FROM MARGIN TO MAINSTREAM:
THE REGULATION AND SUPERVISION 
OF MICROFINANCE

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Monograph Series No. 11
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# CONTENTS

**FOREWORD**, by Maria Otero .............................................................. vii

**ACKNOWLEDGMENTS** ....................................................................... ix

**CHAPTER I: INTRODUCTION**, by Rachel Rock ............................. 1  
A. CONTEXT .................................................................................... 5  
B. FINANCIAL SYSTEM REFORMS IN LATIN AMERICA .......... 10  
C. DISTINCT CHARACTERISTICS OF MICROFINANCE ........... 20  
D. PRUDENTIAL REGULATION AND SUPERVISION OF MICROFINANCE ................................................................. 23

**CHAPTER II: ISSUES IN THE REGULATION AND SUPERVISION OF MICROFINANCE**, by Robert Peck Christen ...... 29  
A. INTRODUCTION ........................................................................ 31  
B. WHY DO BANK SUPERINTENDENCIES NEED TO KNOW ABOUT MICROFINANCE? ........................................................ 32  
C. BASIC ISSUES CONFRONTING BANK SUPERINTENDENCIES IN THE MICROFINANCE FIELD ..... 33  
D. MICROFINANCE INDUSTRY STANDARDS ............................ 34  
E. HOW BANK SUPERINTENDENCIES MIGHT SUPERVISE MICROFINANCE ................................................. 42  
F. CONCLUSIONS ......................................................................... 47

A. INTRODUCTION ........................................................................ 51  
B. LEGAL FRAMEWORK APPLICABLE TO FINANCIAL INTERMEDIATION ACTIVITIES IN BOLIVIA ...... 51  
C. FINANCIAL INSTITUTIONS: SUPPLY AND DEMAND FOR CREDIT ........................................................................ 54  
D. NEED FOR A NEW TYPE OF ENTITY SPECIALIZED IN SMALL BUSINESS AND MICROFINANCE ...................... 59  
E. CONCLUSIONS ......................................................................... 63
CHAPTER IV: BANCO SOLIDARIO, S.A.:
A REGULATED INSTITUTION, by Rachel Rock ..... 65
A. PRODEM: RESTRICTIONS ON GROWTH ......................... 67
B. FULFILLING THE REQUIREMENTS OF REGULATION
   AND ONGOING SUPERVISION ........................................... 68
C. COSTS AND BENEFITS OF REGULATION AND
   SUPERVISION ....................................................................... 81
D. COMPETITION IN THE MICROENTERPRISE SECTOR ...... 85
E. BANCOSOL'S IMPACT ON THE BOLIVIAN FINANCIAL
   SYSTEM .................................................................................. 86

CHAPTER V: OTHER MICROFINANCE INSTITUTION
EXPERIENCES WITH REGULATION, by Rachel
Rock with Carlos Castello and Vivienne Azarcon .... 87
A. ACCION COMUNITARIA DEL PERU:
   BECOMING AN EDPYME ...................................................... 89
B. FINANSOL: SUPERVISING CRISIS ....................................... 93
C. CAJA DE AHORRO Y PRESTAMO LOS ANDES:
   THE FIRST BOLIVIAN PRIVATE FINANCIAL FUND .......... 96
D. MULTI CREDIT BANK IN PANAMA: WORKING TO
   PENETRATE THE MICROENTERPRISE SECTOR ............ 100

CHAPTER VI: CONCLUSIONS AND RECOMMENDATIONS,
by Rachel Rock ................................................................. 107
A. INTRODUCTION .................................................................. 109
B. POLICYMAKERS ................................................................. 110
C. SUPERVISORY AGENCIES ..................................................... 111
D. DONORS ............................................................................... 113
E. COMMERCIAL BANKS ......................................................... 114
F. MICROFINANCE INSTITUTIONS ......................................... 115

APPENDIX: Supervisory Agency Representative
Participation, ACCION International Conference,
November 1995 ................................................................. 117

BIBLIOGRAPHY ...................................................................... 123
LIST OF TABLES

1. Response to Demand by the ACCION Network of Microfinance Institutions ............................................................. 6
2. Latin American Regulatory Frameworks: Selected Indicators 15
3. Comparison of Characteristics of Traditional and Microfinance Institutions in Developing Countries .................. 21
4. Performance Indicators for Three Leading Microfinance Institutions .................................................................................. 36
5. Bolivian Financial System: Portfolio and Share Classification by Dollar Amounts and Number of Borrowers ................. 56
6. Nongovernmental Credit Organizations and Banco Solidario, S.A. Portfolio Quality ............................................. 58
7. Bolivian Superintendent’s Risk Classification and Provisioning Requirements ....................................................... 75
8. Risk Weighting of Assets to Determine Capital Adequacy, BancoSol, May 1996 ................................................................. 79
9. Reporting Requirements of the Bolivian Supervisory Structure ..................................................................................... 80
10. History of Savings: Banco Solidario, S.A ............................................. 83
11. Peruvian Provisioning Requirements ............................................. 92
12. Financial Impact of the Crisis on Finansol ............................... 95
13. Los Andes Provisioning Policy .................................................. 97
15. History of Savings: Los Andes ................................................ 100
16. Multi Credit Bank Portfolio Indicators ................................................ 101
17. Multi Credit/Acción Empresarial’s Provisioning Policy ........ 103
18. Comparative Regulation and Supervision .......................................... 105
FOREWORD

As the microenterprise sector’s enormous demand for financial services grows, an increasing number of microfinance institutions around the world are becoming regulated financial intermediaries. Linking themselves to the financial systems of their countries strengthens their ability to access international capital and obtain legal authorization to capture the savings deposits of their clients and the public. Formalizing the financial structure of the intermediaries allows their clients to benefit from and contribute to the income and growth potentials of a productive national and international financial system. Full inclusion of these millions of self-employed poor men and women, who represent a vibrant and productive sector of the economies of the developing world, could ultimately alter the local -- and potentially global -- environment.

The first stage of microfinance has witnessed the achievement of scale and sustainability by the best performing nongovernmental organizations (NGOs). This monograph examines the second stage of microenterprise development, in which regulated institutions -- specialized nonbank intermediaries, as well as commercial banks -- are accessing capital from the local and international financial markets to lend to the microenterprise sector. This evolution requires cooperation and negotiation between regulatory agencies and microfinance managers. Regulators must maintain the underlying goals of prudential regulation and supervision while enabling microfinance, whose operations, capital structures, and lending technologies fundamentally differ from traditional finance, to serve clients previously considered unbankable. Accustomed to self-regulation, microfinance managers must adapt to the discipline of a supervisory system that at times may be measuring performance by financial standards that do not accurately portray the health of their portfolios. Managers must likewise accept the costs and changes in corporate culture associated with becoming regulated.

Commercial banks, which are increasingly interested in expanding their operations to serve the microenterprise sector but are already part of the regulated system, likewise face regulatory hurdles. These institutions must adapt to the realities of microfinance to allow for a minimization of
the costs and risks associated with the broadening and deepening of their reach through microloan portfolios.

Finally, policymakers encourage the formation of specialized microfinance institutions and the increased involvement of commercial banks to ensure that the process of reform of the financial sector in Latin America will not lead to the exclusion of low-income clients from banking services. This is especially the case where there has been large-scale privatization or closure of state-owned banks.

In November 1995, ACCION International organized a conference to gather high-level representatives from Latin American and U.S. bank supervisory agencies, development professionals, and donors, to address for the first time at a regional level issues related to regulation and supervision of microfinance institutions.¹ This conference represented a first step toward defining a framework and guidelines through which supervisory agencies may attend to this newly emerging challenge for regulation. This document is an attempt to share the work and learning of that conference, as well as to give additional information on microfinance institutions that have already entered the regulatory environment or are in the process of doing so.

Although this monograph is based on efforts in Latin America, much of what is presented can be applied to work in Africa and Asia with respect to establishing links to the formal financial sector. In fact, we hope this monograph provides useful guidance to those in supervisory agencies and microfinance institutions around the world involved in the critical evolution of financial service delivery to microenterprises.

Maria Otero
Executive Vice President
ACCION International

¹ See Appendix for a list of supervisory agency representatives in attendance.
ACKNOWLEDGMENTS

The editors express their appreciation to the Ford Foundation, the Wallace Global Fund, and the U.S. Agency for International Development, who provided support through its matching grant program, for funding this publication.

Several individuals with expertise in this topic have contributed valuable input. Critical review was provided by ACCION staff members Carlos Castello, Michael Chu, and Deborah Drake, as well as Claudio Gonzalez-Vega of Ohio State University, Elisabeth Rhyne of USAID, Richard Rosenberg of World Bank/CGAP, and Glenn Westley of the Inter-American Development Bank. Each addressed the issue from a different perspective and posed challenging questions for further review.

The institutional perspectives were provided by Hermann Krutzfeldt and others of the staff of BancoSol, Eduardo Bazoberry of PRODEM, Mery Valenzuela and Pedro Arriola of Caja de Ahorro y Préstamo Los Andes, Manuel Montoya and Jesus Ferreyra of Acción Comunitaria del Perú, Isaac Btesh and Norberto Delgado of Multi Credit Bank of Panama, and María Eugenia Iglesias of Finansol. Their involvement has greatly enhanced our understanding of the effects of regulation and supervision on microfinance.

Other perspectives and input came from Efraín Camacho and Javier Fernández of the Bolivian Superintendency of Banks, Steve Smith and Kim Brown of the USAID Mission in Bolivia, and Brian Gaitley of WOCCU.

Our thanks also to ACCION staff -- Vivienne Azarcon, Craig Churchill, Lisa Lindsley, Ivette Manrique, Alvaro Rodriguez and Jean Steege -- for their immeasurable contribution to this document.

Finally, for editing support, we would like to thank Sonya Manes, Elizabeth Shaw, Diane McCree, as well as Diego Guzmán of ACCION in Colombia for coordinating the printing.

ix
CHAPTER 1

INTRODUCTION

by Rachel Rock
In the last five years, two developments in the microenterprise field -- enormous demand for financial services among microentrepreneurs and an increasing number of regulated microfinance institutions -- require that one carefully examine the issue of supervision and regulation of these microfinance institutions (MFIs). With regard to the first development, it has become widely accepted that the millions of self-employed poor around the world turn to microenterprise as a source of livelihood. Like any business owner, these microentrepreneurs -- bakers, food vendors, carpenters, mechanics, and many others -- require working capital to operate and investment capital to grow. Those who can save also require a secure, trustworthy, and convenient place to deposit their money.

The second development relates to the evolution of microfinance institutions, most of them nonprofit, nongovernmental organizations (NGOs), toward increased capacity for outreach and improved application of lending technologies that make financial viability possible. The most advanced of these microfinance institutions have already transformed into regulated financial institutions, and several others are also moving in this direction. In addition, pioneering commercial banks, which have recognized the potential of this untapped market, are creating specialized portfolios.

From the perspective of supervision, regulators must apply the basic principles of prudential regulation and supervision to these new financial institutions and emerging portfolios in existing commercial institutions. The issues that emerge in the application of existing regulations and supervisory mechanisms to microfinance institutions and microfinance portfolios are the subject of this monograph.

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2 The term “microfinance institution” (MFI) is used in this monograph to refer to any financial institution, a regulated intermediary or an unregulated nongovernmental organization (NGO) providing financial services to the microenterprise sector. Several unregulated institutions have become formal financial institutions while others are in the midst of doing so. Several regulated and soon-to-be regulated institutions are described in this document.
This introduction reviews the context in which microenterprise financial services are being delivered and provides an overview of recent financial sector reforms in Latin America, focusing on the area of regulation and supervision. This chapter also outlines the basic characteristics of microfinance that differentiate it from traditional banking, as well as the application of the basic principles of prudential regulation to microfinance.

The remaining chapters of the monograph delve in greater depth into key issues related to the regulation of microfinance institutions and present them from the perspective of a supervisory body and of a regulated microfinance institution.

Chapter II, by Robert Peck Christen, examines the financial characteristics of microfinance by presenting the earnings, asset quality, and capital adequacy of leading institutions. Within this context, the chapter discusses the major issues surrounding the supervision of microfinance and provides suggestions on how Superintendencies can address the question of risk related to this type of lending. This chapter is intended to provide a conceptual framework for the rest of the monograph.

Chapter III, written by the Bolivian Superintendent of Banks, Jacques Trigo LoubiPere, presents the experience of the Private Financial Funds (PFFs), created as a new category of the financial entities that are designed to service the small and microenterprise sector. The chapter analyzes the PFFs in the larger context of financial sector reform in Bolivia.

Chapter IV presents the experience of Banco Solidario, S.A. (BancoSol) in Bolivia, focusing on the supervisory and regulatory dimensions of this bank. The first private commercial bank in the world created to provide financial services to microenterprises, BancoSol was chartered as a commercial bank but served a completely different market from that of other Bolivian banks. The chapter traces issues pertaining to supervision and regulation from the perspective of BancoSol.

The establishment of the PFF structure in Bolivia, as presented in Chapter III, occurred two years after the creation of BancoSol. It was in direct response to the need for a different type of regulated financial institution that could more appropriately deploy financial services to microenterprises. The creation of the PFF legislation illustrates the evolution of the Bolivian financial system toward the inclusion of the microenterprise sector as a market for regulated financial institutions.

As such, the PFF structure is far more responsive than traditional finance institutions to the characteristics of microfinance. It is interesting that many of the issues that BancoSol faces in the area of supervision and regulation, as discussed in Chapter IV, originated because it was chartered as a commercial bank and not as a PFF.
Chapter V summarizes the experience of additional microfinance institutions in four Latin American countries: Peru, Colombia, Panama, and Bolivia. These microfinance institutions are regulated or are in the process of becoming regulated. Chapter VI outlines key conclusions drawn from the earlier chapters and makes a series of recommendations directed to policymakers, supervisory agencies, donors, commercial banks and microfinance institutions.

A. CONTEXT

1. Demand for Financial Services

**Demand for credit:** Worldwide demand for credit among the poor continues to grow at a dramatic rate with the explosion of economic activity on the smallest scale. The Inter-American Development Bank (IDB) estimates that in Latin America and the Caribbean, 80 percent of all businesses have ten employees or less (IDB, 1995). The International Labor Organization (ILO) statistics show that in 1994, 56 percent of the economically active population in Latin America worked in the informal sector. In Paraguay, the 1994 figure was as high as 69 percent (ILO, 1995).

In Latin America, the rapidly growing population of poorly educated young men and women, increasingly concentrated in urban centers, has far outstripped the capacity of the formal economy to provide employment. With few social safety nets in place, individuals turn to whatever self-generated productive activities will earn them income to survive. As is the case for even the largest corporations, these microenterprises require access to working and investment capital in order to increase production and earn income.

Historically, commercial banks throughout the developing world have not been interested in servicing the informal sector given the level of risk and cost associated with unsecured lending to very small unregistered businesses. The transaction costs of disbursing loans averaging US$400, language and cultural barriers, and inappropriate lending technologies were disincentives for commercial banks (Drake and Otero, 1992). However, as new and unconventional methodologies of providing credit to the microenterprise sector are promising examples of potential profitability, more commercial banks are looking to this clientele as a possible market for their services.

Supply of credit to the self-employed working poor has not kept up with demand. In no country have institutions come close to reaching the majority of poor households that are potential borrowers. The IDB (1995) estimates the potential number of microenterprises in Latin America to be 50 million. With a few notable exceptions such as BancoSol in Bolivia, market penetration estimates range from 5 percent to often less than 1 percent in
some countries. Even among institutions experiencing dramatic growth, market penetration has not yet reached significant proportions.

One example of the dramatic growth in microfinance is among the ACCION International affiliate institutions working in thirteen Latin American countries. See Table 1 for statistics on overall growth of the ACCION Network.

<table>
<thead>
<tr>
<th>Indicators</th>
<th>1995</th>
<th>1992</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active Clients at Year-End</td>
<td>276,991</td>
<td>130,798</td>
<td>39,071</td>
</tr>
<tr>
<td>Year-End Outstanding Loan Portfolio</td>
<td>$155,995,100</td>
<td>$45,204,378</td>
<td>$6,377,385</td>
</tr>
<tr>
<td>Total Amount Disbursed during Year</td>
<td>$330,853,028</td>
<td>$96,506,481</td>
<td>$18,052,961</td>
</tr>
<tr>
<td>Average Loan Size</td>
<td>$591</td>
<td>$373</td>
<td>$218</td>
</tr>
<tr>
<td>Late Payment Rates</td>
<td>4.5%</td>
<td>4.83%</td>
<td>11.54%</td>
</tr>
<tr>
<td>Number of Institutions in Network Achieving Financial Self-Sufficiency</td>
<td>9 of 18</td>
<td>8 of 19</td>
<td>3 of 19</td>
</tr>
</tbody>
</table>

- Late payment rate (%) = loan payments > 30 days late/outstanding loan portfolio.
- Cumulative total amount lent since 1989 by the ACCION Network is nearly US$1 billion.

**Demand for savings services:** With notable exceptions in Bangladesh, Indonesia, Bolivia, and a handful of other countries, institutions serving the microenterprise sector around the world are not capturing the savings deposits of their clients or the public at large. In part, this is due to the historic credit-led origin of most microfinance institutions, which focused on the need of poor people for loans rather than for broader financial services. In addition, most countries appropriately do not allow unregulated financial institutions to accept deposits. Finally, some institutions believe the establishment of effective credit delivery must precede the rigors of liquidity management associated with savings mobilization. The major providers of savings services have been credit unions, which exist in most developing countries.

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3 ACCION International (ACCION), is a U.S.-based private development organization that specializes in microfinance programs. ACCION provides technical assistance to microfinance institutions throughout the Americas. The majority of ACCION affiliates are private not-for-profit institutions mostly dedicated to the exclusive provision of credit and training to microentrepreneurs. Several are regulated for-profit financial intermediaries; these include Banco Solidario, S.A., in Bolivia, Finansol, in Colombia, Cooperativa Emprender, in Colombia, and Multi Credit Bank/Acción Empresarial, in Panama. Several others are becoming regulated financial intermediaries; these include Genesis, in Guatemala, and Acción Comunitaria del Perú.
Forced savings programs in which credit clients are required to “deposit” a certain percentage of the loan received with the lending institution have been common among microfinance programs for several years and have, in many cases, improved the clients’ ability to save regularly. Evidence strongly suggests that if appropriate services are available, the poor will voluntarily save in large proportions. Voluntary savings programs are critical for two reasons: as potentially the largest and most immediately available source of finance for microcredit programs and as a much needed and demanded financial service for the poor (Robinson, 1994).

Surveys of small borrowers have demonstrated that the primary source of finance is personal savings, followed by loans from family and friends. Personal savings, however, tend to be highly illiquid, often making credit a substitute. Available deposit facilities would increase the liquidity of personal savings and enhance the productive use of assets in the economy (Gadway and O’Donnell, 1996).

Perhaps the best example of an institution that has harnessed the potential of savings of the microenterprise sector is the Bank Rakyat Indonesia (BRI) through its Unit Desa System. Its $2.7 billion in local savings (in over 14 million deposit accounts), compared to its $1.4 billion in credit outstanding, its 2.3 percent long-term loss ratio, and its 6.7 percent return on assets, shatters any doubt about the demand for savings services and their long-term potential as a funding source. Evidence also suggests that those microfinance institutions that do mobilize funds from the public can also capture the savings of more affluent individuals who live or work near branch offices. Microentrepreneurs also have the need for mechanisms to transfer cash from one location to another securely (Robinson, 1994).

While the benefits of mobilizing savings are substantial, the process requires a strong regulatory and supervisory structure. Unlike credit delivery, savings exposes microfinance clients, often living on the edge of subsistence, to potential personal losses should the microfinance institution collapse. Given clients’ inherent mistrust of formal institutions, the insolvency of an intermediary capturing savings could wipe out years of work in the field of microfinance.

2. Evolution of Financial Service Delivery to the Poor

The second development that contributes to the current demand for regulation of microfinance is the institutional evolution of NGOs over the past two decades in delivering financial services to the poor. Central to this progression has been the achievement of financial self-sufficiency by the institution, defined as a credit operation that uses fees and interest charges

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4 Informal moneylenders are third, and NGO and government credit programs are fourth.
to cover financing costs, operating costs, including loan loss reserve, and imputed capital costs\(^5\) (Rhyne and Otero, 1994; Yaron, 1994). Indeed, it is only through covering all its costs that an institution will be able to sustain the “flow of valued benefits and services to its members or clients over time” (Edgcomb and Cawley, 1994, p. 77).

Several frameworks have been constructed to detail this evolution.\(^6\) Each describes the stage at which an NGO, motivated by its desire to significantly expand its client outreach, must look beyond finite and inadequate donor funds and raise private sector funds.\(^7\) For the institution to access new sources of capital successfully, it must submit to market-based quality control by creditors and investors. These individuals demand verifiable and accurate financial performance information from the institution, as well as certified audits that display a high-quality portfolio over a period of time (Christen, et al., 1995). Such information is also essential to managers faced with an increasingly complex financial operation.

Administrative costs for efficiently run institutions at this stage of evolution are generally in the range of 10-21 percent of the loan portfolio (Christen, et al., 1995). Although these figures are very high when compared to traditional banking, they reflect the higher transaction costs of microlending and represent best practice. To attain these percentages, institutions must have developed effective service delivery and institutional competence in governance, organizational structure, management information systems, and staff development (Rhyne and Rotblatt, 1994).

Seen from the donor perspective, as presented by Richard Rosenberg, this evolution also allows for increasing leveraging of donor funds to expand outreach, which ultimately leads to the transformation of the NGO into a formal financial institution. Rosenberg poses an essential question: If donors put one dollar into a program today, how much in microfinance assets will that program have generated after, say, five years? At the beginning level of this typology, where the institution is losing money, the donor dollar is actually diminished. Once the institution has achieved operational self-sufficiency, the donor dollar will at least be maintained, though as long as the portfolio is financed by donor funds exclusively, no leverage is realized. It is only once the microfinance institution has

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\(^5\) The imputed capital cost ratio represents the amount (in percentage terms) that the performing assets must yield in order to cover the devaluation of the institution’s capital base resulting from inflation (Bartel, McCord, and Bell, 1995).

\(^6\) See Drake and Otero (1992), Edgcomb and Cawley (1994), and Rosenberg (1994).

\(^7\) For example, estimates of the potential market for microloans in Bolivia tend to cluster around $300 million. In ten years of relatively aggressive support, the donor community has managed to provide only about $10-$15 million for microfinance (Rosenberg, 1994).
significant equity funding (again often granted by the donor) and is an economically viable institution that the original dollar will enable it to borrow from commercial sources, resulting in about $2.00 of funds available for microfinance clients. True leverage (in the commercial sense of the term) occurs once the institution has become a formal financial institution, gaining the legitimacy necessary to capture deposits and obtain larger commercial loans. Based on a capital adequacy ratio of 8 percent, as established in the Basle Accords, regulated microfinance institutions can potentially leverage a donor dollar by as much as 12 to 1 (Rosenberg, 1994).  

This “expansion-led” approach, orienting a microfinance institution toward national coverage and local commercial funding sources, represents a first major step on the road to regulated financial intermediation. The vast majority of microfinance institutions around the world, however, have not yet reached the point in this evolution at which they are ready for formal financial intermediation and maximum leverage. Instead of pursuing full institutional transformation, many microfinance institutions explored -- and are exploring -- alternative frameworks.

Those on the frontier, however, having either become regulated financial institutions or being in the process of doing so, have already required that supervisory agencies understand the distinct nature of their operations. Regulators are studying ways to adapt current regulatory frameworks to ensure the safety and soundness of the financial entity while allowing it to continue on the path of expansion. These efforts are also relevant for traditional commercial banks contemplating deepening their reach through microloan portfolios.

3. Entry of Commercial Banks

Historically, commercial banks in Latin America have not extended credit to the microenterprise sector. Major reasons include perceived high risk of uncollateralized clients, high administrative costs that could not be recovered with historically prevailing interest rate controls, and cultural barriers based on deeply held misconceptions about this market. Unsupportive legal systems that do not provide clear recourse in the case of loan default have furthermore acted as a disincentive for commercial banks to enter an unfamiliar market niche (Fry, 1988).

With the deregulation of interest rates in many Latin American countries, banks are increasingly able to price the financial products for microentrepreneurs in a financially viable manner, especially if they can generate economies of scale unavailable to smaller or informal

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8 Rosenberg argues that newly licensed microfinance intermediaries should not be allowed debt/equity ratios any higher than 5 to 1.
intermediaries. Banks also have the proven success of NGOs on which to base the development of appropriate lending methodologies.

Current regulatory restrictions in many countries, however, continue to limit banks’ ability to serve the microenterprise sector. As adaptations are made to existing legal frameworks and regulations that govern such elements as the proportion of an intermediary’s portfolio that may be disbursed in loans that are considered unsecured by traditional definitions, and as lending technologies for reaching this sector are applied, commercial banks will more likely lend to clients they never before considered profitable.9

The achievements of microfinance development in the last decade create the conditions to alter fundamentally its traditional nonprofit institutional model for delivering financial services. The establishment of regulated financial institutions, the new institutional model for microfinance, is most advanced in Latin American countries, which during this same decade have undertaken very significant changes in their financial systems. These changes, as well as the current state of financial systems, especially supervisory structures, are important pieces of the backdrop to this monograph.

B. FINANCIAL SYSTEM REFORMS IN LATIN AMERICA

1. Overview

In the late 1980s, many Latin American countries began to relax the strict financial controls that had been in place for twenty years, with the aim of increasing the formal financial system’s capacity to mobilize resources and improve financial deepening. An indicator of the depth of a financial system is the ratio of monetary aggregates to gross domestic product (GDP) over time. In the early 1980s, this ratio was below 30 percent in most of the large economies of Latin America, indicating a shallow financial system (Morris, et al., 1990). This lack of depth was exacerbated by the dramatic contraction of foreign investments in the aftermath of the debt crisis in 1982, driving Latin American governments to recognize the pressing need to mobilize domestic savings and to fundamentally rethink their approaches to the capital markets. Of paramount importance was the need for a transparent market-based system of credit allocation to increase productivity (World Bank, 1993).

9 The Inter-American Development Bank’s Global Microenterprise Loans channel credit to traditional financial institutions and, in the case of Colombia, to unregulated organizations, which in turn on-lend to small and microenterprises. By offering rediscouned lines of credit through the Central Bank, or through some type of wholesale banking arrangement with a public institution, the IDB opens the way for these institutions to risk their own resources in financing micro and small enterprises.
Historically, the banking sector has been the major component of the financial system throughout Latin America. While finance companies and credit unions also are a major presence, with the exception of Chile’s system, few institutional investors have existed on any great scale. Although their market share declined throughout the 1980s, commercial banks still held over 50 percent of total financial system assets by the end of the decade (Morris, et al., 1990). Earning sizable profits by maintaining wide spreads between lending and borrowing rates, banks disbursed large loans to a small number of clients, which in some cases were associated with the bank and received preferential treatment.

Financial sector reforms undertaken by many Latin American countries in the late 1980s focused on seven areas that would lay the groundwork for increased resource mobilization: deregulation of interest rates, elimination of directed credit programs, reduction and harmonization of reserve requirements for commercial banks, lower barriers for entry into the financial system, promotion of capital markets and institutional investors, privatization and liquidation of public banks, and creation of modern supervisory systems (World Bank, 1993). While each of these reforms has played a crucial role in strengthening financial systems, for the purposes of this monograph we will focus on the creation of modern supervisory systems.

2. The Purpose of Bank Regulation and Supervision

Financial deepening is achieved by increasing financial intermediation through any of the various institutions in the financial sector, including commercial banks, stock markets, credit unions, consumer finance companies, investment banks, and insurance companies. By making more resources available for investment and by allocating those resources efficiently, increased financial intermediation contributes to economic growth. Institutions are also much better able than individuals to bear the risks of lending capital given the ability of institutions to diversify financial products, their use of economies of scale, and their expertise in lending (Ritter and Silber, 1974).

Nonetheless, financial intermediaries require careful risk management. For banks, risk emanates from three major sources: insufficient diversification of portfolios, insufficient liquidity, and the risk-taking propensity of managers, or moral hazard (Benston, et al., 1986). In this case, moral hazard refers to the existence of an incentive for the institution’s owners/managers to place at risk the assets of depositors because the owners/managers bear less than the full consequence of any loss yet would directly gain from any profits. The nature of information in the financial markets as a public good, and the market imperfection arising from insufficient information among depositors, the financial institution, and borrowers about the likelihood of promises being kept,
justifies government intervention in the management of these risks (Chaves and Gonzalez-Vega, 1994).

The challenge is to create a regulatory structure that controls moral hazard without introducing distortions that would undermine the efficiency of the market in allocating resources toward the most productive sectors. It is generally accepted that a regulatory structure should maximize the effectiveness of government intervention as it minimizes the amount and should harness market forces and incentives to maintain stability (Benston, et al., 1986). Further, at the core of an effective regulatory regime is the successful management of excessive risk-taking. The purpose and philosophy of the government’s prudential regulation and supervision of financial institutions have been likened to that of the loan agreement covenant established between a bank and its borrowers (Dewatripont and Tirole, 1993). In theory, prudential regulations are intended to clearly define the rules of the game for financial intermediaries, identify and ameliorate associated risks, and provide for an ongoing cooperative relationship between supervisory agency and financial institution.

Regulations also seek to enhance and support the dynamic nature of financial markets and allow them to be responsive, flexible, and versatile (Fry, 1988). Moreover, a flexible regulatory structure allows for the appropriate management of different types of risk from certain segments of the financial market served by different institutional structures. Such adaptability enables each kind of financial intermediary to find its comparative advantage in prudentially serving all possible segments of

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10 Dewatripont and Tirole quote Zimmerman (1977), who provides an interesting analogy for supervision. He says of the philosophy of loan agreements: "Through the loan agreement, the bank creates a clear understanding with the borrower as to what is expected of it. In doing so, the bank establishes its control of the relationship and provides for several basic functions to effect that control.

The lender attempts to ensure regular and frequent communication with the borrower by using certain covenants in the loan agreement. The communication results in an up-to-date assessment of the borrower’s financial situation and its general management philosophy.

When the bank requires that the borrower maintain certain financial ratios, it is accomplishing several objectives. On the surface these covenants provide triggers or early warning signals of trouble which will allow the bank to take rapid remedial action. The borrower is made aware of where the minimum performance cutoffs are. However, the banker is also helping the borrower set reasonable goals in terms of financial condition and growth. In some cases, a ‘growth formula’ is created which states that until a specified set of financial conditions is met, the borrower may not be eligible for further debt.

All these controls -- required ratios, ratio goals, required actions and forbidden actions -- may seem arbitrary or restrictive; but applied wisely, they are not. The process lets all parties know where they stand, thus reducing the number of unknowns or uncertainties in the loan relationship."
the market (Chaves and Gonzalez-Vega, 1994). Ultimately, such flexibility results in efficient and sound deepening of the financial system.

The two components of an effective government risk-management structure -- prudential regulation and supervision -- encompass the set of legal rules that govern stable and efficient performance by financial institutions as well as the mechanisms by which a government determines these institutions’ risks and verifies compliance. Regulations address basic public policy goals: ensuring the solvency and soundness of all intermediaries; protecting the stability of the country’s payments system; protecting consumers against the potential risks associated with bank failure, fraud, or opportunistic behavior by management; and promoting market efficiency and appropriate functioning of competitive market forces (Chaves and Gonzalez-Vega, 1994; Polizatto, 1990).

Supervision gives meaning to regulations. Effective supervision requires a clear definition of roles, support from the government and banking industry, and little political interference. Given the insular nature of the banking industry in most developing countries, supervisors must be able and willing to close down the insolvent banks of their friends and colleagues. Strong institutional frameworks in the legal, auditing, and accounting arenas are prerequisites for effective prudential regulation and supervision (Polizatto, 1990). Finally, the overall quality of a supervisory structure depends not only on political autonomy but also on an established legal framework, adequate resources, and strong enforcement powers (Morris, et al., 1990).

3. Reforming the Regulatory Structure in Latin America

The supervisory frameworks throughout Latin America in the early 1990s were characterized by various weakening factors that significantly increased risk within the financial systems. Information disclosure was minimal or nonexistent; the quality of loan portfolios was analyzed infrequently; standards of external auditing were often deficient; rollover of questionable loans was allowed; accrual of interest on nonperforming loans was commonplace; unsecured loans, often to insiders, were prevalent; political interference prevailed; governments provided implicit free deposit insurance, worsening the issue of moral hazard and resulting in inadequate provisioning; supervisory agency enforcement powers were weak; agency salaries and computer systems were inadequate; and the procedures outlining the steps involved in cases of insolvency were unclear (World Bank, 1993).

However, in many countries, particularly those of South America, reforms were and are taking place to correct a large number of these problems. A recent IDB study examined the financial sector reforms undertaken by its twenty-six borrowing member countries in the period of
1988 through 1994. The results of the study showed that generally the South American countries plus Mexico underwent more reform than the Central American countries, which in turn reformed to a greater extent than the Caribbean countries. Commercial bank deposit rates are market determined in twenty-two of the twenty-six countries, and all commercial bank lending rates are freely determined in fourteen of the twenty-six countries. In no country did the Central Bank become less independent or allow commercial bank supervision to deteriorate significantly (Westley, 1995). After reform, which occurred at different times in different financial systems, seventeen of the twenty-six countries have in place a modern set of prudential regulations. Table 2 shows the results of eighteen countries selected from the twenty-six countries examined. Each table is divided into two parts, one on regulation and the other on supervision. The first column of each part defines the overall status of either regulation or supervision, and the remaining columns provide additional information on specific aspects of the general theme.

As a group, the twenty-six countries are weak in terms of capital adequacy requirements and in dealing with insolvency, while stronger in provisioning requirements and freedom of entry. In eleven of the twenty-six countries, supervisory agencies are able to detect most major occurrences of mismanagement and fraud, thus earning the rating of “Reasonable.” In these eleven countries, the overall organization of the supervisory agencies and political independence are stronger than the quality and quantity of personnel. This disparity suggests inadequate resources. Six countries need some overhaul in their supervisory agencies, while nine need major overhaul (Westley, 1995).

The regulatory and supervisory structures into which microfinance institutions are entering in the mid-1990s have acquired new strength, but often still show inadequate performance in key areas. How, then, might these structures effectively regulate and supervise microfinance? The effective management by supervisory agencies of the risks associated with microfinance first requires an understanding of microfinance’s distinct characteristics.\footnote{Within the development world, the existence of different types of financial delivery institutions suggests the need for further specificity in the establishment and implementation of appropriate regulation and supervision. These institutions include private commercial banks, finance companies, specialized government banks, credit unions, NGOs using the solidarity group model, and NGOs making loans to individuals using special collateral substitutes, as well as NGOs using the village bank model.}

\footnote{Within the development world, the existence of different types of financial delivery institutions suggests the need for further specificity in the establishment and implementation of appropriate regulation and supervision. These institutions include private commercial banks, finance companies, specialized government banks, credit unions, NGOs using the solidarity group model, and NGOs making loans to individuals using special collateral substitutes, as well as NGOs using the village bank model.}
# TABLE 2

LATIN AMERICAN REGULATORY FRAMEWORKS: SELECTED INDICATORS

<table>
<thead>
<tr>
<th>Country (And Period of Main Reforms)</th>
<th>Presently Exists a Modern Set of Prudential Regulations? (Date)</th>
<th>Freedom of Entry, Subject Only to Minimum Standards of Capital and Management?</th>
<th>Ability to Promptly Close Down Bankrupt Banking Institutions?</th>
<th>Reasonable Capital Adequacy Standards (Basle or not)?</th>
<th>Reasonable Provisioning for Bad Loans?</th>
<th>Change in Supervision (Before Reform, After Reform): 1 =Reasonable, 2 =Some Overhaul, 3 =Major Overhaul</th>
<th>Quantity of Personnel</th>
<th>Quality of Personnel</th>
<th>Salary Levels</th>
<th>Organization of Supervisory Unit</th>
<th>General Freedom from Political Interference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bolivia (+/-1990)</td>
<td>Yes (+/-1992)</td>
<td>N/Y</td>
<td>?/Y</td>
<td>N/Y</td>
<td>N/Y</td>
<td>3-1 (Major Overhaul, Reasonable)</td>
<td>MR</td>
<td>MR</td>
<td>M/S</td>
<td>MR</td>
<td>MR</td>
</tr>
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- In the regulation columns (3-6) Y = Yes, N = No. In the supervision columns (8-12) R = reasonably good, S = needs some upgrading, M = needs major upgrading. In both sets of columns, a question mark (?) indicates that the information was unknown.
- In both sets of columns, the letter before the slash indicates the response that applies in the pre-reform period, while the letter after the slash indicates the response that applies to the date information was gathered (November 1994).
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<th>Ability to Promptly Close Down Bankrupt Institutions?</th>
<th>Reasonable Capital Adequacy Standards (Baseline or not)?</th>
<th>Reasonable Provisioning for Bad Loans?</th>
<th>Change in Supervision (Before Reform After Reform) (1 = Reasonable, 2 = Some Overhaul, 3 = Major Overhaul)</th>
<th>Quantity of Personnel</th>
<th>Quality of Personnel</th>
<th>Salary Levels</th>
<th>Organization of Supervisory Unit</th>
<th>General Freedom from Political Interference</th>
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<tr>
<td>7. Venezuela (1989-93)</td>
<td>Yes (Before Reform)</td>
<td>N/Y</td>
<td>N/N</td>
<td>N/N</td>
<td>3-3 (Major Overhaul)</td>
<td>MM</td>
<td>MM</td>
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- In Nicaragua, no supervisory entity existed before the 1990-91 financial reforms.
### TABLE 2 (Continued)

#### LATIN AMERICAN REGULATORY FRAMEWORKS: SELECTED INDICATORS

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<thead>
<tr>
<th>Country (And Period of Main Reforms)</th>
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<th>Ability to Promptly Close Down Bankrupt Banking Institutions?</th>
<th>Reasonable Capital Adequacy Standards (Basle or not)?</th>
<th>Reasonable Provisioning for Bad Loans?</th>
<th>Change in Supervision (Before Reform After Reform) 1 = Reasonable, 2 = Some Overhaul, 3 = Major Overhaul</th>
<th>Quantity of Personnel</th>
<th>Quality of Personnel</th>
<th>Salary Levels</th>
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| Country          | Freedom of Entry, Subject Only to Minimum Standards of Capital and Management? | Ability to Promptly Close Down Bankrupt Banking Institutions? | Reasonable Capital Adequacy Standards (Basle or not)? | Reasonable Provisioning for Bad Loans? | Change in Supervision (Before Reform) | Quantity of Personnel | Quality of Personnel | Salary Levels | Organization of Supervisory Unit | General Freedom from Political Interference |
|-----------------|--------------------------------------------------------------------------------|-----------------------------------------------------------------|------------------------------------------------------|---------------------------------------|--------------------------------------|-------------------------------------|---------------------|---------------|-----------------|----------------------------------|-----------------------------------------------|
| Brazil          | No                                                                            | Y/Y                                                             | Y/Y                                                  | Y/Y                                   | 1-1 (Reasonable → Reasonable)       | S/M                                 | S/M                     | R/R           | R/R             | R/R                              |                                |
| (1988-89)       |                                                                                 |                                                                  |                                                      |                                       |                                      |                                     |                       |               |                 |                                  |                                |
| Chile           | Yes (Before Reform)                                                           | N/N                                                             | Y/Y                                                  | Y/Y                                   | 1-1 (Reasonable → Reasonable)       | R/R                                 | R/R                     | R/R           | R/R             | S/S                              |                                |
| (1989 & 1993)   |                                                                                 |                                                                  |                                                      |                                       |                                      |                                     |                       |               |                 |                                  |                                |
| Costa Rica      | No                                                                            | Y/Y                                                             | N/N                                                  | N/Y                                   | 3-3 (Major Overhaul → Major Overhaul) | M/S                                 | M/S                     | R/R           | S/S             | MM                               |                                |
| (1988 & 1992)   |                                                                                 |                                                                  |                                                      |                                       |                                      |                                     |                       |               |                 |                                  |                                |
| Honduras        | No                                                                            | N/Y                                                             | N/N                                                  | N/N                                   | 3-3 (Major Overhaul → Major Overhaul) | S/S                                 | MM                      | MM            | MM              | S/S                              |                                |
| (1991-92)       |                                                                                 |                                                                  |                                                      |                                       |                                      |                                     |                       |               |                 |                                  |                                |
| Paraguay        | No                                                                            | Y/Y                                                             | N/N                                                  | N/N                                   | 3-3 (Major Overhaul → Major Overhaul) | R/R                                 | MM                      | R/R            | MM              | MM                               |                                |
| (1988-92)       |                                                                                 |                                                                  |                                                      |                                       |                                      |                                     |                       |               |                 |                                  |                                |

- In the regulation columns (3-6) Y = Yes, N = No. In the supervision columns (8-12) R = reasonably good, S = needs some upgrading, M = needs major upgrading. In both sets of columns, a question mark (?) indicates that the information was unknown.

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### IV. LITTLE OR NO REFORMS

<table>
<thead>
<tr>
<th>Country (And Period of Main Reforms)</th>
<th>Presently Exists a Modern Set of Prudential Regulations? (Date)</th>
<th>Freedom of Entry, Subject Only to Minimum Standards of Capital and Management?</th>
<th>Ability to Promptly Close Down Bankrupt Banking Institutions?</th>
<th>Reasonable Capital Adequacy Standards (Basle or not)?</th>
<th>Reasonable Provisioning for Bad Loans?</th>
<th>Change in Supervision (Before Reform After Reform)</th>
<th>Quantity of Personnel</th>
<th>Quality of Personnel</th>
<th>Salary Levels</th>
<th>Organization of Supervisory Unit</th>
<th>General Freedom from Political Interference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Panama (No Recent Reforms)</td>
<td>No</td>
<td>/Y</td>
<td>/N</td>
<td>/N</td>
<td>/Y</td>
<td>Currently 3 (Needs Major Overhaul)</td>
<td>/M</td>
<td>/M</td>
<td>/M</td>
<td>/M</td>
<td>/R</td>
</tr>
</tbody>
</table>

- In the regulation columns (3-6) Y = Yes, N = No. In the supervision columns (8-12) R = reasonably good, S = needs some upgrading, M = needs major upgrading. In both sets of columns, a question mark (?) indicates that the information was unknown.
- In both sets of columns, the letter before the slash indicates the response that applies in the pre-reform period, while the letter after the slash indicates the response that applies to the date information was gathered (November 1994).
- For Panama, there is no recent period of reform, so no answers can be given before the slash.
C. DISTINCT CHARACTERISTICS OF MICROFINANCE

Microfinance deploys small amounts of short-term working capital and in some cases longer-term investment loans, and provides deposit facilities to small-scale businesses and households. Like formal finance, microfinance harmonizes the opposing forces of risk and confidence to produce transactions and create value (Von Pischke, 1991). Five characteristics distinguish microfinance institutions from traditional financial institutions: client base, lending methodology, administrative costs, nature of the portfolio, and institutional structure and governance. (See Table 3 for a summary of the traits.)

Client base: Clients of microfinance institutions are low income and operate their businesses in what is considered the informal sector of the economy. Clients are usually uneducated and unfamiliar with terms used in the formal financial sector, and have unregistered businesses. They are often women. The income streams of microfinance clients vary with the seasons, holidays, and other contextual factors.

Lending methodology: Traditional banking is collateral based and requires lengthy application procedures to assess credit risk adequately. Low-income clients of microfinance institutions do not possess acceptable collateral and their loan size needs fall much below the minimums of the commercial banking industry. In response to these requirements, microfinance institutions have turned to information-based or character lending: building personal relationships and relying more on a client’s demonstrated willingness to repay than on the existence of a guarantee.

Administrative costs: Microlending is labor intensive. Even among efficient institutions, administrative costs range from 10 to 21 percent of the loan portfolio (Christen, et al., 1995). Microfinance institutions discovered that microentrepreneurs, for whom capital is extremely scarce, can put borrowed funds to very productive use. If transaction and opportunity costs are low, they are willing to pay interest rates higher than the market rate and thus cover the costs of administration. The rationale for charging the poor more than the rich is best understood by making the more appropriate comparison to the even higher rates of the informal moneylenders who oftentimes represent the only other provider of credit to microentrepreneurs.

Though high, costs are reduced in microfinance by decentralizing decision making, streamlining information systems, using borrower groups who assume some of the processing and administrative responsibility, developing incentive systems, and training staff effectively (Rhyne and Otero, 1994). Nonetheless, only a few microfinance institutions cover all of their cash costs with operating income; their use of combined sources often results from an unwillingness to pass the full administrative cost onto their clients.
They may have a philosophical disagreement with the required rate, or operations may have not yet achieved economies of scale.

### TABLE 3

<table>
<thead>
<tr>
<th>Financial Characteristics</th>
<th>Traditional Finance Institutions in Latin America</th>
<th>Microfinance Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Client Base</strong></td>
<td>• Middle to high income</td>
<td>• Low income</td>
</tr>
<tr>
<td></td>
<td>• Work in the formal sector</td>
<td>• Work in the informal sector</td>
</tr>
<tr>
<td></td>
<td>• Possess collateral guarantees</td>
<td>• Lack collateral guarantees</td>
</tr>
<tr>
<td><strong>Lending Methodology</strong></td>
<td>• Collateral-based, requires lengthy application to assess credit risk</td>
<td>• Information-based, uses personal relationships and relies on clients' demonstrated willingness to repay</td>
</tr>
<tr>
<td><strong>Administrative Costs</strong></td>
<td>• Charge market rates 4-6% of portfolio</td>
<td>• Charge higher than market rates Admin. expenses = 10-21% of portfolio</td>
</tr>
<tr>
<td><strong>Portfolio Characteristics</strong></td>
<td>• Fewer, larger loans</td>
<td>• Hundreds of small, short-term loans</td>
</tr>
<tr>
<td></td>
<td>• Credit risk tends to be concentrated</td>
<td>• Credit risk is widely dispersed</td>
</tr>
<tr>
<td></td>
<td>• Static delinquency</td>
<td>• Volatile delinquency</td>
</tr>
<tr>
<td><strong>Structure and Governance</strong></td>
<td>• Centralized headquarters and branch offices located in center of city</td>
<td>• Decentralized set of small retail outlets in areas with weak infrastructures, linked by a superstructure</td>
</tr>
<tr>
<td></td>
<td>• Private commercial equity; high level of individual risk</td>
<td>• Donor or institutional equity, low level of individual risk</td>
</tr>
</tbody>
</table>

Institutions use a sequential lending process, initially providing small loans, after which clients are granted successively larger loans with each repayment. Additional repayment incentives are created by using group guarantees, which generate social pressure to repay. Decentralized loan approval authority, which often allows the loan officer to make an initial recommendation subject to the approval of a regional or central manager, is another essential element of microfinance lending. It decreases the client waiting time and staff time while increasing accountability (Rhyne and Rotblatt, 1994). A testament to the success of this methodology is the achievement of repayment rates as great as 98 percent, higher than many institutions in the formal system.
**Portfolio**: Microfinance institutions make small, short-term loans using simple application procedures and loan officers who visit the clients. Through volume, they attain economies of scale needed to attain financial viability. Loan officers in large microfinance institutions may manage as many as 400 clients at a given time. The portfolio consists of thousands of microloans, which means that the loss of one is insignificant.

Evidence has shown that risk to the microloan portfolio derives primarily from bad management, which can be caused by several factors: poor information systems, rapid growth of the portfolio without the necessary supporting systems and training, a lack of clarity within the institution regarding the importance of 100 percent repayment, restructuring loans and hiding delinquency, and weak financial management (Stearns, 1991). A secondary cause of undermined portfolio quality may be adverse contextual variables that affect a large number of clients who are concentrated in one sector.

Due to the factors just mentioned, loan delinquency, though usually very low, can be volatile. Given this volatility and the fact that clients’ willingness to repay their loans is most affected by their perception of the strength and viability of the lending institution, bad management could significantly weaken a microfinance institution in a matter of weeks, whereas it might take several years to undermine the portfolio of a traditional bank. As the administrative burden is so high, loan losses can quickly result in operating losses for the institution (Christen, et al., 1995).

**Structure and governance**: Organizational structures of large microfinance institutions follow a common pattern: a set of small retail outlets that do the frontline work, linked by a superstructure that provides financial, management, and technical support functions to the retail units. Similar to franchising, institutions develop a basic module (i.e., branch office) and then replicate it. In larger institutions, regional offices provide an additional layer to this basic model, which allows for the more responsive provision of superstructure services to the units. This decentralized framework is the most effective method of making the financial services accessible to clients who require low transaction costs. The size of branch offices, often located in neighborhoods with weak infrastructures, is determined by the density of client concentration in that area (Rhyne and Rotblatt, 1994).

In the case of microfinance institutions, most of which are NGOs, there are no owners in the traditional sense. These NGOs have obtained their capital base largely from donor institutions. More important, NGO board members are not at personal risk for potential losses by the institution and are not likely to supply additional equity capital were the need to arise. While many microfinance institutions are heavily capitalized, their nonprofit
status and lack of owners mean they cannot distribute dividends or make use of this capital as would occur in a private institution.

A few microfinance institutions have become formal financial institutions. Even in these cases, shareholders are mostly international organizations and not-for-profit institutions. Attracting private, for-profit equity investment remains one of the major challenges for microfinance. Decades of experience with NGOs and state-owned businesses raises questions about the ability of microfinance institutions to provide consistent and internal control to a financial operation over the long term in the absence of commercial shareholders.

D. PRUDENTIAL REGULATION AND SUPERVISION OF MICROFINANCE

This section discusses three dimensions of the prudential regulation and supervision of microfinance: creating a competitive market for microfinance, protecting the quality of the microfinance portfolio, and providing adequate and appropriate supervision. Resolution of these issues will occur on a country-by-country basis as more NGO finance institutions become regulated and as more commercial banks extend their services to the microenterprise sector. The following is intended to serve as a guide to the spectrum of issues related to the prudential regulation and supervision of microfinance identified to date. Most of these issues are synthesized and discussed in greater detail in the following chapter.

1. Creating a Competitive Market for Microfinance

Creating a competitive market for microfinance requires determining the size of the microenterprise sector, identifying the current supply of credit to this sector, and assessing the feasibility of established regulated financial institutions increasing this supply. Regulatory agencies will face a fundamental dilemma: whether to adapt regulations to enable already established financial intermediaries to provide microfinancial services or to create a specialized legal framework for microfinance. The following points, as well as Chapters II and III, provide some of the information needed to respond to this question.

Interest rate limits: Given the cost structure of microfinance, interest rate restrictions usually undermine an institution’s ability to operate efficiently and competitively. The distortion applies to both commercial banks or other existing financial entities and any new specialized intermediaries that might be established.

---

12 The IDB study on financial sector reforms indicated that whereas the deposit rates in twenty-two of the twenty-six member borrowing countries is market determined, in only fourteen is the lending rate also market based (Westley, 1995).
**Number and type of specialized institution:** Several examples now exist of specialized microfinance intermediaries. One is the Private Financial Fund (PFF) in Bolivia, while another is the EDPYME (Entidad de Desarrollo para la Pequeña y Microempresa) in Peru. The creation of the PFFs is discussed in Chapter III, and specific examples of a PFF and EDPYME are discussed in Chapter V. The number and size of such intermediaries are determined on a country-by-country basis, taking into account variables such as the geographic spread of the microenterprise sector, total demand, and availability of managers with experience in the financial, as well as microenterprise, sectors.

**Minimum capital requirements:** Specialized financial structures with low capital requirements may serve as an important intermediate step toward becoming a full-fledged financial intermediary in countries where there is little private sector support or understanding of microfinance or where the microfinance managers need time to adapt to the rigors of supervision. Regulators, however, must consider the ownership structure of microfinance institutions that do not have private owners and therefore do not have a readily available source of additional capital when needed.

**Authority to mobilize deposits:** The extent to which a specialized microfinance intermediary is authorized to mobilize deposits, and carry out other financial operations, is an important area for consideration. Can the institution only accept time deposits, which require less sophisticated liquidity management, or will it be allowed to provide more liquid forms of savings services such as demand deposits? Regulators may decide to determine a time period during which the institution is able to establish a track record of success and after which the institution’s operational authority will be broadened.

**Who should be regulated?** The vast majority of unregulated microfinance institutions provide credit only and do not mobilize deposits. These institutions should probably not be regulated given that the primary justification for government intervention is the protection of depositors. Instead, donors might provide the necessary oversight to the recipient of the institution’s funds.

2. **Protecting the Quality of the Portfolio**

Protecting the microloan portfolio is essential to the long-term viability of regulated financial intermediation for the microenterprise sector. Regulators face three main challenges in evaluating asset quality: allowing for the value of personal guarantees, addressing the concentration of large numbers of small, short-term loans within certain sectors, and adapting documentation requirements.
Allowing for the value of personal guarantees: The majority of microloans are not secured in conventional terms. The practice of restricting the amount an intermediary can lend without collateral guarantees -- often to a certain loan amount, the cumulative total of which must not exceed a percentage of equity -- effectively blocks an institution’s ability to reach massive numbers in the microenterprise sector. Regulators might consider establishing a loan size high enough to clear most of the microloan portfolio, but low enough to protect the intermediary’s traditional portfolio from the risks of unsecured lending in large amounts. More fundamentally, policymakers need to initiate change in existing banking laws to include measuring the probability of repayment in addition to defining acceptable forms of collateral.

Related to restrictions on unsecured lending are the risk classification system and corresponding levels of provisioning. If unsecured loans require heavy provisions, regardless of portfolio quality, they may be rendered unprofitable. For microloan portfolios, supervisory agencies might consider risk classification guidelines that would incorporate certain features of those used for classifying traditional portfolios, such as repayment status of the loans and repayment capacity of the borrower, while excluding collateral since it is not relevant for microenterprises.

Guidelines would also have to determine whether to treat microloans as business or consumer loans. Classification as a business loan recognizes the future stream of income available from its investment, which suggests lower risk of default and lower provisioning requirements. On the other hand, in Colombia microloans are classified as consumer loans because of their small size and are subject to stricter provisioning requirements. Stricter provisioning requirements reveal a deterioration in the portfolio at an earlier point, have a severe impact on the institution’s profitability, and alert supervisory authorities to problems at their beginning stages. This discipline is particularly challenging for those intermediaries that had been unregulated, not-for-profit entities, accustomed to resolving a portfolio crisis in a longer time period by turning to donor sources.

Directly related to provisioning requirements are the regulations governing the refinancing of nonperforming loans. Microfinance intermediaries are subject to these practices due to their clients’ irregular flow of income. Regulators may mandate the receipt of partial payment of interest before allowing for refinancing or set terms under which refinancing may take place.

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13 In October 1995, the Colombian Superintendency established new, stricter provisioning requirements for consumer loans. Banks are required to cover any consumer loan that is three to six months overdue with a 50 percent provision for principal and a 100 percent provision for interest (Griffith, 1996).
Addressing the concentration of large numbers of small, short-term loans in geographic and economic sectors: Concentration is normally controlled by setting limits on loan size relative to institutional capital and by requiring diversification across economic sectors. For microfinance, loan size restrictions do not play a role. When regulators consider the application of restrictions on concentration of microloan portfolios, it is important to recognize that given the hundreds of small loans of a microfinance portfolio, if one is lost, the effect will be minimal. A more relevant issue is the concentration of loans in a single financial product - that is, working capital -- and in a limited geographic and economic sector. While allowing for maximum operational efficiency, microloan concentration increases risk and may contribute to volatile delinquency. Regulators need to design portfolio restrictions so that they promote this competitive advantage of microfinance institutions while also protecting against widescale default were the microenterprise sector to be adversely affected by a geographic or economic variable. This represents one of the challenges to protecting the quality of the microloan portfolio.

Adapting documentation requirements: Though basic information is necessary for microlending, effective management of loans requires that loan officers be in close personal contact with the client to develop the base of trust and to monitor performance and the ability to repay. Regulators must adapt documentation requirements to capture appropriate client information while minimizing administrative costs.

3. Providing Adequate and Appropriate Supervision

The newness of regulating microfinance intermediaries demands special attention from supervisory authorities. With regulation, microfinance institutions confront restrictions and levels of discipline that may not perfectly accommodate the practice of microlending. Nonetheless, both regulators on the one hand and managers on the other, must strive to achieve an optimal level of intervention, one that maximizes effectiveness and minimizes amount, while reducing risks and enhancing a competitive market. Following are the main issues facing regulators in providing adequate and appropriate supervision for microfinance.

Building the internal agency capacity: Even though supervisory structures throughout Latin America are improving, they lack adequate resources to supervise even the traditional financial sector. The distinct characteristics of microfinance and the microenterprise market further demand that regulators be specially trained in supervising microfinance. In Chapter II, Robert Christen presents some suggestions for how supervisory agencies with limited resources might monitor microfinance activities. Donor agencies also play a key role in helping Superintendencies build microfinance capacity and in subsidizing that capacity until the
regulated microfinance institutions reach a scale at which they can pay for their own supervision.

**Establishing effective off- and on-site supervisory mechanisms:** Once trained, regulators must have in place well-tested mechanisms to monitor the operations of microfinance intermediaries. The distinct characteristics of microfinance (clients, lending, cost recovery, portfolio, and structure and governance) require adaptations to the traditional regulatory structure. The reporting requirements for off-site monitoring (the quantitative measures) mirror established norms, but on-site monitoring of management and internal control mechanisms (the qualitative measures) should also be adapted. In microfinance, the risk of mismanagement and fraud is more deeply entrenched in the decentralized institutional structure, as well as in the highly personal relationship between loan officer and client. With such limited access to much needed working capital, clients can be more easily manipulated by a loan officer looking for kickbacks.

**Understanding the limits of capital adequacy standards:** For newly licensed specialized microfinance intermediaries, the absence of a track record in intermediation may suggest stricter capital adequacy guidelines than those implemented by traditional financial institutions. Once intermediaries have proven their ability to handle the complexities of asset/liability management and demonstrated prudent risk-taking, leverage could be increased. As important, the ownership structure of microfinance intermediaries is shaped by there being little individual equity money at stake, and this means that regulators must implement other mechanisms such as more frequent examinations of the institution to reduce the potential for excessive risk-taking by managers and owners.

**Obtaining adequate and timely financial information from microfinance intermediaries:** Building the management information systems (MIS) of regulated microfinance intermediaries is necessary if effective supervision is to occur. The availability of accurate financial performance information for depositors and investors allows for informed decision making, but the requirements of supervisory agencies will help drive this process. As the MIS of microfinance institutions is enhanced, so too must supervisory agencies (and others in the microfinance industry) define a reasonable set of standard performance indicators. Delineating the potentials and limitations of microfinance will greatly contribute to its further introduction into the mainstream of financial services.14

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14 ACCION and others have already made progress in this area. ACCION has adapted the U.S. regulatory bank examinations into a diagnostic instrument known by the acronym CAMEL (Capital Adequacy, Asset Quality, Management, Earnings/Efficiency, and Liquidity) for use among its network of affiliated institutions. Even CAMEL, however, is only a measurement of financial health at a moment in time. Given how quickly microloan portfolios can deteriorate, additional reporting tools must be established for dynamic measurements.
Detecting and preventing fraud in a highly personal-based lending technology: Fraud detection in microfinance operations is particularly difficult given the informal basis of the lending methodology, which does not emphasize a paper trail, and the high volume of small operations. Fully understanding the microenterprise market and techniques of lending will enhance the regulators’ ability to detect fraud. Regulators must get as close as possible to lending transactions, conduct reviews of a sample of client files, and closely examine the institution’s MIS.

Handling potential insolvency: Supervisory agencies need to be able to deal with unsafe practices in microfinance intermediaries. As with any form of regulation and supervision, legally mandated measures such as the ability to remove directors or management, levy fines or penalties, restrict or suspend dividend payments, restrict branch or corporate approvals, and impose financial liability against directors must exist.

The demand for financial services among the poor and the evolution of service delivery have taken microfinance, with its distinct characteristics, one step through the door of the formal financial sector. That policymakers and supervisory agencies are now being asked to learn about and regulate microfinance is a function of its potential. The remaining chapters of this monograph address issues related to supervision and regulation of microfinance institutions with the objective of contributing to the knowledge base in this area. In addition, the discussion presented here should serve as input into the decisions made by policymakers in regulatory and supervisory institutions, as well as by microfinance institutions.
CHAPTER II

ISSUES IN THE REGULATION AND SUPERVISION OF MICROFINANCE

by Robert Peck Christen
A. INTRODUCTION

The majority of the world's labor force is self-employed or works in tiny businesses. In most countries, 90 percent of these working poor cannot go to a bank and open a savings account, much less take out a loan. Nevertheless, these workers have many of the same financial requirements as do members of middle- and higher-income families. Most have fluctuating income streams and must save or borrow during certain times of the year in order to get by during others. They need loans to finance their business activities or improve capital assets. They need savings for emergencies and to meet the costs of certain important family or social obligations such as marriage and burial ceremonies.

To obtain these services, low-income families turn to informal arrangements such as rotating savings and loan groups; borrowing from family, friends, and moneylenders; and saving through the purchase of real assets such as building materials, gold necklaces, and livestock. Although these informal arrangements may fulfill the basic requirements for liquidity management and capital accumulation, they have important limitations.

Borrowers may find loans from moneylenders to be exceedingly expensive and, in some parts of the world, guarantee mechanisms to be excessively harsh. Those who accumulate savings through the purchase of real property such as building materials or seed may find that these items are prone to physical deterioration. Individuals who lend their excess liquidity (savings) to family and friends may find they cannot recover loans promptly. Savers who hold real assets or loans will find that these are not particularly liquid or divisible. For others, cash hidden under the mattress presents a major security risk.

Private commercial banks have traditionally considered low-income earners to be unattractive as clients. In relation to the bank’s normal cost structure, the tiny size of the individual transactions of such clients makes them prohibitively expensive to administer. In addition, low-income clients cannot offer real property guarantees that can be successfully recovered through local legal systems within reasonable periods of time and for
reasonable monetary value. Finally, in most countries, due to the longstanding prevalence of financial repression, banks have not been overly liquid and, therefore, have not been driven to seek the new market opportunities lower-income groups might represent.

Over the past few decades, specialized development finance initiatives have sought to offer banking services to the poor, mostly unsuccessfully. J. D. Von Pischke, Robert Vogel, Dale Adams, and Claudio Gonzalez-Vega, among others, have been particularly eloquent in pointing out that the politics of targeted credit usually generates a negative impact on loan recovery rates, that subsidized interest rates generate perverse results such as credit rationing and disintermediation in the financial system, and that financial institutions without owners in the traditional sense have difficulty with governance issues and quality control. With notable exceptions, their critique fairly describes the state of targeted finance for low-income clients as it has been carried out over the past three decades.

This situation may be changing. A number of microenterprise credit programs have overcome the traditional shortcomings of targeted development finance that continue to plague many agricultural and industrial development banks. Charging interest rates that allow for full or at least substantial cost recovery, these microenterprise credit programs employ a self-sustaining lending methodology. It is the strength of this performance that has allowed a few of the very best nongovernmental organization (NGO) microcredit operations in Latin America to transform themselves by acquiring bank or finance company licenses.

PRODEM, Bolivia’s most successful microcredit NGO, has founded Banco Solidario, S.A. (BancoSol) and transferred most of its outstanding loan portfolio to that specialized commercial, private banking institution. AMPES/Servicio Crediticio, operating primarily in San Salvador’s central market, became a nonbank financial company (financiera) and now operates as Financiera Calpia. Other NGOs are looking for similar alternatives in their local environments. Likewise, pioneering commercial banks, such as Banco de Desarrollo in Chile, have begun to expand their reach by establishing microloan portfolios to service the microenterprise sector.

B. WHY DO BANK SUPERINTENDENCIES NEED TO KNOW ABOUT MICROFINANCE?

Today, Bank Superintendencies around the world are being asked to supervise institutions that offer financial services to low-income clients. Given the political pressure to grant licenses to institutions that will devote their energy to the provision of financial services for the poor, most Superintendencies should expect to oversee microfinance institutions in the near term, if they are not already doing this.
In some cases this supervision is limited to conducting audits of the use of targeted resources. In these instances donor agencies, governments, and investors request that Superintendences become involved to ensure the correct use of special funds destined for the microenterprise sector. This approach separates the supervision function from the channeling function. Traditionally, both functions have been carried out by a Central Bank division or second-story development finance entity charged with development finance programs. This responsibility is transferred under the assumption that the Bank Superintendency, as a more technically qualified and less interested party, will do a better job at ensuring quality control on these programs. In other cases, Superintendences have been asked to regulate the new types of banking institutions being created to serve the poor. These new legal structures have much lower entry requirements than those of commercial banks. However, they are restricted in the range of financial services they can offer, so they cannot compete directly with traditional banks.

These types of intermediaries have been created in Indonesia, Bolivia, and Peru, to cite just three cases. In Indonesia, any entrepreneur can establish a licensed entity that can intermediate on a community level with a capital investment of US$50,000. In Peru, local municipalities need a minimum capital investment of US$300,000 to form a caja municipal, of which there are now thirteen. The recent creation of a new category of regulated entity, EDPYME (Entidad de Desarrollo para la Pequeña y Microempresa), which starts operating with a capital investment of US$265,000, is another example. In Bolivia, a new institutional framework, Private Financial Funds (PFFs), has been established with a minimal capital requirement of US$1 million, to allow successful NGOs to become regulated financial intermediaries. Several of these new entities have been approved.15

C. BASIC ISSUES CONFRONTING BANK SUPERINTENDENCIES IN THE MICROFINANCE FIELD

What is the overall challenge Superintendences face at this crossroads? They must accommodate and effectively oversee a very different type of financial operation from those that normally fall within their domain; in terms of number of individual operations, the scale of these operations may well represent a substantial percentage of the formal financial sector combined. For example, BancoSol currently has about 60,000 clients. The Bolivian banking sector has approximately 187,000 clients. Thus, BancoSol has clients equal to 33 percent of the entire banking sector yet

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15 The first, and still only, PFF to serve the microenterprise sector, Caja de Ahorro y Préstamo Los Andes, is discussed in Chapter V. The transformation of Acción Comunitaria del Perú (ACP), an ACCION-affiliated institution, into an EDPYME is also discussed in Chapter V.
has assets equivalent to 1 percent of the total for all banks. In Indonesia, according to managers at the Unit Desa System of the Bank Rakyat Indonesia (BRI), they mobilize savings from one out every three households in a program that is scarcely ten years old.

Two basic questions emerge:

1. Can microfinance services be provided in a manner that meets the standards of performance necessary to ensure sound financial system development? and

2. Can Bank Superintendencies, as presently constituted, effectively add value to microfinance intermediaries and their depositors by regulating and supervising these activities?

D. MICROFINANCE INDUSTRY STANDARDS

Effective regulation and supervision are based on the establishment and measurement of appropriate industry standards. Some constituent groups associated with microfinance institutions, ranging from important politicians, to the influential private businesspeople who sit on microfinance institution boards, to the clients themselves and public opinion, have lobbied for more lenient standards to be applied to microfinance. They argue that microfinance is essentially a nonprofit activity that serves as a “public good” and should be allowed to operate at lower standards than those imposed on commercial banks.

This argument, that microfinance institutions ought to be allowed to operate within reduced standards since they serve a public purpose, is wrong. When one considers that many microcredit institutions seek a regulatory umbrella in order to mobilize savings from the same low-income client group they serve with credit, this position becomes even more dangerous. If anything, we should hold microfinance institutions to a higher level of scrutiny than traditional commercial banks, particularly if they intend to capture the deposits of low-income clients who can scarcely afford to lose their limited savings due to poor management of the microfinance institution.

On the other hand, leniency must not be confused with flexibility. Microfinance institutions are structurally different from traditional financial institutions. Bank Superintendencies must establish distinct rules and procedures for their oversight, but the standards should be no less rigorous. Appropriate microfinance industry standards have not yet been developed, although these are of primary importance at this juncture. Significant work will be required to develop databases of comparative indicators on the financial performance of microfinance institutions as a means to enhance the supervision function. These databases must necessarily transcend national borders given the very low number of adequately performing institutions within any one country.
1. Microfinance Performance Indicators

In countries with strong regulatory environments, very few of the organizations that now provide microfinance services would meet those standards currently applied to banking institutions. There is, however, a group of leading microfinance institutions with impressive results. Table 4 shows relevant performance indicators for three of these institutions that operate as licensed financial intermediaries. The profit and loss statements of each have been adjusted to eliminate subsidies and to correct for the cost of inflation on the equity base. Five performance indicators have been presented and might form the basis for setting microfinance standards. The outreach variables, such as size of loan program and average loan size, can be used to create key peer group categories because they reflect both the scale of the program and the nature of the client group. Poorer clients will generally have smaller average outstanding balances than higher-income groups, even within the field of microfinance.

Earnings, asset quality, and capital adequacy go to the heart of the purpose of setting standards. They represent the overall financial performance and the risk to depositors or investors from the institution’s activities. Earnings represent the capacity of the institution to cover all operating and financial expenses, including the cost of capital, and to generate profits to sustain growth by increases to equity. Asset quality represents the risk to earnings derived from the investments made in the loan portfolio. Capital adequacy represents the solvency of the institution in relation to the size of potential losses from operations. These categories of variables measure the first line of defense capability of the institution to protect depositor’s funds, the most important concern of the regulating agency.

Operational efficiency has also been included as a performance variable, although it is not nearly as central as the other three in reflecting or protecting against general business risk. It is included simply because most institutions are not yet operationally efficient, and achieving this characteristic represents an important financial goalpost along the path to long-term sustainability.

Liquidity management is an extremely important area and one in which microfinance institutions tend to be weak. For the most part, the institutions do not manage their liquidity in the way a bank would. They confuse liquidity management with liabilities management, focusing instead on the long-term funding of productive assets. They do not really plan a liquidity buffer in their financial projections or management schemes. As a result, microfinance institutions frequently encounter a liquidity crisis generated by excess and unprogrammed loan demand to which they cannot respond. Normally, they are forced to restrict loans, either in amounts or by denying
new loans to new clients. This ultimately generates a deterioration in the quality of the loan portfolio.

Nevertheless, effective liquidity management in a microfinance institution does necessarily show up in key variables or financial ratios. Liquidity, measured as a ratio of some class of liabilities in relation to some class of assets, is completely contextual. A ratio of liquid assets to total assets of 0.10 on January 1 in Bolivia is plenty. On October 1, it is wholly inadequate because of the impending Christmas season. Even the January 1 liquidity position may be inadequate if the institution is about to embark on a doubling of its branch office network during the following months. The contextual nature of liquidity in microfinance institutions makes this area of liquidity management less susceptible to regulation and supervision than such areas as capital adequacy, asset quality, and earnings, which are measured by objective and unambiguous financial ratios. For that reason it is not treated further in this monograph. We recognize, however, that Bank Superintendencies would certainly wish to include in their inspection program a look at the liquidity planning tools that programs are using to ensure their adequacy.

### TABLE 4

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<tr>
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<tbody>
<tr>
<td><strong>Outreach</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan portfolio (US$ Million)</td>
<td>$18.8</td>
<td>$937.6</td>
<td>$33.2</td>
</tr>
<tr>
<td>Number of Loans (Clients)</td>
<td>145,000</td>
<td>1,897,000</td>
<td>62,000</td>
</tr>
<tr>
<td>Average Balance</td>
<td>$130</td>
<td>$494</td>
<td>$530</td>
</tr>
<tr>
<td>Number of Savers</td>
<td>394,000</td>
<td>11,431,000</td>
<td>27,234</td>
</tr>
<tr>
<td>Average Balance</td>
<td>$48</td>
<td>$181</td>
<td>$180</td>
</tr>
<tr>
<td><strong>Asset Quality</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Past Due Loans &gt; 90 Days</td>
<td>3.9%</td>
<td>6.46%</td>
<td>5.14%</td>
</tr>
<tr>
<td>Loan Losses</td>
<td>0.0%</td>
<td>3.07%</td>
<td>0.00%</td>
</tr>
<tr>
<td><strong>Earnings</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on Assets</td>
<td>7.4%</td>
<td>3.3%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>29.6%</td>
<td>--</td>
<td>14.5%</td>
</tr>
<tr>
<td><strong>Capital Adequacy</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk-Weighted Assets/Equity</td>
<td>4.06x</td>
<td>--</td>
<td>5.32x</td>
</tr>
<tr>
<td><strong>Operational Efficiency</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operational Costs/Average Assets</td>
<td>7.7%</td>
<td>13.6%</td>
<td>15.4%</td>
</tr>
<tr>
<td>Salary Costs/Average Assets</td>
<td>5.0%</td>
<td>8.0%</td>
<td>9.2%</td>
</tr>
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</table>
In general, the performance of these three leading microfinance institutions is consistent with the standards that would be applied to traditional financial institutions. In fact, on some accounts, these institutions lead the performance of the entire financial sector where they operate. Nevertheless, standards for microfinance should probably be somewhat more stringent in the areas measured by the five indicators than those applied to traditional financial institutions.

Following is an evaluation of asset quality, earnings, and capital adequacy of these institutions in the context of prudential regulation and supervision. Suggestions have been made for ways in which supervisory agencies might accommodate the distinct characteristics of microfinance while maintaining the underlying principles of prudential regulation and supervision.

2. Asset Quality Standards

Excellent programs maintain past-due arrears levels below 5 percent (defined as the outstanding balance of loans with payments overdue more than ninety days). Although some outstanding institutions have maintained arrears levels below 3 percent over long periods of time, virtually every one has had some period of deteriorated repayment performance in its past. Inevitably, management becomes sloppy and loan officers lose sight of the fundamental credit methodology, or rapid growth brings in new officers before they are fully trained and administrative systems are fully in place. Given that delinquency in microfinance programs is fundamentally a function of the effective management of a credit methodology, these types of distortions lead directly to deteriorated loan portfolios. Excellent programs manage to institute a systematic response to these inevitable crises and do not repeat them. Normal institutions periodically repeat them, though to a lesser extent.

This volatility of delinquency may result in a doubling of the arrears levels of excellent programs. As much as 15 percent of the portfolio may be affected by past-due loans. In spite of this relatively high arrearage, aggressive loan recovery policies can return performance to excellent levels within one to two years, with write-offs ranging from 2 to 5 percent. Although these write-off levels would seem high to traditional banks, the spreads normally associated with microfinance can easily absorb them, particularly over the short term.

The problem lies with the less-than-excellent programs. Those that normally run arrears rates of between 10 and 20 percent walk a fine line. When repayment performance deteriorates, they can find themselves rather quickly with half of their portfolio compromised by past-due loans. These levels are much harder to overcome on the basis of the financial spread alone. Write-offs may reach 10 to 20 percent and clearly affect the capital base of the organization.
Asset quality standards should be stricter than those used for traditional banks. Given that most microlending is based on unsecuritized loans and management-intensive credit technologies, normal fluctuations in the quality of management will directly and immediately affect the quality of the portfolio. Asset quality indicators should include early warning signals, not just write-off rates or other measures of long-term credit risk. Microfinance clients are not inherently more risky than traditional bank clients, but microlending as an activity may be, due to its sensitivity to management quality. Although one would not necessarily wish to have a higher loan loss provision for microloans, one might very well have a higher provision for those loans that go bad once they have entered into a higher risk classification due to becoming overdue.

The very best programs have sustained extremely low arrears rates over periods of several years at a time during their overall evolution. In reality, portfolio risk in microfinance programs is actually “management risk” that manifests itself in the repayment rate, in other words, moral hazard. The variation in asset performance is more a function of institutional than of client-based factors. Standards and tracking procedures should be designed accordingly.

Quite often, poor or deteriorated management in microfinance institutions is due to fundamental problems in the governance structure of the institution itself. Since many of these specialized institutions do not have owners in the same sense as private commercial banks or finance companies, the weakness of their internal governance structure will be an issue that Superintendencies and practitioners alike will need to address over the long term. Otherwise, the microfinance field may fall prey to the same organic failings intrinsic to the cooperative movement. An interesting related question is: How can Superintendencies inform the process of designing new banking legislation that creates these specialized institutions so these errors are not repeated?

3. Earnings Standards

Some successful NGO microfinance institutions have generated more capital from retained earnings than from initial donor contributions. Profits may in fact be quite high, depending on the interest rate policy selected by the institution and on its operating efficiency. Typically, those institutions that have generated high retained earnings have, for whatever reason, known that they could not count on large donations to build their capital base. Thus they have relied on their clients, through interest payments, for their equity.

If microfinance institutions are to be held to higher standards in terms of solvency (hence a lower equity multiplier -- relationship of total assets to
capital), and at the same time hope to attract private investors, they must generate higher profits, measured in return on assets, than traditional banking institutions.

Furthermore, returns in microfinance institutions are potentially more volatile than those of traditional banks because of the substantially higher administrative burden. Administrative costs in an inflationary environment can adjust more quickly than revenues, especially if program management is not financially sophisticated. To cover the potential for this increase in costs without an offsetting increase in revenues, average returns must be higher in order to generate an acceptable risk profile for a private investor.

Finally, exponential growth is tremendously expensive. This growth is normally sustained on the basis of current profits, lacking direct subsidies to do so. Returns in microfinance institutions are therefore depressed during the strongly expansionary phases, which is where most successful microfinance institutions now find themselves.

Nevertheless, if institutions are free to establish their interest rates as they need in order to cover all reasonable operating costs, they can generate high levels of sustained profitability after two or three years from their inception. Once a market has been established for microfinance services in a specific locality, it will be harder for new entrants to gain market share, so the old providers will enjoy a permanent advantage as long as they provide adequate service and competitive interest rates.

As the next section describes, microfinance institutions should have lower equity multipliers than is the case for traditional banks, and consequently, they require higher returns on assets if they are to attract investment capital.

4. Capital Adequacy Standards

Capital adequacy standards for nonbank microfinance intermediaries should be more rigorous than for traditional financial intermediaries. Financial performance on the whole for the industry is more volatile than for traditional banking, and there is greater business risk. This risk derives in part from the structure of microfinance itself and in part from the governance issues already mentioned.

**Structural issues:** The necessary “burden” (relationship of administrative expenses to the total assets) for microfinance is as much as five times that of commercial banking. Although the spreads in microfinance can most certainly be much higher than those for traditional bank finance, adverse economic conditions that dramatically change the costs of operations, unsophisticated financial management, or high arrears without aggressive changes in interest rates can quickly generate operating losses. Given the much higher level of administrative expenses in relation to total assets, a
microfinance institution could easily end up with a negative return on assets under the same conditions that for commercial banks would simply generate lower profits. For that reason, at least until a specialized microfinance intermediary has established a track record of good management, capital adequacy standards should be considerably tougher than for the rest of the financial sector.

**Governance:** When setting capital adequacy standards for microfinance, another important consideration for Bank Superintendencies is the nature of microfinance institution capital. In the case of state development banks, capital is less important because of the guarantee on deposits implied by state-owned depository institutions. In the case of private institutions such as NGOs and cooperatives, no such guarantee exists. Should these types of institutions require additional capital, either to support rapid growth or to cover operating losses (among which may be considered bad debt write-offs), they may have substantial difficulty raising the necessary funds.

In NGOs or private financial institutions owned principally by NGOs, the boards of directors are composed of representatives who usually do not have significant amounts of their own personal funds at risk in the institution. Such boards have not always dealt aggressively with situations that threaten the financial health of the microfinance institution. BRI, today’s premier state-owned microfinance institution, is dependent on political support for the continuation of its microfinance program: there is no way of assuring the maintenance of such support if there should be a change of political direction in the future.

Most microfinance institutions have been capitalized by donor agencies who have a long project cycle. Usually donors require at least eighteen months to generate a project and disburse funds, even if everyone is completely in agreement. Often these processes can take two to three years. These time horizons are completely unacceptable for Bank Superintendency purposes. In addition, the fact that a donor agency has initially capitalized a microfinance institution gives no guarantee that it will do so again. In fact, the probability of repeat funding may actually decrease, since most donors prefer to spread their funds around and provide opportunities to a number of initiatives.

Most microfinance institutions have not taken concrete steps to include on their boards of directors persons or institutions that see themselves as true owners and who would be willing to supply additional equity financing if required. Moreover, most institutions are not comfortable forming alliances with those types of institutions or individuals who would. They do not feel at ease sharing operational control with a group that has not accompanied them throughout their entire process. In fact, both groups are fundamentally distrustful of each other: NGOs generally feel that
business-type individuals only want to make a profit, whereas the business-
type individuals distrust the soft side of the do-gooders in NGOs. The need
for increased capital may be one of the most important transforming catalysts
influencing microfinance institutions as they seek licenses to operate in the
formal banking sector.

Another fundamental issue that grows out of the capital structure of
microfinance institutions is the tremendous power that management may
assume due to the lack of ownership. In much the same way as occurs in
very large U.S. public corporations, the absence of owners that participate
actively in setting policy, demanding results, and taking strategic decisions
often results in management taking control of virtually every facet of the
entity. For this same reason, the Basle Accords require banks to have at least
half of their capital in paid-in shares, and cooperatives are limiting retained
earnings (general reserves) to half of total capital. Microfinance institutions
should be required to generate capital that has ownership attached to it in its
more traditional form: owners that see themselves as having a stake in the
institution’s future.

The significance of that stake may not be in direct proportion to the amount
of equity capital contributed by the stakeholder. Relatively small stakeholders
may place a high degree of importance on their stake. Their involvement may
have a greater significance to the organization than the amount of the
investment might indicate. This is the case for ACCION International and its
investment in BancoSol. ACCION can scarcely allow BancoSol to get into
trouble because ACCION has an important reputation as a founder and
technical assistance provider for microenterprise credit organizations.

The inverse can also be true. A major donor agency can give a microfinance
institutions millions of dollars for its equity base and never take on the role of
a traditional owner. In fact, a traditional owner is usually rejected by both the
donor and the recipient as being interventionist. It may well be that donors
seldom are in a position to offer more than capital, at least directly. Even
though the donor may realize that the microfinance institution requires
management assistance, it has no real power to force the institution to pay
attention to its recommendations. It retains no intrinsic rights for having
provided capital. Thus it finds itself in the position of having power only if it
continues the flow of resources, not unlike the credit relationship between the
microfinance institution and its clients. Besides, even a multimillion-dollar
investment by a donor may be small change within its entire program,
especially if considered over time.

Thus, to answer the first of the two basic questions posed earlier in this
chapter, the best microfinance institutions do have the potential to perform
at standards at least as tough as those imposed on traditional private banks.
In fact, given the generalized weakness in microfinance institution ownership,
the heretofore volatility in their financial results, and the fact that many will probably seek to mobilize the savings of low-income clients, they should probably be required to perform within even more rigorous standards until individual institutions have proven themselves over the medium to long term.

E. HOW BANK SUPERINTENDENCIES MIGHT SUPERVISE MICROFINANCE

Turning to the second question posed -- Can Bank Superintendencies, as presently constituted, effectively add value to microfinance intermediaries and their depositors by regulating and supervising these activities? -- one can argue that although Superintendencies are already involved in this activity to varying degrees and with varying degrees of success, the answer is not entirely clear. While microfinance institutions, in their current state, suffer from fundamental structural weaknesses and, taken as an industry, have performed inconsistently, it is not clear that most Bank Superintendencies are presently equipped to add microfinance to their already full agenda.

The majority of Superintendencies are not currently prepared because of the very different nature of the audits and work plans needed to oversee microfinance in the most appropriate manner. These differences stem from the distinct nature of the service delivery technologies utilized. Virtually every aspect of microfinance institution operations requires a special treatment by regulators, even if standards are similar or more rigorous to those in existence. The principle differences between traditional and microfinance lie in the areas of portfolio quality, financial performance, fraud prevention, operations, and solvency.

Related questions confront Superintendencies if they are required to extend specially legislated licenses or normal bank licenses to specialized microfinance institutions: How will they evaluate the prior track record of the potential microfinance institutions, particularly given the constituencies involved? How will they determine the financial solvency of the “owners” of proposed microfinance institutions? Sometimes owners may be very solvent, but cannot easily be held responsible for increasing equity participation should a need arise. What should minimum scale be for licensed microfinance initiatives? What should the guidelines be for taking a license away from a microfinance institution in case it cannot perform up to standards? How can that be done practically?

Following are some suggestions for how Bank Superintendencies might effectively create a competitive market for microfinance while simultaneously protecting the financial system, investors, and clients from the risks involved.
1. Protecting the Quality of the Portfolio: Auditing the Portfolio

How should we evaluate portfolio risk and diversification in microfinance? Microfinance institutions rely on character-based lending methodologies that feature neither collateral guarantees (although in some cases these may be required) nor the types of analytical information normally gathered for traditional loans. Classification based on traditional review procedures would not capture the true risk profile of a microcredit portfolio because client files and guarantee valuation reveal little. Second-guessing credit decisions is virtually impossible for an outsider given the informality of the borrowers’ businesses.

The fundamental problem with arrears in microfinance institutions is the rapidity with which strong performance can deteriorate, especially due to lax management. To ensure that institutions avoid severe problems, Superintendences will have to insist on the utilization of management information systems (MIS) that generate early warning indicators. In addition, they will have to develop some internal capacity to visit microfinance institution branch operations in order to reach an independent opinion on the extent to which branches carry out their stated loan policies. The greatest challenge will be to send a regulator who truly understands microfinance institutions and who will not simply apply the rules and parameters of traditional bank operations.

The solutions that traditional bankers and Superintendences would instinctively suggest in order to solve an arrears problem, such as increased centralization of decision making, for the most part would be inappropriate or irrelevant for microfinance institutions.

In fact, such tactics might well be very dangerous as they undermine the basic tenets of trust so integral to microlending methodology. Normally, the solutions to microfinance arrearage problems lie in returning to the essence of what makes them different from traditional lending technologies -- rebuilding the fundamental personal relationship between loan officer and client -- and in reinforcing the field staff’s accountability for performance.

Microcredit portfolios consist of tens and even hundreds of thousands of tiny, homogeneous operations. Rather than focusing on collateral guarantees or a review of individual physical credit files, audit procedures should probably combine a statistical sampling of the loan portfolio and an audit of the management information system.

These audits should concentrate on the veracity of an institution’s portfolio risk classification criteria, which should be based on two things: the individual client’s credit history and the overall performance of each type of loan product in the portfolio.
2. Ensuring Sound Management and Governance

Financial performance auditing: When evaluating financial performance, how should Bank Superintendendencies take into consideration the fact that most microfinance institutions still receive some degree of direct or implicit subsidy? A related issue is the effect of inflation on equity. Since initially the standards for microfinance will undoubtedly require higher levels of capitalization than those of traditional financial intermediaries, accounting for the effects of subsidies and inflation will be especially important.

Subsidies distort any analysis of financial performance that is based solely on standard audited financial statements. In order to compare the performance of particular institutions with the international standards as these are developed, and to more accurately compare the financial evolution of a specific institution over time, corrections must be made to eliminate the effect of subsidies on profits. Since inflation can be relatively high in many countries, and equity composes an important part of the microfinance institution capital and liabilities structure, the cost of inflation must also be accounted for when measuring profitability. Once Bank Superintendendencies make these two adjustments, they can gauge the long-term viability of microfinance institutions and compare their performance with the worldwide industry standards which are yet to be developed.

Fraud prevention auditing: What can Superintendencies do to ensure effective operational audits by experienced staff? The principal fraud in microfinance occurs in the field officer/client relationship and comprises kickbacks, bribes, favors, and phantom loans. These types of fraud are virtually undetectable through normal internal auditing procedures that consist of a review of documentation.

Although general disorder in the accounting department might tip off external auditors, auditors are not generally in a strong position to discover the most common types of malfeasance present in microfinance institutions. This type of fraud is mostly detectable through specialized operational audit procedures developed by the microfinance institution itself and performed by individuals who have had experience as loan officers.

Superintendencies must develop some capacity to review the quality of the internal operating audit procedures implemented by microfinance institutions. This Superintendency-level capacity might include joining internal auditors on some of their site visits to microclients, reviewing work plans, participating in the training of internal auditors, and conducting selective and random client-level follow-through on loans granted.

Operational audits: How can a Bank Superintendency, heretofore unfamiliar with microfinance technologies, look at an institution and sense that something is fundamentally wrong with its management in time to
intervene? Microfinance programs can fall apart very quickly, as already discussed in the section on asset quality. The instinctive reaction of Superintendencies to managerial weakness will be to suggest greater administrative controls, essentially meaning greater hierarchy and bureaucracy.

As noted in the discussion of asset quality, this is often the wrong direction in which to move. The structure of microfinance operations is fundamentally more decentralized than those of traditional banks. Branch offices must have much more autonomy than those of regular banks.

Weak management can usually be countered by returning to greater personal accountability, incentives systems, and quality of the management information system rather than by authoritarian measures that mostly increase costs without adding to effectiveness. Bank Superintendencies should train themselves after the manner in which excellent microfinance institutions incorporate these features into their program design and day-to-day management. Thus they will more readily sense when an institution strays away from best practice and alert the program. Bank Superintendencies may want to rely on external and independent expert opinions for occasional reviews of this nature if they do not have a critical mass of microfinance institutions to supervise.

3. Providing Adequate and Appropriate Supervision of Microfinance

How should Superintendencies equip themselves and their staffs to carry out the functions related to microfinance institutions? Should special units be set up and can they be maintained, or should Superintendencies contract specialized outside rating agencies for some of the analytical work? Rating agencies for microfinance do not currently exist, but perhaps they could be created. Can microfinance institutions be reasonably expected to pay the true cost of effective regulation?

Some Superintendencies have already faced these issues in relation to the credit union movement. In some countries, Superintendencies have been asked to become involved in this movement due to the generalized failure of the cooperative agencies traditionally charged with this function. Usually Superintendencies have established either specialized departments or working groups to supervise credit unions rather than hire outside expertise. In some cases they are reviewing only two to five qualifying institutions and omitting smaller ones, in order to apply their scarce supervisory resources to greatest effect.

An alternative approach would involve contracting some portion of the review tasks to an external agent who is very familiar with the workings of microfinance institutions. If this agent were given relatively strict guidelines
for evaluation, the quality of this assessment might easily exceed that
done by the Superintendency staff, given the staff’s relative inexperience
in this area and the limited number of institutions any one inspector is ever
likely to see. The agent could be an international expert or a specialized
institution. The disadvantage to this approach is found in the inability of
the Superintendency to accumulate knowledge or expertise in the supervision
of microfinance.

Further support for such an approach comes from the fact that most
supervisory agencies in Latin America are already too overburdened and
underfunded to examine adequately the commercial banks in the financial
sector. They are unlikely to eagerly assume greater responsibility in a
fledgling and unfamiliar sector. One solution to this would be to pass on
the costs of supervision to the institution being supervised. In the case of
specialized intermediaries, this might occur after an initial start-up period,
a time when there are only one or two small institutions to be supervised
and during which donors might cover the costs.

**Dealing with Insolvency:** What can a Superintendency do about the
potential insolvency of a microfinance institution given that there may be
no other providers of these same services? Complicating the issue is that
some Superintendencies, lacking broad enough faculties in the law that
governs their operations, do not have the power to intervene should the
microfinance institution enter bankruptcy. If they cannot take these final
measures, they fall prey to the same weakness that has afflicted the
cooperative movement: poor performers are not weeded out and thereby
the integrity and image of the entire system is compromised.

Normally a Superintendency would look to merge the insolvent institution
with another or to bring in investors willing to take over the institution.
Many microfinance institutions operate virtually alone in a given country,
and as was discussed earlier, microfinance has not yet become attractive
for private investors. This very special situation of microfinance creates
the temptation to let poor performers ride longer than prudence would
dictate. It also leads to the temptation to bail out poor performers (and their
management staff responsible for the problem), rather than replacing
defective institutions and management with others that have a proven
track record. This reality might support the argument for the promotion of
competing institutions within local markets, rather than for the building up
of single monolithic entities. This issue should be considered when
Superintendencies evaluate the attractiveness of extending microfinance
institution licenses.

Lastly, default by a microfinance institution could have more severe
consequences than default by a bank, especially for other microfinance
institutions. Banks are a familiar part of the financial system, and
depositors who rarely lose their savings in the long run accept that banks might fail every so often. Deposit clients of microfinance institutions, new to the formal financial system, could completely desert these institutions if a recognized program were to fail.

F. CONCLUSIONS

Recent experience demonstrates that financial services can be provided to the poor by specialized microfinance institutions that can perform as well as traditional banks, although they have fundamental structural differences. These structural differences should not affect the overriding quality measures relating to asset quality, profitability, and solvency, the first line of defense for depositors' funds. Today, only a few of the most excellent programs would sustain performance levels comparable to banks if assessed with these indicators. Most fall far short.

Leading programs are tapping into local financial markets in a variety of ways, either by directly mobilizing savings after obtaining bank or finance company licenses, or by obtaining bank loans. For Bank Superintendencies, microfinance is here to stay. For microfinance institutions, the rules of financial markets are here to stay.

As presently constituted, Bank Superintendencies may not be well positioned to add value. Most are struggling with the challenge of improving overall supervisory capacity in relation to the traditional banking sector. This chapter suggests that good microfinance is significantly different in its operational structure from traditional banking and therefore must be dealt with differently by Superintendencies on a procedural level. Nonetheless, if the costs of supervision were passed on to the financial institution and hence the clients, quality supervision by the legal authority would significantly improve the microenterprise sector's access to sound financial services.

A way in which Bank Superintendencies can presently add value to microfinance is by clarifying the general rules of financial markets to all those involved in microfinance, as well as by developing appropriate institutional guidelines. These steps will encourage improved focus on financial performance, rigorous standards, and homogeneous measurement criteria from the microfinance industry. This will benefit all involved.

Because the institutional framework for microfinance differs from country to country, the specific organizational solution for each Superintendency may well vary. In all cases, nevertheless, Superintendencies must begin a process of familiarizing themselves with the workings of the best programs around the world, their potential, and their weaknesses.

This involves specific training, site visits, meetings with local programs, and the hiring of experienced consultants and staff. Fortunately, although
the number of options for obtaining this type of information is still limited in given countries, opportunities are increasing significantly worldwide.

Most important, Bank Superintendencies can contribute to the separation of excellent programs from inadequate programs. Given the general predisposition of the donor agencies to bet on winners in the microfinance field in order to leverage their funds, it appears that the major future growth in microfinance will come from the few leading programs, which in turn will offer the greatest security to local financial markets. This trend will contribute fundamentally to the liberalization and deepening of financial markets, and potentially, increase the stock of local financial savings.
CHAPTER III

SUPERVISION AND REGULATION OF MICROFINANCE INSTITUTIONS:
THE BOLIVIAN EXPERIENCE

by Jacques Trigo Loubière

Superintendent of Banks and Financial Institutions in Bolivia
A. INTRODUCTION

One of the objectives of the Superintendency of Banks and Financial Institutions of Bolivia (Superintendency) is to administer the appropriate mechanisms for the authorization, supervision, and regulation of banks that operate as financial intermediaries to serve the needs of microenterprises. The Law on Banks and Financial Institutions of April 14, 1993, introduced the concept of a multiple-service banking system (multibanca), which allows banking institutions to offer several financial services, including lending to microenterprises. Laying down such regulations was aimed at accelerating market entry of these institutions, so as to deepen the Bolivian financial sector to include populations not served or underserved by the current system.

This chapter begins with an overview on regulation of the Bolivian financial sector, including a description of the types of financial intermediaries and the existing supply of credit and an overall assessment of the potential demand for financial services at the microlevel. Later sections in this chapter address the causes behind the creation of a new financial intermediary specialized in microcredit, along with a description of the regulations issued and other special provisions for such operations.

B. LEGAL FRAMEWORK RELATED TO FINANCIAL INTERMEDIATION ACTIVITIES IN BOLIVIA

1. The Law on Banks and Financial Institutions

The Law on Banks and Financial Institutions (the Law), enacted in April 1993, was the culmination of a process of institutional reform begun in Bolivia in 1987 with promulgation of Supreme Decree 21660, which included a series of measures aimed at strengthening the private banking system and expanding its role as allocator of resources to the various sectors of the economy. In late 1988, when this reform process was beginning, the Bolivian banking system captured deposits of less than US$500 million, the average period of term of deposit was sixty-five days, and the rate of interest on deposits in foreign currency was over 16
percent. Bolivian banks could count on practically no credit from foreign financial institutions. Further, the closing of several insolvent banks had just been ordered, and little was known about the actual financial situation in the rest of the banking system.

The Bolivian banking system has undergone major transformations in recent years. As of October 31, 1995, deposits captured came to more than US$2.42 billion, period of term of deposit is 216 days (approximately seven months), and the average interest rate on deposits in foreign currency is approximately 9 percent annually. Not only has direct external credit recovered -- to date it comes to more than US$400 million -- but in addition, some Bolivian banks are beginning to place debt paper in foreign markets. Achieving monetary stability, setting appropriate rules of the game for banking institutions, and decreasing the involvement of the state enabled the Bolivian banking system to regain its major role in the country’s economy and to once again obtain credit from foreign institutions.

2. Philosophical Principles of the Law

The philosophical principles of the new Law on Banks and Financial Institutions can be summarized as follows:

a. The Law consolidates liberalization or financial deregulation, by preventing the state from controlling certain variables that affect the financial system: (1) interest rates are fixed based on market forces, (2) legal reserves are set at minimal percentages, above which the Central Bank must remunerate funds so set aside, and (3) financial intermediaries are free to place their resources with no conditioning factors guiding credit in one direction or another.

b. The Law establishes a universal or multiple-services banking system, allowing banks to embark upon new businesses and financial services, such as insurance, mutual fund management, financial leasing, factoring, and so on. Likewise, the Law provides that banks can participate as investors only in other financial companies, but not in corporations or companies engaged in productive activities.

c. The Law regulates financial intermediation activities independent of the corporate form of the entity dedicated to this activity. As a result, it expands the scope of the Law to all nonbank financial intermediaries and to companies that provide services to the financial system.

d. The Law lays down minimal capital requirements denominated in bolivianos equivalent to a constant international unit of value, the Special Drawing Rights (SDRs) of the International Monetary Fund. In addition, the minimum operating equity of the financial intermediaries is determined by weighing their risk assets, consistent with the Basle
Accords, setting the minimal operating coefficient at 8 percent. Pursuant to the Law on the Central Bank of Bolivia, No. 1670 of October 31, 1995, this coefficient has been amended and increased to a minimum of 10 percent.

e. It establishes criteria for the entry of new actors to the market based on a rigorous review of the solvency and capabilities of the founding shareholders.

3. Main Regulatory Aspects of the Law

The new regulatory framework determines the scope of action of the financial intermediaries, bringing the Bolivian financial sector into the prevailing international trend of multiple-services banking with sufficient capital in light of the risks assumed. The key aspects of this law are as follows:

Creation of banking institutions: The Law sets forth specific requirements for chartering banking institutions, as well as chartering the branches of foreign banks.

Banking operations, limitations, and prohibitions: The Law fosters competition in banking, allowing intermediaries to innovate in their forms of operation and to diversify their activities in multiple-service banking operations. It defines all financial activities and service operations that banking institutions, financial service companies, savings and loan cooperatives, and mutual companies with savings and loans operations are authorized to undertake. Similarly, the Law lays down limits on operations of financial entities for the purpose of minimizing exposure to the risks inherent in financial activity. The legal limits directly affect the supply of credit in the Bolivian financial system with the following prohibitions:

- Loans to a borrower or borrower group may not exceed 20 percent of the intermediary's net worth.
- Loans to a borrower or borrower group may not exceed 5 percent of the intermediary's net worth, if these loans are not duly guaranteed.
- A total loan portfolio without guarantees may not exceed twice the net worth of the financial institution.

In addition, the Law seeks to limit conflicts of interest in the management of banking institutions; such conflicts have been the main cause of bankruptcies among banking institutions in Bolivia and elsewhere.

- Loans cannot be made to borrowers or borrower groups related to the lending institution; persons have until June 30, 1998, to regularize their status in this regard.
• The directors, statutory auditors, managers, and officers of banking institutions are made liable for losses caused by failure to abide by legal provisions and prohibitions; in case of fraud, the Superintendency is authorized to lodge the respective complaint with the Public Ministry.

**Prudential regulation of banking activity:** The Law provides for application of healthy and prudent banking practices to the management of banking institutions. It stipulates a set of prudential principles which:

• Foster permanent backing for depositors, consistent with the nature and extent of risks assumed by a bank.

• Regulate the compulsory contracting of collateral guarantees in consideration of the materiality of the loans made.

• Place limits on the ability to tie up resources in fixed assets.

• Require banks to maintain and publish their income statements and balance sheets at their true values, authorizing the Superintendent to determine the system for bookkeeping and asset valuation and to inspect the banks and require that they provide information periodically.

**Investment in corporations:** The Law requires the consolidation of the bank's financial statements to include any incorporated branches and subsidiaries engaged in intermediation or financial services, as well as those of insurance companies that have received bank investment. This mechanism prevents the evasion of prudential standards of capitalization or spread of risk used to assess a bank's solvency.

**Framework for sanctions:** The Law authorizes the Superintendency to impose administrative sanctions, including fines and suspension from one's duties, on both a financial institution and its directors, statutory auditors, managers, and staff, as well as on their external auditors, expert appraisers, and valuators for breach of regulations or for negligence.

**Treatment of financial institutions in crisis:** The Law sets forth an approach for banks to deal with solvency problems, including mechanisms and deadlines for replenishment of equity capital by the shareholders or third parties. The Law also defines the parameters of insolvency, a bank's administrative responsibilities, and special provisions applicable to a forced liquidation of insolvent institutions.

**C. FINANCIAL INSTITUTIONS: SUPPLY AND DEMAND FOR CREDIT**

Five major groups of financial institutions are covered by the April 1993 Law: banking institutions; savings and loan mutuals; credit unions; financial services companies, including financial leasing companies, factoring companies, and general warehouses; and other nonbank financial institutions.
1. Banking Institutions, Savings and Loan Operations (Whose Principal Purpose Is to Mobilize Funds for Housing Finance), and Savings and Loan Cooperatives

The main institutions providing credit in Bolivia are the banks, mutual companies with savings and loans operations, and credit unions, which together represent a credit supply of US$3.73 billion, based on the direct and contingent portfolio as of June 30, 1995. The banks account for 90 percent (US$3.43 billion) of that credit supply; they hold a diversified portfolio in different productive and commercial sectors and serve primarily large and medium-size economic units. The mutual companies with savings and loan operations for housing account for 6.6 percent (US$203 million) of the total portfolio, covering mainly the housing finance needs of middle-income wage-earning sectors. Credit unions account for 3.2 percent (US$97 million); they mainly finance housing needs, as well as small businesses and merchants.

The total number of borrowers in the banking system has increased from less than 86,000 individuals and entities in June 1990 to 180,559 in June 1995. Of this 1995 total, 61,172 borrow from Banco Solidario, S.A. (BancoSol), a commercial bank specialized in microenterprise credit which started in January 1992. The clientele of the mutual companies has increased from 24,000 borrowers in June 1992 to 31,243 borrowers as of June 30, 1995; borrowers from credit unions equaled 41,042 as of June 30, 1995.

The banking system, excluding BancoSol, invests 94 percent of its resources in loans in amounts greater than US$10,000, particularly in productive and commercial enterprises, which account for 18.8 percent of all borrowers in the system. (See Table 5). In recent years many banks have begun aggressive programs to make small loans mainly to finance consumption or acquisition consumer durables, vehicles, or soft credit lines. Loans have also been made to finance housing construction or purchases for both high- and middle-income sectors. The structure of the BancoSol portfolio stands in marked contrast to these characteristics of the “traditional” banking system. Banco Solidario, S.A., began operations in January 1992 and specialized in serving the financing needs of urban microenterprises. Of its US$26 million portfolio (as of June 1995), 92 percent is made up of loans of amounts less than US$10,000, for a total of 61,172 borrowers, whose average outstanding loan is US$457.

The savings and loan companies finance housing purchases and construction, and other housing-related activities. As of June 30, 1995, 39 percent of the portfolio of the mutual companies is in loans in amounts less than US$10,000; such operations account for 82.8 percent of active clients of the mutual companies, with average outstanding loans of approximately US$3,080.
## TABLE 5

### BOLIVIAN FINANCIAL SYSTEM
PORTFOLIO AND SHARE CLASSIFICATION BY DOLLAR AMOUNTS AND NUMBER OF BORROWERS
(In U.S. Dollars; as of June 30, 1995)

<table>
<thead>
<tr>
<th>Classification</th>
<th>Percentage of Portfolio</th>
<th>Percentage of Borrowers</th>
<th>Percentage of Portfolio</th>
<th>Percentage of Borrowers</th>
<th>Percentage of Portfolio</th>
<th>Percentage of Borrowers</th>
<th>Percentage of Portfolio</th>
<th>Percentage of Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over $100,000</td>
<td>67.3%</td>
<td>3.6%</td>
<td>3.0%</td>
<td>0.0%</td>
<td>5.2%</td>
<td>0.4%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>$10,000 to $100,000</td>
<td>26.7%</td>
<td>15.2%</td>
<td>5.5%</td>
<td>0.8%</td>
<td>55.5%</td>
<td>16.8%</td>
<td>16.0%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Under $10,000</td>
<td>6.0%</td>
<td>81.2%</td>
<td>91.5%</td>
<td>99.2%</td>
<td>39.3%</td>
<td>82.8%</td>
<td>84.0%</td>
<td>98.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Portfolio Shares and Borrowers</th>
<th>Thousands of Dollars</th>
<th>Number of Borrowers</th>
<th>Thousands of Dollars</th>
<th>Number of Borrowers</th>
<th>Thousands of Dollars</th>
<th>Number of Borrowers</th>
<th>Thousands of Dollars</th>
<th>Number of Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$3,401,933</td>
<td>119,387</td>
<td>$27,975</td>
<td>61,172</td>
<td>$203,016</td>
<td>31,243</td>
<td>$96,944</td>
<td>41,042</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Average Outstanding Loan</th>
<th></th>
<th>Average Outstanding Loan</th>
<th></th>
<th>Average Outstanding Loan Under $10,000</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>$28,945</td>
<td></td>
<td>$6,497</td>
<td>$2,362</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$2,105</td>
<td></td>
<td>$3,084</td>
<td>$2,020</td>
</tr>
</tbody>
</table>
In the case of the credit unions, 84 percent of the portfolio is in loans less than US$10,000, accounting for 98 percent of their clients (or 43,825), with average outstanding loans of approximately US$2,400. In the credit union sector, 41.8 percent of the resources captured are earmarked for housing construction and repairs, 29.8 percent finances consumption, and the remaining 28.4 percent is loaned to microenterprises engaged in production.

In rural areas, home to 42 percent of Bolivians, the banking system finances the agricultural activities of the entrepreneurial sector. In some areas of production, especially crop farming, this sector in turn provides financing to community groups and production cooperatives.

Small rural businesses and microenterprises are not being covered by the formal sector financial intermediaries. Even the rural credit unions, though representing almost half of the members in the entire credit union system, account for only 15 percent (approximately US$15 million) of the credit union system’s total loan portfolio.

2. Credit Supply and Demand in the Bolivian Financial System: Conclusions

Financial intermediaries have been engaged in important efforts to expand their client base. Nonetheless, the economically active population numbers some 2.1 million, more than 1 million of whom are self-employed workers. Whereas the formal business sector includes more than 100,000 enterprises (including sole proprietorships, corporations [sociedades anónimas], limited liability and collective companies, and others), the informal urban microenterprise sector numbers some 600,000 enterprises nationwide.

BancoSol’s current coverage and that of the specialized and unregulated nongovernmental organizations (NGOs), which serve approximately 85,000 microenterprise borrowers, fall short of the potential demand.

To meet this potential demand, which is centralized in urban areas, the traditional financial institutions -- commercial banks, mutual companies, and credit unions -- would have to serve just over 450,000 additional borrowers. (See Table 6).

The types of institutions currently participating in the financial market, both the supervised sector and the NGOs, are insufficient to guarantee efficient financial intermediation for microentrepreneurs and small businesses.

Multiple-service banking is an excessively broad framework for lending operations to microentrepreneurs and small businesses, requiring minimum capital that overprotects microlending operations and acts as a barrier to entry.
TABLE 6

NONGOVERNMENTAL MICROCREDIT ORGANIZATIONS AND BANCO SOLIDARIO, S.A.
PORTFOLIO QUALITY
(In Thousands of U.S. Dollars; as of June 30, 1995)

<table>
<thead>
<tr>
<th>NGO Associations</th>
<th>Active Portfolio</th>
<th>Delinquent Loans</th>
<th>Total Portfolio</th>
<th>Delinquency Rate</th>
<th>Total Borrowers</th>
<th>Average Loan Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIPAME a/b</td>
<td>7,019</td>
<td>375</td>
<td>7,394</td>
<td>5.1%</td>
<td>12,921</td>
<td>572</td>
</tr>
<tr>
<td>FINRURAL c</td>
<td>10,308</td>
<td>809</td>
<td>11,117</td>
<td>7.3%</td>
<td>73,908</td>
<td>150</td>
</tr>
<tr>
<td>Total NGOs</td>
<td>17,327</td>
<td>1,184</td>
<td>18,511</td>
<td>6.4%</td>
<td>86,829</td>
<td>213</td>
</tr>
<tr>
<td>Banco Solidario, S.A.</td>
<td>26,460</td>
<td>1,515</td>
<td>27,975</td>
<td>5.4%</td>
<td>61,172</td>
<td>457</td>
</tr>
<tr>
<td>Total</td>
<td>43,787</td>
<td>2,699</td>
<td>46,486</td>
<td>5.8%</td>
<td>148,001</td>
<td>314</td>
</tr>
</tbody>
</table>

a Figures as of December 1994.

b Corporation of Private Industries Supporting Microenterprise (Corporación de Instituciones Privadas de Apoyo a la Microempresa), composed of the principal NGOs specializing in urban credit to small and microbusinesses.

c Association of Financial Institutions for Rural Development (Asociación de Instituciones Financieras para el Desarrollo Rural), composed of the principal NGOs specializing in rural credit to small and microbusinesses.
D. NEED FOR A NEW TYPE OF ENTITY SPECIALIZED IN SMALL BUSINESS AND MICROFINANCE

The analysis set forth in the previous section regarding today’s institutional actors and how they are situated in the Bolivian financial market clearly shows that a considerable part of the potential demand for financial services among low-income sectors, be they wage earners or microentrepreneurs or small businesspersons, is not met by the institutions of the regulated market, nor by NGOs specialized in supplying credit to these sectors. As access to sources of financing for economic development is crucial, one of the priority tasks of the state is to foster conditions that would help bring about a swift deepening of the financial sector.

1. Obstacles to Expanding the Credit Supply of the Regulated and Unregulated Market

The current intermediaries of the regulated Bolivian financial system face several obstacles to expanding their supply of credit to the microenterprise and small-business sectors:

• Absence of appropriate technology that would reduce the costs of credit risk and allow interest rates to cover administrative costs, which are greater than those incurred by the commercial banking system.

• Relatively low levels of profitability of microlending products as compared to those investment alternatives offered by the banking institutions that are most similar.

• Economic problems faced by mutual savings and loans and credit unions that make unlikely the expansion of their supply of credit to microenterprises and small businesses.

For NGOs, expanding their credit supply is limited by their dependence on donor agencies and restrictions on capture of deposits. The experience of the regulated intermediaries, those authorized to capture deposits from the public, indicates that it is very difficult to reduce operating costs sharply when engaged in deposit operations, and therefore becoming part of the formal sector is not a comprehensive solution.

Even given the expanded access to credit that the regulated financial sector enjoys, existing financial institutions are insufficient to guarantee efficient financial intermediation for the microenterprise and small-business sectors. The various institutional models that exist now, including BancoSol, do not yet come close to full inclusion of microenterprises and small businesses in the regulated financial system.

A new type of institution is necessary for expanding the Bolivian financial system and guaranteeing the most efficient form of intermediation of
resources captured from the public to investment in microenterprise and small business. The mission of the Bolivian government, and in particular the Central Bank and the Superintendency of Banks and Financial Institutions, is ultimately to create the contextual conditions that would make such efficient financial intermediation possible.

2. Private Financial Funds (PFFs) as Instruments for Fostering Small Business and Microcredit in Bolivia

The state has a duty to create mechanisms to encourage efficient financial intermediation and to make it possible to bring broad sectors of the population into the financial system, while safeguarding the interests of their depositors and creditors. In April 1995, the Bolivian government enacted Supreme Decree 24000, which regulates the incorporation and operation of the Private Financial Funds (PFFs),\(^\text{16}\) entities contemplated in Article 81 of the Law on Banks and Financial Institutions. These institutions were established with the following characteristics:

**Purpose:** The principal purpose of the PFFs will be to channel resources to finance the activities of small businesses and microenterprises in the productive and commercial sectors, as well as to make loans to individuals for durable goods purchases. As an additional means of facilitating access to credit for individuals, PFFs may also engage in small-scale consumer credit operations.

**Incorporation:** The PFFs will be organized as corporations (*sociedades anónimas*), as this is an ideal form for financial intermediation, in view of both the legal stability of a commercial entity in civil society, and because it allows for timely increases or replenishment of equity when required by the Superintendency of Banks and Financial Institutions. This legal form may also help attract financial institutions from abroad, private as well as public.

**Scope:** The PFFs will be national in scope and will operate under the general framework established by the Law of Banks and Financial Institutions and related provisions, and must abide by the regulations issued by the Central Bank of Bolivia and the Superintendency of Banks and Financial Institutions.

**Minimum operating equity:** In order to incorporate and function, the PFFs will require capital in an amount equivalent to at least 630,000 Special Drawing Rights (SDRs), or US$1 million. This is significantly less than the 2 million SDRs, or US$3.2 million, required for incorporating a bank. This start-up capital, together with a strict prudential framework that establishes credit limits lower than those established for banks, and a

\(^{16}\) Fondos Financieros Privados (FFPs).
prohibition on making loans to the PFFs own shareholders and managers, represents a reasonable combination of equity backing and spread of credit risks. The PFF framework, furthermore, provides adequate protection for depositors in savings and fixed-term accounts, making such accounts attractive to potential financiers, national and foreign.

The PFFs should maintain net worth equivalent to at least 10 percent of their assets and contingencies weighted on the basis of risk; institutions already in operation shall have three years to bring their equity levels into line with this new legal requirement.

**Financial operations:** Supreme Decree 24000 permits PFFs to hold broad operational powers, which allow for financial leasing, in addition to traditional lending, certificates of deposit to guarantee performance (boleta de garantía), and factoring. This diversity of credit instruments will make it possible to adapt credit supply to the specific needs of small borrowers, in both the productive and commercial sectors, including wage earners.

As the making and management of small loans is a specialized activity in both the urban and rural sectors, Decree 24000 provides that before receiving an operating license, the PFFs must have managers with extensive experience serving these market sectors. Bolivia now has professionals trained in these activities, particularly as a result of the development of appropriate financial technologies adopted in recent years by several institutions.

The PFFs will also be able to carry out operations and channel their resources through financial institutions overseen by the Superintendency of Banks and Financial Institutions and shall be subject to the credit limits laid down by the Law on Banks and Financial Institutions. This mechanism will provide an incentive to the banks and other formal sector financial intermediaries to expand their supply of credit to small borrowers.

The PFFs may provide their clients financial services such as making drafts and payment orders demandable in the country, foreign-exchange operations, and the buying and selling of foreign currencies. In addition, they may receive savings and time deposits, and contract obligations with second-tier banking institutions pursuant to the limits set by these intermediaries.

**Limits:** In order to avoid risks that jeopardize their main purpose and are incompatible with the amount of capital they involve, PFFs are restricted from several types of banking operations. These include, among others, capturing demand deposits, foreign trade operations, trust operations and other charges of fiduciary duty, investments in enterprise capital, participation in the underwriting and placement of securities, and mutual fund management. To carry out these operations, there is always the alternative of creating a bank. Some additional restrictions are as follows:
• The loan made to a borrower or borrower group may not exceed 3 percent of the net worth of the PFF; this helps disperse the credit supply of these institutions to lower levels than those reached by the current intermediaries and to secure the financial stability that comes with spread of credit risk.

• Credits with personal guarantees may not exceed 1 percent of the PFF’s net worth, as the PFFs are authorized to make loans with security pledges in the form of movables, jewels, and other valuables, a practice that is hardly used in the Bolivian financial system today, but which, given the characteristics of the market segment, may be a viable solution to the question of loan guarantees.

• A PFF may not maintain a credit relationship with an institution of the national financial system for more than 20 percent of the PFF’s net worth; PFFs are also subject to any operative restriction that the Superintendency of Banks and Financial Institutions deems prudent.

• To avoid conflicts of interest, shareholders, statutory auditors, directors and managers, and individuals or entities associated with a PFF may not obtain loans, directly or indirectly, from the institution.

3. Special Regulations for Small Business and Microcredit

Given that the small size and large spread of loans for less than the equivalent of US$2,000 allow them to be considered minor risks, when classifying and evaluating assets and their accruals in the calculation of equity position (which includes the limit on the total amount of loans made with a personal guarantee to twice the financial institution’s net worth), the following exceptions are made:

• The banking institutions should exclude from this limit all loans they make that are equivalent to US$2,000 or less, or 1/1000 of the institution’s net worth, whichever is greater.

• The nonbank institutions should exclude from this limit loans equivalent to US$500 or less, or 1/20 of 1 percent of the institution’s net worth, whichever is greater.

Similarly, the Superintendency of Banks and Financial Institutions qualifies the loan portfolio for operations up to US$5,000, including special treatment based mainly on the evaluation of payment capacity, taking into account the analysis of assets, liabilities, and cash flow in the borrower’s socioeconomic unit (considering the business and the household) and making the appropriate qualification in light of performance of the payment time lines or seniority of outstanding arrears.
Such a measure reduces the unit cost of managing microcredits for financial institutions specialized in this area.

E. CONCLUSIONS

This analysis of lending to microenterprises and small businesses by Bolivian commercial banks, savings and loan mutuals, and credit unions reveals the challenges facing Bolivian financial intermediation within this market segment. Commercial banks currently serve a very small number of wage earners; the percentage of microentrepreneurs and small businesspersons who obtain loans from the system is also very low. Therefore, the development of a personal bank that provides loans for small-scale consumption and for the expansion of the corporate banking sector to serve small-business credit needs involves moving beyond the usual type of product and usual borrower in the system.

The lack of credit supply to microenterprises and small businesses is not generally related to the availability of loanable resources or to factors associated with restrictive policies in the financial markets, but rather to the inherent characteristics of these operations, which keep the present-day financial intermediaries and private investors from penetrating these market segments in the short term. In other words, there is a potentially profitable market opportunity that most present-day financial intermediaries are not yet equipped to meet.

From the standpoint of the financial institutions, there are two basic problems related to microfinance products: the high administrative costs and the apparently high costs of credit risk. The relatively small loan amounts for microenterprise and small business entail high administrative costs for intermediaries, in terms of proportion of loan amount. Further, what has been called the asymmetry of information -- that is, the lack of reliable and consistent information on an enterprise operating in the informal sector -- and the lack of real guarantees both increase the risk. Financial intermediation with microenterprises and small businesses is a losing proposition from the perspective of conventional banking methods.

 Nonetheless, the credit market served by NGOs has yielded positive results that call for some flexibility in applying the criteria set out earlier. To be able to operate in the microenterprise and small-business sector, the banks would have to begin a fundamental transformation of their lending technology and adjust the interest rates they charge these “new” borrowers. However, this must occur within a carefully adjusted regulatory framework, as the law on PFFs provides.

The Bolivian regulations establish consistent criteria for authorizing new financial intermediaries (PFFs), whose objectives are to make small loans in a financially viable manner and to cover demand unmet to date by the
existing regulated and unregulated institutions. Increasing the number of regulated institutions that operate in the financial sector is a necessary strategy for expanding the financial market.

Conceiving and designing a new type of prudentially regulated financial intermediary capable of providing efficient services to small-business and microenterprise borrowers require a guarantee of long-term consistency between the purpose of creation and the actual development of activities. Understood in broad terms, the concept of a PFF encompasses a wide array of intermediation and financial services, as well as different forms of incorporation, target groups, and forms of operation. It is hoped that this type of legal entity will serve as a basis for private enterprise to direct its efforts to serving an unmet demand for credit, which can be expected to help expand the Bolivian market for financial products.
CHAPTER IV

BANCO SOLIDARIO, S.A.: A REGULATED INSTITUTION

by Rachel Rock
In February 1992, Banco Solidario, S.A. (BancoSol), commenced operations as the first private commercial bank in the world dedicated to deploying financial services to the microenterprise sector. BancoSol grew out of a successful Bolivian nongovernmental organization (NGO), PRODEM,\(^{17}\) which was established in 1985 by prominent members of the Bolivian business community, ACCION International, and Calmeadow Foundation in response to the growing demand for financial services among Bolivia’s estimated 600,000 people working in the informal sector. This chapter analyzes the process of establishing a regulated institution and how the regulatory framework affects microfinance operations from the perspective of BancoSol.\(^{18}\)

BancoSol entered the regulated financial sector as a commercial bank because the Private Financial Funds (PFFs) discussed in the previous chapter did not yet exist. In meeting the requirements to become a commercial bank, BancoSol confronted the full array of regulatory issues and was a test case in the applicability of banking regulations to microfinance institutions. Several of these issues may not face the specialized microfinance intermediary.

### A. PRODEM: RESTRICTIONS ON GROWTH

In its first few years of operation, PRODEM had implemented the “expansion-led” approach described in Chapter I. Several features characterized PRODEM prior to the transition to BancoSol:

- **Visionary leadership and clarity of purpose** provided by its board of directors. This group of local business leaders insisted from the beginning that PRODEM attain national outreach.

- **Rapid growth.** By the end of 1987, PRODEM had a portfolio of US$158,000. By the end of 1991, it had increased to US$4.56 million,

\(^{17}\) PRODEM’s full name is Fundación para la Promoción y Desarrollo de la Microempresa.

\(^{18}\) For a full discussion of the transition of BancoSol from PRODEM, see Glosser (1994) and Drake and Otero (1992).

- Achievement of operational self-sufficiency within eighteen months of operation followed by financial self-sufficiency in 1990.

- High portfolio quality in which the delinquency rate, measured as the percentage of the portfolio composed of payments more than twenty-one days past due, never surpassed one-half of 1 percent.¹⁹ Loan losses totaled $1,700 on US$27 million lent between 1985 and 1991. By the end of 1991, each loan officer managed an average portfolio of US$55,000, lent to between 180 and 200 clients (Drake and Otero, 1992).

- Emphasis on staff training, which resulted in a low attrition rate. An institution that began with 19 people in 1987 had increased its staff to 146 by December 1992.

Reaching less than an estimated 3 percent of the potential market, PRODEM’s limiting factor became access to funds. Donor funds could not keep pace with PRODEM’s ability to expand. PRODEM’s local commercial capital supply of US$710,000 in 1991 could not support the US$2 million per month lending pattern (Drake and Otero, 1992). As an unregulated NGO, it could not rely on the potentially much larger voluntary savings of its clients and the public. The operational and financial rationale to become a regulated institution was well established.

The decision to create a bank derived from a basic commitment by the board of directors of PRODEM to a market-driven approach to development. The board perceived the informal sector as an economic challenge rather than a social problem. Creating a long-term economic solution, independent of donated funds, suggested a fundamental shift in conventional methods of poverty alleviation. The establishment of a formal institution would open a door into a system long closed to the vast majority of the Bolivian population (Glosser, 1994).

What, then, was the process of becoming a regulated financial intermediary in Bolivia? And what are the issues in the ongoing supervision of BancoSol? The following section will address these questions.

B. FULFILLING THE REQUIREMENTS OF REGULATION AND ONGOING SUPERVISION

In Bolivia, bank incorporation is approved by the Superintendency of Banks and Financial Institutions. As outlined in the previous chapter, major reforms in the financial sector began in 1988, creating a

¹⁹ At this time, delinquency was not calculated on the basis of contaminated portfolio but rather on the basis of individual payments past due.
Superintendency with greater political independence and control over the banking industry, and culminating in the 1993 Law on Banks and Financial Institutions and the 1995 decree creating the PFFs. Over this period, accounting practices had been harmonized across institutions, theoretically enabling the Superintendency to better monitor banks’ portfolios to manage credit risk (World Bank, 1993).20

The Bolivian Superintendency of Banks is considered to be one of the most innovative in Latin America, making significant strides in creating a competitive financial market and committed to opening the financial sector to microenterprises. It has, however, been unable to resolve key issues surrounding the supervision of microfinance; these issues will be discussed later in this chapter.

Relations between BancoSol staff and the regulators from the Superintendency have been characterized as open and cooperative. The Superintendency has remained receptive to a number of requests submitted by BancoSol and they are currently being analyzed.

The Superintendency remains fundamentally concerned with the prudential regulation and supervision of BancoSol but understands that the distinct characteristics of microfinance require adjustments to certain regulations. Whatever the adjustments, however, they will be made so as to maintain symmetry among institutions in the financial system and avoid preferential treatment of one institution over another.

Using the presentation set out in Chapter I of this monograph as a guide, BancoSol’s relationship with the Superintendency will be analyzed in three areas: entering the formal financial sector, protecting the quality of the portfolio, and providing adequate and appropriate supervision. Whereas the burden fell on BancoSol in fulfilling the regulatory requirements for market entry, the burden to supervise falls on the Superintendency in the current operational relationship.

1. Entering the Formal Financial Sector

The formal process of establishing BancoSol commenced in late 1989 with the creation of COBANCO (Comité Promotor del Banco para la Microempresa) to manage the planning and transition of PRODEM into BancoSol. Several prominent local businessmen provided the vision and leadership for this effort. Requirements for entry into the formal sector

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20 In 1995, the Superintendency liquidated two banks after significant delay at an estimated cost to the government of US$60-70 million. Lawsuits have been brought against the Superintendency by both the banks’ owners and the depositors, resulting in a crisis management process that has preoccupied the agency for most of the last year.
included (1) raising the minimum capital, (2) fulfilling legal and technical requirements, (3) detailing financial information about the owners and experience of the managers of BancoSol, and (4) demonstrating operational capability to the Superintendency.

**Raising minimum capital:** Legal incorporation of a commercial bank required a minimum of US$3.2 million in equity. Initial plans outlined the funding to come from concessionary loans and donations. However, the project gained an increasingly commercial structure as negotiations advanced. In the end, equity funding came from three types of sources: PRODEM’s loan portfolio (35 percent); external institutions, including the Inter-American Investment Corporation (IIC), Calmeadow Foundation, ACCION International, FUNDES, the Rockefeller Foundation, and SIDI/ France (46 percent); and Bolivian individuals (19 percent). By the end of 1991, COBANCO had raised nearly US$5 million of equity financing, US$1.8 million more than the required minimum.

During this process, PRODEM assumed a new role by becoming the research and development arm of BancoSol, shifting its focus to rural lending. PRODEM was to continue to establish new branches and sell them to BancoSol once they became profitable.

**Legal and technical requirements of becoming a bank:** In completing the two-step process of establishing a commercial bank in Bolivia -- obtaining approval for a bank charter and gaining authorization to operate -- there were legal and technical dimensions. The legal requirements dictated raising a minimum capital base of US$3.2 million, fulfilling the requirements of legal incorporation as a sociedad anónima (S.A.), and issuing stock. The technical requirements in this case centered on the development of a detailed feasibility study for BancoSol, which projected a positive return within three years and provided a well-defined business plan.

Though the legal requirements were time consuming, the technical process was in certain ways more difficult. COBANCO had to convince the Superintendency of the importance of BancoSol’s mission in targeting the microenterprise sector and its chances of success in using a lending methodology devoid of traditional guarantees. Here began a process of negotiation and mutual learning between the staff of PRODEM/COBANCO and the staff of the Superintendency, which continues into the present and has been one of the main ingredients of success in the formation and operation of BancoSol. The agreed-upon objective has always been to

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21 Though these funding sources were not commercial, their participation lent credibility to the effort and allowed it to happen. It is of critical importance in terms of long-term governance issues that BancoSol has no individual investors with significant resources at stake.
deepen the Bolivian financial sector by using a market-driven approach to provide greater numbers of microenterprises with access to credit.

To familiarize regulators with the distinct characteristics of microfinance, the COBANCO team took them to visit PRODEM’s branch offices, to meet with the accountants, loan officers, and clients and witness operations firsthand. The project leaders also worked with the Superintendent to brief him on the incorporation process. Not only did the Superintendent have prior experience with credit unions and cooperatives, he was also personally enthusiastic about the idea of BancoSol as an instrumental link in democratizing credit in Bolivia.

While the Superintendency quickly accepted the mechanics of the lending methodology, it also recognized the associated costs and questioned whether BancoSol could earn a good rate of return. In addition to requiring that BancoSol make a profit after three years, the Superintendency also appropriately required that the bank perform financially at a level comparable to other banks. The project leaders immediately realized that BancoSol would have to raise its interest rates. Determined to commence operations maintaining PRODEM’s rate of 4 percent a month, the bank planned to move to a fluctuating interest rate policy after the first year. The rate would vary with the market rate and the changing costs of operations (Glosser, 1994).

The Superintendency also questioned how the bank would fund itself over time, asking specifically about deposit mobilization. It is in this regard that BancoSol would differ most from other financial institutions. Because it began operations with donated capital and because PRODEM was prohibited from capturing savings, there was very little experience to demonstrate BancoSol’s potential. Ultimately, the Superintendency exercised a measure of leniency, recognizing that the equity investments far exceeded the minimum requirements.

**Financial information and management experience:** The Superintendency required extensive legal and financial information about the founders of the bank who were to take on its legal responsibility and about other investors. As the specifics of these requirements were designed for the incorporation of a traditional bank, the process proved complicated. The major challenge was in applying the documentation requirements to the nontraditional investors such as PRODEM, the multilaterals, and the nonprofit organizations.

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22 The Superintendent of Banks at the time was Luis del Río. Jacques Trigo Loubière, author of Chapter III, is the current Superintendent of Banks in Bolivia.

23 To date, BancoSol has not raised its interest rate on lending.
Operational requirements: Once BancoSol had obtained its bank charter, management had ninety days to demonstrate its capacity to operate a bank. This included such tasks as the development of operational and security manuals to ensure standardized procedures, as well as the secure and efficient handling of cash. More important was the capacity to generate the requisite daily, weekly, fifteen-day, monthly, quarterly, and yearly reports measuring, among other things, deposit levels, interest rates, interbank operations, assets and liabilities, and liquidity reserve requirements. Several new systems were required to manage the liabilities side of the balance sheet.

Obtaining a bank charter took seven months. Authorization to operate came four months later, in February 1992. Ironically, by Bolivian standards, the formation of BancoSol occurred faster than the average traditional commercial bank.

2. Protecting the Quality of BancoSol’s Portfolio

In Bolivia, portfolio restrictions are based upon distinguishing between secured and unsecured lending. What is appropriately intended to protect traditional financial institutions from credit risk directly constrains microfinance intermediaries in reaching their target market.

Portfolio restrictions: The Bolivian Law on Banking establishes that the portion of a financial entity’s portfolio backed by personal guarantees may not exceed twice the equity of the institution. A subsequent resolution in November 1993 further stipulates the exemption of loans for banking institutions that are equal to or less than US$2,000 or equal to or less than 1/1000 of the institution’s equity (US$600 in the case of BancoSol), whichever limit is greater.25 (See Chapter III for a more detailed discussion.)

BancoSol’s loan portfolio was US$35.1 million as of June 1996. Of this, 15 percent was in loans equal to less than US$500. The bank uses the solidarity group lending methodology in which a single large loan (average size of US$2,000) is disbursed to four to five people.

Rather than considering this as 4 to 5 smaller loans, the Superintendency counts it as a single larger loan, exceeding the US$2,000 limit set for unsecured lending. Given net equity levels of approximately US$7 million,

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24 Resolution of the various issues discussed in this section as presented by BancoSol to the Superintendency remains in progress. The Superintendency is working to examine the regulation of microfinance in Bolivia, taking into account all relevant institutions and the implications of any possible regulatory adaptations.

25 In order for this second qualification to appreciably increase the limit above $2,000, the financial entity would have to have $20 million in equity, clearly a qualification geared toward traditional commercial banks.
regulations allow for US$14 million in unsecured lending. BancoSol has approximately US$24 million in unsecured loans, which results in US$10 million, or 27 percent of the portfolio, in permanent noncompliance (BancoSol, 1996).

This restriction affects BancoSol as a microfinance intermediary far more significantly than it does traditional commercial banks, given microfinance lending technology and loan sizes. Though intending to reduce exposure to credit risk, this restriction does not take into account the viability and proven track record of the solidarity group lending mechanism.

The mechanism is furthermore backed by a financially viable institution with correct pricing policies, high-quality training of its staff, established relationships with its clients, structured repayment collection methods, and an image of permanence, yielding delinquency rates (contaminated portfolio) of 4.2 percent of the total portfolio as of May 1996, and negligible loan-loss rates. Demanding tangible guarantees undermines a basic characteristic of the microlending model. It furthermore blocks BancoSol’s clients from building a credit history and the potential ability to provide tangible guarantees in the future.

BancoSol understands this restriction as a measure intended to protect the interests of its thousands of clients. The bank argues, however, that this regulation results in unreasonable capital adequacy standards and restricts its financial leverage, directly limiting its portfolio growth and outreach, which in turn reduces profitability. BancoSol estimates that if it had complied with this resolution, it would have missed some 22,300 clients, which represents 35 percent of its total number of borrowers (BancoSol, 1996).

The Superintendency is aware of how this regulation limits BancoSol’s operations and is seeking alternatives. BancoSol has recommended that the Superintendency adapt the resolution to apply to those institutions serving the microenterprise sector by raising the threshold loan level from $2,000 to $10,000 and increasing the percentage of equity from 0.01 percent to 0.15 percent. The latter would result in a $10,500 maximum loan amount at present equity levels of US$7 million. As of this writing, the Superintendency had not yet determined the viability of this recommendation and is working with institutions serving the microenterprise sector to craft a broad-based solution.

**Documentation:** Client and loan documentation requirements can reduce the credit risk exposure of a financial institution by accurately assessing a client’s repayment potential. The process of information collection directly affects the efficiency and productivity of the loan officer. The Bolivian regulatory framework calls for detailed loan application requirements, which fall into four general areas: general personal
information; risk analysis data; financial information used to determine loan size and guarantee structure; and information related directly to each loan, such as individual credit history (BancoSol, 1996).

Though BancoSol recognizes and supports the need to gather and evaluate various sources of client and loan information, most of the required documentation is superfluous to a character-based rather than collateral-based lending methodology that relies on personal contact between loan officer and borrower. It is especially onerous where each loan officer is managing hundreds of loans; it ties loan officers to their desks when they need to devote maximum attention to client follow-up in the field.

Ease and flexibility of obtaining credit, which are fundamental elements in attracting microentrepreneurs to pay the necessary high interest rates, are also undermined. Operational costs of BancoSol, which are already much above traditional commercial banks, are further increased.

To address this issue, BancoSol has proposed the following guidelines for documentation relevant to microfinance operations. These include evaluating the economic and financial status of its clients at least once a year rather than with each disbursement; verifying the use of loans greater than US$3,000 only, rather than of all loans made; continually evaluating the risk assessment of a family unit but without the regulatory requirement of a signed affidavit by the spouse verifying their assets/liabilities, income/expenses, and methods of determination of these indicators; and maintaining adequate files of original documents according to the regulations (BancoSol, 1996).

**Loan classification system and provisioning:** The Bolivian system of classifying loans takes into account the size of the loan, the length of delinquency of the loan, the existence (or not) of a tangible guarantee, and the economic situation of the client. There are no distinctions made between consumer and business credit for the purposes of provisioning. Financial institutions are required to report their loan classification to the national credit bureau on a monthly basis.

Loans are separated into four groupings: (1) those equal to US$20,000 or more, (2) loans less than or equal to US$20,000 but more than US$5,000, (3) loans less than US$5,000 and a loan term equal to or greater than one month or payments that are monthly or less frequent, and (4) loans less than US$5,000 and a loan term less than one month or payments that are less than monthly.

Using the factors just listed, each loan is classified into one of five categories based on delinquency, with each category requiring a given level of provisioning as outlined in Table 7.

74
For unsecured loans of US$20,000 and more, regulations require 100 percent provisioning. As the Superintendent considers BancoSol’s group loans as single loans, the larger ones (comprised of 4 to 5 US$4,000 to US$5,000 loans) require 100 percent provisioning. In the case of Bolivia, loans of more than US$20,000 are to be evaluated by a regulator at least every six months. Loans equal to or less than US$20,000 are to be evaluated at least once a year.

**Write-offs:** For the first time in its four-year history, BancoSol has begun to write off unrecoverable loans. Given the nature of solidarity group lending -- small amounts backed by personal guarantees -- the legal costs of recuperating the losses can easily exceed the possible collected amount. In Bolivia, one set of procedures applies to loans equal to or less than $1,000, and another to loans above $1,000. For loans equal to or less than $1,000, regulations allow banks to avoid initiating a legal process and instead institute internal procedures. BancoSol has proposed packaging the nonperforming assets subject to an internal write-off approval process. The process will include a report and recommendation by the following individuals in order: loan officer, branch credit committee (signed by the branch manager), regional manager, loan administration management, and shareholder’s representative, followed by final approval by the board of directors.

For loans above $1,000, each case would be handled individually. BancoSol has presented two procedures for collection. The first is to initiate a judicial process. Once the debtors, the guarantors, and the judge have been notified,

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### TABLE 7

**BOLIVIAN SUPERINTENDENT’S RISK CLASSIFICATION AND Provisioning REQUIREMENTS**

<table>
<thead>
<tr>
<th>Classification of Loan</th>
<th>Number of Days Delinquent and Provisioning Requirement</th>
<th>Less Than US$5,000, and a Loan Term = &gt; 1 Month or Payments That are Monthly or Less Frequent</th>
<th>Less Than US$5,000, and a Loan Term &lt; 1 Month or Payments That are &lt; 1 Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Normal Loans</td>
<td>5 or less 0%</td>
<td>5 or less 0%</td>
<td>5 or less 0%</td>
</tr>
<tr>
<td>2. Potential Problem Loans</td>
<td>6-30 0%</td>
<td>6-30 0%</td>
<td>6-15 0%</td>
</tr>
<tr>
<td>3. Deficient Loans</td>
<td>31-90 10%</td>
<td>31-60 10%</td>
<td>16-30 10%</td>
</tr>
<tr>
<td>4. Doubtful Loans</td>
<td>91-180 50%</td>
<td>61-90 50%</td>
<td>31-60 50%</td>
</tr>
<tr>
<td>5. Lost Loans</td>
<td>&gt; 180 100%</td>
<td>&gt; 90 100%</td>
<td>&gt; 60 100%</td>
</tr>
</tbody>
</table>
a lawyer will prepare a detailed report with the documentation endorsing the
termination of the judicial action due to a lack of sufficient recourse. This
report will be evaluated by the regional manager who made the initial
recommendation and then presented to the shareholder’s representative
who previously brought the case before the board of directors.

The second option would avoid a judicial process and involves situations
in which the client receives an extension on a loan, documented in an
addendum to the original contract. Usual extensions are given for ninety
days in order to give clients a chance to pay before commencing legal
action. BancoSol is proposing a process that gives a total of 180 days to
allow for the erratic income streams of clients. If a payment has not been
made after the first ninety days, BancoSol will initiate a judicial process
for collection as outlined in the first option.

Branch openings: Monitoring the geographic scope of a financial
institution is another mechanism for managing the concentration of risk of
the portfolio. As outlined in Chapter I, a basic feature of microfinance is
the decentralized structure, which places the services closest to the
client’s place of business. Bolivian regulations for branching are based on
the centralized structure of traditional financial institutions. The
Superintendency authorizes the opening of agencies operating on a full-
time schedule that are expected to become full-scale branches.

There are many areas of Bolivia where there is a demand for financial
services but where BancoSol does not have a branch office. Initial
demand in any given area may not justify the systems and staff costs of
a full-scale branch office, which operates five days a week. Depending on
the size of the market and existence of competition (usually from NGOs)
in a given area, it may take one to two years to build up enough business
to cover the costs of operating a branch full time with conventional hours
and its own accounting capacity.

For BancoSol, there is no rationale for opening more branch offices
without achieving the break-even point. BancoSol has proposed two
options for overcoming this dilemma. The first is the authorization to open
mini-offices that operate on a specific part-time schedule, with accounting
and operations centralized in a nearby larger branch close to the new one.
This new office would be allowed to accept loan applications and disburse
loans, accept loan payments, open savings accounts, receive deposits,
pay out deposits, and close out deposit accounts.

The other option also involves opening a small office on a part-time
schedule with all of the functions just listed except it would be prohibited

26 Although BancoSol is currently interested in further penetrating the markets they now
serve, rather than broadening geographically, the bank nonetheless is interested in
the authorization to increase the number of regions it accesses in the future.
from accepting loan payments and opening savings accounts. It would also house its accounting and centralization of operations in the nearest branch office, and its hours would be determined by the branch office.

3. Providing Adequate and Appropriate Supervision

**Internal capacity of the Superintendency:** The 1995 Inter-American Development Bank (IDB) study discussed in Chapter I rated the quality and the quantity of Bolivia’s supervisory personnel as adequate for overall supervision of the financial sector (Westley, 1995). Among the Superintendency’s strengths is its ability to collect financial performance information from institutions.

It could, however, improve its analysis of this raw data. Trend analysis and comparisons between institutions would greatly help their managers. The Superintendency has some 100 employees, 40 of whom are inspectors responsible for monitoring a total of US$5 billion in assets. Currently, the Superintendency carries out both the auditing and examining functions. Auditing is based on the past and uses U.S. Generally Accepted Accounting Principles (GAAP). Examination is a future-oriented process and assesses such factors as the institution’s earnings and loan collection procedures.

Outside observers advocate for the Superintendency to transfer the auditing task to the private sector to alleviate some of the workload. While the agency has a cadre of trained and competent regulators, there are often delays in reporting the results of examination. As conditions can change rapidly within a financial institution, particularly a microfinance institution, timeliness of reports is critical.

In the meantime, steps have been taken to better equip the Superintendency to assess the progress of microfinance institutions. Bolivian regulators have received training in microfinance. USAID in Bolivia is currently funding an internal capacity-building project for regulators in both credit unions and microfinance.

**Internal capacity of BancoSol:** Originally, BancoSol inherited PRODEM’s high-quality custom-designed information system, which tracked loans, payment dates, and accounting records, allowing its loan officers to learn within a day which client groups were delinquent. This system did not, however, provide the necessary information required by the Superintendency. In preparation for the operational transition, PRODEM installed a new accounting system, as well as a parallel system to manage savings operations.

As the BancoSol operational structure has expanded into four regions and thirty-three branch offices, the process of consolidating information for purposes of reporting to the Central Bank and the Superintendent’s office has become more complicated.
At the end of each day, the regional offices receive information from their branches, which they consolidate and send into the national office in La Paz the following morning. Until recently, the accounting department then manually consolidated the regional data to send on to the supervisory agencies.

This was not only inefficient but also subject to human error. Flexibility and integration are now required of the management information system (MIS). BancoSol identified and is in the process of installing a new system designed for banks and based on four factors:

1. installation can be completed in modules
2. all components can be fully integrated
3. the system will produce valuable, accurate, and timely information, and
4. the system will make available efficient technical support.

The savings module is the first to be installed and has been completed in 85 percent of the bank. The accounting module is in the pilot phase in the central office, while the other modules are scheduled for installation in the next ten months. The new system will capture more information about each client and allow for greater sophistication in tracking important financial ratios. The greatest challenge in adapting the system to microfinance is enabling it to manage solidarity group lending.

**Capital adequacy requirement:** BancoSol is required to maintain a ratio of capital to risk-weighted assets of 10 percent as established for all Bolivian financial institutions in October 1995. This ratio is 2 percent above the 8 percent level set by the Basle Accords and institutions have until 1998 to come into compliance.

Assets are grouped into six categories according to the relative liquidity of the asset and exposure to risk: cash, investments, loans guaranteed by mortgages or liens (real guarantees), loans without real guarantees, past-due loans, and loans in legal recovery.

The associated risk for each category is expressed in terms of a percentage coefficient, which determines the amount of the asset that must be considered in determining the required level of capital the institution must maintain. The larger the risk profile of assets, the higher the requirement of reserve capital to offset it. Table 8 is the computation of BancoSol’s capital adequacy in May 1996.
<table>
<thead>
<tr>
<th>Category</th>
<th>Classification</th>
<th>Active Portfolio</th>
<th>Percentage of Total Portfolio</th>
<th>Risk Coefficient</th>
<th>Risk-Weighted Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category I</td>
<td>(Cash)</td>
<td>Assets at 0% risk</td>
<td>12,632,284</td>
<td>5.5%</td>
<td>0</td>
</tr>
<tr>
<td>Category II</td>
<td>(Investments)</td>
<td>Assets at 20% risk</td>
<td>11,806,691</td>
<td>5.2%</td>
<td>2,361,338</td>
</tr>
<tr>
<td>Category III</td>
<td>(Loans Guaranteed by Mortgage or Lien, Real Guarantees)</td>
<td>Assets at 50% risk</td>
<td>5,365,010</td>
<td>2.3%</td>
<td>2,682,955</td>
</tr>
<tr>
<td>Category IV</td>
<td>(Loans without Real Guarantees)</td>
<td>Assets at 100% risk</td>
<td>154,652,227</td>
<td>85.2%</td>
<td>194,952,227</td>
</tr>
<tr>
<td>Category V</td>
<td>(Past-Due Loans)</td>
<td>Assets at 150% risk</td>
<td>3,252,113</td>
<td>1.4%</td>
<td>4,878,170</td>
</tr>
<tr>
<td>Category VI</td>
<td>(Loans in Legal Recovery)</td>
<td>Assets at 200% risk</td>
<td>710,064</td>
<td>0.3%</td>
<td>1,436,128</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td></td>
<td></td>
<td>226,732,989</td>
<td></td>
<td>206,315,818</td>
</tr>
</tbody>
</table>

8% of Risk Weighted Assets¹  
Net Equity  
Excess/Deficiency in Equity  
Actual Capital Adequacy

¹ BancoSol has until 1996 to comply with the 10 percent capital adequacy level.
BancoSol’s assets are concentrated in Category IV, or in solidarity group loans, which the Superintendency considers to be unsecured loans without real guarantees. As discussed in the section on protecting the quality of the loan portfolio, this classification and corresponding risk weighting of 100 percent heavily penalize BancoSol in the computation of its capital adequacy level. Currently this does not pose a problem as BancoSol is still significantly underleveraged at a capital adequacy level of 17.38 percent (as compared to the required 8 percent).

**Reporting requirements:** As mentioned earlier, the supervisory structure requires all Bolivian financial institutions to submit reports on a daily, weekly, ten-day, monthly, quarterly, thrice yearly and yearly basis. These reports constitute the off-site monitoring of the bank’s operations and should serve as an early warning system in case of a problem. Table 9 lists these requirements.

### TABLE 9

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Daily</td>
<td>• Funds captured&lt;br&gt;• Average interest rates</td>
</tr>
<tr>
<td>Weekly</td>
<td>• Interbank operations&lt;br&gt;• Reserve requirement&lt;br&gt;• Total deposits by contractual maturity</td>
</tr>
<tr>
<td>Every 10 Days</td>
<td>• Liquidity levels</td>
</tr>
<tr>
<td>Monthly</td>
<td>• Credit bureau&lt;br&gt;• Financial statements (Consolidated and disaggregated by regions and by branches)&lt;br&gt;• Consolidated adjustments&lt;br&gt;• Verification of legal financial requirements (Compliance with financial ratios)&lt;br&gt;• Fluctuations in share price&lt;br&gt;• Risk-weighted asset report</td>
</tr>
<tr>
<td>Quarterly</td>
<td>• Changes in financial situation&lt;br&gt;• Changes in equity&lt;br&gt;• Notes to financial statements&lt;br&gt;• Statement of institutional compliance (Regarding labor laws, taxes, etc.)&lt;br&gt;• Quarterly financial information</td>
</tr>
<tr>
<td>3 Times per Year</td>
<td>• Loan portfolio classification&lt;br&gt;• Board meeting minutes&lt;br&gt;• Breakdown of deposits by size&lt;br&gt;• Liquidity management policies</td>
</tr>
<tr>
<td>Yearly</td>
<td>• External auditing report&lt;br&gt;• Published audited financial statements&lt;br&gt;• Annual report&lt;br&gt;• Published list of shareholders</td>
</tr>
</tbody>
</table>
Internal control mechanisms: BancoSol created an internal auditing department in the beginning of 1996. Up to this point, the bank used an outside firm to conduct its required internal audit. Although in the early stages of development, this department, which consists of a manager and three assistants, has in place several critical elements that will enable it to operate effectively and efficiently. These include procedural manuals to complete an internal audit, detailed workplans, and a schedule of yearly examinations to be carried out throughout the bank. As BancoSol’s internal control mechanism strengthens, so too will its ability to ensure the sound management and governance of the bank.

Compliance: For the most part, BancoSol has not experienced major issues of compliance with the exception of those outlined in earlier sections. Minor infractions have included delays in submitting reports or inconsistencies with the deposit reports and in these cases the Superintendency levies a small fine. Overall, BancoSol is strong in this area. In fact, when the Superintendency ranked Bolivian commercial banks by noncompliance, BancoSol appeared in the better half of the group.

C. COSTS AND BENEFITS OF REGULATION AND SUPERVISION

Any process of imposing structure on an operation carries associated costs and benefits. The net of the two determines whether such a move adds overall value. In the case of BancoSol (and to a great degree, any NGO microfinance institution considering institutional transformation), becoming a private commercial bank brings with it significant costs and several expected and unexpected benefits. Implicit in the process of becoming a regulated financial institution is the concept of growth. Managing this growth also has various costs and benefits, which are inextricably linked with the costs and benefits of regulation and supervision.

1. The Costs

The major costs with respect to the impact of regulation and supervision occurred in four areas: systems, staff, security, and changes in institutional culture. Changes made to most of these components also have associated benefits.

Systems: The initial process of upgrading the PRODEM systems cost BancoSol US$40,000. BancoSol estimates that the total cost of the new management information system may be as much as US$1.5 million upon completion. Increasing the internal capacity of BancoSol, and thereby enhancing the supervisory process, is most directly accomplished by improving MIS. The availability of accurate and timely financial performance information, analysis of current trends, and provision of future projections is of crucial importance to the efficient and safe operations of any financial institution. It allows institutions to assess their cost structure and understand how to manage risk.
Of critical importance to microfinance institutions disbursing credit, this information allows them to effectively track their portfolio and quickly identify delinquency. It takes on even greater significance in the case of an intermediary that is also capturing demand deposits. The complexities of this asset/liabilities management, as well as assessing credit, liquidity, and interest rate risk, require hardware and software systems designed to manage and produce the relevant data for management. This MIS should also enable management to consolidate and disaggregate data from its regional and branch operations.

**Staff:** Historically, the management and credit officers of most NGO microlending institutions have experience in the development field, or perhaps formal training in social science fields such as sociology and anthropology. These are fundamental skills in a field whose success of operations depends on building strong, trusting, personal relationships with clients and their communities. Increased financial complexity, however, has required increased financial skills, as well as a conceptual change among the staff as they assume greater fiduciary responsibility. An institution can train from within and hire from outside. Both approaches are expensive, as the market dictates a relatively high salary rate for professionals with financial skills. Training is also important to motivate staff and maintain clear institutional objectives.

Changes at BancoSol were also required in absolute numbers to manage the growth in outreach. In December 1992, ten months after commencing operations, the staff totaled 146. By the middle of 1996, the number had increased to 474.

**Security:** As a primary objective of prudential regulation and supervision is to protect depositors, physical security is of paramount importance. BancoSol was required to purchase vaults, hire and arm guards (who, in Bolivia, are members of the police force), and install building and teller alarm systems. In addition to the monetary costs it presents, increased security has a contextual effect. On the one hand, it instills confidence among the clients that their money is protected in the formal system. On the other hand, this increased formality may be intimidating for men and women who operate in the informal sector.

**Changes in institutional culture:** This is a less quantitative cost and has both internal and external implications. Internally, even with PRODEM’s rapid growth in staff, the institutional culture was highly familial. The general manager had a personal relationship with almost every staff member and with many of the clients. This base of mutual respect and trust created a sense of ownership of the institution by all its staff members and directly contributed to its long-term sustainability. Growth inevitably creates formality and distance between the top and bottom
rungs of the ladder. Though still much less rigid and hierarchical than Bolivia's commercial banks, BancoSol has moved along the continuum of formality away from the familial culture of PRODEM.

2. The Benefits

Expected benefits of regulation and supervision include the ability to mobilize savings, offer additional financial products, and provide access to international capital markets. Unexpected benefits were the imposed discipline on the bank’s MIS, auditing requirements, and the use of the financial sector’s credit bureau.

Mobilizing savings and offering additional financial products: BancoSol began its savings program in 1992 as it began operations. There were four stages planned: pilot project, expansion, consolidation, and market penetration. The pilot project tested three products: a more liquid savings account (cuenta libre), a money-market-type account (cuenta capital), and a fixed-term deposit account (depósito de plazo fijo). Each of the first two accounts is available in both Bolivianos and dollars. The fixed-term account is only available in dollars. In 1995, BancoSol expanded the savings program from two to twelve branches. A major challenge for BancoSol was to overcome the perception created by the forced savings program of PRODEM. Clients were required to place a certain percentage of their loan, creating a compensating balance for the institution. This mechanism became tied to the client’s ability to receive credit. The inactive accounts in Table 10 have been so for the previous twelve months. Although it is difficult to determine the reason behind the inactive accounts, BancoSol suspects these clients are holding a savings account because they believe it is necessary to obtain credit. BancoSol has made a variety of adjustments to simplify their savings instruments.

### TABLE 10

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Active Portfolio</td>
<td>$35</td>
<td>$33.7</td>
<td>$26.3</td>
<td>$26</td>
<td>$13.5</td>
</tr>
<tr>
<td>Voluntary Savings</td>
<td>$6.6</td>
<td>$6.6</td>
<td>$5.2</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Inactive Accounts</td>
<td>$0.56</td>
<td>$0.49</td>
<td>$0.83</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Total Accumulated Savings</td>
<td>$8.7</td>
<td>$7.1</td>
<td>$6</td>
<td>$4.9</td>
<td>$2.6</td>
</tr>
<tr>
<td>% of Portfolio Financed by Savings</td>
<td>25%</td>
<td>21%</td>
<td>22%</td>
<td>19%</td>
<td>19%</td>
</tr>
</tbody>
</table>

Accessing additional sources of capital: As mentioned previously, within the first few years of operation PRODEM had outstripped donor-backed sources of commercial capital. As a bank, BancoSol’s position in obtaining foreign sources of capital was fundamentally changed. In 1994,
BancoSol successfully placed its first certificate of deposit (CD) in the U.S. capital market with the investment management company Scudder, Stevens & Clark for US$500,000. Later in 1994, a religious partnership, Partners for the Common Good, 2000, purchased a $250,000 certificate of deposit, followed in 1995 by the Bank of Boston ($500,000), Calvert Social Investment Fund Managed Growth Portfolio ($260,000), and Calvert World Values Global Equity Fund ($260,000).

Several individual investors have also purchased BancoSol CDs since then. Investor support by recognized financial institutions has great significance for the movement toward establishing full financial intermediation for the microenterprise sector. Becoming a bank also allowed BancoSol to access capital on behalf of the microenterprise sector through interbank facilities and through bonds placed in the domestic and international capital markets (Gonzalez-Vega, et al., 1996). What is now a novel idea may in time become an accepted part of the financial systems of Latin America.

**Improved organization of client files:** The requirements of regulation included portfolio auditing and reporting that forced greater rigor onto the management of client files. As the number of clients and loans continued to climb and regulators needed to classify the risk associated with these loans, a much higher level of organization was required. The extent to which the Superintendent of Banks had confidence in BancoSol’s systems -- both computer and hard copy -- and the system’s ability to act as an internal early warning mechanism directly affected their willingness to exercise a measure of flexibility in the supervisory process.

**Auditing requirements:** Audits have several important purposes: to uncover any financial weaknesses, to detect fraud, and to legitimize an institution in the eyes of outside investors. The board of directors and executive management use the information provided to shape short- and long-term strategic planning. On a yearly basis, banks in Bolivia are required to have an internal and external audit of their operations. The Superintendency of Banks completes an additional audit of financial institutions on a random basis. Using a lottery system, every institution is supposed to receive this third audit at least once every two years. In the case of BancoSol, audits have been instrumental in establishing its legitimacy as a formal institution that serves a sector of the population other banks had never considered viable.

**Credit bureau:** The Bolivian Credit Bureau (la Central de Riesgos) consolidates information on the delinquency status of borrowers in the system, preventing individuals who owe money to one institution from taking out loans from another if they have not repaid the first. At first
glance, BancoSol did not see the value in providing information for the credit bureau, as staff believed it was highly unlikely that any of their current or potential clients were borrowers from other institutions in the formal financial sector. In the early days of BancoSol, few clients appeared on the monthly list provided by the Superintendency. Over a period of one month, however, the list expanded to nearly 100 names as a result of the closing of several state-owned institutions. The credit bureau quickly became a useful tool for BancoSol’s operations. Other benefits of regulation for BancoSol include the possession of a bank charter in a financial system that severely limits competition (Gonzalez-Vega, et al., 1996). This has importance because if the Superintendency of Banks were approached today to approve a BancoSol, it would likely deny the application. This is not because authorities no longer support BancoSol’s mission or operations, but rather because the Superintendency believes that the bank structure, with all of its financial capacity, far exceeds the needs of a microfinance operation. The evolution of this thinking was the creation of the PFFs.28

Though BancoSol is perhaps at a regulatory disadvantage as it struggles to fit its microlending operations into a conventional commercial bank structure, it does maintain a competitive advantage over other Bolivian institutions, NGOs, and nonbank financial institutions involved in microfinance given the range of operations in which it is allowed to engage. Most important, BancoSol has the unlimited ability to capture savings, including demand deposits. The PFFs, in contrast, are limited to savings accounts and fixed-term deposits.

D. COMPETITION IN THE MICROENTERPRISE SECTOR

The creation of BancoSol occurred at a time when microfinance in Bolivia was known only to those in the NGO sector and a small group of visionary private sector leaders. The sole regulated legal framework was the commercial bank structure. The creation of the specialized PFFs, as outlined in Chapter III, represents the emergence of regulated competition for BancoSol. Additional competition comes from the many NGOs serving the microenterprise sector in Bolivia and, to a lesser degree, some credit unions. All of these institutions, including BancoSol, possess a competitive advantage over any other regulated institutions that might consider entering the microenterprise market. They understand their market after many years of work, they have a proven lending technology, and they operate with a decentralized structure necessary for efficient operations. What BancoSol maintains over the others, however, is market share, potential economies of scale and scope, and the unlimited ability to capture savings.

28 See Chapter III for further discussion of the Bolivian Private Financial Funds and Chapter V for more information on Caja de Ahorro y Préstamo Los Andes, the first and still only PFF to serve the microenterprise sector.
Commercial banks in Bolivia still have not entered the microenterprise sector. Most believe that for the near future this will remain so, as the focus will be on the consolidation of the Bolivian commercial banking sector. Traditional banks are more interested in broadening their reach within their own markets to lending to large businesses and expanding into consumer credit. It is expected that over time, as BancoSol garners increased confidence and as industry regulations such as portfolio restrictions and rules governing write-offs are adapted to accommodate the distinct needs of microfinance, commercial banks will seriously focus on reaching the individuals and enterprises they have previously ignored. To do so, they will have to purchase the methodology and make changes in their centralized operational structure.

E. BANCOSOL’S IMPACT ON THE BOLIVIAN FINANCIAL SYSTEM

The establishment and successful management of BancoSol has had a significant impact on existing attitudes and perceptions about the Bolivian informal sector. Though highly successful, PRODEM, as an NGO, lacked the financial legitimacy to effect this fundamental change in the minds of large segments of the financial sector. BancoSol has demonstrated convincingly that serving the microenterprise sector can be profitable. It has elevated the client’s personal promise to pay to a guarantee mechanism for lending.

Whether or not Bolivian commercial banks eventually serve this market, they are certainly much more inclined to lend to microentrepreneurs once they have “graduated” into a commercial bank’s minimum lending categories. BancoSol has opened the doors of access to credit for the self-employed poor. In a country where the typical BancoSol client was not allowed to enter into a formal bank a few years ago, this change cannot be underestimated. The creation of BancoSol also led directly to the creation of the PFF structure, which should expand access more quickly to the poor. The Superintendency as well as others involved in the PFF process anticipate the establishment of approximately five to seven PFFs over the next five years. The experience in establishing BancoSol educated the Superintendency about the practice of microfinance and made the microenterprise sector significantly more transparent.

As discussed earlier, various issues remain outstanding and in this sense BancoSol has been the laboratory for the regulation and supervision of microfinance in Bolivia and in the rest of the world. Nevertheless, the Superintendent of Banks and BancoSol have worked together to establish a regulatory framework for BancoSol while staying focused on the underlying principles of prudential regulation and supervision. This process is bringing important advances in regulating and supervising microfinance and serves as a useful model for other countries.
CHAPTER V

OTHER MICROFINANCE INSTITUTION EXPERIENCES WITH REGULATION

by Rachel Rock with Carlos Castello and Vivienne Azarcon
A. ACCION COMUNITARIA DEL PERU: BECOMING AN EDPYME

In 1995, Peruvian banking regulations were modified to provide for a new legal structure called EDPYME (Entidad de Desarrollo para la Pequeña y Microempresa or Small Business and Microenterprise Development Institution) that allows nongovernmental organizations (NGOs) involved in microfinance to become regulated financial institutions. Acción Comunitaria del Perú (ACP), ACCION International’s affiliate in Peru, has received approval to establish an EDPYME, which will be known as ACCIONSOL. ACP expects to transfer its microcredit operations to ACCIONSOL in 1997.

1. Emergence of a New Institution

ACP was founded in 1969 by several prominent Peruvian business leaders. Originally established as a community development organization, ACP launched a microcredit program in 1982. ACCION provided technical assistance while financial support came from Banco Wiese, one of Peru’s largest banks, the Inter-American Development Bank (IDB), and the Inter-American Foundation. ACP’s portfolio grew quickly in the first few years; however, it was seriously undermined by the disastrous fiscal, monetary, and foreign exchange policies of the Alan Garcia government. By August 1990, with inflation rates as high as 2,700 percent, the value of ACP’s US$2 million loan portfolio shrank to US$27,000.

The economic environment had stabilized substantially by 1991, and ACP initiated an aggressive expansion plan. By December 1994, the institution’s loan portfolio stood at US$2.3 million, increasing to US$6.7 million by December 31, 1995. With an average loan term of eight weeks, the organization disbursed a total of US$39 million in 1995, reaching over 19,000 clients in the Lima vicinity and yielding a delinquency rate (defined as portfolio at risk over thirty days/total portfolio) of 2.5 percent.

As with other NGO microfinance institutions, ACP considered becoming a regulated financial institution to increase its access to capital to fund continued growth. Despite ACP’s increased outreach, it is only covering about 1.6 percent of the needs in the Lima-Callao area. Approximately 70
percent of ACP’s loan portfolio has been funded through retained earnings, with the remainder of the portfolio provided by local commercial bank lines from Banco Wiese and other Peruvian banks.

The structure under consideration during initial meetings in June 1994 had been a finance company (financiera) which has the ability to capture savings and a minimum capital requirement of US$2.67 million. The minimum capital requirement to become a bank in Peru is US$5.87 million.  

29 The process of establishing a finance company appeared protracted and complex, due in part to the Superintendency’s lack of experience in supervising entities specializing in microenterprise. Consequently, in mid-1994 the Peruvian development bank COFIDE 30 proposed the EDPYME framework to meet the financing needs of small and microenterprises. In December 1994, the Superintendency authorized the creation of the EDPYMEs, and additional regulations governing operations were issued in 1995.

2. The EDPYME Framework

The minimum capital requirement for an EDPYME is US$265,000, and prospective organizers of an EDPYME must submit a feasibility study incorporating a market survey of the past three years in the relevant geographic area, as well as three years of financial projections. ACP’s three-year goals for the credit program are to achieve 12 percent market share, as well as to have twenty offices in the Lima area and five branches outside the metropolitan area. The portfolio to be transferred to ACCIONSOL in December 1996 is approximately $6 million; three-year internal projections estimate an increase in equity to $22.8 million (3.8 times current equity).

In response to the Superintendency’s concern about ownership of a financial institution by an NGO, ACP’s board of trustees is named as the owner of the portion of shares held by ACP. ACP will become the major shareholder of ACCIONSOL, with Profund S.A. and ACCION International also participating as shareholders. Eventually 10 percent of ACCIONSOL’s shares will be offered to third parties, including employees and directors of ACCIONSOL, and will be listed on the Lima stock exchange.

EDPYME’s institutional objective is the provision of financing to persons engaged in small or microbusiness activities. The law defines small businesses as having assets less than or equal to US$300,000 and/or

29 In Bolivia, the minimum capital requirement for private financial funds (PFFs) is US$1 million and for banks, US$3.2 million. See Chapter III for more detail on this specialized legal structure.

30 COFIDE (Corporación Financiera de Desarrollo, or Development Finance Corporation) is the government agency that channels resources to micro and small businesses through financial intermediaries.
annual sales less than or equal to US$750,000; microbusinesses are defined as having assets less than or equal to US$20,000 and/or annual sales less than or equal to US$40,000.

As EDPYMEs, microfinance institutions will be able to access capital markets, additional bank funding, and special rediscount credit facilities from COFIDE. In order to access the capital markets, however, an EDPYME is required to register with CONASEV 31 and submit unaudited financial reports every semester, in addition to the year-end audited financial statements. Regulations also allow EDPYMEs to use real guarantees as security to access a line of credit. Previously, these guarantees could only be used to secure a loan. As a first step to accessing new sources of capital, ACCIONSOL plans to issue fixed-income securities in the Peruvian market.

In principle, EDPYMEs are authorized to accept various forms of deposits from the public. The resolutions do not specify what types of deposits are acceptable or how these savings services are to be regulated, but simply states that EDPYMEs must obtain authorization from the Superintendency. The access to COFIDE’s lines of credit, however, diminishes the motivation to increase funding through savings. Under its current status as an NGO, ACP cannot capture deposits, and it does not plan to do so in the near future as an EDPYME. The only other EDPYME formed to date -- INPET -- also currently does not capture deposits.

Those involved in the process of developing regulations and operational systems for the EDPYMEs have attempted to ensure that the supervisory requirements reinforce operational efficiency while taking into account the characteristics that distinguish microcredit programs from traditional banking. Following are some of the most significant areas of regulation as currently incorporated into the EDPYME structure.

• EDPYME’s total liabilities are limited to no more than ten times its net equity.

• EDPYMEs are required to submit various reports to the Superintendency, which include daily treasury reports indicating liquidity levels, weekly statements of the balances carried forward, monthly financial statements, and portfolio quality reports every four months. The EDPYME is subject to regular annual inspections and special inspections according to criteria determined by the Superintendency.

• No new loan application requirements have been imposed on ACP’s previous requirements for any loans below US$10,000, or for any loans below the stipulated limit of 5 percent of net equity. ACP does not

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31 CONASEV stands for Comisión Nacional Supervisor de Empresas y Valores (or National Commission for Businesses and Stocks) equivalent to the SEC in the United States. CONASEV regulates the placement of securities in the commercial market.
foresee that client relationships will be affected when it transfers its portfolio to ACCIONSOL.

- The loan loss reserve requirement is equivalent to 25 percent of capital. At least 10 percent of after-tax profits must be transferred to this reserve annually.
- EDPYMEs are subject to a 30 percent tax on income.
- The institution must request authorization prior to opening new branches.
- Provisioning requirements are as follows: The Superintendency considers the microcredit of an EDPYME as commercial credit. ACP has already implemented stricter provisioning requirements as part of the process of adapting its activities to the standards defined by the Superintendency. The portfolio is evaluated on a monthly basis. The categories in Table 11 apply to the portfolio outstanding as of September 30, 1996.

   **TABLE 11**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Days Delinquent</th>
<th>Provisioning.a</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Required for Consumer Credit</td>
<td>Required for Commercial Credit</td>
</tr>
<tr>
<td>1. Normal Loans</td>
<td>7 days or less</td>
<td>0%</td>
</tr>
<tr>
<td>2. Potential Problem Loans</td>
<td>8-30</td>
<td>3%</td>
</tr>
<tr>
<td>3. Deficient Loans</td>
<td>31-60</td>
<td>30%</td>
</tr>
<tr>
<td>4. Doubtful Loans</td>
<td>61-90</td>
<td>60%</td>
</tr>
<tr>
<td>5. Lost Loans</td>
<td>&gt; 90</td>
<td>100%</td>
</tr>
</tbody>
</table>

a The percentage is taken from the loan amount, which is equal to the total of capital and interest for the installments already due plus the installments still to be paid. For the purpose of determining the category to which a loan belongs, the reference point is the oldest past-due installment.

ACP has hired a chief accountant (formerly of a commercial bank) to prepare the reports and documents requested by the Superintendency and a new internal auditor to design its control procedures. In addition, ACP has established a new management information system, which includes a client-tracking database containing all portfolio information, accounting
software designed to comply with the Accounting Plan (Plan de Cuentas) instituted by the Superintendency, and a software package for monitoring payroll and fixed assets.

From the start, the process of establishing the EDPYMEs has drawn upon the joint efforts of the Superintendency and the NGOs. The Superintendency has solicited input from ACP and other organizations as it develops the regulations that will govern the new entities. It has requested such items as copies of the manuals and procedures employed in the field by the NGOs to use as models. ACP has anticipated many of the changes that are required of EDPYMEs by putting the infrastructure in place while still an NGO. It has hired key staff with extensive financial sector backgrounds to design its control procedures and prepare reports for the Superintendency.

The legal framework leaves some issues, such as savings mobilization, unresolved, under the assumption that both the Superintendency and the new institutions will develop these areas as they gain experience. This provisional legislation takes into account that the government and the microfinance institutions need room to grow and opportunities to learn from each other, and it underscores the need for open channels of communication so that any subsequent regulations promote the sustained growth of the microenterprise sector without compromising the stability of financial markets.

Finally, ACP believes that the minimum capital requirement for EDPYMEs is too low and will allow many weak lending institutions into the market. Although ACP has enough capital to establish a finance company, the EDPYME structure will allow for a period of transition to regulation. With experience as an EDPYME, ACP expects to become a finance company and eventually a commercial bank.

B. FINANSOL: SUPERVISING CRISIS

Over the past year, Finansol, a regulated microfinancial intermediary in Colombia and an affiliate of ACCION, experienced a crisis that caused severe deterioration of portfolio quality. With the assistance and collaboration from both the private and nonprofit sectors, ACCION developed and implemented a recovery plan. This section will analyze this crisis from the regulatory perspective.

1. Origins

Finansol grew out of ACTUAR Bogotá, an NGO created in 1987 by influential Colombian businesspersons with the technical assistance of ACCION International. From its inception, ACTUAR Bogotá grew at a dramatic rate. In 1989, it provided integrated training and access to credit to 3,000 microentrepreneurs, an outreach that increased to 25,000 by the end of 1992. ACTUAR Bogotá was also one of the first microlending institutions to initiate
its lending activities by obtaining lines of credit from commercial banks, initially through the personal guarantees of the founders, and afterward through guarantees from ACCION’s Bridge Fund and from FUNDES, a Swiss-based foundation. However, these different sources of capital were insufficient to sustain the institution’s rapid growth. By 1992, ACTUAR Bogotá began to explore ways to tap directly into financial markets by forming a regulated financial intermediary.

After examining the feasibility of a number of options, ACTUAR Bogotá decided ultimately to purchase a commercial finance company (CFC), to be named Finansol. Not only would ACTUAR Bogotá avoid raising the large minimum capital requirement (US$13.7 million at that time) to create a bank along the lines of Banco Solidario, S.A. (BancoSol), in Bolivia, but it could purchase an existing CFC license and begin operations immediately. Upon establishing Finansol, ACTUAR Bogotá changed its name to Corposol and, until recently, held 71 percent of the shares of Finansol. Other founding members of Finansol were the Corporacion Financiera de Desarrollo, a national development bank subsequently privatized, with 7 percent; ACCION, Calmeadow, and FUNDES with 4 percent each; and individual Colombians holding the remaining 10 percent. In 1995, ACCION, Calmeadow, and FUNDES transferred a portion of their Finansol shares to ProFund.

2. Emergence of a Crisis

In early 1995, Finansol’s loan portfolio quality began to deteriorate. Several factors contributed to the emergence of the crisis. First was the relationship between Corposol and Finansol, in which Finansol lacked the ability to control its loan placement and the will to conduct independent action. Second was a growth-at-all-costs management strategy that resulted in major deviations from the well-tested methodology of microenterprise credit and in the introduction of a variety of new lending products without proper staff training. Third was poor decision making by management in response to changes in banking regulations.

In 1994, the Colombian government, as part of a monetary policy used to contain inflation, had limited the asset growth of regulated financial institutions to 2.2 percent per month -- an extremely low figure considering that annual inflation was in excess of 20 percent. Finansol was immediately affected, but as an NGO, Corposol was not. It became expedient for Corposol to retain a portion of the loans to permit the combined portfolio to grow at a faster rate than permitted by the regulated system. Thus began a practice of shifting portfolios between institutions that lacked transparency and misrepresented their financial positions.

Finansol’s presentation of information to the Superintendency was not always accurate, as management made a very conscious effort to avoid full disclosure of the deterioration of the portfolio by engaging in major
refinancing efforts with delinquent loans. Until mid-1995, management stayed permanently in contact with the Superintendency with the purpose of falsely assuring the authorities that problems with the portfolio were being addressed successfully. Although the Colombian Banking Superintendency was aware of the deterioration in asset quality, its lack of knowledge about microfinance prevented it from understanding all of the reasons behind the increase in loan arrears.

Colombian regulations governing loan classification shaped the evolution of this crisis. Small loans are classified as consumer loans, regardless of their use. As a result, all the microenterprise credit provided by Finansol is considered consumer credit. Late payments were therefore subject to provisioning requirements that had to be implemented much more quickly than those that apply to conventional business loans provided by the banking sector. As an NGO, ACTUAR Bogotá would have had much more flexibility in terms of provisioning for bad loans. Likewise, the negative effects on the profit and loss statement would not have become apparent so quickly.

Finansol was forced to absorb these rapid losses and, as a supervised financial institution, came very close to having its operations intervened in by the banking authorities. Indeed, due to the fact that those losses represented more than 50 percent of paid equity at the beginning of 1996, the institution, under orders from the Superintendency, had to suspend lending operations by June of that year. (See Table 12).

### TABLE 12

**FINANCIAL IMPACT OF THE FINANSOL CRISIS**  
(In Millions of Colombian Pesos)

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1995 (US$1.00 = P 987.65)</th>
<th>July 31, 1996 (US$1.00 = P 1,056.74)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>36,540</td>
<td>17,042</td>
</tr>
<tr>
<td>Provision</td>
<td>(1,520)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>55,084</td>
<td>32,015</td>
</tr>
<tr>
<td>Deposits</td>
<td>35,528</td>
<td>22,583</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>12,400</td>
<td>9,307</td>
</tr>
<tr>
<td>Equity</td>
<td>7,156</td>
<td>125</td>
</tr>
<tr>
<td>Interest Revenue</td>
<td>12,653</td>
<td>7,032</td>
</tr>
<tr>
<td>Financial Expense</td>
<td>(11,621)</td>
<td>(6,705)</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>(3,026)</td>
<td>(7,930)</td>
</tr>
<tr>
<td>Net Income</td>
<td>(1,994)</td>
<td>(7,603)</td>
</tr>
</tbody>
</table>
This would not have been the case for an NGO, since it could have applied a less stringent provisioning policy and could have depleted most of its equity without having to halt its lending operations. The short-term nature of the funding sources certificates of deposit.

This monograph has argued that microenterprise lending institutions should be supervised with similar or greater rigor than other financial entities, although requirements should be adjusted to take into account the particular characteristics of these types of loans. The imposition of provisioning policies created for consumer credit is often cited as unfair for microlending. Given how quickly a poorly managed microenterprise credit portfolio can deteriorate (because of the nature of the methodology and loan products provided) and the fact that operating costs tend to be quite high in microenterprise lending when compared with conventional credit operations, rapid provisioning may indeed be desirable. It would force management to face a deteriorating portfolio with the required sense of urgency. Indeed, in the case of Finansol it is open to question if slower loan provisioning would have delayed the actions that were taken to turn around the institutions and, if so, whether it could have been rescued.

The Finansol experience demonstrates that the lack of knowledge of banking authorities regarding microenterprise can clearly undermine effective supervision. Special regulations do not substitute for a lack of expertise by regulators. This implies that, in the future, banking authorities may need to develop in-house expertise on microenterprise lending. In Colombia, the Superintendency already has specialized departments for different types of financial institutions (banks, finance companies, savings and housing institutions, and so on). If and when more financial institutions become involved in microenterprise lending, the need for specialized units to supervise them may be justified.

C. CAJA DE AHORRO Y PRESTAMO LOS ANDES: THE FIRST BOLIVIAN PRIVATE FINANCIAL FUND

In July 1995, Caja de Ahorro y Préstamo Los Andes (Los Andes) was established as the first Bolivian Private Financial Fund (PFF).32 It remains the only PFF lending to the microenterprise sector. Los Andes grew out of the nongovernmental microlender PRO-CREDITO, with the technical assistance of the private consulting firm IPC as financed by the German development agency GTZ. The establishment and evolution of BancoSol, as discussed in Chapter IV, demonstrated the need for a specialized legal framework for regulated microfinance. Rather than authorize as commercial banks other NGOs interested in entering the regulated financial sector, the Bolivian Superintendent of Banks created the PFF in April 1995.

32 The full set of regulations governing the PFF is discussed in Chapter III.
1. The Legal Framework

The basic regulations governing PFFs are as follows:

- Minimum capital required is US$1 million. The majority of the total paid-in capital to Los Andes of US$600,000 came from PRO-CREDITO.33
- To legally reduce the tax impact on a newly established PFF, organizational costs incurred up to US$64,000 may be deferred to future years. Los Andes did not defer any of its start-up costs.
- Consistent with the general Bolivian financial sector regulations, capital adequacy standard is set at 8 percent currently, with a requirement to adjust it to 10 percent by 1998.
- PFFs can access funds from the public through savings and term deposits and from second-tier institutions.
- PFFs are authorized to make loans with security pledges in the form of movables, jewels, and other valuables, a form that is hardly used in the Bolivian financial system today.
- Los Andes is required to provision according to the norms established by the Superintendency of Bolivia.34 In addition, it chooses to provision a more conservative amount in Category 4 of 100 percent when it is required to provision only 50 percent. (See Table 13).

### Table 13

<table>
<thead>
<tr>
<th>Classification</th>
<th>Los Andes Provisioning (Number of Days Delinquent – Provisioning Requirement)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less Than US$20,000 and Greater Than US$5,000</td>
</tr>
<tr>
<td>1. Normal Loans</td>
<td>5 or less</td>
</tr>
<tr>
<td>2. Potential Problem Loans</td>
<td>6-30</td>
</tr>
<tr>
<td>3. Deficient Loans</td>
<td>31-90</td>
</tr>
<tr>
<td>4. Doubtful Loans</td>
<td>91-180</td>
</tr>
<tr>
<td>5. Lost Loans</td>
<td>&gt; 180</td>
</tr>
</tbody>
</table>

33 PRO-CREDITO remains a legal entity but without any operations.

34 See Chapter IV, page 70 for a detailed table of the Bolivian provisioning requirements.
The majority of Los Andes’ loans fall into the third grouping of loans equal to less than US$5,000 and a loan term less than one month or payments that are less than one month. Los Andes does not account for interest until it is received and therefore does not provision or write off interest on bad loans.

The norms governing the PFF are being revised and are expected to be completed by the end of 1996. Applications have been submitted for three additional PFFs.

2. Los Andes in Operation

From its inception as PRO-CREDITO in 1991, the institution was planning to enter the regulated financial sector. In contrast to BancoSol, no operational changes were implemented once it became a PFF. Sophisticated management information systems (MIS), which could integrate data on savings and credit operations, had been put in place. Consequently, Los Andes has been able to provide the required reports to the Central Bank and Bolivian Superintendency with few modifications. In addition, in contrast to many other microfinance institutions, the Los Andes loan officers (known as analistas) have backgrounds and training in business.

Los Andes achieved significant outreach first in its three and one-half years of operation as PRO-CREDITO, and then during its first year of operations as a PFF. PRO-CREDITO sold its US$4.4 million portfolio to Los Andes to commence operations. (See Table 14)

<table>
<thead>
<tr>
<th>Indicators</th>
<th>1992</th>
<th>1993</th>
<th>1994</th>
<th>1995a</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year-End Outstanding Portfolio</td>
<td>$.71</td>
<td>$1.4</td>
<td>$2.9</td>
<td>$5.95</td>
</tr>
<tr>
<td># of Loans Outstanding (Active Clients)</td>
<td>1,163</td>
<td>3,173</td>
<td>7,684</td>
<td>13,849</td>
</tr>
<tr>
<td>Total Amount Loaned</td>
<td>$2.6</td>
<td>$4.4</td>
<td>$9.0</td>
<td>$15.6</td>
</tr>
<tr>
<td># of Loans Made</td>
<td>4,346</td>
<td>7,771</td>
<td>20,023</td>
<td>31,146</td>
</tr>
<tr>
<td>Average Loan Size</td>
<td>$598</td>
<td>$566</td>
<td>$450</td>
<td>$500</td>
</tr>
</tbody>
</table>

* In June 1995, PRO-CREDITO became Los Andes.

As of June 1996, Los Andes had 106 employees, of which 53 were loan officers. No human resources department currently exists. Los Andes has
nine branch offices, each of which has one administrative manager, five to seven loan officers, a cashier, and a data-entry person. Loan officers manage, on average, 400 clients each, though some of the more experienced loan officers manage more than 600 clients. Whether this can be sustained over time remains to be seen.

All of Los Andes’ loans are individual loans. Clients must have had at least one year in business and demonstrate the capacity to repay. Clients must also provide a spouse’s co-signature who in many cases jointly owns the valuable being used to guarantee the loan. In addition, loan officers work hard to understand the income stream into the house as opposed to only focusing on the business, and they work with their clients to establish effective payment plans.

Los Andes also provides small business loans up to a maximum US$36,000 through two loan officers to enterprises with assets equal to more than US$20,000. Most of Los Andes’ loan operations are in urban areas, though it is experimenting with rural credit as well.

Los Andes also offers a unique emergency line of short-term credit to clients in La Paz, which can be guaranteed with jewelry. A client is eligible to receive 50 percent of the worth of the item provided and can extend payment. Similar to how they would use a pawn shop, clients can access credit very quickly. Contrary to a pawn shop’s services, however, this line of credit allows clients to extend payment and, assuming their ability to repay in time, they are guaranteed to receive their jewelry; it is securely stored at the main office. At year-end 1995, Los Andes had an active portfolio for this line of credit equal to US$131,301, comprised of 2,105 loans averaging US$62.

Los Andes began capturing savings in May 1996. Most of its deposits are institutional investors in fixed term deposits. Los Andes is confident of a demand for savings services. First, it recognizes the need to establish its reputation as a trustworthy institution with the microenterprise sector. Second, it is aware of the expense associated with managing small-scale savings. Table 15 presents Los Andes’ brief history of savings.

In its articles of incorporation, Los Andes adopted a policy of reinvesting all profits back into the institution rather than distributing dividends to shareholders. For the short term, Los Andes believes this policy will protect it from the pressures of performing for the commercial markets. It also recognizes, however, that without distributing dividends, Los Andes will have difficulty attracting private individual investors.

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35 The idea originated in a microfinance institution in Peru.
Los Andes’ main competition is BancoSol and NGO microlenders, though it anticipates the entrance of several other PFFs into the microenterprise sector in the near future. As with BancoSol, the success of Los Andes has measurably changed the perception of the poor as good credit risks, and the PFF hopes to continue to broaden and deepen its outreach.

D. MULTI CREDIT BANK IN PANAMA: WORKING TO PENETRATE THE MICROENTERPRISE SECTOR

In 1991, Multi Credit Bank in Panama made the strategic decision to extend financial services to microentrepreneurs. It was the first and remains the only commercial bank in Panama to do so, and its primary motivation was to prove it could make money by lending to the microenterprise sector. Multi Credit’s main operational challenge has been to balance profit making with the mission to reach the microenterprise sector. Its main regulatory challenge has been to cover the high costs of microlending in a regulatory framework with interest rate caps.

1. Establishing a Microloan Portfolio

Multi Credit established Acción Empresarial in 1991 as a specialized microlending department within the bank. With the technical assistance of ACCION International and later ADEMI (Asociación para el Desarrollo de Microempresas, Inc.), a successful nongovernmental microlender in the Dominican Republic, Multi Credit/Acción Empresarial has experimented and gained enough experience to cover the costs of microlending in 1995.

<table>
<thead>
<tr>
<th>Month 1996</th>
<th>Savings Deposits</th>
<th>Fixed Term Deposits</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Accounts</td>
<td>Dollar Amount</td>
<td>Total Number of Accounts</td>
</tr>
<tr>
<td>May</td>
<td>73</td>
<td>31,384</td>
<td>14</td>
</tr>
<tr>
<td>June</td>
<td>143</td>
<td>33,652</td>
<td>21</td>
</tr>
<tr>
<td>July</td>
<td>239</td>
<td>84,182</td>
<td>38</td>
</tr>
<tr>
<td>August</td>
<td>314</td>
<td>116,220</td>
<td>47</td>
</tr>
<tr>
<td>September</td>
<td>391</td>
<td>150,349</td>
<td>66</td>
</tr>
<tr>
<td>October</td>
<td>474</td>
<td>187,439</td>
<td>71</td>
</tr>
</tbody>
</table>

Los Andes' main competition is BancoSol and NGO microlenders, though it anticipates the entrance of several other PFFs into the microenterprise sector in the near future. As with BancoSol, the success of Los Andes has measurably changed the perception of the poor as good credit risks, and the PFF hopes to continue to broaden and deepen its outreach.

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Critical first steps were to obtain the methodology, build internal capacity by hiring and training staff, and establish a cost structure that would allow for long-term sustainability and profits for the bank. After initial use of the solidarity group lending methodology, Multi Credit/Acción Empresarial now disburses individual loans exclusively. The microloan portfolio is a small but growing part of Multi Credit Bank’s total portfolio. (See Table 16).

**TABLE 16**

<table>
<thead>
<tr>
<th>MULTI CREDIT BANK PORTFOLIO INDICATORS</th>
<th>(In Millions of U.S. Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multi Credit Bank Total Outstanding Loan Portfolio</td>
<td>$60</td>
</tr>
<tr>
<td>Acción Empresarial Total Outstanding Loan Portfolio</td>
<td>$.48</td>
</tr>
<tr>
<td>Acción Empresarial Portfolio as a Percentage of the Bank Total</td>
<td>.8%</td>
</tr>
<tr>
<td>Total Acción Empresarial Clients</td>
<td>640</td>
</tr>
<tr>
<td>Acción Empresarial Average Loan Size</td>
<td>$757</td>
</tr>
<tr>
<td>Acción Empresarial Late Payment Rate (&gt; 30 days)</td>
<td>1.49%</td>
</tr>
</tbody>
</table>

Multi Credit/Acción Empresarial’s average loan size is significantly higher than the needs of most microenterprises. Several factors have been identified to explain this disparity and are currently being addressed. The first is the fact that Multi Credit/Acción Empresarial is actually serving two market segments.

One is microenterprises and the other is small contractors working with large customers (often state/municipal entities) whose working capital needs are in the range of US$25,000 to US$50,000. Because loan officers have been trained to visit sites of business and transact with great speed as part of the microlending methodology, they have discovered this contractor niche that their conventional bank colleagues are not geared to serve.

A second factor is Multi Credit/Acción Empresarial’s incentive system for its loan officers. Many microfinance institutions base their incentive systems on several criteria, including delinquency, number of microenterprises, total
active portfolio, and total amount lent per month. Multi Credit/Acción Empresarial strongly favors size. These incentives, combined with the needs of the small contractors, have resulted in many fewer larger loans. The bank, however, remains committed to broadening its reach into the microenterprise sector. In early 1997, the bank will implement changes in the incentive plan that reward the addition and maintenance of a microenterprise portfolio.

A third factor is the low growth rate of the client base of Acción Empresarial. In trying to create a model that allowed for profits, the bank did not hire additional loan officers and existing loan officers were not encouraged to identify large numbers of new clients. A lack of growth coupled with increasing capital needs of existing clients pushed the average loan size upward.

Though Multi Credit/Acción Empresarial’s average loan size is significantly higher than that of other microfinance institutions, the bank has lowered the floor of lending in the Panamanian financial system. It also represents a conventional bank moving into microfinance, a transformation of which successful examples are rare. If Multi Credit/Acción Empresarial proves to be successful both in coverage and profitability, it will serve as a beacon for other banks.

Multi Credit considers the tangible benefits of microlending to be significant. Return on assets on the traditional bank portfolio from 1991 to 1995 averaged 2 to 2.5 percent. In the first half of 1994, Multi Credit/Acción Empresarial achieved a break-even point in its microlending operations. It anticipates a 6 to 6.5 percent return on assets by the end of 1996. The intangible benefits are likewise of note to Multi Credit, as it values its contribution to alleviating poverty and empowering individuals and communities. Its image has been greatly enhanced within the country, and the bank has received recognition from critical observers. Internally, Multi Credit/Acción Empresarial is motivated by different means. The strength of this commitment has begun to pervade the traditional bank branch.

Costs of microlending have likewise been significant. In addition to the start-up costs, measured in time, energy, and funds, maintenance costs are very high. Multi Credit/Acción Empresarial’s staff of 50 handling US$9 million contrasts significantly with the 250 individuals handling US$174 million in the rest of the bank. Multi Credit/Acción Empresarial recognizes that success requires reaching scale by lending in the range of US$25 to 30 million and projects cumulatively lending US$100 million over the next five years. As Multi Credit/Acción Empresarial grows, it plans to lower its average loan size.
Finally, Multi Credit Bank has realized significant economies of scale in its microlending operations as a commercial bank with established capacity. Both branches of the bank share most of the essential services including legal, computer, public relations, strategic planning, credit analysis, accounting, and auditing. Multi Credit/Acción Empresarial also uses the same receptionists, messengers, tellers, and security guards as the remainder of the bank.

2. Regulation and Supervision

The major regulatory hurdle that Multi Credit Bank faced in establishing microfinance operations was the interest rate caps in Panama equal to an effective rate of 24 percent. Given the need to charge interest rates well above commercial rates to cover the high costs of microlending, Multi Credit/Acción Empresarial, like other microlenders, charged fees for services provided to the microloan customers in the processing of applications. Over time, however, Multi Credit bank was required to establish a finance company (financiera), which in Panama has a higher interest rate cap. A fully owned subsidiary of Multi Credit, the finance company Multi Credit/Acción Empresarial handles all lending and pays a commission to Multi Credit. In this way, Multi Credit/Acción Empresarial sustainably services its microloan customers with the full support of the regulated legal framework.

There are no distinctions in the regulatory supervision of Multi Credit’s microloan portfolio and its traditional portfolio. Given the small size of regulated microlending in Panama, no changes have been made (nor are any anticipated) to the regulatory structure to adapt to microfinance. Likewise, regulators do not receive specialized training or examine Multi Credit’s microloan portfolio with a different lense. A single regulator examines a random sample of the microloan folders, as is done with the majority of Multi Credit’s portfolio. Multi Credit classifies Multi Credit/Acción Empresarial’s loans as commercial microloans and bases categorization on delinquency. Provisioning requirements are the same for all parts of the bank portfolio as shown in Table 17.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Days Delinquent</th>
<th>Provisioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Normal Loans</td>
<td>7 days or less</td>
<td>0%</td>
</tr>
<tr>
<td>2. Potential Problem Loans</td>
<td>8-30</td>
<td>0%</td>
</tr>
<tr>
<td>3. Deficient Loans</td>
<td>31-60</td>
<td>0%</td>
</tr>
<tr>
<td>4. Doubtful Loans</td>
<td>61-90</td>
<td>50%</td>
</tr>
<tr>
<td>5. Lost Loans</td>
<td>&gt; 90</td>
<td>100%</td>
</tr>
</tbody>
</table>
Panamanian capital adequacy standards for commercial banks (as well as other financial institutions) are set at 5 percent, lower than the international standard of 8 percent as set by the Basle Accords. Multi Credit voluntarily maintains an 11.5 percent ratio of assets to equity, while the average in the remainder of the financial sector is around 8 percent.

Multi Credit Bank, in general, has not spent much effort on mobilizing short-term deposits from the public. The potential is therefore unknown. What savings the bank has captured is primarily in the form of fixed deposits, which comprise 64 percent of the total portfolio. Forced savings among its microenterprise customers has yielded a US$500,000 compensating balance. Microloan customers that do use Multi Credit/Acción Empresarial’s savings facilities tend to deposit money from which debits are made for loan repayments. Use of checking accounts is not widespread. Multi Credit/Acción Empresarial’s plans to expand financial services to its client base by offering pension funds, housing and consumer loans, and medical and life insurance. Table 18 presents the regulations under which the various institutions described in this chapter (plus BancoSol) operate. Chapter VI provides a detailed summary of the general issues in the regulation and supervision of microfinance.
This was the minimum capital requirement for a commercial finance company in 1993, the year Finansol was established. This amount is adjusted to internal inflation on a yearly basis.

Capital Adequacy requirement in Bolivia was increased from 8 percent to 10 percent in October 1995. Financial institutions have until 1998 to comply.

In Bolivia (hence for BancoSol and Los Andes), the number of days delinquent corresponding to a given category varies based on the size of the loan. See Chapter IV, page 70 for these variations.

In Colombia, for loans in Category 4 (Doubtful Loans), institutions must provision 50 percent of capital and 100 percent of interest. For Category 5 (Lost Loans), they must provision 100 percent for both capital and interest.

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>Banco Solidario, S.A. (Bolivia)</th>
<th>Acción Comunitaria del Perú ACCIONSL</th>
<th>Finansol (Colombia)</th>
<th>Caja de Ahorro y Préstamo Los Andes (Bolivia)</th>
<th>Multi Credit Bank/Acción Empresarial (Panama)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Capital Requirement</td>
<td>US$3.2 million</td>
<td>US$265,000</td>
<td>US$3 million</td>
<td>US$1 million</td>
<td>US$3 million</td>
</tr>
<tr>
<td>Required Capital Adequacy Ratio</td>
<td>8% (12:1)</td>
<td>10% (10:1)</td>
<td>11% (9:1)</td>
<td>8% (12:1)</td>
<td>5% (20:1)</td>
</tr>
<tr>
<td>Provisioning Policy on Microloan Portfolio</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification Category (Commercial or Consumer)</td>
<td>Microcredit Classification</td>
<td>No Distinction Made</td>
<td>Commercial Credit</td>
<td>Consumer Credit</td>
<td>No Distinction Made</td>
</tr>
<tr>
<td>1. Normal Loans</td>
<td></td>
<td>0%</td>
<td>&lt; 7</td>
<td>0%</td>
<td>&lt; 30</td>
</tr>
<tr>
<td>2. Potential Problem Loans</td>
<td></td>
<td>0%</td>
<td>8-30</td>
<td>25%</td>
<td>31-60</td>
</tr>
<tr>
<td>3. Deficient Loans</td>
<td></td>
<td>10%</td>
<td>31-60</td>
<td>50%</td>
<td>61-90</td>
</tr>
<tr>
<td>4. Doubtful Loans</td>
<td></td>
<td>50%</td>
<td>61-90</td>
<td>75%</td>
<td>91-180</td>
</tr>
<tr>
<td>5. Lost Loans</td>
<td></td>
<td>100%</td>
<td>&gt; 90</td>
<td>100%</td>
<td>&gt; 180</td>
</tr>
</tbody>
</table>

a This was the minimum capital requirement for a commercial finance company in 1993, the year Finansol was established. This amount is adjusted to internal inflation on a yearly basis.

b Capital Adequacy requirement in Bolivia was increased from 8 percent to 10 percent in October 1995. Financial institutions have until 1998 to comply.

c In Bolivia (hence for BancoSol and Los Andes), the number of days delinquent corresponding to a given category varies based on the size of the loan. See Chapter IV, page 70 for these variations.

d In Colombia, for loans in Category 4 (Doubtful Loans), institutions must provision 50 percent of capital and 100 percent of interest. For Category 5 (Lost Loans), they must provision 100 percent for both capital and interest.
CHAPTER VI
CONCLUSIONS AND RECOMMENDATIONS
by Rachel Rock
A. INTRODUCTION

As recently as five years ago, the transformation of unregulated not-for-profit microfinance institutions into formal financial intermediaries had just begun. Today, it is becoming part of the financial landscape in certain countries in the developing world. As reflected by the descriptions of various intermediaries in this document, institutional structure varies. Whereas Banco Solidario, S.A. (BancoSol), in Bolivia, is a private commercial bank, specialized microfinance intermediaries such as the Private Financial Funds (PFFs), in Bolivia, and EDPYMEs (Entidad de Dessarrollo para la Pequeña y Microempresa), in Peru, directly address the need for prudential regulation and supervision to accommodate the distinct characteristics of microfinance.

The current paradigm for prudential regulation and supervision has been designed for traditional collateral-based finance, which presupposes the existence of wealth. That the methodology of microfinance lending circumvents this basic tenet is fundamental to its success as an approach to poverty alleviation. In place of tangible guarantees stands the client’s demonstrated promise to pay, alongside well-designed repayment incentives, which include future access to larger loans. Carefully developed personal relationships between loan officer, borrower, and institution strengthen the lending technology.

The challenge is to create new models for the prudential regulation and supervision of financial institutions that serve the poor. Meeting this challenge will enable millions of the world’s population who work in microenterprises to contribute to the growth of their national economies.

The various constituencies who must participate in creating new models include policymakers, supervisory agencies, donors, commercial banks, and microfinance institutions. For each, this chapter draws upon the experience in Latin America to present conclusions and recommendations
applicable around the world for the active engagement of all parties in a rapid process of change.

B. POLICYMAKERS

1. Conclusions

Continued financial sector reforms to promote strong regulatory frameworks are essential for the effective financial intermediation of all sectors of the economy. The financial sector reforms of the past five to twelve years have made great strides toward improving the effectiveness of banking and nonbanking institutions. Liberalizing economic regulations by removing obstacles to efficiency, such as interest rate controls, directed credit guidelines, and barriers to entry, has significantly improved the allocation of capital and credit. Significant additional tasks remain, however, especially in the area of prudential regulation and supervision.

The movement toward regulation and supervision of microfinance institutions has arrived at an opportune moment. A renewed interest in the regulation of banks among governments, policymakers, regulators, and academics has resulted from large-scale banking problems experienced in the 1980s in many countries. Efforts around the world are defining what changes should be made to existing regulatory structures. Regulated microfinance will become a part of this redefinition.

2. Recommendations

Governments must incorporate the financing of the highly productive microenterprise sector into the formal financial sector because it is an important part of the economy and requires access to capital and because fostering its growth will increase the income earning potential of the poorest sectors of the society. Mobilizing savings and productively investing this accumulated capital benefit all segments of society. First, evidence strongly suggests that if appropriate services are available, the poor will save in large proportions. Second, the ability and willingness of microenterprises to pay high interest rates demonstrate their high level of productivity. It is incumbent upon governments to intermediate these funds, and regulated microfinance institutions are an important mechanism for this purpose. Though microenterprises contribute a small percentage to a country’s GDP, facilitating their movement into the regulated financial market will increase the stock of domestic savings and help to ensure the equitable distribution of growth to all segments of society.

Empower regulators to be flexible. Regulated microfinance institutions, which protect the scarce resources of the poor, require as rigorous a level of regulation and supervision as traditional financial institutions. The effectiveness of this supervision is dependent on the regulators’ ability to develop the appropriate interventions for identifying and managing the
unique risks associated with microfinance. Because these risks are different from those faced by traditional financial institutions, so too must the tools of regulation and supervision be changed.

C. SUPERVISORY AGENCIES

1. Conclusions

Effective prudential regulation and supervision of all intermediaries must be sound, fair, and objective. The supervisory agency is the referee in the efforts to protect the payments system, and the stability of the financial sector and depositors and to promote efficiency through competition. Allocation of credit or access to savings services should be independent of political influence or personal affluence. The credibility of the supervisory agency will ultimately rest on its willingness to promote healthy intermediaries that serve all sectors of the economy, as well as its willingness to close down corrupt and inept institutions that hide deteriorating assets.

Training regulators to supervise microfinance institutions and portfolios is essential to protecting the long-term health of the industry. Supervisory agencies are the linchpin to successful inclusion of microenterprises into the formal sector. They will determine which institutions are allowed to enter the financial system, and their staff must therefore be trained to identify the associated risks.

2. Recommendations

Create a competitive market for microfinance. Supervisory agencies should determine the size of the microenterprise sector, identify the current supply of credit to this sector, and assess the feasibility of using established regulated financial institutions to increase this supply. The data they obtain will form the basis for determining the need for a specialized legal framework for microfinance. Whatever regulations or institutions are created or adapted to serve the microenterprise sector should be applied evenly to all relevant institutions. Other key factors to consider follow.

The microenterprise market: Like the formal economy, the microenterprise sector consists of several segments: commercial, manufacturing, and service. Environmental factors such as weather and seasons, as well as macroeconomic circumstances that effect the flow of credit and savings, influence repayment. Understanding the environment and cash flow of the client will enhance regulators’ ability to supervise effectively.

Appropriate number of entrants: Entry requirements for specialized intermediaries should allow for competition but prevent the establishment of an overabundance of institutions. First, it is unlikely that there are enough experienced individuals in any one country who
could manage a large number of institutions. Second, supervisory agencies do not have adequate resources to supervise a large number of institutions effectively. Third, though the potential market is enormous, the operational structure of microfinance may imply economies of scale and thus suggests fewer institutions.

A critical mass of intermediation, however, may justify establishing specialized departments for microfinance within supervisory agencies. Furthermore, dealing with potential insolvency will be eased by the existence of other institutions that serve the microenterprise sector. Whether these are commercial banks or specialized institutions, clients can potentially be absorbed by another institution. The appropriate number of regulated microfinance institutions will be determined on a country-by-country basis.

**Protect the quality of the microloan portfolio.** Portfolio restrictions must allow for the value of personal guarantees rather than simply of collateral guarantees. Without such adaptations, regulations will block an institution from reaching massive numbers in the microenterprise sector. Restrictions must likewise take into account the large numbers of small, short-term loans concentrated in certain geographic and economic sectors. Restrictions must be designed to promote this competitive advantage while also protecting against wide-scale default were the microenterprise sector to be adversely affected by a geographic or economic variable.

**Provide adequate and appropriate supervision.** While understanding the basic characteristics of microfinance may be straightforward, effective supervision of microfinance operations is a far more difficult task.

*Capital adequacy:* Required leverage ratios should initially be higher than the 8 percent set by the Basle Accords. After institutions have established a track record in regulated microfinance, capital adequacy ratios could be lowered.

*Financial performance auditing:* Supervisors must correct for direct or implicit subsidies received by most microfinance institutions. Likewise, the cost of inflation must be accounted for when measuring profitability.

*Fraud prevention auditing:* Supervisors should develop mechanisms to evaluate the specialized operational audit procedures used by microfinance institutions to detect fraud. This task requires establishing close working relationships with individuals in the organization getting close to the operations. Loan officers of microfinance institutions go to the clients’ places of business in marginal areas of the city. Regulators must be willing to accompany them to observe and evaluate procedures firsthand.
**Operational audits:** Supervisors must ensure that senior staff in a microfinance institution has the experience and skills to manage effectively the rapid growth that will take place in the program once it becomes regulated. Supervisors must counter weak management by demanding the return to greater personal accountability, incentives systems, and quality of management information systems rather than increased administrative controls that result in greater bureaucracy.

**Address the unique capital structure of microfinance institutions:** Although many microfinance nongovernmental institutions (NGOs) are heavily capitalized, the ownership structure prohibits the capital from playing its normal function as insurance against excessive risk-taking by owners. In designing regulations for microfinance institutions, supervisory agencies must create mechanisms that place at risk something else of value to the board member, such as reputation to replace the lack of significant amounts of individual equity. Owners will then make every effort to govern the institution honestly and effectively.

**D. DONORS**

1. **Conclusions**

   **The role of donors in microenterprise development remains fundamental.** Without the support and commitment of donor institutions to the field of microenterprise development, the need for regulation and supervision would not exist. Donors have provided critical funds for technical assistance, for loan portfolios, and for the research and development of new innovative technologies. Although institutions such as BancoSol have made great strides toward creating a market-driven approach to poverty alleviation, microfinance remains in the development field and thus continues to rely strongly on donor support in several key areas which will be discussed under “Recommendations.”

2. **Recommendations**

   **Enhance financial management capacity of microfinance institutions.** Increased financial complexity requires microfinance managers to improve their management skills. Inadequate skills can result in poor reporting at best and insolvency at worst. The loss of savings for microfinance clients would be enormous. In addition, the private sector will maintain itself at a distance unless it is assured that the management of microfinance intermediaries is of high quality. Donors might consider supporting regional training institutes or providing technical assistance directly to institutions.

   **Reconcile donor reporting requirements with market requirements.** Financial indicators that may be important to funders are often irrelevant
to regulators and investors. Microfinance managers are therefore forced to provide multiple sets of data. The development of widely accepted financial performance standards for microfinance would fulfill the needs of regulators and investors and be used by microfinance managers to ensure quality control. Donors should not only apply these standards but take a lead in developing them.

**Finance investment in the capacity of supervisory agencies.** Latin American supervisory agencies are already overburdened without the additional responsibilities of supervising microfinance intermediaries. Donors can play an instrumental role in training regulators to understand the requirements of adequate supervision of microfinance and design the necessary procedures for supervision.

**Promote the sharing and dissemination of experience in regulation.** With the exception of Indonesia, no country has a critical mass of regulated microfinance institutions. Donors can add great value in supporting opportunities to bring together the individuals around the world who have been involved in the frontier efforts of regulation and supervision.

### E. COMMERCIAL BANKS

#### 1. Conclusions

**Commercial banks, driven by returns to investors, will ultimately follow profit potential.** Though commercial banks in many Latin American countries still have not entered the microenterprise sector, as competition increases and as the commercial viability of microfinance continues to be demonstrated, they will be driven to reach new markets. Whether or not they expand into the microenterprise market will depend on owners and management overcoming several basic concerns such as that lending to informal sector businesses is too risky or too expensive and that charging their poorer clients higher rates than their wealthier clients is a justifiable part of expanding access to credit.

**Commercial banks are positioned to maximize potential economies of scale given their structure.** What commercial banks may lack in experience and in confidence in lending to microenterprises, they possess in size, infrastructure, financial management skills, and access to financial markets. If they are able to obtain the necessary lending methodology and staff to appropriately reach the microenterprise sector, they will be able to take advantage of their competitive advantages in providing microfinance.

#### 2. Recommendations

**Work with regulators to identify and overcome regulatory obstacles in servicing the microenterprise sector.** Those commercial banks interested in penetrating the microenterprise market are most aware of the
regulatory obstacles they face in their countries. Identifying these obstacles and proposing alternatives to regulators will most effectively advance the entry into microfinance. Experience from commercial banks in other countries, such as Chile, Panama, and Mexico, can provide guidance.

**Obtain and adhere to appropriate microfinance lending methodology.** Microfinance is distinct from conventional finance. Commercial banks must fundamentally understand the microenterprise market, such as the factors that affect the ebb and flow of income and how to gain the trust of the clients. Commercial banks must also be comfortable with the special techniques of microfinance, which differ greatly from conventional lending. Experience in microfinance has proven that deviations from well-tested microlending technologies result in high levels of default.

**F. MICROFINANCE INSTITUTIONS**

1. **Conclusions**

   **Leading microfinance institutions can perform at standards consistent with sound financial sector development.** There is a small group of leading microfinance institutions that meet the standards currently applied to banking institutions in countries with strong regulatory environments. The measurement of earnings, asset quality, and capital adequacy of these institutions yields impressive results. In fact, given microfinance ownership and that many microfinance institutions will try to mobilize the savings of the poor, these institutions should probably be required to perform at higher standards in the short term.

   **The majority of nonprofit microfinance institutions, however, are not yet ready to assume financial intermediation.** In most cases, these institutions are not prepared to take on the financial complexity that comes with intermediation. They may lack adequate management information systems (MIS), have limited financial expertise, or prefer the characteristics of NGOs than those of formal regulation. Whatever the reasons, in contemplating the move, boards of directors and managers must consider the associated costs and benefits of regulation. A failure to do may result in unrealistic expectations and ultimately in the failure of the institution.

2. **Recommendations**

   **Improve management information systems.** Institutions must be able to provide accurate and timely financial performance information for depositors, investors, and regulators. This is perhaps the most important and pressing need of the microcredit industry and applies to regulated, soon-to-be-regulated, and unregulated institutions providing microcredit.
**Build capacity and train staff.** Microfinance institutions must hire staff with experience in financial management and must train existing staff. As these two groups tend to come from different professional disciplines (banking versus social development) and offer different perspectives, efforts must also focus on integrating their skills and experience.

**Define Responsibilities.** Regulation requires greater hierarchy and formality than in an NGO structure. Accountability and direction should be a built-in part of these changes.

**Evaluate the costs involved with regulation.** While significant benefits exist, transformation is a costly process. Among the most important costs is a heavy investment in MIS. Without accurate and timely financial performance information, management’s ability to navigate is hindered. Building staff capacity, implementing adequate security measures, and adapting the institutional culture also add to the start-up costs.

**Understand the responsibility of accepting deposits.** All levels of the institution must understand that authorization to accept deposits brings with it a responsibility, as the institution is charged with protecting the scarce resources of the poor. The institution becomes subject to rules of financial prudence and must report financial conditions transparently and regularize ownership and accountability structures.

**Prepare the clients for the transition.** Because regulating microfinance is in essence bringing the poor into the mainstream, part of the challenge is gaining client trust in formal institutions. Loan officers should explain to the clients that the new institution will continue to serve their needs though in an enhanced capacity. Changes in lending procedures should be kept to a minimum.

Successfully navigating from the margin to the mainstream of regulated financial intermediation requires great effort, long hours, and large doses of cooperation among the various participants. Perhaps most important, it requires visionary and practical thinking about how to adapt existing regulatory frameworks to microfinance so that the client is fully served. Pioneering efforts are under way and additional work is needed. Regulators and microfinance practitioners must learn together how to responsibly protect the interests of microenterprises as well as the financial system as a whole.
APPENDIX

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“Financial Services for Microenterprises: Principles and Institutions.” In Otero and Rhyne, editors, The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor. West Hartford, CT: Kumarian.


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**ACCION International**, founded in 1961, is a private, nonprofit organization dedicated to reducing poverty and unemployment in the Americas through the provision of credit and basic business training to microentrepreneurs. ACCION provides financial services and technical support to a network of associated institutions in thirteen countries throughout Latin America and in six cities in the United States. In 1996, ACCION’s Network disbursed an estimated US$365 million to 297,500 clients, with a combined portfolio of approximately US$168.5 million and a default rate below 5 percent. ACCION has lent a cumulative total of nearly US$1 billion since 1989. ACCION is headquartered in Somerville, Massachusetts, with offices in Bogotá, Colombia; Tucson, Arizona and Washington, DC.

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ISBNXXX-XXXX-XX-X
Printed in Colombia, S.A.