. The situation where laws are made for all non-deposit taking institutions, including microfinance, needs to be revisited. A *one size fits all* approach to regulatory framework may not work for microfinance.

Microfinance needs its own laws or legislative instruments to govern it. Typical microfinance institutions need a separate law (not guidelines) to regulate them. The starting point of microfinance law is through enacting an Act of Parliament. MFI regulation should also not compromise on mission drift. Regulation should not lead to a mass exodus of MFIs but should rather strengthen their operations. Like the microfinance categorisation, there should be some distinction between deposit and non-deposit taking institutions in terms of the regulatory requirements. For non-deposit MFIs such as tier 3 and 4, there is the need for some amount of flexibility since they do not take deposits.

On governance and customer protection, the current Corporate Governance Directive issued in 2018 for Banks, Savings and Loans Companies, Finance Houses, and Financial Holding Companies may not work for all MFIs, especially the tier 3 and 4 institutions. Therefore, specialised corporate governance directives are needed for tier 2, 3 and 4 MFIs. Insurance against risks of losses on deposits in the MFI sector is also crucial.

Regulating microfinance in Ghana cannot be effective without the support and collaboration of the Microfinance Associations. The Associations can enforce regulations, bylaws, rules, and codes of conduct. However, legal support from the regulator is paramount. Involving the Associations may correspond with *delegated supervision* - an arrangement where the regulator delegates direct supervision to

an outside body, while monitoring and controlling that body's work. This strategy could reduce the overwhelming tasks carried out by the Central Bank.

Based on the policy implications outlined, we recommend that the Bank of Ghana should separate the regulatory architecture for banks and NBFIs. Like other countries, the government should establish a specialised institution to take charge of microfinance regulation or create a dedicated unit committed to the prompt, regular and effective supervision and implementation of laws and complementary guidelines.

The regulator should provide a specialised corporate governance directive for tier 2, 3 and 4 MFIs. Microfinance Associations should also be empowered to strengthen supervision. Additionally, the regulator should consider establishing a special deposit protection fund for MFIs. Learning from other countries' best practices is fundamental. Beyond policy, the regulator should advocate for a specific legislative instrument (LI) or an Act of Parliament that would be promulgated into law to regulate microfinance activities in Ghana.

The lessons gathered and suggested recommendations should aid the policy-making process to devise customised MFI laws and a regulatory framework that directly seeks to resolve particular monitoring and supervision issues within the microfinance sector. These efforts should enable the industry to sustainably provide timely, diversified, affordable and dependable financial services to the low-income population in an integrated financial ecosystem.

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