



Microfinance Regulation in Developing Countries:
A Comparative Review of Current Practice

by

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TABLE OF CONTENTS

<i>LIST OF TABLES</i> _____	<i>iii</i>
<i>LIST OF ABBREVIATIONS</i> _____	<i>iv</i>
<i>LIST OF ABBREVIATIONS</i> _____	<i>iv</i>
1. Introduction _____	1
2. Regulation and Supervision of Microfinance: Issues and Approaches _____	2
Rationale for Tailored Microfinance Regulation/Supervision _____	2
General Approach to Regulation _____	4
<i>Tiering</i> _____	4
<i>Definition of Microfinance</i> _____	7
<i>Who is Regulated and Who Regulates?</i> _____	8
Prudential Regulation and Supervision _____	10
<i>Prudential Ratios</i> _____	11
<i>Supervision and Reporting Systems</i> _____	13
Regulation of Entry, Operation, Graduation _____	14
<i>Entry and Graduation Requirements</i> _____	14
<i>Operating Regulations</i> _____	16
3. Approaches to Microfinance Regulation and Supervision:	
<i>Summary Case Studies</i> _____	18
Directly Regulated and Supervised Institutions _____	18
<i>Bolivia: Private Financial Funds</i> _____	18
<i>Ethiopia: MFIs</i> _____	19
<i>Ghana: NBFIs</i> _____	20
<i>Peru: EDPYMEs</i> _____	21
<i>The Philippines: Rural banks</i> _____	21
<i>Uganda: MDIs</i> _____	22
Institutions That Are Not Directly Supervised _____	29
<i>Bangladesh: PKSF Network</i> _____	29
<i>Indonesia: Variety of MFIs</i> _____	30
<i>Peru: CMACs</i> _____	31
<i>Philippines: NGO-MFIs</i> _____	32

<i>South Africa: Microlenders</i>	32
<i>UEMOA: Mutual MFIs</i>	33
4. Analysis and Conclusions	41
Tiering	41
Who Regulates and How	42
Market Definition and Entry	44
Tailoring Norms and Systems	46
<i>Annex: Case Studies</i>	47
Bangladesh: PKSF Network	47
Bolivia: Private Financial Funds	49
Ethiopia: MFIs	51
Ghana: NBFIs	53
Indonesia: Variety of MFIs	55
Peru	58
1. <i>EDPYMEs</i>	59
2. <i>CMACs</i>	60
The Philippines	61
1. <i>Rural Banks</i>	62
2. <i>NGO-MFIs</i>	63
South Africa: Microlenders	64
UEMOA: Mutual MFIs	66
Uganda: MDIs	68
<i>Bibliography</i>	70

LIST OF TABLES

<i>Table 1: Tiering Structure</i>	<i>6</i>
<i>Table 2: Sample Provisioning Schedules.....</i>	<i>13</i>
<i>Table 3: Directly Regulated and Supervised Microfinance Institutions.....</i>	<i>23</i>
<i>Table 4: Microfinance Institutions That Are Not Directly Supervised</i>	<i>35</i>
<i>Table 5: Cross-Country Comparison of Economic Indicators and Microfinance Sectors</i>	<i>45</i>

LIST OF ABBREVIATIONS

APPEND	Association of Philippines Partners in Enterprise Development
APR	Annual Percentage Rate
BKD	<i>Badan Kredit Desa</i>
BOU	Bank of Uganda
BOZ	Bank of Zambia
BPR	<i>Bank Perkreditan Rakyat</i>
BRI	<i>Bank Rakyat Indonesia</i>
CDA	Cooperatives Development Authority
CMAC	<i>Caja Municipal de Ahorro y Credito</i>
COFIDE	<i>Corporacion Financiera de Desarrollo</i>
EDPYME	<i>Entidad de Desarrollo para la Peuuena y Microempresa</i>
FEPCMAC	Federation of CMACs
LDKP	<i>Lembaga Dana Kredit Pedesaan</i>
MDI	Microfinance Deposit-taking Institutions
MFI	Microfinance Institution
MFRC	Microfinance Regulatory Council
NBE	National Bank of Ethiopia
NBFI	Non-Bank Financial Institution
NGO	Non Governmental Organization
PARMEC	<i>Projet d'Appui a la Reglementation Sur Les Mutuelles d'Epargne et de Credit</i>
PCFC	People's Credit and Finance Corporation
PFF	Private Financial Fund
PDIC	Philippines Deposit Insurance Corporation
PKSF	Palli Karma Sahayak Foundation
ROSCA	Rotating Savings & Credit Association
UEMOA	<i>Union Economique et Monetaire Ouest Africain</i>

Note : All currency figures are in U.S. dollars.

1. Introduction

In one way or another, almost every country in the world has seen the need to adapt its structure of financial services to improve outreach to the many as yet “unbanked” people and enterprises. This was the genesis of thrift institutions, local savings associations, and cooperatives across the world over the past century and more. The same need motivated the rise of formal microfinance institutions in developing countries since the Grameen Bank came into being in the 1970s. Microfinance across the world began variously as the activity of informal savings and credit groups, moneylenders, donors, and NGOs. In many if not most developing countries, microfinance activity has grown to the point where financial regulators see the need to frame a policy, and eventually to integrate some portion of the microfinance spectrum into the framework of regulated financial services institutions. This paper aims to provide the necessary comparative data and analysis to support sound regulatory policy in this field.

To ensure a fully informed policymaking process, it is important to examine the lessons of experience from the countries that have begun to address the legal and regulatory framework for microfinance. One can learn from good practice as well as from misguided practice. This paper examines twelve examples of microfinance institutional forms that are in some way recognized, registered, regulated, and supervised – whether directly by the government or indirectly by private (or state-owned but non-regulatory) institutions. The presentation of cases here is not intended to be comprehensive. Rather, we take a selective approach, focusing on those examples that illustrate important principles, and for which sufficient information is available. In each case, the context of previous financial sector development, estimated demand for small credit and savings services, and a range of other factors suggest some distinctive approach toward safeguarding the sound growth of the microfinance market. By reviewing the mechanisms put in place in other countries, policymakers can see what other nations have tried, the context in which these efforts have taken place, and the potential for using aspects of these models in their own contexts. The reader should bear in mind that the examples presented here encompass the range of current practice, but do not purport to illustrate *best practice*.

We proceed as follows. The section that follows presents the core problems of recognition, regulation, and supervision presented by microfinance activities. Some guiding principles are also discussed. Part three presents several abbreviated case studies. (More detailed presentations of these cases appear in the Annex.) These include, first, examples of institutions that are directly regulated and supervised by the financial authorities, and second, types of institutions that are supervised and in some cases regulated by other, including non-governmental, entities. In the case presentations, we stress the important distinction between prudential and non-prudential oversight. Part three includes a series of tables in matrix format that present the solutions adopted in each country on the full range of regulatory issues. Part four brings all of this together into a synthesis and distills some concluding lessons and recommendations for policymaking in this field.

2. Regulation and Supervision of Microfinance: Issues and Approaches

In determining the regulatory and supervision structure to be applied to microfinance markets, policymakers need to address a range of questions. First and foremost, it is important to be clear about the rationale for regulating microfinance institutions (MFIs). With this in mind, the policymaker can develop a general approach to the regulatory framework. This involves defining the market in terms of how MFIs fit into a tiered financial services structure, how microfinance is in fact defined for this purpose, and determining which kinds of institutions are regulated and by whom. The general structure must be translated into specific prudential norms, supervision and reporting systems, and rules governing entry and operations of MFIs. One last important set of issues arises from the implementation of these norms and systems. Are they designed in ways that make them easy to administer, and have the necessary resources and capacities been made available to ensure their proper implementation? This chapter provides a general overview of these issues. The two chapters that follow discuss these matters with specific reference to twelve exemplary cases of microfinance regulatory structures around the world.

Some important matters must be left aside in this discussion. Microfinance operations are subject to a range of other laws and regulations that deal with matters such as taxation, contract, collateral security, consumer protection, bankruptcy, and incorporation. These have a critically important impact on MFIs, but are not the main concern of central bankers and financial regulators in constructing the framework for microfinance regulation and supervision. They are therefore not discussed in this paper. An analysis of these issues – specifically with respect to microfinance in one country, Zambia – is presented in Meagher and Mwiinga (1999).

Rationale for Tailored Microfinance Regulation/Supervision

The regulation of financial institutions is generally explained as a response to the need for systems to maximize the mobilization and intermediation of funds, enhance efficiency in the allocation of capital, ensure appropriate risk management, and protect depositors. Existing regimes of financial services regulation are generally aimed at ensuring soundness in the practices of the major institutions, namely commercial banks. Thrift institutions and non-bank financial institutions (NBFIs) usually form a second tier defined by a separate set of norms, and sometimes by a different supervision structure as well.

When it comes to regulating MFIs, one needs to keep in mind the differences between these institutions as a group, on the one hand, and existing regulated institutions on the other hand. The essential premises for establishing a tailored legal/regulatory framework for microfinance are the following. First, in order to reach significant scale and to provide adequate service to clients, microfinance institutions need to go beyond government and/or donor support to attract private capital and to mobilize savings. For MFIs to achieve this goal, they need an appropriate, facilitative legal and regulatory environment. Second, standard banking regulation and supervision tend to impose

ineffective and overly burdensome requirements on MFIs if applied without modification. It is equally important to allow for innovation at the lower levels, especially among small informal institutions, by exempting them, in whole or in part, from full registration and regulation.

The special features of microfinance that need to be accommodated within the regulatory structure include:

- its attempt to deepen financial markets to serve microenterprises and poor households;
- its high unit costs of lending;
- its approach of physically taking banking services to clients who have few other options to receive financial services;
- the relatively undiversified and sometimes volatile nature of MFI credit portfolios;
- the fact that most MFIs began as unregulated credit NGOs, with a focus on social goals rather than financial accountability and sustainability;
- the difference in institutional orientation, with some MFIs clearly profit-oriented while others are committed to providing services to the poorer segments of the population on a non-profit basis, creating very different cost structures and funds sources;
- the fact that MFIs deal in savings and credit transactions with relatively low value in relation to the system as a whole -- and as a result are unlikely to have problems that cause broad systemic instability (Jansson 1997); and
- the market risk posed within the microfinance sector itself when MFIs (especially large ones) are not properly managed and monitored.

At the same time, any regime that is adopted must cope with the special problems of regulating and supervising MFIs. These include: the absence for most MFIs of owners' capital to draw on to meet capital calls, the fact that MFI lending modalities make audits and corrective steps such as lending moratoria difficult at best, and the potentially high costs of MFI supervision. (Christen and Rosenberg 1999)

Avoiding over-regulation is at least as important as putting well-tailored rules and systems in place. Seasoned observers warn that the regulation of microfinance often creates problems, due to a mismatch between regulatory and lending technologies as well as attempts to use the regulatory framework for objectives other than the core rationale of avoiding excessive risk. (Gonzalez-Vega 1998) Therefore, microfinance regulation should be "light-touch," focusing on market safety and soundness principles applicable to the financial markets as a whole.

Regulators have in fact become involved in the microfinance market for a host of reasons beyond protection against excessive risk – and the likely result, harm to ordinary depositors. In some cases, donor agencies have encouraged regulation in order to help them select microfinance institutions (MFIs) for funding. In others, microfinance industry associations have encouraged regulation in order to strengthen the reputation of

the industry and discourage fraud or poor practice by entrants. In still other instances, microfinance legislation has been required to enable microfinance institutions to begin operations and grow. Some suggest that this new focus on microfinance regulation has led, inappropriately, to the regulation of non-depository institutions which do not represent the kind of risk to the payment system or to depositors that regulators are mainly concerned about. (Vogel et al 1999) However, one might also argue that the result of sound regulation has been to deepen the microfinance market, enhance the institutional vehicles for provision of microfinance services, and create competition and new services, as it has in Bolivia (Rhyne, 2001).

For regulation to be fully justified, it needs to pass a battery of tests. For example, one could pose a series of questions about a proposed scheme of regulation, such as:

- What is the existing market circumstance? What are the related issues or problems? Whom does it affect?
- What would happen if no action were taken? What is the risk and how great is it?
- To what extent is it possible to solve the issue or problem through regulation – can government realistically do anything about it?
- Are there mechanisms other than regulation, which would achieve the intended objectives more cost-effectively?
- What are the likely direct and indirect costs of compliance with each alternative?
- Are the proposed enforcement mechanisms practical, realistic, and cost-effective?¹

The answers to these questions have implications for the decision whether to regulate, as well as the scope and design of any regulatory regime.

General Approach to Regulation

Once policymakers reach the conclusion that regulation is necessary to deal with the concerns at play, a general regulatory structure and approach will be needed. This essentially defines the field of regulation, in this case the segments of the market to be regulated, and identifies the regulatory agencies. In defining this structure, the policymaker will need to ensure consistency with the types of rules to be established, and the tools to be used for supervision and enforcement.

Tiering

Most countries' approaches to microfinance regulation fall into one of four broad categories: mandatory control under banking law, paternalistic support according to a charitable model, a tiered structure incorporating banks as well as MFIs, and neglect. If one takes seriously the objective of MFIs financing themselves from savings and investment, and achieving fully financially sustainable operations, then some form of integration between microfinance and the formal financial services sector is needed. One

¹ Adapted from *The Better Regulation Guide* (Government of Kenya 1999), quoted in Cracknell (2000).

approach would involve encouraging highly-capitalized formal banks and institutions to integrate downward into the microfinance market. This would work best in very liquid markets with relatively stable and well-established financial sectors, and middle to high per capita income. For example, there is good evidence that this has occurred in the U.S. and Western Europe. An alternative approach that recognizes informal start-ups and provides for phased growth, consolidation, formalization, and regulation of MFIs is more likely to be successful in the poorer markets of Asia and Africa. The challenge here is to balance the necessary goals of stimulating innovation, deepening, and financial market integration, while providing reasonable assurance of stability to depositors and investors.

In practice, a tiered financial structure can accommodate both top-down and bottom-up integration. Financial sectors feature a tier of commercial banks with high minimum capital and relatively strict prudential supervision. They may also have a second tier of deposit-taking² institutions such as thrifts, building societies, or savings associations, and perhaps also non-depository NBFIs such as finance and insurance companies. Any depository institutions in this tier would also be subject to prudential supervision, but because they frequently are greater in number and smaller in size than banks, these institutions are sometimes supervised by an agency or agencies other than the main banking supervision department. In poor countries, since these two tiers of licensed institutions tend to serve only a small minority of the population, other activities have filled some of the gap – credit unions, money lenders, ROSCAs, etc. The idea of setting up a licensed structure for one or more tiers of MFIs is a response to the need for stability and further development in the microfinance sector, which is usually by far the largest sector in terms of clients served. Just as thrifts are (usually) smaller institutions with more limited operations authority than commercial banks, licensed MFIs could exercise restricted powers under a regime of tailored regulation with limited or delegated supervision.

The idea of a tiered structure running from commercial banks down to non-profit NGO-MFIs is most fully presented in Van Greuning et al (1999). In that study, the tiers are defined according to the institutions' source of funds: the public's money (deposits), members' money (in the case of cooperatives), and "other people's money" (donor funds). It is thus the activities on the *liability* side of the balance sheet that trigger the need for registration, regulation, and/or supervision of the institution. Differences in funding sources and the corresponding risks that must be managed create a need for internal controls, and when the institution's activities in fund mobilization pass a certain defined threshold, the institution should then be subject to mandatory external regulation and supervision. Each threshold or tier matches more stringent regulation and supervision with a wider field of activity and risk. Graduation to higher tiers would require MFIs to strengthen their operations, reach significant scope, and achieve financial self-sufficiency. Graduation brings an expansion of authority, such as the ability to accept deposits of a certain type or size, permission to handle financial transfers, authorization (after registration with the securities agency) to emit shares to be publicly traded, or permission to obtain wholesale finance from commercial banks and other sources. The basic structure of this tiering concept is summarized in Table 1.

² In this case, taking deposits other than demand deposits.

Some experts take a skeptical view of the utility of setting up a separate “regulatory window” for microfinance. They suggest that the goal of microfinance *promotion*, which often motivates the opening of these windows, is not compatible with the regulatory goal of a sound financial system. Also, the real problem, in this view, is a shortage of licensable MFIs – i.e. techniques, capacities, organizations, and capital have not developed sufficiently. Alternatives to the “window” approach include reliance on delegated supervision or rating agencies, regulating by exemption (i.e. providing ad hoc exceptions to institutions that do not meet licensing requirements), and facilitating alliances with already-licensed institutions – for example, requiring MFIs to transfer any deposits to commercial banks and not to put them at risk. (CGAP 2000) What the concept of the “window” actually means in this analysis is hard to say, since the various alternatives also describe a kind of regulatory niche or tier that could be described as a “window.” What the authors may be suggesting is that creating a regulated MFI tier to supplement the bank and non-bank tiers already in existence will not, without more, create a stable and growing microfinance market. Stated this way, it difficult to argue with the proposition.

Table 1: Tiering Structure

Institution type	Possible activities requiring regulation	Resultant need for external regulation	Recommended regulatory agency
Category A (other people’s money) with finance from donor funds	Exploitation of borrowers through near monopoly position, opportunistic behavior on the part of borrowers; sector refinance sources depend on confidence in sector	Conducive environment (safeguarding of competition, market transparency, certainty in law, etc.)	No or self-regulatory body
Category A with finance via commercial loans or securities issues	In addition: wholesale deposit taking with possible harm to investors through opportunistic behavior	Investor protection through incorporation, stock exchange supervision and rules	Hybrid or self-regulatory body
Category B (member’s money)	Deposit taking from members	Small, informal savings and credit groups: no need for regulation. Recommended: registration as a cooperative or ROSCA; compulsory membership in association	Umbrella body
Category C (the public’s money)	Retail deposit taking from general public with danger of a run and opportunistic behavior by the MFI	Law tailored to specific features of MFIs	Government or hybrid regulation, with possible delegation of supervision to a private institution

Source: Van Greuning et al (1999) as adapted by Staschen (1999)

The near-universal phenomenon of financial sector tiering shows that the use of “regulatory windows” is quite common. Part 3 of this paper provides examples of this

phenomenon in developing countries, and similar experiences abound in the industrial world. The above discussion suggests two main criteria to keep in mind when financial sector tiering is under consideration. First, the top priority for financial regulation is to protect the system's safety and soundness, especially as it affects the payments system and depositors. Thus, defining tiers in the system primarily with respect to the types of liabilities they hold can make sense. In addition, there is usually some need for further categorization based on size measures, which can be used as thresholds for registration and some regulatory requirements. Finally, linking size and liabilities with permissible activities seems sensible, with large-scale or more sophisticated financial services limited to those institutions capable, in terms of size and resources, of providing them responsibly.

The second criterion to keep in mind is the feasibility of administering and implementing such a structure. A badly designed structure, such as a proliferation of tiers aimed at promoting growth in various existing niches, could easily cause harm. While the regulatory regime should be designed to facilitate responsible growth, this must inevitably involve competition, consolidation, the failure of some institutions, and the disappearance of some market niches. The structure needs to balance such considerations as innovation, learning, competition, scale, and stability. Part 3 of this paper (and the Annex) explores specific ways in which this balance has been struck in several countries.

*Definition of Microfinance*³

Defining a tier of limited banks or microfinance providers means delimiting the activities permitted within that regulatory "window," or defining the activities that trigger a specific set of regulatory requirements. Microfinance often is defined as lending small amounts of money for short periods with frequent repayments. Ceilings are often placed on loan sizes, or more favorable regulatory treatment is given to loans under the size threshold. Savings services are often permitted or included in the definition of microfinance, and recently MFIs in some countries have begun to offer a wider array of services, such as insurance and fund transfers. Normally, all second tier institutions such as thrifts and MFIs are limited to a smaller range of activities than commercial banks. In most cases, drafts and demand deposits are off-limits, and in many cases involvement in securities issuance, insurance, and/or foreign exchange transactions is prohibited. As a general principle, it is important to provide a definition that will enable market participants to be responsible, energetic, and innovative. The legal definition should be broad enough both to enable a focus on a sensible target group and to provide a wide range of appropriate financial services for that group.

While all MFIs face some limitations on their activities, they are not always defined by their activities. Sometimes, a microfinance institution is defined as an organization that works solely with the poor, which suggests that having clients above the poverty line would not be consistent with the rule. This definition of the customer base occurs for three reasons: in order to focus institutional attention on poverty alleviation; in

³ This section was adapted in part from Wilkinson (2001).

order to prevent unscrupulous individuals from using the microfinance institutional structure to operate under less stringent regulatory scrutiny; and in order to define a set of organizations often capitalized by donor contributions – a form of preferential treatment. Although the approach of defining the customer base responds directly to the poverty-alleviation objective of microfinance, it is not necessarily the most effective way to secure this objective. In practice, it requires some scrutiny or proxy measurement of the income levels of the clientele – not an easy proposition for a regulatory agency.

Countries that take the simpler approach of limiting the size of loans (directly or through regulatory incentives) have been successful in ensuring services to low income groups. This essentially relies on client self-selection. Another option is to link tiers of MFIs to loan sizes, with amounts increasing as the size and liability/capital sources of an MFI increase.

Presumably, the definition of microfinance will determine how big a market is being regulated, thus yielding some notion of how much regulation and what kind of regulatory and supervisory system will be affordable. A simple estimation system for rural microfinance demand in Ethiopia assumed that 50% of rural households are below the poverty line, 80% of these households have an economically active member able to benefit from credit, and that the three main microenterprise activities requiring credit (agriculture, animal husbandry, and petty trading) had different average loan sizes. (Shiferaw and Amha 2001) Another method used for this process involves multiples of the annual per-capita income. Such methods could help estimate potential demand in the market, hence the likely growth of micro loan portfolios in existing and new institutions. On this basis, policymakers could arrive at a benchmark or ceiling for regulation and supervision costs as a percentage of overall market value.

Who is Regulated and Who Regulates?

Which institutions should be regulated? How should the thresholds for more stringent regulation be defined? It is widely agreed that informal small-scale organizations such as ROSCAs are best left out of any system of registration and regulation, in order to avoid stifling financial innovation at the lowest levels. Many commentators take a further step, suggesting that institutions which do not take savings do not warrant regulation. However, many countries do regulate credit-only institutions, and indeed the need for transparency, market stability, and control of unfair practices suggests that some regulation is often needed.

A more nuanced argument is that *prudential* regulation should be applied only to deposit-taking institutions, since these are the only ones that intermediate deposits from the general public. Credit-only institutions, in this view, could simply be governed by general legal and regulatory norms applicable to firms and lenders – and these would be “supervised” if at all, by their owners, investors, and creditors.⁴ Prudential supervision

⁴ Alternatively, as in South Africa, these credit institutions could be overseen by a non-prudential regulator charged with policing operations in the microfinance market to deter fraud, predatory lending, and other irregular practices. (Meagher and Wilkinson 2001)

signals to third parties that government essentially stands behind or takes responsibility for the soundness of approved institutions. In addition, regulation and supervision are a scarce, expensive public good, and they often create opportunities for corruption (CGAP 2000). Regulation and supervision need to be targeted in such a way that their benefits in terms of depositor protection and the safety of the financial system generally outweigh the costs and risks involved. This inevitably means that only certain classes of institutions receive full regulatory scrutiny, while others face less stringent control, and some will not be regulated at all.

Both for purposes of permitting innovation and of conserving regulatory resources, it makes sense to apply no more than minimal requirements to MFIs that do not have significant deposit balances (net of loans) from their members and do not accept deposits from non-members. The minimal requirements could include registering with the central bank and sending regular reports, complying with non-financial regulations such as securities laws, and adhering to rules of transparency and consumer protection in dealing with borrowers. Reporting rules and perhaps regulatory oversight could be intensified for those credit-only institutions that have grown large in terms of membership, loan balance, and market share.

Receiving deposits or quasi-deposits from members or investors usually triggers more careful regulatory treatment. Full prudential regulation and supervision, including regular reporting and examinations to ensure sound practice and compliance with capital regulations, is applied in the majority of well-functioning financial systems (but not all) only to institutions taking retail deposits from the public – in some cases, only to those taking *demand* deposits. Again, the liability and capital structure determines whether prudential regulation and supervision apply, although other factors such as size may define the strictness of non-prudential rules.

Closely related to the definition of regulated institutions is the designation of the regulatory and supervisory agencies. Typically, these functions are handled separately, whether by different arms of the central bank, or by a ministry of finance and a bank supervision department. For institutions that do not fit the category of full prudential regulation and supervision, the alternatives used include a hybrid combination of non-governmental agencies supervising MFIs according to official regulations, a non-governmental entity serving independently as both regulator and supervisor, and “self-regulation” by an association of MFIs. It is widely recognized that central banks have neither the training nor the resources to supervise the entire MFI sector. Assuming appropriate capacity development in the banking supervision departments, one might envision a division of labor in which central bank supervisors retain ultimate responsibility for the entire sector but only take on direct supervision of apex institutions and the largest MFIs accepting public deposits.

Below this level, several approaches are possible, from benign neglect to delegation of supervisory powers to a private institution such as an apex institution or a microfinance industry association. Self-supervision by associations is widely agreed to have failed due to problems of self-dealing and regulatory capture. (CGAP 2000) The

market incentives of creditors have a somewhat better track record, although this depends on the source of creditor funds, with donor-funded institutions being less effective in this regard. MFIs borrowing from apexes, commercial banks, or other formal entities for on-lending to their clientele are subject to creditor monitoring. Central bankers sometimes either leave this segment to be governed by market incentives, or require these large-scale creditors to report on their MFI debtors, perhaps in return for a share of regulation fees or some other incentive.

Supervision of MFIs by an apex organization is often viewed as a valuable adjunct or substitute for direct supervision by financial regulators. However, the research on this suggests that apexes are a less than perfect solution. (Gonzalez-Vega 1998) Apexes are most effective in well-developed microfinance markets where, in any case, there are a plethora of profit-making competitors that make apexes redundant. Apexes in theory have informational advantages over commercial wholesale lenders who might be reluctant to lend to relatively unknown MFIs. However, apexes have conflicting incentives. There is a potential conflict between the apex's lender and supervisor roles. (CGAP 2000) Especially in cases of default by one of its debtors, the apex is likely to pursue its interests as a creditor to the detriment of other interests (e.g. depositors) that might be better protected by a pure regulator. Limiting apex supervision to non-depository institutions would alleviate, but not eliminate, this conflict.

There is at least as big a conflict between apexes' commercial and promotional roles. They are often expected not only to mediate funds, but to develop and promote the microfinance market, which usually involves moving large amounts of concessionary donor funds through their microfinance network, as well as providing training and other capacity building support. As a result, apexes face difficulty focusing on the financial bottom line to the same extent as commercial lenders, since they will also be judged on their promotional and developmental results. This creates a moral hazard problem, where their attempts to impose strict monitoring and especially to enforce loan agreements with MFI borrowers are not credible – and default does not bring harsh consequences. This means that apexes are frequently not effective creditor-supervisors of MFIs. A further result of this is that apex-based microfinance development may not be sustainable, since it is developing the ability to attract and repay commercial finance sources that most clearly enables MFIs to become self-sustaining. (Gonzalez-Vega 1998)

Prudential Regulation and Supervision

This category comprises rules that impose prudent financial management standards on MFIs, and systems to implement them through supervision. Effective prudential oversight of financial services markets involves the management of key risks. For the great majority of microfinance institutions, failure and closure will not cause significant damage to the financial sector. Therefore, regulation and supervision of the microfinance sector can be based on five risk factors:

- risk to the small saver in cases of intermediation,

- risk to the microfinance sector itself in cases of institutional failure of very large institutions (the “too big to fail” problem),
- risk of non-commercial investors making sub-optimal decisions (leading to loss of those resources to the nation),
- management risks due to the orientation of many MFIs to social issues rather than commercial ones, as well as fraud at local levels, and
- liquidity risks, since microfinance institutions operate on thin liquidity levels, and so problems occur suddenly and cause instability quickly.⁵

The management of these risks is embodied in the prudential rules and supervisory practices discussed below, and dealt with in more detail in the country cases presented in part 3.

Prudential Ratios

Regulation of capital adequacy – the minimum equity that owners must have at risk as a percentage of an institution’s (risk-weighted) assets -- poses a challenge for microfinance in many countries. In most, the ratios for banks are at least arguably set too low for purposes of microfinance. Stricter capital adequacy standards would be justified where the reduction of risk is greater than or equal to the consequent reduction in expected social and private returns. It is quite likely that MFIs are or would be viewed as too risky by potential investors under Basel or similar system-wide standards. The alternative approaches here include the following: (i) base capital adequacy on selected proxies of the riskiness of each loan; (ii) require more capital for all loans below a certain amount; and (iii) require smaller (or less sound) financial institutions to maintain higher capital adequacy than larger ones. (Jansson 1997) All of these approaches in different ways take the special nature of microfinance into account, but they all would likely be viewed as containing certain biases against MFIs and would therefore need to be explained thoroughly.

One concern that cannot be addressed by capital adequacy ratios alone arises in the context of NGO-MFIs that begin taking deposits. What is the *source* of their capital? Generally, when these organizations are able to raise the required minimum capital and to maintain capital adequacy, their equity is in fact provided by their sponsors or donors – and there are no “owners” with funds at risk. Many countries do not allow NGO-MFIs to accept deposits if they have not met the requirements for bank licensing. (Chavez and Gonzalez-Vega 1994) The alternatives might include much higher capital requirements for such institutions, or some form of equity equivalent such as a guarantee or subordinated debt instrument provided by an investor on behalf of the NGO-MFI. One proposal aimed at meeting supervisors’ need for rigor and MFIs’ need for flexibility in this area is to use the net present value of a microfinance NGO’s existing credit portfolio in calculating initial capital, at the point where the NGO applies for conversion to a regulated MFI. (Jansson 1997).

⁵ This paragraph was adapted from Wilkinson (2001).

Strict prudential standards are needed for most MFIs, due to the potential volatility of their loan portfolio quality. One usual characteristic of MFIs is the relatively undiversified nature of their loan portfolios. Only large MFIs of national scale, such as the BRI *unit desa* network, can avoid this. Regulators can adjust for undiversified risk in most MFIs by requiring higher emergency reserves than would be required for standard bank lending. (Chaves and Gonzalez-Vega 1994) For example, Ghana now requires its rural banking sector to meet a liquid reserve requirement of 52 percent (which would likely be *too* tight even for the most careful regulators). This also serves to alleviate liquidity risk in MFIs, which is higher than normal in financial institutions because of the strong contagion effect of repayment problems in this market.

Another aspect of prudential regulation is control of portfolio quality through reporting and loan provisioning. This system needs to deal appropriately with microfinance credits, i.e. in a way that corresponds to their particular repayment cycles (e.g. weekly). This usually requires the application to microcredits of special treatment reserved for consumer loans or small commercial loans. Microfinance methodologies also pose a challenge for auditing, for example where existing systems focus on the largest loans and therefore would ignore portfolios of small loans altogether. (Jansson 1997). The recent troubles of the Grameen Bank demonstrate the importance of agreeing on common standards for reporting and provisioning throughout the industry, in order to create an even playing field.⁶

There is a good case to be made for treating microenterprise loans in the same way or similarly to consumer loans, i.e. requiring careful monitoring and a more rapid provisioning schedule than commercial loans. Episodes like the Finansol crisis in Peru show that badly managed microfinance portfolios can deteriorate rapidly. (Rock and Otero 1997) The slow movement of cash and information in most developing countries can exacerbate these problems. At a minimum, monthly account statements, and perhaps biweekly reports for the largest MFIs, would be needed in order to monitor potentially volatile movements in asset quality. One proposed benchmark for setting appropriate provisioning schedules for microloans was proposed by Jansson (1997). The most relevant standard would not be the number of days past due but the number of unpaid installments. This produces the schedule for consumer (monthly installments) and microenterprise loans (weekly installments) presented below in Table 2.

Central bank requirements of physical collateral for commercial bank loans pose an additional problem, and ways need to be found to accommodate the group solidarity and unsecured individual lending modalities of MFIs. Most financial systems do not officially consider group liability to be valuable as security – and many only recognize real property mortgages. Systems also vary as to whether they impose aggregate limits on unsecured loans by financial institutions, or use single borrower percentage limits, and below what threshold, if any, loans are exempt from such rules. (Jansson 1997) A number of countries, including Bolivia and Indonesia, have found ways to accommodate group-based security (see the discussion in part 3 below). This is not to suggest that mandatory

⁶ Pearl, Daniel, “Bank that Pioneered Loans for the Poor Hits Repayment Snag,” *Wall Street Journal*, November 27, 2001, p. 1, col. 1.

rules on security are undesirable, but rather that, in the microfinance context, they are much more efficient when they recognize microcredit technologies that are at least as secure as collateral lending.

Table 2: Sample Provisioning Schedules

Unpaid installments	Provisions	Days: consumer loans	Days: Microenterprise loans
1	1%	30	7
2	10%	60	14
3	20%	90	21
6	50%	180	42
12	100%	360	84

Source: Jansson (1997)

Supervision and Reporting Systems

A recent study states the heart of the matter simply: “The most carefully conceived regulations will be useless, or worse, if they can’t be enforced by effective supervision.” (CGAP 2000) Microfinance presents a difficult challenge to supervisors, especially those steeped in commercial banking supervision methodologies. In most MFIs, systems that facilitate commercial bank portfolio monitoring – internal audit systems, hierarchical loan approval systems, documentation and filing systems – are weak at best, non-existent in some cases. Monitoring prudential ratios and other formulae developed for commercial banking does not work well for microfinance, given the risk profile, volatility, and lending technology involved in MFIs’ portfolios.

For example, many countries require bank inspectors to evaluate either the largest borrowers or, which frequently will mean the same thing, a fixed percentage of the banks’ portfolios. This method, especially in the case of banks that have entered the microfinance market, does not yield a representative sample of the portfolio, and is only feasible where a significant portion of the portfolio is comprised of a small number of large loans. Stratified portfolio sampling, which looks at different loan categories (e.g. by size) based on their representation in the portfolio, can avoid this problem, but can produce perverse results if weighted averages are not used. (Jansson 1997)

Reporting and offsite supervision must also be adapted to the microfinance context. Given the relatively undiversified nature of MFI loan portfolios, and their potential for rapid deterioration, a fairly stringent reporting system is needed to provide regulators with useful and timely information. Peru, for example, requires MFIs (EDPYMEs) to submit daily treasury reports as well as weekly and monthly financial reports, among other things. This is arguably too strict, and in many countries, would be viewed as overly burdensome. Monthly, biweekly, or weekly reports might constitute a more workable compromise. Some experts suggest that insufficient comparative data exist in this new industry for purposes of effective offsite monitoring. Also, given the inappropriateness in this field of most sampling methods used by bank examiners, it may

make sense for regulators to focus much more on the quality of MFI risk management and information systems – the latter are especially important in light of MFIs’ decentralized operations and their managers’ needs for real-time monitoring information. The small risk represented by any individual microloan also argues for a focus on systems. (Vogel et al. 1999)

Also, the enforcement tools available to commercial bank supervisors are not very effective in the microfinance field. For example, calling a temporary halt to lending until a problem is sorted out may be a useful tactic in commercial bank supervision, but in the microfinance field it could wreak havoc. It would jeopardize the collectability of existing loans, since these are secured mainly on the promise of additional loans in return for on-time repayment. A stop-lending order would breach an implicit agreement between an MFI and its clients, and potentially wipe out the value of its existing loans. Other tools, such as imposition of new management or forced mergers, are not feasible where MFIs have broadly different models and objectives. Some observers suggest that regulation and supervision of MFIs works best where the supervision of commercial banks is already done well, and the supervisors may then be able to take on the additional task of adapting appropriate methodologies for supervision of the microfinance market. (CGAP 2000) However, examples are so far non-existent.

Lastly, supervision of MFIs will usually be more expensive than supervision of commercial banks. This is a result of MFIs’ generally smaller asset base, larger number of accounts, decentralized operations, and the lack of systems available to facilitate efficient inspection. (CGAP 2000) Some examples of high supervision costs, and the approaches used to minimize and cover these costs, are presented in part 3 (and the Annex) below.

Regulation of Entry, Operation, Graduation

Financial institutions are subject to an array of regulations that go beyond core prudential concerns of capital ratios and sound management. Here again, the challenge for policymakers is to design non-prudential standards and controls in ways that accommodate the realities of microfinance and help stabilize and develop the market rather than suppress it. It is possible to group the main rules in this area into those dealing with entry and graduation, and those mandating certain operating practices.

Entry and Graduation Requirements

Careful consideration must be given to the rules affecting MFIs’ start-up, conversion into regulated entities, and graduation to a higher tier. These requirements include: minimum capital requirements, institutional form and governance requirements, and ownership (e.g. foreign investment) restrictions.

High minimum capital requirements pose a significant obstacle to the entry or conversion of MFIs, although requirements set too low would create the supervisor’s nightmare of too many entrants, with resulting painful exit and consolidation. How

should one set minimum capital requirements? One suggestion is to assess the economies of scale that are available in the market, and to encourage MFIs to move in that direction. For example, if minimum capital adequacy is 8%, and a size of \$40 million is required to exhaust major scale economies, then an appropriate minimum capital requirement would be \$3.2 million. (Vogel et al 1999) Such an assessment is likely to produce widely varying outcomes in different countries, given the range of potential demand, economies of scale, and the supply of capital and MFI promoters. Some countries, such as the Philippines, tailor their rules to the market by having capital requirements that vary according to the type of town or district (based on size, population, and urbanization) in which an institution operates. Comparisons of minimum capital requirements across countries are provided in part 3 below, and some analysis of these based on macroeconomic data appears in part 4.

Generally, minimum capital levels for commercial banks are set much too high for purposes of microfinance. A study of microfinance regulation in Latin America (Jansson 1997) made clear the impact of a high minimum capital requirement for MFIs. In the case of Colombia, with a requirement of \$27 million for banks, this implies a portfolio of \$210 million when fully leveraged (assuming 9% capital adequacy and 100% risk-weighting, as indicated by survey results in Colombia). Using an average loan size of \$500, this would require the institution to have over 420,000 clients in order to operate as a bank and remain fully leveraged – some eight times the client base of the largest MFI then operating in Latin America. The alternatives in this case would be for MFIs to remain informal, or to register as finance companies (non-bank financial institutions, NBFIs), which would only permit them to accept fixed term deposits.

With respect to institutional form and ownership, these rules must balance concerns about governance, asset ownership, foreign control and money laundering against flexible entry and the ability to draw on substantial sources of funds. Often, the balance is struck on the side of rigidity, with negative results – for example, in Honduras, the limitation of financial institution shareholding to individuals, enacted due to money laundering concerns, makes it virtually impossible for NGOs to become regulated MFIs. (Jansson 1997). The tradeoff between safety and the flexibility to innovate must be carefully drawn in every context.

A related issue is whether corporate form is required, which is the case for financial institutions in most countries, and what this entails. Generally, regulators demand a corporate form for financial institutions so that there are responsible parties to tap in case of capital calls or other ownership issues. A requirement of corporate form may be ideal if company formation is cheap and flexible, or if simplified options are available (such as S corporations in the U.S.). However, many company statutes are unduly rigid, with costly requirements and highly regulatory approaches to company purposes and governance. Also, many countries restrict foreign ownership of banks and MFIs. In the banking context, liberal foreign investment rules tend to promote growth, competition, and efficiency. In the case of MFIs, restrictions are perhaps less likely to be motivated by protectionism than by concerns about dependence on international donors or a desire to orient MFIs toward localism in service provision. It is by no means clear

that serving these goals at the expense of potentially reduced investment and competition represents a favorable tradeoff.

Policymakers need to keep the full costs and benefits of entry requirements carefully in mind. One study estimated the cost of establishing a non-bank MFI (PFF) in Bolivia at \$700,000 – apart from the deposit of minimum capital. The costs included the following: feasibility study, legal advice, computer and security systems, procedures manuals, personnel recruitment and training, and a range of opportunity costs. (FONDESIF/GTZ 2001) In short, the deposit of minimum capital may comprise only part of the entry costs, and policymakers would do well to estimate all of the costs in order to understand the entry barriers and to adjust policy accordingly.

Last, best practice suggests the need for a transition and graduation path for institutions entering the market. Experience shows the wisdom of a liberal approach in which no attempt is made to require the incorporation, registration, or regulation of small informal microfinance organizations, such as rotating credit and savings associations (ROSCAs), for example within a social group or firm. Also, newly-emerged MFIs (e.g. village banks and NGOs that plan to expand their service area and client base) might well be subjected to relaxed entry standards under provisional registration, until such time as they reach the rapid growth stage, and face more demanding requirements. At a later point in the life of an MFI, expanded services and client bases would justify stricter rules, guarantees, and supervision. Entry into any of these “tiers” usually requires the institution to meet certain qualitative standards such as a “fit and proper” review of its key officers, an evaluation of its management systems, submission of a business plan or feasibility study, and scrutiny of its track record, including its level of self-sufficiency. While applying these kinds of standards inevitably involves some discretionary judgments, these kinds of checks, when conducted properly, are helpful in establishing *ex ante* the soundness of the proposed entrant.

Operating Regulations

This category consists of regulations that place limits on several aspects of day-to-day operations. These include: usury laws and interest rate caps, loan documentation requirements, and operational restrictions affecting, for example, branch openings and business hours.

Interest rate controls are often part of old criminal usury laws, but some have been developed in recent times as part of a financial law or a directed credit policy. These rules restrict interest rates to a particular band for specified sectors, or limit interest rates to a certain percentage above average commercial rates or prime rates. In either case, such rules, if enforced, can make sustainable operation difficult for MFIs, given their operational costs and methodologies. Also, these rules are almost uniformly detrimental to the borrowers they aim to protect, since they suppress the supply of formal credit and push borrowers into a less transparent and often much more abusive informal credit market. It appears that, in many cases, these limits are not enforced, which creates space for MFI viability in the near term, but also creates the risk of shut-down, or at least

extortion and bribery, where enforcement becomes a real possibility. In some instances, MFIs can qualify for a limited formal exemption from interest rate ceilings, as in South Africa, where microlenders obtain exempt status by registering with an authorized private regulator and complying with its rules (see part 3 and Annex).

A range of other controls are often applied to banks and MFIs. Many countries specify loan documentation, and their use sometimes entails payment of notarial and other fees. These are a potentially significant constraint on MFI operations, except in systems that exempt micro or consumer loans from the requirements. In any case, there does not appear to be a strong rationale for documentation requirements, since creditors would normally have an incentive to use the types of documents that best ensure repayment. Branching and business hour regulations are also ubiquitous, and have obvious impacts on the extent to which MFIs can take their operations to the client. Often, the rules adopted for banks are not sufficiently flexible for MFIs, for example requiring full daily opening hours and permanent, secure premises that MFIs often cannot afford. Several countries allow financial institutions to use alternative “platforms” such as mobile banking units, that are more flexible and less expensive than regular branches. (Jansson 1997).

Operating regulations also include rules for fair treatment and information disclosure to borrowers. Microfinance involves relatively vulnerable borrowers such as poor households and microentrepreneurs. This raises the importance of fair disclosure rules such as those applied to consumer transactions in industrial countries. The main issues here are truth-in-lending standards and fair credit reporting standards. These rules impose transparency on the documentation and procedures of lenders and credit rating agencies, in order to reduce informational constraints that often plague low-end finance markets. For example, these rules usually require clear documentation and explanation of interest and fees, such as their presentation in the form of a consolidated annual percentage rate (APR). In the U.S., the Truth-in-Lending Act mandates the use of a standard format. In the area of credit reporting, regulations often require the debtor’s consent to the use of credit information, and protect the debtor’s right to review and challenge any report. These standards are variously enforced, sometimes by bank supervision agencies, sometimes by separate consumer agencies. In the South African case, the microfinance regulator has authority to enforce these rules against registered lenders.

3. Approaches to Microfinance Regulation and Supervision: Summary Case Studies

Microfinance regulatory systems are best developed and understood in close relation to their specific contexts. This paper therefore discusses twelve separate examples of microfinance regulatory systems, from ten jurisdictions spanning the developing world (Bangladesh, Bolivia, Ethiopia, Ghana, Indonesia, Peru, the Philippines, South Africa, Uganda, and the West African Economic and Monetary Union). These cases are divided, for ease of presentation, into two groups – one comprising MFIs that are directly regulated and supervised by the banking and financial services authorities, and one comprising institutions subject to indirect regulation (hybrid or self-regulation). Two countries, Peru and the Philippines, are represented in both groups, since they have both types of systems. We present the cases in summary form here – the detailed cases appear in the Annex. The cases highlight the range of regulatory concerns that must be addressed in the near term by regulators considering active microfinance market governance. A series of tables follows the discussion of each set of examples, presenting key regulatory variables in a cross-country comparative matrix format.

Directly Regulated and Supervised Institutions

Here we consider six examples. All but one of these (EDPYMEs in Peru) can accept savings deposits from the public under certain conditions. One case (Bolivia) involves simply a depositary non-bank institutional form that can be used for microfinance, while the others, in various degrees, were more specifically tailored to serve the microfinance market. The entities in this group are directly regulated and supervised by government agencies, hence the possibility of full prudential oversight exists. Indeed, in each case, some or all of the relevant institutional forms are prudentially supervised. Contrast this with the next set of examples, below.

Bolivia: Private Financial Funds

In 1995, Bolivia created the *Private Financial Fund* (PFF) by Presidential Decree. The purpose of the PFF was to provide for a second-tier non-bank financial institution (NBFI), which had been lacking until then, and to channel resources to small and microenterprises, as well as to individuals for durable goods purchases. Among other things, PFFs can lend, engage in finance leasing and factoring, and take savings and time deposits. (Trigo, 1997; Rock, 1997) As of late 1997, there were six PFFs, of which two were MFIs and an additional three NGOs were in the process of conversion to PFFs. (Jansson 1997) More recently, as of early 2001, the four major PFFs that were NGO conversions had some 104,000 clients and a portfolio valued at approximately \$105 million. (FONDESIF/GTZ 2001)

The Central Bank and the Superintendency of Banks and Financial Institutions have regulatory authority over PFFs. Some of the key features are the following. PFFs are required to be corporations and to have minimum paid-up capital equivalent to U.S.

\$1 million, which is one-third the amount required for a bank. The minimum capital adequacy ratio is 10%, and the maximum portfolio allocation to loans is two times the value of equity. The latter is a stringent constraint on operations. The PFFs are subject to the supervision methods applied to banks and to special methods developed for MFIs, which include an evaluation of the institution's credit methodology, a review of sample files, and visits to clients. A recent survey estimated the cost of formalizing a PFF, i.e. bringing an institution (e.g. an NGO) up to PFF regulatory standards, at \$700,000. Additionally, the Superintendancy was estimated to incur \$24,000 in costs in the course of licensing a PFF and annual costs of \$42,000 for supervising a PFF – recovered in part through fees. (Monje et al 2000, FONDESIF/GTZ 2001)

Some of the PFF regime's elements may not be ideal as prescriptions for the promotion of a microfinance market. The minimum capital required for a PFF is quite high as compared to NBFIs and MFI rules in many other countries. This, of course, does not prove that the rate is too high, but does indicate a relatively restrictive policy on entry to the sector (or alternatively, a lot of well-capitalized MFI promoters). Also, the rules do not recognize informals or provide for formalization and step-wise graduation of MFIs to higher-tier financial institutions. Last, the PFF framework has been heavily used in recent years for consumer finance, which helped to create problems of over-indebtedness that affect the microenterprise finance market, as well as predatory lending practices. (Staschen 1999)

Ethiopia: MFIs

The Ethiopian regulatory structure for MFIs was established under a 1996 law. Microfinance, as defined by the statute and National Bank of Ethiopia (NBE) directives, consists of extending "small" credits to "rural small farmers or urban entrepreneurs." All MFIs must be 100% Ethiopian-owned, meet minimum capital of approximately \$25,000, and obtain a license from NBE. Licensed MFIs can accept savings, demand, and time deposits; draw and accept drafts payable (i.e. transfers) within Ethiopia; and manage funds for the purposes of on-lending them to peasant farmers and microentrepreneurs. Only licensed MFIs may accept concessional credits or assistance from foreign organizations. When savings mobilized by an MFI reach approximately U.S. \$125,000, the institution is required to re-register, subject to NBE conditions.

Although this framework provides useful clarity and structure to the microfinance market, it poses a number of problems. The statute requires a license from NBE for carrying out *any* microfinance-related activities. No informals are recognized or tolerated, there is recognized no multi-tiered structure of graduated standards nor any system of self- or hybrid regulation. This potentially constrains innovation at the base of the microfinance market, and puts emergent MFIs in legal jeopardy. Also, the ceilings on loan size and term are apparently maladapted to many farmers' needs. (Shiferaw and Amha 2001) The other important problem here is that the legal structure potentially places serious strain on the limited supervisory resources of NBE. If all MFIs must be licensed and supervised by NBE, then the scope of NBE's work in this area is potentially huge. In practice, the central bank has not enforced MFI reporting requirements –

whether as a policy decision under its statutory discretion, or simply as a result of thin capacity.⁷

Experience since the 1996 law suggests that the framework has been generally helpful, but that it also has contributed to a buildup of problems endangering the market's sustainability. Some 16 MFIs operate in Ethiopia, with a mixture of regional government, NGO, and individual ownership. These MFIs reach nearly half a million active clients at a given time with about \$34 million in credit outstanding (cumulatively \$66.8 million) and hold about \$16 million in savings. Repayment rates for most MFIs are close to 100%. However, the prohibition of foreign ownership and ministerial control on donor funding appear to have deterred involvement in the sector by foreign donors and international NGOs. (Shiferaw and Amha 2001)

Ghana: NBFIs

Ghana's⁸ Financial Institutions Law affords potential microfinance providers a non-bank licensing option. This category includes thrifts and a variety of finance companies. The law requires an NBFi to be incorporated and licensed by the Bank of Ghana (BOG), and to have a minimum paid-up capital of approximately U.S. \$140,000 – recently increased to approximately U.S. \$2.1 million for new entrants. NBFIs must maintain a minimum capital adequacy ratio of ten percent.

Applicable regulations specify three kinds of NBFi license – for institutions taking retail, wholesale, and no deposits. Both depository and credit-only institutions are regulated, although more stringent prudential standards apply to deposit-taking NBFIs. Credit-only NBFIs may apply for special permission from the BOG to accept term deposits from the public. Importantly, there are markedly different provisioning schedules for business, hire-purchase, and micro loans – reflecting the potential volatility of microcredit portfolios. Loans backed by group guarantees are allowed a much higher ceiling in meeting the “micro” designation than individual loans (\$1,400 vs. \$140). However, group guarantees are not reflected in the risk-weighting criteria at all – nor is moveable collateral for that matter. The rules applicable to non-depository NBFIs are the same in many respects, with the main differences being lower minimum capital, and a ratio of liabilities to own funds of 10:1 (instead of the depository capital adequacy ratio). The rural banks are treated as a sub-category of bank, with their own prudential rules.

The provision for rural banks under the Banking Law (see the Annex), the range of NBFIs under the Financial Institutions Law, and the Bank of Ghana's commitment of resources to supervise them, sets up a useful structure of tiering. At the same time, NGOs as such are left unregulated, hence able to experiment, but they could theoretically grow to significant proportions with no Bank of Ghana oversight. As important, where NGOs wish to transform into regulated institutions, the 30-fold increase in NBFi minimum

⁷ There apparently has been discussion of deferring any direct NBE supervision until an MFI reaches the \$125,000 savings level, but this has not been adopted as policy.

⁸ This section benefited substantially from the information and commentary provided by Dr. David Obu Andah of the Bank of Ghana, and William Steel of the World Bank.

capital over the last 2 years is making this difficult if not impossible. (Ameyaw 2000, Gallardo 2001)

Peru: EDPYMEs

Peru established a framework for MFIs through a 1995 amendment of its banking regulations, providing for an entity called EDPYME (*Entidad de Desarrollo para la Pequeña y Microempresa*). The EDPYME form was conceived as a vehicle for the conversion of NGOs to the status of regulated financial institutions. A registered EDPYME would have as its objective the provision of finance to persons engaged in small or microenterprise activities.⁹ In serving this market, EDPYMEs can access commercial bank credit, equity markets, and special rediscount facilities from COFIDE, the Peruvian development bank. The entry and regulatory requirements for EDPYMEs include minimum capital of U.S. \$256,000, and a limitation of total liabilities to a maximum of ten times net equity. Importantly, this legal structure allows for a period of transition into fully regulated status. (Rock and Otero 1997)

A recent study quantified the costs of microfinance supervision in Peru. The Banking Superintendancy (SBS) charges banks and MFIs a fee of 0.06% of assets – but the supervision of MFIs was found to be costing SBS about 30 times that, equal to 2 percent of MFI assets. The study concluded that, if SBS charged a fee that covered its costs, the 30-odd MFIs in Peru would need to add 3 percent to their loan charges in order to pass the cost on to their customers – and this was expected to be relatively easy. (CGAP 2000)

The Peruvian EDPYME framework provides a workable mechanism for formalization of NGO-MFIs as incorporated and regulated non-banks. However, the framework appears to have undermined its objective of promoting a sustainable microfinance sector in one sense: because EDPYMEs have easy access to bank credit, equity markets, and government refinance, none of them (at least until recently) applied to SBS for permission to take retail deposits from the public. (Staschen 1999)

The Philippines: Rural banks

The legal framework for rural banks in the Philippines defines their target clientele as “farmers, fishermen and merchants with small cash requirements.” Minimum capital requirements for rural banks vary according to the type of area in which a bank operates – with the lowest legal requirement (\$50,000) set for the least populous districts (5th and 6th class municipalities), and the highest (\$500,000) for Metro Manila. Rural banks must be wholly-owned by Filipino individuals or entities, a requirement (as in the case of Ethiopian MFIs) that appears to have no economic rationale. There were over 800 rural banks in the Philippines as of the end of 1997, of which 51 were cooperative rural banks. (Gomez et al 2000, Montemayor 1997)

⁹ “Small” is defined as having assets of U.S. \$300,000 or less and/or annual turnover of \$750,000 or less; and “micro” as having assets worth \$20,000 or less and/or annual turnover of \$40,000 or less.

One recent analysis (Gomez et al 2000) suggests that, while the regulations applicable to rural banks in the Philippines accommodate microfinance, prudential supervision practices in fact discourage it. The central bank (BSP) has in practice set a ceiling of 30% on unsecured loans, and supervisors do not recognize group guarantees and other microfinance mechanisms as valid security. The banking law's requirement that institutions remain open at least 6 hours per day, 5 days per week imposes extra costs on MFIs, such as the need for full-time labor and office space. Also, BSP's supervision department has apparently not been equal to the task of overseeing the rural banks (CGAP 2000).

As a result of the constraints imposed by the regulatory regime, there has been (as of this writing) only one NGO transformation in the Philippines: CARD Bank. Also, the arrears rate for rural banks rose from 14% in 1996 to 19.8% in 1999 due to weak management and lending technologies. This could be compared to CARD Bank, which uses a Grameen methodology (resulting in violation of BSP security standards, and sanctions) thereby maintaining an on-time repayment rate above 99% during the same period. (Gomez *et al* 2000)

Uganda: MDIs

Uganda has been developing its policy on the regulation of microfinance activities. The Bank of Uganda's (BOU) policy envisions four tiers in the financial sector: (1) Banks, (2) Formal NBFIs, (3) Microfinance Deposit-taking Institutions (MDIs, to be defined by law), and (4) Credit-only MFIs and informals. Fourth tier member-based MFIs under a certain size (by number of members, to be determined by BOU) will be excluded from the reach of the law, nor will they be supervised by BOU. (Opiokello 2000)

The draft law now being considered in the parliament of Uganda, the Micro Deposit-Taking Institutions Bill 2001, provides the framework for licensing and regulating depositary MFIs (MDIs). Regulatory norms and supervision rules are, somewhat unusually, well defined in the bill itself. Minimum capital is determined by an adjustable formula, with the level initially set at approximately U.S. \$400,000. The bill sets minimum capital adequacy at 15% for "core" capital (fully paid-up shareholders' equity) and 20% for total capital. For donor-funded MDIs, donor capital must be converted to subordinated debt and paid down or supplemented by an equal amount of institutionally-raised reserves (an understandable but fairly onerous requirement). The precise details of these provisions remain to be spelled out in regulations, once the bill is passed.

Table 3: Directly Regulated and Supervised Microfinance Institutions

<i>3.a. General Approach</i>						
	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit-taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Financial Sector Tiering	Banks, mutuals (S&Ls), PFFs, credit unions, unregulated NGOs	Commercial & development banks, MFIs Tiers within MFI sector not legally recognized, but NBE powers allow for implicit tiering	Banks: Commercial and Rural Banks NBFIs: Institutions taking (i) public, (ii) wholesale, (iii) no deposits, including those offering microcredit	11 categories of institutions including: commercial banks, finance companies, leasing & factoring companies; MFIs include thrifts (CMACS, and CRACs), EDPYMEs, cooperatives	Universal and commercial banks, thrifts, rural banks, quasi-banks, NBFIs, NGOs	Tiers: 1-Banks, 2-Formal NBFIs, 3-Microfinance Deposit-taking Institutions (MDIs), 4-Credit-only MFIs and informals
Definition of microfinance	Small loans: < \$2,000 (banks) Micro loans: < \$500 (PFFs)	Legal duty to give preference to marginal farmers, Loan ceiling = \$625	Loans up to \$140, up to \$1,400 with group guarantee	Credit to small (assets < \$300,000, turnover < \$750,000) or micro (assets < \$20,000, turnover < \$40,000) enterprises	Unsecured loans to the poor, up to \$2,900 Rural banks: target clientele are “farmers, fishermen, and merchants with small cash requirements”	Principal business: accept deposits, loans to micro-enterprises & low income households using collateral substitutes
Regulatory body for these MFIs	Central Bank, Superintendancy of Banks & Financial Entities (NBF Division)	National Bank of Ethiopia (NBE), Ministry of Finance	Bank of Ghana (BOG)/NBF Department	Banking Supervision (SBS), NBF department	Central Bank of Philippines (BSP)	Bank of Uganda (BOU), umbrella body for credit-only MFIs
MFIs subject to regulation & supervision	PFFs, others not regulated in practice	All MFIs, but in practice only limited supervision	Credit-only and depository (stricter standards for the latter) NGOs and small informals not regulated in practice	Depository (CMAC) and credit-only (basic EDPYMEs) Transition to regulated status for EDPYMEs	Banks and quasi-banks (funded via deposit substitutes) Exclusions: non-banks, institutions with < 20 depositors	Depository only, Exclusions: member-based MFIs under certain size (no. of members, TBD)

3.b. Supervision and Reporting

	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit-taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Supervision Method	Annual external audit, monthly offsite followup & quarterly report, evaluation of credit technology, review of sample files, client visits No delegation of supervision	Annual external audit, regular on-site inspections, follow-up on quarterly reports	Annual outside audit, on and offsite Supervision No delegation of supervision	Regular annual, and special, on-site inspections	Regular onsite examination, offsite reviews as required Examinations include wholly-owned or controlled companies BSP may place banks in conservatorship, intervene in liquidations	Annual published outside audit, regular offsite and discretionary onsite supervision BOU has broad corrective authority, including mgmt takeover, receiver-ship, liquidation
Costs of Supervision	PFFs pay annual fee of 1/1,000 of assets	NBE licensing fees	BOG licensing fees	SBS supervision fees: 0.06% assets	Fees and commissions set by BSP	Licensing fees TBD
Disclosure and reporting	Annual and quarterly reports	Reports to NBE: quarterly statements of income, balance sheet, credit & savings, impaired loans	Quarterly returns, annual audit reports and audited accounts, notice of changes (name, place, director, rules)	Daily treasury reports, weekly & monthly financial statements, portfolio quality reports every 4 mo. to SBS Semi-annual (unaudited) & annual (audited) accounts to securities agency (registered firms)	BSP may require external audit Quarterly financial statements to BSP and published in newspaper	Annual audited accounts, with regulatory violations listed, to BOU and published in newspaper Periodic reports Non-performing loans, financial malpractice to be reported to Credit Reference Bureau
Deposit Insurance, Lender of Last Resort	Unknown	None for MFIs	Unknown	Unknown	Philippine Deposit Insurance Corp. covers up to \$2,000 per depositor, per bank	MDI Deposit Protection Fund Donor capital in MDIs becomes subordinated debt & over time replaced by reserves

3.c. Capital and Reserves

	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit-taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Minimum capital	\$1 million	\$25,000	Existing NBFIs: \$140,000 New NBFIs: \$2.1 million (Non-depository: \$70,000 & \$1.4 million, Rural banks: \$20,000)	\$265,000	\$50,000 to \$500,000, depending on location (Cooperative rural banks: \$30,000 and up)	\$400,000
Minimum capital adequacy/ gearing ratio	10% risk assets	Un-known	10% (Rural banks: 6%) (Non-depository: max ratio of liabilities to equity = 10:1)	Max ratio of liabilities to net equity = 10:1	10% risk assets	Core: 15% risk assets Total: 20%
Risk-weighting of assets	Personal guarantees, moveables, group liability accepted as security; Max allocation to loans = 2 times equity capital, but micro and consumer loans exempt	Un-known	0%: cash, govt bonds, funds in well-rated banks 20%: money mkt funds (in Discount Houses) 50%: home mortgages 100%: other (includes loans secured by moveables & group guarantees)	Unknown	Loans amounts limited to 75% security value Due diligence requirements BSP rules recognize “peculiar characteristics of micro financing”	TBD
Loan loss provisioning, write-off	Loan < \$5,000, term < 1 mo: 15-30 days overdue = 10%, 30-60 days = 50%, > 60 days = 100% Small & micro loans (< \$500) exempt from provisioning requirements	> 6 mo. overdue: 50% > 1 year overdue: 100%	<i>Business loans:</i> 6-9 mo overdue: 20%, 12-15 mo.: 50%, > 15 mo.: 100% <i>Hire-purchase:</i> 30-90 days: 20%, 3-6 mo.: 40%, 6-9 mo.: 60%, 9-12 mo.: 80%, >12 mo.: 100% <i>Micro/small business loans:</i> overdue < 30 days: 5%, 30-60 days: 20%, 60-90 days: 40%, 3-4 mo.: 60%, 4-5 mo: 80%, > 5 mo: 100% General loss provision: 1% of loans	8-30 days overdue: 1% 31-60 days: 25% 61-90 days: 50% > 90 days: 100%	< 90 days overdue: 25%, > 90 days overdue: 50%, > 1 year overdue: 100% Plus general loss provision of 2% portfolio (net of non-risk loans)	TBD
Reserves, Liquidity requirements	Unknown	Un-known	Annually, 50% net profit until reserve = min. capital, then 15% Primary liquidity reserve: 10% total deposits, Secondary: 15% (Rural bank liquidity reserve: 52%)	Loan loss reserves: 25% of capital; 10% after tax profit annually goes to loan loss reserve	15% liquidity reserve requirement But forbearance for rural and thrift banks in microfinance	TBD

3.d. Business and Risk Management Guidelines

	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit-taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Guidelines & restrictions on business activities	Permitted: savings & time deposits, range of credit activities, factoring Not permitted: demand deposits, foreign trade, enterprise investment, securities	Permitted: savings, demand, time deposits; transfers; purchase of T-bills and some other instruments Restricted: accept donor funds only with MOF approval; loan amount and term ceiling	75% income must be from principal (licensed) business; non-deposit NBFIs may get special permit for term deposits from public; no gambling, speculation, “undesirable” activity	Credit only Can access bank credit, equity markets, COFIDE refinance, Public deposit-taking only with prior SBS approval	Savings and time deposits, rediscounting of paper permitted Checking and NOW accounts with prior BSP approval and higher minimum capital No operating as insurer	No checking accounts, engaging in non-financial business, securities/trust/derivatives business, forex transactions Limit on shares in non-financial firms = 25% core capital
Concentration of risk limits	Max credit to single borrower or group = 3% net worth, based on personal guarantee = 1%, credit to financial inst = 20%	Maximum credit to single borrower = \$625, to be repaid in 1 year max.	Max. loan to individual/ entity: secured = 15% net worth, unsecured = 10%; Equity max. = 15% net worth per company, 25% overall	Special application procedures for credits > 5% net equity or > \$10,000	Max. credits/guarantees to any person or entity = 20% net worth, 30% if secured, 15% if small business loan	Max advance = 1% core capital for individual, 5% for group
Limits on connected/ insider business	No credits or guarantees to related person/company	Unknown	Max. exposure: Affiliates = 15% net worth per inst., 25% overall; Connected companies = 10% & 5%; Directors = 2%; Staff = 2 years’ salary	Unknown	Loans/guarantees to officers or related interests only with written approval of majority of bank directors, and not on preferential terms Limit = their unencumbered deposits and paid-in capital	Max preferential unsecured credit to director or connected firm = 1% core capital Max unsecured credit to staff = 1 years’ salary

<i>3.e. Entry, Rules of Operation</i>						
	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit-taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Registration/ Licensing	Registration with Superintendancy required	All MFIs to register with NBE – unlicensed microfinance activity illegal	Bank of Ghana license required	SBS license, securities agency registration required to access equity market, Transition period for fully-regulated status	BSP license required	Bank of Uganda license for: credit plus time deposits and/or savings
Institutional form, ownership	Corporate	Share company, 100% Ethiopian-owned	Corporate	Corporate	Stock corporation, 100% Filipino-owned	Corporate; acquisition of 10% or more of MDI shares subject to Bank of Uganda review; max single holding of MDI shares = 20% unless by financial inst and approved by BOU
Competition/ Consumer protection	Unknown	Unknown	Procedures for deposit-taking (applications & receipts), disclosures in ads for deposits defined	Unknown	BSP regulates micro credit interest rates, may regulate terms of other credits Rules on prepayment, amortization, foreclosure	Unknown
Operational rules	Unknown	Floor on deposit interest rate = 6%, Loan interest rate controls repealed	Bank of Ghana can issue “directions” on interest rates, de-license for “undesirable” methods	SBS Authorization needed to open branches	BSP may prescribe loan rates, maturities, security requirements Operating hours: min. 6 hours per working day, notice to BSP if open on non-working days	TBD

3.f. Qualitative Indicators for Entry, Graduation						
	Bolivia PFFs	Ethiopia MFIs	Ghana NBFIs (deposit- taking)	Peru EDPYMEs	Philippines Rural Banks	Uganda MDIs (proposed)
Size/Self-sufficiency of institution/portfolio	N.A.	Re-registration required when savings = \$125,000	N.A.	N.A.	N.A.	Number of members (TBD) in member-based inst determines whether it is subject to regulation.
Quality of personnel, owners	Management required to have experience in microfinance	CEO must have university degree & 3 years' experience	Bank of Ghana may replace NBFi board if deemed acting Improperly	Unknown	Directors and officers must be "fit and proper" No public officials as officers of private banks (unless public funding provided)	Operators, Board members must be "fit and proper," trustworthy, experienced, qualified, have adequate resources
Feasibility study/business plan	Unknown	Corporate documents, business plan	Unknown	Feasibility study, market survey in proposed area of operation, 3 years' financial projections required	Unknown	Detailed feasibility study required

Sources for Table 3: *Bolivia*: Decreto Supremo no. 24000 of 1995, Resolucion SB no. 0071/96, Trigo (1997), Rock (1997), Jansson and Wenner (1997), FONDESIF/GTZ (2001); *Ethiopia*: Proclamation no. 40 of 1996, Directives MFI/11/98 and MFI/12/98; *Ghana*: Banking Law of 1989, Financial Institutions (Non-Banking) Law of 1993, Non-Bank Financial Institutions Rules (2000), Gallardo (2001); *Peru*: Rock and Otero (1997), CGAP (2000); *The Philippines*: The Rural Bank Act (no. 7353) of 1992, The General Banking Law (no. 8791) of 2000, Gallardo (2001), Gomez et al (2000), Montemayor (1997), Luang and Vasquez (1997); *Uganda*: The Micro Deposit-Taking Institutions Bill, 2001.

Institutions That Are Not Directly Supervised

This sub-section presents examples of microfinance regulatory systems involving oversight by non-governmental entities. Included here are cases where the banking regulator delegates supervisory tasks (Indonesia, Peru, West Africa), creditors or funding agencies set and supervise quasi-regulatory standards for their borrower MFIs (Bangladesh, the Philippines), a non-governmental regulator applies non-prudential rules (South Africa), or the MFIs agree to “self-regulation” by an association (the Philippines). The indirect nature of regulation and supervision in these cases means, in effect, that there is no prudential oversight. In most of these cases, some (non-governmental) body is supervising the institutions described – but *government* is not vouching for the soundness of these institutions by supervising them itself. The key regulatory issues arising in all these cases are summarized in a series of comparative tables at the end of this section, and a complete presentation of the cases appears in the Annex.

Bangladesh: PKSF Network

Bangladesh does not have a tier of rural banks or similar regulated institutions providing credit to the lower end of the market, nor does its uncompetitive commercial banking sector serve this segment. Microfinance providers in Bangladesh have had considerable freedom to operate – and innovate -- free from regulatory intervention, due to a combination of official tolerance and incapacity mixed with extremely high levels of donor funding and protection. MFIs are not subject to any official standards or prudential requirements. Entities engaged in microfinance are registered in an assortment of forms under various laws and regulatory structures. (Carpenter 1997) The legal/regulatory framework does not seriously contemplate market-oriented MFI operations. Most MFIs admit to being out of compliance with applicable rules by virtue of their credit operations, and indeed resist any form of regulation. (Cracknell 2000)

An important part of the environment in Bangladesh is the Palli Karma Sahayak Foundation (PKSF), the government-sponsored apex institution created in 1990 to on-lend funds from government and international agencies on highly concessional terms to NGOs engaged in microfinance. PKSF plays a quasi-regulatory role in holding NGO-MFIs to certain performance criteria as a condition for its credits. These include: encouragement to recover at least recurring administrative and funding costs from interest income, a minimum interest rate of 16% (to promote cost recovery and prevent lending at below-commercial rates), and encouragement of MFIs with outside funding sources to set aside reserves. Further, PKSF requires MFIs to provide savings services to members, and to keep most savings in a bank – with only the highest-rated MFIs being allowed to use the savings in credit programs. (McGuire et al 1998)

Since its establishment in 1990, PKSF has disbursed \$140 million in loans, and partner MFIs have used this support to extend a total of \$411 million in loans to clients (Ahmed 1999) One observer suggests that the success of PKSF is due to peculiar circumstances that are not replicated in most other countries. These include its location in a very large and developed microfinance market, and its access to plentiful funds at

concessional rates, which allowed it to retain substantial sums as capital. (Gonzalez-Vega 1998) One could also argue that donor protection of microfinance institutions in Bangladesh ensures that PKSF will continue to be successful.

Indonesia: Variety of MFIs

Indonesia has supported financial deepening through a number of strategies. It has a vast array of formal MFIs – some 15,000 by one estimate – in addition to hundreds of thousands of informals. Out of this entire number, only some 1,000 privately owned MFIs are directly regulated by the central bank, *Bank Indonesia* (BI). Best known is the *unit desa* network. These units, now small local banking offices numbering more than 3,700, were originally part of a subsidized agricultural credit program run by *Bank Rakyat Indonesia* (BRI), a state commercial bank. In 1983, they were transformed into full service rural banks operating under BRI – thereby forming the largest microfinance network in the world. The unit desa have some 23 million depositors and borrowers with total loans (ranging in size up to U.S. \$2,500) of close to U.S. \$500 billion. (Berenbach 1997, McGuire 1998) The BRI unit desa system is almost universally considered a huge success.

The unit desa system is subject to a hybrid form of regulation, in which BRI is authorized by Bank Indonesia to supervise the unit desa by means of personnel based in its branch network and regional audit offices. The Village Unit Division of BRI, which runs the unit desa system, is separate and independent of BRI's large commercial banking network. Pricing policies are set for the whole unit desa network, but each unit is treated as a profit center and has a separately generated and examined balance sheet. BRI provides an incentive for high performance by conducting a semi-annual achievement contest among the units, with the winner receiving cash prizes along with recognition. (Hannig and Katimbo-Mugwanya 2000, Rhyne and Christen 2000) Interestingly, the BRI unit desa network weathered the recent East Asian crisis much better than other financial institutions in Indonesia. (CGAP 2000)

Indonesia also has a second tier of institutions recognized under the Banking Law of 1992, the small-holder credit banks (*Bank Perkreditan Rakyat*, BPR), which are small limited-charter institutions with very low minimum capital (until recently, \$5,000). The BPRs number over 2,400 and have total loans outstanding of about \$200 million. While Bank Indonesia has the power to supervise them, it delegates most of this function to the Provincial Development Banks. Unlike commercial banks, the BPRs have no access to the payment system and can offer only savings and time deposits, not demand deposits. Beyond the BPRs, there are thousands of other formal MFIs. The largest single category is that of the village-owned bank (*Badan Kredit Desa*, BKD), numbering 5,435. The BKDs are much smaller than the BRI *unit desa*, with lower average loan amounts and savings. BKDs as such have limited deposit-taking authority, taking only passbook savings in their local village areas. Bank Indonesia has delegated supervision over these entities to BRI. The BKDs pay the supervisory costs, based on BRI's annual budget for this function, historically about 25% of BKD operating costs. (Berenbach 1997,

McGuire et al 1998, Bank Indonesia and GTZ 2000, CGAP 2000, Hannig and Katimbo-Mugwanya 2000, Rhyne and Christen 2000).

In an effort to rationalize the regulation of non-bank MFIs, Indonesia is now in the process of developing a microfinance law. The Draft Act Concerning Microfinance provides a regulatory structure for BKPs, LDKPs, and NGOs (but not cooperatives) engaged in microfinance, which is defined as mobilization of funds and provision of small loans primarily to low-income persons and groups engaged in microenterprise. The draft act requires registration and compliance by all MFIs that have mobilized aggregate funds in excess of \$5,000 – this includes all savings, both public deposits (including term deposits) and member savings. MFIs that mobilize funds in excess of \$100,000 must obtain a small-holder credit bank (BPR) license. MFIs must be wholly Indonesian-owned (and entirely Indonesian-staffed), whether by individuals (minimum number per MFI: 20), companies, associations, or local governments – once again, the economic rationale for this is questionable. The supervising institution for MFIs (not named in the draft) may delegate both licensing and supervision of MFIs to provincial governors, commercial banks, or others.

Peru: CMACs

Peru first undertook the regulation and supervision of small financial services providers when it enacted legislation in 1980 creating the *Caja Municipal de Ahorro y Credito* (CMAC) framework. In the early 1990s, Peru extended this framework with decrees creating a rural version of the CMAC (CRAC) and the EDPYME (see above). The CMACs were intended (a) to provide financial services to persons and enterprises without access to formal financial intermediaries, and (b) to decentralize financial intermediation and thereby counteract the flow of funds from rural areas to the capital. Initially, the CMACs financed their lending with capital from provincial governments and depositors, but were permitted by a 1990 decree to access national and international capital markets. They had a total credit portfolio of approximately \$160 million in the mid-1990s. (Rock 1997)

The Federation of CMACs, FEPCMAC, was established in 1983 as an independent public coordinating body for the CMACs, housed in the Ministry of Finance and Industry. The Federation not only acts as an apex, channeling investment and donor funds to CMACs and providing training, but also handles supervisory functions delegated by the Peruvian Banking and Insurance Supervision (SBS). The CMACs pay monthly membership dues to the Federation, which covers some of the cost of supervision (the rest being funded by donors). (Rock 1997) This system proved effective for several years, although more recently the unavailability of external funds has ushered in some problems, and corruption allegations at FEPCMAC have exposed the need for SBS oversight of the Federation. (Staschen 1999)

*Philippines: NGO-MFIs*¹⁰

The Philippines has a range of regulated banks and NBFIs. NGOs providing microcredit operate outside this framework and are not permitted to accept deposits from the public. They do take member deposits, although this is not clearly permitted under banking legislation. This segment of the financial services market is thus not regulated by the state as such. Instead, systems of self-regulation have emerged, which involve oversight by NGO-MFI associations and apex financing bodies as well as efforts to define governance standards across this market segment.

The People's Credit and Finance Corporation (PCFC), a government-owned finance company, plays the leading role in intermediating concessional state and especially international agency funds destined for microfinance – specifically, for MFIs using the Grameen approach. As an NBFIs, the PCFC reports to the central bank but is not supervised by it. It also provides technical and training support for MFIs, and also serves some credit cooperatives. PCFC imposes a set of conditions and performance standards on MFIs receiving lines of credit from it. PCFC also sets minimum performance standards for accredited MFIs in the start-up, intermediate, and advanced stages of development.

In addition, two main networks of MFIs, APPEND (the Association of Philippine Partners in Enterprise Development) and PHILNET (a group of MFIs engaged in Grameen replication) provide a structure for self-regulation, along with the usual funding, coordination, and training service traditionally offered by such networks. The credit cooperative federations have their own internal regulatory schemes and deposit guarantees, some of which may be opened on a wider basis. Last, there are some initiatives to develop generally applicable standards and policies for microfinance. One such is an effort by the Microfinance Coalition for Standards (MCS, the outcome of a USAID project) to survey the sector, document best practice, develop benchmarks, and facilitate training and dialogue. The Coalition's standards deal with institutions' changing performance over time, comparison to industry performance overall, meeting best practice benchmarks, and meeting of the institution's own performance targets.

South Africa: Microlenders

South Africa's Micro Finance Regulatory Council (MFRC) was established as an authorized regulatory institution under a 1999 exemption to the Usury Act. The Exemption Notice defines the category of exempt moneylending transactions as those not exceeding 10,000 rand (approximately U.S. \$1,000), payable within 36 months, and excluding credit card schemes or overdrafts on a checking account. Lenders are required to register with an authorized regulatory institution (in this case, the MFRC), and to comply with the Notice rules, in order to be exempt from the Usury Act interest rate caps.

¹⁰ Source: McGuire et al (1998)

MFIs operating under the Exemption notice are credit-only, and not authorized to accept retail or wholesale deposits. As such, they are not required to meet prudential ratios. On the other hand, they are required to report on a regular basis to the MFRC, which checks their adherence to management and consumer protection standards, responds to complaints, and reports to government and the public. Outside auditors (accounting firms under contract) are used for annual on-site inspections, and quarterly returns and reporting of credit data to a national registry are also required. These rules and procedures aim to regularize and legitimize for-profit microcredit services, to balance the rights of the parties, and in doing so, to promote a sustainable microfinance sector. The MFRC, although it does not have formal powers over unregistered lenders, has sought them out on its own initiative. It also offers provisional registration as a transition path to formalization.

The MFRC regulatory regime has created an environment in which a range of large and small lenders have an interest in extending finance to the low-income market. This has led to product innovation across a broad front, including housing and SMME finance, development of better savings products, and an expanding network of financial services accessible to low-income groups. MFRC has registered 1,334 institutions with a total of 5,051 branches as of the end 2001, and these entities have gross microloans outstanding of approximately \$1.6 billion.

UEMOA: Mutual MFIs

In 1996, the eight countries of the *Union Economique et Monetaire Ouest Africaine* (Benin, Burkina Faso, Ivory Coast, Mali, Niger, Senegal, Togo, Guinea-Bissau) agreed to a common approach to the regulatory framework for MFIs, to be developed under the aegis of the regional central bank, BCEAO. This initiative, the *Projet d'Appui a la Reglementation sur les Mutuelles d'Epargne et de Credit* (PARMEC), uses a mutualist or cooperative model. The law's requirements of a mutual structure and the accommodation of local interest rate regulations are the two most obvious weaknesses of the law, although it has other more useful features.

Apparently, the intention behind the regional PARMEC law was to bring all MFIs under this regulatory structure. Thus, credit institutions that do not either conform to PARMEC standards, register under the banking laws, conclude a special agreement with the Ministry of Finance, or fall into the exclusion for informals can face sanctions including criminal sentences. (Staschen 1999) NGO microfinance programs, among others, would run afoul of the law. The mutuals designated in the PARMEC law, along with their unions, federations, etc. are subject to the regulatory authority of BCEAO, and to the supervision and prior approval authority of the national Ministry of Finance.

An interesting feature of the law is its provision for hierarchical supervision and control by mutuals and their unions and federations – i.e. a form of hybrid supervision. Each higher level has internal supervision and control requirements over the lower level, conducts audits, and represents the lower-order entities at the next higher level. Each lower-level entity can belong to only one higher-level entity. At the pinnacle of this

hierarchy are *organes financiers*, which can be formed by networks of mutual institutions. These manage the surplus funds of their members, receive deposits, issue negotiable instruments, and are directly supervised by the central bank and banking commission. The text of the law clearly envisions and facilitates a division of supervisory tasks between the MOF and the mutualist networks – such that the latter could take on most of these functions as a self-regulatory organization. One observer suggests that direct oversight by the ministries of finance in the UEMOA countries, rather than actual delegation to the mutualist networks, has all too often been the pattern in practice. (Staschen 1999) On the other hand, self-regulation, notably in the cooperative sector, has repeatedly succumbed to conflicts of interest.

Table 4: Microfinance Institutions That Are Not Directly Supervised

<i>4.a. General Approach</i>						
	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO-MFIs	South Africa Microlenders	UEMOA Mutuals
Financial Sector Tiering	Banks, NBFIs, largely unregulated MFIs	Banks: commercial (includes BRI unit desa), small-holder (BPRs), NBFIs: leasing cos, BKDs, LDKPs, NGOs	See Table 3	See Table 3	Universal and commercial banks, Mutual Banks, regulated MFIs, informals	Entities recognized: mutualist institutions, their unions, federations, and apex organs
Definition of microfinance	None	Generally defined by loan amount ceilings, self-selected clientele Draft MFI law: mobiliz. of funds, small loans primarily to low-income persons/groups engaged in microenterprise	Financial services for persons and enterprises without access to formal financial intermediaries	See Table 3	Loans under approx. \$1,200, payable within 36 mo.	Mutual savings and credit
Regulatory Body for MFIs	PKSF supervising its MFI borrowers	Private BPRs: Bank Indonesia (BI) Unit desa, BKDs: BI, supervision by BRI LDKPs: Ministry of Finance, with supervision delegated to Provincial Development Banks MFIs under draft MFI law: regulator TBD, delegation authorized	Banking Supervision (SBS) NBFIs department, with most oversight delegated to CMAC Federation (FEPCMAC)	Funding agency supervision: PCFC Self-regulation: APPEND & PHILNET Standards: NCC, MCS, NATCCO	Microfinance Regulatory Council (MFRC) or other authorized regulatory institution for all MFIs within Usury Act exemption	Central Bank of West African States (BCEAO), Ministries of Finance, Delegation of some supervisory functions to mutualist networks envisioned – and network membership required
MFIs subject to regulation	PKSF: partner MFIs only Most MFIs unregulated	All formal MFIs (some must convert to BPRs) Informals not regulated in practice Draft MFI law: exempt if mobilize < \$5,000 funds	See Table 3	See Table 1	All MFIs Small informals not regulated in practice	All, but small informals exempt

4.b. Reporting and Supervision

	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO- MFIs	South Africa Microlenders	UEMOA Mutuals
Supervision Method	Field visits quarterly for each MFI, annual PKSF and external audits	Unit desa: Unit managers at BRI branches conduct weekly on-site visits and review reports BPRs: CAMEL system prompts on-site inspections LDKPs: annual on-site visit, insts classified by risk for early warning	Formal annual audit by SBS, audits and regular monitoring by FEPCMAC	PCFC: delegated supervision Other: MFI networks monitor adherence to standards	Authorized regulatory inst (e.g. MFRC) supervises MFI adherence to standards of management & consumer protection, deals with complaints, gathers & publishes information on the industry, makes annual report to Minister of Trade & Industry; MFRC does inspections using outside auditors	Intervention on own initiative by BCEAO or West African Banking Commission, Special supervision department of MOF (supervision & direct administration if necessary), Concurrent or delegated supervision by unions, federations and apex organs
Costs of Supervision	Unknown	Unit desa: An operating cost of BRI BKDs: fees to BRI = 25% operating costs	Licensing fees, plus CMAC dues to federation	Unknown	Authorized regulatory inst (MFRC) funded by fees from MFIs	Depends on country and mutualist federation
Disclosure and reporting	Monthly and cumulative income, expenditure, and cash flow statements; lists of borrowers	Unit desa reports: Daily trial balance; Weekly liquidity report; Monthly progress report, balance sheet, income statement; Quarterly personnel report; Semi-annual contest indicators report; Annual balance sheet, income statement	Reports: daily (interest rates), semi-monthly (reserves), monthly (financial statement, equity, assets, principal debtors), thrice yearly (debt quality), annual financials	Unknown	Annual audit report and re-registration, Quarterly statistical returns, On-site record-keeping requirements, Reporting of credit data to National Loans Register	Annual reports to MOF, Reports of federations & apex organs also must be audited and sent to BCEAO & West African Banking Commission
Deposit Insurance/ Lender of Last Resort	Largely foreign donors	Deposit protection for commercial banks and BPRs Draft MFI law: compulsory membership in MFI support scheme	Unknown	Unknown	N.A.	Depends on country and mutualist federation

4.c. Capital and Reserves

	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO-MFIs	South Africa Microlenders	UEMOA Mutuals
Minimum capital	\$240,000 (large MFIs, World Bank program)	BPRs: approx. \$200,000 in capital region, \$100,000 in provincial capitals, \$50,000 elsewhere	\$265,000	Working capital of at least \$10,000 (PCFC)	Depends on organizational registration	Varies by country and mutualist federation
Minimum capital adequacy/ gearing ratio	Large MFIs, World Bank program: 40%, i.e. max. debt-equity ratio = 2.5:1	BPRs: 8% risk assets Risk-weighting higher for unsecured loans	None	None	None	50%, i.e. max value of outstanding loan/investment portfolio = 2 X value of members' savings (excluding risks covered by donor funds)
Loan loss provisioning, write-off	Past due: 50% One year past due: 100% (proposed rules under World Bank program)	BPRs (monthly installments, value net of collateral): > 90 days overdue: 10% > 180 days: 50% Loss: 100% Unit desa: < 3 mo overdue: 50% > 3 mo overdue: 100% > 12 mo overdue: write off	Microcredits treated as consumer loans: 9-30 days past due: 3% 31-60 days past due: 30% 61-120 days past due: 60% 120 days or more: 100%	Unknown	N.A.	Varies by country and mutualist federation
Reserves, liquidity management	PKSF encourages MFIs with outside funding to set aside reserves	BPRs: Liquid deposits = 5% assets	Unknown	Unknown	N.A.	15% net surplus annually goes to general reserve Short term assets must = 80% short term liabilities

4.d. Business and Risk Management Guidelines

	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO-MFIs	South Africa Microlenders	UEMOA Mutuals
Guidelines/restrictions on business activities	Savings programs required/encouraged, most savings to be deposited in bank, largest MFIs may on-lend savings	NBFIs may not accept deposits without prior authorization Draft MFI law: deposits permitted for registered MFIs, but no demand deposits, forex operations, loans to other MFIs	Permitted: Savings, term, pension & current accounts (no checking); pawn, personal, business loans; bill payment and forex operations Phasing: Savings and pawn loans permitted in 1 st year, phase-in microenterprise loans in 3 rd year	No deposits from the public	No retail or wholesale deposits Max. loan = approx. \$1,200 Max. repayment term = 36 mo. No retention of bank card & PIN number	Permitted: savings & credit, transfers No checking, Other activities with prior MOF approval
Concentration of risk, Limits on related/insider business			Max. credits to related parties: 7.5% net effective equity; directors/employees: 7%			Equity investment limited to 5% of loan portfolio Max loan to individual = 20% member deposits (excluding risks covered by donor funds) Max loan to a director = 10% value of member deposits (excluding risks covered by donor funds)

4.e. Entry, Rules of Operation

	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO-MFIs	South Africa Microlenders	UEMOA Mutuals
Registration/Licensing	None In practice, member MFIs must have a legal form	Registration with BI for banks, Ministry of Finance for NBFIs Draft MFI law: MFI registration if mobilize funds > \$5,000, BPR registration if mobilize funds > \$100,000	SBS registration required	Registration with SEC, BSP, or CDA (PCFC)	Registration with authorized regulatory institution (e.g. MFRC) required – or Usury Act applies, MFRC can give provisional registration	Registration with Ministry of Finance required
Institutional form, ownership		Draft MFI law: all MFIs to be 100% Indonesian owned	Originally state (province) – owned, transition to private corporation	Corporate, non-profit, or cooperative	Company, cooperative, trust, NGO, mutual bank, or bank	Mutual only
Competition, Consumer protection, Operational rules	Minimum interest rate (MFIs-clients): 16%	BRI sets prices and procedures for unit desa and BKDs Draft MFI law: branching requires Supervisor approval	Unknown	Standards set by MFI networks	Loan term disclosure rules, fee regulations, cooling-off period, limits on collection methods	Institutions must comply with local usury laws

4.f. Qualitative Indicators for Entry, Graduation						
	Bangladesh PKSF Network	Indonesia MFIs	Peru CMACs	Philippines NGO-MFIs	South Africa Microlenders	UEMOA Mutuals
Size/Self-sufficiency of institution/portfolio	PKSF requires min. 400 clients, in savings groups; Requires min. 95% recovery for new MFIs, 98% for older MFIs; Encourages recovery of at least recurring costs and funding these from interest income	Draft MFI law: > \$5,000 funds mobilized requires MFI license, >\$100,000 requires BPR license	N.A.	3-year track record, good credit record, effective systems in place (PCFC) Performance trends, industry comparison, benchmarks, internal targets (MCS) Standards for MFIs (startup, intermediate, advanced): Cost recovery: 50%, 75%, 100% Outreach: 500, 1,500, 5,000 Collection rate: 90%, 95%, >98% (PCFC)	N.A.	N.A.
Quality of personnel, owners Feasibility study/business plan		Draft MFI law: management experience in microfinance and business plan required for registration			Officers and staff not convicted of crimes or de-registered as lender	Assessment of human, financial, tech. resources, Financial plan for first year

Sources for Table 4: *Bangladesh*: Carpenter (1997), McGuire et al (1998), Cracknell (2000), www.pksf-bd.org; *Indonesia*: Berenbach (1997), Hannig and Katimbo-Mugwanya (2000), Rhyne and Christen (2000), Bank Indonesia and GTZ (2000), Draft Act Concerning Microfinance, 2002; *Peru*: Rock (1997); *Philippines*: McGuire et al (1998), ADB (2001); *South Africa*: Exemption Notice to the Usury Act, 1999, Meagher and Wilkinson (2001); *UEMOA*: CONVENTION-CADRE DEVANT RÉGIR LES STRUCTURES OU ORGANISATIONS NON CONSTITUÉES SOUS FORME MUTUALISTE OU COOPÉRATIVE ET AYANT POUR OBJET LA COLLECTE DE L'ÉPARGNE ET/OU L'OCTROI DE CRÉDIT, adopted by the UMOA Council of Ministers, July 3, 1996. PROJET DE LOI PORTANT REGLEMENTATION DES INSTITUTIONS MUTUALISTES OU COOPERATIVES D'EPARGNE ET DE CREDIT, December 30, 1993. PROJET DE DECRET D'APPLICATION DE LA LOI PORTANT REGLEMENTATION DES INSTITUTIONS MUTUALISTES OU COOPERATIVES D'EPARGNE ET DE CREDIT, December 30, 1993.

4. Analysis and Conclusions

What lessons should policymakers draw from the varied experience of microfinance regulation across the developing countries? In this field, the available analytical tools do not enable us to generate a detailed set of regulatory guidelines to use, based on universal criteria. As in most policy arenas, the actual framework to be applied will arise from various sources, including not only the decision-maker's interpretation of best practice, but also the actual set of policy priorities currently in play, and one's understanding of the evolving microfinance market in a given country – based on less than complete information. With this caveat in mind, we discuss in this section those findings from the above review that appear to have general application.

Tiering

Most obviously, financial policymakers confront the question of whether and how to amend a structure of financial services tiers (“windows”). In part 2, we discussed two important observations on this point – first, that tiering is most effective when based on the types of liabilities or funding sources used by the institution (Van Greuning et al 1999), and second, that the creation of regulatory tiers should be done (if at all) parsimoniously, in close relation to actual developments in the market (CGAP 2000). These two principles contain a number of subsidiary points. Regulation and supervision are expensive, subject to a host of principal-agent failures such as corruption, and tend to be of uneven quality and limited supply in most countries. The capacity to create and administer regulatory frameworks effectively is particularly scarce in developing countries. Regulation and supervision should be used sparingly, hence carefully focused on high priorities. This means deploying them in the areas with the highest payoffs in terms of systemic risk mitigation, protection of depositors, efficient intermediation, and responsible growth. Setting up tiered systems is usually an important aspect of this. However, there is always a danger of overreaching here, pushing the market too hard by extending state guarantees to a host of market niches through a proliferation of regulatory windows.

The systems reviewed in this paper have taken diverse approaches to the design of financial sector tiers. Some (e.g. Peru) have formalized a large number of tiers while others (e.g. Bangladesh) have kept these tiers to a minimum while facilitating the growth of MFIs within evolving frameworks of private and self-regulation. Most formal tiering systems are designed so that regulation tightens and supervision intensifies as institutions draw on public deposits and potentially impinge on the payments system. Ethiopia, Ghana, and Peru have to some extent violated this principle by bringing credit-only institutions under direct supervision. However, these systems clearly allow for differential treatment in a way that keeps the strongest emphasis on deposit-taking institutions. The question that critics have raised is whether the costs of taking responsibility over non-depository institutions are outweighed by the benefits of helping stabilize the microfinance market and providing a graduation path toward deposit-taking. Ethiopia clearly does not have the capacity to do this effectively, and Ghana has had problems as well. Peru appears to have handled this much better, with the EDPYME tier

serving as a regulatory transition point for NGOs coming into the system and eventually being authorized to take deposits. Clearly in each of these cases the tiers are limited in number, with three or four levels, to prevent confusion and costly transitions.

Who Regulates and How

Closely related to the questions of tiering and supervisory focus is the issue of how labor is divided in the system. The questions here are who is regulated, what entities handle the regulating and supervising, and what kind of regulation is applied. Most of the systems reviewed here have found ways to exclude the smallest institutions for which regulation makes little sense – through either formal or informal exemptions. In almost all countries small informals and traditional rotating and credit associations are exempt *de jure* or *de facto* (the latter case is usually referred to as “regulatory forbearance”). This standard protects regulators from unreasonable burdens.

Bolivia, Ethiopia, and UEMOA appear to take the most directive approach in principle, allowing no formal exemptions. Bolivia appears to make this workable through a combination of encouraging downward integration of banks and NBFIs into the microfinance market, and implicit toleration of informals. Ethiopia simply cannot and therefore does not in fact apply its regulatory system to many of the entities envisioned in its law, and the UEMOA system is meeting resistance and capacity constraints. Using regulatory forbearance instead of explicit exemptions is less than ideal, given the potential uncertainty this creates – but may be the only near-term option in some systems.

A useful response to this disparity between the scale of the microfinance market and the real limits on regulatory policy and capacity, has been the development of hybrid and self-regulation systems. This paper has reviewed six diverse examples of alternatives to central bank/supervisor regulation. These other options range from the combination of apex oversight and self-regulation used for NGO-MFIs in Bangladesh and the Philippines to the varied systems of shared oversight in the other countries, which involve centrally-determined regulatory standards and supervision by other entities. The entities include federations of MFIs (in Peru and UEMOA), financial institutions that are parent companies of MFI networks or delegated supervisors (Indonesia and UEMOA), and authorized private regulators in systems where MFI registration with such an entity is mandatory (South Africa). Experience has been varied, with delegated supervision achieving good results, creditor and apex oversight leading to mixed outcomes, and self-regulation performing worst. These outcomes are to be expected, although they are neither fully consistent nor inevitable – for example, a capable apex might perform better than a badly designed scheme of hybrid regulation and supervision.

Another influence on the quality of regulation and supervision is the system’s ability to cover its costs. We have previously cited analyses showing the costs of entry, compliance, and supervision. Provided entry and compliance costs are kept at reasonable levels, a microfinance market of significant scale can support the costs of supervision – and these will not be trivial, as supervision cannot be done both well and cheaply. The example of supervision costs in Peru suggests that MFIs could cover these costs with rate

increases that the market could bear. Supervisors in emergent markets must be ready to absorb some of the supervision costs of the microfinance sector, and thus to tailor their approach to the nascent nature of the market (and its consequent lower systemic risks.)

As to what kind of oversight is provided, whether by financial regulators directly or by others, it is important to keep in mind the distinction between prudential regulation and supervision, and other kinds of regulation. Prudential oversight places the supervisor in the position of vouching for the safety and soundness of the system, thus requiring the supervisor to make this credible through functioning systems of reporting and inspection. This is classically a public good, but is one that has been handled well by delegation – as in the case of BRI, especially with respect to the unit desa network. Here, the central bank (or other supreme financial regulator) makes the rules but acknowledges the impossibility of directly supervising thousands of MFIs, handing this over to an entity with the systems and incentives in place to keep the system sound (again, this applies mostly to the unit desa, much less so to the BPRs overseen by BRI).

At the far extreme of delegation – not really delegation at all – is oversight by apex creditors and self-regulation. Here, the bank supervisors do not vouch for the system, leaving this to the apexes and associations. The apexes (if not governed by microfinance market players) have more consistent incentives in this regard, since they are not lobbyists for the MFIs that they oversee, and have a creditor's interest in ensuring sound portfolios. One could compare this to situations where non-bank finance companies are not supervised, but can only fund themselves through investments and wholesale deposit-equivalents. In this case, the fund providers are not dispersed small depositors but investors and banks who can be assumed to have an ability to safeguard their investments on their own, provided that disclosure and other securities regulation norms are met.

Another configuration is for government to hive off a range of non-prudential regulatory concerns, making other official or private bodies responsible. This is frequently the treatment given to NBFIs that do not accept retail deposits – they might be subject to registration with the financial authorities, and perhaps some reporting requirements as well, but not full prudential supervision. The NBFIs would also be subject to registration with the securities commission if publicly owned (or issuing debt securities), and to regulations dealing with consumer protection, consumer credit, and credit reporting that are enforced by some or all of the following: financial regulators, consumer agencies, and attorneys general. This is often the case in industrial and developing countries. One developing country case of this in the microfinance area is that of South Africa's Microfinance Regulatory Council. The MFRC is a financial regulator, but one that deals only with non-prudential regulation – mainly transparency and consumer protection rules – of non-depository MFIs. It has clearly helped ensure sound practice and stability in the microcredit market, and it can now sustain itself through licensing and supervision fees. It is equally clear that not every microfinance market has the scale and capitalization of the South African market, hence could afford a self-sustaining private regulator like the MFRC at this point.

Market Definition and Entry

A further set of issues related to the policy concern about allocating regulatory power and delimiting the field of regulation is the control of entry. There are two aspects of this: the definition of the regulated activity or market (microfinance) and the rules governing admission to regulated status and mandatory licensing. The countries reviewed in this paper have addressed these issues in diverse ways. Table 5 below presents some comparative data on this area – including market definition, minimum capital requirements, and figures on economic and financial sector (including microfinance) development. The data are suggestive but do not provide clear guidelines for market definition and entry rules based on economic and financial services market indicators.

Some systems define microfinance in terms of maximum loan size, with the highest being \$1,400 in Ghana for loans with group guarantees. Others define it more loosely as serving low-income groups or microenterprises, a definition that appears to leave matters to the discretion of regulators and in part to self-selection by financial institutions. Peru defines microenterprises in terms of asset value – a useful objective criterion, but one that would be difficult to administer in most developing countries. These definitions have no obvious connection in practice with factors such as per capita income, population, poverty, or the reach of the banking system. Microfinance definitions address a range of policy priorities, such as reaching the unbanked, or reaching the poor, or serving microenterprises. The risk in not defining the market closely is that regulatory arbitrage may well occur, particularly if (as seems likely) entry costs or supervisory rules are looser for microfinance institutions than they are for other NBFIs. Accordingly, loan size restrictions in terms of a multiple of per-capita income may be sensible, since it will allow MFIs to grow as the economy expands.

Other entry requirements, such as minimum capital and the various implicit costs of bringing the institution into compliance, reflect a similar range of policy choices. Of the group reviewed, Ghana is now the most restrictive, with a \$2.1 million minimum capital requirement for new deposit-taking NBFIs (although the requirements for existing institutions are much lower), and Bolivia is next with a \$1 million requirement and high additional costs of compliance. At the other extreme are Ethiopia, with MFI minimum capital set at \$25,000, and the Philippines, with a level of \$10,000 required of NGO-MFIs by the governmental refinance company (PCFC). Once again, neither income levels nor the size of the market obviously dictate these levels. Rather, they reflect policy decisions about what types of institutions should be licensed and regulated, whom they are to serve, and what the appropriate scale and concentration of the providers might be (presumably with some expectation about intensity of competition and likely exit). Tailoring these provisions as finely as possible to local markets suggests that the approach of varying minimum capital by region (as in case of quasi-banks in the Philippines and Indonesia) might be the best approach – at least in large, diverse markets with the likelihood of local investment and startup at an early stage.

Table 5: Cross-Country Comparison of Economic Indicators and Microfinance Sectors

	PPP gross national income per capita (2000)	Population, and percentage with income under \$2 per day (1990s)	Domestic credit from banks as share of GDP (2000)	Definition of microfinance	Minimum capital for MFIs	Microfinance clientele	Total microfinance portfolio
Bangladesh	\$1,650	130 million 77%	34.8%		\$240,000 for large MFIs (World Bank)	8-9 million	Approx. \$450 million (Grameen and PKSF network)
Bolivia	\$2,380	8 million 51.4%	63.2%	Loans under \$500	\$1 million	104,000 (PFFs)	\$105 million (PFFs)
Ethiopia	\$660	64 million 76.4%	63.3%	Loans \$625 or less, esp. marginal farmers	\$25,000	500,000	\$34 million
Ghana	\$1,940	19 million 74.6%	38.7%	Loans up to \$140, \$1,400 with group guarantee	Old: \$140,000, \$70,000 non-depositary New: \$2.1 mill, \$1.4 mill non-depositary		\$8.9 million (rural banks)
Indonesia	\$2,480	210 million 55.3%	66.2%	Small loans to low-income persons/micro-enterprises	\$50,000 to \$200,000 (BPRs)	23 million (BRI unit desa network)	\$700 million (unit desa and BPRs)
Peru	\$4,720	26 million 41.4%	26.2%	Finance for those without access to formal system, microenterprises (assets under \$20,000)	\$256,000		Approx. \$160 million (CMACs)
Philippines	\$4,220	76 million	62.9%	Services to farmers, fishermen, merchants with small cash needs	\$50,000 to \$500,000 (rural banks)	500,000 (rural banks)	\$1.04 billion (rural banks)
South Africa	\$9,180	43 million 35.8%	76.6%	Loans under \$1,200, payable within 36 mo.	None; institutional form rules apply		\$1.6 billion (MFRC microlenders)
Uganda	\$1,230	22 million	12.1%	Services to micro-enterprises and low-income households	\$400,000		

Source: World Bank (2002), Tables 3 and 4 *supra*.

Tailoring Norms and Systems

The actual prudential norms and the reporting and supervision systems in use need to be well-adapted to the lending methodologies used by the regulated MFIs. Many systems use essentially the same Basel-based capital adequacy standards as banks, while others (e.g. Uganda, UEMOA) apply requirements of up to 50% for MFIs. Similarly, while risk-weighting is sometimes adjusted to account for the safety of many microcredit techniques, reserve requirements are often kept much higher than bank levels (e.g. Ghana and UEMOA). Obviously, tighter policies in these areas raise costs and potentially dampen competition, but they aim to achieve the offsetting benefit of enhancing safety and soundness in the system. Whether the policies achieve this aim depends on the quality of internal information and risk management in the MFIs, and on the reliability of their financial reports to the supervisors.

In similar fashion, reports, supervision visits, and provisioning need to be scheduled in ways that align with the repayment cycles of micro loans. These measures are also costly, but are needed to deal with the realities of microcredit portfolios and their potential volatility. Approaches to reporting and inspection range from being similar to those used for commercial banking (e.g. Bolivia and Ghana) to the systems used in the BRI unit desa network in Indonesia – i.e. daily reports and weekly visits (feasible because these do not involve the central bank). It is less clear in most cases that portfolio sampling methods used in inspections are appropriate for microfinance. Also, provisioning schedules in most systems reviewed here are tailored to microfinance methods, but some are not (e.g. Ethiopia).

Last, although a thorough discussion is beyond the scope of this paper, it is well to bear in mind the importance of relevant complementary institutions and policies to the outcomes of microfinance regulation and supervision systems. These institutions include the legal regime for banks and non-bank financial institutions generally, secured finance, contract enforcement, general consumer protection systems, securities regulation, accounting standards, administrative accountability mechanisms, criminal sanctions against fraud and corruption, and others. The development of microfinance depends on the quality of these systems, although carrying out reforms in problem areas may be a long-term project. For now, policymakers must realize that the impact of regulatory changes will surely be influenced by the state of these complementary institutions, and it may be important to factor those influences into regulatory designs from the start.

Annex: Case Studies

Bangladesh: PKSF Network

Bangladesh does not have a tier of rural banks or similar regulated institutions providing credit to the lower end of the market, nor does its uncompetitive commercial banking sector serve this segment. Residual interest rate bands and other regulatory interventions have slowed further development of formal banking. Yet Bangladesh undertook the earliest experiments in modern microfinance, and supplies a wide array of services to one of the world's largest microfinance client groups – some 8 to 9 million people. The credit portfolio of Grameen Bank and the major network of NGO-MFIs is about \$450 million. The Grameen Bank, a range of unregulated MFIs, and government programs provide these services. The Grameen Bank Ordinance, 1983 provides a special charter and provisions for Grameen Bank, exempting it from Bangladesh Bank regulations except for those concerning branch expansion. (Carpenter, 1997, McGuire et al 1998, Ahmed 1999)

Microfinance providers in Bangladesh have had considerable freedom to operate – and innovate -- free from regulatory intervention, due to a combination of official tolerance and incapacity blended with extremely high levels of donor funding and protection. MFIs are not subject to any official standards or prudential requirements. Entities engaged in microfinance are registered in an assortment of forms under various laws and regulatory structures.¹¹ Many MFIs are cooperatives, but as with other forms, cooperatives have their own regulatory authority, the Registrar of Cooperatives. Bangladesh Bank has the authority to inspect cooperatives engaged in financial operations, but does so only rarely. (Carpenter 1997) The sector is massively subsidized by foreign donor funds. The legal/regulatory framework does not seriously contemplate market-oriented MFI operations. Most MFIs admit to being out of compliance with applicable rules by virtue of their credit operations, and indeed resist any form of regulation. (Cracknell 2000) NGO-MFIs have been formulating a code of conduct including these requirements: an independent board with technical expertise, effective internal control and risk-management practices, and appropriately qualified auditors. (DPC 1998)

The most visible option for MFIs seeking to become regulated financial institutions, and thereby secure larger sources of funds, is to incorporate and register as a non-bank financial institution (NBFI) under the Financial Institutions Act, 1993. The main requirements for a license are: 50 million taka (slightly more than U.S. \$1 million) minimum capital, or 6% of total liabilities as equity, whichever is higher; status as a public limited company; sound financial condition, with audited accounts for at least 5 years; and efficient and qualified management. Registered NBFIs can accept all deposits from the public except demand deposits. MFIs in Bangladesh generally operate as

¹¹ These include the Societies Registration Act, 1860, the Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961, the Companies Act, 1994, or the Cooperative Societies Ordinance, 1985.

cooperatives and NGOs rather than NBFIs, since they are unwilling or unable to meet NBFi standards and funding for expansion is easily available from other sources without changing institutional form.

An important part of the environment in Bangladesh is the Palli Karma Sahayak Foundation (PKSF), the government-sponsored apex institution created in 1990 to on-lend funds from government and international agencies on highly concessional terms to NGOs engaged in microfinance. PKSF plays a quasi-regulatory role in holding NGO-MFIs to certain performance criteria as a condition for its credits. These include: encouragement to recover at least recurring administrative and funding costs from interest income, a minimum interest rate of 16% (to promote cost recovery and prevent lending at below-commercial rates), and encouragement of MFIs with outside funding sources to set aside reserves. Further, PKSF requires MFIs to provide savings services to members, and to keep most savings in a bank – with only the highest-rated MFIs being allowed to use the savings in credit programs. (McGuire et al 1998) PKSF has been conservative in accepting loan applications from MFIs, requiring those accepted to have at least 400 clients organized in groups that regularly mobilize savings. Recovery rates of 95-98% are required, depending on the age of the institution. (Gonzalez-Vega 1998)

Under a World Bank program, PKSF imposes somewhat more stringent performance criteria, and large MFIs must maintain minimum equity of \$240,000, a maximum debt-equity ratio of 2.5 to 1, a client base of at least 100,000 borrowers, and loan recovery rates of 95% or higher. Under this program, PKSF has received technical assistance in MFI supervision, and has set up policies and standards including loan loss provisioning rules calling for 50% provisions against all loans that are past due, and 100% for loans one year past due. (McGuire et al 1998, PKSF guidelines¹²)

PKSF's system for monitoring its MFI partners consists of the following. PKSF uses a standard form to collect information monthly on changes in clientele, savings, loan disbursement, and recovery. The MFI partners submit monthly and cumulative income, expenditure, and cash flow statements – and submit lists of borrowers. PKSF officers conduct field visits, usually examining each MFI every three months, more often for very large MFIs. Annual audits are done by both PKSF and external auditors. (Ahmed 1999)

Since its establishment in 1990, PKSF has disbursed \$140 million in loans, and partner MFIs have used this support to extend a total of \$411 million in loans to clients (Ahmed 1999) One observer suggests that the success of PKSF is due to peculiar circumstances that are not replicated in most other countries. These include its location in a very large and developed microfinance market, and its access to plentiful funds at concessional rates, which allowed it to retain substantial sums as capital. (Gonzalez-Vega 1998) One could also argue that donor protection of microfinance institutions in Bangladesh, and the absence of policies to ensure the safety of savers, ensures that PKSF will continue to be successful.

¹² At: www.pksf-bd.org.

Bolivia: Private Financial Funds

Bolivia's 1993 *Law on Banks and Financial Institutions* introduced multiple-service banking or "multibanca" allowing banks to offer several types of services, from universal banking to microfinance. The law takes a liberal approach, freeing interest rates to be set by markets, and placing few directions or conditions on financial institutions' placing of resources and investments. Banks can exclude from classification requirements loans of US \$2,000 or less (for non-bank financial institutions – NBFIs – \$500), since these represent little risk to the system. This approach was found not to meet anything close to the level of demand at the lower end, including microfinance.

As a result, in 1995, Bolivia created the *Private Financial Fund* (PFF) by Presidential Decree (a quasi-legislative act having the status of law). The purpose of the PFF was to provide for a second-tier non-bank financial institution (NBF), which had been lacking until then, and to channel resources to small and microenterprises, as well as to individuals for durable goods purchases. PFFs are required to incorporate. The stated reasons for this are legal stability, investor confidence, and access to replenishment funds. PFFs are national in scope and subject to central bank and banking supervision rules. Among other things, PFFs can: lend, engage in finance leasing and factoring, and take savings and time deposits. PFFs cannot engage in the following: demand deposits, foreign trade operations, any trust or fiduciary operations, enterprise capital investment, securities underwriting or placement, or mutual fund management. Special portfolio and conflict of interest rules apply. (Trigo, 1997; Rock, 1997) As of late 1997, there were six PFFs, of which two were MFIs and an additional three NGOs were in the process of conversion to PFFs. (Jansson 1997) More recently, the four major PFFs that were NGO conversions had some 104,000 clients and a portfolio valued at approximately \$105 million as of early 2001. (FONDESIF/GTZ 2001)

It is worth reviewing some of the specifics of the Bolivian PFF regime. The regime is set up by Presidential Decree no. 24000 of 1995 (*Decreto Supremo no. 24000*), and Superintendancy of Banks and Financial Institutions Resolution no. 71 of 1996 (*Resolucion SB no. 0071/96*). The Central Bank and the Superintendancy of Banks and Financial Institutions have regulatory authority over PFFs. Some of the key features are the following:

- PFFs are required to be corporations and to have minimum paid-up capital of 630,000 special drawing rights (SDRs, equivalent to U.S. \$1 million, which is one-third the amount required for a bank).
- The minimum capital adequacy ratio is 10%, and the maximum portfolio allocation to loans is two times the value of equity. The latter is a stringent constraint on operations.
- A PFF cannot lend more than 3% of its net worth to a single borrower or group (1% if based on a personal guarantee – i.e. not real estate), or lend more than 20% of net worth to a financial institution, nor extend credits or guarantees to related persons or companies.

- Loan provisioning is based on the amount and term. Loans under \$500 are exempt from provisioning. Loans between \$500 and \$5,000 have two provisioning schedules, one for loans with a term of more than a month, and a more rapid one for loans to be repaid with one month.
- Loan documentation is specified, but made more flexible for small borrowers. Acceptable security for small loans includes moveables and group guarantees.
- Detailed rules on PFF licensing are provided in the 1996 regulation. These provide for a process of license application, admission and publication of the application, notice of grant or refusal within a defined time frame and on stated grounds, and limits on organizational startup costs that can be incurred by PFFs. (Trigo 1997, Jansson and Wenner 1997)

The Superintendancy directly oversees the PFFs – banking law does not allow delegation of the supervisory function. Without delegating supervision *per se*, the Superintendancy is seeking to contract out certain control functions, such as auditing. The PFFs are subject to the supervision methods applied to banks – including annual external audits, monthly offsite follow-up, and quarterly reports – and to special methods developed for MFIs, which include an evaluation of the institution’s credit methodology, a review of sample files, and visits to clients. A recent survey estimated the costs of formalizing and regulating PFFs. The cost of formalization, i.e. bringing an institution (e.g. an NGO) up to PFF regulatory standards, including MIS requirements, and getting it licensed, was estimated at \$700,000. The Superintendancy was estimated to incur \$24,000 in costs in the course of licensing a PFF. The four major conversion processes of NGOs becoming PFFs took an average of over two years. The annual costs to the Superintendancy of supervising a PFF were estimated at \$42,000 (including 70 person-days for on-site inspection, and 36 days for off-site work). The Superintendancy covers part of this cost by collecting fees from the PFFs amounting to 1/1,000 of assets annually. (Monje et al 2000, FONDESIF/GTZ 2001)

Some of the PFF regime’s elements may not be ideal as prescriptions for the promotion of a microfinance market. The minimum capital required for a PFF is quite high as compared to NBFIs and MFIs in many other countries. This, of course, does not prove that the rate is too high, but does indicate a relatively restrictive policy on entry to the sector. (At the same time, several promoters have had sufficient capital to meet this standard, and the pressure it creates for consolidation appears to have been useful.) Also, the rules do not recognize informals or provide for formalization and step-wise graduation of MFIs to higher-tier financial institutions. Last, the PFF framework has been heavily used in recent years for consumer finance, which helped to create problems of over-indebtedness that affect the microenterprise finance market, as well as predatory lending practices. (Staschen 1999)

Some additional actors in the Bolivian microfinance market are worth mentioning. There are over 30 financial NGOs and some 200 cooperatives supplying the market, all unsupervised. The NGOs had a portfolio estimated at the end of 1995 at \$33 million. Legally, such organizations require a license as a bank or PFF in order to engage in the financial services market, but in practice, they continue to do so without converting

into licensed financial institutions. Absent enforcement of the banking laws, the legal situation of NGO-MFIs is unclear. Those that receive government funds are supervised by the government audit office. As in other countries, one might expect an apex organization to be taking on the role of wholesale lender and delegated supervisor. However, the main government apex, NAFIBO, through which official and foreign donor funds are channeled, can lend only to supervised financial institutions. Thus, this organization's potential role as facilitator of market development and supervisor is lost, and the NGOs must rely for this on private investors and non-governmental apexes. This situation has also contributed to the rise of several apexes in Bolivia, none of which appears able to reach sufficient scale to sustain itself. (Navajas and Schreiner 1998)

Ethiopia: MFIs

The Ethiopian regulatory structure for MFIs was established by legislative Proclamation No. 40 of 1996, Licensing and Supervision of the Business of Micro Financing Institutions, and by the implementing Directives of the National Bank of Ethiopia. All MFIs must be 100% Ethiopian-owned (this is a requirement of all companies under the commercial code), and obtain a license from the National Bank of Ethiopia (NBE). Minimum capital (to be deposited with NBE) is set at 200,000 birr (approximately U.S. \$25,000), and licensing requires submission of company documentation and a business plan. Microfinance, as defined by the statute and NBE directives, consists of extending "small" credits to "rural small farmers or urban entrepreneurs." The maximum single-borrower credit limit is set at 5,000 birr (U.S. \$625), and repayment periods can be a maximum of 12 months. The legislation originally capped interest rates at two percent above commercial bank rates, and the floor on deposit interest rates was set at 1% below commercial bank rates. (Proclamation No. 40/1996, NBE Directives 01/96 to 09/96). Two 1998 directives (MFI/11/98 and MFI/12/98) liberalized interest rates and fixed a 6% floor on deposit rates, to encourage small savings.

Obtaining an MFI license authorizes an institution to:

- accept savings, demand, and time deposits;
- draw and accept drafts payable (i.e. transfers) within Ethiopia;
- borrow money against the security of institutional assets;
- purchase treasury bills and other financial instruments; and
- manage funds for the purposes of on-lending them to peasant farmers and microentrepreneurs.

Only licensed MFIs may accept concessional credits or assistance from foreign organizations – and only with prior approval of the Ministry of Finance, which also has discretion to provide tax breaks for such activities. Qualification for a license is subject to the discretion of the NBE, which "may issue directives at any time and prescribe additional conditions to be complied with before a license is issued," and before an institution may begin operations. When savings mobilized by an MFI reach the level of

one million birr (approximately U.S. \$125,000), the institution is required to re-register, subject, again, to the discretion of NBE to add any conditions it sees fit.

Experience since the 1996 law was adopted suggests that the framework has been generally helpful, but that it also has contributed to a buildup of problems that create dangers for the market's sustainability. Microfinance emerged as a response to rural small credit demands being met neither by the commercial banking sector that came into being since Ethiopia's 1991 change of regime, nor by the loss-making agricultural credit parastatals. Some 16 MFIs operate in Ethiopia, with a mixture of regional government, NGO, and individual ownership. These MFIs reach nearly half a million active clients at a given time with about \$34 million in credit outstanding (cumulatively \$66.8 million) and hold about \$16 million in savings. Repayment rates for most MFIs are close to 100%, with a minority achieving rates closer to 80%. Since the liberalization of interest rates, MFIs have not moved quickly to adopt rates that would support sustainable operations – rates vary between the old ceiling of 12.5% and 25%. (Shiferaw and Amha 2001) There apparently has been almost no business relationship between MFIs and commercial banks. (Lemma 2000) The prohibition of foreign ownership and ministerial control on donor funding appear to have deterred involvement in the sector by foreign donors and international NGOs. (Shiferaw and Amha 2001)

Although this framework provides useful clarity and structure to the microfinance market, it poses a number of problems. The statute requires a license from NBE for carrying out *any* microfinance-related activities. Since 1998, MFIs have been expressly prohibited from engaging in microfinance operations without an NBE license. (Lemma 2000) Thus, no informals are recognized or tolerated, there is recognized no multi-tiered structure of graduated standards nor any system of self- or hybrid regulation. The structure sets up a monopoly on all microfinance activity by corporations wholly owned by Ethiopian nationals or organizations, and there is no transition path for informals or NGOs. This potentially constrains innovation at the base of the microfinance market, and puts emergent MFIs in legal jeopardy. Also, the ceilings on loan size and term are apparently maladapted to many farmers' needs – there is demand for bigger and longer-term credits, but the gulf between the product range offered by MFIs and that provided by commercial banks is sufficiently vast that farmers do not “graduate,” and their needs are not met. (Shiferaw and Amha 2001)

As for the transition path, the legal and regulatory structure does seem to allow for the case-by-case development of a tiered system, by requiring re-registration when savings levels reach \$125,000. At that point, the authorities have discretion to tighten prudential standards. Additionally, the Council of Ministers is given authority to exempt applicants from licensing conditions, with a view to encouraging “innovative” MFIs (*Id.* art. 2). This authority could be used to exempt small and start-up MFIs from the full set of licensing and capital requirements, which could also result in a tiered structure.

The other important problem here is that the legal structure potentially places serious strain on the limited supervisory resources of NBE. If all MFIs must be licensed and supervised by NBE, then the scope of NBE's work in this area is potentially huge. In

practice, the central bank has not enforced MFI reporting requirements – whether as a policy decision under its statutory discretion, or simply as a result of thin capacity.¹³ Several MFIs, mainly the largest, have failed to make regular monthly reports as a result of dispersed operations and weak MIS, and very few have carried out any external audits, which are required to be done annually. Thus, there appears to be little evidence that these institutions are complying with prudential rules. The Supervision Department of NBE, with an inspectorate of only 25, has not managed to carry out regular on-site inspections of MFIs – only five took place from 1996 to 2000. Moreover, extant laws and regulations do not define MFI prudential ratios or reserve requirements – presumably the NBE has policies in this area that are made known to the MFIs. (Shiferaw and Amha 2001)

It is also of concern that the law places a great deal of discretionary power in the relevant authorities. NBE, Council of Ministers, and Ministry of Finance retain significant discretionary control over the grant of MFI licenses and the flow of foreign funds into the microfinance system – a set of bureaucratic monopolies to match the local private sector monopoly described above. The rationale for controlling donor funds is understandable as a response to international donor interference in the sector, but it appears overly restrictive and subject to ministerial discretion. It is possible that general banking or administrative law in Ethiopia provides some limit to official discretion in these areas. However, the only limitations mentioned in the statute are the requirement to provide 30 days’ notice concerning additional license conditions, and the presumed need for consistency with the statement of NBE duties in this area. These duties include promoting microfinance investment, traditional savings institutions, and commercial bank involvement in microfinance.

Ghana: NBFIs

Ghana¹⁴ has several types of organizations engaged in microlending, including informals, NGOs, credit unions, thrifts (savings and loans, and building societies), and rural banks. Informals, including *sususu* (mobile deposit collectors) and moneylenders, as well as NGOs are not regulated by the Bank of Ghana. Incorporated non-bank MFIs (including thrifts) and cooperative credit unions fall under the Financial Institutions (Non-Banking) Law of 1993, while rural banks operate under the Banking Law of 1989, which brings both of these categories of institutions under the authority of the Bank of Ghana.

The Financial Institutions Law requires an NBFIs to be incorporated and licensed by the Bank of Ghana, and to have a minimum paid-up capital of 1 billion cedis (approximately U.S. \$140,000) – recently increased to 15 billion cedis (approximately U.S. \$2.1 million) for new entrants.¹⁵ Experts suggest that, while these requirements may

¹³ There apparently has been discussion of deferring any direct NBE supervision until an MFI reaches the \$125,000 savings level, but this has not been adopted as policy.

¹⁴ This section benefited substantially from the information and commentary provided by Dr. David Obu Andah of the Bank of Ghana, and William Steel of the World Bank.

¹⁵ For rural banks, the minimum is \$20,000 (Gallardo 2001).

be appropriate to large thrifts and finance companies, they are too stringent and, among other things, will make NGO conversion into licensed MFIs impossible. NBFIs must maintain a minimum capital adequacy ratio of ten percent, and to limit advances to any one client to no more than 15 percent of net worth if secured, and 10 percent if unsecured.¹⁶ The Bank of Ghana retains authority, according to its regulations, to provide “directions” to NBFIs on such matters as interest rates, and to suspend or revoke the licenses of any of them using “undesirable methods,” although formal interest rate regulation was abolished in Ghana in 1988.

The Non-Bank Financial Institutions Rules specify three kinds of NBFIs license – for institutions taking retail, wholesale, and no deposits. Both depository and credit-only institutions are regulated, although more stringent prudential standards apply to deposit-taking NBFIs. Credit-only NBFIs may apply for special permission from the BOG to accept term deposits from the public. Importantly, there are markedly different provisioning schedules for business, hire-purchase, and micro loans – reflecting the potential volatility of microcredit portfolios. Micro loans backed by group guarantees have a much higher ceiling than individual micro loans (\$1,400 vs. \$140), but group guarantees are not reflected in the risk-weighting criteria at all – nor is moveable collateral for that matter. In each case, the loans are treated as unsecured and given a 100% risk-weighting for capital adequacy purposes. Loan procedures and documentation are specified. Supervision methods include annual outside audits and quarterly returns. The rules provide three provisioning schedules, in rising order of rapidity: for business finance, hire-purchase, and micro/small business loans. A phase-in of general reserves is provided for and liquidity requirements of 10% (primary) and 15% (secondary) of total deposits are required.

The rules applicable to non-depository NBFIs are the same in many respects, but with some important differences. The main differences are: (i) lower minimum capital (500 million cedis or \$70,000 for existing institutions, 10 billion cedis or \$1.4 million for new ones); (ii) instead of the depository capital adequacy ratio, a ratio of liabilities to own funds of 10:1; (iii) no required liquidity ratio; and (iv) no special provisioning rules for small and micro business loans.

The rural banks are treated as a sub-category of bank, with their own prudential rules. They are quasi-cooperative institutions, owned by all members of a community. Single shares held by residents are valued at less than one U.S. cent (50 cedis or U.S. \$0.007), thus dispersing ownership and undermining capable management and sustainability. In order to shore up the rural banking sector after years of weak performance, the Bank of Ghana closed several institutions and set a required secondary liquidity reserve of 52 percent. Moreover, the government has established an apex bank to channel funds to the rural banks (and therefore to provide another layer of oversight). Despite the fact that the Bank of Ghana has dedicated a disproportionately large number of regulatory staff members (variously estimated between 20 and 40) to the supervision of these institutions (currently numbering 114), substantial supervision is not really

¹⁶ For rural banks, the capital adequacy floor is 6% (Gallardo 2001). As of this writing, these standards were being considered for revision.

possible, given the geographic dispersion of rural banks. By recent estimates, all rural banks were covered by the supervisors, but only half of those institutions were in full compliance with Bank of Ghana standards, and 8 percent were in distress. Outstanding loans in mid-1999 were approximately \$8.9 million. (Ameyaw 2000, Gallardo 2001)

The provision for rural banks under the Banking Law, the range of NBFIs under the Financial Institutions Law, and the Bank of Ghana's commitment of resources to supervise them, sets up a useful structure of tiering. On the other hand, NGOs as such are left unregulated, and while this enables useful experimentation, NGO-MFIs could theoretically grow to significant proportions with no Bank of Ghana oversight. Where NGOs want to transform into regulated institutions, the 30-fold increase in NBFIs minimum capital (from 500 million to 15 billion cedis) over the last 2 years is making this difficult if not impossible. Moreover while informals are not included in the law or regulation, they are also not explicitly excluded. A microfinance network called GHAMFIN works with informals, NGOs, and BOG on the development of performance standards and monitoring systems.

Also, Bank of Ghana oversight of cooperative credit unions under the Financial Institutions Law theoretically allows for a comprehensive regulatory system. However, in practice, the Bank of Ghana does not exercise this supervisory authority. It has been proposed that credit unions be supervised under a delegation of authority to their registrar, the Department of Cooperatives. This would require legislative changes, since the Financial Institutions Law does not permit delegation of the Bank's authority.

Indonesia: Variety of MFIs

Indonesia has supported financial deepening through a number of strategies. First, a small business credit regulation requires every financial intermediary in the country to direct at least 20% of its loan portfolio to small enterprises (directly or through specialized small-scale credit providers). This means that commercial banks and traditional NBFIs are required to be involved in microfinance, not just specialized MFIs.¹⁷ Second, Indonesia has a vast array of formal MFIs – some 15,000 by one estimate – in addition to hundreds of thousands of informals. Importantly for purposes of this review, out of this entire number, only some 1,000 privately owned MFIs are directly regulated by the central bank, *Bank Indonesia* (BI). The central bank sets regulatory standards and has ultimate supervisory authority over all of these MFIs, but its policy has been to delegate most of this, due to the heavy effort and cost that direct supervision of all these institutions would involve. (Berenbach 1997)

Most well known is the *unit desa* network. These units, now over 3,700 small local banking offices, were originally part of a subsidized agricultural credit program run by *Bank Rakyat Indonesia* (BRI), a state commercial bank. In 1983, they were transformed into full service rural banks operating under BRI – thereby forming the largest microfinance network in the world. These units compete with the nearly 6,000

¹⁷ Experience with these kinds of quotas internationally, and the condition of the Indonesian banking sector since 1997, suggest that this approach is often unsuccessful.

offices of the other 170 commercial banks, including regional development banks, as well as MFIs. The unit desa have some 23 million depositors and borrowers with total loans (ranging in size up to U.S. \$2,500) of close to U.S. \$500 billion. All unit desa offer two main products: a passbook savings account (SIMPEDES) and a collateral-based installment credit (KUPEDDES) for enterprise investment and working capital. (Berenbach 1997) Collateral for KUPEDDES loans is generously defined to include moveables kept in clients' households. (McGuire 1998)

The unit desa system is subject to a hybrid form of regulation, in which BRI is authorized by Bank Indonesia to supervise the unit desa by means of supervisors based in its branch network and its 15 regional audit offices. BRI also supervises over 5,000 village-owned banks, under contract to *Bank Indonesia* (see below), and conducts standard-setting and oversight as the conduit bank for government microcredit programs. The Village Unit Division of BRI, which runs the unit desa system, is separate and independent of BRI's large commercial banking network. Pricing policies are set for the whole unit desa network, but each unit is treated as a profit center and has a separately generated and examined balance sheet. Unit desa supervisors operate out of the BRI branches, visiting each unit weekly and reviewing their regular reports. These include daily trial balances, weekly liquidity reports, as well as less frequent reports on income and performance that are also sent to regional and head offices. BRI also applies a very conservative provisioning schedule to unit desa loans, with provisions of 100% required once the 3-month point is past. Limits on cash at the units and protections against fraud are especially strict. Last, BRI provides an incentive for high performance by conducting a semi-annual achievement contest among the units, with the winner receiving cash prizes along with recognition. (Hannig and Katimbo-Mugwanya 2000, Rhyne and Christen 2000) Interestingly, the BRI unit desa network weathered the recent East Asian crisis much better than other financial institutions in Indonesia, apparently due to more professional management, more regionally diversified portfolios, and depositors' "flight to safety" in response to the implicit government guarantee of BRI deposits. (CGAP 2000)

The BRI unit desa system is almost universally considered a huge success. It has reached unprecedented numbers, offered well-tailored services, and more than covered its costs, including the costs of supervision. Informed observers have been careful to point out the specific circumstances and astute decisions that contributed to this success. These include:

- The backdrop of a dynamic economy (until the recent crisis), with stable macroeconomic policy and financial sector liberalization and a very high and physically proximate population
- Strong leadership within BRI and substantial resources from government and international agencies, enabling large investment in training – among other things;
- Complete operational autonomy for each unit desa, run on a for-profit basis without government mandates;
- Simple, standard, and transparent financial reporting procedures, clear accountability;

- Financial instruments designed and priced specifically to meet local demand – based on thorough knowledge of local markets – and to earn a profit;
- Well-designed and implemented supervision process, with prudential norms and procedures carefully tailored to unit desa products and operations;
- Delegated supervision, but with the primary regulatory authority continuing to carry out its responsibility (i.e. delegation does not become self-regulation). (Berenbach 1997, CGAP 1997)
- The implicit safety of savings in the BRI due to its ownership by government.

Indonesia also has a second tier of institutions recognized under the Banking Law of 1992, the small-holder credit banks (*Bank Perkreditan Rakyat*, BPR), which are small limited-charter institutions with very low minimum capital (until recently, \$5,000). The BPRs number over 2,400 and have total loans outstanding of about \$200 million (comprising short-term cash loans up to \$200, term loans up to \$1,000). An estimated 1,000 BPRs are privately owned, and these, like commercial banks, are directly supervised by the central bank. The remaining BPRs are owned by local governments, villages, and cooperatives – and while Bank Indonesia has the power to supervise them, it delegates most of this function to the Provincial Development Banks. Unlike commercial banks, the BPRs have no access to the payment system and can offer only savings and time deposits, not demand deposits. Bank Indonesia has a CAMEL-based statistical warning system to prompt on-site inspections of the BPRs that it directly supervises, but this was found to be too similar to standard commercial bank supervision systems to be useful for MFIs. The Indonesian banking system in general -- and the BPR in particular, due to easy entry, rapid growth, and very limited supervision -- suffered spectacular reverses in the regional crisis of the late 1990s. The post-crisis process of consolidation and regulatory strengthening is ongoing. (Berenbach 1997, Hannig and Katimbo-Mugwanya 2000, Rhyne and Christen 2000).

Beyond the BPRs, there are thousands of other formal MFIs. The largest single category is that of the village-owned bank (*Badan Kredit Desa*, BKD), numbering 5,435. The BKDs are much smaller than the BRI *unit desa*, with lower average loan amounts (\$26 versus \$664) and savings (\$4 versus \$178). BKDs as such have limited deposit-taking authority, taking only passbook savings in their local village areas. Bank Indonesia has delegated supervision over these entities to BRI, which has a Small Business and Cooperative Division dedicated to this purpose. The BKDs pay the supervisory costs, based on BRI's annual budget for this function, historically about 25% of BKD operating costs. BRI establishes the interest rates on loans and savings, as well as maximum loan sizes, for the BKDs. BRI supervisors oversee about 20 of these institutions each, and are required to make monthly visits. The relationship between BRI and the BKDs has evolved into something closer than a supervisory relation – it is now said to be more like a bank and its branch network. (Berenbach 1997, McGuire et al 1998, Bank Indonesia and GTZ 2000, CGAP 2000)

In addition to the BKDs, there are as many as 6,000 non-bank rural credit institutions (*Lembaga Dana Kredit Pedesaan* or LDKP) providing credit (and certain categories of these are authorized by the Ministry of Finance to accept deposits), operating under the ownership of provincial governments, villages, and cooperatives. The Ministry of Finance (under its authority to regulate all NBFIs) sets regulatory standards for the LDKPs, but delegates supervision of these entities to the Provincial Development Banks – entities that appear in practice to lack the requisite powers to enforce standards. In some cases, provincial governments and audit agencies are directly involved in oversight. Typically, the supervisors will review regular reports from the LDKPs and conduct an annual on-site visit. In some cases, the institutions are classified according to factors such as total equity, portfolio quality, and number of new borrowers – for purposes of setting credit ceilings and early warning. Both the BKDs and some types of LDKPs were required by the 1992 Banking Law to upgrade their operations to meet the standards for registration as BPRs by late 1997 – those that have not done so are no longer authorized to accept deposits. (Berenbach 1997, McGuire et al 1998, Bank Indonesia and GTZ 2000) Last, Indonesia has an estimated 400 (essentially unregulated) NGO microcredit programs. (Bank Indonesia and GTZ 2000)

In an effort to rationalize the regulation of non-bank MFIs, Indonesia is now in the process of developing a microfinance law. The Draft Act Concerning Microfinance provides a regulatory structure for BPKs, LDKPs, and NGOs (but not cooperatives) engaged in microfinance, which is defined as mobilization of funds and provision of small loans primarily to low-income persons and groups engaged in microenterprise. The draft act requires registration and compliance by all MFIs that have mobilized aggregate funds in excess of \$5,000 – this includes all savings, both public deposits (including term deposits) and member savings. MFIs that mobilize funds in excess of \$100,000 must obtain a small-holder credit bank (BPR) license. Licensed MFIs may conduct a range of credit, deposit, and transfer activities, but may not accept demand deposits, conduct forex operations, extend credit to or acquire other MFIs (although mergers are permitted), among other things. MFIs must be wholly Indonesian-owned (and entirely Indonesian-staffed), whether by individuals (minimum number per MFI: 20), companies, associations, or local governments – once again, the economic rationale for this is questionable. The supervising institution for MFIs (this is not named in the draft, but would be either BI, the Ministry of Finance, or a special-purpose agency) may delegate both licensing and supervision of MFIs to provincial governors, commercial banks, or others. Licensed MFIs are required to participate in an MFI support scheme (providing TA and support for troubled institutions), and the draft calls for the establishment of a microfinance promotional body – the National Consultative Council for Microfinance.

Peru

Peru has informals and NGOs, as well as financial institutions providing microfinance services in two main regulatory niches. These are directly supervised non-banks and indirectly supervised thrift institutions.

1. *EDPYMEs*

Peru established a framework for MFIs through a 1995 amendment of its banking regulations, providing for an entity called EDPYME (*Entidad de Desarrollo para la Pequeña y Microempresa*). The EDPYME form was conceived as a vehicle for the conversion of NGOs to the status of regulated financial institutions. A registered EDPYME would have as its objective the provision of finance to persons engaged in small or microenterprise activities. “Small” is defined as having assets of U.S. \$300,000 or less and/or annual turnover of \$750,000 or less; and “micro” as having assets worth \$20,000 or less and/or annual turnover of \$40,000 or less. In serving this market, EDPYMEs can access commercial bank credit, equity markets, and special rediscount facilities from COFIDE, the Peruvian development bank. In order to access capital markets, EDPYMEs must register with the securities regulatory authority, submitting semiannual unaudited and year-end audited accounts. These organizations can also use mortgages to secure lines of credit, and can accept various forms of deposits from the public with prior authorization of the Banking Superintendancy (SBS). At the time this regulation was put in place, it was unclear what types of deposits the Superintendancy would find acceptable, and this was expected to be worked out case-by-case.

The main entry and regulatory requirements for EDPYMEs are as follows:

- the minimum capital requirement is U.S. \$256,000;
- the founders must submit a feasibility study including a market survey of the past three years in the proposed area of operation, and three years of financial projections;
- total liabilities can be no more than ten times net equity;
- daily treasury reports, as well as weekly and monthly financial statements are required, along with reports on portfolio quality every four months, and regular annual inspections and special inspections;
- loan loss reserves are required in the amount of 25% of capital;
- authorization is required to open new branches; and
- loan provisioning is the same for all EDPYME loans as for commercial credits (although consumer credit provisioning rules are not dramatically tougher).

Importantly, the EDPYME legal structure allows for a period of transition into fully regulated status. In addition, in the case of *Accion Comunitaria del Peru*, SBS showed that it will deal with NGO ownership of newly-formed EDPYMEs by requiring the transforming NGO to dilute its share – but in this case, it did not require the sale of shares to outside for-profit investors. (Rock and Otero 1997).

Another important player in this market is COFIDE (*Corporacion Financiera de Desarrollo*), which channels credit lines (mainly international) to regulated financial institutions. The limits on COFIDE financing as a factor of equity and liabilities, and its limitation to licensed entities provided the impetus for the EDPYME decree, setting up alternative regulated institutions that provided a vehicle for NGO-MFIs to formalize and to receive COFIDE financing.

A recent study quantified the costs of microfinance supervision in Peru. SBS charges banks and MFIs a fee of 0.06% of assets – but the supervision of MFIs was found to be costing SBS about 30 times that, equal to 2 percent of MFI assets. The study concluded that, if SBS charged a fee that covered its costs, the 30-odd MFIs in Peru would need to add 3 percent to their loan charges in order to pass the cost on to their customers – and this was expected to be relatively easy. (CGAP 2000)

The Peruvian EDPYME framework provides a workable mechanism for formalization of NGO-MFIs as incorporated and regulated non-banks. However, the framework appears to have undermined its objective of promoting a sustainable microfinance sector in one sense: because EDPYMEs have easy access to bank credit, equity markets, and COFIDE refinance, at least until recently, none of them applied to SBS for permission to take retail deposits from the public. The savings of low-income populations, a core concern of microfinance worldwide, in practice have no place in this system. Further, one commentator notes that the SBS in this case is unnecessarily straining its capacity – i.e. the lack of any depositor protection rationale for supervision means it has essentially taken over the role of private investors. (Staschen 1999) On the other hand, Peru is generally cited as a success story, in which the banking supervisors began to address microfinance only after getting the supervision of commercial banks, its core task, well in hand.

2. CMACs

Peru first undertook the regulation and supervision of small financial services providers when it enacted legislation in 1980 creating its thrift or *Caja Municipal de Ahorro y Credito* (CMAC) framework. In the early 1990s, Peru extended this framework with decrees creating a rural version of the CMAC (CRAC) and the EDPYME, which was conceived as a vehicle for the conversion of NGOs to the status of regulated financial institutions. The CMACs were inspired by the German *Sparkasse* model, and were accordingly owned by municipalities – although they were required to convert to corporate form under the December 1996 Law on Banks. The CMACs were intended (a) to provide financial services to persons and enterprises without access to formal financial intermediaries, and (b) to decentralize financial intermediation and thereby counteract the flow of funds from rural areas to the capital. In other words, they follow the principle of local service provision similar to the *Sparkassen*, traditional building societies and S&Ls. Initially, the CMACs financed their lending with capital from provincial governments and depositors, but were permitted by a 1990 decree to access national and international capital markets. They had a total credit portfolio of approximately \$160 million in the mid-1990s. (Rock 1997)

The Federation of CMACs, FEPCMAC, was established in 1983 as an independent public coordinating body for the CMACs, housed in the Ministry of Finance and Industry. The Federation not only acts as an apex, channeling investment and donor funds to CMACs and providing training, but also handles supervisory functions delegated by the Peruvian Banking and Insurance Supervision (SBS). While the SBS directly

conducts a formal annual audit of CMACs, the Federation carries out its own audit using consultants, and handles regular on-going monitoring of CMACs through its internal auditing department. Detailed (unaudited) reports are produced by the CMACs and FEPCMAC on a monthly, quarterly, and annual basis – along with monthly aging of portfolio reports. The CMACs pay monthly membership dues to the Federation, which covers some of the cost of supervision (the rest being funded by donors). (Rock 1997) This system proved effective for several years, although more recently the lack of availability of external funds has ushered in some problems, and corruption allegations at FEPCMAC have exposed the need for SBS oversight of the Federation. (Staschen 1999)

The CMACs, like the EDPYMEs, are required to have corporate form. They follow a prescribed institutional growth pattern, starting with lower risk activities and building up to higher risk ones, i.e.: savings accounts and gold-based pawn loans in the first year, microenterprise lending beginning in the third year. CMACs offer a range of products, including – since their decision to move in this direction in 1993 – microenterprise credit, along with pawn loans, personal loans, and other business loans. New microloan products developed since the early 1990s include: specialized agricultural and fishing credits, “automatic” or expedited credit for those with good credit histories, and “parallel” loans during peak production seasons. On the savings side, accounts offered include passbook savings, current accounts without checking, term deposits, and “CTS” accounts that are comparable to pension funds. The absence of checking facilities means that CMACs lose substantial deposit business to commercial banks. (Rock 1997)

The Philippines

The Philippines has a range of directly and indirectly supervised institutions involved in microfinance. This range includes thrifts, rural and cooperative banks, pawnshops, NGOs, credit unions, village “banks,” and ROSCAs. The government formally recognized microfinance in a central bank circular (no. 272) of 1997, defining it as follows:

...small loans granted to the basic sectors, as defined in the Social Reform and Poverty Alleviation Act of 1997..., and other loans granted to the poor and low-income households for their microenterprises and small businesses so as to enable them to raise their income levels and improve their living standards. These loans are granted on the basis of the borrowers’ cash flows and are typically unsecured. The maximum principal amount of microfinance loans shall not exceed P 150,000...¹⁸

The circular also requires the amortization schedule of microloans to take the borrowers’ cash flow into account (Gallardo 2001).

Here, we examine two groups of institutions in the Philippines, rural banks and NGO-MFIs.

¹⁸ Equivalent to U.S. \$2,900. Quoted in Gallardo (2001).

1. Rural Banks

The Rural Bank Act of 1992 (no. 7353) and the General Banking Law of 2000 (no. 8791) provide the framework for these second-tier institutions, defining their target clientele as “farmers, fishermen and merchants with small cash requirements.” The Act also authorizes them to serve the credit needs of cooperatives and employees. There were over 800 rural banks in the Philippines as of the end of 1997, of which 51 were cooperative rural banks – i.e. owned by and serving the needs of cooperatives. Minimum capital requirements for rural banks vary according to the type of area in which a bank operates – with the lowest legal requirement (\$50,000) set for the least populous districts (5th and 6th class municipalities), and the highest (\$500,000) for Metro Manila. Cooperative rural banks (except for national cooperative banks) have somewhat lower legal minimum capital requirements than other rural banks. Rural banks must be wholly-owned by Filipino individuals or entities, a requirement (as in the case of Ethiopian MFIs) that appears to have no economic rationale. (Gomez et al 2000, Montemayor 1997) The Philippine Deposit Insurance Corporation (PDIC) covers the deposits of financial institutions authorized to take public deposits up to \$2,000 per person. (Gallardo 2001)

One recent analysis (Gomez et al 2000) suggests that, while the regulations applicable to rural banks in the Philippines accommodate microfinance, prudential supervision practices in fact discourage it. Despite BSP’s legal authority to intervene with respect to interest rates, there are no rate regulations in effect and usury laws have been repealed. The regulations allow banks to maintain an “unspecified” portion of their portfolios in unsecured loans, and indeed security can take a range of forms including personal property (50% loan to value) and crops (40% LTV). However, the BSP has in practice set a ceiling of 30% on unsecured loans, and supervisors do not recognize group guarantees and other microfinance mechanisms as valid security. Documentation requirements for small loans are generally minimal -- except for submission of tax returns, which poses a problem for micro-borrowers. The banking law’s requirement that institutions remain open at least 6 hours per day, 5 days per week imposes extra costs on MFIs, such as the need for full-time labor and office space. Last, subsidized and directed credit programs continue to distort the market, and furthermore impose interest ceilings on the 25% of banks’ credit portfolio that must be set aside for agriculture. In this same vein, rural banks receive a range of benefits and exemptions in such areas as taxes, fees, and foreclosure procedures.

As a result of the constraints imposed by the regulatory regime, there has been only one NGO transformation in the Philippines: CARD Bank. Also, the arrears rate for rural banks rose from 14% in 1996 to 19.8% in 1999 due to weak management and lending technologies. This could be compared to CARD Bank, which uses a Grameen methodology (resulting in violation of BSP security standards, and sanctions) and maintained an on-time repayment rate above 99% during the same period. On the other hand, rural banks do reach small borrowers, with the average loan sizes of the top four ranging from \$39 to \$209. Their client base is about half a million, and loans outstanding approximately \$1.04 billion. (Gomez *et al* 2000)

BSP's supervision department has apparently (and not surprisingly) been unable to fully handle the task of supervising the rural banks. These banks held only about 2% of the banking system's assets, but comprised 83% of the institutions (there are some 824 rural banks, as compared to about twice this many branches of commercial banks). This supervision task has overstretched BSP's resources, taking up about half of its staff and budget. Some 200 inspectors were said to be assigned to the rural banks as of 1996, but even this level of resources was considered inadequate, given the number of institutions, the required on-site visits, and the fact that each inspection requires up to 3 person-weeks of effort. (CGAP 2000)

2. *NGO-MFIs*¹⁹

The Philippines has a range of regulated banks and NBFIs. NGOs providing microcredit operate outside this framework and are not permitted to accept deposits from the public. They do take member deposits, although this is not clearly permitted under banking legislation. This segment of the financial services market is thus not regulated by the state as such. Instead, systems of self-regulation have emerged, which involve oversight by NGO-MFI associations and apex financing bodies as well as efforts to define governance standards across this market segment.

The People's Credit and Finance Corporation (PCFC), a government-owned finance company, plays the leading role in intermediating concessional state and especially international agency funds destined for microfinance – specifically, for MFIs using the Grameen approach. As an NBFIs, the PCFC reports to the central bank but is not supervised by it. It also provides technical and training support for MFIs, and also serves some credit cooperatives. PCFC has been slated for privatization for several years now, as required under a loan covenant with the Asian Development Bank (ADB 2001).

PCFC imposes a set of conditions and performance standards on MFIs receiving lines of credit from it. PCFC's accreditation requires that the MFI be registered with the securities authority (SEC), BSP, or the Cooperatives Development Authority (CDA); that it have a 3-year track record of lending and working capital of at least \$10,000; that it keep lending activities segregated from other activities; that it not have more than 20% of loans past due or any loans in arrears to PCFC; and that it maintain systems of proven effectiveness in place. PCFC also sets minimum performance standards for accredited MFIs in the start-up, intermediate, and advanced stages of development. These are, respectively: cost recovery rates of 50%, 75%, and 100%; outreach to 500, 1,500, and 5,000 clients; and collection rates of 90%, 95%, and over 98%.

In addition, two main networks of MFIs, APPEND (the Association of Philippine Partners in Enterprise Development) and PHILNET (a group of MFIs engaged in Grameen replication) provide a structure for self-regulation, along with the usual funding, coordination, and training service traditionally offered by such networks. The credit

¹⁹ Source: McGuire et al (1998)

cooperative federations, such as NATCCO, have their own internal regulatory schemes and deposit guarantees, some of which may be opened on a wider basis. Last, there are some initiatives to develop generally applicable standards and policies for microfinance. One such is the National Credit Council's (NCC) effort to rationalize government lending programs, encourage private sector participation, and set standards. Another is an effort by the Microfinance Coalition for Standards (MCS, the outcome of a USAID project) to survey the sector, document best practice, develop benchmarks, and facilitate training and dialogue. The Coalition's standards deal with institutions' changing performance over time, comparison to industry performance overall, meeting best practice benchmarks, and meeting of the institution's own performance targets. The indicators being used include organizational and operational factors (e.g. structure, efficiency, MIS), scale of outreach and services, and achievement of financial sustainability.

South Africa: Microlenders

South Africa's Micro Finance Regulatory Council (MFRC) was established as an authorized regulatory institution under a 1999 exemption to the Usury Act, which regulates loan interest rates among other things. This was part of a broader process of financial sector liberalization. The MFRC is a unique non-prudential that supervises the operations of those institutions lending under the unrestricted interest rate window, in order to enable more effective consumer protection and regularization of microlender operations in a growing market. The regulated institutions are credit-only, unless they have also registered as banks or mutual banks. The Exemption Notice under which the MFRC was founded defines the category of exempt moneylending transactions as those not exceeding 10,000 rand (approximately \$1,000), payable within 36 months, and excluding credit card schemes or overdrafts on a checking account. Lenders are required to comply with the Notice rules and to register with an authorized regulatory institution (in this case, the MFRC) in order to be exempt from the Usury Act conditions. Those microlenders who register and comply are exempt from the interest rate controls of the Usury Act, and hence are free to determine their rates. Failure to comply with the rules causes the Usury Act to apply to all further transactions.

The Notice defines an authorized regulatory institution as a legal entity with a Board of Directors that has approval from the Minister to operate. Among its Directors there must be equal and balanced representation between the industry and consumers. It must have mechanisms in place to (among other things) register lenders and require adherence to standards, fund itself from contributions, address complaints and educate the public, and publish statistics on the microcredit market. The MFRC, a government-sponsored Section 21 (non-profit) company, came into being under the 1999 Exemption Notice as the authorized regulatory institution. Following an unsuccessful court challenge to its authority, the MFRC has acted decisively to provide both consumer protection and a vehicle for non-prudential supervision of microlenders.

MFIs operating under the Exemption notice are credit-only, and not authorized to accept retail or wholesale deposits. As such, they are not required to meet prudential ratios. On the other hand, they are required to report on a regular basis to the MFRC,

which checks their adherence to management and consumer protection standards, responds to complaints, and reports to government and the public. Outside contracted auditors are used for annual on-site inspections, and quarterly returns and reporting of credit data to a national registry are also required. MFIs must re-register annually. The loan term disclosure and other consumer protection rules are quite stringent, and certain collection procedures that were used in the past (retention of bank cards, use of blank court process documents) are outlawed. These rules and procedures aim to regularize and legitimize for-profit microcredit services, to balance the rights of the parties, and in doing so, to promote a growing microfinance sector. The MFRC, although it does not have formal powers over unregistered lenders, has sought them out on its own initiative, and facilitates formalization by offering a transition path by means of provisional registration.

The reform has had the following impacts according to our observations, as confirmed by numerous sources (e.g., Thordsen and Nathan 1999, Coetzee 2000):

- 1) Formalization and legitimization of the microloan industry, as institutions are encouraged to register and report, and as registered violators are punished for non-compliance;
- 2) Better understanding of the market, as data on microlenders is collected, processed, and (more recently) selectively made public;
- 3) Consolidation, as the smallest lenders -- unable to expand due to lack of funds -- sell their "loan books" to competitors;
- 4) Expansion and extension, as furniture, appliance, and other retailers increasingly add microlending to their activities in order to enable more profitable credit sales;
- 5) New investment by the banks, particularly the larger ones, in the form of subsidiaries that undertake term micro-lending;
- 6) Entry of the industry into the equity market, with mixed results;
- 7) Fragmentation, as some microlenders operate without registering due to the inability of the DTI or the MFRC to enforce the rules on the entire microlender market (there are some problems with gaps and overlaps in the legal framework);
- 8) Increased consumer awareness and action, as MFRC education programs and enforcement actions take hold;
- 9) Substantially expanded credit, supporting expanding consumption spending – and, the flip-side of this, mounting indebtedness and debt spirals, which have caused some hardship for clients; and
- 10) With the strong focus on consumer finance, lack of sufficient focus on mobilization of loan funding for productive purposes: income generation/small business investment and low-cost housing.

In short, the MFRC regulatory regime has created an environment in which a range of large and small lenders have a real interest in extending finance to the low-income market. This market is thus no longer marginal – financial service providers are competing to get into it rather than mainly trying to withdraw. This has led to product innovation across a broad front, including housing and SMME finance, development of better savings products, and an expanding network of financial services accessible to low-income groups. MFRC has registered 1,334 institutions with a total of 5,051

branches as of the end 2001, and these entities have gross microloans outstanding of approximately \$1.6 billion.

It should be kept in mind that the South African microcredit market is somewhat peculiar. This is not only because of its regulatory structure but also because typical borrowers are urban employees of formal enterprises or the public sector who take loans for housing, consumption, or emergencies, and often have loan payments deducted from their paychecks or by bank debit. Also, MFIs (beyond common bond institutions such as employee credit unions) are not authorized to take any deposits, hence cannot offer savings vehicles to clients and face some significant challenges financing their operations.

UEMOA: Mutual MFIs

The eight countries of the *Union Economique et Monetaire Ouest Africaine* (Benin, Burkina Faso, Ivory Coast, Mali, Niger, Senegal, Togo, Guinea-Bissau) agreed to a common approach to the regulatory framework for MFIs, to be developed under the aegis of the regional central bank, BCEAO. This initiative, the *Projet d'Appui a la Reglementation sur les Mutuelles d'Epargne et de Credit* (PARMEC), uses a mutualist or cooperative model. The agreed text of the PARMEC law and implementing decree, for enactment into domestic legislation by each member-country, was ratified by the UEMOA Council of Ministers in 1996.²⁰ Legislation to implement the regional model has been passed in most UEMOA member countries.²¹

The law requires compliance with local usury statutes, which introduces some variation across countries. For example, as implemented in Burkina Faso, the law and regulations allow interest rates in credit programs to rise from 13 to 27 percent. (Churchill, 1997) The mandatory mutual structure and the accommodation of local interest rate regulations are the two most obvious weaknesses of the law, although it has other useful features.

Articles 3 to 6 of the law state clearly that the law applies only to mutuals (cooperative societies), and to aggregations such as unions and federations of mutuals. This puts different organizational types in different regulatory regimes, under different jurisdictions. At the same time, articles 4 and 6 go some distance toward diminishing the

²⁰ *CONVENTION-CADRE DEVANT RÉGIR LES STRUCTURES OU ORGANISATIONS NON CONSTITUÉES SOUS FORME MUTUALISTE OU COOPÉRATIVE ET AYANT POUR OBJET LA COLLECTE DE L'ÉPARGNE ET/OU L'OCTROI DE CRÉDIT*, Adopted by the UMOA Council of Ministers, July 3, 1996. *PROJET DE LOI PORTANT REGLEMENTATION DES INSTITUTIONS MUTUALISTES OU COOPERATIVES D'EPARGNE ET DE CREDIT*, December 30, 1993. *PROJET DE DECRET D'APPLICATION DE LA LOI PORTANT REGLEMENTATION DES INSTITUTIONS MUTUALISTES OU COOPERATIVES D'EPARGNE ET DE CREDIT*, December 30, 1993.

²¹ For example, the PARMEC law and implementing rules were enacted in Cote d'Ivoire: *Republique de Cote d'Ivoire: Loi no. 96-562 du 22 juillet 1996 portant reglementation des institutions mutualistes ou cooperatives d'epargne et de credit*. *Republique de Cote d'Ivoire, Ministere de l'Economie et des Finances: Decret no. 97-37 du 22 janvier 1997 portant application de la loi portant reglementation des institutions mutualistes ou cooperatives d'epargne et de credit*. The author has not been able to review other laws or regulations applicable to the financial sector in Cote d'Ivoire (whether emanating from national authorities, BCEAO, or UMOA), and so cannot address those areas left by the PARMEC law to the authority of such laws and regulations.

problem thus created. Article 4 excludes *groupements*, essentially small and informal microfinance arrangements, from the application of the law, and provides for their voluntary formalization and registration. This, in principle, prevents the mutualist focus of the law from repressing necessary forms of financial innovation at the base, and allows groups to be formalized at some appropriate time. Unfortunately, the law does not define when such entities need to be registered and regulated, but that presumably is dealt with in the applicable banking and financial institutions laws and regulations. Article 6 of the law provides that other types of organizations (non-credit unions) will continue to be regulated by the other competent authorities, while Art. 8 excludes mutualist credit organizations from cooperative and banking laws. Apparently, the intention behind the regional PARMEC law was to bring all MFIs under this regulatory structure. Thus, credit institutions that do not either conform to PARMEC standards, register under the banking laws, conclude a special agreement with the Ministry of Finance, or fall into the exclusion for informals can face sanctions including criminal sentences. (Staschen 1999) NGO microfinance programs, among others, would run afoul of the law.

The mutuals designated in the PARMEC law, along with their unions, federations, etc. are subject to the regulatory authority of BCEAO (and its direct intervention when it deems necessary), and to the supervision and prior approval authority of the Ministry of Finance. Importantly, any decision by the MOF not to approve an organization must be justified by a specific reason, and these decisions are subject to appeal to the “competent jurisdiction,” presumably an administrative tribunal. Generally, the UEMOA finance ministries, which are responsible for bank regulation in the region, are required to set up special monitoring units for the mutuals, which are also expected provide advice in establishing decentralized financial control systems in the mutualist institutions. (Staschen 1999)

An interesting feature of the law is its provision for hierarchical supervision and control by mutuals and their unions and federations – i.e. a form of delegated or hybrid supervision. Supervision and control responsibilities are placed in the following (descending) hierarchy: network-confederation-federation-union-credit union. Each higher level has internal supervision and control requirements over the lower level, conducts audits, and represents the lower-order entities at the next higher level. Each lower-level entity can belong to only one higher-level entity. The law does appear to recognize initial freedom of choice as to which aggregation to join, hence there may be some “exit” option and competitive discipline. At the pinnacle of this hierarchy are *organes financiers*, which can be formed by networks of mutual institutions. These manage the surplus funds of their members, receive deposits, issue negotiable instruments (*titres*), and are directly supervised by the central bank and banking commission. They must have corporate form (*societe a capitale variable*). It is unclear from the documents reviewed, and perhaps should be spelled out, whether an existing bank or NBFIs can become a network’s *organe financier*.

Supervision and reporting requirements reflect this network structure. Annual reports of mutualist MFIs must be made to the MOF, and federations and apexes must send audited reports to BCEAO and the banking commission. Reporting within mutualist

networks is not specified. The text of the law clearly envisions and facilitates a division of supervisory tasks between the MOF and the mutualist networks – such that the latter could take on most of these functions as a self-regulatory organization. This, of course, depends on the Ministries’ willingness to delegate authority. One observer suggests that direct oversight by the ministries of finance in the UEMOA countries, rather than actual delegation to the mutualist networks, has all too often been the pattern in practice. (Staschen 1999)

There are a number of other features worth mentioning. First, member institutions are subject to liability to third parties at least as great as their capital contributions, and the rules of liquidation are essentially based on commercial insolvency rules. Mutuals are tax-exempt, but the relevant provision does not make it clear whether this exemption extends only to revenues or also applies to employee income and social insurance taxes. Mutuals cannot engage in checking, but can handle fund transfers, obviously a critically important service at the micro level. ‘Professional secrecy’ applies to credit and deposit information. This is a necessary requirement, and one that is subjected to regulatory exceptions. The question here is whether this, in practice, will be allowed to obstruct the development of credit information and reporting services. The decree spells out quite conservative prudential ratios: outstanding loan and investments cannot exceed twice the value of member deposits, general reserve deposits of 15% of net earnings are required annually, and there must be an 80% match of short-term assets and liabilities. The decree also specifies concentration of risk and related transaction ceilings.

Uganda: MDIs

Uganda in recent years has been in the process of developing its policy on the regulation of microfinance activities. The Bank of Uganda’s (BOU) policy envisions four tiers in the financial sector: (1) Banks, (2) Formal NBFIs, (3) Microfinance Deposit-taking Institutions (MDIs, to be defined by law), and (4) Credit-only MFIs and informals. In the fourth tier, member-based MFIs under a certain size (i.e. number of members, to be determined by BOU) will be excluded, while the remaining institutions will be required to obtain a license or cease operations. These tier 4 credit-only institutions are not included in the draft microfinance law, nor will they be supervised by BOU. (Opiokello 2000)

The draft law now being considered in the parliament of Uganda, the Micro Deposit-Taking Institutions Bill 2001, provides the framework for licensing and regulating depository MFIs (MDIs). The bill defines MDIs as institutions whose principal business is accepting and intermediating deposits, including loans to microenterprises and low-income households, using lending techniques that depend on collateral substitutes such as group guarantees and compulsory savings. MDIs are required to be incorporated and licensed – and licensing is contingent on status documentation, a feasibility study as detailed in the bill, sufficient resources, and operators and board members deemed by BOU to be “fit and proper,” qualified, trustworthy, and experienced.

Regulatory norms and supervision rules are, somewhat unusually, well defined in the bill itself. Minimum capital is determined by an adjustable formula, with the level initially set at approximately U.S. \$400,000. The bill sets minimum capital adequacy at 15% for “core” capital (fully paid-up shareholders’ equity) and 20% for total capital. For donor-funded MDIs, donor capital must be converted to subordinated debt and paid down or supplemented by an equal amount of institutionally-raised reserves (an understandable but fairly onerous requirement). MDIs cannot provide checking accounts or engage in securities or forex operations, and are held to strict limits (1% in most cases) on concentration of lending risks and related transactions. The reporting rules are somewhat unusual in that they require publication of audited accounts in the newspapers, reporting of problems to an official credit bureau, and a listing of any regulatory violations in the MDIs’ regular returns. The BOU has broad authority to take over troubled MDIs. Last, an MDI Deposit Protection Fund is envisioned in the bill. The precise details of these provisions remain to be spelled out in regulations, once the bill is passed.

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