REGULATION AND SUPERVISION OF MICROFINANCE INSTITUTIONS

Experience from Latin America, Asia, and Africa

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The MicroFinance Network
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LIST OF ACRONYMS

ADB    African Development Bank
ASA    Association for Social Advancement
BCEAO  Central Bank of the West Africa States
BKD    Baden Kredit Desa
BKK    Badan Kredit Kecamatan
BRAC   Bangladesh Rural Advancement Committee
BRI    Bank Rakyat Indonesia
CGAP   Consultative Group to Assist the Poorest
COFIDE Corporacion Financiera de Desarrollo
EDPYME Entidades de Desarrollo para la Pequeña y Microempresa
FEPCMAC Federation Peruana de Cajas Municipales de Ahorro y Credito
FMO    Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden
GTZ    Gesellschaft fur Technische Zusammenarbeit
K-Rep  Kenya Rural Enterprise Program
KHL    K-Rep Holdings Limited
KURK   Kredit Usaha Rakyat Kecil
IDB    Inter-American Development Bank
IFC    International Finance Corporation
IPC    Interdisziplinare Projekt Consult
MFI    Microfinance Institution
MIS    Management Information Systems
NGO    Non-Governmental Organization
NHFC   National Housing Finance Corporation
ODA    Overseas Development Administration
PFF    Private Financial Fund
PRODEM Fundacion para la Promocion y Desarrollo de la Microempresa
ROSCA  Rotating Savings and Credit Associations
ROA    Return on Assets
UEMOA  West Africa Economic and Monetary Union
USAID  United States Agency for International Development
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An expert panel of bank supervisors served as advisors to this research. Their contributions helped to ensure that this study considered the concerns and limitations of supervisory bodies. Most importantly, they repeatedly emphasized that, for the most part, bank superintendents are not particularly interested in small financial institutions that do not pose a significant threat to the stability of the financial system. This panel includes:

• **Hennie van Greuning**, the former Chairman of the South African Reserve Bank, currently employed at The World Bank

• **Jorge Castellanos**, the Colombian Banking Superintendent from 1994-95, now works for JP Morgan in New York

• **Luis Cortavaria**, the former Banking Superintendent of Peru, currently works with the International Finance Corporation (IFC)

• **Christopher Beshouri**, a Financial Economist at the United States Department of Treasury

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We would also like to thank the members of the MicroFinance Network for supporting this research.
The MicroFinance Network is a global association of microfinance institutions (MFIs) committed to improving the quality of life of low income communities through the provision of credit, savings and other financial services. Network members believe that these services should be provided by sustainable and profitable financial institutions that reach large numbers of clients who are not served by the traditional banking sector.

This research is designed to serve as a resource for bank supervisors, regulators and policy makers. The Regulation and Supervision Project of the MicroFinance Network reviews case experiences in nine countries that have some experience with MFIs, and draws conclusions regarding approaches to regulation and supervision that are suited to the unique characteristics of those institutions. Countries selected for review were identified because of the presence of a MicroFinance Network member and because this sample presents a range of regulatory responses taken in diverse settings. The principal findings from this desk review are summarized in this first volume. The country case studies, presented in a second volume, offer detailed analysis of the field experience.

Experiences in Bangladesh, Indonesia and Bolivia provide evidence of the potential of microfinance institutions to provide financial services on a large scale. While these are exceptional cases, the microfinance community is emulating these models of success. Under proper conditions, including an appropriate regulatory environment, there will be an increasing number of successful MFIs in the coming years. This document hopes that regulators will be proactive in their preparations for the microfinance wave. It is not necessary, desirable, or realistic to regulate all microfinance institutions. However, if these services include mobilizing voluntary savings from the general public beyond closed communities where common bonds exist, it is critical that some form of supervision be involved.

The cases highlight two general approaches to regulating microfinance institutions. The situations in Bolivia, Kenya and Colombia show the experiences of regulating MFIs within the existing regulatory framework, either as a commercial bank or a finance company. These experiences also highlight mismatches between the standard regulatory framework and the provision of microfinance services. The cases from Peru, West Africa and Bolivia (again) provide insight into initial attempts to create special categories of laws designed specifically for microfinance institutions.

A third set of experiences, from South Africa and the Philippines, demonstrate a learning process—for MFIs and policy makers—designed to create standards for the local microfinance industry. While, these efforts are too early in their
development to have significant bearing on the discussion, they do suggest possible first steps toward identifying an appropriate regulatory approach for microfinance.

This document does not provide a tool kit to tell policy makers how to regulate microfinance institutions. There is not sufficient experience or evidence to offer specific standards, ratios and guidelines. This document outlines the key issues involved in regulating and supervising MFIs as the foundation for discussions, such as when is regulation necessary and what is the unique risk profile of microfinance institutions.
INTRODUCTION

The emergence of the microfinance industry presents an unprecedented opportunity to extend financial services to the vast majority of the economically active population. In developing countries, traditional banks typically serve no more than twenty percent of the population; the remaining communities historically have not had access to formal financial services. Yet, this non-traditional market is immense. The World Bank estimates that the potential global market for microenterprise credit currently stands at about 100 million clients.

In the last twenty years, leading microfinance institutions (MFIs) have devised appropriate financial service technologies to become profitable financial intermediaries. These developments have established the means to extend financial services to excluded sectors, thereby laying the groundwork for the microfinance industry. Just as new agricultural technologies spawned the green revolution in the 1970s and ‘80s, new financial technologies are producing the microfinance revolution in the 1990s.

In many countries, bank regulators now face the challenge of determining whether to regulate the emerging microfinance sector at all. If so, regulators need to consider an appropriate regulatory approach. As unregulated financial entities, the better microfinance institutions have had considerable freedom to adapt operating methods to serve their target markets effectively. This has led to the development of a small but growing number of robust, specialized financial institutions, innovative delivery methods, and an extension of the financial services market. When regulation is warranted, it requires coherent prudential guidelines that will allow the growth of the microfinance sector while protecting the interests of small savers and supporting the integrity of the financial sector as a whole.

Many banking superintendents and their staff, central bank officials and personnel from other public sector agencies are relatively unfamiliar with MFIs and the recent regulatory developments for microfinance institutions around the world. As an introduction to the young microfinance industry, the first chapter describes the unique characteristics of microenterprises, the elements of effective microfinance services, and the features of successful MFIs. This study gives particular attention to microfinance institutions that fall outside the set of those already regulated.

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1 Microfinance institutions (MFIs) assume a variety of institutional forms. While this document speaks most frequently about non-profit microcredit programs that create regulated MFIs, other institutional types include government-owned banks that operate microfinance units and commercial banks that create microfinance subsidiaries. Successful MFIs typically provide a range of financial services to low income communities, such as savings, personal or consumption loans, housing and enterprise loans.
financial intermediaries that reach small savers or small farmers, such as credit unions, cooperatives or agricultural banks. To illustrate the potential growth of microfinance institutions, Chapter 1 briefly describes three of the world’s most successful MFIs: Bank Rakyat Indonesia, Grameen Bank in Bangladesh and BancoSol in Bolivia.

The second chapter examines the unique risk profile of microfinance institutions. This profile provides the framework for the recommendations to regulate and supervise these distinct institutions, which are presented in the final chapter. Many of the risk features are applicable to microfinance portfolios of commercial banks as well as to MFIs that have their roots in the nonprofit world. Chapter 2 outlines the range of possible regulatory approaches for microfinance and discusses when it is appropriate to regulate MFIs. This chapter also describes exploratory processes taking place in South Africa and the Philippines by microfinance institutions and policy makers. These efforts to introduce industry standards represent initial steps toward identifying an appropriate regulatory approach for MFIs.

The next two chapters describe different approaches to regulating MFIs. Chapter 3 analyzes the challenges and opportunities of establishing microfinance institutions within the existing regulatory framework. Important lessons are drawn from the experiences of non-governmental organizations, such as PRODEM in Bolivia and K-Rep in Kenya, to create commercial banks, and Corposol in Colombia to establish Finansol, a finance company.

Chapter 4 reviews recent initiatives to establish special legal or regulatory categories designed specifically for microfinance. In Peru, Bolivia and West Africa, regulation has emerged in response to: a) the proliferation of financial services being provided by NGOs; and b) the regulators’ interest to introduce sound prudential guidelines for this growing sector of the financial services market. These guidelines were established to create an appropriate regulatory framework for MFIs that permits their establishment, yet limits their functions. However, the efforts in all three jurisdictions are too recent to determine if they will achieve this objective. The results from these initiatives must be evaluated in due course, once there is sufficient experience to assess the costs and benefits—to the institution, regulators and the economy—of special categories for MFIs.

Issues related to the supervision of microfinance institutions are examined in Chapter 5. Whether established as a specialized microfinance institution or as a standard commercial bank or finance company, the supervision of MFIs presents a challenge due to their large number of small transactions, lack of conventional security and decentralized operations. The institutional capacity of the supervisory body to oversee these unconventional financial intermediaries, and the availability of financial resources to do so, are constraining factors. This chapter discusses supervision practices within the context of financial and technical constraints.

The final chapter proposes a set of recommendations for the regulation and supervision of microfinance institutions. It is important to note that these
recommendations are theoretical and preliminary based on initial field experience. In the few cases when it is necessary to regulate microfinance institutions, regulation is possible either through exemptions and modifications to existing banking guidelines or through the creation of specialized categories for microfinance institutions. The essence of this analysis is to consider the unique risk profile of microfinance institutions and to apply prudential guidelines rigorously where MFIs are vulnerable, but to offer relative flexibility in measures initially adopted to control risk features that do not apply to the microfinance sector.
1. AN INTRODUCTION TO MICROFINANCE

As an introduction to the young microfinance industry, this chapter describes the unique characteristics of microenterprises and their vast demand for microfinancial services. To fulfill this demand, microfinance institutions have devised effective methods to provide financial services that are appropriate for this target market, yet circumvent obstacles that inhibit traditional financial institutions from reaching the micro sector. To illustrate the potential growth of microfinance institutions, this chapter also describes three of the world’s most successful MFIs: the Unit Desa System of the Bank Rakyat Indonesia, Grameen Bank in Bangladesh and BancoSol in Bolivia.

1.1 Characteristics of Microenterprises

In developing economies, firm distribution follows a classic pyramid pattern. At the top of the pyramid there are a few very large corporations, with the number of firms increasing as the size of firm decreases, as shown in Box 1. In many countries, the bottom two categories, small and micro businesses, comprise nearly 90% of all firms. Most firms fall within the “microenterprise” range, generally employing fewer than five people and using few fixed assets. The microenterprise end of commercial activity is

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3 This point was emphasized by Pedro Jimenez, the Executive Director of ADEMI, a microfinance institution in the Dominican Republic, in his discussions with the author.
known as the “informal sector,” meaning that they are generally not licensed or taxed, and do not conform to labor legislation. In many developing countries, this sector employs as much as 50 percent of the working population. The microenterprise sector grew substantially during the 1980’s as the performance of the formal economy faltered in many countries. Faced with few employment alternatives, labor market entrants turned to self-employment or casual employment in the informal sector.

While there is no single definition, most microenterprises demonstrate the following characteristics:

- **Employment**: Microenterprises employ one to five persons, including unpaid family members and paid staff.

- **Fixed Assets**: Firms are labor-intensive with limited fixed assets.

- **Location**: Many microenterprises are home-based, operate from informal market stalls, or are mobile vendors. More established microenterprises operate out of commercial locations.

- **Marketing & Supply**: Microenterprises generally sell to, and buy from, local markets. They are less likely to export their products or rely upon imports than larger firms.

- **Management**: Microenterprises are owner-operated and use rudimentary management techniques. Most firms do not maintain written accounts.

- **Legal Registration**: Microenterprises often operate outside the bounds of the regulatory framework. These firms may not be legally registered, pay taxes or adhere to health, safety or labor regulations.

Microenterprises operate in all business sectors, including small-scale manufacturing, service and commerce, as outlined in Box 2.

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**Box 2: Illustrative Types of Microenterprises**

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<tr>
<th>Services</th>
<th>Commerce</th>
<th>Manufacturing</th>
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<tr>
<td>Transportation</td>
<td>Street vendors</td>
<td>Tailor/seamstress</td>
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<tr>
<td>Barbers/hairdressers</td>
<td>Snack food sellers</td>
<td>Cabinet/furniture making</td>
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<tr>
<td>Machine repair</td>
<td>Used clothing vendors</td>
<td>Metal working</td>
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<tr>
<td>Electronic repair</td>
<td>Convenience stores</td>
<td>Bakery/food processing</td>
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<tr>
<td>Rice husking</td>
<td>Market vendors</td>
<td>Dairy cows</td>
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<tr>
<td></td>
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<td>Beer production</td>
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4 Otero, Maria and Elisabeth Rhyne, eds. (1994). The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor. West Hartford, CT: Kumarian.
The following financial features of microenterprises significantly influence the dynamics of microenterprise lending.

- **Limited Capitalization**: Since microenterprises are typically labor-intensive, their capital requirements for start-up and expansion of microenterprises are small.

- **Rapid Inventory Turnover**: The majority of the firm’s assets is working capital, which turns over quickly. Many microenterprises meet the profile of the proverbial cash cow, in that they generate steady, consistent earnings for their owners.

- **High Return on Assets**: Microenterprises are efficient users of capital. The return per dollar invested may be as high as 100% to 500%.

- **Low Leverage**: Because microenterprises have difficulties accessing loans, they rely almost exclusively on retained earnings and family support to finance business growth. Most microenterprises are therefore highly under-leveraged.

- **Household Business**: For many microenterprises, business and household resources are intertwined into one financial unit.

These characteristics of microenterprises and the level of household poverty associated with the owners of microenterprises create very specific, yet largely unmet, demands for microfinancial services. These features suggest that small, short-term loan products are appropriate. The high marginal return to additional units of capital allows these firms to pay financial service charges substantially above commercial rates. The next section describes why these demands are unmet and lists commonly used informal sources of microenterprise financing.

### 1.2 Microenterprise Access to Financing

In most countries, microenterprises cannot access financing through the standard commercial financial markets. Although the demand for microcredit is immense, in nearly all countries the commercial banking sector has not found this market segment attractive for the following reasons:

- **Perceived Risk**: Without legal registration, reliable financial information or a fixed location, commercial lenders perceive the small borrower as high-risk.

- **Lack of Collateral**: With low fixed asset levels and few personal assets, microenterprises cannot satisfy commercial lender collateral requirements.
**High Administrative Costs:** The operating guidelines and administrative procedures of commercial lenders are designed for large loans. These procedures are prohibitively cumbersome and costly for the scale of financing required by microenterprises.

**Price Structure:** Microenterprise lending does not seem profitable for commercial banks given the significantly higher unit costs of administering microloans and the prevailing market rates of interest.

**Legal and Regulatory Constraints:** As discussed below, serving unregistered businesses may detract from the financial institution’s compliance with banking regulation.

**Social obstacles:** Commercial banks generally have avoided providing financial services to low-income communities because of social obstacles that exclude this population from mainstream society.

Without access to commercial sources, microentrepreneurs instead rely on informal sources of funds, which usually carry a significantly higher cost than formal financial institutions. Microentrepreneurs raise the majority of start-up funds through intra-household savings. Individuals may save the initial seed capital during periods of prior employment. Deposit-taking services that reach the informal sector therefore serve a vital function to support start-up capital accumulation.

When not drawing upon their own savings, microentrepreneurs often acquire financing through loans or investments from family members. Intra-household financing, while not carrying direct finance charges, may be accompanied by non-cash and cash familial obligations, rendering the family loan at times more costly than one provided by an institution. In most cases, the business generates financing for enterprise expansion internally. Earnings are reinvested to permit enterprise growth. This constrains enterprise growth to the pace that funds are available through profits.

Other important sources of business financing include supplier credit and traditional informal saving clubs. Supplier credit for inventory or equipment typically incorporates a premium over cash prices; this premium is an implicit financial charge. Microentrepreneurs also tap traditional rotating savings and credit associations (ROSCAs), common among poorer households, to finance business requirements. While often technically interest-free, funds through these saving groups may not be available according to the timing requirements of the business and carry considerable risks. In addition, they often require the entrepreneur to set aside large portions of his or her available savings without earning any direct return; the availability of funds is limited to the level invested by the members.

Moneylenders are the most expensive funding source. Moneylenders make short-term, working capital loans or financing, often to meet personal emergencies. The costs vary from country to country. For illustrative purposes, among market vendors in the Philippines, moneylenders often use a “five for six” system, whereby
hawkers borrow five at the beginning of the week and pay back six at week’s end (e.g., 20% per week). Outside the marketplace, moneylending rates may range from 10 to 60 percent per month. Because their steep charges may exceed the businesses’ return on assets, microentrepreneurs cannot sustain the interest rates charged. Continued reliance upon moneylenders may decapitalize the enterprise.

1.3 Microfinance Institutions Emerge to Meet Financing Gap

While most commercial banks have elected not to serve the microenterprise sector, over the last twenty years a wide range of microfinance institutions has emerged to respond to this market. Successful MFIs have adapted lessons learned from informal finance, such as moneylenders and ROSCAs, to provide access to credit and, in some cases, savings services. In many countries, microfinancial services were initially available from development projects and non-governmental organizations (NGOs) that engaged in charitable activities to assist the poor.

Of the several thousand NGOs worldwide that now offer financial services, the majority provide financial services as just one of many facets of development assistance. These organizations may employ management and staff who are not technically prepared for their financial management responsibilities; their credit operations, which only reach a small number of borrowers, may have problems with portfolio quality. Where these institutions engage in savings mobilization, deposit-taking may be limited to their borrowers and the funds are likely to be deposited with commercial banks. The majority of NGOs engaged in microfinance services rely upon subsidized funds, do not engage in financial intermediation, and do not seek commercial viability.

Nevertheless, from this broad pool of institutions, there is a growing number of organizations specializing in the delivery of microfinancial services that are effective financial intermediaries. In some instances, the successful microfinance institution may be a branch of a multi-faceted development organization. In other cases, the MFI was spun-off as a commercial entity from an NGO parent. In a growing number of examples, microfinance units are being added to commercial financial institutions. All these different types of successful microfinance institutions recognize the following features of the micro market:

- Poor households have funds to save; when offered a convenient, safe and liquid facility, savings from this sector can reach a significant volume.
- Credit access can greatly assist microentrepreneurs with cash flow management.
- Microentrepreneurs know how to use credit intelligently.
- Timeliness of loans and consistency of availability of credit is far more important to borrowers than interest rates.
- Access to repeat loans is a powerful incentive for timely repayment.
• Technical training for borrowers, where employed, must be demand-driven and carefully adapted to individual situations.

• Borrowers understand and respect a hard-nosed approach to loan collection.

A well-managed and efficient microfinance institution, which may mobilize savings and uses the appropriate lending techniques described below, can create a profitable strategic niche in the financial services market. Demand for savings services and loan products is high in the micro market. Given the financing alternatives available to the microenterprises, the availability of credit from an MFI is especially attractive. This demand for credit is elastic given the financial features of microenterprises.

Borrowers have proven themselves reliable, consistent consumers. The majority of microfinance clients seek repeat loans. Repayment rates in the commercially oriented microfinance institutions consistently exceed those of traditional state-owned development banks by a wide margin and in many cases are comparable or superior to rates attained by commercial banks. A well-managed microfinance institution can expect to enjoy strong growth and profitability.

While the growth impetus for MFIs has generally come from microenterprise lending, the leaders in the field are now expanding their product range to meet the diverse demands for financial services from low income communities. These new products may include savings, consumer and housing loans, emergency lines of credit, and fee-based products such as money exchange, wire transfer and insurance services. Other MFIs have roots outside of enterprise lending, but are also diversifying their services to low income communities. They may be savings-led financial institutions, like credit unions, or began in the housing loan market.

1.4 Microfinance Service Methods

The lack of regulation of the microfinance sector to date has allowed institutions across the globe to adopt innovative microfinance methodologies. While each MFI makes some adjustments to respond to the particular features of a local economy or culture, there are remarkable similarities in the service delivery approaches used in the microfinance industry. Specific features of successful microfinance services are addressed below.

Credit Features: Most MFIs use a “stepped lending” approach. MFIs initiate borrowers with small, short-term loans. Although the loan sizes vary from country to country, nearly all MFIs in developing countries offer initial loans under US$1,000, and many offer initial loans of less than US$100. If repayment is timely, borrowers can access successively larger, longer term loans according to enterprise requirements.5

5 The definition of short-term varies from country to country. At Accion Comunitaria del Peru (ACP), for example, loan terms average eight weeks, whereas at Grameen Bank (Bangladesh) first loans are usually repaid over twelve months.
Borrowers are encouraged to undertake repeat loans and may receive multiple loans over the span of several years.

The majority of microloans are used for working capital, although as mentioned above MFIs are now diversifying into fixed-asset lending and even non-business loans. Credit administration is conducted quickly. While different organizations have diverse policies regarding the turn around time on initial loan requests, the period is generally short. Often, MFIs extend repeat loans on the spot or within a few days. The repeat lending function allows MFIs to screen clients and to direct larger loans to proven borrowers. In this way, the MFI establishes a long-term relationship with the client who, in turn, has the incentive to complete his or her obligations to obtain a continuing, and perhaps increasing, flow of resources.

**Appropriate Requirements**: The credit process is appropriate for its market. To issue microenterprise loans, MFIs remove impediments that the formal financial sector has established to transact a loan application, such as collateral, financial statements, letters of reference from banks and businesses, and bylaws of the enterprise.

MFIs allow clients with no credit history to establish a track record; like other prudent financial institutions, MFIs lend against that credit history. Through this approach, MFIs keep loan applications simple, sidestepping the need for historical financial information. Security arrangements are also appropriately conceived. The MFI secures credit through group guarantees, character references, reliable prior performance, the viability of the business, and through chattel mortgages when available. When borrowers grow to small enterprise scale, they can point to a reliable credit history and an adequate asset base to qualify for subsequent loans.

**Repayment Discipline**: The borrower’s on-time repayment is *sine qua non* for subsequent loans. Where available, computerized credit administration systems provide loan officers with accurate and current repayment information. Successful MFIs do not tolerate loan delinquency. Generally, clients with late payments are penalized and they may not be able to access continued loans. This approach, with the accompanying incentives built into the lending process, is highly successful. Competent microfinance lenders are able to hold delinquency and default to levels that rival well-performing financial institutions, levels that are easily handled by standard provisioning policies without detriment to profitability.

**Interest Rates**: The lending policy of a successful MFI is based on the use of positive real interest rates that cover the full cost of lending on the understanding that subsidies are unnecessary to the microentrepreneur and damaging to the institution’s sustainability. Interest charges are calculated to cover the full cost of lending operations, sometimes including a surplus for financing further loans.

These relatively high interest rates are appropriate and essential. They are appropriate because of the high rate of return experienced by microenterprises. Conventional wisdom would suggest that low-income people could not pay high interest rates, when in fact the characteristics of their businesses actually make it possible.
High interest rates are essential because they make it possible for low-income communities to have continued access to financial services. Since subsidies cannot last indefinitely, MFIs have to charge a high enough interest rate to cover their costs, both operational and financial, if they want to provide these services over the long-term. To extend the lending market while covering their costs, MFIs must charge significantly higher interest rates than the traditional banking sector. This is a function of economies of scale in loan size. Just as small business loans have higher rates than multinational loans, micro loans must carry still higher interest rates. Annual real effective interest rates typically fall into the 20 to 60 percent range.\(^6\)

The importance of high interest rates does not give MFIs liberty to be inefficient and to pass on their inefficiencies to low-income clients. Instead of regulating interest rates, however, a more effective approach to ensure that the rates charged by MFIs are appropriate is to encourage competition. This will spur innovation aimed at reducing the risks and costs associated with microlending.

**Savings Facilities:** While in most countries NGO microlenders are not legally permitted to accept deposits, in a small number of cases, particularly in Asia, some microlenders are authorized to do so. This is allowed if they maintain a “Chinese wall” between these liabilities and their assets, and if they only collect savings from their borrowers. This deposit service encourages saving habits and serves as collateral for potential loan losses. In these cases, MFIs do not use deposits as a source of loan capital and therefore are not financial intermediaries.

Many MFIs initially require compulsory savings from prospective borrowers before accessing loans. Some organizations are changing to a voluntary saving approach, whereby clients contribute deposits to an emergency reserve fund, because of client dissatisfaction with the hidden financial costs of compulsory savings. For these institutions, deposit-taking may begin as “loans” from their clients. These term notes, which are not guaranteed, offer higher yields than are available to small savers in commercial banks. In these cases, since most clients are net borrowers, superintendents believe that it is not necessary to regulate these institutions.

The provision of savings services is becoming an increasingly important issue in the field of microfinance. In some regions, either because microfinance services have evolved out of the credit cooperative movement (West Africa) or because voluntary savings from borrowers are permitted (Bangladesh), savings facilities are an essential service offered by MFIs. In Latin America, however, with the exception of common bond organizations such as village banks, most NGO microfinance institutions are not

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allowed to accept deposits. The perceived importance of offering a savings service is one of the reasons driving non-profit MFIs to become regulated financial institutions.

**Efficient Administration:** In successful MFIs, typically less than one quarter of staff is devoted to administrative functions, and more than 60 percent of all personnel is involved in the direct delivery of financial services. The administrative costs of well-managed MFIs, when expressed as a percentage of the average portfolio, are reasonable given the target population, its average loan size, and its fixed administrative costs relative to the total portfolio size, but are much higher than commercial banks.

When reviewing all types of financial institutions, there is a consistent adverse correlation between loan size and the administrative costs. Whereas a commercial bank with large corporate clients may have administrative costs of approximately 1 to 2% of portfolio, a finance corporation that lends to smaller and riskier projects may have administrative costs in the 10 to 12% range. Within this context, many MFIs have administrative costs around 25% over the average portfolio.

**Decentralized Credit Delivery:** The loan officer’s basic functions are to select microentrepreneurs through personal promotion, propose the amount and terms of the loan, visit the clients regularly, coordinate group guarantee schemes (where applicable), monitor repayments and follow-up on delinquencies. Loan officers select clients based on site visits and operate in a decentralized manner. The information that loan officers collect is usually qualitative and subjective, such as assessing contextual elements in the home, which they are only able to interpret effectively after significant experience. One of the greatest strengths of successful microfinance institutions is the credit-assessment skills of its seasoned loan officers. With microenterprises, credit scoring techniques and quantitative indicators of risk are neither appropriate nor effective.

Loan officers typically work out of branch offices located close to the target market. During the term of the loan, loan officers regularly visit their clients to evaluate the business and track its development. This approach guarantees continuous contact between the loan officer and the borrower, accumulating knowledge and experience that is of great importance for the continued livelihood of the program. Loan officers perform outreach, promotion, assist clients to formulate loan requests, and directly supervise loans at clients’ workplaces. Portfolio management reports allow loan officers to track on-time repayment. For an MFI to be successful, loan officers need to know the day a repayment is overdue and respond immediately to delinquent loans.

### 1.5 Potential Scale of MFIs

MFIs that develop effective service delivery methods quickly lend out their initial subsidized funding. Such organizations recognize that to obtain the maximum impact, to reach cost-effectiveness and to achieve financial viability, they must significantly increase the scale of their operations. The challenge faced by such MFIs is to raise sufficient capital to meet the demand for their services while developing the administrative and management capacity to continue to grow. The demand for capital
prompts the MFI’s development process. If an MFI elects to establish a regulated financial intermediary to finance its growth by deposits or inter-bank loans, its potential scale is bounded primarily by its equity base and its management and administrative capacity.

Bank Rakyat Indonesia, Grameen Bank of Bangladesh and Banco Solidario, S.A. of Bolivia demonstrate that it is possible to deliver microfinancial services on a large scale. These institutions operate decentralized service delivery methods, as described above, with small average loans (US$560, US$140 and US$660 respectively) that are identified, evaluated and disbursed at the local branch level. It is important to note that these three microfinance institutions are all legally chartered financial institutions with a long track record. These institutions demonstrate the potential that smaller, younger MFIs may soon achieve.

Bank Rakyat Indonesia

Bank Rakyat Indonesia (BRI), a century old, state-owned commercial bank, is the largest provider of microfinancial services in the world. As of October 1996, BRI’s microfinance branches, or Unit Desas, served 3,500 locations with 15.7 million depositors (total deposits of US$2.8 billion) and 2.5 million borrowers (total loans of US$1.7 billion). Of the 43,000 BRI employees, 23,000 are employed in the Unit Desa system.

BRI Unit Desa dates to the early 1970s when BRI established a branch network to support subsidized agricultural programs. By the mid-1980s, however, agricultural subsidies were depleted. The Ministry of Finance pressed for a significant liberalization of bank regulations that permitted branch units to set their interest rates for loans and deposits. The Unit Desa’s success stems largely from the BRI policy to treat each branch unit as a semi-autonomous profit center that is evaluated independently. BRI finances its microlending operations through market-rate deposits totally independent from international donor grants. Deposits raised by branch units exceed the lending volume by forty percent. While the Unit Desa system represents only 23% of BRI’s total assets, it generates close to 40% of the bank’s revenue. The Unit Desa system is profitable and generates a 31% average return on equity.

The experience with village-based microfinance institutions in Indonesia dates back more than 100 years and is part of the Dutch colonial legacy. Particularly in

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7 Although BancoSol was only established in 1992, its track record of success begins with its parent organization, PRODEM, in 1987.


Central Java, the Dutch encouraged the formation of village small-holder banks. In the late 1960s, during a period of monetary instability and high inflation rates, many of the village small-holder banks faltered. The growth of the Unit Desa System, as well as other village-level financial programs, can be understood as an extension of this well-established tradition of local rural financial services.

While BRI is the largest single institution that provides microfinance services in Indonesia, it is not alone. A complex network of private and other state-owned small scale banking institutions has evolved that provide financial services at the sub-district market towns, a combination of sub-district market towns with village posts or through village small holder banks. Besides BRI, there are a number of prominent microfinance networks including: BKD (approximately 5,345 village units with one million borrowers); BKK of Central Java (approximately 3,525 village units with half a million borrowers); KURK (approximately 1,426 village units and less than 200,000 borrowers); and several other private and municipally owned microfinance institutions.10

**Grameen Bank**

The Grameen Bank began in 1976 as an experimental project of the Chittagong University in Bangladesh. During this initial project phase, the Grameen Bank benefited from the operational support provided by Bangladesh Bank (the central bank) and a credit line from state-owned commercial banks. In 1983, the Grameen Bank was established under a parliament-approved special charter. Originally, the Grameen Bank was owned 60% by government and 40% by its landless borrowers. This ownership distribution has shifted over time. As of October 1996, the Grameen Bank was only eight percent government-owned with 92% ownership held by bank borrowers. The government has board representation, and this serves as the primary method of oversight of the bank.

The Grameen Bank is dedicated to lending to the rural poor. It operates in nearly 36,000 villages and reaches more than 2.1 million borrowers with a total outstanding balance of around US$200 million as of June 1996.11 While the Grameen Bank has both voluntary and compulsory saving schemes, capital to finance the bank’s growth

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10 The number of village-owned banks as of year-end 1996 was provided by the Cooperative Division of BRI responsible for their supervision. Estimates for the number of private village banks is dated as of 1992 and cited in “Report on the FID in Indonesia, October 1992.” All other data is as of 1991 and is derived from, Chaves, Rodrigo and Gonzalez-Vega, Claudio, “The Design of Successful Rural Financial Intermediaries: Evidence from Indonesia”; World Development Vol. 24, No. 1, pp. 65-78, 1996.

has largely come from international donors as grants.\textsuperscript{12} When needed, the Government of Bangladesh has also assisted the Grameen Bank to borrow funds locally.

Grameen Bank lends to small groups of members who are organized into village centers of 60 women each. Loans are available for women’s economic activities, home construction and other medium term credit requirements. Credit services are combined with other social and economic services that are intended to help the rural landless of Bangladesh build assets and increase income.

Grameen Bank is the most visible microfinance institution in Bangladesh—and perhaps in the world—and it is the country’s only MFI with a parliamentary-approved banking charter. Nevertheless, there are hundreds of other microfinance institutions in Bangladesh. As of June 1996, the Bangladesh Rural Advancement Committee (BRAC) served 1.4 million borrowers. In addition, approximately 400,000 households are served by Proshika, and another 400,000 borrowers have loans from the Association for Social Advancement (ASA). The Credit and Development Forum of Bangladesh tracks the performance of more than 200 local NGOs that serve the microfinance market. Combined there are more than five million poor households in Bangladesh that benefit from microfinance services, but the vast majority of the services are provided by Grameen and the top five NGOs.\textsuperscript{13}

Grameen Bank’s 2.1 million borrowers is similar in scale to the 2.5 million borrowers served by BRI in Indonesia. There are, however, a number of critical differences between the two institutions worth noting:

(i) BRI serves a broader, richer, client population including microenterprises, small businesses and employed individuals, while the Grameen Bank focuses on rural landless households only;

(ii) BRI’s savings services significantly exceed the lending activities which is not the case with the Grameen Bank;

(iii) BRI is solely a banking facility while the Grameen Bank also pursues other development activities that extend beyond core financial services;\textsuperscript{14}

(iv) BRI finances its profitable Unit Desa system through local deposits, while Grameen Bank operates at about break-even and depends on international donor grants to support its growth.

\textsuperscript{12} Although the Grameen Bank has relied upon donor grants to fund some of its borrowing requirements, according Khandker, Khalily and Khan (1994), as of 1993 total savings and deposits mobilized could have funded its lending operations.

\textsuperscript{13} The Credit and Development Forum indicates that the top five NGOs have 3.0 million borrowers in addition to the 2.1 million borrowers of the Grameen Bank.

\textsuperscript{14} Grameen Bank’s social activities include organizing day care, distributing seedlings and a tube well program.
But the similarities are more important. These two organizations both operate well-disciplined branch networks that delegate authority to the field. They engage in true financial intermediation and have reached impressive scale.

**BancoSol**

The discussion of leading MFIs would not be complete without a profile of Banco Solidario, S.A., in Bolivia. Although much smaller than BRI or Grameen, with just 75,000 active borrowers, BancoSol has achieved significant scale compared to the population of Bolivia (approximately seven million). BancoSol’s clients represent 40% of the banking customers in Bolivia—impressive outreach for a bank that has only been in existence for five years.

The story of BancoSol begins with PRODEM, a non-governmental organization. In 1987, PRODEM was created as a joint venture between prominent members of the Bolivian business community, who provided seed capital and leadership, and ACCION International, a US-based NGO that provided the technology and methodology. This methodology includes providing small short-term loans for working capital to solidarity groups of four or five entrepreneurs.

With initial funding from USAID, Calmeadow\textsuperscript{15} and the Bolivian private sector, PRODEM began lending in 1987. Its early success opened the doors to new funders and larger grants. By the end of 1991, PRODEM was operationally self-sufficient. It had eleven branches, 116 employees and a loan portfolio in excess of US$4 million—yet, it had not made a dent in the demand for financial services from the informal sector. As an NGO, PRODEM was unable to access sufficient financial resources to keep pace with the demand, and was restricted from providing additional services to its clients, most notably savings.

In response to these limitations, the directors of PRODEM decided to create a commercial bank, of which PRODEM would be the largest shareholder. PRODEM sold its urban branches to BancoSol and then turned its attention to developing financial products and delivery systems for rural areas. PRODEM now owns slightly more than 30% of BancoSol. Other shareholders include Profund\textsuperscript{16} and local Bolivian investors.

Although the bank began as a microcredit program, BancoSol is now a financial intermediary. After a year-long pilot project, BancoSol introduced a voluntary saving service in all branch offices in mid-1994. BancoSol currently funds

\textsuperscript{15} Calmeadow is a Canadian NGO specializing in microfinance that channeled funding from the Canadian International Development Agency (CIDA) to PRODEM.

\textsuperscript{16} Profund is an equity fund based in Costa Rica that was designed specifically to invest in Latin American microfinance institutions. Profund’s founding sponsors are ACCION International, Calmeadow, SIDI and FUNDES. Other investors now include the International Finance Corporation (IFC), IDB, Swiss government, Commonwealth Development Corporation, Corporacion Andina de Fomento (CAF) and the Calvert Investment Fund.
approximately 25% of its loan portfolio by savings mobilization. The rest of its loan portfolio is funded through inter-bank loans and equity.

BancoSol relies on market pricing. The bank has an excellent loan repayment rate despite a real annual interest rate of approximately 30% on US dollar loans and 45% on Boliviano loans. It is possible to describe BancoSol as both a development organization and a profit-seeking commercial bank; it aims to succeed by combining both of these goals. Since 1992, profit levels have fluctuated from a low of 5% to a high of 18% return on equity.

Although BancoSol is the largest and best known MFI in Bolivia, the local regulatory environment has encouraged significant competition for the microfinance market. The Bolivian government has created a new category of financial institution designed specifically for MFIs. The first institution to qualify under this category, Los Andes, has approximately 20,000 borrowers. Other successful Bolivian microfinance institutions include BancoSol’s parent, PRODEM, which provides loans in rural areas to nearly 30,000 clients, and FIE with more than 14,000 borrowers. Both PRODEM and FIE are also in the process of becoming licensed under this special category, which is discussed in more detail in Chapter 4.

BRI in Indonesia, Grameen Bank in Bangladesh and BancoSol in Bolivia, all demonstrate the significant impact that may be obtained by successful microfinance institutions. Given the unsatisfied market demand for microfinancial services, there is every reason to believe that other institutions will meet the challenge of raising sufficient funds and effectively administering these resources to achieve this level of scale and impact.
2. **RISK PROFILE AND REGULATORY APPROACHES TO MICROFINANCE INSTITUTIONS**

An appropriate MFI regulatory approach is based on an understanding of the risk profile of microfinance institutions and the legal and institutional framework of a given country. In some circumstances, it may be necessary to regulate MFIs to manage their risk profile effectively. In this chapter we consider the risk profile of microfinance institutions, the range of possible regulatory responses, and the appropriate time to regulate MFIs. While this risk profile explicitly describes institutions that have moved from the non-profit to the for-profit sector, many of these issues are also applicable to the microfinance portfolios of commercial or government-owned banks. This chapter will also review initial steps taking place in two countries of an education and policy process to identify the appropriate regulatory approach for MFIs.

2.1 **Microfinance Risk Profile**

Microfinance institutions hold many risk features in common with other financial institutions. For example, MFIs and commercial banks are both vulnerable to liquidity problems brought on by a mismatch of maturities, term structure and/or currencies.

On the other hand, many risk features of commercial banks are not directly applicable to microfinance. For example, commercial banks are vulnerable to concentration of risk when a large loan to a single borrower can put at risk the total bank’s capital or when multiple loans are exposed to the risk of a related enterprise group. Insider lending is another area of concern for commercial banks when managers or owners can use their influence to extract unsound loans of significant size. Yet, because of the volume of transactions and their very small size, such issues do not present significant risks to microfinance institutions.

Many regulatory features adopted to address the risks of standard commercial financial institutions do not apply to MFIs. The design of appropriate microfinance regulation should be based on an understanding of the risk features particular to MFIs and effective measures to mitigate them. Leading MFIs, such as those described in the previous chapter, have demonstrated that it is possible to manage these risks effectively and that they can achieve excellent performance over many years.

There are four principal areas of risk that are specific to microfinance institutions: ownership and governance, management, portfolio, and new industry. Except for ownership and governance risk, which is particular to NGOs creating regulated
financial institutions, these risks are applicable to microfinance portfolios regardless of whether the implementing institution is a commercial bank, government bank or an organization with its roots in the non-profit sector.

Ownership and Governance Risk

While effective external regulation and supervision from regulatory bodies are important to the health of the financial system, no amount of external oversight can replace accountability that stems from proper governance and supervision performed by the owners and directors of financial institutions. For small financial institutions, such as MFIs, which are not likely to receive significant attention from bank supervisors, the importance of governance is heightened.

As a point of reference, the owners of microfinance institutions that have evolved out of the non-profit sector typically include: donors, government agencies or donor-funded agencies from developed countries; local private investors; socially responsible commercial investors; and the NGO parent.

Adequate oversight of management: Ownership and governance risk occur if the owners and directors of the MFI do not have the capacity to provide adequate management oversight. This is an issue because of the nature of institutions and individuals who typically own an MFI, or who are on its board. For example, the directors of a non-profit organization may not have the skills and experience to govern a formal financial institution. If investors are socially motivated institutions, like donor or government agencies, they may place a priority on the institution achieving social objectives. The personnel from these owner-institutions, who are usually trained in social and political matters, may not be prepared to exercise supervision over a financial institution. If investors include the local government or government-owned institutions, MFIs may experience political interference and be encouraged by these owners to direct credit to a particular region or party members. Even when private individuals invest their resources, they will likely place the investment to accomplish social goals. As a result, they may not hold this investment to the same standards that they apply to commercial ventures. Furthermore, the private capital invested in the MFI by high net worth individuals may be of symbolic importance, but may not be financially material for the investor. Without significant resources at risk, investors lack incentives to monitor the institution adequately. MFI management may not face the same scrutiny and be held accountable to the same commercial standards by owners and directors.17

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Ownership and organizational structures: In some regulated microfinance institutions, there are unclear ownership and organizational arrangements involving the non-governmental organization or public institutions that played a role establishing the newly formed regulated MFI. High risk scenarios can develop. If an NGO, which is funded with public resources and does not have owners, oversees the management and determines the policies of the regulated financial intermediary, the social mission may take priority over financial objectives. Where service delivery is shared by the NGO and the financial institution, transfer pricing may obfuscate the true performance of the regulated financial intermediary, hindering bank regulators from gaining an accurate financial profile of the regulated entity. Instability at the unregulated parent NGO level could undermine the stability of the financial intermediary.

Sufficient financial depth: While MFIs may be capable of raising the initial capital requirements from their founding shareholders, these owners may lack financial depth or flexibility to respond to additional calls for capital as may be needed. In the case of a deterioration of portfolio quality or other unforeseen difficulties that place pressure on minimum capital levels, MFIs may have difficulty raising additional capital promptly. Development institutions may require a lengthy approval process to secure disbursement of funds; private sector investors with modest investments may be unwilling to place more funds into a troubled organization. This makes the MFI more vulnerable to temporary shocks that could quickly undermine the financial health of the institution.

Management Risks

The management risks that apply to microfinance portfolios are generated by the specific service delivery methods required to serve this market. Therefore, they are applicable regardless of the type of institution that is operating a microfinance portfolio. Other industries with similar service delivery systems (e.g., decentralized operations, high volumes and low returns per loan), such as consumer finance, encounter similar management risks.

Decentralized operational systems: As discussed above, a decentralized organizational structure, which permits the delivery of field services directly at the borrowers or savers’ locations, is central to microfinance service methodologies. Such decentralized operating methods present management challenges in any industry. Poor telecommunications and transportation infrastructure can compound this challenge. Furthermore decentralized operating methods generate an environment that can be subject to fraudulent practices if internal controls are not sufficient.

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18 This was the case between Corposol and Finansol in Colombia, which is discussed in detail at the end of the following chapter.
Management efficiency: Microfinance institutions offer a high volume, repetitive service that operates on low returns per loan. If a branch or unit falls short in the projected loan volumes, profits can quickly turn to losses. The short term nature of microfinance loans compounds these problems—in many microfinance institutions the dollar value of accumulated disbursements may double the average portfolio value for the year because of high portfolio turnover. If funds are not relent promptly, earnings will suffer. The quality of management to ensure brisk and timely services is essential to the financial success of microfinance portfolios.

Management information: The backbone of an MFI’s management is its management information system. While this is true of all financial institutions, the decentralized operating methods, the high volume of short-term loans, the rapid portfolio turnover, and the requirement for efficient service delivery make accurate and current portfolio information essential for effective MFI management. Timely and reliable management information is also critical at the branch level. As emphasized in the previous chapter, loan officers need to know the day a repayment is overdue and respond immediately to delinquent loans. A weak management information system might delay the follow-up on delinquent loans and could quickly undermine the quality of a microfinance portfolio.

Portfolio Risk
The basic features of the products and services that are appropriate for the micro market contribute to a different set of portfolio risks than are usually encountered by commercial lending institutions.

Unsecured lending: Most microlending is unsecured in traditional terms. Microlending is based upon character references, either through a group guarantee or other methods. Collateral, when pledged, may not be legally registered or may have little liquidation value. For example, payroll pledges from a friend or family member of a borrower become meaningless if the guarantor is laid off. While most MFIs seek to enhance the quality of the loan security arrangements where possible, recourse to property titles and other security may not be available. The non-traditional approaches employed in microfinance are usually as effective as traditional collateral, but economic shocks could expose the institution if these approaches break down in a crisis.

Delinquency management: Some MFIs have undergone significant swings in the on-time repayment of their portfolio. Although the MFI may hold delinquency levels low for extended periods, precipitous changes in delinquency rates may arise. Strong and continuous supervision of branch offices is key to the success of microlending. Consequently, lax management practices could prompt a rapid deterioration in performance.
Liquidity problems can lead to higher delinquencies since the primary incentive for on-time repayment is access to repeat financial services. Delinquency could also arise from unrealistic growth targets and poor staff training. Since operating costs are so high relative to the size of the portfolio, temporary delinquency problems become more serious more quickly than in traditional banking. A spike in the portfolio delinquency and resultant loan losses could rapidly erode the MFI’s equity base.

**Sector or geographic concentration risk:** Unlike the risk concentration typically borne by commercial banks, where an individual large loan or loans to a related enterprise group may put the bank at risk, MFIs may be subject to risk if many clients come from a single geographic area or market segment that is vulnerable to common economic dislocations. Furthermore, unlike other types of financial institutions, which offer a variety of products across many markets, many MFIs have highly specialized portfolios that consist solely of short-term working capital loans to informal sector clients. While an institution may have thousands of loans to diverse industries, externalities could affect the MFI’s entire market. It is important to point out, however, that this risk is largely theoretical. There are very few examples to date of sector or geographic concentration risk affecting microfinance portfolios.

**New Industry Risk**

A number of the risks that face the microfinance industry stem from the fact that its techniques are relatively new and untested. At the same time, formal financial services may also be new to the micro market. These risks should diminish with time as the microfinance industry and its market mature. In the meantime, this risk is particularly relevant to bank regulators since it suggests that they should take a cautious approach to this new industry.

**Adequate professional experience:** There are few professionals with prior professional banking experience that are also directly familiar with microfinance methods. Nevertheless, many of the core banking functions of a microfinance institution, such as treasury, internal audit and administration, are similar to those of other financial intermediaries. Because microfinance is a new industry and many MFIs are unable to offer attractive compensation packages, MFIs may have difficulty attracting capable management talent. This leaves microfinance portfolios vulnerable to inexperienced managers. This problem is exacerbated by the low status banking professionals generally attribute to small enterprise services. Commercial banks that operate microfinance portfolios may have similar problems since the better bankers are likely to be attracted to larger scale lending activities.
Growth management: MFIs that expand into new markets may face little competition. These institutions can experience dramatic growth in their initial years of operation. It is not uncommon for microfinance portfolios to double in size on an annual basis. Sustaining such growth rates presents management with the challenges of developing a trained cadre of employees, implementing standard policies and procedures, and maintaining portfolio quality.

New products, services and methodologies: While this industry has made considerable advances in the design of appropriate microfinance products and services, the field remains relatively young and untested. It is difficult to assess whether a new product, service or methodology is an ill conceived deviation from an existing methodology or is a breakthrough in new services for the market.

New market: Because MFIs are reaching out to new segments of the financial services market, there is little knowledge about this market’s performance over time. Will demand continue to grow at the same rate, accelerate or taper-off? Market trends or patterns are not well documented. And, just as the market is new to MFIs, financial services are new to the market. Many clients still need to learn the basics of financial planning and the value of the financial services offered.

Young institutions: A fundamental risk is that most MFIs, whether they have evolved from the non-profit sector or they are subsidiaries of commercial banks, are relatively young institutions. Therefore, there remains much to learn about how these institutions behave in a crisis. What is the institutional learning curve? What is its ability to absorb lessons and apply them to improve organizational effectiveness?

While “New Industry” risks will resolve themselves as the industry matures, other risks must be managed through internal and external means. The experiences of BRI, the Grameen Bank and BancoSol, as discussed above, demonstrate that it is possible to manage these risks and that MFIs can grow to significant scale. The discussion below examines different regulatory approaches that can be adopted to address the risk profile of MFIs effectively.

2.2 Regulatory Approaches to Microfinance Institutions

The challenge facing regulators as they consider appropriate regulatory approaches to this sector is complicated by the fact that MFIs range significantly in institutional type, scale of operations and level of professionalism. Informal rotating savings and credit associations (ROSCAs), village banks, national or regional non-governmental organizations, credit cooperatives and commercial banks may all fall within the broad definition of microfinance institutions. The
regulatory approach in a given country must be consistent with the overall financial sector framework and must consider the variety of institutional types.

Possible responses to microfinance institutions, outlined in Box 3, range from no regulation to full external regulation:

(i) _No regulation:_ Because microfinance has evolved outside of a regulatory framework, it has been free to innovate and develop non-traditional approaches to providing financial services. In some countries, as the local microfinance industry matures, MFIs have established associations or interest groups to initiate a formalization process. Such efforts may include defining best practices and industry standards.

(ii) _Pure self-regulation:_ Self-regulation occurs where the industry develops its own supervisory and governance bodies. This has occurred primarily through federations of credit unions or cooperatives.

(iii) _The hybrid approach:_ In the “hybrid approach”, regulatory authorities contract a third party, such as an accounting or consulting firm, to perform some or all of the supervisory functions. This is particularly relevant to microfinance since superintendents may not have the technical expertise to monitor this unique type of institution, nor an interest in paying close attention to such small financial institutions.

(iv) _Existing law:_ Some countries have opted to regulate microfinance institutions within the existing legal and regulatory framework for formal financial institutions, but to adapt required ratios and supervisory practices to address their unique risk profile.

(v) _Special law:_ Other jurisdictions have established specialized laws or regulations specific to MFIs or to portfolios of microfinance loans.

The impetus for addressing the microfinance sector has varied widely. In the Philippines and South Africa, for example, an association of microfinance institutions has initiated a policy dialogue with the government as a first step toward educating regulators, establishing industry performance standards and defining an appropriate regulatory approach. These ‘initial steps’ are discussed in more detail later in this chapter.

In other cases, a single microfinance institution attracts the attention of regulators by establishing a regulated entity, such as a commercial bank or finance company, under existing regulatory guidelines. This was the experience in Bolivia, Colombia and Kenya, and is addressed in Chapter 3. Regulators in West Africa, Bolivia and Peru have established regulations, by law or by order of the banking superintendency, that are designed specifically for microfinance institutions. The regulation of these non-bank financial institutions is presented in Chapter 4.
Box 3: Regulatory Approaches to Microfinance Sector\(^{19}\)

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<td>Government Mandate</td>
</tr>
<tr>
<td>Examples</td>
<td>Alliance of Microenterprise Practitioners in South Africa, coalition in the Philippines</td>
<td>Credit Unions</td>
<td>BRI supervises village banks in Indonesia, FEPCMAC in Peru</td>
<td>BancoSol, commercial banks</td>
<td>PFF in Bolivia, EDPYME in Peru</td>
</tr>
</tbody>
</table>

The self-regulation approach, as is typically adopted by credit cooperatives, is widely applied in countries with an active credit cooperative movement. Important lessons about self-regulation can be drawn from the credit union experience, but it is not the focus of this research. Experience with the “hybrid approach” is less common, but is represented by innovative approaches to banking supervision adopted in Indonesia and Peru, and discussed in Chapter 5.

2.3 To Regulate or Not

The vast majority of microfinance institutions are small and informal, and operate as voluntary associations at the local level. It is not feasible nor desirable to regulate them. Regulators should concentrate their attention on institutions that would like to offer deposit-taking services to the general public. The fact is, very few MFIs have the combination of ownership structures, management, financial discipline, information systems and profitability that are necessary to be safe deposit takers. In most countries, there are no more than one or two institutions that might warrant regulatory attention. In exceptional cases with more mature microfinance industries, such as Indonesia, Bolivia and Bangladesh, there may be a greater number.

In general, it is only necessary to regulate MFIs that mobilize voluntary savings for the purpose of on-lending. However, there are organizations that mobilize voluntary savings which do not need to be regulated. For example, it may not be

\(^{19}\) Adapted from the framework presented by Sizwe Tati, Khula Enterprise Finance Ltd. at the Microcredit Summit in Washington, DC, February 3, 1997.
necessary to regulate common bond institutions, such as village banks and
ROSCAs, which are small enough so that all members know each other.

Regulators are primarily responsible for two things: 1) to preserve the integrity of
the financial system and 2) to protect small depositors. Almost all of the experts
who advised this research felt strongly that as long as MFIs do not mobilize
savings from the general public, they should not be regulated.

Nevertheless, it is possible to make two arguments for regulating credit-only MFIs.
First, if the MFI has access to government credit lines for on-lending to the
microenterprise sector, regulation may be required to ensure effective use of public
resources. This argument is questionable since wholesale lenders, whether they are
public or private, should assume responsibility for monitoring their loans instead of
delegating that responsibility to bank supervisors.

Second, if the MFI wishes to become a deposit-taking institution in the future,
regulators may want to become familiar with the institution and its capacity,
thereby laying the groundwork for authorizing deposit-taking at a later date. The
counter-argument to this point is based on practicality. Most regulatory and
supervisory agencies do not have the capacity or the resources to monitor small
institutions that do not pose a threat to the integrity of the financial system.
Therefore, this “nice to have” transition arrangement may not be practical in many
countries. Overall, if regulation is deemed necessary for credit-only MFIs, then the
requirements and levels of supervision would undoubtedly be less stringent than
for financial intermediaries.

2.4 Initial Steps

In South Africa and the Philippines, local microfinance institutions have begun a
dialogue with regulators and policy makers to define the appropriate regulatory
approach for their environment. Through initial efforts to outline best practices in
the field and to establish industry standards, MFIs are educating regulators and
vice versa. Other jurisdictions may want to consider a similar path towards
identifying an appropriate regulatory response to the dynamic growth of
microfinance in their countries.

South Africa

In South Africa, MFIs have established the Alliance of Micro Enterprise
Practitioners. This association provides local microfinance organizations with an
opportunity to share experiences and technologies, and it plays an important
lobbying role. For example, the Minister of the Department of Trade and Industry
proposed repealing the exemption to the Usury Act, which currently allows MFIs
to charge higher than commercial interest rates on loans below R6,000
(US$1,350). The government wants to repeal the exemption because it allows
moneylenders to charge interest rates that exploit the poor. The Alliance has
appealed to the government not to remove the exemption—and requested that it increase the loan amount to which the exemption applies from US$1,350 to US$4,350—because MFIs cannot provide sustainable microfinance services within the interest limitations imposed by the Usury Act.

Some members of the Alliance have been working with two government-owned wholesale development finance institutions—the National Housing Finance Corporation (NHFC) and Khula Enterprise Finance, Ltd.—to develop codes of conduct for retail microlending, known as Statements of Sound Practice. The objectives of this initiative are to:

- Establish meaningful best practice standards to which retail lending MFIs would adhere in order to qualify for funding from wholesalers;
- Create a framework of self-regulation which would raise standards in the industry and make it easier to raise institutional funding over time; and
- Develop a long-term framework of appropriate regulation for retail MFIs.

NHFC and Khula have also established an advisory panel that is working with the government on matters pertaining to the MFI industry. This ten-person panel consists of representatives from NHFC, Khula, the South African Reserve Bank, five MFI practitioners, a representative from the private sector and a representative of the Institute of Chartered Accountants. This Advisory Panel is responsible for approving an initial draft of the Statements of Sound Practice and any subsequent amendments. It also advises the wholesalers on trends and developments in the microfinance industry; and will be responsible for developing proposals for a long-term regulatory framework for microfinance institutions.

The South Africa experience stands out as a broad and participatory process to enhance the regulatory environment for microfinance. This case illustrates two points made in the previous section. First, South African regulators are not rushing in to license MFIs because they do not mobilize voluntary savings. In South Africa, there is a widespread availability of savings services, through commercial banks and the Post Office Savings Bank, and therefore most NGO microfinance institutions are more concerned with increasing the scale and quality of their lending activities than offering savings services. The second point is that the Advisory Panel initiative was led by the government-owned wholesalers, NHFC and Khula. They have involved the Reserve Bank in the discussions in an advisory capacity, but the result of this process is likely to be some form of industry self-regulation. If this approach is adopted, it will give the wholesale funders confidence as they extend public resources to MFIs, and yet it will not burden the Reserve Bank with the responsibility of supervising credit-only institutions.

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20 The South African Reserve Bank is responsible for licensing and supervising all commercial and mutual banks, as well as protecting the value of the currency and influencing the monetary supply. The independence of the Reserve Bank is guaranteed in the South African constitution.
Philippines

A similar initiative is being undertaken in the Philippines. The process of establishing performance standards for microfinance in the Philippines has involved assembling a multi-sectoral coalition which as of December 1996 consisted of 34 member institutions, including:

- Leading NGO microfinance practitioner coalitions;
- The Supervision Unit of the Central Bank;
- The People’s Credit and Finance Corporation (a new wholesale development finance intermediary for microfinance);
- Two commercial banks that lend to NGOs for microfinance;
- Other government planning and regulatory bodies;
- Private foundations, academic and research organizations; and
- Donor agencies.

Funding for this project comes from USAID, and the project is managed by TSPI Development Corporation, a leading microfinance institution in the Philippines. This two-year project, which started in August 1996, is designed to develop and promote standards for microfinance operations. Standards are expected to help NGOs build capacity to increase their outreach and access to funds. Microfinance industry standards will assist banks and other financial institutions to identify effective MFIs. This project will also establish baseline data to help the government define an enabling policy environment. Project activities include the design and implementation of a national microfinance survey, regional forums to promote the adoption of performance standards, and a series of training workshops.

The participation of government and regulatory agencies is considered critical to the project success. Through this project, the Central Bank will evaluate and recommend to the Monetary Board an appropriate regulatory approach for microfinance institutions. The National Credit Council, under the Department of Finance, is involved in this process because it is responsible for coordinating and rationalizing existing government credit policies. And the National Economic and Development Authority, the top economic planning body, is participating to incorporate microfinance into national economic policies. Besides defining performance standards and promoting their application, an important outcome of this project is to involve the appropriate regulatory and governmental officials in generating a suitable environment for microfinance institutions.

These initiatives in South Africa and the Philippines suggest possible approaches to defining an appropriate regulatory environment for microfinance. While the efforts in both countries are too recent to evaluate their effectiveness, similar initiatives are worth considering in countries where regulators, policy makers and MFIs need to learn more about each other. The common elements in these two initiatives are: (i) they involve a wide range of participants in the policy process including leading
MFIs or national microfinance associations, planning bodies and governmental ministries, in addition to regulatory bodies; (ii) they begin by establishing voluntary industry performance standards to promote professionalism, uniform practices in the microfinance industry and peer group comparisons; and (iii) dialogue and analysis are undertaken before launching microfinance regulation.
3. REGULATION: EXISTING LAW APPROACH

In a number of countries, successful NGOs have established regulated financial intermediaries within the country’s existing regulatory framework. For example, in the early 1990s, PRODEM of Bolivia and Corposol of Colombia, both non-governmental organizations, spawned regulated financial intermediaries—one a commercial bank (BancoSol) and one a finance company (Finansol)—to provide microfinancial services. K-Rep, an NGO in Kenya, has recently presented a license application to create a commercial bank; in the Philippines, TSPI Development Corporation has submitted an application to establish a thrift bank; while the Bangladesh Rural Advancement Committee (BRAC) is preparing to spin off its financial services to a BRAC-owned commercial bank.

This chapter reviews the experiences of regulating MFIs within the existing regulatory framework, with an emphasis on minimum capital requirements, ownership issues and management qualifications. These experiences highlight mismatches between the standard regulatory framework and the provision of microfinancial services. An understanding of these discrepancies suggests ways of accommodating MFIs within the existing regulatory framework on a case by case basis. Finally, this chapter reviews the recent financial crisis that occurred at Finansol in Colombia, and the lessons that this experience suggests for regulating microfinance institutions.

3.1 Creating Regulated Entities

In nearly all cases, the primary factor motivating NGOs to shift their microfinancial services to a regulated financial intermediary is the organization’s desire to ensure its long-term financial and institutional viability through increasing access to borrowed funds, by accepting deposits, entering the inter-bank market or opening access to credit lines. Other possible benefits may include heightened credibility with both investors and depositors, deposit insurance, and the opportunity to increase the scale of operations significantly.

The decision for an NGO to establish a regulated financial intermediary involves a number of tradeoffs. While electing to increase its access to external financial resources, NGOs perceive regulations as limiting their operational and financial flexibility. As a regulated entity, provisioning, write-off and other operating policies would now be defined by bank regulators; and the organization would have to comply with monetary policy controls and reserve requirements. The organization would not be able to transfer resources easily between its financial
operations and any development activities in which it is involved. Although access to additional funding sources can be a powerful incentive for creating a bank, after establishing a regulated financial intermediary, the institution may no longer qualify for subsidized funds.

The financial institution would be subject to time consuming reporting requirements. Estimates of the costs of complying with financial regulations in some countries may range from 30 percent of total profits (United States) to 20 percent of total operating costs (Colombia).21 Most MFIs cannot afford these additional costs unless the market allows them to increase their interest rates.

If the NGO continues to function, an appropriate relationship must be determined, defining boundaries of operations for the regulated financial entity separate from the NGO. This may generate significant management challenges. The new entity will require experienced bank managers who may bring a different management culture. In addition, the functions of the NGO and the regulated financial intermediary must be coordinated.

In general, for NGOs, the decision to establish a regulated financial intermediary indicates significant institutional commitment to providing financial services in a commercially viable and sustainable manner. While NGOs debate the relative advantages of establishing a regulated financial intermediary, regulators need to consider whether it is necessary or desirable to regulate microfinance institutions.

3.2 Applying to Become a Regulated Financial Intermediary

In Bolivia and Kenya, the process of applying for a commercial bank license was one of reciprocal education.22 The NGO assumed responsibility for orienting the local banking superintendency about the features of microfinance and its potential in the local economy. In the Kenyan case, representatives from K-Rep accompanied Kenyan regulators to Bolivia to examine BancoSol’s operations first-hand and to discuss its supervision with their Bolivian counterparts. The education of regulators in both cases also included visits to the field operations of successful microfinance NGOs in their own country. In Bolivia and Kenya, bank regulators, who were familiar with cooperatives and other forms of mutualist societies, now view microfinance institutions as a means to further extend the financial services in their country.

Once familiar with the microfinance sector, the process of securing a commercial bank or finance company license was similar in the countries examined. The

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21 Author’s conversations with Jorge Castellanos and Hennie van Greuning.

22 In Colombia, Corposol bought an existing finance company license, thereby significantly reducing the hurdle of securing superintendency approval. In Bangladesh, the Grameen Bank, which had been awarded a special charter from congress in 1983 had already familiarized banking superintendent officials to microfinance.
standard license application process included the preparation and submission of marketing studies, feasibility analysis, financial projections, a plan for branch development, and lists of proposed managers and directors.

NGOs that have entered the licensing process have encountered several challenges, including finding investors to assemble the minimum capital requirement, the ongoing role of the parent NGO, developing effective governance and ownership structures, and the appropriateness of management qualifications. Each of these is discussed below.

Minimum Capital Requirements

There are diverse views of the purpose and effectiveness of minimum capital requirements. The main reason a financial institution needs capital is to absorb shocks. The more capital a financial institution has, the better able it can sustain losses. In addition, the more money owners of the financial institution have at stake, the more closely they will monitor the behavior of bank managers. As such, capital serves as an incentive to avoid high risk decisions. Some bank regulators use minimum capital requirements as a tool for controlling the number and type of market entrants—by decreasing the minimum capital level to encourage market competition or increasing the level when regulators believe there is an adequate number of financial intermediaries. Where minimum capital levels are high, they can serve as a barrier to the development of microfinance institutions.

In Colombia, for example, Corposol seriously contemplated establishing itself as a commercial bank, but it found the US$13.8 million in minimum capital required at the time to be prohibitive. Instead, Corposol acquired a finance company with a lower capital threshold (US$3.0 million). The only limitations on its functions as a finance company were activities, such as foreign exchange transactions, that the institution was not interested in anyway. In South Africa, where the minimum capital requirement for commercial banks is US$11.1 million, the government created a category for mutual banks with a minimum capital requirement of US$2.2 million. One of the main purposes of creating this category was to extend the provision of financial services to lower income persons.

Since the minimum capital requirement can also be viewed as a means to establish the owner’s commitment and financial depth, it can encourage responsible owner behavior. Low minimum capital standards—such as the US$25,000 requirement in Indonesia to become an independent village bank—could open the door to investors with high-risk practices.

23 The minimum capital requirement to establish a bank in Colombia has subsequently increased to US$ 22.8 million.

24 In Colombia, a commercial finance company can offer checking accounts and savings services if its equity base is 60% of the minimum capital requirement of a commercial bank.

25 R10 million at an exchange rate of US$1 to R4.50.
Box 4: Minimum Capital Requirements, 1996 (US$)

<table>
<thead>
<tr>
<th>Country</th>
<th>Commercial Bank</th>
<th>Finance Company</th>
<th>Specialized MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>3.25 million</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Bolivia</td>
<td>3.2 million</td>
<td>N/A</td>
<td>1.0 million</td>
</tr>
<tr>
<td>Colombia</td>
<td>22.8 million</td>
<td>4.0 million</td>
<td>N/A</td>
</tr>
<tr>
<td>Kenya(^{26})</td>
<td>1.3 million</td>
<td>670,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Peru</td>
<td>5.5 million</td>
<td>2.8 million</td>
<td>265,000</td>
</tr>
<tr>
<td>Philippines(^{37})</td>
<td>80 to 180 million</td>
<td>4.0 million</td>
<td>N/A</td>
</tr>
<tr>
<td>South Africa</td>
<td>11.1 million</td>
<td>none</td>
<td>2.2 million(^{28})</td>
</tr>
</tbody>
</table>

While regulators may set minimum capital standards in accordance with their objectives of encouraging competition and low-risk behavior, they must also consider the source of the capital and the proposed ownership structure. Does the money belong to the proposed owners, are they honest, and why do they want to create a financial institution? Because MFI owners may hold social objectives over profit-maximization goals, minimum capital requirements may not be as powerful an inducement to sound governance as would generally apply with standard commercial banking institutions. This is particularly relevant if the founding NGO is an owner of the financial institution since the NGO itself does not have owners.

The Continued Role of the Founding NGO

A critical issue for NGOs spawning regulated financial intermediaries is the continued role of the founding NGO. The situation with PRODEM/BancoSol and K-Rep are discussed briefly here; the arrangement in Colombia between the NGO Corposol and the finance company Finansol is addressed in detail at the end of this chapter.

**Bolivia:** PRODEM began as 35% owner of BancoSol. Forty-six percent of BancoSol’s shares were owned by international institutions, including the Inter-American Investment Corporation, Calmeadow, ACCION International, FUNDES, SIDI and the Rockefeller Foundation; and 19% was invested by Bolivian private capital.

\(^{26}\) For locally-incorporated finance institutions; internationally incorporated companies have significantly higher capital requirements.

\(^{27}\) The range of minimum capital requirements depends on whether the bank is based in or outside of Metro Manila. TSPI has applied to be a Thrift Bank, which has a minimum capital requirement of $1.6 to 10 million. The Philippines also has a category for rural banks with a minimum capital requirement of $80,000 to $800,000.

\(^{28}\) This amount is for a Mutual Bank, which is not designed specifically for microfinance institutions. However, the purpose for creating this category was to extend the financial markets to low-income communities, as is the case for special regulations for MFIs.
Upon creating BancoSol, the directors of PRODEM decided to continue to function as a microfinance NGO, but to operate in different geographic areas than the bank. Initially, PRODEM transferred its profitable urban-based field offices to BancoSol in exchange for share capital and then refocused its mission on two activities: (i) developing a sustainable model of rural lending for Bolivia; and (ii) developing new financial services for the microenterprise sector. As the semi-rural offices in medium sized towns became profitable, PRODEM sold them to BancoSol for a price established as an arms-length transaction. Today, instead of selling the profitable rural offices to BancoSol, PRODEM is now considering the creation of a regulated intermediary under specialized legislation to operate as a rural bank.29

One of the reasons the BancoSol/PRODEM split has functioned successfully is that PRODEM developed its own strategic identity and direction, independent of BancoSol, including separate (although overlapping) boards of directors, separate management, and strict control of inter-company subsidies. While the two organizations collaborate on several fronts, they are operationally independent of one another. Although PRODEM remains the largest shareholder of the bank, Bolivian law limits the influence of any one shareholder to 20% of the votes. This ensures that the NGO owner cannot control the behavior of the bank without the agreement of at least two other directors.

In another example from Bolivia, Pro-Credito, the NGO parent of Caja Los Andes and initially its majority shareholder, limits its function to that of a holding company of the financial institution. This arrangement may not be desirable for some NGOs if they want to continue to offer financial or non-financial services that complement the objectives of the affiliated regulated financial intermediary.

**Kenya:** The K-Rep NGO intends to take a different approach. After the creation of the K-Rep Bank, the NGO will fashion itself as a microenterprise development support institution. It will assist microfinance institutions throughout Africa by providing consulting and product development services, staff training, and market, impact and feasibility research. Its operations will be completely separate from the financial institution, and any work that it does for the bank will be on a fee for service basis.

Although the minimum capital requirement for a commercial bank in Kenya is US$1.3 million, K-Rep Bank Ltd., will be established in 1997 with a capital investment of US$5.9 million. This level was set by K-Rep in order to demonstrate the strong financial backing of K-Rep bank and to assuage some of the concerns of the bank superintendent about licensing a microfinance bank.

The bank will be 25% owned by K-Rep Holdings Limited (KHL), which also “owns” K-Rep the NGO, in a manner of speaking. This structure is designed to allow the NGO and the bank to operate independently while maintaining some

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29 This special legislation for Private Financial Funds (PFFs) is discussed in Chapter 4.
degree of coordination. The size of KHL’s stake is the largest ownership share possible under Kenyan law, which forbids any person or institution, except banks and public companies, from owning more than one-quarter of a bank. International, socially motivated institutions will hold additional ownership, including Shorebank of Chicago 18% and Triodos of Holland 8.6%. Public shareholders of the proposed K-Rep Bank include the International Finance Corporation and the African Development Bank both at 16.7%, and FMO at 5%. In addition, Kwa, the K-Rep employee association (for staff and directors), will hold 10% of the shares.

Owners of Microfinance Institutions

This section considers four types of owners of microfinance institutions: NGOs, donors, government and the private sector.

**NGOs:** In many countries, regulators have guidelines that limit the ownership of financial service companies by firms engaged in other industries. These limitations are designed with a purpose similar to the restrictions on loans to related parties: to insulate the financial intermediary from the diverse objectives of the parent company. Presently, in most countries, there are no specific guidelines regarding the ownership of for-profit financial institutions by non-profit organizations; nor are there guidelines that preclude an NGO parent of a for-profit entity from commingling staffing and services. Yet, many of the concerns that apply to private companies owning financial service operations also apply to NGOs owning MFIs. Ownership arrangements must adopt effective safeguards to limit the risk of “insider dealing.” The design of the relationship must ensure transparency, arms-length transactions and honest transfer pricing. The newly formed regulated financial entities should be operationally independent from the parent NGOs.

The experience from PRODEM/BancoSol in Bolivia demonstrates that distinct and complementary roles can be defined, which allow the for-profit and the non-profit entities to work together successfully. However, the outcome of the relationship between Corposol and Finansol in Colombia, in which the NGO was the driving force behind the financial institution, proved to be one cause for the problems discussed below. It is important to note that PRODEM was a minority shareholder of BancoSol (albeit the single largest shareholder) while Corposol was the majority shareholder of Finansol. In the Kenyan case, K-Rep is avoiding this issue altogether since the NGO will not have an ownership stake in the bank.

The proposed ownership of the financial institution must provide stability and adequate management oversight. In Bolivia and Kenya, to qualify for the banking license, regulators required the local NGO to expand its shareholder base to

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30 FMO is the Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanded (Netherlands Development Finance Company)
include private investors and others with international microlending expertise. This is a useful model to replicate, to ensure that the board composition provides an appropriate balance between economic development and profitability.

The question remains: can non-profit organizations, which are capitalized with donor funding, serve as effective owners of a regulated financial institution? To date, there is not sufficient experience to conclude one way or another. However, it is useful to consider ownership structures that are being introduced in various jurisdictions to guard against potential irresponsible owner behavior.

**Donors and donor proxies:** To date, the primary source of capital for microfinance has come from donors and government agencies. The internal policies of some donor organizations, however, restrict them from having an ownership stake in businesses. It is also possible that they may not have the technical skills or the organizational structure to supervise an investment in an MFI. Yet donors want to leverage their resources to create models of success that will allow the microfinance industry to attract commercial investment. To achieve this objective without becoming owners of microfinance institutions, some donors are employing a proxy approach, whereby they place grants with third-parties to invest in MFIs. For example, the Ford Foundation has given Shorebank grants to invest, in conjunction with its own resources, in the proposed banks of BRAC and K-Rep; and USAID has placed a grant in ACCION’s Gateway Fund to invest in ACCION’s affiliates that are creating for-profit financial institutions.

The advantage of this approach is that these shareholders, ACCION and Shorebank, can provide the MFI with technical assistance and ensure that the board includes individuals with microfinance expertise. This link with third-parties, which are involved in microfinance in other parts of the world, also helps the new financial institution to learn from a global base of experience. While their investment is non-traditional, if the investment passes through the third-party’s books, then they will be sufficiently motivated to ensure that they do not show a loss on that investment. This is particularly true if the grant is conditional on a co-investment by the proxy. Perhaps more importantly, these proxies have their reputations on the line. Since they exist to promote the microfinance field, they will do everything possible to achieve that objective. The response of ACCION to the crisis at Corposol indicates that the reputation of a microfinance support institution is at least as powerful an incentive, if not more powerful, as having one’s own financial resources at risk.

Profund, a for-profit investment fund based in Costa Rica, represents a variation of the proxy approach. Profund is designed to place equity and quasi-equity in MFIs in Latin America. The major shareholders of Profund are primarily socially-responsible private and public investors, including the International Finance Corporation, the Multilateral Investment Fund of the Inter-American Development Bank, the Andean Development Corporation, the Swiss Government and FUNDES, a private Swiss foundation. Most of Profund’s shareholders are
primarily interested in receiving a return on their investment, but they also want to play a key role in developing the microfinance industry.

K-Rep has found an alternative way of turning donor money into ownership shares. Kwa, the employee association, will receive its 10% ownership stake as a grant in the form of shares from K-Rep Holdings Limited. This grant is intended to facilitate the participation of K-Rep’s employees and board members in the bank’s ownership. Its objective is to reward existing employees for their contribution to the formation of the bank as well as to establish a performance-based incentive system. The rights to half of the shares will be apportioned to Kwa members based on seniority and duration of employment. Of these shares, half will be granted free of charge and the rights to the other half shall be granted in consideration of cash payments. Kwa will facilitate the payment process by allowing members to pay over a five year period for a charge of 11% per annum. The balance of the shares shall remain in treasury for future issue to new staff and as an incentive bonus to be determined by the KHL board.

**Government:** In the experiences of Grameen Bank and BRI described in the first chapter, the governments of Bangladesh and Indonesia respectively served important roles as owners of microfinance institutions. However, state ownership of banks in general is becoming increasingly discredited. State-owned banks often distort financial markets by lending at rates with which private banks cannot compete, and their credit-assessment record is not impressive. In Argentina for example, approximately 30% of the portfolio of public sector banks was in arrears at the end of 1994 compared with only 10% for the private banks. In sub-Saharan Africa, the World Bank estimates that 15 countries have experienced systemic banking crises involving state banks. This poor track record of the public sector in banking does not bode well for microfinance which, because of its social agenda, governments may be tempted to use for political purposes.

**Private Sector:** To date, most private investors in MFIs are prominent local business leaders who placed their funds as a result of a commitment to the social mission of the institution. The amounts invested typically have not been material to these local leaders; such owners may not have held these investments to the same criteria that they would hold other investments. Nevertheless, as MFIs demonstrate their profitability and scale, private risk capital is expected to enter the microfinance industry to capture the attractive returns which can be generated. Commercial banks in a number of countries, including Chile, Panama, Indonesia and South Africa, have begun to establish subsidiaries dedicated to this market,

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31 The equity of K-Rep Holdings Limited originally came from donor grants to the K-Rep NGO and retained earnings.

recognizing both the wide spreads which may be earned and the potential scale of the micro market.  

MFI Management and Director Qualifications

In addition to ownership issues, regulators must consider the quality of proposed managers and board members, and their capacity to administer and govern a regulated microfinance institution. The application process typically includes a presentation of proposed managers and directors. This requirement is intended to satisfy the regulatory body that the new finance institution will employ management with competent professional background in financial intermediation. As stated above, no amount of external oversight can replace the accountability that stems from proper governance. It is crucial that regulators are comfortable with the skills, motives and commitment of the directors of the proposed institution.

Are the original NGO managers prepared to perform these functions? Should regulators require that professional bank management be recruited for this function? For MFI management positions, banking experience can contribute most in the areas of treasury management, administration and internal auditing. However, some commercial bankers may be ill-suited for microlending operations. Success in microlending is tied to familiarity with clients and their needs, reliance on character appraisal, decentralized operations, and fast turnaround on decisions. Some bankers may have difficulty adapting to the culture explicit in this approach. Ideally, all senior staff should be committed to the dual goals of microfinance—economic development and profitability—and should learn how to balance the two.

The board should consist of members with a diversity of skills, including financial, legal and managerial expertise, to give effective guidance to senior management and to critically analyze management’s plans and reports. There is no magic formula for board composition. If board members represent particular constituencies, they may be unable to act as a member of the board in the interests of the institution, but instead will be apologists for other interests. This highlights the importance of including some independent board members who are chosen for their qualities of excellence. Since they do not have a financial stake or represent a specific constituency, they can be purely responsible to the interests of the corporation.

3.3 Issues in Conforming to Standard Commercial Bank Regulations

From the experiences in Bolivia and Kenya, it is possible to highlight mismatches between the standard regulatory framework and the provision of microfinance services. These differences emerge from regulation and supervision practices that are not appropriate for the unique characteristics of microfinance. The implication here is not to eliminate or even reduce regulations, but to redefine them in order to provide regulation that is appropriate for microfinance portfolios. This section reviews these important issues and suggests means of resolving them.

**Non-secured Lending Restrictions:** In many countries, bank regulations limit the percentage of the portfolio that may be extended as non-secured loans. The types of security available from microentrepreneur clients, such as solidarity group lending and chattel mortgage on personal assets, are not usually recognized. This drives up the percentage of total assets that may be considered unsecured. For example, in Bolivia, the Law on Banking establishes that the unsecured portion of the portfolio may not exceed twice the equity of the institution. For BancoSol, with net equity of US$7 million and an unsecured portfolio of US$24 million, US$10 million or 27% of its portfolio can be considered in permanent non-compliance. This suggests a flexible approach to determining the ceiling on loans exempted from the unsecured lending requirement. This same issue arises in connection with risk-weighting for solvency purposes and provisioning rules.

**Reporting:** By creating regulated intermediaries, MFIs have to adjust their reporting significantly. This necessitates a substantial investment in their accounting and portfolio management systems, and entails additional personnel and expenses. Reporting formats were originally conceived for banks with fewer, larger transactions. Although MFIs need the same types of financial management information as commercial banks, such as liquidity and asset quality, microfinance institutions are more concerned with aggregate indicators. Since their portfolio consists of thousands of little loans, it is not necessary, nor realistic, to monitor the performance of each individual loan. Portfolio reporting formats should be appropriate to the volume, loan size and term of MFI transactions.

**Loan Documentation:** The documentation guidelines required by bank superintendents for commercial loans are not appropriate for microlending. Microlending methods have demonstrated that simple loan applications, perhaps with a basic cash flow analysis, are all that is required. In MFIs with very short-term loans, repeat loans may be automatically approved without a business assessment for clients in good standing. The approval of a loan application relies more on the client’s repayment history and the qualitative assessment of loan officer than on any quantitative information in the application. Most microloan documentation does not include credit checks, business plans or traditional collateral. In some countries,
documentation guidelines for consumer banking have been adopted, even though microloans are typically for commercial rather than consumer purposes. However, the credit scoring models used in consumer banking are not applicable to microfinance because of the reliance on qualitative rather than quantitative assessments.

**Portfolio Examination:** Portfolio sampling methods used by bank examiners are generally not appropriate for microfinance portfolios. Bank examiners usually review 30% of a bank’s loans, but this scope is not feasible in an MFI. In addition, since the loan documentation of unsecured lending is considerably different from that of conventional lending, examiners would not find the type of information in the files that they would find at a commercial bank. The loan volume and frequency are so large that the standard guidelines for determining the sample portfolio, like large loans and loans to related parties, are also not appropriate. For microfinance, it is more important to examine the trends in the performance of the portfolio as a whole, as well as for subsets of the portfolio, instead of a sample of individual loans. The process of examining a microfinance portfolio should also include a determination that proven lending methods are being properly implemented and that internal control practices are effective in rooting out fraud. In fact, if internal and external auditors are performing their functions effectively, it is possible to question if the value of on-site inspections by bank examiners outweighs the costs.

**Branching:** In most countries, banking superintendents must approve the opening of new branch offices. This approval process is intended to protect against over-branching, which could affect the institution’s profitability and solvency. This is a valid concern for both banks and microfinance institutions. But it is not valid for superintendents to query the location of new branches. Some superintendents have looked askance at plans to establish microfinance offices in poor, remote communities that are perceived as crime-ridden and unsafe. Serving clients in their communities during convenient times is a critical element to achieving a sound microlending portfolio. Artificial restrictions on the location of branch offices and the operating hours could actually increase the risk of delinquency. Therefore, regulators should allow MFIs to operate close to their target market during business hours that the institution has identified as most appropriate for that market.

**Operational Cost Ratios:** Operational cost ratios of microfinance institutions are consistently higher than those achieved by commercial banks. This is a simple reflection of the microlending methodology described above. The ratios of operational expenses over average portfolio for the MFIs profiled in Chapter 1 are presented in Box 5. When conducting the standard CAMEL rating, bank examiners should recognize that the small scale transactions are the source of the high ratios. Even
with these higher administration costs, microfinance institutions in many countries still demonstrate satisfactory levels of profitability. The operating ratios of microfinance institutions should be compared with a peer group of other MFIs rather than with commercial banks. Since most jurisdictions do not have a large enough sample to form a microfinance peer group, it may be necessary to compare MFIs on a regional basis.

**Box 5: Operational Cost Ratios of Selected MFIs (1993)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>BRI</td>
<td>937.6</td>
<td>1,897</td>
<td>494</td>
<td>8.5%</td>
<td>1.6%</td>
<td>31.0%</td>
</tr>
<tr>
<td>Grameen Bank</td>
<td>159.5</td>
<td>1,587</td>
<td>101</td>
<td>14.5%</td>
<td>-3.3%</td>
<td>-9.7%</td>
</tr>
<tr>
<td>BancoSol</td>
<td>24.8</td>
<td>46</td>
<td>535</td>
<td>21.0%</td>
<td>1.0%</td>
<td>4.3%</td>
</tr>
</tbody>
</table>

Source: Christen, Rhyne and Vogel (1995)

### 3.4 Case by Case Supervision

It is possible to address the mismatches between the standard regulatory framework and the provision of microfinance services through adjustments to existing banking regulations. In countries where there are not enough MFIs to merit a full review of the regulation and supervision process, bank regulators can adopt some immediate steps to improve the regulatory environment for MFIs significantly. These measures are presented below in a *quid-pro-quo* arrangement. If MFIs surpass accepted guidelines in one area, the recommendation would seek relaxation in another.

*Exceeds capital adequacy requirements / Relax limits on unsecured lending*

Most MFIs are not fully leveraged. For example, BancoSol, one of the most fully leveraged microfinance institutions as of year-end 1995, had a risk-weighted capital adequacy of 17 percent. If MFIs exceed the required capital adequacy measures, and thereby increase their capacity to absorb losses, regulators could relax applicable statutory limits on unsecured lending. The character-based lending methods used by MFIs will nearly always contribute to higher levels of unsecured lending.

*Demonstrates lower than average delinquency / Modify portfolio documentation requirements*

In many countries, the on-time repayment rates achieved by MFIs exceed those obtained by most commercial banks. In those environments, where average delinquency has been sustained below normal for a determined period thereby indicating the quality of the portfolio, regulators may consider a more flexible perspective on appropriate loan documentation. Loan documentation collected by microfinance institutions, according to the lending methodologies adopted,
are rarely consistent with guidelines adopted by the commercial banking systems.

**Above average ROA / No penalty for higher operational costs**

Because of the elasticity of demand for microfinance services, MFIs may outperform the commercial banking sector in terms of revenues and earnings obtained. Yet, given the small size of loans and deposits, the operational costs of MFIs as a percentage of portfolio consistently exceeds those commonly achieved by commercial banks. If an MFI is able to demonstrate a better than average return on assets consistently, it should not be penalized for its higher administrative costs.

**Provides services to the poor at a reasonable cost / Exempt from usury laws**

Although usury laws are intended to protect the most vulnerable sectors of the population, they inadvertently serve to limit access of the poor to financial services. Because of the higher administrative costs of serving small deposits and loans, it is frequently not possible to provide financial services needed by the poor and to conduct these below the limits set by usury laws. While there is reason to question the appropriateness of interest rate limits of any form, financial institutions that provide services to the poor at a reasonable cost should receive exemption in countries where usury laws are in effect.

### 3.5 Lessons from the Finansol Crisis

How a financial regulator treats failure has important implications for investors and depositors, for the evolution of local financial markets and, in this case, for the maturation of a new financial industry. Bearing in mind that regulatory authorities have as their principal purpose the safety of, and confidence in, local financial markets, their approach to the problems of one financial institution will be conditioned by their primary objective—namely, to see that lenders and depositors get repaid.

Although the establishment of regulated microfinance institutions is a relatively new phenomenon, one regulated MFI has already experienced a financial crisis: Finansol of Colombia. The situation has taken over a year to work through, since early 1996, and despite overcoming numerous hurdles, Finansol is still in the process of reestablishing its operations. Even after an intense period of negotiations with the Colombian banking superintendency, two successive injections of new equity capital, and the transfer to a new President, it is premature to declare victory. Another year will be required to prove that the institution has returned to sustained profitability. The principal factors contributing to the predicament and its resolution are discussed below.

Corposol, a Colombian NGO, was established in 1987 by local business leaders with the support of a US-based technical services organization, ACCION
International, to provide integrated training and microcredit to informal sector businesses. It grew at an unprecedented rate, from more than 3,000 clients in 1989 to nearly 25,000 active borrowers at the end of 1992, while maintaining excellent asset quality. As its need for capital outstripped available resources, Corposol examined ways to tap into financial markets directly by forming a regulated financial intermediary.

In October 1993, Corposol and minority shareholders, purchased a finance company, which they renamed Finansol. By late 1995, Corposol had increased its equity ownership from 51% to 71% through successive capital increases, leaving minority shareholders, ACCION International, Calmeadow and FUNDES, with a combined 12%; Instituto de Fomento Industrial (IFI), Colombia’s development bank, with 7%; and private individuals with 10%.

Regulatory Issues Affecting Finansol

Usury Law: Before establishing the finance company, Corposol’s cost of lending (administrative and financial costs) was about 36% of its average portfolio. Interest fees to meet these costs would have exceeded the usury limits at that time. To cover its full operating costs and comply with the usury law, Corposol charged a training fee with each loan disbursement. This strategy permitted the institution to raise adequate revenues to operate profitably and remain in compliance with the usury law. After purchasing the finance company, this arrangement continued with the functions split between the two organizations. Finansol provided the loans and Corposol provided the “training” services. Since Corposol’s revenues in training fees were tied to loan disbursement, and credit officers remained Corposol employees, this arrangement encouraged the approval and disbursement of new loans regardless of loan quality. Finansol had little control over loan generation activity.

Cap on Growth: Finansol’s financial plan required significant growth in the organization’s assets. However, months after acquiring the finance company, the banking superintendent restricted asset growth of all regulated banking entities to 2.2% per month to attain monetary policy goals. To avoid this restriction, new loans were periodically transferred from the books of Finansol (the regulated entity) to Corposol (the unregulated non-profit entity). Corposol also booked new loans during this period. This not only circumvented the superintendent’s policies, but it also undermined the transparency of the financial reporting, and hindered effective oversight by owners, board members and bank supervisors.

Governance and Management: The initial team hired to manage the new finance company consisted of experienced bankers. However, during first year, the original banking team conflicted with Corposol management. The NGO manager was a particularly dynamic and persuasive individual with grandiose plans for

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34 Corposol was initially established as ACTUAR Bogota and adopted the name Corposol in 1993.
expansion to numerous related and unrelated sectors. Corposol leadership prevailed; the experienced banking team resigned and a new manager, with allegiances to the NGO’s management, took control of Finansol.

**Transparency**: The lack of separation—operationally, financially and culturally—between the new financial intermediary and the parent NGO led to a confusion of purpose, a lack of independence, and inadequate management and financial information to assess the performance of either the operations or the loan portfolio. The minority shareholders of Finansol were unable to understand the performance of the various joint initiatives given the extensive inter-company transactions between Finansol and Corposol. As a result, the underlying financial status of Finansol was masked.

**Crisis and Resolution**

In 1995, the Finansol portfolio increased from US$11 million to US$35 million. The rapid growth of new loans included a series of untested loan products that were aggressively promoted by Corposol. In addition, management and accounting systems were inadequate to keep up with the growth. These factors contributed to a breakdown in the lending methodology and a contamination of the portfolio. In an attempt to mask the deterioration, massive loan refinancing took place in the summer of 1995. This only compounded the problem as the contamination rapidly spread to other borrowers. Although the internal auditing group reported such developments to management, their reports were largely disregarded.

Alarmed by this growth rate and the deteriorating loan quality, the bank superintendent increased its supervision. ACCION International, a minority shareholder, conducted its own diagnostic exercise of Finansol in the summer of 1995 that illuminated many of the problems, but not the severity nor the urgency.

Finansol’s external auditors issued unqualified financial statements later in the year. This suggests the need for caution in relying solely on audited statements, even if they are prepared by the local franchisee of a large international accounting firm. Caution is especially warranted if they are using standard auditing methods rather than ones tailored to the unique features of microfinance institutions.

Toward the end of 1995, concerned by an expansion of consumer finance companies of dubious quality, the Colombian finance authorities decided to further tighten a restrictive monetary policy and imposed greater provisioning requirements for such consumer debt. These new requirements, although similar to those applying to microfinance standards in other jurisdictions caught Finansol at the worst possible time. The rapid increase in Finansol’s loan delinquency in late 1995 triggered provisioning expenses that significantly eroded the capital position of the company.
At the end of 1995, the Board finally took action. An experienced banker was hired to analyze and evaluate the situation. Steps were taken to improve loan collections and the delinquency rate on new loans began to improve. In December 1995, the banking superintendent required that all operational ties between Finansol and Corposol be severed. Five months later, due to its eroded capital position, Finansol was technically in violation of the Superintendent’s minimum capital requirements, and thereby in danger of intervention by the Superintendent. An intervention probably would have resulted in a rapid sale of assets in order to liquidate the company to repay the outstanding debt.

At that time, Finansol had accumulated obligations of over US$30 million to the local money markets, in the form of 30 to 180 day certificates of deposit, only a small percentage of which would have been covered by the Government’s guarantee fund. However, the bank superintendent decided not to intervene, but instead permitted a team composed of the new Finansol President, ACCION International, FUNDES, Profund and other minority shareholders to restructure Finansol’s operations and to raise fresh capital.

It was not until late 1996 that Finansol’s capital was replenished. The process was complicated by several factors: (i) serious financial difficulties at Corposol, which preoccupied Corposol’s bankers and made new investment in Finansol difficult, to say the least; (ii) increasing operating losses, as Finansol was effectively shut down by the superintendent for six months; and (iii) an overall negative economic climate exacerbated by political uncertainty.

Nevertheless, with an additional investment by Profund, the conversion by IFI of some of its debt to equity, and some additional investment from Corposol’s bankers in the hope of recovering some of their lost capital, Finansol was brought back from the brink in December 1996. Corposol, the NGO, was forced into liquidation.

In early 1997, Finansol started operations again from a much-reduced base, about US$10 million in assets, having made practically no new loans during the lengthy restructuring process as debt was gradually repaid. Today, Finansol faces the daunting challenge of rebuilding its portfolio, retraining and restarting its loan distribution and collection systems, and reestablishing itself as a sound financial intermediary.

Lessons

The Finansol crisis demonstrates vulnerable features of MFIs, and suggests safeguards that can be adopted to mitigate risk. Bank regulators and microfinance professionals can learn multiple lessons from this situation:

• *Stick to basics*: The first lesson from the Finansol case is that the crisis had nothing to do with its basic microlending methodology. The methodology worked fine when it was implemented correctly.
• **NGO owners**: An NGO is not inherently bound to the same standards of economic performance or financial prudence that may be reasonably expected in the business sector. While this concern is not insurmountable, as the BancoSol case demonstrates, the NGO parent must ensure that it sets standards appropriate to the financial sector in dealing with its regulated microfinance subsidiary. From the Finansol experience, it is apparent that NGOs should not be owners of MFIs unless they are separate operationally and the only financial link is the ownership one. This relationship must be transparent and any financial exchange must include proper transfer pricing. Also, NGOs should not fully control the board and management of an MFI.

• **Insider dealing**: This case highlights the need for banking supervisors to develop tools to monitor insider dealing. All insider dealing should be reported to supervisory bodies in full and the superintendent should have authority to challenge questionable transactions.

• **Auditors**: It is premature to discuss bank supervision if audits are not done properly. At Finansol, neither the internal nor external auditors properly performed their function. Internal auditors reported their findings to management, when in fact they should be reporting to the board. External auditors apparently did not have a good understanding of the unique characteristics of microfinance, and therefore were not able to assess the situation effectively. This suggests a need for training.\(^{35}\)

• **Hazards of Regulations**: It is important to note that regulatory restrictions, such as the usury laws and limits on portfolio growth, constrained the finance company’s development and contributed to the adoption of inappropriate financial practices at Finansol/Corposol. These economic, as opposed to prudential, regulations often have undesirable side effects and should be considered with great care.

Important lessons can also be derived from the resolution of the crisis. Not surprisingly, support was most forthcoming from those institutions with the most to lose. Local financial intermediaries with outstanding credit lines were very involved in the recapitalization process. They required Corposol to surrender its majority stockholder position in Finansol through a debt for equity swap with its banks to whom those shares were pledged. International support organizations, such as ACCION, Calmeadow, FUNDES and Profund, had both financial resources and their credibility at stake. As a result, they worked around the clock for months, lining up new investors and negotiating with regulators. Multilateral donor institutions were unable to respond directly in a timely fashion, but indirectly their financial support was made available through Profund.

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\(^{35}\) Under contract with the Consultative Group to Assist the Poorest (CGAP) at the World Bank, Deloitte Touche are currently preparing auditing guidelines for microfinance institutions.
This experience suggests the type of ownership mix that may be appropriate for microfinance institutions. It highlights the importance of having owners who have something at risk, who are able to monitor their investment, and who have deep pockets, or can find deep pockets, in the event of a crisis.
4. **REGULATION: SPECIAL LAW APPROACH**

Regulators need to consider if it is necessary to regulate MFIs and, if so, whether a special law for microfinance is appropriate. In some cases, regulators have established special categories for microfinance institutions in an attempt to foster the provision of financial services to the informal sector. In other situations, regulation has emerged in response to the proliferation of financial services being provided by NGOs, and the regulators’ interest to introduce sound prudential guidelines to this growing sector of the financial services market.

In general, if a special regulatory framework for microfinance institutions is considered necessary, it should permit the establishment of MFIs through appropriate entry standards, but limit their functions in comparison to a commercial bank. While a specialized category for MFIs may not prevent all institutional crises, it can protect against crisis situations by establishing an enabling framework for the appropriate growth and development of microfinance institutions. This chapter will present the experiences of three jurisdictions that have created special categories for microfinance institutions, explore the advantages and disadvantages of creating a special category including the issues of deposit-taking, entry standards and capital to asset ratios, and suggest appropriate characteristics for special microfinance regulations.

### 4.1 New Legal and Regulatory Initiatives

This section presents recent experiences in Peru, Bolivia and West Africa with special categories for microfinance institutions.

**Peru**

**Municipal Banks:** The first law governing microfinance institutions in Peru was adopted in 1980 to establish publicly owned municipal savings and loans. The law was adapted from a German model for municipal bank ownership; the principle owner of a municipal bank is the provincial council. Technical assistance for the creation and supervision of the municipal banks was financed by GTZ, the German Technical Cooperation agency and provided by Interdisziplinare Projekt Consult (IPC), a German consulting firm. The municipal banks, required by law to be

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located outside the capital city, fill a financial service vacuum that emerged from periods of hyperinflation, which drove credit cooperatives and mutual loan societies into bankruptcy.

The first municipal bank was founded in 1982 and in 1985 a three-way partnership between GTZ, German municipal banks and the Peruvian superintendency was established. In 1987, FEPCMAC, a federation of municipal banks was founded.\(^{37}\) The federation plays a key role in the supervision of these institutions, as discussed in the following chapter. Today, there are twelve municipal banks with a combined microloan portfolio of US$25.7 million and a total net worth of US$11.0 million. The municipal banks offer a range of services including savings accounts and term deposits, as well as pawn, personal, microenterprise and agricultural loans. The minimum capital requirement to establish a municipal bank is US$265,000.

The regulations initially prescribed that each municipal bank must be governed by a separate board consisting of the following local representatives nominated by the mayor: three members of the municipal council; one representative of the church; one representative from the Central Bank or COFIDE,\(^{38}\) the development finance company; one representative of the chamber of commerce; and one member of the local small business community. The pluralistic nature of the board was designed to protect the social mission of the municipal banks. In 1996, the board structure was changed to lessen the political influence and to include more technical expertise. The three representatives of the council were replaced with two appointees from FEPCMAC and one representative from COFIDE.

The Municipal Bank regulation requires institutions to undertake a gradual development process. Operations are limited during the first year to simple, low risk activities such as savings services and pawn loans. Once the municipal bank is established, more complicated services are added. Microenterprise loans are considered high risk, and are typically initiated in the third year once the bank has attained certain performance standards.

**Rural Banks.** In August 1992, the Peruvian Congress adopted a law to establish rural banks, which are owned by a group of local business leaders from rural communities, and offer a similar service mix in response to their client demands in the rural areas. Over 16 rural banks are now in operation. Regulatory provisions for the rural banks are similar to those which apply to the municipal banks. Experience thus far indicates that the municipal banks are more successful than the rural ones. Further research is required to determine if the difference is endemic to the geographic areas in which they operate, or if it has to do with the supervisory role of FEPCMAC, or the technical assistance provided by IPC, or if it is a matter of governance and operational issues.

\(^{37}\) *Federación Peruana de Cajas Municipales de Ahorro y Credito.*

\(^{38}\) *Corporacion Financiera de Desarrollo.*
### Box 6: Laws and Regulations to Create Specialized MFIs (1996)

<table>
<thead>
<tr>
<th></th>
<th>Municipal Banks - Peru</th>
<th>EDPYME Peru</th>
<th>PFF - Bolivia</th>
<th>Village Banks - Indonesia</th>
<th>BCEAO - West Africa - PARMEC Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min Capital (US$)</td>
<td>265,000</td>
<td>265,000</td>
<td>1,000,000</td>
<td>25,000</td>
<td>None</td>
</tr>
<tr>
<td>Capital Adequacy</td>
<td>10%</td>
<td>10%</td>
<td>8%</td>
<td>10%</td>
<td>None</td>
</tr>
<tr>
<td>Deposit-taking</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Checking Accounts</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Govt. Credit Lines</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Security</td>
<td>Recognizes jewelry &amp; movables</td>
<td>No definition</td>
<td>Recognizes solidarity group, movables &amp; jewelry</td>
<td>No definition</td>
<td>No definition</td>
</tr>
<tr>
<td>Unsecured Credits</td>
<td>No limits</td>
<td>No limits</td>
<td>1% net capital (US$10,000 min)</td>
<td>No limits</td>
<td>No limits</td>
</tr>
<tr>
<td>Maximum Loan Size</td>
<td>5% net capital (US$12,500)</td>
<td>5% net capital (US$12,500)</td>
<td>3% net capital (US$30,000)</td>
<td>20% net capital (US$5,000)</td>
<td>N/A.</td>
</tr>
</tbody>
</table>

39 While the PARMEC law does not specify a capital adequacy ratio, but MFIs must cover all their long term (over one year) assets with long term liabilities and equity.

40 Special permission must be received from Banking Superintendent to provide savings services.
Entities for the Development of Small and Micro Enterprises (EDPYME):[^41]

The EDPYME format was developed to diversify the types of regulated financial intermediaries that could serve the micro sector.[^42] COFIDE, the national development finance company, was instrumental in promoting the EDPYME regulation. As a second-tier financial intermediary, COFIDE discounts national and international credit lines for on-lending through local financial institutions. COFIDE is able to finance up to three times the core capital of a financial institution with credit lines. While COFIDE views the informal sector as an important engine for the country’s economic growth, it is restricted to channel its funding only through regulated entities. To date, it has already extended over US$22.5 million to the municipal and rural banks described above.[^43]

COFIDE considered the ownership guidelines for the municipal and rural banks too restrictive for the development of the informal economy because they did not allow the formalization of microcredit NGOs. COFIDE worked with the bank superintendency over a two year period to develop a more generic institutional form. The objective of the EDPYME category is to promote the provision of financial services for persons engaged in small and micro enterprises. The law defines small enterprises as having assets of US$300,000 or less and or annual sales less than or equal to US$750,000; microbusinesses have assets of US$20,000 or less, and sales less than or equal to US$40,000.[^44]

Since the special regulations were adopted in December 1995, as of year-end 1996, one institution was established as an EDPYME and 13 other applications are in process. Interestingly, while the crafters of the regulations intended the guidelines as a means of formalizing microfinance NGOs, a variety of companies have filed to establish EDPYMEs including a local consulting group and a pharmaceutical company that will use the EDPYME to finance their chain of retail pharmacy outlets. While officials at COFIDE are pleased with this diverse response, banking supervisors anticipate that it will be difficult to monitor these various types of institutions with common supervisory practices.

The process of securing an EDPYME license is similar to the methods for establishing a commercial bank. Besides raising the initial capital, it is necessary to present a marketing and financial feasibility plan, financial projections, and a demonstration of management experience. The EDPYME license is released when the applicant meets a series of conditions, including the investment of the share capital, the drafting of bylaws, the development of operations manuals, and the recruitment of management.

[^41]: Entidades de Desarrollo para la Pequena y Microempresa.

[^42]: In Peru, the Banking Law of 1991 authorizes the Bank Superintendent to create new classes of regulated financial institutions. In Bolivia, such a new class of financial intermediary could only be created by an act of congress.


[^44]: Rock and Otero, eds. (1997).
In principle, EDPYMEs are authorized to accept deposits from the public, but they must receive special permission from regulators. According to an interview with a former bank regulator in Peru, an EDPYME is expected to operate for a year or two to demonstrate its institutional capacity before it will be authorized to take deposits.

Throughout the process of developing regulations and operational systems for the EDPYME, a key consideration is to ensure that the supervisory requirements enforce operational efficiency while accounting for the unique characteristics of MFIs. For example, the superintendency will not impose documentation requirements for loans less than US$10,000. The EDPYME regulation is a work in progress. As such, certain aspects are being addressed provisionally. Some of the regulation and supervision requirements include:

- the submission of various reports to the superintendency on a daily, weekly and quarterly basis;
- annual inspections and special inspections according to the criteria determined by the superintendency;
- total liability no more than ten times net equity;
- portfolio classifications defined by the superintendency, but the provisioning percentages determined by the institution;
- EDPYMEs cannot dismiss the internal auditor without the approval of the superintendency;
- the institution must request authorization before opening new branches.

The legal framework for EDPYMEs leaves much to be addressed, as both the superintendency and the new institutions gain experience. The legislation takes into account that both the government and the MFIs need room to grow, and opportunities to learn from each other. It underscores the importance of a transparent relationship between the two, and the need to maintain open communication channels so that future regulations promote the sustained growth of the microfinance industry without compromising the financial markets.

**Accion Comunitaria del Peru (ACP):** ACP is one of the microfinance NGOs in Peru presently forming an EDPYME, which will be named Accionsol. ACP’s interest in creating a regulated financial intermediary predates the EDPYME guidelines and is based on the institution’s need to access additional capital to fund its growth. Initially, ACP intended to establish a commercial bank because it believes that it would gain better market acceptance for raising deposits and placing loans as a commercial bank. When the EDPYME category became an option, ACP selected this route as an intermediate step toward formalization even though it has sufficient capital to qualify as a bank. This transition period, between NGO and commercial bank, will allow staff to become familiar with supervisory requirements and a for-profit institutional culture.

The total capital to be invested in Accionsol is US$8 million, or nearly 30 times the minimum capital required for an EDPYME. Accionsol will be 70% owned by
ACP, the NGO parent, with Profund and ACCION International owning 15% each. ACP’s board of trustees is named as the owner of the portion of shares held by ACP in response to the superintendency’s concern about NGOs owning financial institutions. After the Finansol experience described in the previous chapter, it may not be advisable for an NGO (or in this case its trustees) to have majority ownership of a financial institution. Regulators are currently exploring voting rights restrictions to ensure that the financial institution is not driven by the NGO.

Once Accionsol is launched, ACP will continue to operate as an NGO, but will no longer conduct lending in the urban markets where Accionsol will operate. Like PRODEM in Bolivia, the NGO will develop rural lending methods and other non-financial services. For ACP, the most immediate benefit of creating a regulated institution is access to new sources of capital through lines of credit and the issuance of stock in the capital markets. Access to capital in the form of savings deposits is a potential benefit, although ACP does not plan to mobilize savings in the near future.

Bolivia

**Private Financial Fund (PFF):** The PFF category was established as an Act of the Bolivian congress in April 1995. The superintendency’s practical experience of licensing and supervising BancoSol, a microfinance bank under the existing regulatory regime, led to an understanding of the regulatory environment that would be appropriate for MFIs. This exposure helped to convince Bolivian regulators that microfinance institutions, which satisfy lower capital requirements and provide fewer financial services, can effectively meet the financial service needs of the informal sector.

The minimum capital requirement for a PFF is US$1 million, or less than one-third of that required for incorporating a commercial bank. The banking superintendent believes that this start-up capital, together with a strict prudential framework that establishes credit limits lower than those for banks, and a prohibition on loans to PFF shareholders and managers, represents a reasonable combination of equity backing and spread of credit risks. The capital adequacy ratio is 10:1. To avoid risks that jeopardize their main purpose, and are incompatible with the amount of capital involved, PFFs are restricted from offering checking accounts, foreign trade operations, equity investments and placement of securities. PFFs are allowed to provide foreign exchange operations, to receive savings and time deposits, and to contract obligations with second-tier financial institutions.\(^{45}\)

To address some of the constraints BancoSol encountered regarding the limits on unsecured lending, the PFF guidelines adopted unconventional guidelines for

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\(^{45}\) Trigo Loubiere, Jacques, Superintendent of Banks and Financial Institutions in Bolivia, in Rock and Otero, eds. (1997).
collateral. Specifically, the PFF regulations makes use of a 1937 law that permitted financial entities to accept peer group and personal guarantees, and movable properties (e.g., jewelry, furnishings, appliances) as collateral. By adopting this creative approach to loan collateral, the PFF is able to expand access to regulated financial services substantially.

At the time of the PFF law’s passage, a number of NGOs had already submitted applications to the bank superintendent. As of year-end 1996, there were four operating PFFs. Private Financial Funds are currently supervised by the banking superintendency, however a special unit may be set up to supervise microfinance institutions (perhaps including BancoSol) once there are sufficient numbers.

**Los Andes:** *Caja de Ahorro y Prestamo Los Andes* (Los Andes) was awarded its PFF license in July 1995, transforming Pro-Credito, an NGO, into the first Private Financial Fund. Since its inception in 1991, Pro-Credito benefited from the support of the German government, which financed technical consulting services from IPC. Pro-Credito was firmly committed to launching a regulated financial intermediary and since the outset had established the reporting and administrative systems that would allow it to conform easily to regulatory guidelines. IPC also served as an advisor to the bank superintendency, which further facilitated the transition from NGO to regulated entity.

Los Andes is owned 50% by Pro-Credito, 25% by international organizations, such as the Swiss Technical Corporation and Corporacion Andina de Fomento, and 25% by private capital. After creating the PFF, Pro-Credito’s sole function is to serve as a holding company of Los Andes—it does not continue to provide operating services.

**The Mutualist Law of French West Africa**

During the 1980s, the banking crisis in the West Africa Economic and Monetary Union (UEMOA) led to the virtual disappearance of banks from rural areas and provincial towns. To meet the gap in financial services, a wide range of informal financial institutions emerged, offering savings and credit services.

As these informal financial intermediaries grew in number and scale, the Central Bank of the West Africa States (BCEAO) sought to establish an appropriate framework for their regulation. In 1992-1993, with the technical support from the Canadian Societe de Developpement International Desjardins, the BCEAO implemented a saving and credit union regulation project to prepare draft legislation for a new law. The proposed law was adopted by the Council of Ministers of the UEMOA in December 1993. Following this adoption each

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46 This section was prepared with the assistance of Anne-Marie Chidzero from CGAP.

47 According to the Analysis of Draft Legislation Governing Mutual and Cooperative Savings and Credit Institutions, an internal World Bank report dated June 3, 1996, there are an estimated 1,000 institutions that would be affected by the law.
signatory country must ratify the law at the national level. As of March 1997, all countries have ratified the law except Benin.

The legislation is quite detailed. It addresses the organizational structure, management standards, financial guidelines and the process of approval, recognition and affiliation with apex institutions. Most importantly, the law was designed to promote credit cooperatives and local, regional and national apex cooperative associations. Credit cooperatives are defined as those in which membership is unrestricted and voluntary, the “one member, one vote” rule applies, and the returns on share capital are limited. The law also requires registered institutions to comply with the usury law, which places a ceiling on interest rates at twice the discount rate, which is currently 8 percent. The monetary authorities recognize that this restriction impedes the development of MFIs and are proposing to the Council of Ministers mechanisms to remove the ceiling.

To be recognized under the law, each microfinance institution must adopt the credit union structure within a two year period. If an institution chooses not to do so, it must receive special permission to operate from the Ministry of Finance of the respective country. It is unclear whether permission would give MFIs legal recourse against bad credits; in fact, it is unclear what the legal status of these “permitted” but not mutualist MFIs would be.

The law has prompted considerable debate because many of the MFIs operating in this region do not meet the definition of a credit cooperative and do not intend to do so. There is concern that these organizations are being boxed into a legal framework that is not consistent with their institutional objectives. While this is a good credit union law, it does not allow for the development of different types of financial institutions. Another challenge posed by the new law is that it stretches the human and technical capacity of supervisory bodies as they attempt to monitor the microfinance sector.

4.2 Specialized Institution: Pros and Cons

Whereas in Peru and Bolivia, a specific institutional form to serve the microfinance sector was adopted, regulators in other countries have no intention of following this route. The decision to establish a specialized MFI category can only be determined from the regulatory framework and the features of the microfinance institutions in each country. This is not just a regulatory issue. It depends on the country’s approach to financial sector development. This section reviews some of the advantages and disadvantages of creating a separate category, including the issues of deposit-taking, entry standards and capital to asset ratios.

Microfinance institutions are clearly different than other financial institutions. To regulate MFIs, it is possible to either make exceptions within the existing regulatory framework or to create a special category of financial institution that is
appropriate to their unique characteristics. Some pros and cons of establishing a special category for MFIs are discussed below.

**Cons.** Regulators who argue that a special category for microfinance is not necessary stipulate that only deposit taking institutions should be regulated. Therefore, if an MFI wants to mobilize voluntary savings from the general public, it should comply with the standard set of regulations. This argument, however, overlooks the unique risk profile of microfinance institutions. This approach would either require a significant number of regulatory adjustments because of the serious mismatches outlined in the previous chapter; or it would require MFIs to change their methods to conform to traditional financial practices, which would ultimately alienate their market.

Those who caution against a special financial category argue for a simple, less intrusive regulatory environment. They suggest that a specialized class would unnecessarily limit the functions that the intermediary may want to assume at a later date. To resolve this potential problem, in Peru, financial institutions regardless of type can apply to provide specific services once they have the minimum capital required for institutions that are authorized to provide that service.

It is also possible to argue that a special regulatory category for MFIs creates disincentives for banks to lend to this sector. In some countries, such as Chile, Panama, Indonesia and South Africa, private banks have established microfinance subsidiaries. This argument contends that, if banks can be encouraged to serve this market, this method of extending the financial system is less risky and easier to regulate than encouraging non-profit organizations to create financial institutions. In most countries, however, banks have not expressed an interest in the micro market.

**Pros.** The primary advantage of creating a special category is to authorize institutions to provide a reduced range of financial services, without becoming a bank, in exchange for a lower capital requirement. This permits an MFI to pursue its goals, but bars its entry into complex services for which the institution may not be well prepared.

A special category allows MFIs to maintain their distinct characteristics and effectively serve their target market. A category of financial institution designed for the specific features of low income communities links the informal sector and the mainstream economy. If microfinance institutions, because of their demonstrated commitment to their target market, can earn the trust of low income communities, it is possible that they will be effective in bringing savings from under the mattress and into circulation, as evidenced by BRI’s impressive savings mobilization efforts.

By creating a special category for MFIs, regulators heighten the visibility of the micro sector. This will attract attention and create interest in forming new
financial institutions. As shown in the Peruvian case, a special category that accommodates various institutional types encourages innovation, such as the use of the EDPYME category to finance a chain of pharmacies. A special category can also encourage microcredit NGOs, which are not already doing so, to think seriously about self-sufficiency.

In the countries that have established a special category, there has not yet been sufficient experience to assess if it has indeed effectively added depth to the financial system without weakening it. It is also too early to tell if the supervisory bodies will have the resources to effectively monitor these new institutions, or whether they will develop alternative ways of supervising microfinance institutions.

**Microfinance Institutions as Deposit Takers?**

The authorization of deposit taking services is perhaps the most pressing issue in the debate about the creation of a special category for MFIs. The two arguments for allowing MFIs to mobilize savings are:

i) The provision of deposit services is a vital need for the informal sector, but as NGOs the majority of MFIs are not in a position to offer savings services.

ii) Microfinance institutions that want to become regulated are usually motivated by the need to finance their growth by mobilizing deposits or accessing the capital markets in other ways.

Should microfinance institutions, which are not commercial banks, be authorized to collect deposits from their borrowers, the general public or both? The PFF law in Bolivia authorizes MFIs to receive savings and time deposits from the general public. The BCEAO guidelines permit deposit-taking, but limit the institution’s loan portfolio to twice the total value of member deposits.\(^{48}\) An EDPYME in Peru is not restricted from mobilizing savings, but it must receive special authorization from the bank superintendent to do so.\(^{49}\)

As mentioned above, very few NGOs have the right management, financial discipline, information systems and profitability to be safe deposit takers. In addition, no institution should be allowed to take savings if its ownership and governance structure is not appropriate for that function. If an institution is capitalized with donor money and retained earnings, and therefore does not have owners in the traditional sense, then it is hard to justify the authorization of deposit-taking services.

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\(^{48}\) Under the BCEAO law, member deposits are treated as shareholder equity. Loans to any one member cannot exceed ten times the value of that individual’s savings.

\(^{49}\) It is important to note that a primary motivation behind the creation of the EDPYME category was to allow COFIDE, the development bank, to lend to MFIs. Access to COFIDE’s credit lines creates a disincentive to savings mobilization.
Short of prohibiting deposit-taking altogether, there are some intermediate positions that may be worth considering. There are four general categories of deposits:

1. Deposits of members or credit clients
2. Government deposits, such as from a development bank or a wholesale financial institution
3. Bank loans, certificates of deposit, and wholesale funds in the private market
4. Small retail savings, which is further differentiated into time deposits, passbook savings and demand deposits

Each category of deposits could be authorized with different standards, such as the minimum capital requirements, capital to asset ratios, and the level of supervision.

In Bangladesh, unregulated microfinance institutions are allowed to mobilize deposits, but only from their borrowers. Regulators feel that it is not necessary to regulate these institutions since the outstanding balance on loans usually exceeds the deposit amount. This logic assumes that, if the institution fails, most clients would be net beneficiaries and therefore are not in need of protection. From the institution’s perspective, the disadvantage of this approach is that it would not likely be able to fund all of its loan portfolio from retail savings.

In Peru, with a considerably lower minimum capital requirement, the emphasis is to open the market to all comers but to shield small savers from potentially risky institutions by not authorizing deposit taking until the MFI demonstrates excellent portfolio management and sound institutional capacity. Measures similar to those adopted in the BCEAO guidelines, which permit deposit-taking but limit the exposure of deposited funds, may serve as a possible middle ground to encourage savings services for the informal sector while protecting depositors.

Should an MFI that does not mobilize savings be regulated? Most of the experts who advised this study conclude that regulation is necessary only when deposits are taken from the general public. However, the EDPYME regulation in Peru provides an example of a specialized law that has been developed for transitional purposes. It allows regulators to become familiar with the MFI and its capacity—and vice versa—thereby laying the groundwork for authorizing deposit-taking at a later date. This approach is only appropriate if this category is not used as a justification for imposing regulation on institutions that do not plan to mobilize savings in the future.

In a few countries, like South Africa, saving opportunities for low income communities are plentiful. If there is heavy competition for depositors, MFIs may realize that it is not cost effective for them to offer savings. In that case, assuming the institution can fund its growth through other channels, they may not want to mobilize deposits. It is probably not necessary to regulate these institutions,
although they may require some recognition in order to access wholesale capital markets.

Standards of Entry

Whether established as specialized microfinance institutions or within existing guidelines, defining the appropriate standards of entry for microfinance is a critical challenge for regulators. How many regulated MFIs do the banking authorities want to encourage? Given the limited human, technical and financial resources of bank superintendencies, how many MFIs can be effectively supervised?

It can be argued that the standards of entry should be relatively low, such as US$25,000 in Indonesia, US$265,000 in Peru, or in West Africa where there is no minimum capital requirement, thereby opening the way for considerable competition in this market. Others contend that MFI owners must demonstrate substantial financial resources to reduce high risk behavior, and therefore the requirement should be set higher. While this financial depth can support an organization in crisis, it limits the number of entrants to the microfinance market.

In several countries, there already exist hundreds of institutions that provide microfinance services. Yet, given the constraints on regulators to supervise specialized financial intermediaries effectively, an argument can be made in favor of fewer, well-managed institutions. It is the regulator’s responsibility to establish reasonable standards of entry, not necessarily barriers to entry, and to foster professionalism in this emerging segment of the financial services industry. Rather than attempt to reach all MFIs, once reasonable entry standards are defined, the regulators should place their emphasis on institutions with the potential to obtain significant scale.

In most countries, it is inappropriate for MFIs to have the same minimum capital requirements as a commercial bank. The small loan sizes and dispersion of credit risk over tens, or hundreds, of thousands of unrelated borrowers do not justify large capital cushions. If the minimum capital requirement for a bank in a country is high, and it is not possible to create exceptions within the existing regulatory framework, then this would be a strong argument for establishing a special microfinance category. Where the minimum capital requirement is not excessive, and regulation and supervision practices can be tailored to the unique risk profile of MFIs within the existing regime, then a special category may not be necessary.

It is worth noting that K-Rep and BancoSol under the existing regulations, and ACP under special regulations, all significantly exceeded the capital required to create a financial institution as a way of demonstrating their commitment and seriousness.
Capital to Asset Ratios

Since MFIs are new types of financial institutions, and there is not sufficient evidence of how they will weather economic crises, it is suggested that the gearing multiples for MFIs should be more conservative than those recommended in the Basle Accord for standard commercial finance institutions. This conservative approach is appropriate because regulators have limited experience with MFIs, and because many MFIs have not yet demonstrated a track record of consistent performance.

How conservative should the gearing multiples be? This is widely debated. Some argue for gearing multiples in the 5:1 range or even lower; others contend that an 8:1 multiple is more appropriate, and that anything lower would unduly constrain the profitability of MFIs. Alternatively, the permitted gearing multiple could be increased as the MFI demonstrates a stable performance track record. Regulators need to balance the objective of requiring an adequate capital cushion while permitting sufficient leverage to produce returns on equity that would attract investors.

4.3 Suggestions for Specialized Microfinance Institutions

In countries that seek to establish specialized microfinance institutions, a number of factors should be considered. It is important to note that the experience to date is too recent to offer conclusive recommendations. The following suggestions are offered for discussion purposes for countries interested in establishing a special category for microfinance:

Authorize services that are commensurate with the demonstrated institutional capacity and the capital at risk

For a start-up institution without a performance track record, or where relatively low capital requirements are specified, the range of financial services authorized (e.g., deposit-taking and foreign exchange transactions) should be limited. In some cases, if deposit-taking is authorized, it could be limited by the types of savings instruments or by other means.

Create a path toward institutional growth

Permitting MFIs to take deposits allows them to provide the target market with a much needed service, while establishing the institutional capacity to receive deposits and engage in financial intermediation. If regulations restrict deposit-taking capacities of MFIs, these services should be expanded as the institution demonstrates its capacity by maintaining its assets. Guidelines should permit institutions to strive to become full service financial intermediaries.
**Set appropriate minimum capital and capital adequacy requirements**

Regulators should set minimum capital requirements to establish standards of entry that qualify serious investors and discourage risky market entrants. At the same time, minimum capital requirements that are too high would unduly serve as a barrier for the establishment of these kinds of institutions and the delivery of financial services to the informal sector. In addition, with young MFIs, the gearing ratio should be more conservative than that which is applied to commercial banks. Capital adequacy levels should reflect the higher risk profile of this relatively new segment of the financial services industry.

**Permit various types of microfinance institutions**

Although MFIs target common markets and provide similar products and services, there are several different institutional forms. For example, mutualist organizations, non-governmental organizations and village banks all provide microfinance services. Any guidelines adopted should be flexible enough to be used by several institutional types that serve this market. The concern with the West African regulation is that it requires MFIs to conform to the credit union model. This level of specificity may stifle innovations that are necessary to provide microfinance in a cost effective manner.

**Allow a flexible maximum loan size**

Most legal and regulatory guidelines for specialized microfinance institutions establish a maximum loan size for regulated MFIs as a risk management tool. Such limits, however, should be set relatively high and based on a percentage of assets or equity rather than a specific value. Successful MFIs have found it to their advantage to continue to serve their best clients as their financing requirements increase. Establishing rigid maximum loan limits would cut off an MFI from its most successful and profitable borrowers. With the PFF in Bolivia, a loan may not exceed 3 percent of the institution’s net worth. This disperses the credit supply of the institution and reduces the concentration risk. If the MFI wants to make larger loans to its successful clients, then it needs to increase its equity base.

**Address the definition of collateral**

The Bolivian Private Financial Fund regulations define a broader range of acceptable collateral than is recognized by standard commercial financial institutions. By formally recognizing peer guarantees, character references and personal movable assets (e.g., jewelry, appliances and furnishings), the guidelines enhance the MFI’s ability to serve its target market and to improve the quality of loan security it can arrange. By acknowledging a broader range of security, the MFI is not penalized for having a portfolio of unsecured loans. Regulators are likely to have reservations about the use of movables as collateral since they are likely to be re-moved before they can be seized. It will be useful to monitor the success of countries that are testing this approach to see if it is indeed successful.
5. **SUPERVISION OF MICROFINANCE INSTITUTIONS**

Whether established as a specialized MFI, as a standard commercial bank or a finance company, the supervision of microfinance portfolios presents a challenge due to the volume of small transactions, the lack of conventional security and loan documentation, and the decentralized operations. The institutional capacity of the bank superintendency to supervise these unconventional financial intermediaries effectively, and the availability of financial resources to do so, provide additional challenges. While the lessons from the microfinance industry are still emerging, experience from the field provides some insights into effective MFI supervision strategies. This chapter considers a hybrid approach to supervision, and provides additional suggestions for supervising microfinance institutions.

5.1 **The Hybrid Approach to MFI Supervision**

Given the limited human and financial resources of supervisory agencies, some countries are using a hybrid approach to the supervision of MFIs in which responsibilities are delegated to third parties. This is logical since the supervision of microfinance portfolios requires different approaches and different sets of skills than supervising commercial banks. Because the value microfinance portfolios are significantly smaller than those of traditional banks, and therefore pose less of a threat to the stability of the financial system, it is understandable that banking supervisors would be willing to delegate responsibility for monitoring their performance. In addition, because most countries do not have a critical mass of MFIs to form a peer group, it may be useful to involve third-parties who can compare microfinance institutions on a regional or international basis.

This approach requires further analysis. It is possible that this is a more cost effective approach, but is it sufficiently vigilant? An important drawback of the hybrid approach is that it does not build internal capacity in the superintendency to monitor microfinance over the long-term. In the examples below, from Indonesia and Peru, the bank superintendency has contracted a third party to perform some or all of the supervisory functions. In Indonesia, a third party, Bank Rakyat Indonesia, supervises village banks; in Peru, with the technical assistance of a German consulting firm, a federation of municipal banks assists the superintendency in monitoring its members. It is also worth considering other third-parties for this role, such as auditors and microfinance support institutions.\(^{50}\)

\(^{50}\) The credit union movement also has extensive experience with third-party supervision. This experience should also be considered in determining if this approach is appropriate for MFIs.
Indonesia

In Indonesia, the banking law provides the power to grant licenses to the Ministry of Finance, while regulatory policy and supervision authority remain with the Bank Indonesia.\(^{51}\) Technically, Bank Indonesia is responsible for supervising all financial intermediaries in the country; in effect, the supervision of more than 8,000 small holder village banks is conducted under a variety of arrangements.

The Unit Desa division of BRI supervises its own branches through 15 regional audit offices. Reports are submitted daily (trial balance), weekly (liquidity report), monthly (progress reports and financial statements), along with reports submitted quarterly, semi-annually and annually to the regional management and auditors.

Besides supervising its own unit system, BRI’s Small Business and Cooperative Division is under contract with Bank Indonesia to supervise more than 5,000 other village banks (BKDs) that are not part of its system.\(^{52}\) The supervision by BRI is funded through a levy charged to the village small holder banks. The division maintains supervisors and bookkeepers. There is one supervisor for every 11 village banks, and they make monthly visits. Each bookkeeper is assigned to four BKDs, and they visit these institutions more frequently. The supervision is not as elaborate as that performed on BRI’s own units, but it includes reviews of the portfolio quality, liquidity, profit and loss statements and balance sheets.

Another class of financial institution in Indonesia, village-owned banks, is supervised by the provincial banks. Even with many institutional partners in the supervision of MFIs, Bank Indonesia’s supervisory responsibilities remain a daunting challenge. In late 1996, the public press claimed that several hundred of the more recently established village banks, supervised by Bank Indonesia itself, have not been effectively monitored and are encountering difficulties.

Peru

The sixteen municipal banks in Peru, which were founded with the support of German development assistance (see section 4.1 above), are supervised by both the bank superintendency and FEPCMAC, the federation of municipal banks. FEPCMAC, established in 1987, is mandated to audit and control the operations of the municipal banks and to provide each bank with specific support, training and assistance as required. Consultants from IPC, the German consulting firm, work in close conjunction with the federation to monitor the needs of individual municipal banks and to review the results of regularly conducted audits.\(^{53}\)

\(^{51}\) Bank Indonesia is the central bank of Indonesia

\(^{52}\) According to sources at Bank Rakyat Indonesia, BRI’s authority and responsibility over the village banks dates back to 1929.

\(^{53}\) In 1996, this arrangement with IPC was being reevaluated.
The FEPCMAC receives from the individual municipal banks monthly, quarterly and annual unaudited financial reports including income statements, balance sheets and portfolio information. It is important to note that the supervision and audits performed by the federation do not replace the supervision and audits performed by the appropriate units of the Peruvian bank superintendency. Nevertheless, the services provided by the federation significantly enhance the reliability and quality of financial reporting presented by the municipal banks to the superintendency. It has been suggested that a similar federation for EDPYMEs, if established, could provide a valuable service.

5.2 Suggestions for Appropriate Supervision

There is general agreement among microfinance practitioners regarding recommendations for appropriate portfolio supervision. The volume of transactions and the difference in loan documentation in microfinance institutions make traditional methods for portfolio supervision unwieldy and ineffective. Instead, supervision—either by banking supervisors, internal and external auditors, and/or third parties—should consider the following guidelines.

Assess the performance of the portfolio as a whole

Traditional supervision methods entail a review of loans that are selected for examination because of their size, risk concentration and participation of related parties. The key to effective supervision of microfinance institutions, with thousands of small loans, is to consider the performance of the portfolio as a whole. Statistical trends of subsets of the portfolio, such as by branch or loan officer, should be examined instead of an in-depth review of a small number of cases.

Monitor “trigger” indicators as an early warning system

The potential volatility of microfinance portfolio quality requires careful monitoring. Since quality can deteriorate quickly, it is useful to monitor “trigger” indicators that will raise red flags if possible delinquency antecedents are outside their normal ranges. For example, a sudden increase in clients, staff turnover, changes in management or specific recovery rate deviations could precede a spike in delinquency. By monitoring leading indicators, supervisors may anticipate changes in future performance.

Examine the validity of the computerized portfolio management system

Because of the high loan volumes and the central role of tight delinquency management in assuring the viability of the institution, management must depend on computerized portfolio management systems to track overall portfolio performance. Supervisors should carefully examine the validity,

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54 Christen stressed many of these points in his presentation at the USAID-sponsored workshop for Commercial Banks in Microfinance, November 1996.
accuracy and reliability of the portfolio management information system. If supervisors have determined that the MIS is accurate, then they will not need to rely heavily on on-site visits to assess the quality of the portfolio, which should reduce the costs of supervision.

**Compare the operating methods applied by field and administrative personnel in practice to the operating policies described in the institution’s operating manuals**

In addition to an examination of the MIS, effective supervision should include an operational audit to assess how the actual lending methodologies compare to the established methods as defined in the institution’s operating manuals. While institutions may choose to refine their methods, once appropriately tested, inconsistencies or deviations in operating methods should be noted. Since it is not practical for bank examiners to monitor policy implementation, and it not likely that they would have the technical skills to do so, superintendents would have to rely on internal auditors and management to perform this function.

**Conduct spot checks on samples of the borrowers**

While the emphasis is on the performance of the portfolio as a whole, it is also necessary to visit a statistically valid sample of the borrowers. In most cases, internal auditors would assume this responsibility, but supervisors should ensure that it takes place. The purpose of these checks is three-fold: (a) to detect fraud by identifying ghost borrowers; (b) to test if loan officers are properly implementing the lending methodology; and (c) to ensure that loan practices, such as loan rescheduling, are consistent with the institution’s policies.

**Adopt conservative risk-weighting and provisioning policies**

In many countries, regulated MFIs, whether they operate as commercial banks or specialized intermediaries, apply the same risk weighting and provisioning policies as pertain to consumer finance loans. These policies should be reviewed to ensure that an appropriately conservative approach is adopted, particularly given the unconventional security used by most MFIs. Provisioning policies should consider the average loan maturity of the portfolio. More aggressive provisioning is called for with the shorter average maturity of most MFI portfolios.

**MFIs pay for the supervision services**

Typically, traditional financial institutions contribute to the cost of their supervision. A similar approach should be used with MFIs. If fees are charged

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55 Los Andes (Bolivia) and ACP (Peru) have both chosen to employ more conservative provisioning policies than stipulated for consumer finance.

56 A three month loan that is two months overdue is more likely to default than a 60 month loan that is two months overdue.
based on the size of the portfolio, then large commercial banks would cross-subsidize the costs of supervising microfinance portfolios—which most microfinance practitioners would probably welcome. In addition, the costs of supervising microfinance portfolios could be kept down if supervisors rely heavily on well-trained auditors, both internal and external. Nevertheless, donor support may be necessary to train supervisory and audit personnel and to develop appropriate auditing and supervision protocols.

5.3 Recommendations from Indonesia

In Indonesia, bank supervision is highly decentralized and performed by a relatively large number of examiners. Based on this experience, the management of Bank Rakyat Indonesia urges the adoption of simple guidelines that are easily understood and applied by local branch management and examiners. Specific recommendations from the Indonesia experience include:

*MFIs should recognize revenue on the more conservative cash basis rather than an accrual basis*

Although formal banking institutions use accrual accounting to provide a precise rendering of the financial position of a financial institution, without a computer system it is more complex to administer than cash accounting. In an environment such as Indonesia, where many bank branches are not computerized and banking supervision is highly decentralized, revenue should be recognized on a cash basis. If, however, the branch offices are computerized, then the more accurate accrual method is appropriate. Furthermore, to be effective, accrual accounting requires that appropriate policies regarding income on non-performing loans be introduced.

*Loan classification and provision guidelines should be based on simple, measurable factors (e.g., days delinquent) rather than allowing individual branch managers to use judgment in the classification process*

In broad, decentralized systems, operating guidelines should be easily measured to ensure consistent application of uniform practices.

*Taxable income base should reflect actual provisions taken instead of setting arbitrary limits to the provisions applied by MFIs:*

In some countries, to curtail under-reporting of income, the formula for defining income used to calculate tax obligations is based on standardized provisioning policies. If an MFI elects to adopt more conservative provisioning, for tax purposes their income is calculated as if the standardized provisions were used. This serves to penalize MFIs that adopt more conservative provisioning practices.

The supervision of regulated microfinance institutions is a relatively new practice. Worldwide, there is little experience of bank superintendencies supervising such
institutions. Where the regulated MFIs are more mature, supervisory responsibilities are often shared or delegated to third parties. Bank Indonesia has delegated much of its supervisory responsibilities to BRI; in Bangladesh, supervision of Grameen Bank occurs mostly through the government’s participation on the board of directors. In Peru, for the past ten years the federation of municipal banks has played a valuable supporting role to the bank superintendency. In most countries, there remain serious questions regarding the available resources for bank superintendents to pursue the supervision methods that are most appropriate to MFIs. Creative approaches to making available effective supervision, through sub-contractual arrangements or other means, merit further exploration.
6. **RECOMMENDATIONS**

Microfinance institutions have demonstrated considerable resilience, flourishing outside the regulated environment. As the number of institutions increases, and as the MFIs have grown in scale and complexity, regulators may seek the means to support their growth, while safeguarding the financial system and protecting the interests of MFI clients, the most economically vulnerable sectors of the population.

While appropriate regulatory approaches must be consistent with the regulatory framework of a given country, this study points to field lessons that illuminate appropriate regulation of this segment of the financial market. The essence of these lessons is to consider the risk profile of microfinance institutions and rigorously apply prudential guidelines where MFIs are vulnerable, but to offer flexibility in risk control measures that do not apply to the microfinance sector. Such effective regulation can be accomplished through exemptions and modifications to existing financial sector guidelines or through the establishment of specialized regulatory regimes.

Whichever means is adopted, regulators should be cautious not to move too hastily to establish regulations, or to establish regulations based only on one institutional model. Microfinance has evolved over the past twenty years in a largely unregulated environment. Microfinance institutions have been free to innovate financial service methodologies appropriate to the characteristics of their target market. There is a danger that regulations designed for the risk profile of commercial banks may box MFIs into practices that require replicating traditional banking practices, thereby losing their ability to reach their target market.

There is also a danger that the proliferation of MFIs, in response to a seemingly limitless market for microfinance services, may exceed the regulator’s capacity of supervision. Yet, once MFIs are regulated entities, depositors may not adequately evaluate their risk. It is necessary to find a balance; regulators should consider a line below which the financial markets are better left unregulated and focus their attention on those institutions with the potential to obtain significant scale. In addition, until regulators develop an expertise with microfinance, it is probably preferable not to license too many institutions.

This chapter provides specific regulation and supervision recommendations designed to address the unique risk profile of MFIs outlined in Chapter 2. These points are relevant in both cases: if an MFI is accommodated within an existing regulatory framework and in the design of a special category for microfinance.
6.1 Specific Recommendations to Address MFI Risk Profile

Leading microfinance institutions have demonstrated that it is possible to manage the four-point risk profile of a microfinance institution. Regulators and supervisors play an important role in this process by recognizing the inherent strengths and vulnerabilities of MFIs. Measures to address the MFI risk profile are outlined below.

Ownership and Governance Risk

Regulators should encourage meaningful participation of private investors, particularly local business leaders.

Bank regulators can assume a highly constructive role to manage ownership and governance risks by encouraging the right composition of MFI ownership. The perspective, contacts and credibility of local private investors could contribute significantly to the stability of an MFI. Furthermore, if private investors have a significant percentage of their own resources at risk, they can be an important source of local governance and a valuable resource if the institution encounters difficulties.

MFIs benefit from the participation of several significant shareholders who bring diverse backgrounds and perspectives to the governance process.

In addition to private investors, regulators should encourage investment by other private or public development-oriented institutions with microfinance or related development finance experience. Many microfinance institutions examined were developed by non-governmental organizations that engaged in the delivery of financial services. The NGO typically invests its already established portfolio as its source of capital to the new financial institution. While this places the NGO in the position of majority shareholder, this is not advisable. Regulators should seek a balance of experience and qualifications among shareholders.

Successful arrangements between the NGO owners and the regulated MFI can be attained if the structure adheres to certain basic principals, including transparency, arms-length transactions, honest transfer pricing and operational independence.

The NGO should maintain its identity and mission with a clear definition of services it provides to the regulated financial intermediary, and vice versa. The regulated MFI must maintain independent management and oversight of its financial services. In addition, banking supervisors should require reporting of all business dealings between the NGO and the financial institution. By applying these principles, effective coordination between the NGO and regulated MFI can be obtained.
Regulators can require that board composition include individuals professionally prepared to define sound policies and to oversee management.

Nevertheless, given the mix of MFI ownership, it is common for some directors not to have pecuniary interests in the performance of the MFI. To compensate for this lack of financial risk, the directors could be held legally liable for the performance of the MFI, as is applicable to directors of private sector companies. This may make it difficult to find directors, but there should be some ramifications for not fulfilling their responsibilities. For this to work, the legal system needs to identify what constitutes gross negligence, such as not appointing an internal auditor or failing to determine the quality or reliability of reported financial information.

Regulators can introduce measures to compensate for the owners’ limited capacity to respond to additional calls for capital.

This can be addressed by the following options: (i) increasing the capital adequacy requirements; (ii) establishing additional reserve funds; (iii) limiting dividend distribution until capital benchmarks are reached; and (iv) requiring standby financing commitments by MFI owners. The capital structure of the MFI should anticipate this limited availability of additional resources.

Management Risk

Regulators should ensure that well-trained internal and external auditors are performing their responsibilities accordingly.

Regulators should require MFIs to maintain strong internal auditing capabilities and aggressive internal auditing procedures, including spot checks on borrowers. Guidelines should also establish the performance requirements of external auditors. Because of the decentralized service delivery methods, and the delegation of considerable decision-making to field personnel, adequate measures of internal control are critical to detect and prevent fraud.

MFIs should apply consistent financial service methodologies.

Supervisors can reasonably require MFIs to document their operating methods and to hold the organization accountable to their operating procedures, as long as flexibility to adjust them over time is not hampered. Senior management must train and supervise mid-level management, introduce appropriate reporting systems, and maintain adequate communication systems so that uniform policies and procedures are adopted. New products and services, including the application of new service delivery methods, should be well tested before implementation on a wide scale.
Portfolio Risk

Bank regulators should accept flexible definitions for loan security that enhance repayment incentives.

Microfinance lending methods rely on repayment incentives and non-traditional collateral—such as access to repeat loans, peer pressure, potential loss of personal assets and personal relationships with loan agents—instead of considering loan collateral a potential secondary source of repayment. Sufficient experience is now documented to demonstrate that such repayment incentives can result in very low delinquencies and permit the delivery of financial services to sectors of the economy that do not have access to conventional collateral.

The accuracy of portfolio management information systems should be verified.

The most effective means of controlling MFI portfolio risk is to ensure the adequacy of the portfolio MIS, to use statistical analysis to evaluate the overall performance of the portfolio, and to verify the results with random portfolio checks. Adequately designed, current and accurate information systems are essential for managing the portfolio risk of microlenders because of the volume of transactions, their short terms, frequent repayment schedules and decentralized operations.

Regulators should adopt aggressive loan provisioning policies.

The provisioning policy is an empirical issue that should be determined on a country by country basis. Loan provisioning policies should be commensurate with loan maturities; risk-weighting that considers the quality of security; and standard methods that can be easily and consistently replicated. The short average maturities of most microfinance institutions indicates that provisioning applied to a microfinance portfolio should reasonably be more conservative than policies adopted for commercial banking. A 60-day delinquency of a 90-day loan may be a greater risk than a 90-day delinquency on a five year loan. Regulators may also want to consider different approaches to the risk-weighting of MFI portfolios. For example, different risk weighting may be assigned to those assets secured by character reference. Most importantly, regulators should encourage the adoption of standard loan classification procedures. By limiting management discretion, it is possible to obtain an accurate and consistent assessment of portfolio quality.

Regulators should not require significant documentation for microloans.

Successful MFIs have demonstrated that simple applications are all that is required. In MFIs with very short-term loans, repeat loans may be approved without a business assessment for clients in good standing. The approval of a loan application relies more on the client’s repayment history and the qualitative assessment of loan officer than on any quantitative information in
the application. Requiring more documentation than a successful MFI deems necessary can add significant costs and undermine its profitability.

New Industry

*Regulators should closely monitor MFIs that dramatically surpass the growth projections presented in the license application.*

Most successful MFIs operate in a market that, until now, has been significantly under-served. As microfinance services extend to the informal sector, the demand is often very strong and an MFI has an opportunity to sustain exponential growth rates. The experiences of Finansol and other institutions have indicated that rapid growth can lead to a deterioration in loan portfolio quality and should be closely monitored.

*New products and services must be well tested before implemented on a broad scale.*

It may be appropriate to limit the number of new products or services that are introduced at any one time. Each innovation in a methodology must be carefully evaluated to determine how the new methods will influence the original service delivery. Furthermore, an institution’s capacity to implement many new products and services, while continuing to grow their existing product lines, must be considered.

*Regulators can safeguard public interest, while contributing to the institution’s potential success, by limiting the products and services that MFIs offer.*

The challenge facing MFIs is to conduct a large volume of very small transactions, and to do so profitably. Given this challenge, it is appropriate to limit the products and services provided by MFIs. However, as an institution demonstrates its capacity and builds a track record of success, it should be permitted to provide additional services required by its market.

*Regulators should require MFI managers to be well versed in both traditional and micro finance.*

Since management is the first line of defense against a failing portfolio, it is reasonable to have high standards for the management of MFIs. While microfinance managers can be created through training, it requires an adequate investment in time and resources to ensure that MFI managers are well prepared for their responsibilities.

6.2 Conclusion

Thousands of dedicated microfinance institutions have emerged around the world. They have developed innovative and unconventional lending methodologies designed to meet the specific characteristics of microenterprises and low income
communities. By doing so, some MFIs have demonstrated that microfinance is profitable. Through the provision of these services, MFIs deepen the financial system and expand the economic contribution of what are normally considered marginal communities.

As MFIs mature, many are realizing that they need to enter the formal financial system to fund their growth and to provide the diversity of financial services demanded by their target market. But, just as traditional lending techniques are inappropriate for the characteristics of microenterprises, traditional banking regulation and supervisory practices are ill-suited to the unique risk profile of a microfinance institution.

While it is not possible nor desirable to regulate all microfinance institutions, there are an increasing number of MFIs that are reaching significant scale, intend to mobilize savings and merit further consideration by bank regulators. This document has reviewed some of the experiences to date of jurisdictions that have attempted to shape regulation and supervision to the specific characteristics of microfinance. A range of responses were considered, including making exceptions to existing regulations, creating special regulatory categories for microfinance and delegating supervisory responsibilities to third parties. This study did not assess the costs, risks or effectiveness of one approach over others. The experience to date is insufficient to offer such an assessment—however it will certainly be warranted in the near future.
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*Also available in Spanish.
**Also available in French and Spanish.

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The MicroFinance Network is a global association of leading microfinance practitioners. Network members are committed to improving the lives of low-income people through the provision of credit, savings and other financial services. The Network believes that this sector should be served by sustainable microfinance institutions. The MicroFinance Network is a vehicle for accomplished institutions to provide each other with technical assistance and to learn from each others’ experiences.

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