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THE RUSH TO REGULATE: Legal Frameworks for Microfinance

CGAP

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Introduction

Formal credit and savings for the poor are not recent inventions: for decades, some customers neglected by commercial banks have been served by credit cooperatives and development finance institutions. These organizations have legal charters that govern their financial operations and allow them access to savings or other public funding.

But the past two decades have seen the emergence of powerful new methodologies for delivering microfinance services,[1] especially microcredit. Much of this innovation has been pioneered by non-governmental organizations (NGOs), who typically do not have a legal charter authorizing them to engage in financial intermediation. Governments, donors, and practitioners are now talking about new legal structures for microfinance in dozens of countries. Microfinance regulation and supervision has suddenly become a hot topic, with conferences, publications, committees, and projects appearing everywhere. Much of the attention is focused on NGO microfinance.[2]

Regulation of microfinance is being discussed in one country after another. But the people doing the discussing are often motivated by differing objectives, which tends to confuse the dialogue:

- Looking to fund themselves, NGOs with microcredit operations often want to be licensed (and thus regulated) in order to access deposits from the public, or credit lines from donors or governments.
- Sometimes microfinance institutions (MFIs), especially NGOs, believe that regulation will promote their business and improve their operations.
- Some NGOs, governments, and donors want financial licenses to be more widely (and easily) available in order to expand savings services for the poor.
- Donors and governments may expect that setting up a special regulatory window for microfinance will speed the emergence of sustainable MFIs.
- Occasionally, where unlicensed MFIs are already taking deposits, the central bank's motivation in pushing to license them is to protect depositors.
- Many MFIs charge surprisingly high interest rates. Government may view these rates as exploitative and want to protect small borrowers from them.
- Local authorities are sometimes troubled by the weakness of many MFIs, and unimpressed with the coordination and supervision being exercised by the donors who fund them. They want someone to step in and clean up a situation that they think is hurting the development of microfinance in their country.

[1] In this paper *microfinance* means formal banking services for poor people (definitions of "poor" in this context vary widely). Governments or others *regulate* financial service providers when they make rules for them, controlling for instance the safety standards they must meet. *Supervision* is systematic oversight of such providers to make sure that they comply with the rules, or close down if they don't.

In order to limit the cumbersome repetition of "regulation and supervision," this paper will sometimes used "regulation" as a shorthand for that phrase.

Unless otherwise indicated, this paper refers only to microfinance in developing countries. Microfinance in rich countries presents very different issues.

[2] It is worth noting that even today, most of the world's microfinance clients are served by banks, credit unions, and other licensed institutions.

- Occasionally governments look to regulation as a means of clamping down on bothersome foreign-funded NGOs or other groups that it would like to control more tightly.
- In some countries there is simply no legal structure under which a socially motivated group can lawfully provide loans to poor clients. Unless such a structure is developed, loans may be legally uncollectable, and microfinance providers may even be at risk of prosecution.
- Finally, microfinance is getting a high political profile in many countries, especially since the 1997 Microcredit Summit and its aftermath. Occasionally, attention to regulation springs from a government's sense that it has to do something about microfinance, for reasons that may combine concern for the poor and the demands of practical politics.

For all these reasons, microfinance today seems to find itself in the midst of a rush to regulate. There is no shortage of people willing to offer views on when and how to do it. But all of them, including the authors of this paper, suffer from the same handicap: experimentation with microfinance supervision is so recent that we can't rely much on its historical results to guide us.[3] Some important questions can be answered only tentatively, if at all. And of course individual country situations vary greatly. So readers looking for a string of confident practical conclusions or one-size-fits-all advice will find themselves frustrated (though not completely!) by this paper.

Organizing this discussion proved troublesome: the logical relationships among the topics are annoyingly complex. At the cost of delaying our arrival at the directly practical questions, we decided to begin with some important background issues:

- The **practical problems faced by bank supervisors** who are asked to take responsibility for MFIs.
- The **costs of regulating and supervising** MFIs, including the danger that defining a legal framework can have unintended consequences.

Then the paper moves into policy questions, arguing

- That **credit-only MFIs should generally not be subject to prudential regulation and supervision** in which the government supervisory agency is expected to monitor the financial soundness of the licensed institution.
- That **small community-based MFIs** should not be prohibited from deposit-taking just because they are too small or too remote to be regulated effectively.
- That the **push to create special regulatory windows for MFIs** may make sense in a few developing countries, but that in most it **is probably premature** right now, running too far ahead of the organic development of the local microfinance industry.
- That **self-regulation** by MFI-controlled federations is highly unlikely to be effective.

The authors believe strongly that the future of microfinance lies in a licensed setting, because it is the only setting that will permit massive, sustainable delivery of financial services to the poor. Thus, the cautionary overall message of this paper is not meant to question the importance of microfinance regulation and supervision, which are essential to any licensed framework. Rather, we are raising questions about timing, and about certain expectations that may turn out to be inflated. In focusing heavily on certain problems, we don't want to imply that they have no solutions—only that they are problems that need to be dealt with realistically.

A. The supervisor's challenges

The problems of bank supervisors[4] in poor countries may not sound like a "visionary" place to start our reflections.[5] But unless we give this subject its due, our planning of frameworks can lead us into an alluring cloudland of elegant structures that can't be implemented. **The most carefully conceived regulations will be useless, or worse, if they can't be enforced by effective supervision.**

For bank supervisors in many developing countries (though certainly not all), the central fact of life is responsibility for supervising a commercial banking sys-

[3]The paper has more examples from Latin America than from other regions, in part because the authors are somewhat more familiar with this region, but mainly because Latin America has more experience with microfinance regulation than some other regions.

[4] We use the term *supervisor* to refer to the government official responsible for prudential oversight of financial institutions, whether in a central bank department, the finance ministry, or an independent agency.

[5] In this paper we focus on bank supervisors in developing countries. Of course, their colleagues in rich countries have plenty of problems too—trillions of problems, in cases like the savings and loan debacle in the United States or the recent East Asian banking crises.

tem with severe structural problems, often including some sizable banks teetering dangerously close to the edge of safety. The collapse of one—or a half-dozen—of these banks could threaten the country's financial system with implosion. In trying to manage bank risk, the supervisor may have to work in a political minefield, because the owners of banks are seldom underrepresented in the political process. The supervisor's legal authority to enforce compliance or manage orderly clean-ups is often inadequate. She[6] may not have enough control over the tenure, qualification, and pay of her staff. Monitoring healthy banks is challenging enough, but the real problems come when it is time to deal with institutions in trouble. When a sick bank finally crumbles, its president can start sleeping again (though perhaps in a different country), while the supervisor has to stay awake at night worrying. The Minister of Finance may be pacing the floor with her, since in many countries a government-issued financial license carries with it a guarantee, implicit or explicit, that the government will bail out depositors if a licensed institution collapses.

If a bank supervisor displays resistance to adding MFIs—mostly small, mostly new, mostly weak on profitability—to her basket of responsibilities, we should recognize that her reasons may be nobler than narrow-mindedness or lack of concern for the poor.

Ownership issues. Even the supervisor who is willing to oversee MFIs faces serious challenges, not all of which are obvious. The most basic problem stems from ownership structure. The ownership of a commercial bank typically includes persons with large amounts from their own private pockets at risk in the bank. Such owners want a financial return from the bank, and can get it only after all others' claims are paid off. They have a strong incentive to watch the performance of the bank's manager closely to make sure that this performance is consistent with the health of their investment. Thus, this kind of owner is a very important line of defense for the safety of the bank. The supervisor cares about capital adequacy ratios, not just to provide a cushion in time of problems, but also to insure that the owners continue to have enough incentive to watch management closely.

Most of today's MFIs do not have this kind of ownership: large chunks of money from private, profit-seeking pockets seldom account for much of their equity base. Almost all MFIs have a governing board that is supposed to provide independent oversight of management. But where members serve on that board for altruistic reasons and do not have serious amounts of their own money at risk, they tend not to look over management's shoulder the same way business investors do. One finds occasional heroic exceptions, but boards of NGOs (for instance) are notoriously more re-

Box 1—Rural banks in the Philippines:
The burden of supervising small intermediaries

In the Philippines, the smallest licensed intermediaries are "rural banks." Despite the name, they are found in both rural and urban settings. Supervised by the central bank, they are integrated into the payments system. Their operations include credit and deposit services for relatively poor clients. As of September 1997, 824 rural banks were serving a half a million clients. These banks had only about 2 percent of the banking system's assets and deposits, but they made up 83 percent of the institutions the central bank had to supervise. Branches of the 52 commercial banks outnumbered offices of the 824 rural banks by more than 2 to 1.

Supervising the rural banks has severely stretched the resources of the Philippine central bank's supervision department, tying up as much as one-half of its total staff and budgetary resources at times. In the early 1990s one in every five rural banks had to be shut down, and many others had to be merged or otherwise restructured.

A 1996 report estimated that 200 inspectors were assigned to the rural banks. Even this level of resources was viewed as inadequate. Each field visit consumed up to three person-weeks or more. At one point the supervisory department found that this burden, combined with its budget limitations, was severely endangering its ability to function.

Minimum capitalization of $100,000[7] to $1,000,000 in equity is now required to constitute a rural bank, depending on the size of the municipality where the bank is located. According to the 1996 report, the experience with the Philippine rural banks showed that minimum capital for such institutions should be set higher rather than lower, in order to provide more stability and to rationalize the demands on the financial authorities.

Deposits in rural banks are protected under the national deposit insurance system. The Philippine Deposit Insurance Corporation (PDIC) covers up to 100,000 pesos (about $2,500) per depositor, per bank. PDIC shares information with the central bank, and the two generally work well together, although there is some overlap in their function that raises the cost of supervision.

[6] We arbitrarily use the feminine pronoun here to celebrate the increased number of female bank supervisors in recent years.

[7] All dollar amounts are U.S. dollars.

laxed about their institution's financial viability than are owners of for-profit businesses managed by someone else. No one should take this as a derogatory observation. The problem derives not from the personal quality of MFI board members, but rather from the organic structure of their incentives. This ownership problem is not solved just by getting a banking license. It is solved only where the ownership moves more into the hands of people who will lose large amounts of money if the institution goes under. (We don't want to push this point too far. Private capital doesn't guarantee bank solvency, nor does its absence inevitably lead to bank failure. There are some cases in poor countries of successful financial institutions owned by non-profit groups, or governed by people who have little money at risk in the bank. But these cases are uncommon, and the following section shows why a supervisor still needs to worry about them.)

Supervisory Tools. The difference between owners with their own money at risk and owners without it becomes most striking when a financial institution gets into trouble. One of the supervisor's most powerful tools in a problem case is the capital call: she tells the owners, "Put more capital into your bank to shore it up, or else I'll close you down." If the supervisor has caught the problem early enough, the owners are likely to comply, in order to avoid losing the capital they have already committed to the bank. (Note that commercial bank owners tend to be people who can come up with additional money on short notice; many countries make this an important condition to getting a license.)

But capital calls lose much of their power when applied to a typical MFI, as the Colombian bank supervisor discovered two years ago. Finansol, an MFI organized as a finance company, had suffered serious loan losses, reducing its cushion of owners' capital. The supervisor issued a capital call. The principal owner was the NGO Corposol, which had no additional money of its own to contribute to the rescue. The closure of the finance company and the resulting loss of the NGO's investment would take nothing out of the private pockets of the NGO's board members. Naturally enough, they chose not to dig into those pockets to put more money into the ailing finance company.[8]

Another common supervisor's tool is to order a halt (hopefully temporary) to new lending until a problem is cleared up. A commercial bank can often stop new loans without jeopardizing the collectability of its existing

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Box 2—Finansol (Colombia): Non-profit governance problems

Corposol, a leading Latin American microcredit NGO, acquired a licensed finance company and renamed it Finansol. Corposol held a controlling share in the licensed company. The same was true for PRODEM and BancoSol in Bolivia. But unlike PRODEM, Corposol from the beginning subordinated Finansol to its broader agenda, treating it simply as an instrument to capture commercial funding. Initially, Finansol was given only the staff necessary to run a back office for the loan portfolio. Corposol and loan officers on its payroll continued to manage all loans. Yet Finansol was accountable to the authorities for the quality of the loan portfolio—a fact that introduced a constant tension in the Corposol-Finansol relationship.

This dual structure was justified as a means to avoid the interest rate cap placed on Finansol by Colombia's usury law. With the tacit consent of the authorities, the NGO Corposol was able to charge a 'training fee' that was not included in calculating the finance company's effective interest rate for purposes of the usury limit. The training fee was far higher than actual training costs, generating about 40 percent of Corposol/Finansol's total income, and covering almost all administrative expenses of the two entities.

Later on, Corposol used this dual structure to deflect another regulation. To control inflation, in 1995 the central bank restricted loan portfolio growth in banks to 2 percent annually. Corposol/Finansol evaded this limit by simply moving loans into the NGO, making the true portfolio situation even less transparent. Corposol management could move the portfolio back and forth between the companies at will, with little concern for arm's length pricing. This practice apparently did not have the consent, tacit or otherwise, of the authorities.

In addition to this non-transparent structure, Corposol suffered from seriously flawed business vision and practice on the part of its manager. Star-struck by the success of the basic solidarity group loan product, the manager launched a hugely ambitious expansion into a wide array of financial products and even wholesale food marketing. Most of these products were poorly executed, generating heavy losses. Even more devastating, he maintained a continual policy of rolling over problem loans, camouflaging delinquency levels both internally and externally. To keep Finansol portfolio quality looking acceptable, poorly performing loans, products, and branches were shuffled back and forth between the two organizations' books as convenience dictated.

The board of directors that presided over this disaster included respected and successful Colombian business people. None of them had substantial amounts of their own money at risk, and it turned out that they did not have enough incentive to scrutinize management's performance seriously. The board did not require of management the basic reports necessary to evaluate the performance of Corposol's diverse activities; nor did they act decisively when the failures finally became apparent. It took external reviews—ACCION's CAMEL exercise, and later the bank superintendency's inspection—to reveal the depth of mismanagement. By then it was too late. Corposol folded completely, huge loan losses were incurred, and Finansol survived only by the skin of its teeth.

[8] In many cases, licensed MFIs are owned in part by donor agencies, whose cumbersome procedures usually cannot produce emergency capital quickly.

loans. MFIs can't. The main reason their clients repay is their expectation of reliable and responsive future services. If the MFI denies prompt follow-up loans to clients who have punctually repaid prior loans, the MFI is breaching an implicit contract with its customers, many of whom will stop repaying their *existing* loans the minute the word gets out. Thus, a stop-lending order to an MFI will wipe out the institution's loan portfolio if kept in place for very long. This supervisory tool turns into an atomic bomb that can only be used if one is prepared to destroy the MFI.

A related problem is that an MFI's principal asset consists of microloans that have little value once they are out of the hands of the team that originated the loan. When a bank is in trouble, the supervisor's first choice will often be to "encourage" acquisition by, or merger with, a stronger bank. Many of the sick bank's loans are backed by collateral or guarantees, so the borrowers' incentive to repay is not tied to their relationship with the sick bank. The healthy bank can expect to recover many of these loans, so it has an incentive for the acquisition if the price is right. Even if the sick bank is simply left to fail, some of its loans can still be collected to reduce depositors' losses.

But if the sick organization's only assets are unsecured microloans, the picture is less encouraging. Once clients' confidence in the MFI as a going concern is shaken, they tend to stop paying their loans, and collection of these loans can cost more than the amounts recovered. The sick MFI's portfolio is usually of little value to anyone else, including those unlucky enough to have trusted the MFI with their savings. A healthy MFI will seldom be interested in taking over such a contaminated portfolio.[9]

While we are talking about supervisors' tools, we might touch on some problems with monitoring microcredit loan portfolio quality, the main locus of risk for most MFIs. Some of the traditional inspection and audit tools that bank supervisors are used to turn out not to work very well in evaluating microloan portfolio risk. Their stress on formal procedures and documentation doesn't fit well with tiny unsecured loans to informal borrowers—for instance, checking elaborate loan files for fulfillment of hierarchical loan approval processes, reviewing amount and registration of collateral, or mailing letters to clients to confirm account balances. Wholesale renegotiation of troubled loans is a common problem in MFIs; detecting it is a burdensome process requiring extensive review of individual loan records and on-site visits to a large proportion of branches. Few MFIs have internal audit departments whose work can be relied on.

Supervisors can't place meaningful reliance on independent external audits of MFIs, at least as such audits are practiced now. The authors have yet to encounter an audit of an MFI that included procedures sufficient to warrant real confidence about the state of its portfolio.[10]

Box 3—The collapse of Finansol:
A bank supervisor's limited options

In February of 1996 the Colombian bank superintendency halted new lending by Finansol, a licensed MFI, because of escalating repayment problems. Three months later, the superintendent declared Finansol to be technically insolvent—loan losses had wiped out over half of its equity during the year. (The lending freeze had worsened Finansol's repayment problem: when the word got out that clients couldn't get new loans, many stopped repaying their old ones.) The superintendency issued a capital call, requiring the finance company's owners to recapitalize it within 60 days.

Donor agencies proved either unwilling or unable to help with the recapitalization. The initial private bailout plan, backed by the prestige of both ACCION International and Citibank, failed. Uncertainty about the recoverability of Finansol loans scared private investors away.

Given the tattered state of the Finansol portfolio, and the fact that it was largely unsecured, the superintendent had little chance of finding a merger partner for the failing finance company. There was little choice but to extend the recapitalization deadline: the only alternative was to close Finansol down and watch its unsecured portfolio become completely uncollectable. ACCION, Profund, Citibank and others participated with good faith money, but their contributions fell far short of the investment required. Ultimately Finansol could be saved only because a government apex, Finansol's principal creditor, was forced to surrender most of its debt in return for shares of equity as the only hope of recovering anything substantial from the disaster.

[9] In Uganda, the Cooperative Bank had a small microfinance portfolio lodged in several stand-alone agencies. When the rest of the bank failed, these agencies were in respectable condition. Centenary Rural Development Bank, a specialized microfinance bank, was willing to acquire some of these agencies, but as the process stretched out for others, their portfolios started to unravel and CERUDEB was no longer willing to pick them up.

[10] The problems with external audits and conventional audit / inspection tools when applied to MFIs are discussed at surprising length in *External Audits of Microfinance Institutions: A Handbook* (CGAP Technical Tool Series No. 3, Washington D.C., 1998).

Better portfolio-monitoring techniques can be transferred to supervisory agencies through technical assistance. We must recognize, though, that the road is often rockier than expected. Staff turnover can be a serious problem. We know of one case—and we doubt that it is an isolated example—where a donor provided extensive (and expensive) training to central bank staff, only to have the majority of them move on to other pursuits a very short time later. In Bolivia, the bank superintendency has received lavish support for training and technical assistance from at least three different donors to build new systems and skills to handle non-bank financial institutions. Seven years into the process, it is still far from complete. In this institution, stronger staff have repeatedly been pulled off to deal with commercial banks in trouble. (We do not wish to suggest that we would quarrel with the Bolivian supervisor's decision to do this.)

Next, we have to recognize that there are a few cases where the supervisory agency is so politicized, incompetent, or corrupt that no amount of external support can make it a reliable supervisor of microfinance.

And finally, we remind ourselves that technical assistance, even if it is outstandingly successful, can solve skill problems at the supervisory agency but doesn't change the issues we noted earlier in connection with MFIs' ownership and portfolio volatility.

The existence and severity of these problems vary from country to country. The point of this daunting catalog of obstacles is not that supervision of microfinance is impossible—only that it involves serious challenges that are not always taken into account when discussing legal frameworks—challenges that some supervisory authorities might do well to defer.

In Peru and Bolivia the supervisory agencies appear so far to be doing a creditable job of supervising MFIs. But it is important to note that both of these countries had greatly improved their capacity to supervise commercial banks *before* specialized MFIs were added to the supervisor's responsibilities. Perhaps this suggests that supervisors should not be asked to take on specialized MFIs unless the supervision of commercial banks is working reasonably well. Unlike MFIs, commercial banks pose systemic risk, because the failure of one or more of them can imperil the country's financial structure. Thus, it could be argued that supervisory attention and resources, including donor assistance, should not be diverted away from bank supervision until that difficult task is being managed effectively.

There are several other countries in Latin America where supervision of banks is advanced enough, and supervisory capacity is strong enough, that the bank superintendencies could probably take on specialized MFIs. The authors would not hazard an opinion about other regions where they are not as familiar with supervisory capacities and challenges in individual countries.

B. Costs of Supervision

The costs of the supervisory agency itself tend to be relatively low in the case of banks—for instance, one per thousand of assets supervised—and can usually be passed on to the banks and their customers. Supervision of MFIs is likely to be much more expensive, given the MFIs' generally smaller asset base, their much larger number of accounts, their high degree of decentralization, and finally the more labor-intensive nature of inspecting their portfolio. For a decentralized MFI of 10,000 clients, we could easily imagine supervision costs from 1 to 5 percent of assets, which may have to be passed on to the MFI and its clients.[11]

But those are just the supervisor's costs. What about the costs to the supervised institution?

BancoSol's chief financial officer estimated that complying with the bank superintendency's reporting requirements cost an amount equal to about 5 percent of portfolio in the bank's first year of operations. Of course this cost declined in later years. The present manager's rough estimate last year was that reporting to the superintendency costs him perhaps 1 percent of portfolio, over and above what BancoSol would be spending for the information it needs for its own purposes.

There are substantial non-financial costs as well. Regulation can cramp competition. Perhaps more seriously, it can stifle innovation. The act of writing a set of rules for microfinance involves the rulemaker in a certain amount of "model-building"—making decisions as to what kinds of institutions are the best to do microfinance, and sometimes even what kind of loan methodologies or operating procedures are best. Boundaries are drawn, and innovation outside those boundaries can be squelched. This is not just a theoretical concern. If Latin American NGOs had not been allowed to experiment with microcredit products that were inconsistent with the legal provisions of the regulated financial system, it's hard to imagine how microfinance in the region could have flowered as it did.

[11] We do not wish to imply that microfinance cannot absorb these costs. Given the high spreads and loan interest rates that characterize many MFIs, another few points of cost may not be a life-and-death issue for them. Some governments may be willing to subsidize these costs by charging MFIs the same percentage of assets that they charge commercial banks.

Box 4: Costs of MFI supervision in Peru

The Peruvian banking superintendency supervises more than thirty MFIs, including municipal funds, rural funds, and small/medium business funds (transformed NGOs). The NGOs pay the same supervision fees as banks—currently about 0.06 percent of assets. A recent cost study showed that microfinance supervision was costing thirty times that amount—about 2 percent of assets. Given that loan portfolio generally constitutes about two-thirds of their assets, the MFIs would have to charge their borrowers an additional 3 percent if they were paying their full cost of supervision (without including a further 1 percent or so for the MFIs' compliance costs). In Peru, MFIs can easily charge interest rates that permit them to pass these costs on fully to clients. The superintendency has yet to decide whether to raise MFI fees to cover full supervision costs.

C. Regulation and interest rates

There is one potential "cost of regulation" that deserves separate treatment. Pushing governments to develop legal frameworks for microfinance may in a few countries risk setting a process in motion whose result could be the imposition of interest rate controls. These controls can make sustainable microcredit impossible, or at least discourage outreach to poorer customers.

Microcredit can be sustainable only if the borrowers can be charged interest rates that are higher—usually much higher—than the rates that are customary in normal banking transactions. It's a simple matter of costs. In relation to the amount of money lent, tiny loans cost more to make and manage than do big loans. Even the most efficient MFIs have found it impossible to reduce their administrative costs much below about 10 to 25 percent of their portfolio, depending on methodology, loan size, and location. By contrast, comparable costs in an efficient developing-country commercial bank are usually below 5 percent, often well below. A sustainable MFI—that is, one that could pay commercial cost for its funding without losing money—must therefore charge an interest rate that could sound obscene in the normal commercial-bank market or in the arena of political discussion. The lower the usury limit, the more borrowers there are at the low end of the spectrum who cannot be served sustainably.

When modern microcredit emerged in Latin America, almost all of the countries had legal limits on interest rates. These limits were set far too low for sustainable microcredit. Most of the microcredit pioneers practiced regulatory avoidance by mounting their operations in NGOs. If the laws had been enforced literally in some of these countries, the usury limits and even a requirement of financial licensing would have applied to all microcredit operations. But in fact the microcredit NGOs were left alone. The authorities were unaware of, or unconcerned with, their existence. Innovation flourished, minor disasters abounded, and out of the ferment emerged a critical mass of successful MFIs that were strong enough to justify a formal financial license. In the meantime, government policy and public attitudes about interest rates had changed (in part because the authorities saw the tremendous demonstrated demand for these high-interest-rate loans), so that by the time strong MFIs were ready for licensing, interest rate repression was no longer an issue in most of the countries. All this happened because the governments involved were not prematurely forced to take a public position on microcredit interest rates. If anyone complained about the MFIs' rates, the central bank president was free to say, "Those groups are not my responsibility."

Suppose that in 1980, Latin American governments had been convinced by a well-intentioned donor that they needed a new regulatory framework to encourage emergence of special financial institutions that would reach poorer clients. Any government acting on such advice has to take a public position on interest rates, either limiting rates or leaving them unregulated. In most Latin American countries at the time, leaving interest rates free, or setting the usury limit high enough to permit microfinance to recover its costs, would have been politically impossible. If the whole issue had been moved into the public arena, it is unlikely that governments could have continued turning a blind eye to NGOs charging high rates. It seems probable that pushing for a legal framework in 1980 would have seriously hindered the development of microfinance in Latin America.

Are there parallel situations today, where governments are being encouraged to set up a regulatory framework even though it is not clear how the government will come down on the interest rate issue? In such cases, is it prudent to push ahead, on the assumption that interest rates will be addressed later, especially when we bear in mind that the new framework may result in extending usury limits and other controls to cover existing credit-only programs that had previously been free to make their own pricing decisions?

Box 5—The PARMEC law (West Africa):
Interest rate restrictions; supervisory capacity

The West African Monetary Union has long had interest rate controls on the books, but as a practical matter these controls were generally not enforced in the case of credit-only MFIs. In the late 1980s the central bank, with donor assistance, embarked on a major effort to regulate the non-bank financial sector. The new PARMEC law, promulgated in 1993 and ratified by the member countries through 1998, underscored the universal applicability of the usury limits, and made their enforcement much more likely.[12] Many MFI operators are caught in a bind: they can't cover the costs of their programs without a higher interest rate, but they feel themselves at serious legal risk if they charge sustainable rates.[13]

The finance ministry in each country is responsible for the supervision of all institutions covered under the PARMEC law. In the past few years, the West African Central Bank and international donors have focused on the ministries' capacity to handle this responsibility. Seven of the eight countries covered by the PARMEC law have created special units of one to five people to supervise these institutions. The central bank is organizing training, and several donors are providing short-term technical assistance, equipment and funding for these specialized units. Nonetheless, the volume of work will be enormous: full compliance with the supervision responsibilities outlined in the PARMEC law would quickly overwhelm the current capacity of the finance ministries in the region.

This is what happened in the countries of the West African Monetary Union. In Bangladesh, where donors have supported an active dialogue with the central bank on microfinance regulation, the central bank president said at a recent conference that one of the main objectives of regulation ought to be to restrain the "exploitative" interest rates being charged by some MFIs.

This interest rate issue is a particular illustration of a more general dynamic, one related to the diversity of motivations discussed earlier. When groups push to get the regulation train rolling, they need to recognize that the people who wind up driving the train may be pursuing objectives quite different from their own.

D. Who should be regulated?

This is a contentious issue. Should credit-only MFIs be regulated? What about "member-owned" institutions? What about small ones? People are coming up with different answers in different countries.

Box 6—Microfinance regulation in Uganda:
Unanticipated consequences; protecting the supervisor

Efforts to develop rating and regulatory schemes for microfinance in Uganda began with an Austrian-financed project in 1996 aimed at educating the central bank about microfinance and setting up a rating system for MFIs. The latter effort was unsuccessful, but ensuing events resulted in the development of legislation (still in draft form) for the regulation and supervision of MFIs and community-based savings and loan organizations. Other donors indicated interest in MFI regulation, especially the World Bank. More recently, the German agency GTZ has been providing technical assistance in this area to the central bank.

Several of the Ugandan NGOs were eager supporters of this initiative at the beginning. The NGO community felt that they had considerable input into the process at the early stages. Since late 1998, the process seems to have become less "consultative," due at least in part to the present authorities' understandable qualms about negotiating regulations with those who are to be regulated. Policy documents available to the public have been silent on some key issues. The NGOs who were most active in the process early on are now disenchanted. They have the impression that the central bank is leaning toward decisions that they see as damaging, including

- Requiring all owners of a licensed intermediary to be natural persons, and severely limiting foreign shareholding. As a practical matter, this would eliminate the only likely sources for equity investment in a transforming NGO.
- Imposing prudential licensing requirements on all community-based MFIs whose number of members exceeds an extremely low limit. If enacted and enforced, this could put out of business many organizations that are providing savings services in places where no one else is likely to provide them. In section D we argue vigorously against such a policy. While unsupervised intermediaries are a risky place to put savings, they are probably less risky than most of the available savings alternatives for many people, especially in rural areas.

At the early stages when the process of developing norms was more "participatory," minimum capital requirements as low as $20,000 were discussed. Lately, the central bank has (quite reasonably) become concerned that such a low hurdle might overburden the central bank's supervisory capacity by permitting too many licenses. The minimum capital levels now being considered are in the range of hundreds of thousands of dollars.

[12] "PARMEC" is an acronym for "Projet d'Appui à la Réglementation des Mutuelles d'Épargne et de Crédit." The law has been ratified by Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, and Togo. Guinea Bissau recently joined the Monetary Union but has not yet adopted the PARMEC law.

[13] The law provides that finance ministries in the member countries may grant discretionary exceptions upon documented application by individual MFIs. No criteria have been established to guide such decisions. The uncertainty of the exception process has deterred most MFIs from applying.

Defining terms. The word "regulation" is a broad one that can produce confusion in this context. We'd like to distinguish between "non-prudential" and "prudential" regulation / supervision.[14] We refer to some requirements as non-prudential, not because they are insubstantial, but because *they do not involve the financial authority in vouching for or assuming any responsibility for the soundness of the "regulated" institution.* Examples of such requirements include

- Registration and legal chartering of licensed entities
- Disclosure of ownership or control
- Reporting or publication of financial statements; norms for the content and presentation of such statements; accounting and audit standards[15]
- Transparent disclosure of interest rates to consumers
- External audits
- Submission of names of borrowers and status of their loans (on-time? late? by how much?) to a central credit information bureau[16]
- Interest rate limits.

Depending on the combination of elements, a package of non-prudential regulation could be painless, or burdensome in the extreme. But these requirements don't entail the government taking a position on the financial soundness of an institution. They don't embroil the government in any accountability, explicit or implicit, as an insurer of depositors' losses in the event of failure. Some kinds of non-prudential regulation don't even have to be lodged in the agency supervising financial institutions. Enforcement of these elements will seldom involve regular supervision or on-site inspection.

Once we step over this threshold of vouching for soundness, the character of regulation changes dramatically. Prudential regulation and supervision of financial intermediaries involves definition of detailed standards for financial structure, accounting policies, and other important dimensions of an institution's business. Enforcing these standards and otherwise monitoring institutional soundness require much more intensive reporting, as well as on-site inspection that goes beyond the scope of normal financial statement audits.

When we refer to "regulation" in this paper, we are generally discussing prudential regulation and supervision, not non-prudential regulation.

"Illegal" microcredit. It is illegal in some countries for NGOs to offer credit, because this activity is not specifically authorized in the laws under which NGOs function. In many countries the financial laws, if interpreted strictly, would prohibit anyone without a financial license from intermediating money (borrowing from one party while lending to another), or from carrying on a business of lending money, regardless of the source of funds. Sometimes the laws don't permit a non-profit organization to generate interest income that exceeds its expenses.

The first question to ask about these laws is whether they are enforced. Many microcredit NGOs operate where such laws are on the books but unenforced. This situation is uncomfortable—the law is a club that an unfriendly public official could use at any time—but it is not necessarily intolerable. Most of Latin American microcredit developed in precisely this situation until recent years. This kind of benign neglect, a sort of regu-

[14] In a sense, this two-element frame is an abbreviation of the more detailed breakdown of elements used by people talking about "tiered" regulation and supervision.

[15] Many countries require NGOs and financial cooperatives to report their financial situation regularly. In other places, governments or federations of MFIs are considering imposition of such a requirement on MFIs. The problem is that MFI financial statements, even if all the reported data is generously assumed to be correct, seldom provide enough information to permit meaningful judgements about portfolio quality or levels of sustainability. When financial reporting is required, the reporting format should be adjusted so that the financial statements or their notes provide the necessary information.

There are numerous texts that detail the kind of information needed. While suggested formats vary, there is little disagreement among analysts as to the necessary elements. One version of the requirements, which can be applied to any financial reporting format, is presented in Annex A of the CGAP *Audit Handbook*, cited earlier. The member donors of CGAP are now working on a common set of guidelines for the content of MFI financial reporting.

[16] In more advanced microfinance markets, borrowers have a choice among multiple formal lenders. When this happens, delinquency tends to rise. Borrowers taking loans from more than one institution find it easier to indebt themselves beyond their ability to repay, because a loan officer doesn't know the total demands on the borrower's cash flow. In addition, the motivation to repay is diluted when a defaulter who loses access to one MFI can simply go to another.

By "credit information bureaus" we mean databases to which all participating lenders provide the names of defaulting clients, or better, names of all clients along with an indication of their repayment behavior. In developed economies, such credit bureaus have made possible a tremendous expansion of unsecured credit to people who otherwise couldn't have obtained it. Credit bureaus allow borrowers to build an asset—demonstrated creditworthiness—that can be used with multiple sources of credit, not just one. Credit bureaus make credit less expensive: the information they provide lowers the cost of appraising a loan as well as default losses, both of which can be passed on to all borrowers.

Credit bureaus can work in some developing countries. There are many such systems in Latin America, including some that cover microfinance. In Bolivia efforts to set up the system on a voluntary basis were fruitless because lenders were reluctant to reveal the extent of their bad portfolio. The system had to be imposed by the bank supervisor. The same would probably be true in many other developing countries. We are told that in Kenya, for instance, the larger banks are responding with a marked lack of enthusiasm to efforts to create a private credit bureau.

There will be practical obstacles in many cases. The lack of a national identity system can make a credit database harder to organize and easier to evade. The demands on communications infrastructure and human capacity can be substantial. Credit information bureaus can be labor intensive and hard to keep up to date—Bolivia is having problems in this latter regard. Bank confidentiality laws sometimes need to be changed. It would be desirable, but difficult usually, to include both licensed and unlicensed lenders in the database. Some lenders fear that the database can be used by competitors to steal their customers, though it is possible to structure access so as to minimize this risk.

lation by winking, is a practical alternative that ought to be considered when weighing regulatory options. It is easier when microcredit is off the country's political radar screen. It becomes less feasible, however, when circumstances (including summits, donors, and politicians) draw a lot of public attention to microcredit.

Clearly, there are some countries where existing financial institutions have no interest in microfinance, for the present at least, and where the only near-term alternative for microcredit experimentation and diffusion lies in NGOs and other socially oriented organizations. If the legal framework makes this alternative very difficult *in practice*, then trying to change that framework should be a priority. But this problem can usually be addressed without building a whole structure of prudential regulation for specialized microfinance institutions. One simple option might be to amend the law authorizing NGOs so as to include credit in their permissible activities.

Credit-Only MFIs. When discussing "credit-only MFIs," we include those that require clients to make savings deposits in order to get loans, as long as they don't mobilize substantial amounts of voluntary deposits. Neither of the classical justifications for prudential regulation apply with much force to such obligatory deposits. (1) They are really just a part of the loan contract, and most of the MFI's clients are in a net debtor position most of the time, so the risk to them in the case of the MFI's failure is relatively low. (2) Compulsory deposits pose no significant risk to the country's financial system, not only because their amount is small but also because the restrictions on withdrawal of these deposits greatly reduces the risk of a run on them.

In some situations there may be a reasonable case for *non-prudential* regulation of credit-only MFIs, even though they do not put depositors' money at risk. We would not argue in principle against requiring such MFIs to register and identify the parties that control them; to give clients transparent interest rate information; to produce financial statements in a meaningful format; or even to participate in a credit bureau, as discussed in footnote 16.

But even non-prudential regulation that is sensible in principle can entail risks that need to be weighed at the practical level. In some countries each additional requirement for a governmental approval represents an additional opportunity for corruption. And it may be hard in some countries to do non-prudential regulation without bringing interest rate controls into effect. Even when the new regulations contain no usury limits, such limits are often present in a country's general commercial law, so that formalization of an NGO's business can make it harder to ignore a lending rate above the legal limit.

When we move up from non-prudential level to prudential regulation and supervision, where the supervisor is responsible for the soundness of the licensed institutions, we think the balance tips decisively against regulation of credit-only MFIs by a government supervisor. As we have discussed already, the costs of such regulation tend to be higher than is generally recognized, not only in terms of cash costs of the supervisor and the supervised, but also in terms of stifling innovation and outreach. The classical justifications for prudential regulation include protecting the financial system, protecting small depositors, and managing the money supply: credit-only MFIs usually have little impact on any of these. And given the serious challenges confronting supervisors in developing countries, there may be a low likelihood that the regulation of these marginal players is going to be effective.

An often-invoked rationale is: "Most MFIs in this country are weak and do not perform well. We need prudential regulation in order to improve these organizations." The problem is that bank supervisors aren't usually very good at *improving* bad organizations. They are better at *excluding* bad organizations, or shutting them down.

But sometimes exclusion of bad players is the rationale: "We want to get rid of the subsidy-dependent programs whose unsustainably low interest rates and high default rates will contaminate the market, making it impossible for good MFIs to operate sustainably." This sounds plausible enough, but the experience has been that many of today's best MFIs have grown rapidly in the midst of competition from other microcredit programs with unsustainable interest and default levels. The unsustainable programs tend to be capital-constrained, and don't pose a very serious challenge. Usually, it takes large government credit programs to contaminate the environment seriously. The biggest contribution some governments could make to microfinance would be to clean up or close down their own politically directed, subsidized credit programs.

Occasionally, regulation of credit-only MFIs is justified on the grounds that the donors who fund them are doing a poor job of selecting and monitoring MFIs. But microfinance is not the only area where donors may fall short of being ideal investors. By the same logic, similar regulation would have to be extended to every local organization that receives donor funds for whatever purpose.

Sometimes the argument is cast in "principled" terms, for instance (1) the central bank and / or other financial authorities are responsible for financial business in the country; (2) credit-only MFIs are carrying out a financial business, so therefore (3) credit-only MFIs must be regulated. Arguments like this often lead in unfortunate directions precisely because they avoid the task of weighing concrete costs and benefits.

Small community-based MFIs. The reach of prudential regulation should have some explicit "lower boundary" that excludes certain classes of smaller intermediaries. To begin with, most countries have many completely informal financial service providers such as moneylenders and ROSCAs (rotating savings and credit associations). As a practical matter, prudential regulation of these actors is impossible. But moving up the scale, one finds a gray area of somewhat more formalized organizations—for instance financial cooperatives, community-based building societies, South African stokvels, and so on—where the decision about prudential regulation has to balance competing factors. One the one hand, one would like to protect their depositors. But the small size and large numbers of such organizations may make effective oversight difficult or prohibitively costly. They seldom pose any real risk to the country's financial system. Finally, there may be some hope that their small size and community-based ownership will make internal supervision by members more effective.

Because the issues involved are so country-specific, it is hard to offer general suggestions about where to set the lower boundary of prudential regulation. Countries use different benchmarks, including

- asset size
- number of members
- ownership and control by members, which is thought to provide some substitute for external supervision
- existence of a common bond among members that limits expansion and perhaps makes effective oversight by members more likely.

Sometimes these factors are used in combination. For instance, an exemption notice issued in 1995 under South Africa's banking law limits the scope of regulation under that law by excluding member-owned organizations with a common bond (e.g., members all work for the same employer, or practice their occupation in the same business district), but only if their assets are less than about $1,500,000. Organizations with assets below that limit but above $150,000 are subject to limited non-prudential regulation, including requirements of an annual audit and membership in a "self-regulatory" federation.[17]

Drawing a line by asset or membership size leaves some governments uncomfortable: for instance, there may be a feeling that if some financial cooperatives are to be supervised, then all of them should be. Uniform treatment of all organizations is an appealing principle, but wooden adherence to it in setting the boundaries of regulation seems unwise, especially in countries where some financial cooperatives are bigger than the smallest banks, while others are so small and numerous as to make practical supervision impossible.

For reasons like these, the Bolivian bank superintendent has chosen to limit the reach of supervision to the larger credit unions. However, he is said to be moving in the direction of a more drastic step: prohibiting deposit collection by small credit unions that are too small to be supervised cost-effectively. We think such a result would be very unfortunate. If some community-based intermediaries are too small or remote to be supervised, then the better policy would seem to be to allow them to operate unsupervised, while requiring prominent and frequent disclosure to depositors that their deposits are not protected by any official supervision.

In our view **it is a serious mistake to prohibit deposit-taking by community-based organizations just because they are too small or remote to be supervised effectively.** Kate McKee of USAID has pointed out that such a policy is often tantamount to telling people in those communities that if high-quality (i.e., effectively supervised) deposit services can't be delivered to them, then they should have no deposit services at all. Especially in rural areas, "unsupervisable" deposit takers may be the only ones willing and able to operate in a given locality. Clients are often well aware that such organizations are risky, but continue to use them because the other available savings options are even riskier—cash in the house can be stolen, livestock can die of disease or be unsalable when you need the cash, and so on. In such cases, the unsupervised community-based depository may well be the least risky option available to a saver. We do her a great disservice if we remove this option because of our paternalistic judgement that it is not safe enough for her.[18]

[17] The South African authorities who crafted the exemption notice did not expect such self-regulation to be very effective.

[18] This point is compellingly illustrated by Graham Wright of MicroSave-Africa in a case study, "Relative Risk in Mt. Elgon," to be included in a forthcoming paper, "Paralysed by a Dream: Myths of Regulation and Supervision."

This principle behind this "lenient" recommendation needs to be applied carefully. One would not, for instance, argue that an unsound bank should be allowed to keep its license on the grounds that it is the only formal deposit option in certain areas. The difference is the license to intermediate, which puts the financial authorities in the position of (1) affirmatively vouching for the institution's soundness, and—in most countries—(2) standing behind deposits as an insurer, whether explicitly or implicitly.

E. Opening separate regulatory[19] windows for specialized microfinance institutions

Identifying the real problem. In many countries the core argument for licensing MFIs runs along the following lines:

"The commercial banks won't serve poor customers. Most of the institutions reaching a poor clientele right now are NGOs. Since these institutions do not have financial licenses, they cannot leverage their resources by capturing deposits, and they cannot provide a savings service to their clients. The requirements for a regular banking license are too high for the institutions interested in poor clients. Thus we need a separate window for MFIs, with lower barriers to entry and standards better suited to microfinance. The existence of such a window will improve the performance of the NGOs trying to qualify for it, and will draw forth solid new entrants who are not yet on the microfinance scene."

This argument has a certain logic, and may be the best policy line in a limited number of countries. But we want to suggest that in most countries it is probably premature right now.

The fundamental question, which seldom seems to get enough attention, is whether the country has MFIs that are suitable for licensing but cannot use an existing window. Assuming the normal meaning of the word, a financial "license" is the government's representation that the institution is strong enough to be a safe intermediator of commercial-source funding, whether it be from retail depositors, institutional investors, or central bank credit lines. **To qualify as a safe depository for such commercial-cost money,[20] an MFI should be profitable enough not only to cover its costs today, but also to pay the full commercial costs of the money its license will allow it to leverage, in addition to generating a surplus to fund growth and perhaps give a return sufficient to attract high-quality investors.**

We believe that it is irresponsible to license MFIs that have not demonstrated their ability to operate at this level of sustainability. How can a supervisor vouch for the soundness of an institution unless she is reasonably sure it can operate profitably with the new sources of money it wants access to? Unprofitable institutions that eat up their equity capital will inevitably put depositors at risk. These days many supervisors focus as much on profitability as on solvency (equity as a percentage of assets), because a bank that is losing money regularly will become insolvent, if not today, then certainly tomorrow.

The vast majority of NGO MFIs do not yet meet this test. In many countries, there is not a single NGO MFI that has achieved this level. Sometimes even profitable MFIs have accounts and information systems that are practically unauditable. In most countries, we have to recognize that **shortage of licensable MFIs is the binding constraint to the growth of microfinance, rather than the absence of a tailor-made regulatory regime.** In other words, the weak quality of retail operations is usually the most immediate bottleneck, not the absence of a legal charter that lets MFIs fund themselves from outside commercial sources.

We argued in the previous section that it would often be best to let certain tiny unlicensed institutions continue taking deposits, on the grounds that unlicensed services were better than no services, despite the depositor risk involved. But the point made at the end of that section bears repeating: this argument does not extend to licensing institutions that are unlikely to be solvent over the medium term. The license is the difference. When a government does prudential licensing and supervision, it is actively certifying to depositors that the licensed institution is safe, and in most countries it is also assuming a financial risk as a *de jure* or *de facto* insurer of deposits in the institution.

[19] The reader will pardon us for repeating that "regulation" here refers only to *prudential* regulation and supervision, in which the supervisor vouches for the soundness of the licensed intermediaries.

[20] Some MFIs expect small deposits to be a cheap source of funding, since the interest rates paid on such deposits are low. They neglect to consider the administrative costs associated with small deposits, because of the high ratio of transactions to deposited amounts. Some MFIs have found small savings no less expensive than large commercial deposits or even bank loans.

Regulation as Promotion? Some agree with the picture painted above, but argue that a new regulatory window for microfinance will be a powerful lever to improve the existing MFIs, or to attract competent new actors into microfinance. The discussion of this issue can be broken into two parts.

First, is a new window likely to be an effective spur to improvements in existing MFIs? The theory is that MFIs will redouble their efforts to strengthen themselves if they have the possibility of getting a license as a reward, and that the licensing requirements spelled out in the regulations will provide clear performance targets for the MFIs. There has not yet been enough experience to justify a conclusion on this point. But our initial tendency is to be skeptical about the expectation. Where special windows have been opened in South America, the NGOs getting the licenses and providing most of the service are mainly NGOs that were already profitable when the new window became available to them. More generally, our experience with hundreds of NGO MFIs leaves us with the impression that a relatively small percentage of their managers have the ingredients needed to reach sustainability: a not-so-common combination of talent, drive, sustainability-focused vision, and willingness to pay the heavy prices associated with sustainability (including the price of spending one's day the way bankers spend their days.)

A second issue is whether a new regulatory window will attract new high-quality actors into microfinance. In Indonesia and the Philippines, the availability of a special legal charter with low capital requirements brought forth large numbers of private rural banks. These banks certainly "extended the frontier," reaching many customers who did not formerly have bank access. In Indonesia, the banks were not effectively supervised. The majority of them are now insolvent. In the Philippines, the financial authorities had to carry out a massive restructuring of the rural banks in the early 1990s, as noted earlier in Box 1: 20 percent of them had to be shut down, and a large number of the others had to be merged to rescue them. At present, the rural bank system is in better condition, but it remains shakier than the commercial bank system. Monitoring the Philippine rural banks ties up a major portion of the supervisory resources of the central bank and the deposit insurance agency.

Box 7—The BPRs and Bank Rakyat Indonesia: The impact of local risk on small MFIs

The 1992 Indonesian banking act authorized two different bank types: commercial banks (Bank Umum) and peoples' credit banks (Bank Perkreditan Rakyat—BPR). BPRs are very small secondary banks whose assets average about $160,000. They have no access to the national payment system. In December of 1998 the 2,420 BPRs had around 4 million clients, but accounted for only half a percent of the country's bank assets.

BPRs are supposed to be supervised through the central bank's regional offices. Regulation, reporting, and supervision for BPRs are basically similar to those for primary banks, raising a question whether the regime is appropriate for very small banks. Supervision of thousands of BPRs has proved cumbersome and expensive, especially in view of the limited payoff in protecting the stability of the whole financial system. In any event, supervision has not been effective: at present an estimated 60 percent of the BPRs are in trouble, largely due to loan losses. In May 1999, the central bank promulgated regulations aimed at structural changes in the sector. Minimum capital has been raised and merger/consolidation has been encouraged.

It is worth noting that during the same crisis BRI's massive Unit Desa system fared much better. The number of Unit Desa depositors grew from 17 million before the crisis to 23 million in July of 1999—a "flight to safety" motivated by BRI's government guarantee. Somewhat more surprisingly, there was virtually no sustained increase in the historical loan delinquency level of around 3 percent portfolio at risk. The Unit Desa system continued to generate adjusted returns of over 4 percent on assets.

Part of the Unit Desas' success during the crisis stemmed from the fact that borrowers tended to repay their loans even in the face of a cash flow crunch, in order to preserve their highly valued relationship with the bank. But there seems to have been another factor: in a large commercial bank like BRI, local risk is diversified throughout the system and administered internally. A large bank can hire better managers, whose policies and responses to problems can be implemented system-wide, given the standardization of the bank's operations. A large bank will find it easier to move cash to branches with liquidity problems, to bring in crisis teams when local performance deteriorates, and to replace weak local managers.

We should also review the experience with licensing of financial cooperatives. In most poor countries, legislation was passed decades ago chartering member-owned financial cooperatives such as credit unions, *mutuelles d'épargne et de crédit, cooperativas de ahorro y crédito*, etc. In response, many new institutions emerged: by 1997, there were 18,000 credit unions affiliated with the World Council of Credit Unions in poor countries around the world. These credit unions have made some important contributions, but for present purposes three results after decades of experience seem particularly relevant:

- Although WOCCU-affiliated credit unions in poor countries held about $6 billion in member savings in 1997, it is hard to find any cases where there has been sustained, effective prudential supervision[21] of credit unions by the government, or the credit unions themselves. More recent efforts to put credit unions under bank supervisors in South America have had mixed results so far.[22]
- Developing-country credit unions have shown a strong tendency toward disruptive boom-and-bust instability.
- In more than a few poor countries, the majority of all credit unions are insolvent—that is, unable to pay off all depositors.

The experience with credit unions and Asian rural banks may suggest that setting up a new legal charter can bring new players onto the scene. But the same experience should also warn us against a facile optimism that these new entrants will be effectively supervised (or that member oversight will keep them sound in the absence of supervision).

Box 8—Bolivian FFPs:

Licensing in response to demand from licensable MFIs; gradual licensing; the motivational effect of creating an MFI license

Bolivia's "private financial funds" (FFPs) are often held up as a model for the regulation of microfinance, an advertisement for the creation of specially licensed non-bank financial intermediaries to provide services to the poor. What is often overlooked is that this step was taken only after several competent financial NGOs obtained outstanding results over several years, and after the superintendency had gained experience by supervising BancoSol (a commercial bank that needed no special license).

The development of Bolivian microfinance began in earnest after the economic crisis and hyperinflation of the mid-1980s. Several NGOs, among them PRODEM, FIE, and IDEPRO, were founded shortly after 1985, and were later joined by PROCREDITO and AgroCapital. By 1994, these financial NGOs had developed a thriving microcredit business throughout much of Bolivia , reaching about 100,000 clients out of a total estimated market of 500,000 microenterprises. Virtually all of the above-mentioned were operationally self-sufficient.

One of these NGOs, PRODEM, acquired a bank license in 1992 and transferred its urban clients to Bancosol. By 1995, Bancosol accounted for 60,000 clients and PRODEM another 10,000. From soon after its inception, Bancosol has been regarded by the bank superintendency as one of Bolivia's best-performing banks, according to CAMEL ratings. Perhaps spurred by the demonstration effect of Bancosol, or perhaps also by news of an Inter-American Development Bank loan fund that would be available only to licensed institutions, the other financial NGOs began lobbying the Bolivian congress for a special license in 1993. The Private Financial Fund license was authorized in a 1993 banking law, but the superintendent and central bank waited until 1995 before approving the decree that implemented the new license.

The FFP license permitted a few strong NGOs to move to the next step of their development—accessing funds from the central bank, institutional investors, and time depositors. The superintendent has not yet allowed them to take passbook savings. This reluctance reflects not only the FFP's general lack of interest in such a funding strategy, but also the superintendent's perception that they do not currently possess the products, systems, or market strategy needed to handle small, liquid savings well. (Even BancoSol, which has a full-service banking license, gets relatively little of its funding from small deposits.)

The FFP law and its application followed a pattern of gradualism in building a financial system for lower-income clients. The special license was developed in response to the emergence of credibly performing financial NGOs that could afford to operate with commercial funding. The prospect of a license motivated these NGOs to adopt the superintendency's reporting standards well before they applied for their new FFP licenses. But it was prior management orientation more than the chance to be licensed that made these NGOs sustainable. At the time the FFP law was passed, there were dozens of other microcredit NGOs in Bolivia. Hardly any of them had an effective orientation toward sustainability. Since the passage of the law, none of them has met the requirements for licensing.

[21] Let us define prudential supervision as "effective" when (a) at least 80 percent of the licensed institutions are in fact solvent, and (b) this situation stays stable over decades.

[22] The problem with supervision of financial cooperatives is that in most developing countries, this task is assigned to whatever government agency is responsible for cooperatives generally. These agencies are often charged with promotion of the cooperative movement, a mission not always consistent with financial regulation and supervision of cooperatives. Such agencies tend to be politicized, and almost never have the financial expertise needed to supervise financial intermediaries. There would seem to be a good argument for placing larger financial cooperatives under the jurisdiction of the financial authorities, at least in countries that have commercial bank supervision reasonably well in hand. In a July 1998 unpublished paper, "Can Financial Market Policies Reduce Income Inequality?", Glenn Westley estimated the 1995/96 credit union share of formal sector microfinance in Latin America at about 90 percent (an estimate that Glenn now suspects may have been somewhat on the high side).

Dangers? Earlier in this paper the reader heard that setting up regulatory windows for specialized MFIs might even be "dangerous." Is there any substance to that somewhat melodramatic assertion?

The biggest danger, illustrated by the foregoing cases of credit unions and Asian rural banks, is that licenses to capture commercial funds, and the government's prudential sanction that goes along with the licenses, will be given to institutions that can't be supervised effectively. The dreary recitation of problems in Section A is relevant here. In the sunny world of plans and project documents, all problems are soluble, given enough operating support and technical assistance. But the real world of practical supervision is a ruder place, where we need to be more cautious about the limits of TA.

Of course, a failure in supervision is not necessarily the end of the world. If a newly licensed MFI has to stop payment, the country's financial system will probably not experience an earthquake. But within the little "system" of the microfinance industry, the results would probably be more serious. In a small group of licensed MFIs that operate far beyond the bounds of a single community, the failure of one or two might well reduce a depositor's willingness to entrust money to their surviving brethren. Worse yet, when borrowers get nervous about the condition of the MFIs and the effectiveness of the supervisor's oversight, their incentive to repay their loans weakens, and a cycle of self-fulfilling prophecy can develop.

Once a new regulatory window for poor people's finance is opened, the supervisor might come under pressure to fill it with something. If she doesn't have licensable MFIs to choose from, she could have to pass out licenses to MFIs whose only demonstration of profitability is found in their financial projections for future years. It is hard to exaggerate the unreliability of such projections. A more trustworthy predictor is the presence of a manager who has already produced two or three years of profits that were high enough so that the MFI could have paid commercial prices on the liabilities it proposes to raise. (This danger is admittedly speculative, given the shortage of practical experience with such windows to date. To the extent that it is real, the danger is probably mitigated by the use of a "tiered" regulatory structure such as the one proposed in Zambia: confronted with an MFI that is not yet safe enough for deposits from the general public, the supervisor can give it a "halfway license" that doesn't allow such deposits and perhaps doesn't even require prudential supervision.)

Another danger is that once the regulation starts, it may not stop at a reasonable point. We've already discussed the worst case, where "building a framework for microfinance" results in the imposition of usury ceilings that make massive outreach of sustainable microfinance impossible. More broadly, there is a natural tendency to over-regulate, which can express itself in unnecessary restraints on innovation—for instance poorly crafted limitations on scope of service, geographical restrictions, onerous physical requirements for branches and other outlets, or regulations that are crafted to fit one particular methodology but then applied universally. Microfinance-oriented observers tend to be quite worried about over-regulation under the West African PARMEC law, in areas that go well beyond the interest rate issue.

A third concern stems from an earlier observation, which few would dispute, that there exists a small minority of countries where the supervisory agency is so politicized, corrupt, or incompetent that outside assistance is unlikely to cause meaningful improvement in the medium term. In such cases, microfinance is not well-served if well-intentioned efforts to "build a framework" result in moving MFIs under the control of such an authority.

A final danger is that the time-consuming process of legislating new windows can distract the attention of MFIs, donors, and governments from other important issues—for instance, the day-to-day business of making existing MFIs sustainable, or securing transparent reporting of results, or fixing regulations that make it impossible for commercial banks to do microfinance, or developing credit bureaus….

Timing. The list of problems and dangers we've reviewed so far does not justify a conclusion that countries should forget about putting microfinance into a licensed environment. If microfinance can't eventually make this leap, it may never reach most of its potential clients. The question is one of timing and phasing.

We argue that most countries ought to go slow on this front. One reason is simply inexperience: around the world there is little experience, not just with supervision of microfinance, but also with the long-term performance of microfinance portfolios and institutions. In such a setting, it makes sense to wait a while before casting a new legal structure in bronze.[23]

[23] As pointed out earlier, Bolivia's experience illustrates this point. For several years, the banking superintendent supervised BancoSol by informal exception, simply declining to enforce certain banking regulations. Special rules of the game for microfinance were not defined until the supervisory agency had years of practical experience monitoring a real microcredit portfolio in a solid institution. It is hardly surprising that this experience proved very valuable when the time came to craft legislation, regulations, and supervisory systems for a new microfinance window.

Specifically, if the main focus is NGO microfinance, we would be inclined to **wait until a few microcredit NGOs (or managers) had proved** for two years or so **that they can manage their loan portfolios profitably enough to pay commercial costs** on whatever portion of their funding the license would allow them to leverage from outside resources. Until this happens, one must ask whether there is anything that can be licensed responsibly. This treatment is not, or at least should not be, different from the treatment accorded to new banks. Licenses are given to start-up banks with no track record as an institution, but a good supervisory regime will typically insist that managers with a good track record in banking be identified and recruited before allowing the bank to commence operations.

If none of the country's MFIs meet the test suggested here, the expectation that opening a special regulatory window will somehow make them profitable seems unrealistic. Some MFIs feel that access to commercial funding will allow scale increases that in turn will make them profitable. Scale economies are important in microfinance, but most of them seem to be captured by the time the MFI moves through the 5,000-to-10,000 client range.[24] Beyond that point, rapid increases in scale tend to depress current profitability. Scale increases will seldom make an unprofitable MFI profitable.

The reverse side of this coin, obviously enough, is that creating a special microfinance charter seems to make the most sense in a country where there already exists a critical mass of strong MFIs that are in a position to use such a charter safely.

F. Alternatives to opening a special window

Let us suppose that a given country has one or two NGO MFIs that are already "licensable," as defined earlier. Depending on local laws and circumstances, it may be possible to move their operations into a licensed framework, giving them access to deposits and other commercial funds, without creating a new regulatory charter for MFIs.

Use of an existing window; regulation by exception. It is often possible for the NGO's operation to be licensed through an existing legal charter, forming a commercial bank, a non-bank finance company, or a financial cooperative. There is a long list of cases where socially motivated MFIs have been able to use licensed structures that were not specially created for microfinance.[25]

Latin America has longer experience than other regions with regulatory windows created specially for microfinance. It is revealing to put these windows in a larger perspective. Non-credit-union microcredit in Latin America totaled about $800 million (1.1 million active borrowers) at the end of 1998. Taking Glenn Westley's estimate of the credit union share of microcredit (see footnote 22) and reducing it to 50% to be hyper-conservative, we come up with a total of $1.6 billion in Latin American microcredit. About 95 percent of that microcredit is provided by licensed institutions. But only $0.25 billion of the total—16 percent—comes from institutions licensed through microfinance-oriented windows.[26] The vast bulk of Latin American microfinance is provided under licensing windows (bank, finance company, credit union) that existed before anyone began talking about microfinance.

It is often said that minimum capital requirements make a bank charter impossibly expensive for an NGO microfinance program. This is true in some countries. But in many others, the minimum capital for a banking license is under $10 million, often as low as $1 to $3 million.[27] In such cases, an MFI with a demonstrably reliable accounting and information system, good portfolio quality, and a profitable track record can usually raise the necessary amount. There are now a dozen international organizations prepared to invest equity capital in such MFIs; most of them face a shortage, not of money, but of strong MFIs to invest in. Institutions that don't meet these criteria will have more trouble raising equity capital, but are these institutions the ones we want to license to take the savings of the public?

[24] This rough generalization is suggested by the authors' experience, by data from the MicroBanking Bulletin, and by spreadsheet financial modeling.

[25] The list includes BASICS (India), K-REP (Kenya), BancoSol (Bolivia), Kafo Jiginew (Mali), BRAC Bank (Bangladesh), FinAmerica (Colombia), Compartamos (Mexico), FINSOL (Honduras), CARD Bank (Philippines), Financiera Calpia (El Salvador), ACEP (Senegal), Genesis (Guatemala), Banco ADEMI and Banco de la Pequeña Empresa (Dominican Republic), CERUDEB (Uganda), and Banco Solidario (Ecuador).

[26] The non-credit-union estimates were calculated by Christen from multiple sources, including most importantly the database of the MicroBanking Bulletin, supplemented by data from Beth Rhyne and Bob Christen's paper "Microfinance enters the Marketplace," (USAID, 1999).

[27] Minimum capital for a finance company license tends to be much lower, although most countries do not permit finance companies to offer passbook savings accounts.

Perhaps some of the regulations affecting the charter under consideration are inappropriate for a microfinance portfolio. For instance, in the Bolivian case mentioned earlier, the NGO (PRODEM) obtained a full banking license. Banking regulations limited unsecured lending to 25 percent of equity capital. BancoSol, the new microfinance bank, couldn't possibly comply, since nearly 100 percent of its portfolio was unsecured at the time: its methodology relied on means other than collateral to buttress loan repayment. In addition, enforcement of the regulations concerning loan documentation would have made lending to BancoSol's customers impossibly expensive.

The supervisor's response was to wink: he simply chose not to enforce these regulation and others for years, in view of the bank's otherwise strong performance.[28] This sort of regulation by exception can be abused, but often it would seem to be the most efficient response to a transitional situation where new types of finance are coming into a market.

Transitional situations could be dealt with by a more radical approach, one that we confess is speculative, because we know of no country that has tried it. Under this approach, a government wanting to give microfinance a boost would give the supervisor explicit legal authorization to grant regulatory exceptions for a very limited number of intermediaries—new or existing ones—whose combined microfinance assets would have to fall below some modest amount that couldn't possibly affect the financial system. This authority to grant discretionary exceptions would terminate in a defined number of years, at which time the formal legal framework would be adjusted as appropriate. An advantage of this approach is that reform of statutes and regulations could be based on concrete experience, instead of concepts and predictions.

Eventually, of course, banking regulations will have to be changed to accommodate new microfinance *methodologies*, whether or not a country creates a special license for new microfinance *institutions*. In most developing countries, the existing bank regulations have not been designed with character-based (i.e., uncollateralized) retail lending in mind.

Below is an illustrative list of typical regulations that may need to be changed for portfolios made up of loans below some ceiling (say, $1,000 to $10,000 depending on the local economy):[29]

- **Interest rate caps** have already been discussed.
- **Limits on unsecured lending** as a percentage of the bank's equity capital or total assets often make character-based microfinance impractical. Similarly, requirements that banks automatically **provision a high percentage** of unsecured lending will be a problem, as will the application of unduly onerous risk-weighting rules for such lending when computing capital adequacy. Banks need to be able to substitute group guarantees or, more importantly, the repayment history of an individual borrower or of the bank as a whole, in place of conventional collateral.
- **Banking** regulations often dictate **requirements for branches** such as security standards, working hours, daily clearing of accounts, or limitations on location. When applied to microfinance, these rules can interfere unnecessarily with innovations that reduce costs and bring more convenient service to clients.
- Standard **loan documentation requirements** are too expensive and time-consuming for good micro-lending, especially when it relies heavily on group guarantees.
- Bank regulations often require full **registration of collateral**, which costs too much to be used with tiny loans. Many MFIs use partial registration techniques that are both effective and affordable.
- Many countries impose **limits on guarantors or co-debtors**, for instance prohibiting them from getting a loan elsewhere. Interpreted strictly, such rules wouldn't allow group loan methods where members are both debtors and guarantors.
- Sometimes it is not feasible for remote microfinance branches to comply with **daily reporting requirements** for clearing accounts and cash balances.
- To do microfinance, a bank may need a unit that can be **legally split off** from the main bank, for instance as a separate finance company or a loan servicing subsidiary. Banking regulations, including rules prohibiting a bank from being a shareholder in other companies or financial institutions, often interfere with a bank's ability to create such separate units.

[28] Eventually, as other licensable institutions emerged in Bolivia and the supervisory agency acquired more experience with microfinance, these regulatory discrepancies and others were resolved through new formal regulations.

[29] A detailed discussion of regulatory impediments to bank microcredit in Latin America can be found in Tor Jansson and Mark D. Wenner, *Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean* (Inter-American Development Bank, 1997).

- Some countries prohibit or limit investment in banks by foreigners, or by institutions (rather than individuals). The former limitation is aimed at preserving national financial sovereignty. The latter restriction aims at clarifying personal responsibility for bank performance and impeding money-laundering. As a practical matter, right now international organizations and local NGOs are the only available source for most of the equity investment in new microfinance-oriented banks, so that these restrictions can make it impossible to capitalize such banks.

In some developing countries consumer finance is emerging rapidly, using sophisticated credit-scoring techniques that allow loans to customers whom banks had previously been unable to serve. This character-based loan product is primarily aimed at salaried employees, but is being extended to microentrepreneurs and other MFI clients in South America. Consumer finance cannot develop unless some of the same regulations discussed above are amended.

Alliance with an already-licensed institution. Another alternative to special licensing of MFIs is to have unlicensed MFIs take advantage of someone else's license. NGO MFIs have teamed up with existing banks or credit unions, in effect using the latter institution's license to increase financial services to the NGO's target clientele. The NGO Freedom from Hunger has such arrangements with financial cooperatives or rural banks in Burkina Faso, Ghana, Mali, Madagascar, and the Philippines.

Box 9—The Chilean Auction:
Minimizing supervisory problems; regulatory adjustments for microfinance in commercial banks

An innovative approach in Chile has catalyzed rapid growth in microfinance services while minimizing supervision difficulties.

Since 1993 the Chilean Social Investment Fund has used an auction system to subsidize the entry of commercial banks into microcredit. A fixed subsidy is auctioned off twice a year to those banks that offer to provide the largest number of microloans for the smallest subsidy. So far the value of the subsidy has fallen steadily from about $240 to about $80 on loans that average about $1,200 (roughly 25 percent of GNP per capita).

Several large banks with strong retail operations have responded. Today, four banks dominate the market for microcredit, reaching an estimated 80,000 active microenterprise borrowers with a total portfolio of about $100 million. About one-third of the microenterprises in Chile are customers of these banks. Chilean NGOs reach only a tenth as many clients.

The banks are big. Banco del Estado and Banco Santander have total assets measured in billions of dollars. Banco Sudamericano and Banco del Desarrollo have hundreds of millions in assets. Microcredit is not, and probably never will be, a large segment of the asset structure of any of these banks: their microcredit portfolios are only 1 to 5 percent of assets. When microfinance is pooled this way with a much larger diversified commercial bank portfolio, the institutional risk posed by the microfinance assets is diluted away almost to nothing. Consequently, the Chilean banking superintendent needs to spend very little supervision time on the microloan portfolios, whose oversight is left to the controller's office in the individual banks.

The Chilean superintendent has been broadly supportive of microfinance in critical ways. The superintendency has authorized two commercial banks to create wholly owned loan-servicing subsidiaries. In recognition of the special operational and staffing requirements of microfinance, banks create these subsidiaries to allow the microloan portfolio to be administered independently, yet stay on the bank's books. In another case, the superintendency allowed a bank to open special microfinance branches, something that is not generally done for other types of products.

Loans to enterprises normally have to be provisioned up to 20 percent at the time the loans are originated if repayment capacity is not demonstrated by financial statements and other documents. This requirement discourages lending to small and informal businesses. The smaller the business, the greater the documentation problem and cost. To encourage loans to micro-enterprises, the Superintendent has chosen to provision such loans using the standards applied to consumer lending, which are based solely on repayment performance.

NGOs may be comfortable working with financial co-operatives, because the latter are socially oriented, non-profit institutions. But NGOs will typically be more nervous at the thought of collaborating with a private bank. They believe (usually correctly) that the bank is uninterested in their clientele. They fear "mission drift" if they join forces with a bank. There is room for a lot of creativity in structuring a bank / NGO relationship, including some options that could preserve the NGO's control over the lending, including methodology, loan sizes / terms, and the choice of clients. The reader who is interested in playing with these possibilities will find a few of them in the footnote below.[30]

It is worth noting that the number of commercial banks interested in microfinance, while small, seems to be growing rapidly. There are at least two or three dozen commercial banks doing microfinance already in Asia, Latin America, Africa, Eastern Europe, and the Middle East (not counting those that were created for this purpose).

We suspect that in some settings mergers and cooperative arrangements with existing licensed institutions might deserve more exploration than they are getting. From a supervisor's point of view, such an arrangement would be immensely easier to supervise than an undiversified institution that does only microfinance and whose owners cannot respond with quick capital in emergencies. Opening a special window for MFI licensing reduces the incentive to explore these possibilities.

Non-intermediated savings. Where the motivation for licensing is to make more savings services available to poor customers, rather than to expand funding for MFIs' credit portfolios, another alternative is to allow MFIs to take savings on condition that the savings are deposited in a licensed bank as quickly as possible, and never put at risk by the MFI. Insulation from risk would involve at least two dimensions: (1) the MFI could not use the savings to finance its lending, or for any other purpose except to pay out savings withdrawals and perhaps maintain a small level of cash on hand so that it can pay out smaller withdrawals promptly; (2) depositors would have a priority claim on the bank account(s) if the MFI fails, so that these deposit claims would not be diluted to pay off other creditors.[31]

Banking regulations may have to be adjusted slightly to permit such an arrangement. But making those adjustments should be worth the while, given the double attraction of the arrangement: it would seem to minimize not only depositor risk but also supervisory burden. After an MFI has managed non-intermediated deposits for a few years, then it should be better situated to apply for a license to intermediate. The MFI will have had the opportunity to prove not only that it can manage its loan portfolio sustainably but also that it can handle the systems involved in savings operations. Thus, a regime of non-intermediated deposit-taking might be a useful halfway house for transforming NGOs.

This does not mean that similar rules ought to be applied to mandatory savings in connection with a credit scheme. The same factors that argue against prudential supervision of MFIs that take only forced savings are relevant here.

[30] For instance, the NGO could act as an agent of the bank, taking a fee to manage a loan portfolio that ultimately belongs to the bank. The NGO would retain control over the management of the portfolio, as long as the portfolio continues to meet agreed performance standards. Thus, the NGO could continue to do exactly the business it knows well, without having to worry about back room operations, treasury functions, reporting to the bank supervisor, and many other complications it will have to learn about if it gets its own license.

To make a such a collaboration more attractive to the bank, the NGO might contribute its existing portfolio to the bank in return for shares. It would get a seat on the bank's board. Under a contract with the bank, the NGO would do all of the portfolio management, just as it has always done, receiving a fee to cover its expenses. Initially, the microfinance portfolio might be 100 percent guaranteed by the NGO's shares in the bank, so the bank would not at risk. [Such a guarantee may not be permissible in all countries.] The bank could immediately leverage the increase in its equity by capturing up to twelve times as much in additional deposits, which it uses however it wishes. If the microcredit portfolio meets certain performance targets as time goes by, the bank would be contractually committed to allocate gradually increasing amounts of those additional deposits to expansion of the microlending. Such an arrangement might include provision for a no-fault divorce, allowing either party to withdraw after reasonable notice if it grows uncomfortable with the arrangement.

Or the NGO could continue its own microlending business, keeping ownership of its portfolio. It would simply use its officers and outlet to offer its clients deposit services on behalf of the bank, which in turn would lend all or part of those deposits to the NGO, contingent on the NGO's financial performance.

[31] This arrangement would eliminate most of the MFI-specific risk. It is true that an occasional MFI could be tempted to poach on the deposits for unauthorized uses. However, any regulation is subject to the risk of deliberate non-compliance. The incentive to comply could be strengthened by including personal liability or criminal sanctions for the individuals involved. Supervising such compliance should be relatively simple. External auditors can probably be relied on to make sure that deposits are being placed in the bank promptly and withdrawn only for authorized purposes. Checking this sort of paper trail is easy, and auditors are much better at it than they are (for instance) at evaluating microcredit loan portfolio quality.

Another risk is that the MFI's systems may be inadequate to keep clients' accounts straight. This would probably be a more common problem than deliberate misappropriation of deposits. Here again, however, testing the adequacy of such systems is routine work for auditors.

G. Alternative approaches to supervision

If a supervisor has to take on responsibility for new non-bank intermediaries (be they specially chartered MFIs or previously unsupervised credit unions), it is confronted with the gamut of problems discussed in section A. Monitoring, on-site inspection, and messy interventions in problem cases are especially daunting if a large number of small institutions has to be supervised. Several alternatives to direct supervision by the banking authority have been suggested.

Self-supervision. Discussion of self-supervision tends to get confused because people's understanding of this term varies widely. For purposes of this paper, we use "self-supervision" to refer *exclusively* to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations to be supervised—usually a member-controlled federation of MFIs. Here at last is a point on which experience appears to justify a categorical conclusion. **In poor countries, self-supervision of financial intermediaries has been tried dozens of times and has repeatedly proven to be ineffective,**[32] even in the many cases where donors provided heavy technical assistance. The reason for the failure of the model is not hard to find. Having a watchdog that is controlled by the parties being watched presents an obvious conflict of interest. The immediate benefit to the participating institutions is not great enough to induce them to hold a rigorous line when problems arise. Most of the experience with self-supervision has been in federations of financial cooperatives, but it is hard to see any reason to expect better results from federations of MFIs.

In both Guatemala and the Dominican Republic, small groups of strong credit unions have formed federations whose task includes monitoring and enforcement of prudential norms. Both these federations bring immense advantages to their task. The credit unions they supervise are all starting out in strong financial condition. The federation's supervisory office need not concern itself with the majority of the country's credit unions that are in poor shape. Accounting and reporting systems are not only good but also uniform. Norms are clearly defined and agreed upon. The supervisory office has strong technical staff. But despite all these advantages, staff in both federations—and many of the member credit unions as well—will admit privately that the "supervisor" is likely to be powerless when a large member gets out of line. They don't believe that a board of directors named by the members being supervised will command credibility or stay the course in an emergency. For this reason and others, both federations have pushed strongly for their members to be subjected to the authority of the bank supervisor.

Federations of MFIs may play some useful roles, such as articulating standards, setting consistent reporting formats, delivering training and technical assistance to members, or even providing central liquidity management. But if the federation is really controlled by its member MFIs, then asking it to bear the carry the primary responsibility for keeping depositors safe would seem to be a highly imprudent wager.

Delegated supervision. Under some proposed models, the supervisory agency maintains legal authority over—and responsibility for—the supervised institutions, but delegates regular monitoring and on-site inspections to a third party. This "agent" might be an MFI federation or an independent technical entity. The role of the supervisor lies in (1) periodically testing the reliability of the agent's monitoring, inspection, and reporting, and (2) intervening in problem situations.

A variant of this model seems to work in Indonesia, where Bank Rakyat Indonesia has long used its rural branch offices to supervise a large number of tiny municipal banks; however, the relationship between BRI and the municipal banks is much closer than is normally implied by the term "supervision." In Peru, the bank superintendent has delegated day-to-day oversight to a federation of municipal savings and loan institutions. However, the superintendent keeps a tight hand on the quality and independence of the federation's work: the norm is that each institution gets an annual on-site supervision visit from the supervisor's office. We are not familiar with other cases where such a model has been used long enough to draw conclusions about its success. Thus, we would only make some general comments:

- If the agent is a federation of MFIs, then it will probably handle problem cases well only if the supervisor's oversight of the agent is active enough to give the supervisor a high degree of *de facto* control over the agent's operations.

[32] Just as we did earlier, we are defining prudential supervision as "effective" when (a) at least 80 percent of the licensed institutions are in fact solvent, and (b) this situation stays stable over decades. Self-supervision of financial institutions occasionally works in a rich country, but it is hard to find successful cases in poor countries.

- Though the supervisory agency may be able to delegate its monitoring, the law will usually not permit delegation of its authority and responsibility to intervene when institutions run into trouble or collapse. Thus the supervisor who accepts responsibility for new MFIs with the expectation that the agent is going to do most of the work may later find herself with serious burdens that can't be delegated.

- If the government accepts responsibility for the soundness of MFIs under a delegated-supervision arrangement, it needs to consider whether it has a viable exit strategy if the delegated supervision doesn't work.

- To be successful, any agent would probably need to be better at monitoring MFI condition and risk than the typical external audit firm. As we observed earlier, external audits of MFIs have so far proved notoriously unreliable in verifying the accuracy of MFI financial statements, in particular the quality of MFI loan portfolios.

Box 10—Bank Rakyat Indonesia and the BKDs: Delegated supervision?

Over one hundred years ago small village-level banks (Badan Kredit Desas—BKDs) were established throughout Java and Sumatra. Today about 5,500 villages have BKDs, often run by volunteer staff. In 1929 Bank Rakyat Indonesia (BRI), a state-owned commercial bank, was delegated the authority for supervising the BKDs. BRI established a Cooperative and Village Bank division that operates through its regular branch office network.

BRI supervises through monthly or even weekly visits to each BKD, many of which are open only one day a week. Each supervisor handles about twenty BKDs. BRI also supplies bookkeepers, each of whom prepares monthly financial statements for the BKDs covered by about five BRI branches. The statements are sent to BRI and to the central bank. BRI sets interest rates and other operational policies as necessary for the BKDs. It handles their bookkeeping and liability management. BRI also handles cash management for the BKDs, and is the exclusive repository for any excess liquidity in the system.

Over time, the "supervisory" relationship between BRI and the BKDs has evolved into something that is close to what a highly decentralized branch network might look like. BRI is providing the services that a bank's headquarters would typically provide to its branches. The fees paid by the BKDs—equal to about 25 percent of their operating expenses—are in the range of what bank branches might be charged for headquarters administrative support. Technically the arrangement is one of "delegated supervision," but in fact it goes much further than that label would imply.

Apexes. In some countries there is an apex institution or national fund that does wholesale lending to local MFIs—typically credit-only MFIs. As an investor, such an apex is by its nature a kind of supervisory agency. If it expects to have its loans repaid, it must evaluate and monitor the soundness of the MFIs it lends to. For MFIs that fail to meet its standards, the sanction is denial of loans.

It is sometimes suggested that apex structures be used to supervise deposit-taking MFIs, usually under a delegated supervision arrangement with the financial authority. Such an arrangement might involve potential conflicts of interest: for instance, would the apex be anxious to close down an MFI that owed it money?

More generally, some apexes have been successful at recovering their loans. But the justification for these apexes often includes an expectation that they will catalyze significant quality improvements in the MFIs they fund. Few have been notably successful at this task. PKSF, the large microfinance apex in Bangladesh, seems to be an exception to the generally disappointing apex experience. But this apex was established *after* a critical mass of credit-worthy MFIs had already developed—a situation that prevails in few other countries.

Rating agencies? Thirteen strong Guatemalan credit unions are setting up a private rating agency that will evaluate and certify their financial soundness.[33] The credit unions will not control the rating agency. The situation prompting this step is that public confidence

[33] Only 10 percent of Guatemala's credit unions are participating, but they account for 85 percent of the country's credit union savings and loans. Here as in most other countries, one does not have to work with more than a few institutions in order to reach the vast majority of the country's microfinance clients.

in credit unions is so low that they have to pay 2 percent more than the banks they compete with to raise deposits. The country's financial authorities have refused to take responsibility for supervising credit unions, so this group of strong institutions is trying a private alternative, at least as a temporary measure. The rating agency will have a large advertising budget to build public recognition of the plaque representing the agency's approval. The principal sanction for a non-complying credit union will be the (well-publicized) revocation of that credit union's plaque. Additionally, contracts with the participating credit unions will give the rating agency the right to replace their boards or management in the event of non-compliance, although enforcement of these rights would probably take too long to be practical. As the rating agency gains credibility, the participants hope that the government authorities will eventually agree to have the bank superintendency supervise the stronger credit unions, and perhaps use the rating agency in a scheme of delegated supervision. Implementation has not yet begun, so nothing can be said yet about the results of this experiment.

The concept of a private, independent rating agency for MFIs seems to be getting a lot of attention lately. Even though one of the authors of this paper was an enthusiastic proponent of the Guatemala experiment, there are some important reasons why the rating agency model needs to be approached with caution:

- The "market" for the ratings in Guatemala is the depositors, who can use the rating to judge the safety of their deposit. In the case of non-deposit-taking MFIs, the market for ratings consists of investors—mainly donors. In Latin America and South Asia, two companies that provide ratings mainly for credit-only MFIs are finding the demand for their services from donors to be somewhat disappointing.
- The Guatemalan experiment has huge advantages that are unlikely to be present in an MFI rating scheme in most countries. The participating credit unions all agree on the norms to be applied. The credit unions were in compliance with these norms before the rating agency was set up, so there is no need to cajole or strengthen laggards.[34] All the credit unions have the same methodologies, accounting standards, and information system. Their competition with commercial banks for deposits provides a strong incentive to submit to supervision.
- Even so, it is far from clear that the Guatemala rating agency will work.

Deposit Insurance. Recently there has been increased discussion of the possibility of deposit insurance for MFIs. Such insurance could be provided by the government as an adjunct to its regulation and supervision; or the insurance could be issued by a non-governmental (and perhaps donor-supported) body as a substitute for official regulation and supervision. The scheme could provide pure deposit insurance, whose only function is to reimburse small depositors in the event of failure of the depository institution, or it might operate a stabilization fund providing emergency liquidity to solvent MFIs, or capital support to MFIs in danger of insolvency who are willing to take corrective measures. In the absence of experience with such arrangements, we can only offer some general observations.

There is a respectable body of opinion that challenges the wisdom of deposit insurance, generally on the grounds that it blunts depositor oversight of institutions, encourages risky behavior on the part of managers, and centralizes risk more than is desirable. But even for those who see deposit insurance as a good thing, deposit insurance for MFIs presents some special challenges.

A specific national insurance fund for MFIs confronts actuarial problems. Given the relatively small number of MFIs, their unsecured portfolios, and the absence of historical loss experience, how does one determine the fund size that is adequate to provide depositors with the degree of safety that is being advertised? To provide such safety, the fund would certainly have to be a much larger percentage of deposits than would be the case with a country's commercial banks. This problem is holding up development of a deposit insurance scheme by the Guatemalan credit unions. These credit unions hope that the problem can be solved by re-insuring residual losses offshore, but they have no indication yet as to whether it will be possible to do so.

If MFIs are folded in with the general deposit insurance scheme for banks, the actuarial problem is lessened, but this would imply normal supervision by the government's financial authorities, rather than providing an alternative to such supervision.

Another way to mitigate the actuarial problem might be to make the insurance fund international, so that it embraces a larger number of MFIs, and can maintain safety standards that might be tighter than what would be practical in a fund limited to a single country. But such an

[34] Although only the soundest credit unions are participating at the beginning, other credit unions will be welcomed with open arms if they are able to comply with the norms.

international insurance fund would probably have very high supervision costs.

Bank guarantees. Building on Burt Ely's work, J.D. Von Pischke has offered an intriguing proposal that non-bank MFIs be allowed to accept deposits on the condition that all such deposits are guaranteed by a bank that is licensed by the supervisor, and at least 50 percent re-insured offshore.[35] This approach would eliminate additional burdens on the supervisor. The obvious practical question is whether banks willing to write such guarantees, and offshore markets willing to reinsure them, could be found at a price that MFIs can pay. Given the very high administrative costs inherent in microfinance, adding (say) another 3 percent for a guarantee cost might seem a good bargain to an MFI that thereby gained access to large amounts of public funding. Is it possible that a bank would be willing to write a guarantee at that price for an MFI with demonstrably credible books, good internal controls, and strong profitability? Would a donor support experimentation along this line by temporarily covering part of the bank's risk? Time will answer these questions, if someone is willing to try.

H. Conclusion

At the risk of some redundancy, the authors want to underscore briefly a few of the key themes of this paper:

- Microfinance is unlikely to achieve anything like its potential unless it can be done in licensed environments. Therefore, prudential regulation and supervision of microfinance is a topic that will unquestionably need to be addressed.
- Nevertheless, in most developing countries today the absence of special licensing regimes for MFIs is not the binding constraint to the development of microfinance.
- Rather, the bottleneck is usually the scarcity of MFIs that are not dependent on continuing availability of subsidies, and that *can operate profitably enough to be able to pay a commercial cost for a large proportion of their funds without decapitalizing themselves*.
- It seems irresponsible to license MFIs to take deposits if they cannot demonstrate their ability to meet the above test.
- The challenges facing a given country's supervisory agency, and the realistic obstacles to meeting those challenges, need to be weighed seriously when examining proposals for regulation of microfinance.
- Regulation and supervision entail significant costs, including non-financial costs like restraint of innovation.
- Non-prudential regulation needs to be distinguished from prudential regulation, under which the supervisory agency has to vouch for the financial soundness of the supervised institutions.
- In some settings, reform of non-prudential regulation is probably essential to the development of microfinance—for instance where the licensed financial institutions have no interest in microfinance, but the legal regime makes it difficult or impossible in practice for non-licensed organizations like NGOs to provide credit.
- Credit-only MFIs, including MFIs whose savings deposits are mainly compulsory compensating balances for loans, should not be subjected to prudential regulation.
- Small community-based intermediaries—for instance small financial cooperatives—should not be prohibited from taking deposits simply because they are too small or remote to be supervised effectively.
- The creation of special regulatory windows for MFIs is probably premature in countries where there is not a critical mass of licensable MFIs.
- The proposition that opening a licensing regime will motivate unsustainable MFIs to become sustainable should be viewed with suspicion.
- Given today's supply and demand of microfinance funding support, in most countries a solidly sustainable MFI could raise the minimum capital necessary to use an existing form of financial license. The supply of funds available for this purpose in international and bilateral organizations exceeds the demand from financially viable MFIs.
- More attention needs to be paid to reforming regulations that make it difficult to do microfinance under existing forms of bank or finance company licenses.
- In developing countries, self-supervision, (defined as oversight of financial intermediaries by a federation or other body that is controlled by the same intermediaries being supervised) has a long history of failure, and is highly unlikely to work for MFIs.
- Rating agencies for MFIs face serious practical obstacles.

[35] "Guaranteeing Deposits in Microfinance Nonbanks" (unpublished manuscript, 1998).

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