NIGERIA'S MICROFINANCE BANK SECTOR: REVIEW AND RECOMMENDATIONS

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Acknowledgment

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Acronyms

APR	Annual Percentage Rate
BOI	Bank of Industry
BOP	Bottom of Pyramid (Program)
BVN	Bank Verification Number
CAMEL	Capital Adequacy; Assets; Management Capability; Earnings; Liquidity
CBN	Central Bank of Nigeria
CB	Community Bank
CGAP	The Consultative Group to Assist the Poor
CPI	Consumer Price Index
DMB	Deposit Money Bank
EFInA	Enhancing Financial Innovation and Access
FFS	Financial Self-Sufficiency
GIZ	German Agency for International Cooperation
IT	Information Technology
KYC	Know Your Customer
MFBs	Microfinance Banks
MFI	Microfinance Institution
MIS	Management Information System
MSMEs	Micro, Small, and Medium Enterprises
MSMEDF	Micro, Small, and Medium Enterprise Development Fund
NAMB	National Association of Microfinance Banks
NAMBUIT	National Association of Microfinance Banks Unified IT Platform
NBCB	National Board for Community Banks
NDIC	Nigeria Deposit Insurance Corporation
NGO	Nongovernmental Organization
NOC	Network Operating Center
NPL	Non-Performing Loans
OFISD	Other Financial Institutions Supervision Department
OSS	Operational Self-sufficiency
PAR	Portfolio at Risk
PMI	Primary Mortgage Institution
RBS	Risk-Based Supervision
SIIF	Special Insured Institutions Fund (of NDIC)
TSA	Treasury Single Account

Executive Summary

1. This report analyzes the status of the Nigerian Microfinance Banks (MFBs) sector and aims to identify and address the challenges of its effective regulation and supervision. Ensuring the financial soundness of the MFB sector is regarded as a prerequisite for its further development. This report was prepared at the request of Other Financial Institutions Supervision Department (OFISD) of the Central Bank of Nigeria (CBN) to inform OFISD's efforts to develop a strategy for regulation of the MFB sector with emphasis on its consolidation. The report does not attempt to address in depth other systemic issues related to microfinance market development, such as funding constraints or gaps in financial infrastructure. While important these factors are secondary to the report's central focus on reforming and recalibrating the regulatory framework and ensuring effective supervision, which is regarded as necessary precursors to the growth of the sector. Only once these regulatory and supervisory reforms are implemented will the MFB sector be better positioned to start to make a more significant and sustainable contribution to financial inclusion.

2. The findings of the report are complemented with fifteen case-studies based on a representative sample of different MFB business models and origins, drawing lessons regarding the challenges faced by the sector about factors such as their business model, governance, funding, and client base. The *Microfinance Policy, Regulatory and Supervisory Framework for Nigeria* of 2005 established MFBs as a means of formalizing microfinance institutions (MFIs) in order to promote financial discipline and sustainability, while also providing access to financial services to the unbanked population. The framework was designed to attract new capital as well as to regularize Community Banks (CBs), which had been established since the early 1990s, mainly as conduits for directed lending. Licensed by the CBN, MFBs are allowed to solicit deposits, which are guaranteed by the Nigeria Deposit Insurance Corporation (NDIC).

3. Despite the large number of licensed MFBs (984 as of end-2016) the aspirations of the CBN's 2005 strategy (as updated in 2011) have only marginally been achieved. While MFBs do provide access to financial services to nearly 13 million depositors (of whom 10 million are otherwise unbanked) and 4 million borrowers, their combined asset base stands at barely 1 percent of the assets of the Deposit Money Banks (DMBs). MFBs add up to 10 percent to the formally financially included population, though their net additional contribution has fallen since 2014 as the proportion served by DMBs has risen to 38 percent. Currently, nearly 900 Unit MFBs are intended to provide outreach at the local level, but they generally remain small and inadequate. The 8 National MFBs hold 44 percent of the sector's assets, 38 percent of deposits, and 52 percent of credits. Over 100 State MFBs reach as many depositors as the National MFBs, but vary widely in performance and soundness.

4. Although the MFB regulatory framework was intended to balance the outreach objective with more attention to financial objectives, it has done little to resolve the financial sustainability challenges of the smaller Unit and State MFBs. While establishing small institutions appears attractive in terms of encouraging such institutions to service small depositors and borrowers, the viability of small financial institutions is

particularly fragile. Many of the legacy CBs now licensed as Unit MFBs remain weak, and there has been periodic de-licensing of insolvent MFBs alongside licensing of new ones that prove to be undercapitalized. Failure to raise the minimum capital requirement for Unit MFBs since 2005 coupled with high setup and administrative costs, particularly during their early years of operation, means that many small MFBs do not have the financial means to achieve financial sustainability.

5. Fundamental challenges persist regarding the soundness of the MFB business model and the CBN's oversight capacity. When licensing, on average 48 new MFBs per year (2013–2016), entry criteria have not been sufficiently stringent or have simply not been adhered to when making decisions as to whether to license new institutions. The CBN's evaluation of the business model of the individual MFBs at the licensing stage does not include analysis of anticipated prudential ratios or the capacity of their management information systems (MIS) to meet financial management and reporting requirements. These are important factors for consideration in the pre-licensing verification phase. Over a third of Unit MFBs and 20 percent of State MFBs have failed to submit regular reports in recent years. Poor reporting impairs the CBN's ability to monitor sectoral performance and forces it to devote excessive resources to on-site supervision. In defining the CBN's policy toward the MFB sector consideration also needs to be given to the CBN's overall oversight capacity. Currently, there are so many MFBs that it becomes impossible for the CBN to supervise them properly. Inadequate supervisory enforcement and the maintenance of licenses of inactive and clearly noncompliant MFBs only contributes to undermining public trust in the role of the CBN as supervisor. Similarly, the provision of deposit insurance by the NDIC is associated with moral hazard, as it provides largely unsupervised MFBs with an unwarranted safety net, resulting in a disproportionate drain on NDIC assets. While the total assets of MFBs account for only about 1 percent of the assets of the DMBs, they have absorbed no less than 30 percent of the value of the payouts administered by NDIC, reflecting both the MFB performance difficulties and inadequate oversight applied to the MFB sector.

6. The CBN's regulatory guidelines need to be reviewed to be made more realistic and then rigorously enforced. Some prudential guidelines, such as the requirement that the portfolio at risk (PAR) encompasses all loans that are only one day overdue (rather than the MFI industry standard of 30 days) are overly restrictive and could, if upheld, severely hamper MFBs in serving their target client group. In other cases, as when licensing new MFBs, the supervisory requirements are similar to those applied to DMBs and appear unrealistic or overly complex, and a more selective approach focusing on fewer key requirements could be more effectively enforced.

7. One factor impeding the financial sustainability of MFBs is that their initial capital is insufficient to meet their establishment costs (including premises, hiring of qualified staff, and investment in MIS and reporting systems) as well as to guard against the financial challenges associated with their first years of operation. Even before taking these challenges into account the minimum capital required for Unit MFBs has declined significantly in inflation-adjusted terms since it was set in 2005. In addition, the challenges to the financial sustainability faced by Unit MFBs, particularly in their first years of operation, call for an overhaul of the level of their required minimum capital.

8. Higher minimum capital requirements for new licenses for MFBs, especially Unit MFBs, would slow down the rate of entry of new MFBs, encourage consolidation, and – following the proposed moratorium period on new MFB licenses – ensure that newly-licensed MFBs have sufficient financial resources to enable them to become financially self- sustainable. Together these actions will considerably ease the severe pressures placed on the CBN's supervisory resources. Restricting entry would also increase the incentives for would-be investors to acquire, consolidate and reinvigorate existing MFBs, rather than establish new MFBs that may compete with already weak existing MFBs. Requiring MFBs to meet higher minimum capital requirements would encourage Unit MFBs that are unable to raise additional capital on their own to seek mergers with others or acquisition by State or National MFBs. MFBs unable to meet the higher capital requirement would be de-licensed and could continue in operation as credit-only institutions. The CBN has previously revoked operating licenses of MFBs for lack of compliance, and lessons from these experiences can be integrated in managing the exit of MFBs that are not able to comply with regulatory requirements. To manage expectations and address potential concerns and misperceptions the CBN should develop a comprehensive communications strategy to inform the MFB industry, MFB clients and the broader public about the CBN's intentions and to report about the reform process as implementation progresses.

9. As immediate actions, the report recommends amalgamating Unit and State licensing regimes resulting in only two license tiers: Statewide and National licenses; increasing minimum capital requirements for both tiers; and applying a moratorium on new MFB licenses until the reform has been implemented. These measures to be introduced over a one to two-year transition period will be beneficial from multiple perspectives. They will provide MFBs with: (a) financial buffer, particularly in their first year of operation; (b) encourage consolidation among MFBs, although de-licensing will still need to be undertaken in those cases where MFBs are insolvent; and (c) once the consolidation and de-licensing processes are complete, reduce the supervisory burden on the CBN. While the financial fragility of MFB sector does not pose a systemic risk to the Nigerian financial system due to its small size, financial stability is a prerequisite for the growth of the MFB sector. Only when the financial soundness of the MFB sector is ensured the MFBs will be able to start making a more significant and sustainable contribution to financial inclusion.

10. Given the difficulties confronted by MFBs in managing the quality of their loan portfolios, OFISD and NDIC should expeditiously introduce corrective actions and, where these are insufficient, de-license them. While consolidation may appear a less painful remedy, many MFBs were established when it was relatively easy to obtain a new Unit MFB license and the minimum capital required was low and they will remain relatively unattractive as partners in a consolidation; in such cases, the CBN may be compelled to rescind their licenses as deposit taking MFBs. It should also be noted that combining MFBs, particularly weaker ones, poses significant challenges to internal control and governance. Hence it is unrealistic to assume that mergers will arise fast enough to address the problem of insolvency, and de-licensing will still be needed.

11. The failure of many MFBs to report on a timely and reliable basis undermines the CBN's role as regulator. Rather than mobilizing on-site inspections based on the CBN's

off-site assessment of the individual MFBs risk exposure, i.e. in those instances where off-site data suggests there is a need, the CBN finds itself obliged to undertake on-site visits simply because MFBs do not report reliably, in a timely manner, or do not report at all. As long as the off-site data collected by the CBN is of unreliable quality and regularity, it will be very difficult for the CBN and the NDIC to strengthen their supervision. As importantly, these reporting issues are likely to be reflective not only of inadequate data management, but overall weaknesses in the MFBs' internal risk management systems. Approval has recently been given to imposing penalties for late submissions. After a grace period to enable those MFBs with inadequate MIS systems or staff capacity to remedy their situation, graduated sanctions would be imposed to those MFBs not fulfilling the CBN's reporting requirements. Along with imposing graduated sanctions the CBN will need to develop and implement corrective measures for those MFBs that continue not to report financial data on a timely and reliable basis.

12. Significant reforms are required both regarding the structure of the MFB sector and its regulation and supervision and the immediate priority should be given to increasing the minimum capital requirements and encouraging consolidation. Undertaking these reforms, will support efforts to strengthen the supervision process and ultimately enhance the MFB sector performance. Broader reforms of regulation and supervision need to be undertaken in a prioritized and coordinated fashion. Key elements of the reform process are briefly summarized in the table of recommendations, and further elaborated in the report. The table below also specifies whether the suggested reforms are to be implemented in the short term (ST) or medium term (MT).

SUMMARY OF RECOMMENDATIONS

#	Recommendations	Timing
	I. Encouraging clarification and consolidation of the MFB sector	
	A. Streamlining the regulatory structure and strengthening capital standards	
1.	Amalgamate Unit and State licensing regimes resulting in only two license tiers: Statewide and National licenses. Announce amalgamation to take place at the end of a one- to two-year adjustment period and develop a communication strategy to inform stakeholders about this process.	**ST**
2.	Raise the level of minimum capital of MFBs to adequately cover establishment costs (e.g. including premises, MIS, and skilled staff) and to provide a buffer against inadequate viability in the initial years of operation. The starting point for determining the appropriate level of minimum capital could be prior levels adjusted for inflation, but consideration needs to be given to further increasing minimum capital to ensure capital is sufficient to fund initial investments and to provide a buffer for eventual losses, especially for amalgamated Unit and State licensing category.	**ST**
3.	Delicense those MFBs that are already suffering from insolvency and slated for de-licensing, as well as any MFBs that are unable to achieve the raised minimum capital requirement	**ST/MT**
4.	Apply a moratorium on all new MFBs licenses until the transition to higher minimum capital and amalgamation and/or exit processes are completed and the CBN's oversight of the licensing process has been strengthened.	**ST**

B.	**Strengthening the licensing process for new MFBs** (following the moratorium recommended immediately above)	
5.	Require prospective new licensees to demonstrate the financial and operational viability of their business models by strengthening requirements regarding the adequacy of systems, processes, internal controls and governance arrangements during the pre-licensing verification process.	**MT**
6.	Ensure that newly-licensed MFBs live up to the required governance standards as regards their Board and management.	**MT**
7.	Ensure that newly-licensed MFBs have in place the necessary MIS systems to maintain adequate internal control and to report to the CBN reliably and on a timely basis.	**MT**
C.	**Significantly strengthening regulatory enforcement**	
8.	Strengthen MFB internal management processes with a view to enhancing the quality of risk-management and reporting through systematic application of a graduated set of supervisory sanctions.	**MT**
9.	Undertake a thorough review of the regulatory framework, including existing prudential requirements as applied to MFBs, with a view to adjusting these requirements to microfinance business model in line with good practice in this area, thereby supporting the CBN in putting an end to regulatory forbearance.	**MT**
10.	Strengthen CBN's supervisory capacity and place greater reliance on off-site data analysis by upgrading the CBN's skills in monitoring off-site data using algorithms and analytical tools that allow the CBN to test the reliability and consistency of the off-site data reported by the MFBs.	**MT**
11.	Introduce greater transparency about exactly which supervisory corrective actions and penalties will be applied to particular transgressions and identified weaknesses. To encourage compliance with corrective action plans OFISD is encouraged to develop a set of graduated, pre-announced sanctions to be applied according to the severity and duration of reported financial weaknesses and supervisory transgressions.	**MT**

Introduction

1. **This report analyzes the status of the Nigerian Microfinance Banks (MFBs) sector and aims to identify and address the challenges of effective regulation and supervision to ensure the sector's financial soundness as a prerequisite for its further development.** It was prepared at the request of Other Financial Institutions Supervision Department (OFISD) of the Central Bank of Nigeria (CBN) to inform OFISD's efforts to develop a strategy for regulation of the MFB sector with emphasis on its consolidation. The report does not attempt to address other systemic issues in depth related to microfinance market development, such as funding constraints or gaps in financial infrastructure. While important these factors are secondary to the report's central focus on reforming and recalibrating the regulatory framework and ensuring effective supervision. These measures are regarded as necessary precursors to the growth of the sector so that it can start to make a more significant and sustainable contribution to financial inclusion.

2. **The report is organized as follows:**

- **Chapter I provides an overview of the activities of the MFB sector**, including the level of activity of the MFBs and their financial situation.
- **Chapter II describes the regulatory framework applied to the MFB sector,** going back to the Community Banks (CBs) of the 1990s, the introduction by the CBN of a regulatory framework for MFBs in 2005, and the revisions in 2011. The shortcomings of this framework and the need for revision are highlighted.
- **Chapter III reviews the current challenges faced in supervising the MFB sector.** It highlights where there is need to reform current supervisory approaches to ensure greater effectiveness, the risk factors that require greater focus, and how these might best be addressed going forward.
- **Chapter IV provides an overview of the current situation within the MFB sector based on on-site visits to a sample of 15 MFBs selected to be reasonably representative of this far-flung sector.** The chapter draws lessons as to the challenges faced by the sector about factors such as their business model, governance, funding, and client base.
- **Chapter V draws conclusions and makes recommendations about the way forward, focusing in particular on measures to encourage consolidation** and to strengthen supervisory enforcement, and policies to facilitate structural reform with a view to ensuring the sector's viability and growth going forward.

I. Overview and Trends of Microfinance Banks

A. The role of MFBs within the regulatory framework

3. The purpose of licensing MFBs within the regulatory framework for financial intermediation in Nigeria is to increase access to financial services for underserved segments of the population. The intention is to provide a wide range of financial services to a much larger segment of the population than is serviced by the deposit money banks (DMBs) with 'mainstream' banking licenses. According to the CBN's microfinance policy, supervisory and regulatory framework issued in 2005, the purpose is to "enhance the provision of diversified microfinance services on a long-term sustainable basis for the poor and low income groups" (Paragraph 1.5).[1]

4. The importance of promoting and regulating MFBs came into focus in 2004/2005 at the time of the tenfold increase in minimum capital for DMBs (from NGN 2.5 billion to NGN 25 billion), introduced as of end-December 2005. This minimum capital increase resulted both in the fall in the number of DMBs from 89 to 25 (initially) and in an increase in the 'gap' (as measured by asset size) between the large 'megabanks' and the small CBs, most of which were subsequently re-licensed as MFBs. The intention behind the CBN's microfinance policy, regulatory, and supervisory framework was to enable smaller microfinance institutions (MFIs) to formalize and grow, and thereby contribute to lessening this gap.

5. Emphasis was placed on promoting a set of smaller formal deposit taking intermediaries, called MFBs. The purpose was to service those clients that were not being serviced by the DMBs in an attempt to overcome the limited outreach of financial services being provided by other institutions, such as CBs, credit-only MFIs (usually NGOs), cooperative associations, unregistered societies, etc. The regulatory framework for MFBs aimed to fill this gap through a stratified licensing framework whereby MFBs enter as Unit institutions (minimum capital NGN20 million) and can then graduate to Statewide license (minimum capital NGN100 million) and eventually to a National license (minimum capital NGN2 billion). Conceptually, this approach raised issues of risk, as supervising a large number of small institutions implied stretching supervisory capacity, and regulatory arbitrage, due to the relatively low minimum capital requirement for MFBs compared to DMBs which required a minimum capital of NGN25 billion.

B. The limited potential contribution of the MFB sector to financial intermediation

6. The aspirations of the CBN's 2005 strategy (as updated in 2011) have only marginally been achieved, despite the large number of licensed MFBs. Although the policy attracted a number of new entrants, most of the 984 MFBs as of 2016 are CBs that were re-licensed as MFBs. Of these institutions, 867 are Unit MFBs, 109 are State MFBs whose licenses allow them to operate across a particular state, while only 8 National MFBs

[1] *Microfinance Policy, Regulatory and Supervisory Framework for Nigeria,* issued by the CBN in December, 2005.

have been licensed to operate nationwide (Table 1.1). The number of State MFBs has doubled since 2013 to 109 in 2016, while the number of National MFBs rose from 2 in 2013 to 8 in 2016.

Table 1.1: Evolution in the number of licensed MFBs by tier, 2013–16

Tier of MFB	2013	2014	2015	2016
Total	825	884	960	**984**
National	2	6	7	8
State	52	94	95	109
Unit	771	784	858	867

Source: CBN data.

7. Despite the large overall number of MFBs, the eight large National MFBs hold a market share of 44 percent of the sector's assets and 38 percent of deposits. The average assets and deposits of these few National MFBs far outweigh those of the State and Unit MFBs (Table 1.2). Of the credit provided by the MFBs, 52 percent was intermediated by the 8 National MFBs, 21 percent by the 109 State MFBs, while the 867 Unit MFBs only provided 28 percent. The inability of many small MFBs to harness economies of scale limits their business potential, while at the same time their oversight poses a disproportionate work burden on the supervisor.

Table 1.2: Relative market share and average size as regards assets and deposits

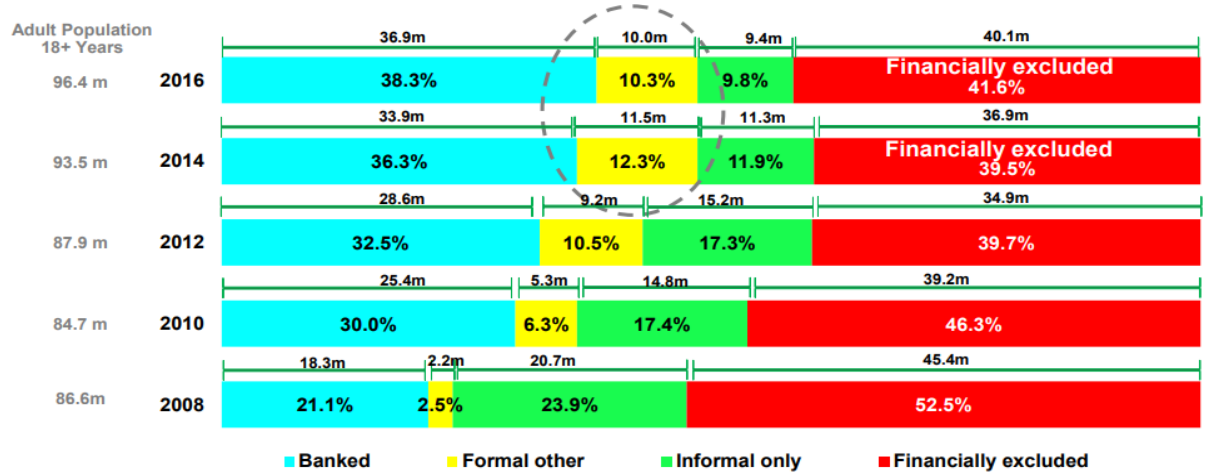
Data for end-2016	Number licensed	Assets (NGN, billions)	Market share (%)	Average assets per institution (NGN, billions)	Deposits (NGN, billions)	Market share (%)	Average deposits per institution (NGN, billions)
Total MFBs	984	331	100	0.34	152	100	0.15
National	8	142	43	17.75	57	38	7.12
State	109	80	24	0.73	38	25	0.35
Unit	867	109	33	0.13	57	37	0.06

Source: CBN data.

8. Despite their number, the services provided by MFBs have achieved little in terms of expanding credit provision. The total credit provided by MFBs at the end of 2016 (NGN 198 trillion) amounted to only 1.1 percent of credit provided by the DMBs (NGN 16,117 trillion). The contribution of MFBs is more significant in terms of increasing the number of adults who are have access to formal financial services, although their net contribution to formal financial inclusion has recently been declining. MFBs contribute significantly to the access of the population to formal financial services, and the number of depositors has been increasing at all levels. Nevertheless, recent surveys undertaken by EFInA (Enhancing Financial Innovation and Access) indicate that the net addition of formal financial institutions other than DMBs to adults over 18 years with formal accounts declined from 11.5 million in 2014 (equivalent to 12.3 percent of those financially-included) to only 10.0 million in 2016 (equivalent to 10.3 percent of those financially-included) (Figure 1.1). EFInA also reports that the proportion of those financially-included serviced by MFBs is only 3.8 percent – i.e. that MFBs only provide services to about a third of those included in the

"formal other" category in Figure 1.1[2]. Of the decline in those serviced by "formal other" institutions of 1.5 million between 2014 and 2016 around half (0.8 million) represents a lower net contribution of MFBs to financial inclusion. This may represent a combination of declining trust in MFBs and graduation to higher level financial services as provided by DMBs.

Figure 1.1: Trends in financial access 2008–2016



Source: EFInA, Access to Financial Services in Nigeria Survey.

9. The data assembled as part of EFInA's surveys is somewhat dissimilar from the data used in the remainder of this chapter as reported to the CBN. This arises because the EFInA data is based on surveys of representative usage, while the data reported to the CBN generally refers to stock data—for example, the number of deposit accounts (12.8 million)[3] rather than whether these accounts are used by individuals for making deposits or withdrawals. However, it is worth noting that these discrepancies are indicative of a significant issue facing the MFB sector relating to the level of activity within the sector. As further discussed in later chapters, many of the 984 MFBs are inactive or dormant institutions making little, if any, contribution to savings and investment flows within the economy.[4]

10. Many small Unit MFBs have low levels of capital and are subject to inadequate oversight, rendering them as potential conduits for illicit activities such as money laundering. Given low capital requirements, inadequate reporting, and limited enforcement of supervisory actions, many MFBs retain their licenses mostly as a matter of convenience.

[2] The "formal other" category includes: adults who have or use financial products and/or services provided by formal financial institutions which are not deposit money banks (including those adults who use the products through somebody else) such as insurance companies, microfinance banks, pension schemes or shares. It also includes remittances (through formal channels), see page 14 of http://www.efina.org.ng/assets/A2F/2016/Key-Findings-A2F-2016.pdf

[3] See section III.

[4] While this distinction was not made in the data provided by the CBN, it should be fairly straightforward to identify 'dormant' MFBs based on low volumes, low changes in values between periods, etc.

This may risk providing a convenient platform for money laundering, as well as for more benevolent accessibility to finance for their clients, should the need or opportunity arise.

C. The weak legacy provided by Community Banks

11. The Nigerian MFB sector had its origins in the rather ill-designed concept of CBs. CBs were launched within the context of supply-driven, government-funded, and subsidized credit schemes, in which provision of loans was emphasized over recovery. The CB business model was far removed from the provision of microfinance on a viable and sustainable basis. Most of the MFBs that were licensed after the launch of the CBN's Microfinance Policy in 2005 were re-licensed CBs. Established in the early 1990s, the National Board for Community Banks (NBCB) promoted "community banks as a community development organization in a special field, that of savings and credit," but it "did not reflect much of real world banking practices and requirements."[5] Consequences included emphasis on disbursement of loans, not on recovery, with high loan arrears; financial viability, profits, and dividends were not major objectives; mandating a minimum number of staff of 13, of whom only 2 were loan officers; poor governance; inadequate internal controls; and undercapitalization.[6] These problems were symptoms a fundamentally weak business concept combined with poor regulatory policy.

12. Transfer of the overwhelming task of supervising over 1,300 CBs to the CBN in 2000 led to tightened licensing requirements and resulted in some improvements, but overcoming the legacy proved to be difficult. Weak performance of CBs resulted in significant rationalization from as many as 1,355 CBs in 1995 to 'only' 532 qualifying for a CBN license in 2004. Explanations for the rationalization undertaken by the CBN included "the rather unprofessional supervision by the NBCB, the insufficient financial endowment of the NBCB, and the lack of attention by policy makers to this segment of the formal financial system during the last years of the military regime."[7] Nonetheless, the fundamental problems regarding the business model and regulatory approach to CBs was never really addressed and has ended up burdening departments at the CBN responsible for regulating and supervising the MFBs with unreformed legacy institutions.

D. Recent trends point to continuing fundamental challenges

13. Following the introduction of the CBN's Microfinance framework in 2005, the CBN adopted a lax approach to re-licensing CBs and to issuing de novo MFB licenses. By the end of 2007, 607 CBs had been re-licensed as MFBs (Figure 1.2). Unfortunately, rather than use the opportunity provided by this re-licensing process to raise the level of compliance with the CBN's supervisory standards, the CBN re-licensed CBs as MFBs more or less on a blanket basis. With the addition of 303 new MFB licenses, the total number reached

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[5] Marx, Michael T. 2005. 'Assessment of Community Banks in Nigeria.' Cologne: University of Cologne, Development Research Center, Working paper No. 2005,5, p. 17.

[6] "Low income clients refused to buy shares as they could not get loans from the bank. Potential investors did not see that the bank in question had paid out substantial dividends…Managers do not regard the selling of shares as one of their prime duties" (ibid., pp. 17, 25).

[7] Ibid., p. iv.

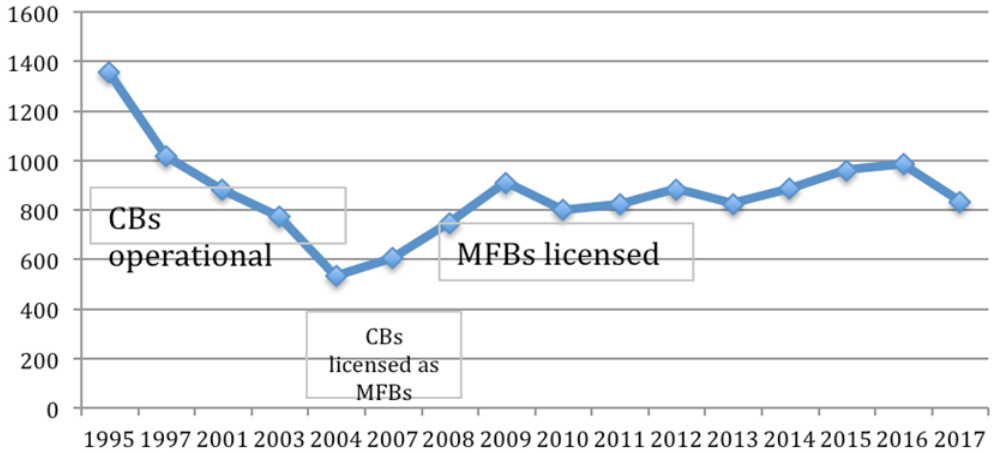
910 in 2009. Of these 224 were identified as insolvent or in distress and 103 had their licenses revoked. However, approval of additional licenses brought the number back to 883 in 2012, of which 528 were former CBs.[8] In 2013, there were 83 liquidations and 27 new licenses were issued. With some 159 new licenses in the period 2014–2016, the total number reached 984 by the end of 2016—of which some 150 have been designated for de-licensing (subject to CBN management approval). Altogether the CBN seems to have lacked the political will and/or the funding required to compensate depositors and undertake a significant transformation of the CB sector.

14. Fundamental challenges persist regarding the soundness of the MFB business model and the CBN's oversight capacity. Besides the legacy weaknesses inherited by MFBs from CBs transformed into MFBs, the continuing repeated cycle of expansion in the number of licenses followed by license revocations indicates that more fundamental weaknesses are at stake:

- Entry criteria have not been sufficiently stringent or have simply not been adhered to when making decisions as to whether to license new institutions.
- Many MFBs do not have the capacity to achieve financial sustainability – i.e., while establishing small institutions appears attractive in terms of encouraging such institutions to service small depositors and borrowers, the viability of small financial institutions is particularly fragile.
- The CBN's licensing policy does not appear to be reflective of the prospective viability of MFBs. The CBN's evaluation of the business model of the individual MFBs at the licensing stage does not include analysis of anticipated prudential ratios or capacity of their management information system (MIS) to meet financial management and reporting requirements.
- Consideration needs to be given to the CBN's overall oversight capacity in terms of defining the CBN's policy towards the MFB sector. Having so many MFBs that it becomes impossible for the CBN to supervise them properly calls for a revision of this policy.
- The CBN should strengthen its capacity to use early corrective intervention mechanisms to avoid situations of financial distress.
- In soliciting deposits from small savers, MFBs have relied on blanket deposit insurance coverage provided by the Nigerian Deposit Insurance Corporation to provide comfort to savers. Given inadequate regulatory enforcement, the provision of deposit insurance results both in moral hazard[9] and significant fiscal costs.[10]

[8] CBN data and World Bank, 'Nigeria: Access to Finance,' FSAP Technical Note, March 2013, p. 14.
[9] Moral hazard occurs when MFBs undertake risky dispositions (such as continuing to lend when the level of portfolio at risk is already above regulatory norms), as they can rely on NDIC to bail out their deposit liabilities.
[10] As of end-2016 the NDIC has reimbursed depositors in liquidated MFBs up to NGN 200,000 per account, with a cumulative disbursement of NGN 2,863 million.

Figure 1.2: Number of licensed Community Banks/Microfinance Banks



Source: CBN data; Michael Marx 2005, 'Assessment of Community Banks in Nigeria.' Cologne: University of Cologne, Development Research Center, Working Paper No. 2005,5; World Bank, 'Nigeria: Access to Finance Technical Note, March 2013 (internal document). Note: The 2017 data assumes that pending revocation of some 150 licenses is carried out.

15. Indicative of the weak oversight provided by the CBN is that those MFBs that do not report to the CBN are not sanctioned and are able to maintain their status as being licensed. Moreover, a portion of Unit (and some State) MFBs are inactive. Over a third of the Unit MFBs have failed to submit regular reports in recent years, as well as over 20 percent of State MFBs (meaning that aggregate data underrepresent actuals for Unit and State MFBs, unless adjusted).

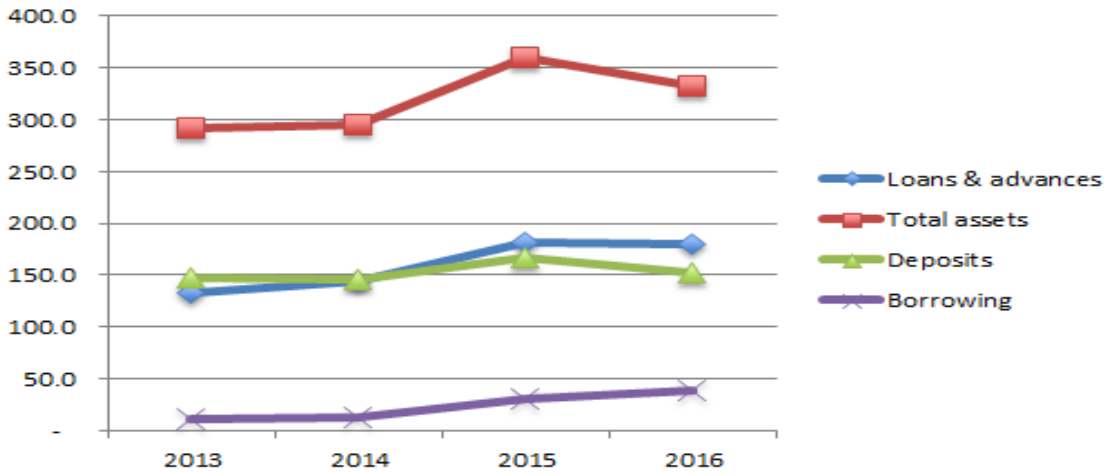
16. Even when considering the large number of Unit MFBs and the growth in the number of MFBs with State and National licenses in recent years, the contribution of the MFB sector to financial deepening remains meager. As a whole, the MFB sector has only about 1 percent of the assets and deposits of the DMBs.[11] Recent trends in assets and liabilities of the MFB sector are shown in Figure 1.3. After some growth in nominal terms in 2015, the nominal value of the MFB sector's deposits and loans declined in 2016. Of particular concern is that in recent years the loans made by MFBs have been growing more rapidly than their deposit base, and this loan growth is increasingly being funded by borrowing (see further discussion of MFB funding in Chapter IV).

17. In recent years the performance of MFB sector has been impacted by the economic crisis caused by the decline in oil prices. This resulted in the currency depreciation and the first recession in over two decades with GDP contracting for five consecutive quarters (only to rebound in the second quarter of 2017 with positive growth of 0.6 percent year-on-year). In addition to the impact of the overall economic slowdown on the performance of the MFBs' loan books, many MFBs (in particular larger ones) had to rely on foreign currency funding, which became much less accessible due to the introduction of the dual exchange rate regime, as foreign funders were obliged to use the considerably

[11] CBN, *Financial Stability Report* - December 2016, pp. 22 and 25; and World Bank, op. cit., p. 8.

undervalued official exchange rate in making new funding commitments[12]. While a more exact analysis of the impact of economic crisis on MFB sector is not available, the impact of the 2015-2017 economic slowdown needs to be borne in mind in analyzing the graphs included in this Chapter.

Figure 1.3: Assets/liabilities of all MFBs, 2013–2016 (NGN, billions)

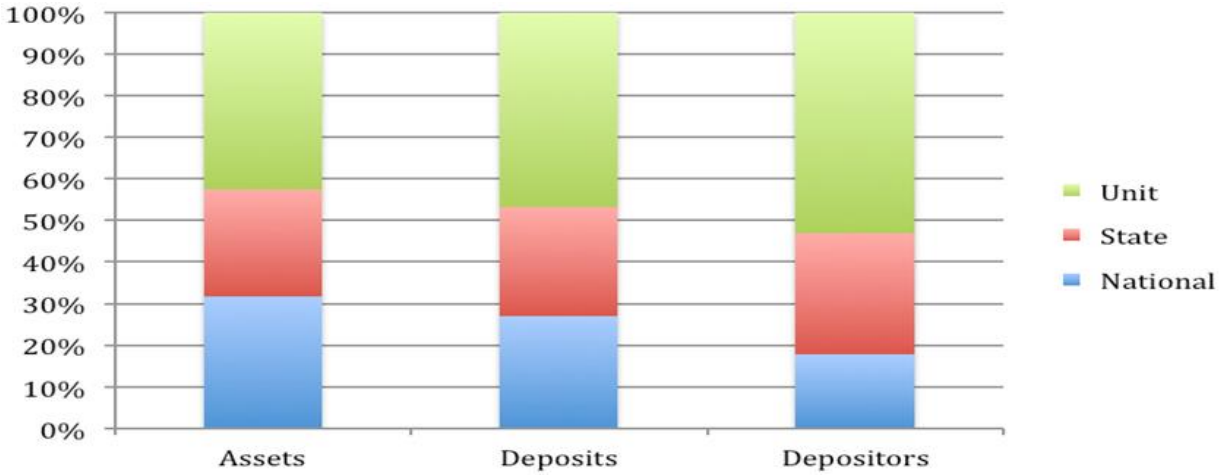


Source: CBN data.

18. National and Unit MFBs each account for about a third to 40 percent of the assets of MFBs (depending on adjustment for under-reporting), and State MFBs account for a quarter of MFB assets. Figure 1.4 shows the distribution of assets and deposits and the number of depositors as between Unit, State, and National MFBs. Unit MFBs account for about half of the value of deposits; and State MFBs and National MFBs each have about a quarter of the of the value of deposits.

[12] See further discussion of the impact of the dual exchange rate regime on MFB funding in Chapter IV.

Figure 1.4: Distribution of assets, deposits, and depositors by tier of MFB, 2016 adjusted for under-reporting (percent)



Source: CBN data.

Deposits and Loans

19. In terms of the number of depositors, reached the contribution made by MFBs is more substantial than in terms of the relative size of their asset base. The number of depositors at MFBs has increased in recent years – from 3.9 million in 2013 to 12.8 million in 2016. While the average size of the funds deposited is much lower, latest data (for 2014) provided by Findex suggest that the number of depositors at MFBs (at that time 9.4 million) reached a seventh of the number of depositors at DMBs. MFBs have been attracting a steadily growing number of depositors in all tiers (Figure 1.5a). While the number of borrowers also increased in 2014 and 2015, it fell in 2016 for Unit and National MFBs (Figure 1.5b).

Figure 1.5a: Number of Depositors (million)

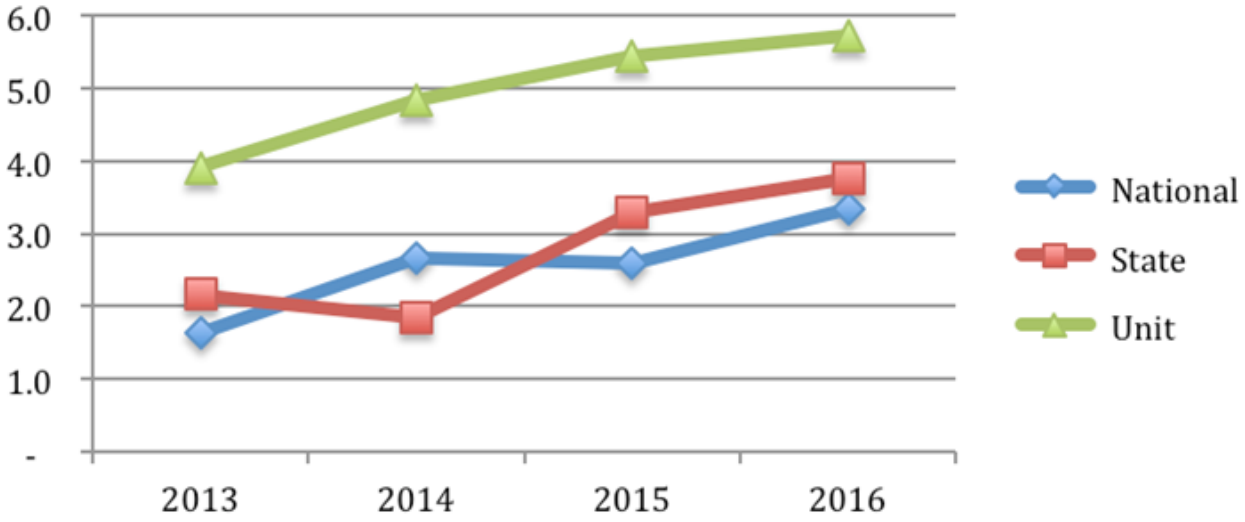
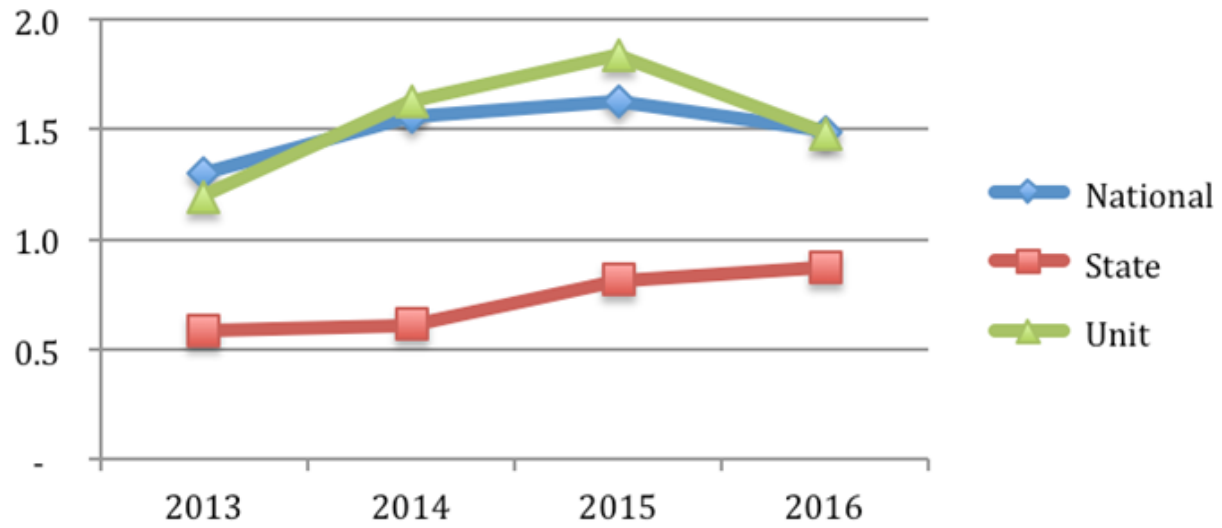


Figure 1.5b: Number of borrowers (million)



Source: CBN data.

20. In recent years, National MFBs have placed greater reliance on borrowing as a source of funding. While the number of depositors increased in 2016, the value of deposits fell for National and State MFBs (Figure 1.6a). The value of the loan portfolio also fell in State and Unit MFBs, although it continued growing in National MFBs (Figure 1.6b), despite the decrease in the number of borrowers (Figure 1.5b). As a result, the ratio of deposits to loans has been declining overall in all tiers, although the ratio recovered somewhat in 2016 for Unit MFBs (Figure 1.7). Deposits account for less than 60 percent of loans in National MFBs, reflecting the greater reliance placed by nationally-licensed MFBs on investment by foreign donors and impact investors.

Figure 1.6a: Total value of Deposits (NGN billion)

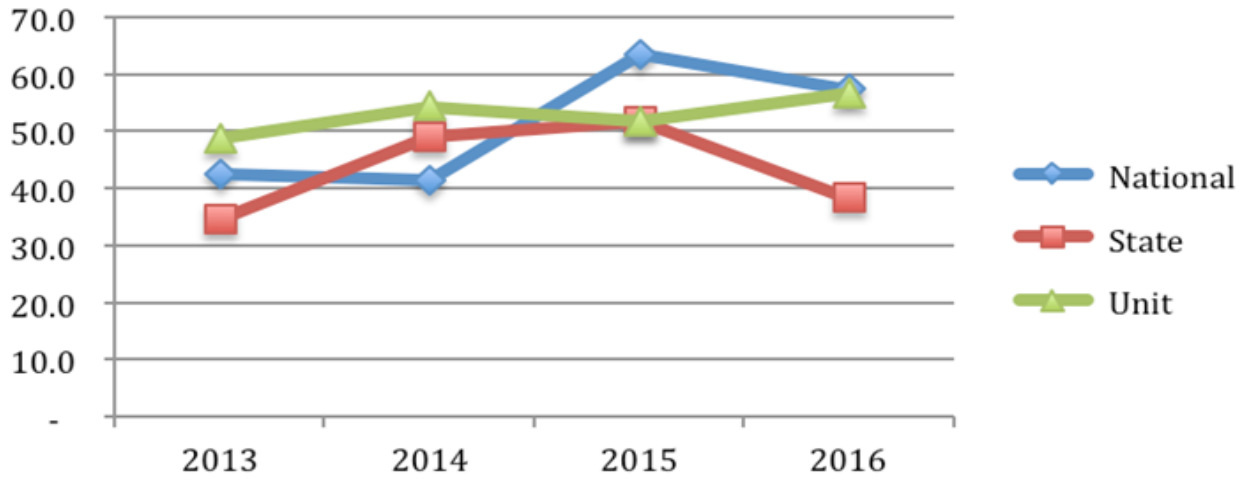
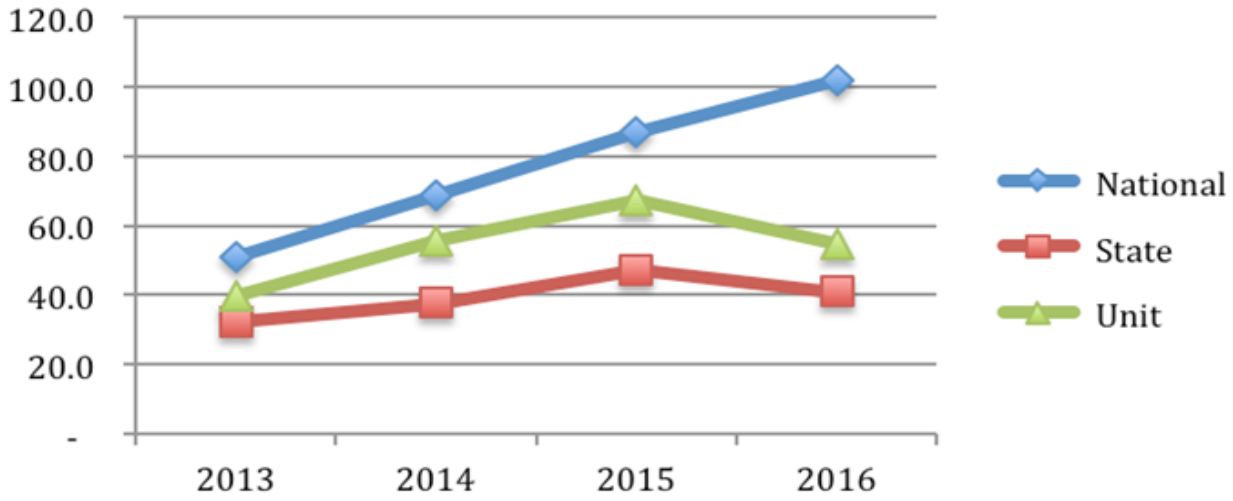
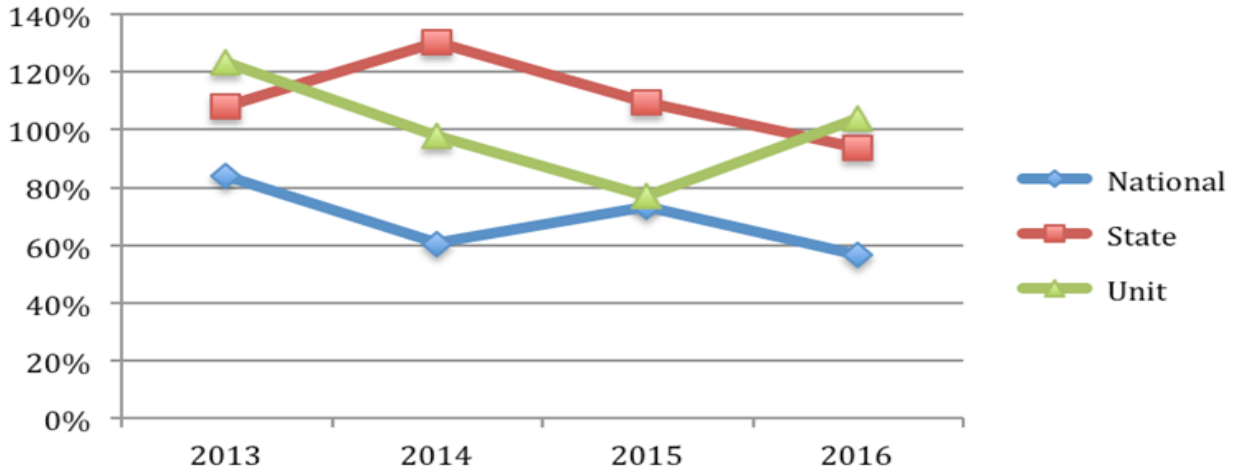


Figure 1.6b: Total value of loan portfolio (NGN, billions)



Source: CBN data.

Figure 1.7: Deposits as percent of Loans



Source: CBN data.

21. While average deposit and loan sizes have on the whole declined in recent years, the average size of loans made by National MFBs has been rising. The average deposit per client has been declining overall in all tiers, with the average client in State MFBs saving about the same amount (NGN10,000) as in Unit MFBs by 2016, while clients of National MFBs save about 70 percent more on average (Figure 1.8a). Average loan size has declined somewhat in State MFBs to about NGN 47,000 compared to NGN39,000 in Unit MFBs; the average size of loans made by National MFBs rose to about NGN68,000 in 2016 (Figure 1.8b).

Figure 1.8a: Average Deposit Size per Depositor (NGN)

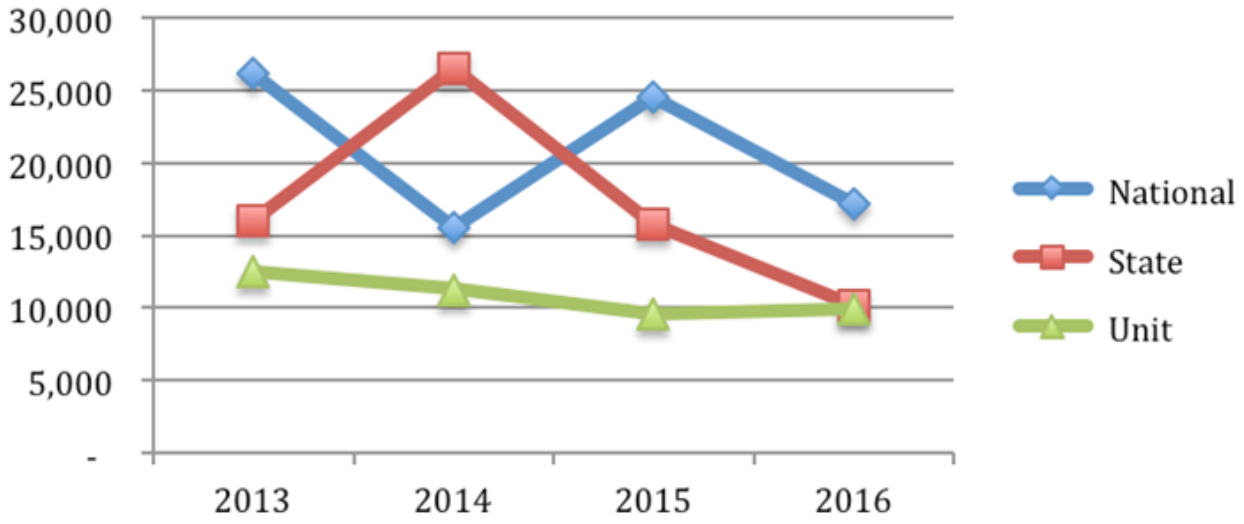
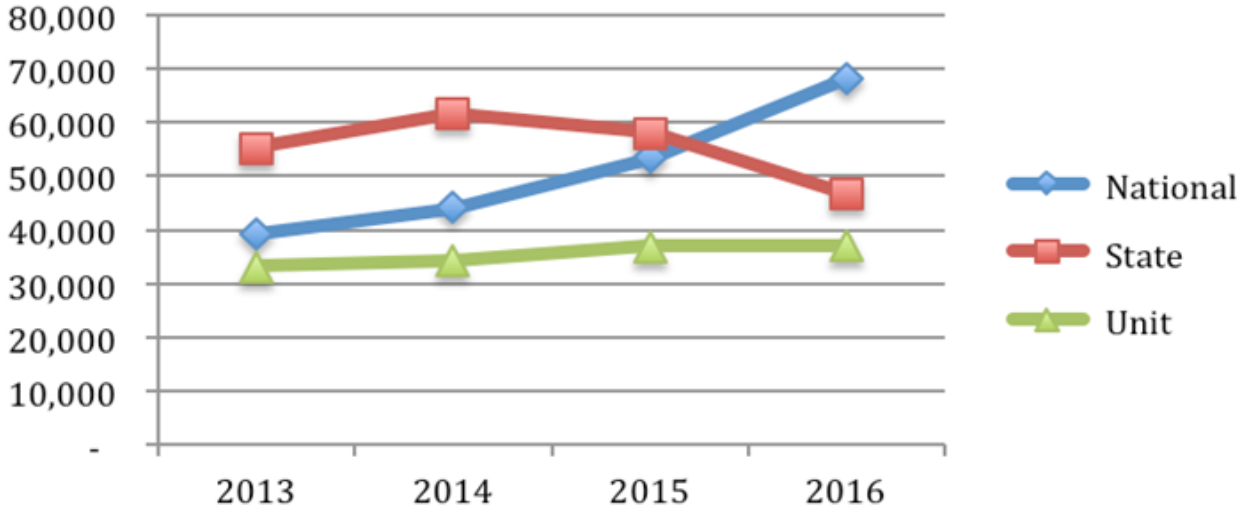


Figure 1.8b: Average Loan Size per Borrower (NGN)



Source: CBN data.

22. The data presented above demonstrate that:

- **The 976 Unit and State MFBs reach a larger *number* of depositors** (5.7 million and 3.7 million, respectively) than the 8 National MFBs (3.3 million) - this is not surprising given the relatively large number of licensed Unit and State MFBs;
- **However, in terms of *value,* the National and Unit MFBs attract similar amounts of deposits** (NGN 57.4 billion and NGN 56.8 billion, respectively), and the contribution made by State MFBs is lower (NGN 37.7 billion);
- **The *value* of the average loan provided by National MFBs (NGN 97.3 billion) is higher** than for Unit (NGN 46.1 billion) and State MFBs (NGN 36.6 billion); but, perhaps <u>more importantly</u>,

- **The penetration of the few (eight) National MFBs as regards the *number* of borrowers reached (1.5 million) is as large as for the 867 Unit MFBs and larger than for the 107 State MFBs** (1.5 million and 0.9 million, respectively).

Capital

23. While the average level of paid-in capital exceeded the required minimum level for Unit and State MFBs, the level of 'excess' capital fell far short of allowing Unit and State MFBs to qualify for State and National level licenses. A comparison of the size of MFBs' paid-up capital and MFB minimum capital requirements within the respective licensing category reveals that Unit and State MFBs have paid-in capital substantially exceeding their minimum capital requirements. The paid-in capital of National MFBs was equivalent to their NGN2 billion minimum capital requirement in 2016 (Table 1.3).[13] The average paid-up capital for State MFBs exceeded the minimum requirement of NGN100 million by 68 percent, and for Unit MFBs' paid-up capital surpassed their minimum of NGN20 million by 61 percent. This may reflect the fact that MFBs need to accumulate capital beyond the minimum level required by regulation to be able to provide a sustainable basis for their business (in terms of real estate, equipment, MIS systems etc.). While the data suggest that in certain instances State and Unit MFBs may be able to accommodate a higher level of minimum capital requirement without having to raise new funds, this very much depends on the quality of the MFBs' assets. The size of any capital buffer could easily be eroded in case of a need to correct for underreporting of loan non-performance.

Table 1.3: MFB Capitalization

Data for end-2016	Paid-in capital (NGN, billions)	Assets (NGN, billions)	Capital as percent of assets	Average paid-in capital	Average paid-in capital as percent of required minimum capital
All MFBs	62.0	331.2	18.7	NGN 62 million	
National	15.9	142.0	11.2	NGN 2 billion	100
State	18.3	80.0	22.9	NGN 168 million	168
Unit	27.8	109.2	25.4	NGN 32 million	161

Source: CBN data.

24. While reported capital adequacy would appear satisfactory, measurement of capital adequacy is highly dependent on reliability in reporting on the quality of the loan portfolio. Reported capital adequacy for 2015 was at 54 percent overall, ranging from 41 percent for Unit MFBs to 56 percent for State MFBs and 65 percent for National MFBs.

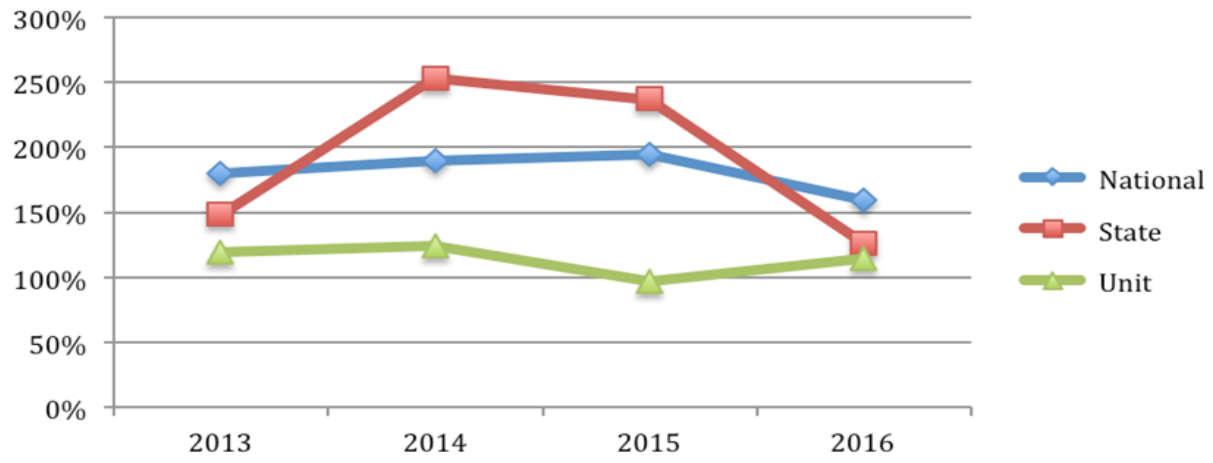
Sustainability and Efficiency

25. The self-sufficiency of Unit MFBs appears to be in doubt, as they are able on average to cover only between 97 percent and 124 percent of their operating costs (Figure 1.9). Operational self-sufficiency (OSS) in this range suggests that many of them are

[13] Reserves and other capital are also counted in meeting the regulatory minimum requirement. Shareholders' funds somewhat exceed paid-up capital (NGN 77 billion vs. 62 billion as of end-2016); reserves were NGN 16 billion in 2016 in the aggregate (negative for Unit MFBs).

not financially self-sufficient (FSS),[14] as they rely on access to subsidies or donor funds provided at below-market rates. Although State MFBs appeared more self-sufficient in 2014 and 2015, the negative trend in 2016 led to a sharp drop to only 126 percent OSS. Despite a slight drop in 2016, the OSS of National MFBs remained above 150 percent OSS.

Figure 1.9: Operational Self-Sufficiency (percent)



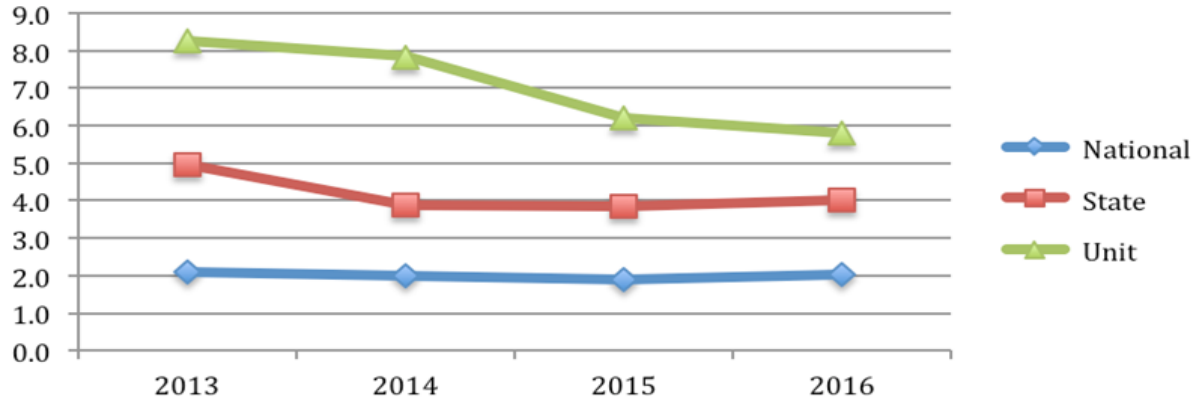
Source: CBN data.

26. Unit and State MFBs achieve only borderline OSS even though they employ relatively few staff. Of the three categories of MFBs, National MFBs employ on average 1,107 staff, while State and Unit MFBs employ, respectively, 52 and 12 staff on average.

27. A key explanation of the low OSS of Unit and State MFBs would appear to be the excessively high ratio of total employees to loan officers (who generate revenues through the loan portfolio). Despite some improvement over the last four years, Unit MFBs still have five other staff for every loan officer, while State MFBs have three staff for every loan officer and National MFBs only one (Figure 1.10) This situation goes back to the mandate imposed by the NBCB that required CBs to have at least 13 employees, of which only 2 were to be loan officers. While the average number of loan officers per Unit MFB has risen gradually to 3.7, the total number of other staff remains very high, with around 12 employees on average. Altogether, it appears that it would be to the advantage of Unit MFBs to reallocate staff to loan recovery, if not to loan origination.

[14] Data are insufficient to measure FSS directly.

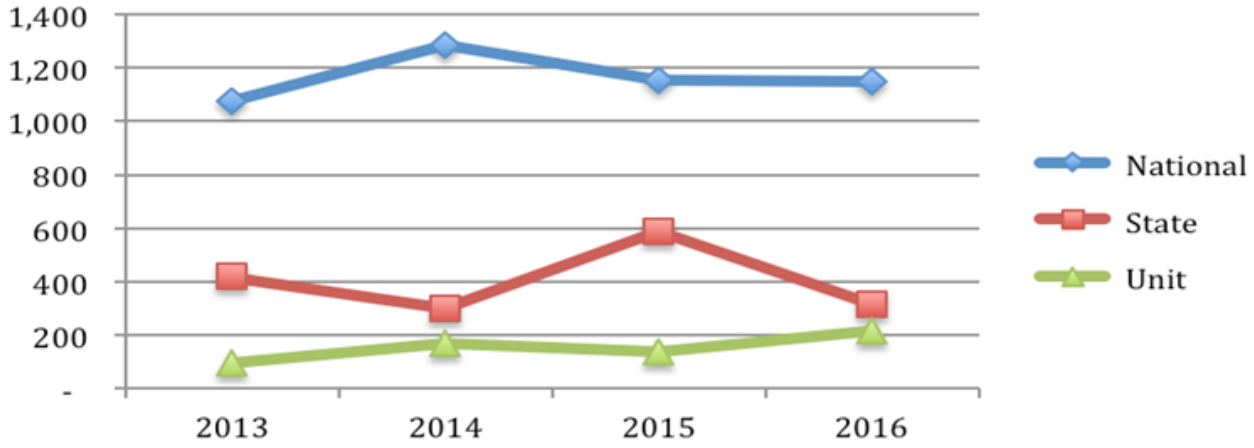
Figure 1.10: Ratio of employees to loan officers



Source: CBN data.

28. The challenges faced by Unit MFBs in achieving viability are reflected in their low gross profits per employee (Figure 1.11). Each employee in a National MFBs generates on the order of four to six times as much profit as an employee in a State or Unit MFB.

Figure 1.11: Gross profit per employee (NGN, thousands)



Source: CBN data.

29. National MFBs benefit from substantial economies of scale, given the larger size of their loans and the greater profits they generate per employee (Table 1.4). Measured in terms of their capital, National MFBs are more effective than State and Unit MFBs in deploying their capital in making loans and able to solicit a relatively larger deposit base when compared to their capital.

Table 1.4: MFB loans and deposits relative to capital

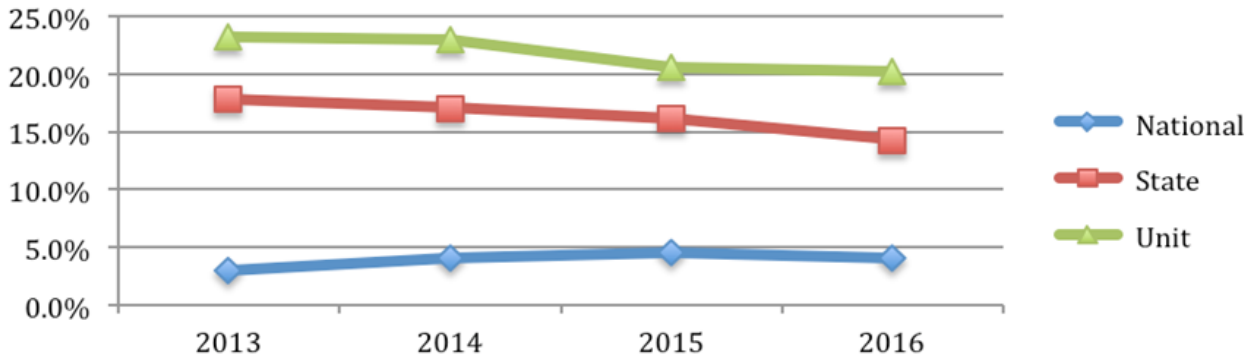
	Loans as a proportion of capital	Deposits as a proportion of capital
All MFBs	3.18	2.46
National	6.29	3.60
State	2.24	2.09
Unit	1.96	2.04

30. In measuring the performance of loans made by MFBs, the CBN uses portfolio at risk (PAR), a ratio commonly used in the microfinance sector, but that can be understated. PAR shows the portion of the portfolio that is "contaminated" by arrears and therefore at risk of not being repaid. PAR is the outstanding amount of all loans that have one or more installments of principal past due by a certain number of days. Several factors may compromise the measurement of PAR:

- ***Some institutions may only report arrears (the actual late payment amount) as opposed to the entire outstanding balance of the delinquent loan*.** This practice can lead to serious underestimation of the value of the portfolio risk in those cases where the delinquency is long-standing or the delinquent amount is low compared to the total outstanding balance of the loan.
- ***Reporting institutions may not include refinanced and restructured loans in their calculation of PAR.*** Including restructured or refinanced loans in PAR is considered good practice, as restructured loans carry higher risk than do current loans. This is likely to be a sensitive area regarding the quality of financial reporting by MFBs.

31. Despite some improvement in recent years, loan nonperformance as measured by PAR (overdue by one day or more, known as PAR≥1), as required by CBN regulations, is at 20 percent for Unit MFBs. This is higher than PAR≥1 of State MFBs, which is also high at around 15 percent. Such a high level of loan nonperformance indicates that the financial self-sustainability of Unit and State MFBs is problematic. As a consequence, these MFBs are forced to raise interest rates to offset their loan losses. This not only makes it more difficult for their borrowers to stay current on their loans, but works against the efforts to make loans available at relatively low cost and encourages good borrowers to find cheaper sources of credit.

Figure 1.12a: Loan non-performance (PAR ≥ 1 day)



Source: CBN data.

32. The overall situation for non-performing loans (NPLs) appears less problematic on the basis of PAR > 30 days, which is more commonly used and is a more realistic determinant of portfolio quality with respect to MFIs. PAR > 30 days is less than half that for PAR ≥ 1 day and was only 6 percent in 2016 (Table 1.5). Figure 1.12b shows the implications of using PAR > 30 days instead of PAR ≥ 1 day for each tier of MFBs. This leads to significant reduction in measured portfolio nonperformance, but confirms that Unit and

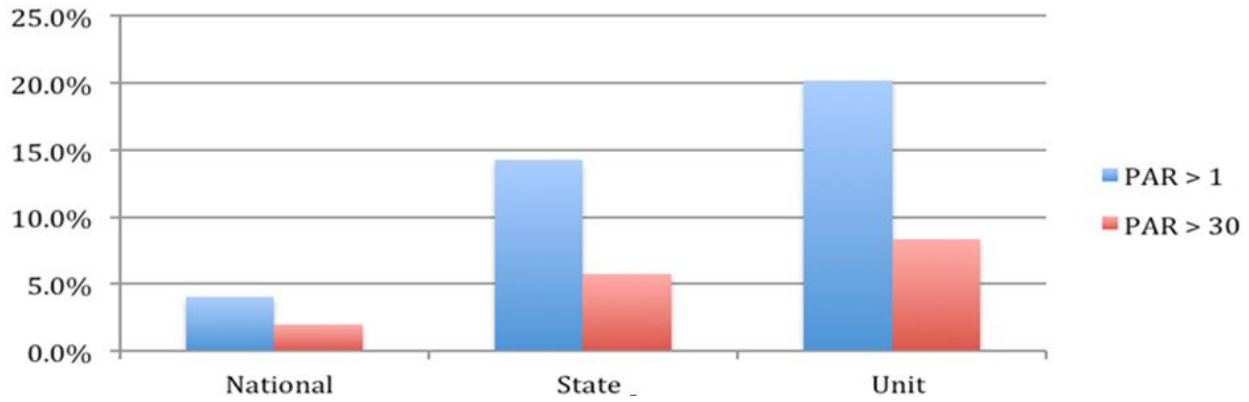
State MFBs are both highly exposed. The difference between the two measures of PAR (PAR≥1 day and PAR>30 days) can be explained by arrears being paid late between 1 and 30 days, a delay in payment that is not necessarily an indication of low recovery performance.

Table 1.5: Average Portfolio at Risk for All MFBs, 2013-16 (percent)

	2013	2014	2015	2016	2016 adjusted*
PAR ≥ 1 day	15	15	14	12.8	14.3
PAR > 30 days	7	6	7	5	6

Source: CBN data.
* Adjusted for under-reporting by State and Unit MFBs.

Figure 1.12b: PAR > 30 days vs. PAR ≥ 1 day by tier of MFB, 2016



Source: CBN data.

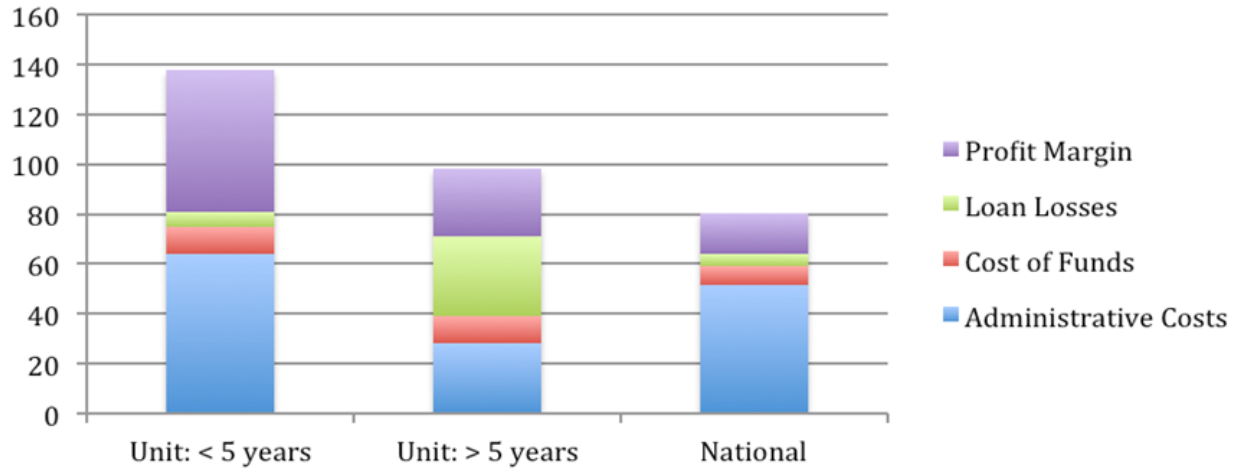
Interest Rates and Cost Structure

33. The annual percentage rates (APR) on borrowing from the MFBs are high. A study of the costs of borrowing from MFBs was undertaken by the German Agency for International Cooperation (GIZ) in 2015 based on a sample of MFBs.[15]. The study found that nominal interest rates in MFBs are typically in the range of 2.5–5.0 percent per month for National MFBs, and up to 7.5 percent or even 9.0 percent per month for Unit MFBs.[16] In about half the loan products in the MFB sample, interest is calculated as a flat rate on the initial loan amount (rather than the declining balance); commitment fees are typically 1–3 percent; and in two-thirds of loan products a portion of the loan amount (between 5 and 30 percent) has to be left in a savings account as security—resulting in effective APRs much higher than the nominal rates would suggest. According to the GIZ study the median APR in 2015 was 102 percent (ranging between 39 percent and up to 337 percent) for Unit MFBs and 78 percent for National MFBs (ranging between 39 percent and up to 208 percent).[17]

[15] It used a sample of 21 Unit MFBs in three states and data on 7 of the 15 largest State and National MFBs responsible for 70 percent of the sector's assets (B. Bernhardt, A. Dannecker, G. Attach, B. Hoback, and S. Ulrich, *Loan Pricing of Nigerian Microfinance Banks: Survey & Methods of Assessment.'* Abuja: GIZ, Pro-Poor Growth and Promotion of Employment Programme, 2015, pp. 8 and 29).
[16] Unfortunately, the GIZ study does not distinguish between the performance of Unit and State MFBs or undertake a comparison with the APR on loans by DMBs.
[17] Ibid., p. 29.

34. The economies of scale associated with National MFBs are evident in CBN data for MFBs for which cost data are available. The evolution of cost structures over time was derived for new and more well-established Unit MFBs and then compared with the cost structure associated with National MFBs (Figure 1.13). In order to cover high initial administrative costs and generate profits for growth, Unit MFBs need to charge an APR of 138 percent on the average in their first five years in operation. This suggests that MFBs need a larger capital cushion in the first year of operation. Subsequently, administrative costs relative to loan portfolio and the profit margin diminish considerably, partially offset by rising loan losses, resulting in an average APR of 98 percent for full sustainability. National MFBs need to charge only 80 percent because of lower loan losses and profit margins.

Figure 1.13: Interest Rate Required to Cover Costs (APR)



Source: CBN data

35. The high interest rates charged by MFBs, together with limited transparency and competitiveness, constitute severe impediments to the potential role of MFBs in achieving greater outreach in the provision of financial services. Mark-ups charged by MFBs on their costs differ widely. The GIZ study examines the link between the various elements of MFB operational costs plus profit margins and the APR which the MFBs charge on their lending. The study finds that wide variation in the mark-ups charged by MFBs reflects both the MFBs' lack of knowledge of rational pricing policies and limited impact coming from competitiveness pressures. One reason for the latter is the absence of an efficient and standardized disclosure regime on disclosure of the APR on MFB lending.

36. To address legitimate concerns with high interest rates charged by MFBs, attention should be given to expediting development and operationalization of a sound financial consumer protection framework and ensuring its subsequent enforcement, combined with broader structural reforms over the medium term to address the high interest rate environment in Nigeria. CBN has already taken an important step towards institutionalizing financial consumer protection with the establishment of a dedicated Consumer Protection Department and development of a high-level Consumer Protection Framework. Most recently the World Bank has conducted a comprehensive Diagnostic Review of Financial Consumer Protection aimed at assessing the

legal, regulatory, and supervisory framework, disclosure and sales practices, fair treatment and business conduct, data privacy, and dispute resolution mechanisms applying to MFB sector (amongst other). The CBN is currently working on development of specific guidelines, with World Bank support - such as those related to disclosure and transparency (e.g. ensuring development of specific requirements for simply expressed, clear disclosures of terms and conditions, interest rates and fees and charges, requirements for a standardized summary document such as a key facts statement, disclosure of the total cost of a loan according to a prescribed formula) - along with planning to operationalize its supervisory functions. Such reforms combined with good regulation and supervision of the microfinance sector, nurturing competition and market development, and improvement in financial infrastructure - some of which are well under way (i.e. with CBN's leadership in recent establishing movable collateral registry) would help address the issue of high interest rates and other charges in MFB sector.

37. What should be avoided is any type of direct intervention involving regulation and/or capping of interest rates which would be damaging to the microfinance industry and financial inclusion. In 2016 the CBN considered introduction of interest rate cap of 3 percent per month on loans extended by MFBs,[18] but following broader stakeholder and technical consultations it decided to drop this proposal which was a right decision. Based on experiences in other countries, imposing interest rate caps would most likely negatively impact financial inclusion efforts in Nigeria. Interest rate caps of this kind could prevent microfinance providers from continuing to serve some of the riskier borrowers, thus pushing these borrowers into the informal lending sector, with much higher interest rates. It could also further increase cost of financing for other borrowers by converging pricing of other loans with the new cap to compensate for losses made on riskier borrowers or as a result of erosion of this market segment. Such caps also result in an unfortunate proliferation of additional and nontransparent charges. Furthermore, this measure would most likely undermine sustainability and growth of the microfinance industry in Nigeria, preventing it from expanding financial services to new clients and at the same time undermining new investment in the sector.

[18] According to *Exposure Draft on the Guide to Charges for Banks and Other Financial Institutions in Nigeria* made available on CBN website during the stakeholder consultation period in 2016.

II. Regulatory Framework for Microfinance Banks

38. The regulatory framework for MFBs in Nigeria represents an effort to resolve tensions between promotion and regulation. Microfinance involves dual objectives of outreach to expand financial access (or inclusion) and financial sustainability, which is supported by regulation. Nigeria's *National Microfinance Development Strategy* seeks to:

> provide *access* to a range of financial and non-financial services to the economically active poor…[by] promoting awareness about microfinance and its benefits; establishing a legal/regulatory framework that assures system *viability* and fairness to all stakeholders; diversifying microfinance beyond mere savings and credit; contributing to rural transformation; and incorporating gender dimensions [*emphasis added*][19]

The legal and regulatory framework for MFBs was set forth in the *Microfinance Policy, Regulatory and Supervisory Framework for Nigeria* issued by CBN in 2005, and updated in 2011 with publication of the *Revised Regulatory and Supervisory Guidelines for Microfinance Banks (MFBs) in Nigeria.*

39. Due to the mandate of MFBs and the legacy provided by CBs, the objectives of regulation and supervision in ensuring the MFB sector's financial sustainability appears to have been seriously compromised. Financial sustainability is crucial to ensuring that MFBs can serve their clients over time and grow commensurate with their resources and capabilities. Achieving financial sustainability is not always consistent with the legacy of those Unit MFBs (approximately 50 percent of currently licensed Unit MFBs) that began as CBs. CBs were established as conduits for directed lending rather than as financially sustainable intermediaries. Conversely, the profit-oriented motivations of some sponsors of the more recently established MFBs are not necessarily consistent with the objectives of giving lower-income and rural populations and micro, small and medium enterprises (MSMEs) access to appropriate financial services. This situation poses challenges to the regulator in setting appropriate criteria for the licensing and oversight of MFBs and, what is even more important, effectively applying them in practice.

A. Tiered licensing system and low levels of required minimum capital are associated with regulatory arbitrage

40. A strong feature of Nigeria's framework lies in the definition of three tiers of MFBs depending on the geographical scope. These tiers constitute an organic growth path designed to encourage the transformation of MFBs from small single units to larger MFBs with statewide and nationwide coverage, with more stringent minimum capital and other licensing requirements. Some distinction is made regarding the governance of the various tiers of MFBs, but according to the regulations this distinction is relatively mild and leaves a good deal of discretion to the CBN. The regulations stipulate that: "The maximum number of Directors on the Board of a Unit MFB shall be seven (7), while the minimum shall be five (5).

[19] Quote from page 2 of the CBN's National Microfinance Development Strategy, draft, 2012 (published only in draft).

For a State or National MFB, however, the maximum number of Directors (Executive Directors inclusive) shall be at the discretion of the CBN"[20]. As noted in Chapter IV, it appears that the requirements regarding minimum size of the Boards of Unit MFBs are not enforced.

41. The tiered licensing process appears unnecessarily restrictive. National MFBs cannot be established directly, but must transform from State MFBs that have at least five branches throughout its State of origin, as well as adequate experience. Unit MFBs that want to establish more than one branch must transform into State MFBs. While the licensing process is intended to encourage organic growth, it seems unnecessarily restrictive, particularly when compared to banks (which are able to operate nationally as soon as they are licensed).

42. One concern is that promoters of some MFBs are taking advantage of relatively low and imprecise licensing requirements to undertake regulatory arbitrage. MFBs can set up as "mini-commercial banks" purely with a profit motive to escape the more stringent capital requirements for DMBs.[21] Concerns about regulatory arbitrage have been present since the regulatory framework for MFBs was established in 2005. The increase in minimum capital for banks from NGN2.5 billion to NGN25 billion at the end of 2005 gave incentives to those banks that were unable to fulfill the new minimum capital requirement to 'reinvent' themselves as MFBs. Similarly, more recently, some Primary Mortgage Institutions (PMIs) that were unable to meet the minimum capital requirements (NGN 2.5 billion for State level) were re-licensed as MFBs or Finance Companies in 2014, taking advantage of the much lower capital requirements. This re-licensing was sanctioned by the CBN, even though the limited capitalization of MFBs is quite clearly inconsistent with the completely different objectives of PMIs in providing longer-term housing finance. [22] Maintaining such relatively low entry barriers for MFBs gives rise to the risk of regulatory arbitrage by encouraging the establishment of MFBs with operations that are not necessarily consistent with the objective of reaching previously underserved lower-income and MSME clients.

B. Minimum capital requirements set a low entry bar

43. Minimum capital requirements for MFBs have been changed over time, except for Unit MFBs. The minimum capital requirement for State MFBs was originally set at NGN1 billion in 2005. The initial intention was to introduce a two-tiered system where MFBs would operate only as single Unit institutions or with a statewide license. Revision of the MFB strategy in 2011 introduced a three-tier system, with a minimum capital requirement of 2 billion applied to National MFBs. The minimum capital for State MFBs was reduced to

[20] "Revised regulatory and supervisory guidelines for microfinance banks in Nigeria", section 4.1.1, published by the CBN in 2012.

[21] Babajide Komolafe, (2011, 'Seven fundamental flaws with microfinance banking in Nigeria,' *Vanguard* (http://www.vanguardngr.com/2011/09/).

[22] 'CBN approves 36 re-capitalized mortgage banks, delist others.' Lagos: *The Guardian*, July 7, 2014. Microfinance Bank methodology would appear to be inconsistent with mortgage financing, since loans are less than NGN 2 million and rarely over 12 months. Microloans for housing are restricted to a maximum of 24 months.

NGN100 million. There was no change in the NGN20 million capital requirement for Unit MFBs that had been set at this level in 2005.

44. Since 2005 and 2011 (when National MFBs were introduced), the minimum capital requirements for MFBs have depreciated considerably in real terms due to inflation. Table 2.1 shows what the minimum capital requirements for all three tiers of MFBs would be today if adjusted for inflation. Since 2005 the consumer price index (CPI) has risen by 247 percent and since 2011 (applicable to State and National MFBs) by 103 percent. To maintain the real value of the minimum capital investment required to establish an MFB, around NGN4 billion, NGN200 million, and NGN70 million would be appropriate today for the establishment of National, State, and Unit MFBs, respectively, to reflect the impact of inflation since the launch of the MFB regime in 2005 and its subsequent update in 2011. While adjusting the size of minimum capital for the impact of inflation is a relevant consideration, other policy considerations also need to be taken into account in setting the suitable level of minimum capital for financial intermediaries.

Table 2.1: Minimum Capital Requirements Adjusted for Inflation

Tier of MFB	**Minimum Capital** (NGN, millions)		**Adjusted for inflation as of October 2017*** (NGN, millions)
	2005	**2011**	
National	n.a.	2,000	4,050
State	1,000	100	203
Unit	20	20	69

Source: 'Consumer Price Index (CPI) 1995-2017,' Trading Economics https://tradingeconomics.com/nigeria/consumer-price-index-cpi;; Microfinanza Rating (2014), 'The Microfinance Sector in Nigeria,' http://www.microfinanzarating.com.
*National and State figures are adjusted from 2011, Unit from 2005.

45. An important concern regarding the minimum capital requirement for Unit MFBs is whether the required capital is adequate to allow them to implement their business plans. The level of minimum capital needs to be sufficient to ensure that Unit MFBs can invest in adequate MIS (including hardware and software) and staff capability to manage their operations effectively and perform essential functions, such as reporting as required to CBN on a timely and accurate basis. Unit MFBs also need to be able to meet other requirements of the CBN regarding suitable business premises, security features, etc. Although the Licensing and Approval Division of the CBN's Financial Policy and Regulation Department considers the MIS capabilities of State and National MFBs as part of their licensing criteria, they recognize that the current minimum of NGN20 million is insufficient to cover the costs of establishing an effective MIS system, and licenses are issued without insisting that new entrants have the means to install the needed MIS capacity. The resulting weakness in MIS capacity, and hence reporting capability, of many Unit MFBs exacerbates the difficulties encountered by the OFISD in supervising MFBs and training existing, as well as new, Unit MFBs to comply with the OFISD's reporting requirements.

46. Higher minimum capital requirements for new licenses for MFBs, especially Unit MFBs, would slow down the rate of entry of new MFBs. Currently MFBs may well be undercapitalized even at entry and before they start their business activities. Such MFBs then have to go through a learning period to be able to report adequately, a period during which they further draw on scarce available supervisory resources. Restricting entry would also increase the incentives for would-be investors to acquire, consolidate, and reinvigorate existing MFBs, rather than establish new MFBs that may compete with already weak existing MFBs. And requiring existing MFBs to meet higher minimum capital requirements would increase the resources MFBs need to have at their disposal and thereby provide incentives for them to consolidate to achieve economies of scale. Unit MFBs that are unable to raise additional capital on their own would be forced to seek mergers with others or acquisition by a State or National MFB.

47. MFBs that cannot comply with reporting and other regulatory requirements, including a higher minimum capital, should be de-licensed unless they are able to find an MFB with which to merge or that is willing to acquire them. If they still wish to engage in microfinance, they could possibly do so as credit-only NGOs or as non-deposit taking MFIs that are not subject to the CBN's licensing requirements. The CBN has previously revoked operating licenses of MFBs for lack of compliance, and lessons from these earlier experiences may be useful in managing the exit of MFBs that are not able to comply with the higher minimum capital requirements.

C. Other licensing requirements appear to set a high entry bar but lack enforcement

48. Given the significant number of Unit MFBs reported to be nonfunctional, it would seem desirable to apply more rigor in evaluating the feasibility reports prepared by prospective Unit MFB licensees. According to the *Revised Regulatory and Supervisory Guidelines for MFBs in Nigeria* (December 2012), an application must include a detailed feasibility study with five-year projections, curriculum vitae of Board members, and the required minimum capital deposited in an escrow account. Given that the aim of the microfinance strategy is to increase outreach on a financially sustainable basis, it will be important to ascertain whether Unit MFB feasibility studies are robust, and, in particular, whether the business models proposed by applicants for Unit MFB licenses are viable.

49. While the CBN's MFB licensing requirements would appear to set a high entry bar, in practice these requirements appear not to have posed any hindrance to new licenses being awarded in large numbers. This seems to suggest that the licensing requirements are rarely adhered to. This may be a result of weak enforcement, or of too many or unrealistic requirements. This suggests that selecting fewer or more 'realistic' requirements could be an appropriate approach. License applications are reviewed for compliance, including that Board members are "fit and proper" (and are not also on Boards of other MFBs). Approval-in-Principle is then issued so that the promoter can proceed to incorporate, obtain premises, and prepare for operations. These processes are expected to be completed within six months, after which the Approval-in-Principle of the license has to be revalidated. On completing these steps physical inspection is undertaken prior to

licensing to ensure that the premises are secure and safe. This process is similar to that applied to DMBs, although it is less stringent for MFBs. According to the regulatory guidelines, MFBs must show evidence that appropriate MIS, internal controls, enterprise-wide risk management systems and procedures, and operational manuals have been put in place. MFBs are expected to have a minimum of five management staff; of whom, the managing director and department heads are required to have university-level education, several years of experience in finance, and "undergone the Microfinance Certification Program and obtained a Certificate in Microfinance Banking issued by the Chartered Institute of Bankers of Nigeria" (para. 4.1.2). In this regard, a revision of the pre-licensing process is recommended whereby focus is placed on adherence to fewer crucial requirements combined with rigorous verification regarding adherence to these requirements.

50. About 80 percent of applicants are eventually licensed. The applicant may be asked to remedy shortcomings, or a license can be issued subject to satisfying certain conditions within a specified period. Issuance of licenses is shown in Table 2.2.

Table 2.2: Number of MFB Licenses Issued, 2006-2016

	2006–2009	2010–2012	2013	2014	2015		2016
CBs converted	607	—	—	—	—		—
New MFBs	303	82	27	59	76		31

Source: Estimated from CBN data; CBN, *Financial Stability Report – December 2016*, p. 24.

D. Regulatory guidelines appear tight, but are not effectively enforced

51. The *Revised Regulatory and Supervisory Guidelines for MFBs* set a number of prudential parameters for the operation of MFBs that are in many ways similar to those applied to DMBs. These include maintaining a minimum of 20 percent of deposit liabilities in liquid assets, of which at least 5 percent in Treasury Bills; capital adequacy of at least 10 percent of risk-weighted assets; reserve requirements; limitations on lending to individual and group borrowers; and a requirement that the proportion of PAR remains below 5 percent at all times. For the latter, a highly restrictive definition of PAR of one day overdue is used. Provisioning requirements range from 1 percent for on-time loans and 5 percent for those 1–30 days overdue up to 100 percent for loans 91 or more days overdue.

52. While the CBN uses a very tight guidance for PAR, the CBN has hitherto applied regulatory forbearance by not sanctioning transgressors. Use of PAR $\geq$ 1 day tends to overestimate the true burden of NPLs on MFBs, as microfinance loans often are paid with slight delays. In general, it is more common to use PAR > 30 days for MFIs. When using PAR $\geq$ 1 day as the benchmark, National MFBs have been able to keep the level of PAR below 5 percent on average, but State MFBs average around 15 percent, and Unit MFBs 20 percent (Chapter I, Figure 1.12b). To date, however, the CBN has failed to respond and has not sanctioned MFBs transgressing the 5 percent threshold.

53. Consideration needs to be given to revising the definition of PAR applied to MFBs to reflect international experience. Given the fragility associated with a measure of loan delinquency that categorizes loans as non-performing from the very first day of delayed

payment, international best practice in microfinance considers a loan to be at risk only after 30 days of non-repayment. PAR is calculated by dividing the outstanding balance of all loans with arrears over 30 days, plus all refinanced (or restructured) loans, by the outstanding gross portfolio as of a certain date. Currently, refinanced and restructured loans do not appear to be included in the implementation of PAR as undertaken by the CBN.[23]

54. Provisioning policies applied by the CBN are also tight and could be gradually relaxed in line with greater reliability and timeliness of PAR reporting. Given the persistent problem of high loan non-performance in MFBs, the rather restrictive provisioning policies contained in the guidelines (as revised in 2011) appear sensible (at least for Unit and State MFBs). Over time, for MFBs (especially National) providing reliable and timely reporting on the quality of their loan portfolios, it may make sense to relax the provisioning requirements, with 100 percent provisioning at 181 days instead of 91. In order to undertake a more thorough assessment of the adequacy of the MFBs' provisioning practices, it would be advisable to compare the level of provisioning with the effective recovery rates and final losses on the MFBs' loan portfolios.

55. The supervisory guidelines, if enforced, are too prescriptive and would restrict MFBs in being able to serve their core client groups. A thorough review of the regulatory guidelines is called for. As part of this review process the MFB guidelines should be compared to those applied to banks with a view to identifying and justifying eventual differences in approach. The following are examples of regulations that are currently too prescriptive:

- The *Revised Guidelines* do not modify the original (2005) limit on the definition of microfinance loans: "the maximum principal amount shall not exceed NGN500,000 or one (1) per cent of the shareholders' fund unimpaired by losses" (para. 1.2.4). Given cumulative inflation of 247 percent since 2005, review of this limit would be in order. In practice, some National MFBs are offering loans (mainly for business) of as much as NGN3 million.[24] To avoid a situation where such guidelines need to be revised periodically, while taking into account inflation and the MFBs' ability to absorb risk, it would be advisable to revise this guideline, to relate the maximum size of the individual MFB loans to the size of the MFB's capital.
- According to the *Revised Guidelines* only 20 percent of an MFB's shareholder funds is allowed to be invested in fixed assets. This is too low when an institution is establishing or expanding its operations.
- The *Revised Guidelines* slightly modify the original guidance as to the normal tenor of microfinance loans. Normally MFB loans are to have a tenor of up to 6 months, or up to 12 months for agriculture loans. The revised guidelines allow for housing

[23] For a further discussion of PAR implementation issues, see Inter-American Development Bank, *Performance indicators for microfinance institutions: technical guide,* July, 2003, and CGAP, *Due Diligence Guidelines for the Review of Microcredit,* by Robert Christen and Mark Flaming, 2009.

[24] B. Bernhardt, A. Dannecker, G. Attach, B. Hoback, and S. Ulrich, *Loan Pricing of Nigerian Microfinance Banks: Survey & Methods of Assessment.* Abuja: GIZ, Pro-Poor Growth and Promotion of Employment Programme, 2015, p. 28.

microfinance as a special case warranting loans of up to 24 months. For larger National MFBs, such loan tenor limits could be unduly restrictive for funding of investments by MSMEs and for some housing microfinance loans. The restriction also impacts the affordability of such loans, as shorter tenors are associated with higher monthly debt service payments.

56. While the introduction of unique Bank Verification Numbers (BVN) for customers of MFBs can be a positive development, it should be ensured that it is applied in alignment with tiered know-your-customer (KYC) requirements issued by the CBN to avoid exclusion of low risk customers without IDs, which are otherwise required for issuance of BVN.[25] In April 2017, the CBN extended the requirement for customers to have a unique BVN to MFBs and other financial institutions, as well as DMBs.[26] While conceptually this can be a positive move intended to facilitate financial inclusion by integrating MFB customers with the rest of the financial system, as well as to combat fraud and money laundering, issuance of BVN requires an ID. Currently only an estimated 38 percent of individuals in the country have any form of ID. In this regard, it should be ensured that tiered KYC requirements are fully observed to facilitate opening and maintaining of Tier 1 bank accounts (or mobile wallets) for low-risk customers that do not have government-issued identification documents.

E. Crucial to review regulatory guidelines, improve regulatory reporting, and strengthen enforcement

57. The failure of many MFBs to report on a timely and reliable basis undermines the CBN in fulfilling its role as regulator. MFBs are expected to report on PAR and provisioning as part of their required monthly returns. But over a third of Unit MFBs and a fifth of State MFBs do not report in any given month[27], making it difficult for CBN to track accurately trends in the overall loan performance situation – an important early indicator of pending fragility and likely later insolvencies. To date, the CBN has not imposed sanctions for late or non-reporting. Approval has recently been given to start imposing penalties of NGN5,000 per day for late submissions. This is a welcome development, but should be implemented in such a way as to enable MFBs with capacity shortcomings to invest in MIS systems and undergo training to be able to meet reporting requirements. Harsher sanctions (removing MFB management, even rescinding an MFB's license) could then be applied to

[25] For additional context, Nigeria's three-tiered KYC framework, launched in 2012, developed flexible requirements for low-value and medium-value account holders. To open a Tier 1 account, the lowest tier (also known as "no-frills"), an individual only needs to provide a passport photo and their basic information (name, gender, birth date, etc.), and evidence of this information is not required. Given the risk, these accounts have limitations and are only able to operate domestically in Nigeria, are limited to a maximum single deposit of NGN20,000 and a maximum balance of NGN200,000. The higher tier 2 and 3 accounts require evidence of basic identification and registration against the identity databases, or have to comply with AML/CFT regulations.
[26] Central Bank of Nigeria (CBN), "Bank Verification Number (BVN) Enrollment for Customers," Other Financial Institutions Supervision Dept., REF OFI/DIR/CIR/GEN/17/139, April 21, 2017.
[27] The CBN data provided imply that a third of MFBs do not report at all. It is not clear to what extent this number also includes late reporting.

those MFBs that, despite having been offered a reasonable period in which to comply, still fail to fulfill the CBN reporting requirements in a timely and accurate way.

58. There is reason to analyze the causes of bad reporting and whether the CBN has sufficient capacity to analyze the reports it receives. It may be the case that the CBN's requirements are excessive, i.e. go beyond the information strictly necessary to undertake the CBN's oversight function. In this context, it is also worth exploring whether the CBN has the capacity to conduct effective automated checks of the quality of the reported data (see further discussion in Chapter III).

59. It is important to ensure that newly-licensed MFBs are able to report effectively from inception. To this end, and to slow down the rate of entry (and eventual exit), it will be advisable to raise the minimum capital in particular for Unit and State MFBs, and the CBN should make sure that newly licensed MFBs have the ability to fully meet the CBN's reporting requirements[28]. Making new licenses conditional on satisfactory reporting would reduce the number of instances where OFISD has to sanction recalcitrant MFBs or go through a lengthy process of revoking their licenses. One option would be to make MFB licenses conditional on regular monthly submission of returns within a transition period of 12 months, at which point MFBs unable to live up to the CBN's reporting requirements would lose their license or have to apply for license reinstatement. License reinstatement should be premised on clear evidence that remedies have been implemented, including necessary investment in MIS and skills-sets.

60. Even more important is the need to strengthen the reliability and timeliness of reporting. For already-licensed MFBs, guidelines for sanctions for late reports should be issued and enforced. For the sector as a whole it is important, as noted above, that the CBN identifies the cause of the poor reporting practices and takes appropriate and effective supervisory action instead of continued regulatory forbearance. This will involve announcing and implementing a set of actions that MFBs will be required to implement during a predesignated transition period and applying sanctions to those MFBs that do not comply. Other measures being considered to improve the reporting system are discussed in Chapter III.

[28] One rationale for keeping the minimum capital for Unit MFBs low has been to encourage the transformation of NGOs and other MFIs into licensed MFBs. However, this argument can be turned around: rather than compromise the ability to supervise MFBs as required, MFIs that are not adequately capitalized and cannot meet reporting and other requirements should be excluded from becoming licensed. Similarly, MFBs that fail to meet these conditions should be de-licensed: they can then consider operating as credit-only MFIs.

III. Supervision of Microfinance Banks

61. This chapter looks at the effectiveness and challenges of supervising licensed MFBs, which is the responsibility of the OFISD of the CBN.

A. Effectiveness of alternative oversight methodologies hampered by poor reporting

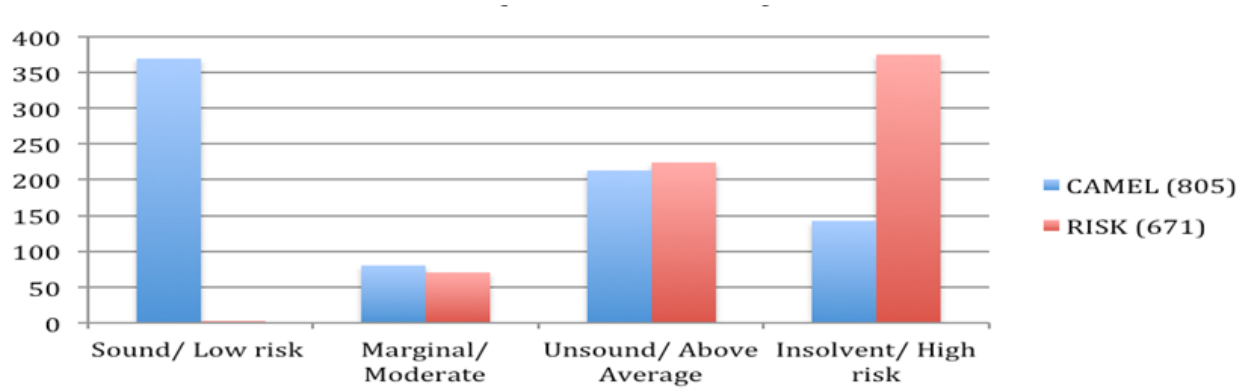
62. While the CBN monitors MFBs off-site using CAMEL ratings and undertakes on-site assessment of MFBs, these efforts are severely hampered by the poor quality of the data reported by the MFBs. Data collected off-site allow supervisors to identify those institutions most at risk, and adjust the frequency and intensity of on-site inspection accordingly. Rather than mobilizing on-site inspections based on the CBN's off-site assessment of the individual MFBs risk exposure, i.e. in those instances where off-site data suggests there is a need, the CBN finds itself obliged to undertake on-site visits simply because MFBs do not report reliably, in a timely manner, or do not report at all. Where MFBs are unwilling or unable to provide reports to the CBN, this should be interpreted as a warning sign regarding their viability and solidity.

63. Actual risk may be even higher than estimated. The CBN introduced risk-based supervision (RBS) in 2009 to facilitate assessment of the actual degree of risk[29], though in practice, however, RBS has faced challenges in implementation due to gaps in reporting and data inadequacies. This assessment identified more than twice as many MFBs in the high-risk category as were rated insolvent by the CAMEL ratings as of 2016 (Figure 3.1). The CBN rates some 375 MFBs as being of high risk, based on its on-site inspections, but as many as 150 active MFBs have not been rated, in part due to the inadequacy of the data available which in turn is a result of the MFBs' inadequate, untimely, and/or no reporting at all.

64. The CBN's oversight procedures are severely constrained by the poor quality of reporting. The CBN has no other alternative but to depend on resource-intensive on-site inspections, which themselves become more challenging because the CBN is unable to rely on the data it receives in preparing these on-site visits. Thus, even among those MFBs that do report, the strong emphasis placed on on-site inspections is a reflection of the poor quality of reporting. As long as the off-site data collected by the CBN is, in many instances, of unreliable quality and regularity, it will be very difficult for the CBN and the NDIC to strengthen the implementation of their supervision. Thus, action on this front by the CBN and the NDIC is imperative.

[29] CAMEL assigns ratings based on Capital adequacy, Assets, Management capability, Earnings and Liquidity. Risk-based assessment involves more quantitative assessment (requiring on-site examination) of different types of risk, including: credit, market, operational, liquidity, strategic, legal and regulatory.

Figure 3.1: CAMEL and risk-based ratings of MFBs (number of institutions)



Source: CBN data (as of the last assessment conducted; not necessarily all in 2016).

B. Emphasis on on-site examinations severely stretches the CBN's resources

65. Due to the inadequacies of the data reported by the MFBs, the emphasis of the supervisory activities is inordinately focused on on-site inspections. Supervision of MFBs is carried out by 193 out of the 220 staff in OFISD, who are also responsible for supervising about 110 other financial institutions (finance companies, mortgage banks, and development finance institutions). NDIC has undertaken an increasing share of the examinations each year (assigned by OFISD), rising to over half in 2016. Together OFISD and NDIC conducted 609 examinations in 2016, about the same number of examinations as in 2012. Excluding 88 MFBs that were newly-licensed or identified as low risk, as well as about 150 MFBs designated for revocation of license, this indicates that only about 130 functioning MFBs were not examined on-site during 2016; they will presumably be examined during 2017. OFISD and NDIC alternate examinations of any given institution.

66. Questions arise as to the effectiveness of devoting so many resources to on-site inspections. OFISD and NDIC conduct on-site examinations of all National and State MFBs and about 45 percent to 50percent of operating Unit MFBs each year. This means that, on average, each MFB is visited twice every three years. In principle, only those MFBs assessed as high-risk under RBS should be examined each year, but given the large numbers of MFBs rated as high-risk and not risk-rated at all, inspecting all high-risk MFBs each year is a strain on the available supervisory resources and is very unlikely to be effective. Indeed, it has not been feasible for the CBN/NDIC to conduct targeted follow-up examinations within six months regarding issues identified during the on-site examination. Targeted examinations are also needed to verify the status of insolvent MFBs that may be slated for liquidation. The effectiveness of on-site examinations appears to be severely compromised by the unreliability of the reporting provided by the MFBs and the limited time that the supervisors are able to devote to each inspection. As a result, on-site visits focus more on strengthening the supervisors' knowledge of the individual MFB's financial situation than on forcing high-risk MFBs to take action by changing their risk-management policies and improving their management and control systems.

67. OFISD is devoting ever more staff to the on-site inspection process to achieve the level of oversight required. OFISD is in the process of restructuring, to allow core

supervisory staff to focus on supervision of other financial institutions (and not be diverted to other activities), supported by a larger number of technical and support staff. The number of experienced staff appears to be insufficient to carry out supervision effectively at the desired level of intensity, particularly with respect to targeted follow-up examinations.

68. Altogether the emphasis on on-site inspections – as evidenced by the number and frequency of inspections – needs to be reconsidered, particularly regarding small Unit MFBs that pose no systemic risks. The focus on on-site inspections is a reflection of the lack of trust OFISD and NDIC place in the quality of the supervisory reporting undertaken by the MFBs. As discussed further below, this would appear to be an area where applying effective sanctions could strengthen supervisory effectiveness.

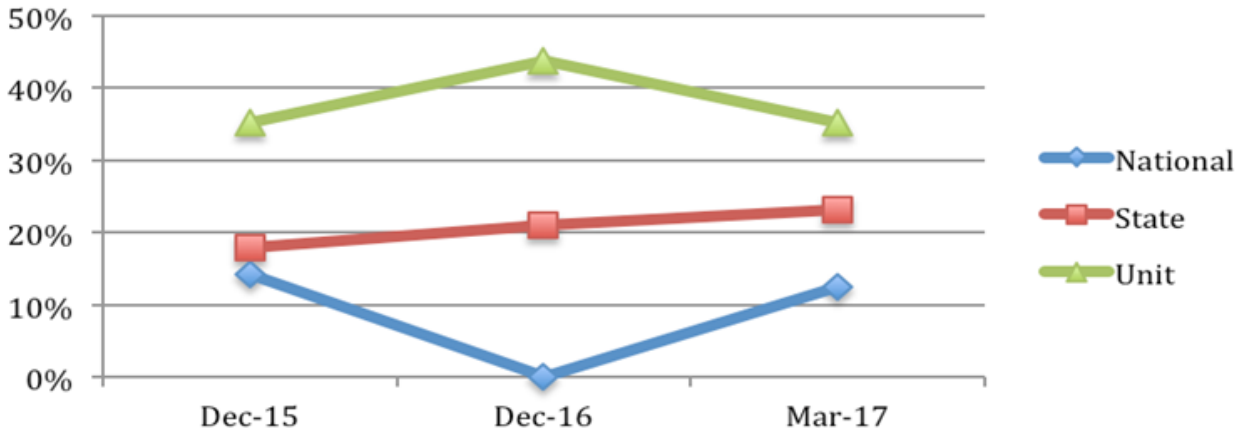
C. Strengthening reporting is a high priority to strengthen both supervisory oversight and the MFBs' internal risk management

69. Although the monthly reports required by CBN are submitted regularly by the 8 National MFBs and most of the 95 State MFBs, more than a third of Unit MFBs do not report in any given month. Of the 311 non-reporting Unit MFBs in March, 2017, about half are likely non-operational or insolvent (i.e., among the 150 slated for liquidation). The others suffer from a combination of weak internal risk management, inadequate MIS, weak staff capacity, and poor overall management. Despite the CBN's efforts to improve the reporting system (discussed below), the problem of non-reporting continues to prevent comprehensive, effective off-site supervision. And even for those submitting returns, there are serious issues relating to the quality/reliability of the data submitted. These reporting issues are likely to be reflective not only of weak data management, but overall weaknesses in internal risk management systems.

70. Over the last three years non-reporting seems to show little sign of improvement. Although National MFBs normally submit returns, even though they may be late in a given month, this is not the case for State and Unit MFBs, which have had non-reporting rates of 18 percent to 23percent and 35 percent to 44 percent, respectively, in recent years (Figure 3.2).[30] Clearly, effective off-site supervision cannot be undertaken with such high rates of non-reporting. In strengthening the effectiveness of off-site supervision, attention also needs to be paid to strengthening the quality of the data submitted by the MFBs.

[30] This means that aggregate data reported for the MFB sector underestimates the actual contributions of State and Unit MFBs (unless specifically adjusted for under-reporting).

Figure 3.2: Share of MFBs not submitting monthly returns



Source: CBN data.

Measures to improve reporting

71. The CBN needs to move to applying a strict set of graduated sanctions to those institutions not reporting accurately on a timely basis. Monetary penalties for late reporting have not been applied in the past, out of consideration for the development orientation and limited capacities of MFBs. However, approval has been given recently to institute penalties of NGN 5,000 per day for late returns. This represents a long-overdue measure to incentivize timely submission of returns - at least for those MFBs that are capable of doing so. A grace period (following announcement of the policy) would be in order to enable those MFBs with inadequate MIS or staff capacity to remedy their situation. For those MFBs not fulfilling the CBN's reporting requirements, even after this adjustment period and after the penalties have been applied, the introduction of stronger graduated sanctions, such as sanctions applied to specific personnel, the removal of managers, and eventually de-licensing, should also be considered.

72. While OFISD has made efforts to strengthen reporting reliability, there may be reason to review the scope of the reporting requirement with a view to simplifying and rationalizing the efforts required of the MFBs. Rationalizing and focusing the scope of reporting systems would assist the MFBs in fulfilling their reporting obligations. OFISD introduced an Excel-based reporting format (consisting of 30 worksheets) in 2001 to facilitate submission of returns on-line. Requiring MFBs to surrender such a large number of reports suggests that the authorities may be requiring the MFBs to 'over-report'. Since its inception, the system has been revamped due to data inconsistencies. Use of validation algorithms reduced errors, but also led to MFBs submitting fewer reports. OFISD has taken a number of measures to improve reporting capabilities in MFBs, including a training manual and videos on the CBN website, and a Help Desk to answer questions by phone or on-line. Nearly 70 percent of MFBs are now reporting electronically.

73. In continuing to support a recent initiative to develop the National Association of Microfinance Banks Unified IT Platform (NAMBUIT) in its operational phase the CBN will be going beyond its regulatory and supervisory mandate. Since 2012, the CBN

has been working with the National Association of Microfinance Banks (NAMB) to introduce a unified information technology (IT) platform for MFBs. Objectives include automating MFB operations and reporting, opening MFBs to the electronic payment system, and achieving economies of scale through bulk purchases. The proposed strategy is to set up a network operating center (NOC) as a non-profit organization owned by the CBN and the National Association of Microfinance Banks (NAMB), called NAMBUIT. A contract has been awarded, and it is now at the implementation stage. The CBN would bear the setup costs, while MFBs would only pay a subscription fee, as well as associated equipment and internet service costs. When it becomes operational NAMBUIT aims to strengthen reporting by MFBs and thereby facilitate processing for the CBN. While the initiative to strengthen reporting is welcome, NAMBUITs management and operations extend beyond the CBN's regulatory and supervisory mandate and should remain the responsibility of the industry.

74. Moving beyond the developmental phase the CBN should exclude itself from ownership, participation in NAMBUIT's governance mechanism, and provision of financial support. While the CBN has sponsored NAMBUIT in its development phase, it should reconsider its further role in this project, once it becomes operational. Rather than effectively subsidizing private MFBs to meet regulatory requirements the focus of the CBN should be on reforming those requirements and effectively enforcing them. Going forward the NAMB should be the key driver and sponsor of this and similar initiatives aimed at supporting its members or facilitating their compliance with reporting and other regulatory requirements. With regard to reporting by MFBs as supported by NAMBUIT, the focus of the CBN should be on testing the reliability of the reported data and, in cases of weak compliance, on sanctioning those MFBs that are noncompliant with the its reporting requirements.

D. Addressing Key Risk Factors

Strengthening the performance of MFBs' loan portfolios

75. Given the difficulties confronted by MFBs in managing the quality of their loan portfolios, efforts are needed to strengthen their internal policies and procedures. The MFBs, particularly smaller Unit MFBs, face considerable challenges in achieving profitability and maintaining/strengthening their capital base. Poor loan performance works against the core objective of reaching the underserved population with affordable financial services. In supervising the sector it is therefore important that OFISD and NDIC focus on identifying those credit policies and procedures which, if not properly implemented, could give rise to poor loan performance. In those cases where such policies and procedures are lacking, poorly developed, or simply not being implemented, OFISD and NDIC should consider introducing limits on new lending to prevent the accumulation of (further) non-performing assets.

76. Corrective actions to support MFBs in restructuring their operations may be insufficient to overcome weaknesses. Given the importance of attaining financial self-sustainability, the CBN needs to more expeditiously delicense non-viable MFBs. Smaller Unit MFBs in particular face major challenges in attaining financial viability, as they are unable to

benefit from economies of scale, and in many instances have not adopted a business model that builds on the group solidarity model espoused by the CBN's regulatory framework.

Strengthening MFB corporate governance

77. Stronger MFB viability depends on strengthening corporate governance within the sector. Greater emphasis needs to be placed on the responsibilities borne by the Board and management of MFBs to develop and implement policies and procedures. While such policies and procedures relate to the overall functioning of the MFBs, policies and procedures regarding risk management and internal control are of particular concern in supporting the move towards greater viability. To the extent that MFBs are still subject to or influenced by "legacy regulations" applied to CBs, which required CBs to have a certain levels or allocation of staffing, such regulations should be discontinued. Going forward, responsibility for adequate staffing rests with Board and management and going forward the focus of the oversight provided by OFISD and NDIC will be on implementation of robust institutional governance.

E. Reducing the number of MFBs: consolidation and licensing policies

78. Rather than adding value in terms of allocating resources to viable, growing small ventures, many MFBs would appear to be misallocating resources to support value-subtracting activities. A total of 186 MFBs were liquidated over 2010-13, of which most are likely to have been former CBs. This should have cleared out the obvious "deadwood" among the weaker CBs that became licensed as Unit MFBs in 2008-09. Nevertheless, an additional 150 MFBs are currently slated for license revocation in 2017. While some of these may be legacy CBs, the large number of inactive or insolvent MFBs indicates that some of the over 200 MFBs licensed during 2012-16 have been unable to perform. The situation presents a substantial challenge to effective supervision, in terms of both monitoring those that are not reporting and the resources devoted to de-licensing MFBs that cannot perform. At a minimum, this indicates the need for tightening up licensing to prevent the problems of insolvency from getting worse while issues relating to reporting and capacity-building are being addressed. In addition, it is advisable that OFISD and NDIC reorient their efforts away from undertaking relatively frequent on-site inspections and devote greater resources to the resolution of failed or non-viable MFBs.

79. As MFBs that fail and are unable to honor their depositors can rely on compensation being paid to their depositors by NDIC, insolvency is associated with both moral hazard and fiscal costs. As is the case for all financial institutions covered by deposit insurance, the responsibility for supervision of MFBs is shared between OFISD and the NDIC, which insures deposits in MFBs up to NGN200,000 per account. MFBs pay 0.5 percent of assessable deposits into a Special Insured Institutions Fund (SIIF), as against 0.65 percent for DMBs. The SIIF currently stands at NGN 9.9 billion. Through 2015, the NDIC's cumulative disbursements to MFBs amounted to NGN 2.9 billion out of total disbursements of NGN 9.7 billion. So, while the total assets of MFBs account for about 1 percent of the assets of the DMBs, they have absorbed no less than 30 percent of the value of the payouts

administered by NDIC, reflecting both their performance difficulties and inadequate oversight applied to the MFB sector.

80. Consolidation of MFBs has been publicly proposed by OFISD as a way to "ensure strong and adequately capitalised institutions [that can] enhance expanded access of low income families to a broad range of formal financial services."[31] Consolidation would be most effective via acquisition of weaker Unit MFBs by new investors seeking to enter the sector or by stronger MFBs as a way of branching out. Combining several weak Unit MFBs risks creating a larger, but still weak MFB. In any case, as long as it remains relatively easy to license new Unit MFBs and the minimum capital required remains low, there is little incentive for such consolidation. It should also be noted that combining MFBs, particularly weaker ones, would pose significant challenges in terms of internal control and governance. Hence it is unrealistic to assume that mergers will encompass all MFBs unable to meet the raised minimum capital requirements. There will be a need to address the problem of insolvency, and de-licensing will still be needed. In preparing to de-license a significant number of MFBs the CBN will be able to draw on lessons learned from previous rounds of de-licensing. In planning the consolidation process it will also be important that the CBN develops a coherent communication strategy and announces its intentions so that the MFB customers understand the advantages associated with amalgamation process in terms of a financially stronger and more resilient MFB sector that will be better able to service the needs of its customers, and – in line with subsequent growth of the sector – make a more significant contribution to financial intermediation.

[31] Ahmad Abdullahi, 'Consolidation in the microfinance sector and the impact on financial inclusion in Nigeria.' Abuja: Keynote address, Second Annual Symposium of the Nigerian Microfinance Platform, May 19, 2016.

IV. The Current Situation of the Nigerian Microfinance Banks: Observations Arising from 15 Case Studies

A. Introduction

81. This chapter describes the situation of the Nigerian MFB sector drawing on lessons learned from 15 case studies undertaken in May/June 2017. The case studies were prepared based on interviews undertaken with the management of the MFBs and using materials made available by the CBN and by the MFBs.

82. The sample of 15 MFBs was selected to be representative of the three different MFB licensing tiers: 4 National MFBs; 5 State MFBs and 6 Unit MFBs spread across different regions. For practical reasons the geographic situation of the selected MFBs was limited to those headquartered in Lagos, Kaduna and Abuja. In selecting individual institutions, an effort was made to assemble a representative sample consisting of both MFBs initially-established under the MFB regulations issued in 2005 (and later updated in 2011), and 'legacy' institutions that were re-licensed as MFBs after having formerly been licensed as CBs (comprising 5 of the sample of 15 institutions). The sample was also selected to be reflective of different business models, including *de novo* institutions, commercial bank subsidiaries, internationally affiliated institutions and those having transformed from being NGO MFIs to licensed MFBs.

83. Clearly a stratified sample of 15 out of altogether 984 licensed MFBs (at the time) can at best be only approximately representative. Nonetheless, the findings from the sample do provide useful indicative lessons learned and useful input in reviewing the strategy for the MFB sector.

84. This chapter discusses the main challenges facing the MFB sector as identified in the case studies. These relate to:

- Being able to source adequate funding;
- Maintaining a client base consistent with the MFB business model;
- Making sure MFBs fulfill their mandate to increase outreach;
- Reliably reporting on MFB financial sustainability;
- Assembling data to facilitate effective supervision;
- Ensuring adequate corporate governance; and
- Strengthening the enabling financial infrastructure.

B. Sources of funding: severe funding pressures

85. As the designation "microfinance banks" implies, the business model associated with MFBs relates to banking as much as to microfinance. MFBs are intended to be hybrid institutions with a business model that attracts clients that are lower-income than those normally serviced by banks (DMBs) and yet provides a more comprehensive array of financial services than unregulated credit-only MFIs. The intention is that MFBs

should support increased financial inclusion by providing their customers with access to the whole range of financial services, spanning payments, savings and credit services.

86. Despite these intentions, the Nigerian MFBs have had difficulty escaping from the MFI funding model. MFBs are still, to a large extent, dependent on resources provided by foreign donors and impact investors. This applies in particular to the larger National MFBs, whose size implies greater absorptive capacity as seen from the perspective of such investors. In specific instances, such larger MFBs have also been able to access funding through issuance of public equity.

87. The eight larger National MFBs have mobilized as much value of deposits as the over 900 Unit MFBs. In part, this is because they have larger branch networks than State and Unit MFBs. However, perhaps more importantly, the National MFBs are more trusted and have established reputations that allow them to attract household deposits. Overall the trust in MFBs, however, appears to be very low according to a recent smallholder survey conducted by CGAP only about 7 percent of smallholder households trust MFBs while 26 percent trust banks[32]. Compared to smaller MFBs, the National MFBs also benefit from economies of scale that allow them to leverage technology as well as their broader physical presence to more economically service their customer-base, thereby allowing them to offer banking services on more attractive terms.

88. The availability of deposit insurance that applies to all licensed MFBs provides some compensation for the unlevel playing field between MFBs with different licenses and of different size. All MFB depositors are covered by NDIC's deposit insurance. Due to the tiered nature of the Nigerian interbank market, access to interbank borrowing is highly constrained and only available to National MFBs. Previously, MFBs could rely on deposits from the government as a means of lessening their funding constraints. However, several Unit and State MFBs referred to the withdrawal of government deposits that arose at the time of the long-overdue and appropriate introduction of the Treasury Single Account (TSA) in 2015 as a factor hampering their liquidity.

89. MFBs have recently benefitted from subsidized funding. Funding windows were established under the CBN's Micro, Small and Medium Enterprise Development Fund (MSMEDF)[33] and by the Bank of Industry (BOI) Bottom of the Pyramid (BOP) program[34]. While these subsidized funding sources provide a lifeline to some MFBs, they are highly

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[32] National Survey and Segmentation of Smallholder Households in Nigeria 2017. Available at http://www.cgap.org/sites/default/files/Working-Paper-Survey%2BSegmentation-of-Smallholders-Nigeria-Oct-2017.pdf

[33] The MSMEDF was established in 2014 to disburse funds to those MFBs that meet a set of eligibility criteria. It lends to MFBs at an interest rate of 3 percent and requires that MFBs on-lend at 9 percent. Loan tenures vary between one year for microenterprises and 5 years for SMEs. While the MSMEDF disbursed N47 billion in 2016 (*Source:* CBN Financial Stability Report, December 2016), it is unclear what proportion of these funds were channeled through MFBs.

[34] In early 2017 the BOI lent N3.1 billion to 14 MFBs as part of its so-called "Bottom of the Pyramid" (BOP) program. This program is co-funded by the Dangote Foundation and 15 Nigerian states. It provides funds to eligible MFBs at an interest rate of 5 percent for on-lending at 7.5 percent with a three-year tenure and 6-month grace period.

distortive of the MFB business model. Firstly, MFBs are required to post collateral in accessing such subsidized funding. One reason for launching the MFB funding model was to provide credit to clients relying on knowledge of their cash-flows as a substitute for collateral. Were collateral available, such clients would most likely have been eligible for borrowing from DMBs. Secondly, when funding is provided by the BOI's BOP program or the CBN's MSMEDF fund (at tenures that are considerably longer than normally available within the MFB sector), the MFBs are required to on-lend at a predetermined spread, and are obliged to cap the interest rate they charge to their borrowers at single digit levels. This introduces significant moral hazard, as borrowers are fully aware that their loans are heavily-subsidized, and therefore will feel less obliged to repay them. It also runs quite counter to experience with the microfinance business model, which has shown that small enterprise borrowers, if given reliable access to micro-credits, are willing and able to pay relatively high interest rates, and that incentive structures such as provided by the collective responsibility or cooperative arrangements are important in incentivizing reliable repayment of credits. Furthermore, since operating costs and loan losses of MFIs typically exceed the mandated spreads (6 percent and 2.5 percent),[35] reliance on these funds risks further undermining the sustainability of already weak MFBs.

90. Reliance on such subsidized funds has increased due to the reduced availability of funding from foreign donors and impact investors. In recent years, foreign sources of funding have largely dried up, as foreign investors are obliged to transfer funds at the official Naira exchange rate. In effect, this considerably depletes the Naira value of any foreign funding. While the spread between the official and parallel market exchange rates has narrowed to 20 percent in 2017, in prior years the value of the transferred funds would be cut by over 50 percent when comparing the value of the transfer at the official rate with the parallel market rate. In addition, foreign investors would be unsure as to whether the CBN would make foreign exchange available to allow the MFB to repatriate income earned on their investment at the official rate.

91. While the MFB designation suggests a hybrid between the business models of banks and microfinance institutions, very few Nigerian MFBs appear to have been able to effectively exploit the common bond that often serves as a collateral substitute in the microfinance business model. Most MFBs do require that prospective borrowers make deposits over a certain period of time before requesting loans, but only few MFBs appear to invest in building a sense of cooperative and shared responsibility by targeting particular client groups. Certain MFBs have successfully targeted certain professional groups, such as teachers, or broader segments of the population, such as women, who are regarded as more financially responsible, but these MFBs are the exception rather than the rule. Only one of the case-study MFBs currently holding a State license has successfully resolved its funding needs through deposit mobilization. This has been achieved by: (a) focusing on the empowerment of women as a target client-group; (b) requiring compulsory savings from all its borrowers; and (c) requiring all borrowers to develop five-year financial plans. Leveraging such a sense of shared responsibility would be especially crucial for small MFBs

[35] CBN data indicate that even National MFBs must charge over 50 percent per annum just to cover administrative costs (Figure 1.13).

to compensate for the diseconomies associated with small size and in bringing financial sustainability and self-sufficiency within reach.

C. Client base: constraints imposed by fragmentation

92. Only a minority of MFBs would appear to have more defined a specific target client base – whether on the asset or liability side of their balance sheets. All too often MFBs seem to adopt a model of providing services similar to banks, but on a smaller scale: 'mini-banks'[36]. As noted above, given economies of scale, achieving financial sustainability is likely to prove challenging for such 'mini-banks'. The results of the case studies suggest it is difficult to identify a path towards financial sustainability unless the strategic approach of the individual MFB leverages the solidarity/common responsibility associated with providing services to a specific client base – for example, within a geographic location or professional association.

93. On the asset side, MFBs generally focus on short-term, cash-flow based lending to small enterprises, undertaken largely without insisting on security in the form of collateral. The MFBs' ability to assess credit risk is hampered by weaknesses in financial market infrastructure, such as in the quality of credit reporting, and by the MFBs' limited professional capacity to assess and continuously monitor credit risks. MFBs seem to have little sympathy for adopting group-lending principles. Several of the case-study MFBs pointed out that group lending is not well-suited to the Nigerian context, while those MFBs that do rely on the solidarity of specific client groups seem to exhibit greater success both in attracting a stable household deposit base and in managing their credit risks.

94. On the liability side, the case studies reveal how difficult it is for MFBs to develop a deposit base that fulfills their funding needs. Despite the availability of deposit insurance, the highly fragmented nature of the MFB industry, with over 900 institutions accounting for just over one percent of the combined balance sheet of the banking sector, makes it almost impossible for any but the largest MFBs to make headway in efficiently providing even the basic package of financial services required by consumers of financial services. In the one instance among the case studies where an MFB with a statewide license has managed to attract sufficient funding from depositors, considerably more reliance is placed on the principles of the common bond adopted from the microfinance industry than is the case among the majority of MFBs, which continue to operate as 'mini-banks'.

D. The MFBs' institutional mandates: uncertain commitment

95. Among the case-study MFBs, it would appear that only the National MFBs and selected state-level MFBs have articulated well-developed strategies. The intended mandate of the MFB sector, as described in the CBN's Revised Micro Finance Policy (2012)

[36] In the revised 2011 framework for microfinance, the CBN warns against the temptation that exists for MFBs to operate as 'mini-banks': "Coming on the heels of the banking sector consolidation, many of those adversely affected found their way into microfinance. Thus, a significant number of the newly licensed MFBs were established or operated like 'mini-commercial banks'. Also, the erstwhile community banks (CBs) that converted to MFBs did not fare any better."

is "to enhance the access of micro-entrepreneurs and low income households to financial services required to expand and modernize their operations in order to contribute to rapid economic growth". Rather than being focused on broader objectives, many of the smaller MFBs are just struggling to stay in business.

E. Reporting on financial performance: varying practices

96. While the case studies indicate that the majority of MFBs use accounting and auditing standards that are IFRS-compliant, the accounts are not readily shared (whether in the context of the interviews conducted as part of the case studies or on the MFBs' websites). In those cases where financial information is posted on MFB websites, it is often outdated (e.g., no update since end-2015). Only in those cases where MFBs have a National license and are funded by international investors, or (as in one instance) reliant on external funding from the Nigerian stock exchange, can some assurance be provided as to the availability and quality of their financial statements, since they are audited by internationally-affiliated auditors.

97. Many Unit MFBs are so weakly capitalized that they do not have the means to deploy MIS that would allow them to adequately monitor and manage their exposures and to provide reliable and timely reports to the CBN (see further discussion in the next section). This circumstance is closely related to the inadequacy of the NGN20 million minimum capital requirement for Unit MFBs. Whereas the minimum capital for National and State licenses was raised as part of the review of the CBN's MFB strategy in 2011, the minimum capital for Unit MFBs has remained unchanged in nominal terms since the initial launch of the CBN's MFB strategy in 2005[37].

F. Supervisory reporting and management information systems: diverging quality and weak supervisory follow-up

98. While all case-study MFBs claim to live up to the monthly reporting requirements of the CBN, the case studies unfortunately do not provide information as to the extent or reliability of this reporting. Doubts exist as to whether the MFBs fully live up to the reporting requirements, whether quality control is performed by the CBN, and what the consequences are if reporting is not undertaken as required on a timely basis.

99. The case studies suggest that the timeliness and quality of supervisory reporting is closely related to whether MFBs have fully automated MIS. The larger National MFBs can afford to invest in fully integrated MIS that facilitate their internal control processes, their efforts to become competitive in delivering digital financial services, and their reporting to the CBN. The majority of MFBs with statewide licenses already have or are in the process of upgrading their MIS, but Unit MFBs face considerable challenges in this

[37] A review of the minimum capital requirements needs to take into account the costs of running MIS/accounting systems, as well as other cost factors associated with establishing and maintaining the business of an MFB, such as the costs of suitable premises with required security features. As pointed out in Chapter II, the nature of these requirements – and whether they are too lax or excessive – needs to be carefully reviewed.

sphere, as for them the cost of installing and maintaining MIS is prohibitive. Although several case-study MFBs referred to the possibility of developing a common MIS that could be implemented across many MFBs, particularly smaller ones, currently no such system has been implemented. Several MFBs referred to a new MIS that is under development, (see paras. 71-74 above). While the development costs of this system are being borne by the CBN and MFBs would only be required to pay a subscription fee, several MFBs expressed concerns about the governance of this common system and the role of the one external provider in managing processes and information across many MFBs.

100. The case studies specifically addressed the issue of loan performance, revealing significant divergence in the performance of the MFBs' loan portfolios; PAR levels were found to vary from very low percentages to over 80 percent. The high level of loan delinquency reported by several case-study MFBs, both some of those with statewide licenses and in particular a number of Unit MFBs, suggests that MFBs are allowed to continue in business irrespective of the level of loan performance and that the CBN has not been taking effective corrective actions on a timely basis.

101. While not obviating the need for supervisory action in cases where MFBs are clearly insolvent, some of the current standards applied by the CBN are considered overly harsh (though not necessarily enforced). Loans are identified as being part of PAR from the first day of non-repayment.[38] The CBN regulation requires that the level of PAR at one day and beyond be held below 5 percent of the loan portfolio. Setting the standard so high has consequences that go beyond establishing an overly tight benchmark for supervisory action, as on the one hand the standard is internalized by MFB management in monitoring performance on their loan book, and on the other hand, rather than modify the standard, the CBN compromises the credibility of the standard by exercising ongoing regulatory forbearance. International best practice suggests that it would be more appropriate to put more emphasis on PAR beyond 30 days.[39]

102. A number of MFBs emphasized that CBN requirements do not take into consideration idiosyncrasies of microfinance business model. The prudential regulations applied to MFBs are to a large extent similar to the regulations applied to banks, and further consideration needs to be given to calibrating these prudential requirements to the particular MFB business model. Furthermore, MFBs would like, CBN to play a more proactive role in advising/supporting MFBs in their efforts to achieve financial self-sustainability, rather than focusing only on observance of prudential requirements. While the CBN should consider reforming the regulatory requirements and adjusting them to realities of microfinance business, the MFBs would appear to have exaggerated expectations

[38] According to the CBN's Revised Regulatory and Supervisory Guidelines for Microfinance Banks in Nigeria (December 2012) a loan is classified as past due once "repayment is past due for at least one day in accordance with the agreed repayment term in the loan contract."

[39] According to CGAP's Guide to Regulation and Supervision of Microfinance (October 2012), the conventional wisdom is that as a general rule, if over 10 percent of a micro-lender's loan portfolio is late by more than 30 days, corrective action must expeditiously be taken by management.

about the kind of support they can expect from the CBN, as the CBN's primary role is to provide regulation and oversight of the sector.

G. Governance and management: cause of fragility especially for smaller institutions

103. The majority of large National MFBs benefit from being sponsored by foreign funders and being able to draw on international best practice regarding both their governance and their management expertise. Overall, the presence of foreign funding appears to have significantly raised standards among larger institutions in the MFB sector. Support such as seconded foreign staff and/or externally-provided training is crucial for MFBs to graduate rapidly from having a Unit license to a State license and eventually being able to operate nationally. While locally-sponsored MFBs included in the case studies may also benefit from foreign investment and knowledge-transfer, the impact on their governance is less pervasive. By listing on the Nigerian stock exchange, MFBs can benefit from transparency and discipline regarding their governance arising from being a quoted company. At the level of MFBs with State and Unit licenses, owner/managers and their families play the key role in MFB governance[40]. Many of these smaller MFBs effectively operate as sole proprietorships. Few of these smaller MFBs can rely on guidance that might be provided by an independent Board.

104. Among case-study MFBs with State licenses, governance arrangements vary considerably and tend to be quite fragile. As with most National MFBs, some of the State MFBs have management teams that include both expatriate and local staff. Other State MFBs have local sponsors: they were set up by former bankers, as a subsidiary of a bank, or by private parties. As might be anticipated, the fortunes of State MFBs that rely on the expertise, commitment and oversight provided by their owners is quite varied, given differences in the nature of the sponsors. Similarly, the governance of one State MFB, which was set up as a subsidiary of a bank, was heavily impacted by the economic misfortunes of the parent bank. The case studies suggest that the governance arrangements of State MFBs tend to be quite fragile, and this can spill over into high management turnover and difficulties in maintaining professional expertise.

105. The governance structure of Unit MFBs is inadequate, with many being so small that they are run as sole proprietorships. In such institutions, there is no real distinction between the owners and the management. Governance is highly dependent on the motivation, professional qualifications, and expertise of the owner/managers. The inadequacy of internal control systems gives rise to situations where fraud, insider lending and collusion among staff is possible. Even in those circumstances where such Unit MFBs are run by highly-experienced and dedicated professionals, they suffer an uncertain future due to the poaching of staff by competitors and the lack of succession planning. MFBs that are associated with local government or local community organizations enjoy greater stability

[40] While the CBN's Revised Regulatory and Supervisory Guidelines for Microfinance Banks in Nigeria (December 2012) require "the maximum number of Directors on the Board of a Unit MFB shall be seven, while the minimum shall be five" (section 4), many Unit MFBs operate without well-structured governance, some effectively as sole proprietorships.

regarding their governance but nonetheless have run into difficulties due to the lack capacity and expertise required to guide their business activities.

H. Strengthening financial infrastructure: leveling the playing field among MFBs

106. Several MFBs suggested further ways in which the financial infrastructure could be strengthened and made more conducive. These go beyond the regulatory issues discussed earlier in this note, such as raising the minimum capital for MFBs and strengthening prudential reporting using improved MIS. As such infrastructure costs are particularly burdensome to small MFBs, addressing these improvements in the enabling environment can also serve the purpose of levelling the playing field among MFBs. The following suggestions were made:

- Strengthening the reliability and coverage of credit information systems so that MFBs can more readily use credit information in assessing their clients' credit-worthiness. Ensuring that MFBs become providers and users of credit information will also be crucial to integrating the markets for financial services provided by MFBs and banks. This will make it more attractive for micro and small enterprises to use the services of MFBs, because their credit histories will migrate with them should they move to using the services of larger intermediaries, if warranted by the growth of their business. To address this concern, the CBN may need to consider how to improve credit reporting process and tailor it to MFBs, and subsequently how best to strengthen oversight and enforcement of current requirements for MFBs to report to and consult with at least two credit bureaus when engaging with new borrowers.
- Developing specific eligibility criteria, possibly supplemented with minimum performance criteria, to allow qualifying MFBs to have direct access to the national payments system rather than having to work through a correspondent DMB;
- Instituting a universal rating system that would strengthen performance incentives within the industry and allow clients/users of MFBs to better discern among the licensed institutions. Obtaining external ratings could be pursued as an industry initiative, given that such ratings would be to the advantage of the MFBs in making them more attractive for investment and in facilitating fundraising.
- Providing increased access to a reliable wholesale funding window (such as that announced by the Development Bank of Nigeria), that provides reliable funds on commercial terms to MFBs provided they demonstrate ability to live up to pre-specified eligibility and performance criteria on an ongoing basis;
- Ensuring that all MFB clients are able to identify themselves using a universally accepted biometric ID. This is under way and in August 2017 the CBN recently announced that it is extending the deadline for introducing BVN registration. As discussed earlier, until conditions are created for customers to relatively easily obtain IDs, the CBN's tiered KYC requirements should be fully observed to avoid exclusion of customers that would otherwise qualify for Tier 1 account, many of which may fit the profile of traditional microfinance clients.

V: Policy conclusions and recommendations

107. The CBN sought to strengthen the framework for microfinance with the launch of a new policy framework in 2005. The objectives of the framework launched by the CBN in 2005 and revised in 2011 were to achieve the dual objectives of (a) providing greater outreach in the provision of financial services; and (b) ensuring the financial sustainability of those institutions delivering these services. The CBN sought to implement this strategy building on the rather shaky foundations provided by CBs. Although the legacy provided by these institutions was inadequate, the CBN re-licensed most of them as MFBs. The CBN also allowed some banks that were unable to meet the increased minimum capital applied to banks in 2005 to continue operation as MFBs.

108. It is clear that MFBs have only partially achieved the objectives set out by the CBN's microfinance policy framework. While the MFBs do provide access to financial services to a sizable number of depositors, their combined asset base stands at around only 1.1 percent of the assets of the DMBs, and in recent years EFInA survey data suggest that the additionality of MFBs in reaching the unbanked population has been declining. While a more accurate assessment of the viability of the MFBs' operations is difficult due to weak or absent reporting, a large number of MFBs, particularly Unit MFBs, are recognized to be inactive and/or insolvent.

109. In reviewing the experiences over the years since 2005, this paper highlights that the concept of microfinance banking is fraught with internal inconsistencies. As banking is associated with significant economies of scale, the viability of MFBs run as 'mini-banks' is confronted with huge challenges. Unfortunately, only a small minority of MFBs have built their business around the principles of a common bond, or cooperative and collective responsibility, which is core to microfinance. The business model concept adopted by small Unit MFBs, which are largely run as mini-banks, is fundamentally inconsistent with the basic principles of microfinance. In those instances where financial institutions have made significant inroads in providing greater access to financial service in recent years by servicing the needs of small savers and borrowers on a financially sustainable basis, their business model is built on exploiting economies of scale and significant investment in technology[41].

110. In addition, the structure of the MFB sector has not been well managed from a supervisory perspective, mainly as a result of regulatory forbearance. While significant resources have been devoted to supervising the MFB sector, the authorities have shied away from taking supervisory action, especially regarding insolvent, inoperative, and non-reporting MFBs. The approach to the regulation and supervision of the sector needs to change to eliminate regulatory forbearance, reduce the number of MFBs, and introduce greater discipline to the OFISD and NDIC's supervisory practices**.** Inadequate supervisory enforcement and the maintenance of licenses of inactive and clearly noncompliant MFBs

[41] The Kenyan Equity bank provides an example of a bank very successfully exploiting economies of scale in the use of technology to strengthen the availability of a broad array of microfinance products covering payments, savings and credit services.

only contributes to undermining public trust in the role of the CBN as supervisor. Similarly, the provision of deposit insurance is associated with moral hazard, as it provides largely unsupervised MFBs with an unwarranted safety net.

111. Significant reforms are required both regarding the structure of the sector and its regulation and supervision and the immediate priority should be given to increasing minimum capital requirements and encouraging consolidation with a view to improving the supervisory process and ultimately enhancing the performance of the MFB sector. The reform of the regulatory framework, and its calibration based on adequate analysis and stakeholder consultation, should commence with the increase of the minimum capital requirements which will ensure that MFBs have sufficient funds to set up and initially run their business and facilitate sector consolidation, thereby reducing the number of MFBs and allowing the CBN to increase the effectiveness of its supervision. In parallel with implementation of the consolidation process, the CBN should embark on a thorough review of existing regulatory and prudential requirements as applied to MFBs. The purpose of this review will be to adjust these requirements so that they are more supportive of the microfinance business model and in line with good practice in this area. Many of the current requirements are 'inherited' from similar requirements applied to banks, and renewed consideration needs to be given to their appropriateness when applied to the MFB business model. In addition, under the current regulations, there are a number of instances where the CBN is not reacting to the inability of the MFBs to observe its prudential requirements (as specified in the Revised Regulatory and Supervisory Guidelines for MFBs, December 2012). Such forbearance undermines confidence in the supervisor and significantly erodes the commitment of MFBs to remain compliant. As an example, among the guidelines to be reviewed are the unnecessarily stringent requirements for maintaining PAR $\geq$ 1 day below 5 percent, whereas requiring MFBs to keep PAR over 30 days below 5 percent would be a more appropriate measure for microfinance business. It should also be ensured that subsequently these requirements are fully enforced. The proposed reforms will support the CBN in strengthening its supervisory function and its capacity to ensure compliance by raising minimum capital, undertaking consolidation of the sector, and revising the regulatory framework. The suggested reforms need to be undertaken in a prioritized and coordinated fashion and include the key elements as outlined below.

A. Encouraging clarification and consolidation of the MFB sector

112. An immediate priority is to determine the appropriate increase of the minimum capital applied to MFBs. There are several reasons for this:

- ***Raising the level of minimum capital of MFBs to achieve two objectives: i) ensure adequate level of minimum capital required for MFBs to establish effective operations (e.g. investment in infrastructure, MIS, skills); and ii) facilitate regulatory capacity and sustainability by ensuring that CBN can efficiently supervise the sector.*** The level of minimum capital applied to MFBs has been unchanged since 2005 for Unit MFBs and since 2011 for State and National MFBs. In real terms minimum capital for Unit MFBs has fallen to a third of its value in 2005 with the result that MFBs are unable to finance their start-up costs and MIS at the time of being licensed. Similarly, the level of minimum capital for State and National

MFBs has fallen to a half of its value in 2011. As it normally takes newly-licensed MFBs several years to attain financial viability, it will be important to build a cushion into the minimum capital to allow MFBs to bridge these first years of operation.

- ***Strengthening supervisory enforcement.*** Consideration needs to be given to modification of the incentives supported by the current licensing framework, which regards graduation from a Unit license to a State license and then a National license as the 'natural' path of progression. Given significant economies of scale both in banking and in the use of new technology, the viability of small MFBs is particularly challenged. Thus, in addition to raising minimum capital requirements, there is a need to focus supervisory enforcement on strengthening viability within the sector, and on ensuring the implementation of corporate governance standards.
- ***Enforcing licensing requirements.*** At present, newly-licensed MFBs do not necessarily fulfill the CBN's licensing requirements. According to these requirements newly-licensed MFBs are supposed to demonstrate *inter alia* that:
  - *Their business models are financially sustainable:* The number of insolvent MFBs suggests that this requirement is observed at best only superficially;
  - *They are to be subject to robust governance structure with constituted Board and management:* Practice suggests they are run as sole-proprietorships, at least in the case of Unit MFBs;
  - *They have in place the MIS* necessary to ensure that they are able to maintain an adequate internal control and report reliably and on a timely basis about their activities to the CBN. In practice delinquency in the frequency and reliability of reporting is significant.

113. The following actions are therefore recommended:

- ***Amalgamate Unit and State licensing regimes resulting in only two license tiers (State-wide and National licenses) and permitting direct application to either license, along with increasing minimum capital requirements for both tiers allowing one- to two-year transition period to comply with new requirements.*** In determining the advisable amount of minimum capital, the starting point could be adjustment for inflation leading to a minimum capital level of at least NGN200 million to be applied to all MFBs that currently have Unit and State licenses (converging with requirements for a State license adjusted for inflation as of 2017), and similarly, to ensure consistency, increasing the minimum capital for National MFBs to NGN4 billion (adjusted for inflation as of 2017).

  However, to allow minimum capital to serve as a buffer during the first years of operation of newly-established MFBs, consideration should be given to applying a higher minimum capital threshold for amalgamated Unit and State licensing category than merely adjustment for inflation. In addition to taking account of inflation, consideration needs to be given to the difficult operating environment caused by weak economic growth and the dual exchange rate market and the impact on the MFB sector in terms of funding constraints and weak portfolio

quality. Such considerations are reflective of the track-record for newly-established MFBs suggesting that it takes newly-established MFBs several years to become financially sustainable. These circumstances justify establishing an extra cushion in the minimum capital. This extra element of minimum capital goes beyond the factors normally associated with minimum capital, such as the need to fund set-up costs associated with establishing a suitable office, hiring qualified staff, installing/using an adequate MIS system, and introducing technology to develop a robust digital offering to stay abreast of industry trends. In addition to providing a degree of security so that newly-established MFBs can absorb losses, this extra capital cushion would introduce an additional margin of safety regarding the CBN's ability to supervise the MFB sector by supporting the process of reducing their number through consolidation and de-licensing.

The CBN is advised to conduct further analysis to determine appropriate level of increase in minimum capital and to engage appropriately with key stakeholders (e.g. NDIC, MFBs) as part of the process of introducing the higher minimum capital requirements as well as to develop an adequate communications strategy to manage this process.

- **One to two-year transition period to provide MFBs (in particular Unit MFBs) sufficient time to transition to the higher minimum capital requirement, or to undertake steps towards consolidation**. Higher minimum capital would encourage amalgamation among MFBs. The CBN's regulatory burden would be lessened both due to the simplification of the licensing framework and due to the reduction of the number of institutions to be supervised. The higher minimum capital requirement will also ensure that MFBs have the necessary resources to invest in MIS and the establishment of MFB operations. Consolidation of the large number of very small MFBs will allow these very small institutions to grow by harnessing economies of scale.
- ***Delicense those MFBs that are already suffering from insolvency and slated for de-licensing, as well as any MFBs that are unable to achieve the raised minimum capital requirement***. Action should be taken to expeditiously de-license those 150 MFBs already slated for de-licensing. Those MFBs unable to meet the new minimum capital standard should be de-licensed immediately following the termination of the pre-announced transition period. Unit MFBs that fail to meet the revised minimum capital requirements could be allowed to continue in operation as credit-only MFIs.
- ***Apply a moratorium on all new MFBs licenses until the transition to higher minimum capital and amalgamation processes are completed and the CBN's oversight of the licensing process has been strengthened.*** Applying a moratorium to new licenses will both encourage the amalgamation process and allow the CBN to move to strengthen its capacity so that licensing requirements are firmly implemented. A revision of the pre-licensing process is recommended whereby focus is placed on adherence to fewer crucial requirements combined with rigorous verification and enforcement regarding adherence to these requirements. Among issues to be addressed are ensuring that the business models pursued by MFBs (a) are financially sustainable, (b) fulfill requirements as to the structure of the Board

and management of MFBs, and (c) have the capacity from inception to sustainably fulfill the CBN's reporting requirements.

B. Significantly strengthening supervisory enforcement

114. Currently the supervision of MFBs is subject to widespread forbearance, deficiencies in reporting or absence in reporting, and (largely as a consequence of the reporting inadequacies) over-reliance on resource-intensive on-site inspections. While the CBN is moving towards applying pecuniary sanctions for untimely reporting, more attention needs to be paid to effective enforcement using sanctions that are applied on a pre-announced and fully transparent basis. The following steps are recommended:

- ***Strengthen MFB internal management processes with a view to enhancing the quality of risk-management and reporting.*** Measures to strengthen reporting include: (i) requirements for and supervisory follow up on development and implementation of bound action plans for MFBs that do not comply with reporting requirements; ii) where these plans are not adhered to pecuniary fines to be applied automatically for late reporting and non-reporting; (iii) pecuniary fines to be applied regarding inconsistency and poor quality of reporting; (vi) notification of more stringent sanctions, such as restrictions on lending activities and sanctions on MFB management (including the removal of managers), to be applied to repeat offenders; and (v) de-licensing procedures to be pursued for institutions that do not react to these graduated sanctions.
- ***Undertake a thorough review of the existing reporting requirements and the causes of misreporting by MFBs.*** This review is required with a view to simplifying the current requirements, which appear to be too broad and onerous. Given the limited capacity of smaller MFBs in particular the authorities need to rationalize their reporting requirements as far as possible. The authorities also need to engage in dialogue with MFBs to explain and motivate their reporting requirements. As part of this review, the causes of misreporting or failure to report need to be explored with a view to justifying modifications and incentivizing improved compliance.

115. Even before the above recommendations are fully implemented the CBN will be well advised to prepare for the transition by:

- ***Placing much greater reliance on off-site data analysis.*** This will be possible as the quality of off-site reporting improves, but will require upgrading of the CBN's skills in monitoring of off-site data using algorithms and analytical tools that allow the CBN to appropriately analyze the data at its disposal and test the reliability and consistency of the off-site data reported by the MFBs. The development of such algorithms and analytical tools is an important function that OFISD needs to strengthen both to enhance skills in off-site supervision and to prepare for the transition to the new MIS platform, NAMBUIT, currently being introduced.
- ***Applying pre-announced and graduated sanctions to all transgressors of the CBN's prudential requirements.*** Once the review and required revisions of prudential requirements has been completed, a clear, pre-announced process of

sanctioning transgressors needs to be adhered to. Discretion in applying prudential requirements needs to be eliminated.

- ***Steps need to be taken to strengthen the capacity of OFIDS to effectively enforce the reformed regulatory framework.*** This includes undertaking an assessment of the capacity, training and information technology needs of OFIDS supervisory staff, focusing in the first instance on strengthening the process of validating reports provided by MFBs and subsequently on the introduction of a structured risk-based approach to the supervisory process.

116. The overall outcome of these changes will be to ensure that appropriate action is taken by OFISD staff and management in overseeing the MFB sector. The purpose of these reforms in MFB oversight is to move away from the current circumstances where the identification of weaknesses and the transgression of prudential standards may or (more often) may not give rise to supervisory action. It is recommended to move to an approach with much greater transparency about exactly which supervisory actions, including but not limited to sanctions, will be applied to particular transgressions and identified weaknesses. The nature and severity of supervisory actions for particular weaknesses and transgressions can be graduated according to a pre-announced schedule in accordance with the severity and duration of the weaknesses and transgressions.

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