

**Supervising & Regulating Microfinance
in the Context of
Financial Sector Liberalization**

Lessons from Bolivia, Colombia and Mexico

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INTRODUCTION

Throughout Latin America, microfinance has become an important part of the financial sector. Though small in money terms, microfinance institutions (MFIs) serve large numbers of people, in some countries even more than mainstream financial institutions. Regulatory authorities in charge of the financial sector have responded to the emerging microfinance “industry” in varying ways, and those responses have contributed to the variation that now exists among microfinance sectors in different countries. The microfinance sector in Latin America today is a joint product of both the drive of the microfinance industry itself and the decisions of regulators.

Where regulatory authorities took microfinance seriously early on and responded with a supportive yet not overly restrictive approach, the sector has developed and matured. Where regulatory authorities ignored or avoided microfinance, the sector has been slower to develop or has developed outside the regulated financial sector. For example, the Bolivian authorities worked together with the microfinance industry to create a special regulatory category for microfinance, and today microfinance in Bolivia is advanced and forms a specialized portion of the formal financial sector. By contrast, in Colombia, regulators wary of microfinance did not develop a pathway for the formalization of specialized MFIs. As a result, most large microfinance providers in Colombia are non-governmental organizations (NGOs) not interested in becoming regulated. In Mexico, regulators have viewed microfinance largely through the lens of cooperatives, with the consequence that Mexico features relatively few non-cooperative microfinance providers.

Looking deeper, it becomes clear that the responses of regulators in various countries has been intimately linked to the overall process of

¹ This monograph was made possible by the generous financial support of the Tinker Foundation.

financial sector reform and liberalization taking place in the region for the past one to two decades. Each country's approach to financial sector reform has created the institutional environment in which microfinance has grown up. Liberalization has created stronger supervisory agencies. Hesitant liberalization in some countries has left public sector banks in place. Both of these institutional structures – supervisory agencies and public banks – have had profound effects on the development of microfinance. Moreover, policymakers carried their general philosophical approach to the financial sector into policy toward microfinance, with interest rate ceilings as a primary example. Finally, many countries in the region have experienced serious financial crises, and both the crises and the responses to the crises have also contributed to the shape of policy toward microfinance.

Most of the analysis of microfinance regulation to date focuses on the regulatory and supervisory frameworks themselves. Little analysis has examined these frameworks in the broader context of the evolving views of the authorities about the financial sector in general. Yet these authorities, with their philosophical predispositions and specific historical experiences, are the makers of the key regulatory policies. It is important to understand where these authorities are coming from to understand the way they have reacted to the opportunities (or challenges) microfinance offers. Rather than criticizing one country as having a deficient framework or another as having an exemplary one, this paper argues that each framework reflects the realm of possibilities that were present as microfinance entered the financial sector picture. It suggests that designers of new microfinance regulation, and the international advisors who propose microfinance frameworks, must take these realities into account.

This paper examines the regulatory framework for microfinance in three countries: Bolivia, Colombia and Mexico, each with very different experiences in financial reform, financial crisis and microfinance. It explores the impact of financial reform and crisis on the choices regulatory authorities have made about microfinance and, in turn, explores how these choices have affected the character of the microfinance industry in each country. This discussion constitutes the first half of the paper.

The second half of the paper takes a more standard approach to the topic of regulation and supervision. It covers the elements of good

microfinance regulation, beginning with the financial sector environment needed to advance microfinance and continuing with preparation of supervisors and specific norms adapted for microfinance. These topics are illustrated by comparing the experiences and policies of the three subject countries. Much of this discussion, although based upon the three country case studies, can be applied to Latin America in general. However, the lessons learned cannot systemically be applied to all regions of the world, where the histories and characteristics of financial sector liberalization and other contributing factors may differ.

PART ONE: HISTORICAL AND COMPARATIVE PERSPECTIVE: BOLIVIA, COLOMBIA AND MEXICO

How Liberalization Enabled the Rise of Microfinance

Before the 1980s, most countries had repressed financial systems, which began to be liberalized in the mid-1980s. This paper holds the perspective that experience with financial sector liberalization has been positive (though not necessarily easy or free of painful adjustment). Liberalized financial systems work better than systems using the old model of financial repression, even when it comes to reaching out to the poor and vulnerable members of society. While this stance may no longer be controversial among most banking authorities, it is clear that some countries have embraced liberalization to a greater degree than others. We now examine several of the major features of liberalization and describe how each affects microfinance.

Universal Banking. Under the old model, laws and regulations treated financial intermediaries as specialized entities allowed to carry out only operations for which a specialized license had been granted. Commercial banks gave only short term commercial loans; development banks gave medium and long term loans for fixed assets; housing banks were restricted to real estate; and the like.

With liberalization, intermediaries became universal banks that were allowed to carry out all types of operations. All three countries – Bolivia, Colombia and Mexico – have instituted universal banking. In highly liberalized settings, universal banking even integrated the markets for banking, insurance and stock exchange operations. For our purposes, it is important to note that universal banking opened microfinance to any type of financial institution, and this has allowed commercial banks and finance companies to enter microfinance in many countries. A recent and rapidly growing trend in Colombia, for example, is for commercial banks to launch microcredit operations.

One remaining set of restrictions that affects microfinance directly is the restriction of smaller financial institutions to a more limited array of operations, on the basis of their capital levels or legal association structures (cooperative, mutual institution). In particular, these smaller institutions have been excluded from direct participation in payment system clearinghouses, and thus cannot offer current accounts. In Bolivia, the private financial funds (*fondos financieros privados*, FFPs), a regulatory category designed for microfinance, and Colombia's commercial finance companies (CFCs) may not offer current accounts, engage in foreign trade finance or provide certain other services. In both of these countries, the trend toward universal banking continues, and these restrictions are under review with an eye toward broadening the scope for capable FFPs and CFCs. By contrast, Mexico's system of licensing institutions based on size and legal structure segments the sector in a way that may not be ideal, as discussed in the section on Mexico, below.

The adoption of universal banking is beneficial to microfinance both because it allows easier entry by a wide variety of non-specialized institutions into microfinance, and at the same time because it provides a basis for development among those institutions specialized in microfinance. The specialized MFIs are free to diversify their product and client range, which assists them in competing successfully and in managing risk. The result benefits the clients of microfinance who receive a wider range of services, with better service quality and lower price (due to competition). This is not to say that all MFIs should aim to be full-service providers. The point here is simply that universal banking provides the option for financial intermediaries to offer a variety of financial products and services and is an important factor within financial sector liberalization that contributes to a robust microfinance sector.

Closure or Reform of Public Banks. The old model relied on public banks to perform tasks believed to be especially important to the economy, particularly tasks seen as unprofitable for commercial financial institutions. In most countries, these banks were extremely inefficient, often presenting enormous recurrent losses that forced the government to recapitalize them with budgetary resources. Moreover, these banks provided loans at subsidized rates to preferred clients, distorting credit markets, eroding credit culture and discouraging entry by commercial operators. At their worst, these intermediaries provided loans to the power groups of the ruling government or used credit as a political

campaign tool. The public banks were not supervised strongly by the banking authorities (due to the internal difficulty of one arm of government supervising another), which had implications for the status and strength of supervisory agencies as well as for credit market competitiveness.

Even while these problems with public banks were becoming more apparent, small savers were placing deposits with them, in the belief that the government would back those institutions and protect their deposits. This fact undermined the development of deposit mobilization among commercial players, and turned the face of the public away from the commercial institutions (which were in any case undergoing serious crises).

Of the three countries in our study, only Bolivia completely eliminated public sector banking during the reforms of the mid-1980s. This left a gap in the provision of financial services to certain sectors, notably agriculture, but it also left the playing field wide open for the entry of commercially oriented microfinance. Mexico and Colombia, by contrast, have continued to rely on public banks. Each has an array of such banks still operating today, although both Colombia and Mexico have closed several of these banks recently. Those in charge of public banks have sought to reform rather than close them. While the question of how well these reforms have succeeded is beyond the scope of this paper, the implications for microfinance are not. In both Colombia and Mexico the entrants into microfinance have had to compete with public sector banks operating under preferred terms. In general, where public sector banks operate well, private initiative is reluctant to enter into direct competition with them.

Interest Rate Restrictions. In repressed systems, regulators set ceilings on interest rates, often based on credit types. Credits considered crucial for economic development usually had lower ceilings than credits channeled to trade. If banks could not operate with the lower rates, they simply did not lend. In the liberalization process, interest rates were fully deregulated in Bolivia and Mexico, but not in Colombia. Regulatory authorities retain interest rate caps today under the arguments that poor people should not have to pay more than the rich and that banks charging too much must be making excessive profits.

The interest rate question is absolutely central to microfinance because the high cost of making very small loans requires interest rates to be well above prime commercial bank lending rates. Unrealistic interest rate controls are a sure and simple way to stifle the development of microfinance.

The argument in favor of open competition as the arbiter of interest rates is spectacularly demonstrated by the history of microfinance interest rates in Bolivia. When microfinance began in the early 1990s interest rates were high – around 80 percent per year on average. The competition engendered by the entry of new players and the growth of the microfinance industry has now pushed interest rates down to levels of between 22 and 30 percent.² This drop in interest rates took place without regulatory pressure from the banking authorities and without unsustainable subsidization of interest rates by the public sector. In Colombia, by contrast, interest rate caps have caused microfinance institutions to hide charges as fees, reducing pricing transparency to the customer. This lack of pricing transparency is not only damaging to microfinance customers, but it hinders competitors from entering the market. More important, they have kept NGOs from joining the financial mainstream as a means of avoiding interest rate controls. In short, interest rate restrictions have retarded the growth of microfinance in Colombia.

Relaxing Reserve Requirements. In almost all countries in Latin America, legal reserves were much higher than necessary for prudent financial management. For example, in Bolivia, legal reserves for current account deposits were 45 percent, for savings deposits 20 percent and for fixed term deposits 10 percent. These reserves were in fact a way for the government to access the resources of the financial sector to finance high fiscal deficits. This resulted in crowding out against the private sector. Banks simply had less money to lend. With financial liberalization, all of the countries standardized legal reserves at about 10 percent for all types of deposits. This freed a significant amount of resources for the private sector, while creating incentives for banks to develop new lines of business – including microfinance – in order to place these resources.

Eliminating Directed Credits. In addition to channeling resources to preferred sectors through public sector banks, financially repressive

² Source: BancoSol analysis of interest rates in the Bolivian microfinance market, February 2004.

governments also tried to force banks to lend to preferred sectors through directed credit rules (for example, by directing a certain percentage of all lending to agriculture). While most countries ended directed credits, a few vestiges remain, notably in Colombia. For the most part, eliminating directed credit has been good for microfinance because microentrepreneurs were not generally considered preferred economic actors and so did not receive the benefit of directed credit. The picture is less clear, however, for directed credits aimed at rural development, given that many micro-level clients are farm families.

Moreover, in some more recent examples, microfinance is among the favored sectors. While there may be compelling arguments for countries not to use directed credit policies, it appears that when well-crafted, such policies can have a positive effect on microfinance. For example, in Colombia, much of the current interest of commercial banks in launching direct retail microfinance operations appears to stem from their directed credit requirements, and Colombia's mandatory investment program has been a significant source of financing for Colombian MFIs.

Financial Sector Crisis. Bolivia, Colombia and Mexico have all undergone financial sector crises. In each case, the crisis has resulted in the exit or acquisition of poorly performing financial institutions, as well as a reduction in total assets in the financial sector. While the crises themselves have not affected microfinance seriously, the response of regulators has.³ In a number of instances, the crises created the impetus for new regulatory frameworks aimed to set the financial sector on a firmer footing. Bolivia's crisis in the mid-1980s was the impetus behind the wholesale liberalization of the financial sector that paved the way for microfinance, while Mexico's mid-1990s financial sector crisis resulted in the imposition of tighter controls across the financial sector spectrum, including a new regulatory framework for microfinance.

Microfinance Initiatives. While financial sector policies and conditions have had a major influence on the development of microfinance in each country, the natural development of the microfinance industry in each country has also been a contributing factor. In some countries there have been numerous, dynamic entrants into the microfinance field who have pushed each other forward competitively. One factor that may help to

³ Now that microfinance is truly part of the financial sector, it is increasingly affected by financial sector crises, as evidenced by the effects of recent crises in Ecuador and Bolivia on microfinance.

explain the dynamic entrants is the presence of international donor funding during the formative years of microfinance, which was far more plentiful in Bolivia than in Mexico, for example, and moderately available in Colombia.

Country Experiences

Supervision and regulation of microfinance can be a double-edged sword. When properly conceived and implemented, laws and supervisory structures can provide the stability, predictability and support that MFIs need to thrive and that are necessary to protect the savings of the poor. However, inappropriate systems – those that are not adapted to characteristics of microfinance, or those not aligned with the local realities of the microfinance industry – will not foster MFI growth.

The three countries analyzed here feature three distinct methods of microfinance supervision and regulation. Bolivia created a system of specialized microfinance regulation and supervision. Mexico, through its *Ley de Ahorro y Crédito Popular*, has initiated a delegated system in which federations comprised of representatives from MFIs engage in self-regulation. Colombia has no regulations specific to microfinance, although recently the government has begun to consider initiatives focusing on microfinance.

In examining the experience of the three countries, we consider a supervisory and regulatory system to be successful for microfinance if it allows microfinance to evolve and become integrated into the mainstream financial sector while appropriately protecting both deposit-taking MFIs and consumers against risk.

Through our analysis, we identify several factors that contribute to good microfinance regulation and supervision. First, a successful system will be tailored to the needs of the microfinance industry in each specific country. That is, countries cannot take a “one-size fits-all” approach when developing or restructuring their systems. Instead, they should consider the unique microfinance environment that currently exists within their own country (although the specific performance norms applied to microfinance should be similar across countries).

Second, governments should engage in a consultative process to arrive at a well-designed system that provides the basis for growth and

development of a healthy industry. Officials should solicit the advice of all local stakeholders (microfinance institutions, other government officials and associations) as well as international experts when designing their systems. Additionally, the existing political and microfinance climate within the country must be suitable. A critical mass of existing microfinance providers should be operating. Banking authorities, and in particular, supervisors assigned to the sector, should have (or be ready to gain) a deep understanding of the credit technologies specific to microfinance. Finally, there should be stable, high-level political support for the microfinance industry.

Bolivia

Bolivia's approach to microfinance regulation and supervision was crafted within a financial sector policy of rigorous, almost textbook, liberalization, which began earlier than similar reforms in many other countries. This liberalization created the space for microfinance to develop. In addition, Bolivian authorities have been highly supportive of microfinance, viewing it as a way to address the important gap left by liberalization. As a result, authorities have been willing to work alongside the emerging microfinance industry in a supportive way, even tolerating a certain degree of ambiguity in the regulatory framework during the development stage. This unique combination of a non-interventionist financial sector policy with a strong (though non-interventionist) backing for microfinance has resulted in a mature, competitive microfinance industry in Bolivia. However, the laissez-faire approach also contributed to (or failed to prevent) the problematic entry and exit of consumer lending into the microfinance market, which stressed the Bolivian microfinance industry severely in the late 1990s.

The main conditions that allowed Bolivia to create a vibrant microfinance industry can be traced back to 1985. As part of its New Economic Policy, the government of President Paz Estenssoro initiated a series of reforms to stabilize a period of hyperinflation, debt and economic turmoil. Estenssoro's reforms liberalized the entire financial system, unified the exchange rate and imposed strict monetary and fiscal policies, successfully staving off hyperinflation. Following the key tenets of financial liberalization, the reforms set the stage for a robust microfinance industry by:

- Liberalizing interest rates

- Eliminating directed credits
- Closing state banks and subsequently closing weak private banks
- Instituting a universal bank system
- Reducing the levels of reserves required on deposits
- Permitting financial institutions to accept deposits in foreign currency
- Strengthening the Superintendency of Banks and Financial Institutions (SBEF) both technically and in terms of increased autonomy from political pressure

Responding to the expansion of the informal sector and new-found economic stability, Bolivia's pioneering microfinance NGOs began to emerge within a year after the policy reforms began. As state banks closed, nonprofit organizations such as Prodem, FIE, and ProCrédito began to provide credit to microentrepreneurs.

What happened in Bolivia depended critically on the response of the private sector (at first the NGO sector) to the opportunities created by liberalization. The major advances occurred because someone was there to seize the opportunities created by liberalization. The early entrants shaped the path of microfinance in Bolivia, first through the transformation of the NGO Prodem into the commercial bank BancoSol and second through the creation of the FFPs. BancoSol presented microfinance in a dramatic fashion to the SBEF as petitioner to become part of the financial system. If the founders of BancoSol had not done this, the evolution of microfinance regulation in Bolivia might have been quite different.

Supervising a microfinance institution operating as a commercial bank required a change in thinking for the SBEF. High operational costs (20 percent or more compared to about five percent for mainstream commercial banks) and a more informal institutional culture were not outright violations of the regulations, but such characteristics at first startled the SBEF. Furthermore, Prodem's unorthodox portfolio comprised solely of unsecured loans actually did violate commercial bank regulations. Any portfolio made up of more than 10 percent

unsecured loans – a rarity among mainstream banks – had to be provisioned at 100 percent.⁴

The SBEF allowed BancoSol to operate even though it was not in compliance with some key regulatory norms because authorities understood that microfinance differed from commercial banking. They had sufficient confidence in microfinance to look at the early years as a learning period that could be codified into regulation as experience was gained. In this way, the SBEF became a partner in the process of innovation taking place in Bolivian microfinance.

At the same time, other NGOs were working with the SBEF to create a new regulatory category for MFIs to become licensed intermediaries without having to meet all of the requirements to become a commercial bank, particularly requirements relating to minimum capital and some of the more sophisticated banking operations (current accounts and foreign trade). The SBEF and the remaining NGOs worked together to create the FFP, the first institutional structure created specifically for microfinance institutions, in 1995.⁵ FFPs have significantly lower minimum capitalization requirements than banks (\$1 million as opposed to \$8.2 million for banks). They can mobilize savings and are subject to the same kinds of prudential and non-prudential norms as banks. In addition, the SBEF developed a parallel regulatory and supervisory framework for cooperatives, which has resulted in the strengthening of the leading cooperatives through incentives for top cooperatives to qualify to be supervised by the SBEF and capture deposits from the public.

In order to work with the microfinance sector, the SBEF created a department for microfinance and directed a great deal of effort to educating the staff of this department about the details of microfinance.

⁴ One of the few amendments to the banking regulations was made to accommodate this major difference, exempting loans less than \$2,000 from the provisioning requirement.

⁵ Supreme Decree 24000 of May 1995, passed into law in 2001 (Law 2297).

The result of Bolivia's regulatory stance toward microfinance has been the following (see Table 1):

- By the mid-to-late 1990s, Bolivia was already becoming a competitive microfinance marketplace. The goal of providing access to microfinance services to the poor was largely accomplished in the urban areas by the end of the decade. Urban market penetration is very high.
- Competition has driven down the price and increased the quality and variety of services. Interest rates on Bolivian microloans are among the lowest in Latin America.
- Microfinance evolved as a specialized portion of the financial system, with the leading microfinance providers operating as regulated, commercial entities. However, few mainstream banks have been directly involved (although some banks lend to microfinance NGOs), and some cooperatives have been important regionally.
- Regulated MFIs perform well relative to the mainstream financial sector.
- The NGO sector continues to operate at the low end of the market and to serve a large number of customers.
- Rural market penetration remains low. The development of microsavings has also lagged.

**Table 1: Providers of Microloans in Bolivia
(year-end 2003)**

	Number of Active Loans	Portfolio (millions of US dollars)	Percentage of Total Portfolio
Banks (BancoSol)	56,707	\$91.2	22%
FFPs	115,897	\$194.0	47%
Cooperatives	23,234	\$46.4	11%
NGOs	176,405	\$85.9	21%
TOTAL	372,243	\$418.4	100%

Sources: ASOFIN, FINRURAL, WOCCU

The SBEF's generally encouraging stance toward providers of small loans was a factor behind the entry and rapid expansion of consumer lending in Bolivia between 1997 and 2000. Commercial banks established consumer lending departments or subsidiaries, and the SBEF

approved two new consumer-lending FFPs. These institutions flooded the low-end market with credit at a time when the growth of the microlenders was also rapid. When an economic recession hit, thousands of borrowers were revealed to have borrowed more than they could handle, often from more than one lender. A crash in the consumer lending market ensued, forcing the exit of most of the consumer lenders and dramatically increasing loan losses among microenterprise lenders.

Once it recognized the magnitude of the problem, the SBEF acted swiftly to impose risk-management restrictions on the consumer lenders (for example, limiting total debt service for an employed person to 30 percent or less of his or her salary and intervening in institutions with eroded capital), triggering the exit of the consumer lenders. The crisis was resolved before the soundness of the microfinance lenders was threatened. A case can be made, however, that the SBEF should have recognized the differences between the microenterprise loan methodology of the MFIs and the salary-based methodology the consumer lenders used. If the regulators had recognized that each methodology was appropriate only for its specific types of clients, they might have kept the boundaries between the two sectors more distinct (i.e., prohibiting consumer lenders from addressing microenterprise clients) or moved more quickly to integrate the microfinance and mainstream banking credit bureaus. The lessons to be drawn from this episode are that a non-interventionist but open regulatory stance such as the SBEF's in Bolivia carries inherent risks, and that it is of the highest importance that supervisory agencies thoroughly understand the specific lending methodologies of the microfinance and other institutions they are supervising.

Colombia

The development of regulated MFIs and regulations specific to microfinance has been slow in Colombia due to a perception by the regulatory authorities and the traditional banking community that microfinance poses excessive risk. Without an understanding of the unique characteristics of microfinance or microfinance-specific credit technologies, the Colombian government in the past has been reluctant to formalize its relationship with the sector. At the same time, although Colombia has adopted universal banking, its regulatory framework has maintained several of the centerpieces of non-liberalized financial systems: interest rate controls, public sector banking and directed credit.

As a result of these factors, microfinance has evolved in Colombia largely outside the regulated financial system. The contrast with Bolivia is dramatic, particularly when one recognizes that in a country with five times the population of Bolivia and an economy 11 times as large (which includes an enormous informal sector), the total portfolio of microfinance loans in Colombia is smaller than the portfolio in Bolivia.

The situation is changing rapidly, however. President Uribe, who took office in late 2002, has communicated a commitment to developing institutional and legal mechanisms to bring microfinance to more entrepreneurs. The approach employed reflects Colombia's continuing reliance on the tools of the pre-liberalization financial sector model.

As summarized in Table 2, a variety of institutions can offer microfinance in Colombia: NGOs, commercial banks, cooperatives, commercial finance companies (CFCs), and savings and credit companies. Until recently the majority of the services came from NGOs, while a smaller portion came from the two microfinance-oriented CFCs (FINAMERICA and Compartir). Cooperatives are presently very weak, following a 1999 crisis, and savings and credit companies are primarily mortgage lenders. These two categories provide a negligible amount of microloans, though they are relatively more important on the savings side. Banco Agrario, the public agricultural bank, has long been the main provider in rural areas, though it is not clear that these loans would be considered microcredit on grounds other than their size.

Starting in 2002, Colombian banking authorities created a reporting category devoted to microcredit (separate from consumer credit) and directed banks to place a large amount of loans into the microfinance sector. This has led to a sudden jump in the amount of microloans banks report, and indeed, to a rush on the part of banks to expand their work in this area. Several of large retail banks, especially those with social objectives (e.g. Banco Caja Social and Megabanco), but also mainstream banks such as Banco de Bogotá and Bancolombia, are actively scaling up their microlending operations.

The profile of the microfinance sector in Colombia today is dramatically different from that of Bolivia, and the differences have everything to do with the regulatory environment. In Bolivia, specialized, regulated MFIs provide most of the services, with NGOs and cooperatives playing a large role and commercial banks almost none. In Colombia, there are

only two specialized, regulated institutions—the CFCs. Cooperatives are not active, while NGOs and increasingly banks dominate.

**Table 2: Providers of Microloans in Colombia
(year-end 2003)**

Institution	Portfolio of Microloans (millions of US dollars)	Percentage of Total
Private banks	89.9	28%
Public banks (Banco Agrario)	103.8	32%
CFCs	16.0	5%
Cooperatives	0.9	0%
NGOs	115.1	35%
TOTAL	325.8	100%

Source: Colombian Superintendency of Banks

Colombian NGOs have resisted transforming into regulated entities, despite the availability of a regulatory category, the CFC, which is somewhat analogous to Bolivia's FFPs. The NGOs cite the following regulatory barriers:

- Interest rate controls applicable to regulated institutions
- Regulations on portfolio quality and the current ratio index⁶
- Costs of deposit insurance and high reserve requirements⁷
- Inability of regulated entities to borrow long-term from other regulated entities
- Restriction of CFCs to deposit-taking only in the form of time deposits (no savings or checking accounts)

When these Colombia-specific restrictions were added to the standard costs of becoming regulated (difficulties of ownership change, loss of tax-free status, increased burden of reporting, etc.) they eliminated the incentives for transformation.

Only in 2003 did regulations begin to address some of these drawbacks: CFCs are now allowed to develop savings accounts; they can borrow from commercial banks; and they can charge commissions to increase

⁶ Akerman, p. 6.

⁷ Ibid.

revenues on loan portfolios.⁸ It remains to be seen whether these new inducements will convince the NGOs to become CFCs.

The Uribe government's microfinance program contains elements of a liberalized financial sector policy, as just noted. However, its strongest tool for promoting microfinance is directed credit. The new rules direct banks to invest in microfinance both as retailers and as wholesalers, through lending to NGOs and CFCs. This mandate has created a rush of activity in the sector, which appears poised to dramatically increase total amount of microlending in Colombia. While advocates of full financial sector liberalization shun this type of policy as distortionary, the current push in Colombia could have a beneficial effect, at least for microfinance. Microfinance is now proven to be commercially viable, but estimates are that there is still a great deal of unmet potential demand. Unlike directed credit policies aimed at unprofitable sectors, this use of directed credit could catalyze the development of a viable microfinance market. It is too early to tell how genuine or sustained the banks' current enthusiasm for microfinance will be. The emphasis in the government's program on commercial banks as financiers of NGOs and CFCs reduces the incentives of these specialized MFIs to mobilize savings, thus leaving microsavings largely in the hands of the large retail banks.

Another government policy tool is the loan guarantee offered by the National Guarantee Fund (FOGAFIN), which has been raised for microfinance from 50 to 70 percent of principal. This policy measure is unlikely to have a major effect. Serious MFIs report that it is too expensive to use cost-effectively, which indicates that those banks that do use it are the banks less likely to know how to deliver microfinance services (and hence more likely to call on the public treasury to make good the guarantees).

An interesting question is why, given a relatively unsupportive regulatory environment, has Colombian microfinance developed as well as it has. Several Colombian microfinance institutions are impressive organizations serving significant numbers of people profitably. This observation serves as a reminder that regulatory authorities do not by themselves drive the development of the microfinance sector; innovative and determined operators in the private sector (and their public and

⁸ Law 795, January 2003 and Decree 710, March 2003, which amend the Financial System Organic Statute.

private backers) are the most important driving force. At the same time, we might also conclude, as noted above, that the stance of the regulatory environment until recently accounts for the relatively low market penetration compared to Bolivia.

It should be noted that incompatibility of data precludes us from making exact comparisons between Bolivia, Colombia and Mexico in terms of the percentage of the microenterprise sector reached. However, it is clear that the penetration of microfinance services among the three countries in our study is far and away the deepest in Bolivia, while Colombia's microentrepreneurs are moderately reached, and Mexico's MFIs have the lowest market penetration.

On the whole, the new regulatory and policy initiatives in Colombia have improved the microfinance environment and should integrate it more thoroughly into the financial system, creating a more competitive sector with greater outreach.

Mexico

Mexico's size and the nature of its banking sector make it a very different setting for microfinance than the other two countries studied. With a population of almost 100 million, Mexico is more than twice the size of Colombia and more than ten times the size of Bolivia. This larger scale leads to much greater stratification in the financial system, ranging from the more than \$40 billion in assets of its largest bank, Banamex, to the tiny community-based savings and credit associations with only a few thousand dollars in assets. It also means that the banking authorities must cope with a much larger number of institutions. Scale and proximity to the United States have attracted foreign banks into Mexico's banking sector. Major U.S. banks have bought into the Mexican banking system (for example, Citigroup owns Banamex), as have Spanish and other European banks. While the trend toward foreign ownership of banks exists in Bolivia and Colombia as well, it is more pronounced in Mexico, with only one of the major banks predominantly locally owned.

Mexico's banking sector has suffered two major crises, in the early 1980s and the early 1990s. Accordingly, the Mexican banking authorities have been preoccupied with bringing strength and order to the financial sector, and their approach to microfinance reflects that orientation.

Among the three countries, Mexico has the least developed microfinance sector and has historically given the least attention to microfinance regulation. Its regulatory structure specific to microfinance is just evolving now, with a decision by the Fox administration to give microfinance considerable attention and resources and with the passage of a new law in 2001 aimed at regularizing the microfinance sector (*Ley de Ahorro y Crédito Popular* or LACP). The administration has even created a Division of Microenterprise within the Ministry of the Economy and charged the president's chief public policy advisor with coordinating government microfinance initiatives. These reforms are needed because microfinance programs within the Mexican government are largely decentralized and not yet well coordinated.

As summarized in Table 3, microfinance services in Mexico are offered through a variety of institutions, including savings and credit *cajas*, cooperatives, *Sociedades Financieras de Objeto Limitado* (SOFOLs) and governmental institutions. SOFOLs are non-bank financial institutions authorized for limited purposes. The majority provide housing or business loans, although a notable exception is Compartamos, an ACCION affiliate, which provides microloans mainly in rural areas. With over 220,000 clients, Compartamos is the largest institution offering microfinance services in Mexico (and in Latin America as a whole). Despite activity in the sector, total market penetration remains very low. Most Mexican microentrepreneurs still lack access to services.

Table 3: Institutions Offering Microcredit in Mexico

	Number of Institutions	Active Clients	Percentage of Total
Microfinance Institutions⁹	45	270,000	23%
Savings and Credit Cajas	14	250,000	21%
Cooperatives	200	200,000	17%
Credit Unions	75	50,000	4%
Cajas Solidarias	210	140,000	12%
FIRA Programs¹⁰	32	35,000	3%
Rural Parafinancieras	372	233,000	20%
Total	948	1,178,000	100%

Source: COLCAMI estimates based on data from BANSEFI, FONAES, FINAFIN and FIRA

⁹ Includes Compartamos, a SOFOL.

¹⁰ *Fideicomisos Instituidos en Relación con la Agricultura* (FIRA) is a program of the Mexican government that acts as a second floor financial entity for rural development.

Under the new law, the Mexican banking authority, the *Comision Nacional Bancaria y de Valores* (CNBV), is trying to organize the disparate microfinance providers (at least nine different institutional categories) into regulated institutions known as *Entidades de Ahorro y Crédito Popular* (EACPs). The EACPs can be either cooperatively-owned, in which case they are *Sociedades Cooperativas de Ahorro y Préstamo* (SOCAPs) or privately owned *Sociedades Financieras Populares* (SOFIPOs). The vast majority in terms of numbers of institutions are SOCAPs, although the outreach of the SOFIPOs may be greater.

Mexico’s current approach to microfinance is the result of a history of financial services to the poor stretching back to the early 1950s, when savings and credit institutions for the poor emerged as ‘*cajas populares.*’ Originally founded by religious organizations, the *cajas* evolved into a diverse system of more than 600 institutions with a wide variety of ownership structures and missions. Many of these small and informal institutions were cooperatives, offering credit and savings to their members. Despite the fact that they took savings, they remained outside of the formal financial sector, with only about 10 percent operating in the regulated environment. The observation that these institutions captured savings from their members with very little supervision combined with a broad desire to strengthen bank supervision following banking crises provided the motivating antecedents to the new law.

The LACP, which applies to deposit-taking institutions, attempts to develop prudential norms appropriate for microfinance institutions that are effective in protecting depositors. Additionally, it creates a deposit protection fund to increase the security of the public’s savings. According to the legislation, Mexican EACPs are organized into four levels based upon asset level, minimum capitalization and provisioning requirements (Table 4).

Table 4: Mexico’s EACP Categories (US\$)

	Level I	Level II	Level III	Level IV
Assets	<\$243,750	\$243,750 – 16.25	\$16,25 mn. – \$91 mn.	>\$91 mn.
Minimum capitalization	\$32,500	\$81,250	\$1.625 mn.	\$8.12 mn.

One of the most important and controversial aspects of the LACP is the supervisory structure it introduces. Modeled after Canada's Desjardins and Germany's Raiffeisen systems of self-regulation, Mexican MFIs will be supervised by federations authorized by the CNBV. These federations, comprised of representatives from member EACPs, are charged with creating and enforcing prudential and non-prudential regulations. This system creates significant supervisory cost savings that the CNBV would otherwise have to absorb. The ability to place the day-to-day tasks of direct supervision outside CNBV was a major attraction for the authorities.

The federation system introduces potential conflicts of interest, however, because the federations are made up of individuals from the very microfinance institutions they are intended to supervise. Moreover, the federations have the authority to design regulations for the microfinance industry, essentially allowing each supervisory organization to issue prudential rules in addition to those issued by the CNBV. Furthermore, the general assembly, which is the supreme authority of the federation structure, is again made up of the same institutions it is to supervise, hindering the general assembly's ability to exercise unbiased judgment. A norm has recently been issued indicating that the federations may hire independent consultants. A better approach would be to *require* independent consultants. From a practical point of view, it is also advisable to restrict the authority to issue rules, prudential regulations, manuals and supervisory procedures¹¹ to the CNBV in order to maintain consistency and quality control.

The LACP also features a special role for a public sector bank, *Banco de Ahorro Nacional y Servicios Financieros* (BANSEFI), a savings bank with over 500 branches and one million savings accounts. Under the new system, BANSEFI is also charged with supporting the EACPs through training and technical assistance.

At the time of this writing, no federation had been approved by the CNBV, and the deadline for certification of federations had been postponed from its original date of June 2003 until June 2005. If there is a change of administration as a result of the presidential election in 2005,

¹¹ The CNBV is working on an Auxiliary Supervision Guide where the methodology and the reports that must be used by the Supervision Committees will appear.

the entire system set up under President Fox could be threatened before it ever becomes fully active.

With most of the attention related to microfinance in Mexico focused on small community-based institutions, it is appropriate to ask why larger MFIs and banks have not played a more significant role. The lack of commercial bank interest in microfinance may have to do with the tight control of banking licenses the CNBV maintains, leaving Mexico a relatively small number of banks and high barriers to entry for becoming a bank. This restriction would dampen the kind of intense competition in the financial sector that has pushed some banks in other Latin American countries to consider microfinance as a new market.

The factors leading to the relatively small number of medium and large specialized MFIS (NGOs, SOFOLs and other forms) are difficult to pinpoint, but a note on the status of the largest MFI, Compartamos, may be instructive. Compartamos originated as an NGO and then transformed into a shareholder-owned, for-profit SOFOL. As a SOFOL, Compartamos, one of the most professionally operated microfinance institutions in Mexico, is not authorized to take savings, while the hundreds of cooperatively owned institutions are. The SOFOL license restricts product innovation in other areas as well. The regulatory options available to Compartamos are not attractive, short of becoming a bank. If Compartamos were to attempt to become a bank, it would have to contend with the high minimum capital requirements (\$18.9 million) as well as the reluctance of the banking authorities to issue new banking licenses.

Other factors may be more important than regulatory environment in explaining why there is a missing middle in Mexican microfinance. These factors may include the relative lack of international donor involvement in Mexico, since donors were crucial in other countries in financing the start-up of microfinance initiatives. Or knowledge about microfinance may simply have arrived late in Mexico. Whatever the explanation, the microfinance sector in Mexico would benefit from regulations that make it easier for specialized, shareholder-owned MFIs to emerge.

PART TWO: CREATING A SUPPORTIVE REGULATORY FRAMEWORK FOR MICROFINANCE

Drawing on the experience of the three countries analyzed here, we now discuss the main elements of a supportive regulatory and supervisory framework for microfinance and the steps governments should take to develop and implement such a framework. The discussion addresses three main topics: 1) prerequisites to developing a microfinance framework in terms of financial sector policy and the microfinance industry; 2) establishment of a framework and preparation of supervisors; and 3) specific norms for microfinance institutions. Comparisons between Bolivia, Colombia and Mexico illustrate many of the main points.

Prerequisites in the Financial Sector and Microfinance Environment

Building Political Will. The experiences of Bolivia, Colombia and Mexico suggest that governments address microfinance seriously only when there is high level political will. In all three countries, central banks and government agencies moved energetically only when top policymakers, including President Fox in Mexico and President Uribe in Colombia, made microfinance a priority. These leaders embraced microfinance out of genuine public policy concerns combined with the belief that microfinance would be a popular initiative. They perceive that microfinance addresses urgent problems in their countries, in terms of job creation, poverty alleviation and building a more just and equitable society.

This observation directs attention to the need to build political will by exposing political leaders to the positive aspects of microfinance. It is essential to obtain the support of legislators and of financial and supervisory authorities through national seminars that explain the characteristics, credit technologies and impact of microfinance, through visits to countries where microfinance is working successfully and through contacts with international leaders in microfinance. Furthermore,

international donors such as the World Bank and Inter-American Development Bank have used their policy dialogue to foster supportive policies for microfinance as part of financial sector liberalization. Of course, the most effective way to convince leaders of the importance of microfinance is for a vibrant microfinance industry to emerge in their own countries.

Perhaps surprisingly, the banking sector crises that have shaken each country have contributed to the development of political will to address microfinance. These crises made policymakers more skittish toward risk-taking in the financial sector, which could be expected to make them avoid microfinance altogether. Furthermore, banking authorities new to microfinance generally believe the sector to be inherently very risky. Nevertheless, financial crises provided an opportunity to microfinance, because in the wake of the crises, policymakers and legislators saw the need to open the financial sector framework for wholesale reforms, providing a space for microfinance to enter the reform agenda.

Once microfinance is on the reform agenda, three critical factors determine whether the resulting policy framework will be effective: a substantially liberalized financial sector; the emergence of strong microfinance providers; and a process of consultation and education guiding the development of microfinance policy.

Critical Mass of MFIs and a Consultative Process. It is often observed that a regulatory framework for microfinance follows from the emergence of a critical mass of financially viable MFIs that operate efficiently with low arrears and sound credit methodologies.¹² These are the kinds of institutions that merit the attention of the regulatory authorities, as only such institutions are suitable candidates for licensing as savings mobilizers. With a critical mass, the regulators can be sure that they are crafting a framework that will be used and will support the needs of real players.

Bolivia's reforms featured a critical mass of MFIs, as well as deep, practical and sustained dialogue between authorities and the microfinance industry. This was supplemented by high quality international advice and exposure to international experience. Similar kinds of dialogue seem now to be advancing in Colombia and to a lesser extent in Mexico. In countries where there is a critical mass, the MFIs

¹² Christen and Rosenberg, 2000.

often have created industry associations that serve as a forum for discussing the common problems of microfinance institutions, with very good results. These associations represent the industry in discussions with the government, the legislature and the supervisory authorities.

Frameworks developed without a critical mass of microfinance players or developed without a consultative process are likely to result in counterproductive policies. Such policies can hinder the sector's growth for years to come. One common phenomenon is for policies to define a narrow range of options for microfinance service providers, implicitly blocking the development of other kinds of institutions. Some countries favor cooperatives while others favor shareholder-owned institutions. Mexico's framework, for example, is strongly oriented toward small, cooperatively-owned organizations. Commercial, shareholder-owned institutions are disadvantaged from a regulatory perspective. In reality, most countries have both kinds of institutions, and policymakers should ensure that appropriate regulatory frameworks are developed for both. A strong preference for one type of organization over another may constitute a major missed opportunity. These observations suggest the importance of education on both the status of the local microfinance industry and about positive and negative international experiences for policymakers.

Financial Policy Prerequisites. Chief among the financial sector reforms that underpin a strong microfinance regulatory framework are the elimination of interest rate controls and a consensus that the public sector (including as a general rule, public sector banks) should not directly provide microfinance services at the retail level.

Public Banks. Latin America, like several other regions, has had a negative experience with financial intermediation institutions managed by the State, especially when those institutions become highly politicized. In many cases, such institutions have channeled loans to supporters of the ruling parties or to poorly conceived projects without an adequate analysis of economic feasibility. Consequently, they lost enormous sums that had to be absorbed by public treasuries, impairing the government's ability to cover urgent social needs such as health and education.

This problem was aggravated even further in the case of microcredit operations when those institutions featured subsidized interest rates that

distorted the market and weakened repayment culture. Clients perceived that these loans need not be paid because they originated from the State. The general trend throughout the past two decades has been to close these banks, which has relieved the burden on public funds. Nevertheless, it is not uncommon for policymakers newly committed to microfinance to come up with the idea of running new microfinance operations through public banks (thus simultaneously achieving two objectives – expanding microfinance and giving the public banks a revived mission).

Certainly it is recommended that the government avoid the creation of new financial intermediaries under the guardianship of State or local governments (banks for the poor). The costs of creating such new institutions are high, and the prospects for success are generally low. However, existing public sector banks that are well-managed can become effective microfinance service providers and can take advantage of prior investments in infrastructure, as the well-known example of Bank Rakyat Indonesia has demonstrated. Banco Agrario in Colombia may become another such positive example, joining institutions such as BAAC in Thailand and Banco do Nordeste in Brazil. Other writers have explored the conditions for successful microfinance delivery by public banks in detail.¹³ In this paper it is only relevant to mention that the abundance of failed attempts to reform public banks should cause policymakers to think twice before deciding to follow this route.

Interest Rate Ceilings. Experience shows that elimination of interest rate caps is essential for development of microfinance. It is therefore highly recommended that governments liberalize their interest rates in order to encourage sound microfinance institutions to cover their costs.

Elevated administrative costs are intrinsic to the microfinance industry: very small loans necessarily cost more per unit lent than traditional loans, mainly because informal sector clients require a labor intensive credit methodology. Thus, for MFIs to cover their costs, microfinance loans must carry higher interest rates than traditional commercial bank loans. Because microfinance institutions offer lower interest rates than those offered by informal moneylenders, even interest rates higher than commercial rates can be considered fair and beneficial to microentrepreneurs.

¹³ Robinson, 2001.

Restricting interest rates leads to inefficient, subsidized institutions, while freeing interest rates fosters the development of a market-based industry that will operate and attract competition over the long-term. Under interest rate controls, lenders use fees to cover their costs: commitment fees, disbursement fees, legal fees, etc. Such practices hinder the development of a transparent marketplace in which educated consumers choose the best providers. Such fees are unfair to borrowers who lack the skills to decipher convoluted pricing formulas, but they are often a survival necessity for institutions operating under interest rate ceilings. Another perverse effect of interest rate ceilings is an increase in average loan sizes, as institutions facing caps cannot lend very small amounts. The regulated MFIs in countries with strong interest rate restrictions may serve only the upper tier of the microenterprise market.

Neither Bolivia nor Mexico cap interest rates. Bolivia removed ceilings in 1985 as part of its New Economic Policy reform. This measure was critical to the development of the microfinance industry. Colombia's interest rate policy poses a significant challenge to MFIs operating as regulated entities. With interest rates capped at approximately 26 percent, regulated institutions participating in microfinance have had trouble covering their costs. To compensate for the unrealistically low interest rate, Colombian authorities have recently issued two provisions that offer some relief for microfinance institutions trying to operate sustainably. First, Colombia's MIPYME law allows MFIs to charge a 7.5 percent commission on each loan less than \$3,300, slightly alleviating the pressure for MFIs. The second provision allows the Superintendency to certify current bank interest rates according to different credit technologies. However, this provision has not yet been activated. Its legal status vis a vis Colombia's Usury Laws must first be resolved.

Fostering an Effective Microfinance Industry¹⁴

With these prerequisites in place, banking authorities can begin designing the regulatory framework and developing their own capacity to supervise the sector. As they sit down to design microfinance policies and regulations, authorities must think seriously about what kind of industry they wish to foster. The desired characteristics of the microfinance market include:

¹⁴ For more discussion of prudential and non-prudential norms, see Christen, Lyman and Rosenberg, 2003.

- Safety and soundness for the system and especially depositors
- Competition, to create efficiency and service quality
- Growth of coverage – reaching more people
- Expansion and innovation in product offerings, especially savings services
- Independence of the industry from public subsidies
- Fair treatment of borrowers

Of course, as the core of their role as regulators, safety and soundness will be the overriding concern.

The chief question that regulators face at this stage concerns who should be regulated. In order to foster growth and manage risk, without dictating, the following choices are relevant:

- Treatment of microfinance as a line of business rather than an institutional type, with the expectation that a variety of institutions will provide microfinance services. In Bolivia and Colombia, banking authorities define microenterprise credit and consumer credit separately. Colombian reporting requirements ask all types of regulated institutions to report on microenterprise loans.
- Allowance for organizations not involved in deposit mobilization and very small community-based organizations to operate without direct regulation and supervision by the banking authority. All three of the countries studied have taken this approach.
- Creation of policing mechanisms for small and medium-sized cooperatives that do not absorb too many supervisory resources. Mexican policymakers have been focused on this challenge. It remains to be seen whether the system of federations they have mandated will be workable.
- When developing special institutional categories, such as Bolivia's FFPs, Colombia's CFCs or Mexico's EACPs, realism about viable scale and the appropriate number of entrants for the market; openness to a variety of lines of business; capacity to supervise.
- Responsiveness to the emerging needs of the microfinance field – at the client level for expansion of savings services and at the institutional level for greater access to commercial funding sources.

Enhancing Supervisory Capacity. The challenge of creating capacity to supervise microfinance should not be taken lightly. In some cases,

supervisory agencies have been reluctant to engage with microfinance. Supervisors may have little interest in adapting regulations and methods of supervision to microfinance, mainly because they are absorbed with implementing the recommendations of Basel I and now Basel II. Observing that microfinance does not pose a systemic risk to the financial system because it generally represents less than one percent of total assets in the financial system, they feel justified in setting it aside.

Additionally, in many countries the supervisory agencies have not been sufficiently strengthened during the process of financial sector liberalization, even though the liberalized approach relies heavily on the existence of vigorous prudential supervision by qualified supervisors. After all, the most important role of the authorities is to maintain the solvency of the mainstream financial sector, while creating a category for deposit-taking MFIs is secondary. Supervisory agencies often lack sufficient functional autonomy, budgetary resources and administrative procedures that would allow them to recruit, train and maintain a specialized team devoted to microfinance.

Only supervisory agencies with appropriate technical capacity may adequately regulate and control a microfinance industry with characteristics that are dramatically different from those of traditional banking. In a survey of Latin American regulated MFIs about their experiences with supervision, the overwhelming message was the need for supervisors to be trained to understand microfinance.¹⁵ The supervisory agencies of the countries that are at the forefront of the microfinance industry have created specialized departments staffed with people who are highly trained in small-scale operations. In Bolivia, supervisors for microfinance occupy a microfinance-specific department within the Superintendency of Banks, trained specifically in the nuances of microfinance.

Supervisors should approach the regulatory and supervisory systems for microfinance with fresh minds, rather than assuming that they can simply adapt a few of the traditional banking sector's regulations. Microcredit portfolios require different supervisory methods than portfolios of conventional loans, and microfinance institutions should be held to performance benchmarks appropriate to their line of business. Some of the highlights of the special requirements for microfinance norms are discussed in the next section. These differences mean that the tools that

¹⁵ Theodore and Trigo, 2002.

are efficient for controlling the banking system are not adequate for this new financial industry. Through an extended process of getting to know microfinance, supervisory agencies can develop a more tailored set of tools.

Furthermore, newly regulated MFIs need time to mature just as supervisory agencies need time to gain experience with them. It may be realistic for operating licenses to be granted for the performance of a small range of operations and for supervisors to work with institutions on a case by case basis over time to increase the range of operations as competence is demonstrated. For example, in all three countries, specialized MFIs (FFPs, CFCs and SOFOLs) were initially only permitted to make loans. In Bolivia, the way was open from the start for these institutions to mobilize savings through a process of application for amendment of license and demonstration of competence. In Colombia, CFCs were originally limited to offering fixed term deposits, but the way is now being opened, upon individual petition, for these institutions to offer savings accounts. Mexico has moved forward in this direction by creating EACPs. To the extent that MFIs grow stronger, the supervisory authority may allow more complex operations such as the capture of deposits into current accounts and expansion of the range of financial services provided, such as money transfers and collections, eventually contemplating the movement of an institution to a higher tier of institutional license.

Governance and Internal Control. A central issue confronting regulatory authorities wishing to create a framework for microfinance is to decide which of the basic institutional structures to support. Should NGOs be allowed to take savings? How should cooperatives be supervised? Should a new category of microfinance company be created? This paper does not delve into these questions in detail, but offers a few comments based on experience from the three countries.

Each of the three main types of legal organization – shareholder-owned limited liability companies, cooperatives and NGOs – can contribute to microfinance. As noted above, some countries have featured more microfinance development in one or the other of these frameworks, in part because of implicit or explicit regulatory preferences (Colombia with NGOs, Mexico with cooperatives and Bolivia with shareholder-owned companies). Only a few countries provide strong frameworks for all forms, as is desirable.

Governance structures of different types of MFIs present very different challenges. All the major governance forms can be effective if carried out properly and all forms are prone to characteristic weaknesses. Nevertheless, the governance features of private, shareholder-owned companies offer stronger frameworks for financial prudence than NGO or cooperative structures because shareholders and their representatives on MFI boards have placed their own funds at risk.

For NGOs, whose governing structure makes them inappropriate for deposit-taking, and where prudential supervision is accordingly unnecessary, regulatory authorities would do well to ensure that the legal framework supports strong governance. To prevent, or at least minimize, problems of governance in NGOs, authorities are advised to determine whether regulations, laws and statutes need revision to strengthen the applicable mechanisms of internal control. In particular, it is fundamental to develop and apply auditing and governance rules that establish liability for noncompliance, omissions, negligence or irregular actions on the part of the board and management of the organizations.

In some instances, connected lending, diversion of funds, nepotism and conflicts of interest have shaken MFIs, including NGOs. It goes without saying that these problems must be addressed in the regulations governing regulated MFIs, but they pose risks for NGOs as well. Without instituting prudential regulation, authorities can introduce codes of ethics and possibly specific penalties for cases of abuse and fraud. Norms and procedures governing ethics, audit practices and internal controls should also be introduced in the statutes of the institutions themselves.

Cooperatives represent a particular challenge because they typically constitute a large number of small institutions engaged in an activity normally reserved for regulated institutions – deposit-taking. And yet, only the largest cooperatives can realistically be supervised by banking authorities. Bolivia has developed a system of qualifying characteristics that brings the largest, most professionally run cooperatives into the family of regulated institutions. The smaller credit unions are not subject to prudential regulation and have more circumscribed deposit-taking limits (i.e. members only).

In Mexico, cooperatives and related institutions, which the government views as the main providers of microfinance services, have historically

had serious difficulties of governance and weaknesses in their internal control systems. The new initiatives of the Mexican government are intended to improve oversight, in part through the creation of self-governing federations, discussed above. In addition to concerns regarding the use of federations, there are issues at the level of the individual cooperatives that require attention to overcome the inherent fragility of cooperative governance. For example, Mexico's law indicates that the total sum of loans to people related or linked to the institution's governance shall not exceed 50 percent of its equity. The fact that among cooperatives, board members are generally also clients of institutions – and therefore may legitimately be borrowers – suggests that some related lending may be acceptable, but risk management and sound governance practice would argue for a much lower level than the 50 percent currently allowed. Many countries (and the Basel committee) ban or tightly limit loans to related parties at least for shareholder-owned institutions, because such loans are a leading cause of bank failures.

When issuing new operating licenses to any regulated institution, supervisory agencies must be able to conduct thorough processes to examine the governance structure and ensure that the directors and executives are qualified professionals with knowledge of the business of financial intermediation. Likewise, a detailed analysis of economic, financial and technical feasibility of the institution must be performed. Otherwise, there is the risk of licensing weak institutions that could quickly become insolvent, affecting the credibility of microfinance in the eyes of clients, the public and investors.

Setting Minimum Capital Requirements. When regulatory authorities decide to create new institutional categories to accommodate microfinance, they must set the bar for entry to the new category through minimum capital requirements (see Table 5). The choice of minimum capital is a balancing act: supervisors must ensure that institutions can be financially viable players in the marketplace (matching the number of qualified entrants with the number of institutions that can be supervised), while providing access to MFIs to fulfill the public purpose of expanding microfinance services.

There is a temptation to set very low minimum capital, almost always due to pressure from legislative interest groups, possibly including the smaller players in the microfinance field itself. This practice is clearly counterproductive, given that the determination of minimum capital must

be based on scale economics. That is, financial intermediation institutions must be of sufficient size to allow them support an adequate infrastructure and still be profitable. Furthermore, when the capital requirement is lower, the supervisory agency will have to supervise many institutions, whereas with greater capital, the number of institutions to be supervised will be lower and the supervision will certainly be more effective.

Table 5: Minimum Capital Requirements

Country	Institution type	Minimum capital requirement (US\$)
Bolivia	FFP	\$1 million
	Bank	\$8.2 million
Colombia	CFC	\$4.4 million
	Bank	\$17.1 million
Mexico	EACP	Level I: \$32,000 Level II: \$81,250 Level III: \$1.6 million Level IV: \$8.1 million
	SOFOL Bank	\$2.8 million \$18.9 million

The Mexican authorities have a particularly difficult challenge in this regard. Because of Mexico's large size, the range of scale of institutions in the financial sector is very wide, and the number of institutions is high. On the one hand, appropriate minimum capital requirements for bank licensing are very high (roughly \$19 million as compared with Bolivia's \$8.2 million requirement). On the other hand, Mexico features over 600 small community-based savings and credit organizations. Spanning this distance with a range of institutional types is quite a challenge. The current Mexican policy focus for microfinance is at the small end, leaving a gap in attention to large microfinance institutions such as Compartamos, with a current capitalization of \$31 million. Institutions of this scale (i.e. large microfinance institutions that are nevertheless smaller than mainstream banks) are major providers of microfinance services in many other Latin American countries, but Mexican regulation has not yet fully addressed their needs.

Credit Bureaus. Credit bureaus play a crucial role in the healthy development of financial systems because they improve financial

entities' knowledge about the borrowing habits of their debtors. Governments and supporters of microfinance should dedicate resources to developing, facilitating or upgrading credit bureaus and ensuring that they include microfinance borrowers.

A borrower may become over-indebted if he or she can get several loans simultaneously from different entities without their knowledge. With a credit bureau, a lender can detect the level of a borrower's indebtedness within the entire financial system and evaluate repayment capacity and credit risk, both before making a loan and during the loan repayment period. Credit bureaus are also a powerful tool for superintendencies to monitor financial institutions under their supervision. When preparing for field inspections, supervisors can consult the credit bureau to select which clients would be most appropriate to visit. Credit bureaus also promote market discipline: each borrower knows that in the event of non-fulfillment, his or her reputation before other potential creditors is at stake. This has a positive effect on repayment culture and minimizes moral hazard.

The Bolivian credit bureau was still under development at the time of the crisis of consumer lending in 2000, and was therefore not able to prevent rising over-indebtedness. At the time the crisis emerged, the credit bureau of the Superintendency did not collect sufficient information on small borrowers and excluded borrowers from the NGO sector (NGOs used a self-administered credit bureau). This deficiency has since been corrected. In addition, the Superintendency has recently put forth a norm that allows the establishment of private credit bureaus.

In Colombia, the credit bureau operated by Colombia's Bank Superintendency omits information on small loans provided by non-regulated entities (i.e. NGOs). It also lacks information on debts with suppliers and utility companies. Nevertheless, private credit bureaus in Colombia make up for these deficiencies. Using advanced information systems and an ample database, they cover clients of all regulated and unregulated financial organizations. They also have information on supplier credit and may in the future collect information on public services. In Mexico, private credit bureaus operate but only serve the formal sector. These credit bureaus do not include the clients of NGOs or savings and credit associations.

Norms for Microfinance Institutions

This section discusses some of the specific norms and benchmarks that are applicable to the oversight of microfinance institutions and their operations, again in the context of the three country comparisons. It argues that in the specific areas mentioned below, it is essential to tailor norms to the unique characteristics of microfinance.

Definition of Microcredit. How bank regulators define microcredit will have a direct impact on the practices of all providers of microfinance services, whether specialized or mainstream financial institutions. Most policymakers instinctively define microcredit in terms of limits on size, but we suggest that it is more important to define microcredit as a line of business with certain risk characteristics. In any case, it is not feasible to define microcredit based on borrower socio-economic indicators of scale such as assets, sales, revenues or number of employees. These variables do not necessarily reflect risk levels, are difficult to measure, and create an arbitrary cutoff for microfinance that is difficult to monitor.

Best practice suggests that regulations define borrowers based upon the purpose of the loan together with the source of repayment capacity. Bolivian regulation, for example, defines microcredit as “a loan to a borrower – either an individual, a business or a group of individuals – for the purpose of financing small-scale production, trade or provision of services and where the assessment of repayment capacity of the borrower is based on the revenues generated by these activities.” This definition is based on the actual credit methodology microenterprise lenders use, and it particularly addresses the primary means of risk mitigation inherent in the methodology. This definition evolved out of interaction between microfinance institutions and the Superintendency over a period of years, and reflects the investment the Superintendency has made in understanding microfinance credit methodology.

Mexico’s regulation does not specifically define microcredit.¹⁶ All loans are considered commercial loans. This lack of definition will lead to ambiguity in the interpretation of the new LACP. It is suggested that regulators clearly define microcredit operations as distinct from

¹⁶ Law on Popular Savings and Credit (LACP).

consumer loans, housing loans and commercial loans because the nature of risk of each type of loan is unique.

Colombia's law defines microenterprises as "an economic unit with no more than 10 workers and total assets not exceeding 501 times the minimum monthly wage provided for by law."¹⁷ It goes on to define microfinance as a system "designed to encourage microcredit activities, their purpose is to finance microenterprises. The maximum amount per borrower shall be 25 times the minimum monthly wage provided for by law." The Colombia definition is a good start, but incomplete because it ignores the situation of the borrower. A salaried employee and a microenterprise owner have two very different profiles in terms of capacity to repay, credit uses and risk profile.

The importance of distinguishing between different loan types was highlighted during the Bolivian crisis of 2000. Before 2000, Bolivian law did not distinguish between MFIs and consumer lenders. When consumer lenders entered the market in the late 1990s, their business model allowed them to grant loans without accounting for a customer's total debt. As a result, microfinance clients began taking out consumer loans on top of existing microenterprise loans, resulting in more debt than they could handle. It was this over-indebtedness that led to the collapse of consumer lending. Since then, the Bolivian Superintendency passed a new norm that defines consumer loans differently than microenterprise loans. This norm mandates that in consumer lending (i.e. loans based on salaries from formal employment) borrowers' monthly debt service cannot equal more than 30 percent of the net salary of their household.

Loan Concentration Limits. As a basic principal of risk management, financial entities should ensure that assets are not concentrated in a few loans which, if non-performing, could threaten the institution's solvency. For this reason, loan concentration limits hold a central place in bank regulations. In microfinance, loan concentration limits are not likely to constrain normal operations, due to the small size of microloans. Nevertheless, loan concentration limits are needed to prevent MFIs from making larger loans beyond their core competence. In fact, because of this, regulators should consider limiting loan concentration of MFIs to a level below that of traditional banks.

¹⁷ Law 590.

In each country, loan concentration limits are based upon the capitalization of the institutions, and therefore the maximum loan allowed increases as the institution grows. For an individual borrower from an FFP in Bolivia, loans are limited to no more than three percent (with guarantees) or one percent (without guarantees) of the MFI's equity. For an institution operating at the threshold level of capital for an FFP, the maximum unguaranteed loan would be \$10,000 and the maximum secured loan would be \$30,000. In fact, the levels of capital of most of the FFPs exceed the minimum several times, with the largest, Caja Los Andes, at approximately \$12 million in capital. Based on this level of capital, Caja Los Andes would be permitted to make unsecured loans up to \$120,000 and secured loans up to \$360,000. Note that these are clearly not microenterprise loan sizes, but the purpose of the regulation is to limit risk, not to constrain institutions to certain types of lending.

The Mexican legislation recently mandated a limit on the concentration of credit as a percentage of an institution's capitalization, which allows very small institutions to have higher ratios (seven percent and five percent for EACP Levels I and II), though smaller maximum loans, while the largest institutions face a three percent limit.

Colombia's loan concentration limit is much looser: thirty percent of equity, regardless of the type of institution (commercial bank or CFC). Therefore, for example, the maximum loan for FINAMERICA, a CFC with total capital of \$4.6, would be \$1.4 million. Nevertheless, as noted above, Colombian law defines microcredit loans as under twenty-five minimum wages (currently \$3,300). This limit applies to the type of loan, not to the type of institution, and so institutions wishing to lend above the microcredit level define the larger loans as small business lending, but are not prevented from making such loans.

Credit Technology and Loan Documentation. Microfinance clients lack formal financial information, such as an accounting system, financial statements or cash flow analysis. Moreover, they lack or have difficulty obtaining legal documents verifying their business activity, land tenure, value of assets and even identity.

Financial institutions offering microcredit compile information about the commercial activities and the client household. The analysis includes the family because, in reality, microenterprise and household finances are

not separated. For that reason, it is important to rely on appropriate credit technologies that depend on limited formal documentation. For microfinance, the decision to provide a loan is made through interviews, site visits, personal references and from the limited documentation the potential client might have regarding his or her business and family.

To effectively oversee MFI operations, supervisors must understand these microfinance credit technologies. They must be able to determine if an MFI has a sound credit technology, and whether that technology is being appropriately applied. Furthermore, supervisors must be prepared to set aside their impulse to ask for more documentation and instead work with an MFI to assure that the type of documentation required by the MFI achieves an appropriate balance between risk mitigation and accessibility to the poor.

The documentation required by the supervisory agencies must be adapted to the characteristics of microcredit operations and must consist of verification of the type of business of the client and of his household, accompanied by the financial information generated by the financial institution's credit manager. The information should be in accordance with what is established in their own credit technology, including verification of the client's liabilities by consulting the credit bureau. Given the informality of the businesses managed by microfinance clients, the supervisory agencies should not require, for example, the payment record of their tax obligations.

Provisioning. Provisioning is one of the most important risk management tools of MFIs that Superintendencies can control. Provisioning requirements for commercial, housing and other loans are not necessarily appropriate for microloans, due to the short terms and unique risks of microloans. Table 6 summarizes the provisioning requirements in each of the three countries and compares them to the CGAP's international standard for best practice in microfinance.

**Table 6: Microfinance Provisioning Requirements
(as percent of portfolio in each category)**

Length of Arrears	Recommended by CGAP	Bolivia	Colombia	Mexico (EACPs) (Levels I and II)
None	0%	1%	0%	1%
1-7 days	10%	1%	0%	4%
7-30 days	10%	5%	0%	50%
31-60 days	25%	20%	1%	50%
61-90 days	25%	50%	20%	50%
91-120 days	50%	100%	50%	90%
121-180 days	50%		100%	90%
Over 181 days	100%			100%

Both Bolivia and Mexico have schedules adapted to microfinance. They begin elevating provisions within one to two months of arrears. Colombia's regulation, which only begins to increase provision after two months, does not fully take into account the risk profile of microlending.

Reporting and Information Systems. The portfolio of MFIs, as opposed to traditional banking portfolios, is characterized by the distribution of risk among thousands of operations. The enormous dispersion of the portfolio makes individual credit analysis impossible. Risk monitoring depends on high quality information systems operating in MFIs. Monitoring of systems is increasingly recognized as a general responsibility of bank supervisors. In the case of microfinance, this responsibility is so central that its importance must be highlighted. Supervisory agencies must have computer engineers that support the supervisory tasks by means of comprehensive system audits that ensure that the information systems of MFIs are operating properly and generating the information needed to control risk.

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