# MICROFINANCE BANKS: THE NEW DIGITAL BANKS?

## A CLOSER LOOK AT THE CBN MICROFINANCE BANKING GUIDELINES 2020 AND IMPLICATIONS FOR DIGITAL BANKS

Nigeria, over 200 million people but as at 2018, the financial exclusion rate was 36.8% and the Central Bank of Nigeria ("CBN") plans to achieve a 95% financial inclusion rate by 2024.[1]

In spite of the above, the near absence of Financial Technology ("Fintech") specific laws have continued to blur the prospects of Fintechs including digitals banks, that are supposed to accelerate the financial inclusion drive of the CBN.

In Nigeria, Fintech startups continue to operate within the realms of regulations implemented without the technology sector in mind. The CBN as the primary regulator of financial services, has continued to monitor the Fintech environment and reel out corresponding regulations based on market trends.

Earlier this year, the CBN issued the Guidelines for the Regulation and Supervision of Microfinance Banks (the "**Guidelines**"). These Guidelines, which came into force on the 1st of April 2020, will impact on the business operations of several Fintech startups that leverage on the microfinance banking license to provide digital

[1] https://www.cbn.gov.ng/Out/2019/CCD/Q2%202019%20Financial%20Inclusion%20Newsletter_Final_08.08.19.pdf accessed 1 September 2020

banking services due to the absence of a specific licensing regime for digital banks.

Against this background, this article seeks to explore, among other things, the key licensing requirements under the Guidelines and highlight the extent of its impact on digital banking services.

## THE EVOLUTION OF MICROFINANCE BANKING IN NIGERIA

Traditionally, financial institutions tend to focus on medium and large-scale enterprises which are considered to be more profitable and viable. As a result, microfinance banks were introduced to facilitate the provision of financial services to low income earners, especially the un(der)banked.

In December 2005, the Microfinance Policy Framework for Nigeria[2] (the "**MFB Framework**") was introduced by the CBN, to accelerate rapid economic growth and reduce financial exclusion. Among other things, the MFB Framework was introduced to provide start-ups, micro-entrepreneurs and low-income households with access to the financial services required in their business operations and day-to-day activities.

In 2012, the CBN issued the Revised Supervisory and Regulatory Guidelines for MFBs ("Old Guidelines"). The Old Guidelines define microfinance services to include the provision of loans, acceptance of deposits, transfer of funds and other ancillary non-financial products targeted at low-income clients. As such, promoters of certain services are required to obtain an MFB license from the CBN in order to provide microfinance services in Nigeria.

In terms of licensing, the Old Guidelines provided for three (3) categories of licenses; the unit, state and national MFB licenses.

### *Unit License*

Unit MFBs are only authorized to operate in one location within a defined geographic area and are prohibited from establishing branches and cash centres. In addition, every Unit license holder is required to have a minimum paid up capital of N20 million (approx. US$52,000).

### *State License*

State MFBs are authorised to operate in one State or the Federal Capital Territory (FCT) and are required to have a minimum paid up capital of N100 million (approx. US$260,000).
Holders of State MFB licenses are allowed to open branches within the same State or the FCT, subject to the prior written approval by the CBN for each new branch.

### *National License*

Other than the requirement for a minimum paid up capital of N2 billion (approx. US$5.2million), there is no geographical restriction on the operations of a National MFB. Thus, a National MFB is authorized to establish branches across different states including the FCT.

## WHY FINTECHS ARE OBTAINING MFB LICENSES?

In view of the increasing number of digital banks, one would have expected the CBN to roll out corresponding digital banking regulations in a timely fashion. However, while the introduction of a special licensing regime for digital banking services is said to be underway, Fintechs are leveraging on the existing MFB Framework to launch their products.

The Old Guidelines provide for a number of permissible activities that an MFB can undertake, including (but not limited to) the acceptance of deposits, provision of credit (loan advancement) to its customers and the provision of ancillary

[2] Further revised in 2011 by the CBN Microfinance Policy Framework for Nigeria.

banking services to its customers such as domestic remittance and safe custody of funds etc.

Therefore, the Guidelines will significantly impact on the business operations of Fintechs that rely on MFB licenses, as provided under the Old Guidelines, to offer their services.

## THE NEW REGIME

Since coming into force, the Guidelines have continued to reshape the regulatory landscape for MFBs.

We have highlighted below some of the key changes introduced by the Guidelines:

### Reclassification of MFB Categories

The Guidelines have introduced a fourth type of MFB license by splitting the unit MFB license into tier 1 and tier 2 licenses.[3]

#### *Tier 1 Unit MFB*

A unit MFB with a tier 1 MFB license is only authorized to operate in the urban, banked and high-density areas and is limited to four branches outside the head office within five contiguous local governments areas unless otherwise approved by the CBN.

#### *Tier 2 Unit MFB*

A tier 2 unit MFB is only authorized to operate in the rural, unbanked or underbanked areas and is allowed to open one branch outside the head office within the same Local Government Area (LGA) subject to the approval of the CBN.

#### *State Microfinance Bank*

Similar to the Old Guidelines, a State MFB is authorized to operate within one State or the FCT, as the case may be. It is also allowed to open branches within the same State or the FCT, subject to prior written approval of the CBN for each new branch or cash centre. However, a State MFB is not permitted to open more than two branches in the same LGA unless it has established at least one branch or cash centre in every LGA of the State.

Further, a newly licensed State MFBs can no longer commence operations with more than ten (10) branches.

#### *National Microfinance Bank*

As authorized under the old regime, National MFBs can continue to operate in more than one State including the FCT but a newly licensed National MFB cannot commence operations with more than ten (10) branches.

### Recapitalization

Whether as minimum shareholders contribution or minimum paid up capital, capital adequacy requirements are treated as an integral part of banking regulation. The rationale behind capital adequacy requirements is to strike a balance between the operational risk assumed by banks and the actual risk-bearing capacity of the bank. Therefore, even at the lowest level, MFBs are required by law to maintain a minimum paid up capital.

Against this backdrop, the Guidelines have reviewed the MFB capital requirements upwards: Tier 1 MFBs are now required to maintain a minimum paid up capital of ₦200 million (approx. US$520,000), Tier 2 MFBs are required to maintain a minimum capital of ₦50 million (approx. US$130,000), State MFBs are required to maintain a minimum capital of ₦1 Billion (approx. US$2.6million) (up from N100 million) and National MFBs are now required to maintain

[3] Section 3, CBN Guidelines for the Regulation and Supervision of Microfinance Banks in Nigeria 2020.

a capital threshold of ₦5 Billion (approx. US$13 million) (up from N2 billion).[4]

The implication of the new capital requirements is that MFBs will now be required to seek additional funding, whether as debt or equity, for the purposes of meeting the new capital adequacy requirements.

Moving forward, existing MFBs that are unable to recapitalize by April 2021 may be forced to consider merging with other MFBs in order to meet the capital requirements, unless an extension is granted.

On the other hand, there is also an option to downgrade to an MFB license with a lower capital requirement albeit this may result in limiting the operational reach of the downgrading MFB, such that an MFB that would have been able to provide microfinance banking services on a national scale will now have to settle for a state MFB license with a restricted geography in terms of physical market reach.

## Foreign Loans

Whilst MFBs can source funding through loans for the purpose of meeting their minimum capital requirements, the Guidelines provide that where the source of funding for a shareholder's equity contribution is by way of loan, such loan shall be a long-term facility with a minimum tenor of 7 (seven) years.[5]

Further, the Guidelines provide that a loan shall not be procured from the Nigerian banking system where the loan is to be utilized in meeting capital requirements.[6] In other words, MFBs are prohibited from borrowing from Nigerian banks if the purpose of the facility is to meet its minimum capital requirements. Such restrictions may limit a start-up's ability to source debt and heighten their market entry barriers in view of the low risk appetite of Nigerian banks in funding start-ups.

## Geographical Restrictions

The geographical reach of an MFB's business operations is essential to the viability of the products they offer.

Whilst there is no definition of the terms '*rural*' and '*urban*' under the Guidelines, the distinction in generic terms may create practical problems for existing unit MFBs. MFBs that are currently operating offices in 'urban' areas (subject to the guidance of the CBN) may be required to move their offices to 'rural' areas for the purposes of complying with the geographical restrictions under the Guidelines.

Fintechs that offer digital banking services take comfort in the fact that the physical location requirements do not affect their ability to offer products and services remotely through the use of digital platforms, especially for digital-only banks. As a result, it is possible that a unit MFB may continue to offer services to customers outside the geographical location of their office.

While this loophole allows unit MFBs to operate despite the new restrictions, there remains a risk that the CBN may seek to regulate against this in the future. It may also be the case that the CBN is aware of this regulatory arbitrage but have chosen to allow digital banks leverage on the MFB license in the absence of a comprehensive digital banks licensing regime for obvious reason: to promote innovation and accelerate the financial inclusion drive of the CBN.

Therefore, MFBs should entertain the idea of recapitalizing to meet the requirements for a state/national license in order to avoid the likely impact of additional regulation in the future.

[4] Section 4.2.7, CBN Guidelines for the Regulation and Supervision of Microfinance Banks in Nigeria 2020.

[5] Section 4.2.2e, CBN Guidelines for the Regulation and Supervision of Microfinance Banks in Nigeria 2020.

[6] Ibid

## Ownership Requirements

Under the Guidelines, individuals, groups of individuals, community development associations, private corporate entities and foreign investors are all classed as eligible promoters. However, individuals and related parties are subject to a maximum of 49% shareholding.

The Guidelines also provide that no individual, group of individuals, their proxies or corporate entities and/or their subsidiaries shall own controlling interest in more than one MFB, except as approved by the CBN. This might impact on investors and funds which focus the technology sector.

Finally, while the participation of state and local governments has not been restricted, governments are now required to divest of its interest within a period of 5 (five) years from its initial investment.[7]

## CONCLUSION

Whilst several Fintech startups may be affected by the Guidelines especially in relation to the recapitalization requirements, in general, recapitalization results in a strengthened balance sheet and ultimately protects consumers. However, it is important for regulators to engage with all stakeholders when drafting and/or amending regulations to ensure that an appropriate balance is struck between all parties.

MFBs were required to meet their minimum capital requirements by April 2021. However, to cushion the effect of the Covid-19 pandemic on microfinance banks, the CBN vide a circular dated 29 April 2020 further extended the deadline for compliance with the revised minimum capital requirements by one year.

Tier 2 MFBs shall meet a N35 million (approx. US$90,000) capital threshold by April 2021 and N50 million by April 2022 while Tier 1 MFBs are expected to meet a N100 million threshold by April 2021 and N200 million by April 2022.

State MFBs are expected to increase their capital threshold to N500 million (approx. US$1.3 million) by April 2021 and N1 billion by April 2022 while National MFBs must reach a N3.5 billion (approx. US$9 million) threshold by April 2021 and N5 billion by April 2022.

Ahead of the expiration of the moratorium period, MFBs, including digital banks that leverage on the MFB licenses to offer their products, must seek additional funding either by way of equity contribution or long-term loan facilities to meet their minimum capital requirements.

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[7] Section 4.1.4, CBN Guidelines for the Regulation and Supervision of Microfinance Banks in Nigeria 2020.