

Regulation and Supervision of Microfinance Institutions:

State of Knowledge



Division 41
Financial Systems Development and Banking Services

Regulation and Supervision of Microfinance Institutions:

State of Knowledge

August 1999

Editor:
Deutsche Gesellschaft für
Technische Zusammenarbeit (GTZ) GmbH
Postfach 5180, 65726 Eschborn
Internet: <http://www.gtz.de>

Division 41
Financial Systems Development
and Banking Services
Financial.systems@gtz.de

Author:
Stefan Staschen

Responsible:
Sylvia Wisniwski

Layout:
Kerstin Fakesch, OE 6002

CONTENTS

ABBREVIATIONS	III
1. INTRODUCTION	5
2. RATIONALE AND OBJECTIVES OF REGULATION AND SUPERVISION	8
2.1 Information and incentive problems on financial markets	8
2.2 Positive regulation theory	10
2.3 Specific regulatory needs of MFIs	11
2.3.1 Different institutional types in microfinance	11
2.3.2 Risk profile of MFIs	14
3. PRINCIPLES AND INSTRUMENTS FOR REGULATING AND SUPERVISING MFIS	18
3.1 Principles of regulation	18
3.2 Regulatory instruments	19
3.3 Supervisory methods	21
3.4 Idealized regulatory and supervisory approaches	22
3.4.1 Regulation by banking law	22
3.4.2 Regulation by a special MFI law	23
3.4.3 Self-regulation	23
4. EXPERIENCE TO DATE WITH REGULATING AND SUPERVISING MFIS	26
4.1 General principles for regulating MFIs	26
4.1.1 Regulatory needs of the different institutional types	26
4.1.2 Recommendations for protective measures	28
4.1.3 Recommendations for preventive measures	29
4.1.4 Accountancy rules and reporting/disclosure requirements	33

CONTENTS

4.1.5	Supervisory methods	34
4.2	Specific experience with different regulatory approaches	36
4.2.1	Regulation by banking law	36
4.2.1.1	BancoSol, Bolivia	36
4.2.1.2	Finansol, Colombia	38
4.2.1.3	K-Rep Bank, Ltd., Kenya	40
4.2.2	Regulation by a special MFI law	42
4.2.2.1	Fondos Financieros Privados, Bolivia	42
4.2.2.2	CMAC and EDPYME, Peru	44
4.2.2.3	West Africa	46
4.2.3	Self-regulation	48
4.2.3.1	Philippine Coalition for Microfinance Standards, Philippines	48
4.2.3.2	AMEDP and MLA, South Africa	50
5.	SUMMARY AND OPEN QUESTIONS	53
6.	REFERENCES	56

LISTE OF TABLES

Table 1: Distinctive features of MFIs	13
Table 2: Risk profile of MFIs	17
Table 3: Regulatory needs of different types of institutions	27
Table 4: Some major regulatory requirements for MFIs	32

ABBREVIATIONS

AfDB	African Development Bank
AMEDP	Alliance of Micro Enterprise Development Practitioners
BancoSol	Banco Solidario
BIS	Bank for International Settlements
BMZ	Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung (Federal German Ministry for Economic Cooperation and Development)
BoU	Bank of Uganda
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
CAMEL	Capital Adequacy, Asset Quality, Management Ability, Earnings and Liquidity
CAS/SMEC	Cellule d'Appui et de Suivi des Structures Mutualistes ou Coopératives d'Epargne et de Crédit
CDC	Commonwealth Development Corporation
CGAP	Consultative Group to Assist the Poorest
CMAC	Cajas Municipales de Ahorro y Crédito
COFIDE	Corporacion Financiera de Desarrollo
DFN	Development Finance Network
EDPYME	Entidad de Desarrollo para la Pequeña y Microempresa
FEPCMAC	Federation Peruana de Cajas Municipales de Ahorro y Crédito
FFP	Fondos Financieros Privados
GenG	Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften (German Law on Cooperatives)
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (German Technical Cooperation)
IFC	International Finance Corporation

ABBREVIATIONS

IPC	Internationale Projekt Consult (IPC) GmbH
LLR	Lender of Last Resort
MFI	Microfinance Institution
MIS	Management Information System
MLA	Association of Micro Lenders
NASASA	National Association for Stokvels in South Africa
NGO	Non-Governmental Organization
NHFC	National Housing Finance Company
PARMEC	Projet d'Appui à la Réglementation des Mutuelles d'Epargne et de Crédit
PCMS	Philippine Coalition for Microfinance Standards
PEARLS	Protection, Earnings, Asset Quality, Rates of Return and Cost, Liquidity and Signs of Growth
ROA	Return on Assets
ROE	Return on Equity
RoSCA	Rotating Savings and Credit Association
SACCOL	Savings and Credit Co-operative League of South Africa
SARB	South African Reserve Bank
SBEF	Superintendencia de Bancos y Entidades Financieras
SBS	Superintendencia de Banca y Seguros
TC	Technical Cooperation
UEMOA	Union Economique et Monetaire d'Ouest Afrique
USAID U.S.	Agency for International Development
WOCCU	World Council of Credit Unions
ZAR	South African Rand

1. INTRODUCTION

The international microfinance community is showing increasing interest in the issue of regulating and supervising microfinance institutions (MFIs). By far the majority of MFIs are still not subject to government regulation. Little practical experience has been gained¹ and theoretical discussion is still at an early stage.² The issue is, however, rapidly attracting attention as many MFIs cannot meet their growing funding needs. On the one hand, regulation could afford them access to refinance by wholesale financial institutions and on the other it is frequently a prerequisite for taking up savings business. Upgrading, downgrading and linking strategies of financial institutions (FIs) (cf. Krahn/Schmidt 1994: 82ff.) are increasingly blurring the demarcation lines between the regulated, formal financial sector and the largely unregulated microfinance sector.

The term regulation is very complex and for the purpose of this report, we shall define it as do Chavez and Gonzalez-Vega: "Regulation refers to a set of enforceable rules that restrict or direct the actions of market participants, altering, as a result, the outcomes of those actions (1992: 2)." It is not confined to government regulation; it also denotes the self-regulation of groups of institutions via networks, associations, etc., provided that this actually induces the actors to alter their behavior. MFIs are called all those financial institutions that provide suitable financial services to meet the needs of low-income sections of the population.³ So the definition features the products offered and not the type of institution.

The aim of this study is to compare the theoretical rationale for regulating financial institutions with current practice in microfinance. Based on the findings of financial market theory, particularly the notion of prudential regulation of financial institutions, we set these off against the specific features of the microfinance sector. Initial practical experience gained in regulating and supervising MFIs is assessed to point out necessary adjustments to the regulatory framework and above all indicate where further studies need to be conducted. We examine the motives for regulating the sector set against the theoretical background and identify possible actors in regulation. We do not purport to be presenting some sort of 'best practices' manual for MFI regulation. It is too early for this and too little information is available.

The regulation and supervision of MFIs should be subsumed in the overriding goal of developing a market-based financial system (the so-called financial systems approach, cf. BMZ 1994). Target group demand is not limited to borrowing; it also includes other financial services such as savings, insurance, transfer facilities, etc. Savings facilities are a particularly important question when considering a prudential regulation of MFIs. The prospective target group is many times larger in deposit business than in lending (GTZ 1997: 6). Where the poor have no access to

¹ The most important examples are described in: Churchill 1997 and Rock/Otero 1997.

² The application of the theory of banking regulation to MFIs has only been rudimentary so far. Cf. Chavez/Gonzalez-Vega 1992, Berenbach/Churchill 1997, Churchill 1997 and Jansson/Wenner 1997.

³ As also defined in the CGAP glossary: Fruman/Goldberg 1997: 127.

savings facilities MFIs should also take up deposit business. Another reason for regulating this sector is that MFIs' available funds cannot keep pace with their lending business. To reach as many prospective borrowers as possible MFIs also need to have access to external finance in addition to their own resources and finance from donors.

Only then can they act as financial intermediaries in the genuine sense, i.e. by directing capital from surplus to deficit areas. Possible sources of funds here are loans from other financial institutions, private savings or – in an advanced microfinance sector - securities issues on the anonymous capital market. This way, MFIs would advance from credit-only institutions to fully-fledged financial intermediaries. Till now, however, savings mobilization with the general public has almost always been contingent on MFIs complying with existing banking law. This also greatly facilitates refinancing via the capital markets. The collapse of MFI Finansol in Colombia, which was regulated under banking law (cf. Chap. 4.2), and the high barriers to market access for MFIs, however, beg the question of whether **banking** regulation is in fact appropriate.

First we shall pinpoint the need to regulate and supervise MFIs, accounting for their special features. Then we identify possible principles and instruments. To collate the different ways of regulating MFIs and supervising regulatory guidelines into a system, we distinguish three typical regulatory approaches: the regulation of MFIs by existing banking legislation (regulation by banking law in the following), regulation by a special MFI law and self-regulation.⁴

Chapter 4 summarizes experience to date with the various approaches and infers recommendations for regulating MFIs, where possible. In the final chapter, the findings are compiled and some areas identified for further theoretical and above all empirical studies.

First of all, the terms used need to be clearly defined. Statutory regulation and self-regulation differ as to who lays down the rules and how they are stipulated. In government regulation this is the task of the legislator (law) or subordinate administrative agencies (decree, ordinance and such like).⁵ In self-regulation the institutions to be regulated set their standards themselves, not each on its own (this would be internal self-regulation), but as a group (e.g. through an association or a chamber), and these are equally binding for all.⁶ Self-regulation and statutory regulation are the two extremes demarcating a continuum of regulatory methods. Pure self-

⁴ Berenbach/Churchill (1997: 25) adopt a similar classification. A distinction has to be drawn between this group self-regulation and **internal** self-regulation, where internal control of a financial institution by its owners, the supervisory board and the management is meant. According to Coetzee/Goldblatt (1998) this can make external regulation superfluous with financial institutions managed and therefore controlled by their owners (so-called member-based institutions).

⁵ The distinction in statutory regulation between regulation by banking law and by a special MFI law is not a methodological necessity (particularly with functional regulation, for example, it is also conceivable that special provisions for MFIs are contained in general banking legislation), but it is very helpful to give existing regulatory approaches a structure.

⁶ In a mail dated 17.11.1998 to the Development Finance Network (DFN) at Ohio State University (devfinance@lists.acs.ohio-State.edu), Richard Rosenberg defines self-regulation as follows: "Self-regulation' refers to an arrangement in which the regulating and supervising agency is an apex institution controlled by the [financial institutions] being regulated."

regulation, i.e. without any government influence, is rare. More frequent is indirect influence through government bodies, e.g. via state licensing of regulatory institutions, such as in the German cooperative system. This approach is also termed 'hybrid regulation'.⁷ With supervisory institutions a distinction can also be drawn between public (e.g. central bank) and private institutions. Here, too, there are 'hybrids', e.g. a private company with government representatives in its supervisory board, as in South Africa (cf. Chap. 4.2.3.2).

⁷ The term in South Africa for example (cf. Chap. 4.2.3.2). Berenbach/Churchill, however, term the monitoring of statutory regulations by a private institution such as an auditing company or a consulting firm a hybrid approach. According to the above definition, this is government regulation with delegation of supervisory tasks to a private institution.

2. RATIONALE AND OBJECTIVES OF REGULATION AND SUPERVISION

2.1 Information and incentive problems on financial markets

Let us look first at the normative theory of regulation and - proceeding on the ideal assumption of perfect and complete markets - identify the distinctive features of financial markets. Every regulation incurs costs. For one thing, complying with regulatory standards (e.g. reporting and disclosure requirements) incurs costs for the financial institution itself and for another the restriction of competition and the attendant efficiency losses make for costs at the macroeconomic level. Regulatory interventions cannot be justified on perfect markets. So the question arises why financial markets and particularly financial markets in developing countries are not perfect markets. The main reason is the asymmetric distribution of information between borrowers and investors which for lack of appropriate institutional precautions results in the problems of 'adverse selection' and 'moral hazard' so often cited in the literature (cf. Stiglitz/Weiss 1981). In the discussion on a prudential regulation of the financial sector, two arguments in particular have been advanced as to why market forces alone fail to achieve a first-best solution (e.g. Chavez/Gonzalez-Vega 1992: 6-14).

In deposit business there is an asymmetric distribution of information available to the depositors on the one hand and the financial institutions on the other. In the principal agent theory, the financial institution is defined as the agent of the depositor (principal). The objective of regulation must be to match the actions of the agent with the interests of the principals, his clients. This can be done by

1. controlling their actions;
2. restricting their decision-making powers, which they could otherwise exercise at the expense of the principals;
3. setting appropriate incentives.

With financial institutions, all three approaches play a role. The perhaps most obvious solution, direct control of the agent by the principal, is not sufficient. Checking how their money is used would incur unreasonable costs for depositors.⁸ This control is a public good, which would be in short supply in a pure market setup. As a consequence, clients would have no effective control over their financial institutions. This affords the owners and the management of financial institutions scope for opportunistic behavior, i.e. for pursuing personal gain at the expense of the creditors. It may be worthwhile for the owners, for example, to finance high risk projects in lending business, since there are no limits on profit-sharing, while losses are confined to their shares and the remainder must be borne by the lenders. Control of the agents must therefore be

⁸ Financial intermediaries therefore take on the task of 'delegated monitoring'. Cf. Diamond (1984).

supported by a third party, i.e. an independent supervisory agency.

The second option, curbing the decision-making powers of management, has its limits. This places a serious constraint on managers, whose job it is to exploit their information lead over single depositors (and of course also over external regulators) for the benefit of the financial institution (Marquard 1987: 33).

The third approach, creating a suitable system of incentives for the agent, is the most elegant one, since it does without compulsion and control, but there is no way to arrive at a full convergence of interests between the financial institution and the depositor.

The second argument for regulating financial institutions picks up on the first. Due to the difficulty of objectively judging the performance of a financial institution, there is the danger of a 'run', i.e. a panic leading to the withdrawal of all deposits, forcing the financial institution into inevitable bankruptcy. As Diamond and Dybvig (1983) have shown, a run can be perfectly rational behavior on the part of depositors. The best strategy for the individual depositor when there is a general loss of confidence in a financial institution is to follow the 'herd instinct' and withdraw his deposit also. A run on a bank can for example be triggered simply by its having a similar name to a bank that has gone bankrupt. The greatest threat is posed by the contagious effect of a single bank collapse, where it triggers a chain reaction and the decline in liquidity on the capital markets can also incur high economic costs (so-called systemic risk).⁹ This problem can be mitigated by regulatory measures.

The situation is somewhat different with financial institutions that do not do business with private sight deposits that can be closed at any time, but refinance via donor funds, loans from apex organizations or savings and time deposits. The danger of a run is not so acute here, but there is still the problem of opportunistic behavior by the financial institution, so that regulatory measures may be appropriate for reasons of investor security.

In the lending business of a financial institution the principal-agent relationship between borrower and financial institution is reversed: the borrowers are the agents of the financial institution. The concern here is to protect the financial institution from exploitation by borrowers. Possible responses to these incentive problems are loan rationing (cf. the Stiglitz/Weiss model, 1981) or special contractual duties (so-called bond covenants, cf. Smith/Warner 1979), which require borrowers above all to proffer loan collateral. Generally no external regulation is thought necessary (cf. in relation to MFIs Chap. 2.3.1).

So prudential regulation must pursue two prime objectives. It must effectively limit the danger of opportunistic behavior, i.e. prevent excessive risk-taking. This is the aim of consumer

⁹ This is a classic case of a prisoner's dilemma from game theory. In the prisoner's dilemma cooperative behavior, in this case refraining from a panic-induced withdrawal of all deposits, benefits everyone. However, without knowing the behavior of the others, a depositor will benefit in any case from withdrawing his money.

protection.¹⁰ Second, it must ensure that there is no **unwarranted** run on a financial institution (Chavez/Gonzalez-Vega 1992: 17), which could result in a system-wide bank panic. This objective can be designated as 'safeguarding the safety and soundness of the financial system'. Regulation must, however, also take into account that a run on an insolvent financial institution can also affect healthy institutions through contagion, hence should better be prevented in the case of sending a powerful adverse signal. When selecting the best regulatory framework the trade off between the soundness and efficiency of the financial system must always be taken into account.

Other frequently cited aims of banking regulation are a certain loan allocation, safeguarding competition on financial markets and monetary control by the central bank (cf. Greenbaum/Thakor 1995: 103). Each of these goals is, however, in dispute or irrelevant for microfinance and will be left aside in this study.¹¹

The information and incentive problems in the financial sector, then, warrant the need for regulating financial institutions. Another question is who is responsible for stipulating regulations, how they are drafted and who monitors compliance. Government or a state agency is not always best suited for this task.

2.2 Positive regulation theory

The information and incentive problems explained in the last section can justify government or also privately organized intervention in the financial sector. In contrast to this normative theory of regulation, the positive theory explicitly includes the process of regulation. It views those involved in regulation (the stakeholders) as individual utilitarians, whose goals at best just happen to coincide with those derived from normative theory. This view is not to be understood as an alternative to normative theory but as a supplement focussing on problems of implementing a prudential regulatory framework.

Regulations are drafted in a political process and made more or less binding by law, ordinance, decree and such like. When general conditions are changed in the financial sector, government regulatory authorities in particular are prone more to inertia than to altering their policy. A considerable time lag can also be expected before expert recommendations result in a corresponding policy shift by the responsible government agencies. Also, the regulatory agency that is supposed to protect clients as their agent and attend to the safety and soundness of the financial system is also in danger of opportunism. Its governance structure should therefore also

¹⁰Here we choose the broader notion of consumer protection, which includes the protection of the depositors as well as the borrowers. The arguments cited so far derive a need for regulation on the grounds of depositor security. In Chap 2.3.1, however, reasons are given why with MFIs borrower protection also argues for regulating the sector.

¹¹The assumption that regulation is necessary to counter monopolization due to increasing scale economies in providing financial services has been disproved by empirical results showing that regulation rather tends to restrict competition (Zimmer 1993: 142).

be subjected to analysis (Richter 1991).¹²

Another major assumption of positive regulation theory posits that regulation is not an 'extramarket activity' (Kane 1988: 345), but that it inherently derives from the interests of the actors involved, at least in the long term. Every regulation elicits evasive responses, which in turn call for a corresponding adjustment of the regulatory guidelines. Positive theory thus highlights the key role of an interest analysis of all stakeholders as the only way to arrive at definite recommendations for implementing a particular regulatory framework.

2.3 Specific regulatory needs of MFIs

Now that the special features of financial markets and the resultant regulatory needs have been described in Chapter 2.1 and Chapter 2.2 has looked at the difficulties of translating regulatory plans into policy, we shall now determine the **specific** regulatory needs of **microfinance** institutions as compared with **traditional** financial institutions.¹³ Our reference here is a prudentially regulated financial system, where the existing regulatory measures cater for the distinctive features of traditional financial institutions. The question is how far these rules need to be tailored to the specifics of microfinance institutions, since they either incur higher costs or afford them less benefit.

2.3.1 Different institutional types in microfinance

Due to the broad range of various types of institutions, it is difficult to make general statements about the specific characteristics of MFIs. Describing the following five characteristics, we can demonstrate that MFIs differ significantly from traditional financial institutions (cf. Table 1): client features, lending technology, loan portfolio features, culture or ideology and institutional structure.¹⁴ MFIs can be classified into three rough categories depending on the structure of the liabilities side of their balance sheets (cf. the classification by van Greuning/ Gallardo/Randhawa

¹²The incentive conflicts in regulatory institutions may be mitigated through regulatory competition. If several regulatory frameworks are offered by different regulators (private and/or public), the financial institutions can choose the most suitable regulatory framework for their needs (so-called regulatory migration) and make arbitrage gains this way: "Regulatory competition induces more timely and economically better-adapted adjustments in regulatory structures than monopoly regulators would choose to make." (Kane 1988: 361). This suggestion by Kane, however, places very heavy demands on market transparency and client training. Clients must be able to come to a clear judgement of the quality of the regulatory framework so they can choose the best regulatory institution for their needs. The higher costs incurred by meeting higher regulatory standards must be rewarded by a higher reputation for the financial institution and a corresponding competitive edge.

¹³As is usual in the literature, financial institutions in the formal sector not engaged in microfinance are designated as traditional financial institutions. We should, however, not forget that many MFIs, such as autochthonous savings and credit groups, have already been in existence for centuries.

¹⁴'Culture/ideology' and 'governance structure' need not apply in this way to all MFIs; rather, they are largely typical for NGOs. Rhyne stresses the distinction between microfinance portfolios and microfinance institutions (1997). So features 1 to 3 also hold for microfinance portfolios in regulated banks, but these do not suffer from an unfavourable governance structure and a conflict between financial and social goals. As a rule, they also have better access to sources of finance.

1999). **Category A** comprises all MFIs which depend on **other people's money** to finance their lending business. This is made up mainly of grants and concessionary loans from donors which can be supplemented by commercial bank loans or also securities issues. These MFIs are described as credit-only institutions as well. They include financial NGOs. MFIs stemming from and still dominated by NGOs with a welfare bias have serious problems with their governance structure. Setting up a viable MFI for the long term requires strict financial discipline, which engenders a conflict "between the imagery of capitalism and the imagery of compassion (Dichter 1996: 246)." Especially for the microfinance sector the following arguments favor regulating credit-only institutions as well:

- ♦ Regulation can act as a 'signal' to prospective investors that a financial institution is financially sound.
- ♦ Access to certain lines of refinance can be contingent on regulation (e.g. donor funds channeled via second-tier institutions to MFIs).

Neither argument necessarily justifies government regulation. At issue here is the selfinterest of MFIs, which does not involve consumer protection or safeguarding the safety and soundness of the financial system. Nevertheless, regulation may make sense for promoting sustainable financial institutions. In this case, its aim is to raise standards in microfinance and thus contribute to financial systems development. Particularly in countries where the microfinance industry is at a rudimentary stage, for example, there is a danger that MFIs may abuse their monopolistic power and resort to exploitative practices, such as usurious interest and improper methods of debt collection. The collapse of individual institutions can also result in credit shortages on the market.

In **Category B**, **member's money** is used to grant loans exclusively to members. Classic examples of this are RoSCAs, savings and credit cooperatives and/or credit unions.

Category C comprises all MFIs that use **the public's money** to finance their lending business, i.e. fully-fledged financial intermediaries. These do not include financial institutions that employ forced savings components to secure their lending transactions, however, as long as their clients are net borrowers.

Another type are formal banks with a microfinance window. The regulations of banking legislation automatically apply to their microfinance portfolio, but these are usually poorly adapted to the requirements in this area. This problem has not yet been solved.¹⁵

Each institutional type stands out for a 'idiosyncratic risk' of its own, which has a bearing on the best regulatory framework to choose (Chavez/Gonzalez-Vega 1992: 19f). With 'idiosyncratic risk'

¹⁵It would be possible to distinguish different portfolios in reporting and disclosure requirements by loan amount and to use weighting factors in ratios (equity capital, liquidity and so on), as already usual with the risk-weighted capital requirements.

we mean that a financial institution is exposed to a risk in a different way than other financial institutions.

A major feature of MFIs is their large number of clients and low overall balance compared with traditional financial institutions with the result that their share in the national financial system is relatively small. On the other hand, the outreach - measured by the percentage of the population doing business with MFIs - can be quite large. As the clients belong to poor sections of the population, a bankruptcy would be particularly harmful. On top of this, client confidence in the safety of their savings needs building up and losing their deposits could do lasting damage to the necessary relationship of trust. The argument that regulation and supervision in microfinance are less important because of its small economic role, misjudges the exceptional sensibility of this segment and its possible contribution to financial systems development.

Table 1: Distinctive features of MFIs

Characteristic	Appearance
Type of client	<ul style="list-style-type: none"> • Low income • Employment in the informal sector or low-wage bracket • Lack of physical collateral • Interlinked household and enterprise
Lending technology	<ul style="list-style-type: none"> • Prompt issue of short-term micro loans • No extensive loan records • Collateral substitutes such as group lending technology or conditional longterm access to credit • Productive consumer credits • Information-intensive character-based lending through cash-flow analysis or delegation of borrower selection to groups
Loan portfolio*	<ul style="list-style-type: none"> • Highly volatile • Risk heavily dependent on management qualities
Culture/ideology (mainly with NGOs)	<ul style="list-style-type: none"> • Remote from government • Culture of compassion • Aim of cost recovery instead of maximum profit
Institutional structure (mainly with NGOs)	<ul style="list-style-type: none"> • Decentralized • Insufficient external control • Quasi-equity capital (grants and soft loans)

* Cf. Table 2

Source: Own compilation after Berenbach/Churchill (1997: 5ff.), Jansson/Wenner (1997: 5) and Rock (1997a: 21)

2.3.2 Risk profile of MFIs

Catering for the specific risk profile of MFIs can help identify necessary adjustments to regulatory methods and instruments compared with traditional financial institutions. This analysis centers on risk categories that differ significantly from those attaching to traditional financial institutions. The list of risk categories makes no claim to completeness; others could easily be cited. A strict demarcation of the individual categories is also difficult. They can, however, be rated as different 'disruptive variables' that increase the solvency risk of a MFI overall. This provides some pointers for prudential regulation. The following risk categories will be addressed: credit risk, interest rate risk, liquidity risk, management risk, ownership and governance risk, new industry risk and subsidy dependence risk (cf. Table 2).

Credit risk denotes the danger of loan losses due to the borrower's inability or unwillingness to repay. A hallmark of MFIs is in part extraordinarily good repayment discipline. This can, however, change very fast, i.e. it is particularly volatile. The reasons for this are:

- ◆ Repayment discipline deteriorates a lot, if, for example, due to a cash flow problem of the MFI access to further loans is barred or tentative confidence in MFIs is disappointed (Rock 1997a: 22);
- ◆ Many MFIs depend heavily on lending business, so a slight deterioration in repayment rates already has a substantial effect on overall performance. Also, when there is a general deterioration in repayment discipline, MFIs usually cannot satisfy their claims and end up with nothing because recourse to property titles and other security may not be available.
- ◆ Default risks of loans granted to relatively homogeneous groups (as is frequently the case in agriculture) are closely correlated. Especially with group technology, there is a trade off between peer monitoring in small groups and risk diversification (Krahnen/Schmidt 1994: 64f.).¹⁶
- ◆ Key here is certainty in law and the cost of debt collection, which can be very high compared with the loan amount.

The danger of a higher credit risk by allotting a sizable portion of the loan portfolio to a single borrower (large-scale credit risk) is relatively small, however, because by definition the institution is engaged in issuing **micro** loans.

The **interest rate risk** results from divergent fixed-interest terms on the lending and deposit side, if for example interest on credit balance must be adjusted for rising inflation while shortterm interest charges are fixed. The size of the interest rate risk with MFIs therefore usually depends

¹⁶Berenbach and Churchill (1997: 23) gauge this risk as more theoretical: "There are very few examples to date of sector or geographic concentration risk affecting microfinance portfolios."

directly on whether microloan interest can be altered in line with changes in the going rate.¹⁷ Due to the short loan periods, this can be done relatively quickly, but can be prevented by legally specified interest ceilings.

Another category is **liquidity risk**, i.e. the risk of high discounts when having to liquidate assets during a cash flow problem. Liquidity planning must cater for operating costs, lending, interest and redemption payments on loans received and – in deposit-taking MFIs – depositor withdrawals. The latter in particular places heavy demands on liquidity management, as liquidity is of paramount concern to small savers. With MFIs that depend heavily on donor funds delayed payment of loans or subsidies can quickly cause acute cash flow problems. This is a particularly high risk with MFIs, because access to subsequent loans is an important incentive for borrowers to make all payments on time.

Management risk denotes the dependence between a financial institution's performance and the quality of its management. With MFIs this dependence is extremely pronounced: "Microfinance clients are not inherently more risky than traditional bank clients, but microlending as an activity may be, due to its sensitivity to management quality (Christen 1997a: 38)." This is a direct consequence of the lending technology, which relies in large measure on the personal ability of the decision-makers. Management should be familiar with the special finance technologies in microfinance and have acquired sufficient banking experience (Berenbach/Churchill 1997: 73). So-called character-based lending involves a very close relationship between the loan officer and the borrower. The quality of credit rating procedure is difficult for outsiders to verify and is thus particularly prone to corruption or fraud. So at loan officer level also, performance depends a lot on the qualification and reliability of staff. Empirical studies have shown that management deficits exert a larger influence on the risk profile of a MFI than portfolio concentration in a sector (Rock 1997a: 22).

Another category of risk with MFIs is the **new industry risk**. Because in many countries till now very little experience has been gained with a cost-effective financial intermediation in microfinance, there is a lack of properly trained managers (who are poorly paid even where available). Rapid growth, as with many MFIs, entails staff upgrading, the introduction of new products and technologies, etc. and these pose an exceptional challenge (Berenbach/ Churchill 1997: 73). Hardly any studies are available on the institutional learning curve of MFIs (ibid.: 24). This also means a higher risk, because regulators also lack experience with regulating and supervising MFIs.

The next two risk categories do not apply equally to all types of MFIs, but especially to NGOs. The dependence of a MFI's solvency risk on internal governance is termed **ownership and governance risk**. Where there is no external regulation, internal control mechanisms play a special role. Crucial to the successful performance of a financial institution for example are rules

¹⁷Where the microfinance sector in a country is not a competition market the going rate is not decisive, but a change in market conditions can necessitate an interest-rate adjustment.

on the distribution of profit, membership of the supervisory board and ownership.¹⁸ It is important that management is properly informed by means of an effective management information system (MIS), that the owners have a substantial financial stake so that they also take an interest in performing their supervisory tasks and that the MFI's clients do not hold a majority in the supervisory board. In NGOs the ownership and governance risk is particularly high, because they are not subject to control by commercial investors and the donor or government as 'quasi-owners' are frequently not prepared or able to exert effective control (cf. Churchill 1998: Theme I). On top of this the distinction between social and financial goals can become blurred (Dichter 1996). This is also a deficit in cooperative societies whose specific governance structure is inimical to proper internal control (cf. Krahen/Schmidt 1994: 52ff).

Lastly, heavily subsidized MFIs run a subsidy dependence risk. This becomes a problem if the subsidies suddenly stop without the MFI having taken sufficient prior precautions.

¹⁸On the role of the ownership structure of a MFI see Churchill 1998: Theme I.

Table 2: Risk profile of MFIs

Risk category	Description of risk	Profile with MFIs
Credit risk	Denotes danger that borrower is not able or willing to service the interest or repay the principal	Particularly volatile, as collateral substitutes depend a great deal on confidence, there is a heavy sectoral and geographical concentration of loans and the portfolio turnover rate is higher. The large-scale credit risk is usually low because micro loans are granted.
Interest rate risk	Stems from diverging fixed-interest terms in lending and deposit business when the commercial interest rate changes	Particularly large when rising commercial interest rates on the deposit side cannot be offset because of interest caps in lending business. This is more often the case with MFIs due to their higher interest rates.
Liquidity risk	Risk of a temporary cash flow problem, because assets can only be liquidated by large discounts	High with many MFIs due to poor liquidity management and lack of access to liquidity pools or lender of last resort. Adverse effect on credit risk, as access to subsequent loans is often the major repayment incentive.
Management risk	Risk of portfolio deterioration due to management defects (inadvertent due to insufficient qualification and willful as opportunistic behavior or fraud)	Success of MFIs particularly dependent on the qualification and the proper conduct of management and staff due to the special lending technology (characterbased lending, decentralized decisionmaking, close personal relationship between loan officer and client)
New industry risk	Risk of trying out new, innovative finance technologies	Relatively high because of new products, technologies, markets and new institutional designs
Ownership and governance risk	MFI solvency dependent on ownership relations and governance structure	Due to a frequent lack of external regulation and supervision the governance structure is particularly important. Risk can be very high with NGOs and cooperatives.
Subsidy dependence risk	Risk of dependence on subsidy donors and a sudden stoppage in subsidies	High for heavily subsidized MFIs

Source: Own compilation after Berenbach/Churchill (1992: 19ff.), Chavez/Gonzalez-Vega (1997: 35ff.), Graham (1998) and van Greuning/Gallardo/Randhawa (1999: IV.).

3. PRINCIPLES AND INSTRUMENTS FOR REGULATING AND SUPERVISING MFIS

3.1 Principles of regulation

To develop individual regulatory instruments and supervisory methods, we need to specify principles as yardsticks for their assessment. There are six to be mentioned:

1. **Competitive neutrality**, i.e. regulation must be organized to avoid distortion of competition amongst the financial intermediaries. The aim is a 'level playing field' (Chavez/Gonzalez-Vega 1992: 15). This should not be confused with having the same regulations for all financial institutions alike, since the impacts on the different types of institutions can differ greatly, thus actually causing competitive distortions: "Regulate different (bank and non-bank) intermediaries differently (Gonzalez-Vega 1995: 16)."
2. **Efficiency**. At the level of financial institutions Chavez and Gonzalez-Vega distinguish between allocational (resources are channelled to their most productive use), operational (minimizing transaction costs) and dynamic efficiency (adaptability to changing environment) (1992: 16). The efficiency of the financial institutions is a measure of the efficiency of the regulatory framework. The prime danger of regulating MFIs is restricting their dynamic efficiency, since little practical experience is available at first and the risk of inappropriate regulation is particularly high as a result. There is a trade off between the objectives of efficiency and stability of the financial system. Measures to safeguard the soundness of the financial system (such as very high equity requirements) always affect competition and therefore tend to incur efficiency losses.

Efficient supervision means maximizing the probability of detecting infringements of regulations (Chavez/Gonzalez-Vega 1992: 34). Of course, this objective should not be pursued at all costs: the requisite intensity of supervision should be determined by a costbenefit analysis.

3. As far as possible, the regulatory framework for financial institutions should stipulate a governance structure that is **incentive compatible**, i.e. that makes full use of the selfinterest of the individuals (owner, manager, depositor, borrower, etc.), to arrive at the desired results (ibid.: 17). This can be particularly important with MFIs, because recourse to legal enforcement mechanisms would be impracticable and too costly due to the informality of the sector. The ownership structure and the MIS play a large role here.
4. The regulatory framework for financial institutions must be **flexible** enough to be able to react to regulatory avoidance, technological innovation, failures of certain regulatory measures, etc. This is particularly important in microfinance, since hardly any experience is available in other countries. Regulation can be seen as an evolutionary process where individual institutional types or only some elements of their ownership and governance structure prevail and others are superseded. One of the great strengths of unregulated MFIs till now has been their ability

to test innovative products. Hence Merton's argument for functional instead of institutional regulation: "The functional perspective takes as given the economic functions performed by financial intermediaries and asks what is the best institutional structure to perform those functions (1995: 23, emphasis in the original)." In institutional regulation there are different regulatory frameworks that prescribe requirements for certain institutional types (e.g. a banking law alongside cooperatives legislation and a law for finance companies), but these rarely allow for an easy transition from one category to another.

5. Ultimately all regulatory guidelines and supervisory methods must be subjected to a **cost-benefit analysis**.¹⁹ Requiring MFIs to keep customary bank loan records for example would incur excessive costs, because they issue a large number of small short-term loans. Similarly, the costs of supervision would be extremely high partly because of the sometimes huge number of MFIs in relation to their national economic significance and the related risk potential, so that banking supervisory bodies are often reluctant to regulate them and lack the requisite resources (Jansson/Wenner 1997: 1). One of the major challenges, then, will be to find cost-saving but effective methods to regulate and supervise MFIs.

3.2 Regulatory instruments

First of all, prospective instruments for regulating MFIs are no different from those for traditional banks. They must be efficient (cf. Chap. 2.1) and comply with the principles of prudential regulation (cf. Chap. 3.1). A general distinction is made between protective and preventive regulatory instruments. Protective measures are for consumer protection and should protect banks and their clients, above all the depositors, when collapse is imminent or has already occurred (Rombach 1993: 102). These include the lender of last resort (LLR) and depositor protection. The LLR furnishes a financial institution with liquidity in a temporary liquidity crisis. The central bank usually undertakes this task.²⁰ In theory only solvent financial institutions are supposed to receive such assistance but this is difficult because of the information asymmetry between the LLR and the financial institution, so that in practice central banks also intervene with insolvent banks (Richter 1991).²¹ Large banks in particular can usually rely on political support (so-called 'too big to fail'). Due to the large moral hazard problems with an explicit entitlement (the incentive to hold sufficient liquid funds diminishes, exacerbating the liquidity risk), this instrument is usually discretionary. This in turn impairs its effectiveness though, since a solvent financial institution with merely temporary liquidity problems cannot rely on access to the LLR.

The LLR aims at protecting the institution (and hence indirectly also the consumer), whereas a

¹⁹Measuring costs entails large practical problems, so it is more of a cautious estimate.

²⁰In Germany, however, for example, it is a separate institution, the liquidity bank (Liquiditätskonsortialbank).

²¹In individual cases it can make sense to save insolvent financial institutions from bankruptcy, since knowledge on the credit rating of individual clients (so-called information capital) is a major asset of MFIs, which would otherwise be lost.

deposit insurance is supposed to provide direct creditor protection. An explicit deposit insurance is a very effective instrument to avert a run, because it directly pre-empts the reason for a run, fear for the safety of deposits. In addition, unlike the LLR it does not discriminate against smaller financial institutions and can be arranged to retain the sanction impact of a bankruptcy on the owner, the supervisory board and the management (Diamond/Dybvig 1983: 417). The outcome is a triple protective effect : "First, protection of the depositor against collective damage to oneself, second, protection of the depositor against the bank and third, protection of the bank against the depositor (Zimmer 1993: 179)."

With deposit insurance, however, depositors are less interested in taking all available information into account when choosing the financial institution and doing their part in controlling it (moral hazard problem). This does away with the depositors' most effective sanction instrument against their financial institution: collective withdrawal of their deposits and the resultant threat of bankruptcy. As long as their deposits are insured, depositors will not worry about their financial institution's solvency. One remedy might be a risk-adjusted premium, which would, however, be very difficult to calculate to everyone's satisfaction. Other ways of mitigating this moral hazard are less than one hundred per cent coverage of the deposit or the simultaneous introduction of preventive regulatory measures to deter the financial institution from taking unjustifiably high risks. Another conceivable option is also a private, association-type deposit insurance system, possibly even by several competing insurance companies. The various membership requirements can at the same time exert a private regulatory influence.²² In many countries the moral hazard is limited by specifying a ceiling for the maximum insured deposit amount per saver. This ensures that primarily small investors benefit from deposit insurance, since these are least able to bear the consequences of deposit loss.

Legislation on usury, which still exists in many countries, is also aimed at consumer protection. In many countries there are without question also 'evil moneylenders', who cannot be forced out of business in the short term by expanding credit supply in microfinance, as the law of the market might lead one to expect. A rigid interest ceiling that does not cater for loan amount, however, discriminates in any case against microloans, which are about twice as expensive, as experience shows (Jansson/Wenner 1997: 31f.). It is virtually impossible to enforce an interest ceiling for informal moneylenders anyway.

Preventive instruments are supposed to mitigate the adverse incentive effects of protective measures and safeguard the soundness of the financial system. The more robust the 'safety net' of protective measures, the greater the moral hazard problems and the more important the preventive instruments (Greenbaum/Thakor 1995: 506). Even without protective regulation, though, it makes sense to set a framework for banking transactions due to the information asymmetry between the financial intermediary and the depositor, provided that this does not intervene directly in operational business. There is a general distinction between prohibitive and enabling rules. While the former prohibit certain kinds of behavior (e.g. granting nonsecured

²²An example of this is the voluntary deposit insurance system in Germany.

loans, if their percentage in the loan portfolio exceeds a certain limit), the latter assign market mechanisms as large a controlling function as possible. For this the transparency of business activity must be improved by better reporting/disclosure and accountancy requirements.

Usual instruments for regulating market access are equity requirements (as an absolute sum), qualification standards for staff and management, prior conduct of a feasibility study and presentation of a business plan, prescribed organizational and ownership structure and limits to business activity. Depending on the type of regulation, a specific institutional type is prescribed (institutional regulation) or certain business practices are made subject to conditionalities (functional regulation). In regular business, certain financial ratios have to be observed (e.g. ratio between equity capital and risk-weighted assets, operating costs, liquidity ratios, etc.); there are rules on provisioning and writing off non-performing loans; certain diversification rules must be observed and prerequisites for an internal management information system met - just to mention the most common regulatory tools. The institution must provide evidence that it has met all these requirements by documenting its business activity in a way that can be verified by an external supervisory institution. Finally, market exit must also be regulated, e.g. the supervisory agency takes over business activity or bankruptcy proceedings are initiated.

3.3 Supervisory methods

Supervision can be effected off-site or on-site (Chavez/Gonzalez-Vega 1992: 34). In the offsite method, the published information of the financial institutions is scrutinized by the supervisory institution according to certain criteria, so that it can gain a picture of the financial performance and the risk profile of the financial institution. Important here are early-warning indicators to enable a timely intervention - by imposing sanctions or conditionalities or even by taking over business activity.²³ Common instruments for supervising financial institutions are the CAMEL method or the PEARLS method, whose discussion would, however, exceed the scope of this study.²⁴

Sample checks on-site are necessary to verify the reliability of the information and gain a picture of the data collection methods and the professionalism of management and staff. An advanced MIS is essential for effective off-site control and can partially replace on-site inspections. Supervision can either be financed through contributions by the financial institutions under supervision (such as is the case with the Federal Banking Supervisory Office in Germany) or from the national budget. An advantage of the latter option is that the financial institutions cannot use their contributions to pressure the supervisory agency, as is the tendency in Germany, for example.

²³Important early-warning indicators, for example, are portfolio at risk and portfolio at exceptional risk.

²⁴CAMEL stands for **C**apital Adequacy, **A**sset Quality, **M**anagement Ability, **E**arnings and **L**iquidity and is used in the US American banking system, PEARLS (**P**rotection, **E**arnings, **A**sset Quality, **R**ates of Return and Cost, **L**iquidity and **S**igns of Growth) is the method for cooperatives developed by the World Council for Credit Unions (WOCCU).

3.4 Idealized regulatory and supervisory approaches

It is difficult to arrive at consistent categories for regulatory approaches and a certain simplification and idealization is unavoidable. A conceivable model is a continuum of regulatory approaches with direct government regulation by the banking supervisory authority at one end and purely privately organized self-regulation at the other. The three regulatory approaches mentioned in the introduction – regulation by banking legislation, regulation by a special MFI law and self-regulation – can quite easily coexist in a country, since they have their own strengths and shortcomings depending on the type of institution.²⁵ In the following we shall outline idealized approaches, before making an initial assessment in Chap. 4.

3.4.1 Regulation by banking law

This type of regulation proceeds on the assumption that MFIs doing bank-type business, i.e. mobilizing private savings and granting loans, should be subject to existing banking legislation and government banking supervision, just like all other financial institutions. Most developing countries lack their own regulatory framework for MFIs and do not allow them as unregulated institutions to mobilize savings from the general public. So the only choice open to MFIs is to continue as credit-only institutions or meet the requirements of banking legislation.

In the latter case the same legal regulatory rules apply for MFIs as for all other financial institutions. A variant of this is the 'exemption orientated approach', where MFIs in general or after individual negotiations with the superintendency are exempted from certain rules (Coetzee/Goldblatt 1998: 12). The regulatory framework is laid down as a law, usually worded in relatively general terms (e.g. "Sufficient provisions have to be built"). Individual, above all quantitative regulations are then stipulated by the central bank or a special supervisory authority. Depending on the autonomy of the supervisory body, regulation can thus be freed from direct influence by everyday political considerations.

Supervision is carried out on-site as well as off-site. It is undertaken either by the government banking supervisory authority or by an (or even several competing) independent, private supervisory institution entrusted with this task under definite conditions. Combining monitoring responsibility and liability can curb opportunistic behavior on the part of the supervisory agency.²⁶

The superintendency has the right to intervene in crisis. This hierarchical arrangement is based on the assumption that management takeover by the banking supervisory authority (or by other experts) is likely to be more effective than a continuation of business operations by the previous

²⁵In various countries a 'tiering approach' is being discussed, where different regulatory frameworks exist for the individual institutional types. In Uganda the central bank has already drafted a proposal in this direction. Cf. BoU/GTZ 1998.

²⁶An instance of this are the audit and joint liability associations of the cooperative societies in Germany. Under § 62 I of GenG the auditing bodies are liable for damages to a cooperative arising from wilful intent or negligence.

management.

The advantage of this regulatory approach is that government can draw on larger financial resources and - with a few exceptions – enjoys a high degree of respect which enhances the credibility of regulation. This way government as monetary authority can provide limitless liquidity through an open discount window in the case of a cash flow problem. It can also legally forbid financial institutions from conducting their business.

In many countries there are different types of institutions (e.g. commercial banks, mutual banks and finance companies) so that a MFI seeking formal status can choose the legal form which best suits its needs and capabilities. As a rule, it has no interest, for example, in doing foreign currency business; more important, though, are regulations on opening new branch offices.

3.4.2 Regulation by a special MFI law

In this regulatory approach a special legal framework is set up for MFIs to account for their specific features. The adoption of a MFI law presupposes sufficient interest on the part of the legislator in regulating the sector and a readiness on the part of MFIs to submit to statutory regulation. Given the lack of experience of the legislative with the microfinance sector on the one hand and the MFIs inexperience with statutory regulation on the other the adoption of a special MFI law should be preceded by a prolonged process of mutual consultation and learning and provisions should be amended in an unbureaucratic way.

The superintendency can only be entrusted with the task of supervision, if it has sufficient capabilities. Otherwise new capabilities need to be created. This can for example be done by setting up a separate department within the existing supervisory authority or by delegating the supervisory task to a competent independent institution. Another possible option is to decentralize supervision by establishing regional institutes under the central supervisory authority as executive organs only. These can also be organized privately (e.g. consulting firms with experience in microfinance). It is, however, important that they can exercise enough authority so that uncovering infringements of regulations has a deterrent effect. In the individual case the supervisory institution should be selected on the basis of the superintendency's reputation and depend on whether MFIs as financial institutions specializing in microfinance should submit directly to the banking supervisory authority in the long term. This would be a reason to entrust the supervisory authority with the task of supervision from the outset, so it can acquire an 'institutional memory'.

3.4.3 Self-regulation

In self-regulation, regulating MFIs is largely done without recourse to government. This can be due to lack of interest, insufficient capabilities or also inadequate knowledge of the government regulatory authority about the microfinance sector. In self-regulation proper, the initiative is in the hands of the MFIs themselves so that government cannot impose repressive regulation with

unsuitable statutory rules.²⁷ The incentive for MFIs to collaborate is to signal their success to outsiders and thus lower their refinance costs thanks to a lower risk premium or just to gain access to certain refinance facilities. These outsiders include donors, apex organizations, commercial investors, but also savers (provided the MFIs are authorized for deposit business). A first step could be to adopt a code of conduct, possibly specifying binding standards for the industry. This 'signaling' is intended to narrow the information rift between MFIs and their sources of capital, so that these can distinguish between 'good risks' and 'bad risks'.²⁸ It is important that this signal is actually meaningful, i.e. that the members of this regulatory framework really do meet certain minimum standards.

The task of regulation and supervision can be performed by an umbrella body which lays down the regulatory rules and supervises compliance. Supervision could also be effected by one or several specialized monitors, acting as a kind of rating agency. The power of sanction of the regulatory institution²⁹ consists solely in its ability to refuse to confer its 'stamp of approval' on the MFI.

In this regulatory approach, government supervision is replaced by the publication of information whose reliability is vouched for by an institution with a maximum of autonomy. Its starting point is the actual rationale for regulation in the financial sector: the information asymmetry between the financial institutions and their depositors. There are, however, distinct limits here, since financial institutions as 'delegated monitors' (Diamond 1984) make their living from making the most of their information leads: "The full regular disclosure of banking strategies, including full balance-sheet information and the like, might impose costs that undercut an important rationale for the existence of intermediaries (Marquard 1987: 20)."

If MFIs which have submitted to self-regulation are also permitted to engage in mobilizing savings from the general public, a privately organized deposit insurance financed from the contributions of member MFIs can enhance deposit safety. To limit the moral hazard problem, the contributions should reflect the risk attached to the respective MFI, at least approximately. A further protective regulatory measure can be mandatory attachment to a liquidity pool from which MFIs can obtain liquidity when required. This can alleviate the danger of a run due to illiquidity.

In this pure form, self-regulation is rare and is essentially nothing other than a rating system for financial institutions. If, however, self-regulation is not only supposed to protect investors but is also concerned with client protection, it requires stronger sanction mechanisms. Submission to a self-regulation institution can for example be prescribed by government, precluding a simple cancellation of membership. The government can also confer the exclusive right on the self-regulation institution to close down individual MFIs or government exercises direct influence on

²⁷ Precisely the absence of regulation in microfinance has enabled MFIs to develop innovative methods (Berenbach/Churchill 1997: 10).

²⁸ Cf. Akerlof's 'lemon model' (1970).

²⁹ To preserve its reputation, the regulatory institution itself is motivated to judge the MFI as objectively as possible.

the regulatory agency, whether it is via its provision of funds or via control over business activity. So the information asymmetry can never be completely eliminated.

This approach closely resembles regulation by an apex organization, through which MFIs obtain refinance (cf. McGuire et al. 1998: 52ff.).³⁰ Unlike self-regulation, the regulations here are not set by the MFIs themselves but by the second-tier institution that makes its lending contingent on certain conditions. Regulation is not, however, compulsory and no direct state influence is exerted over specific regulations (possibly indirectly, if a government second-tier institution is involved, such as a state-owned development bank).

³⁰'Apex organization' is used here as a generic term for institutions which refinance MFIs as wholesale financial institutions and/or offer advisory services in developing the microfinance sector. They are called second-tier institutions, because they do not engage in direct customer business.

4. EXPERIENCE TO DATE WITH REGULATING AND SUPERVISING MFIS

There are some examples of MFI regulation by banking law, some of regulation by a special MFI law and of tentative approaches at self-regulation. It would, however, be premature to generalize the findings and draw up a catalogue of best practices. Experience also shows that generalizations are seldom possible, because the situation at the outset is never the same. Where general statements can be made, however, they are summarized in the following subchapter. Then we shall take a brief look at experience from single case studies that illustrate the advantages and disadvantages of the different regulatory methods.

4.1 General principles for regulating MFIs

4.1.1 Regulatory needs of the different institutional types

In Chap. 2.3.1 we looked at various types of MFIs with different specific risk profiles and therefore different regulatory requirements. With credit-only institutions depositor security cannot serve as grounds for regulatory measures. The few publications that deal specifically with MFI regulation are largely in agreement that credit-only institutions need no regulation.³¹ This also holds for MFIs that make lending contingent on forced savings, where clients are net debtors. This is certainly the case, if regulation is equated with statutory regulation by the respective top institute (central bank or banking supervisory authority). Alternatively, costsaving regulatory approaches such as self-regulation can, however, be definitely desirable.

One of the main problems with regulating MFIs is how to draw the demarcation lines between different regulatory frameworks. There is a danger here that due to practical implementation problems precedence is given to blanket rather than differentiated approaches. As shown in Chap. 2.3.1, institutional types vary greatly and have their own specific risk profile. Questions to determine the need to take action could, for example, be:

- ◆ How does the MFI refinance itself (private deposit business only with members or also with general public, donor/government money, commercial investors, etc.)?
- ◆ How successful has the MFI been so far (performance indicators)? Does it have experienced, qualified managers and staff?
- ◆ Does the MFI have connections to formal financial institutions, access to a liquidity pool?
- ◆ How large is the institution? Could it jeopardize the soundness of the financial system?
- ◆ What prospective regulatory institutions exist already (umbrella bodies, apex

³¹Cf. Berenbach/Churchill 1997: 26; CGAP 1996; Graham 1998: 1 and McGuire/Conroy/Thapa: 49f.

organizations, associations, etc.)?

- ♦ How high are the costs (direct cost of complying with rules, indirect costs due to restricted flexibility) of regulation compared with the benefits?
- ♦ With deposit-taking MFIs: Is there a deposit insurance?

Obviously no regulatory institution is able to answer these questions for all MFIs. With informal financial institutions such as savings and credit groups or RoSCAs voluntary selfregulation at best is feasible. Anything else would be impossible to control and enforce (cf. experience in South Africa, Chap. 4.2.3.2). The following table is an attempt to collate regulatory needs by institution type. It picks up categories A to C mentioned in Chap. 2.3.1. The external regulatory needs and the recommended regulatory body are indicated for every category.

Table 3: Regulatory needs of different types of institutions

Institution type	Possible activities requiring regulation	Resultant need for external regulation	Recommended regulatory agency
Category A (other people's money) with finance from donor funds	Exploitation of borrowers through near monopolistic position, opportunistic behavior on the part of borrowers; sector refinance sources dependent on confidence in sector	Conducive environment (safeguarding of competition, market transparency, certainty in law, etc)	No or self-regulatory body
Category A with finance via commercial loans or securities issues	In addition: wholesale deposit taking with possible harm to investors through opportunistic behavior	Investor protection through incorporation, stock exchange supervision and rules	Hybrid or self-regulatory body
Category B (members' money)	Deposit taking from members	Small, informal savings and credit groups: no need for regulation. Recommended: registration as a co-operative or RoSCA; ³² compulsory membership in association	Umbrella body
Category C (the public's money)	Retail deposit taking from general public with danger of a run and opportunistic behavior by the MFI	Law tailored to specific features of MFIs	Government or hybrid regulation, with possible delegation of supervision to a private institution

Source: Van Greuning/Gallardo/Randhawa (1999: Table 2), modified.

³²For very small RoSCAs without minimum formality (e.g. rudimentary bookkeeping), registration is, however, unrealistic and also unnecessary.

In Uganda an initial proposal by the BoU/GTZ project, Financial System Development, distinguishes four tiers of regulation (BoU/GTZ 1998). The demarcation criteria between the different tiers were: deposit taking (yes/no), size, track record (good performance in the past) and sustainability (measured by recovery of operating costs). This is an attempt to solve the complex problem of the different regulatory frameworks available for different institutional types and the demarcation of these regulatory frameworks from each other to cater for the respective peculiarities while making sure the regulations remain comprehensible and politically enforceable.

4.1.2 Recommendations for protective measures

The job of the lender of last resort is to step in when there is a cash flow problem to prevent the bankruptcy of illiquid but solvent MFIs. Because of the 'too-big-to-fail' doctrine, a discretionary LLR is prone to discriminate against small financial institutions. Generally it cannot be assumed that the central bank will take on the task of the LLR for MFIs. Access to a liquidity pool or connection to a second-tier institution or formal bank, which in turn has access to the interbank market, could, however, already afford the MFI substantial advantages in most cases. This applies in particular to rural areas, which should have access to a horizontal liquidity balance due to correlated risks. "The aim is to provide some direct way to shift funds toward regions that have experienced negative income shocks (Besley 1994: 42)."

Deposit insurance can substantially raise confidence in the safety of deposits. It is a good idea to set up a deposit guarantee fund to cover deposits up to a certain sum. This protects microsavers who would be hardest hit by deposit loss. Compared with an implicit safeguarding of depositors' accounts (i.e. without a legal guarantee) by government, such a fund is better because it does not discriminate against small institutes (whose collapse would have hardly any political effects). In addition, it is a more effective way of mitigating the danger of a run and possible losses are not socialized via taxes. Suggestions have also been made to subsidize or even fully finance such a fund from government coffers, since promoting the microfinance sector is in the public interest.³³ Altogether, little discussion has been devoted to safeguarding depositors' accounts in microfinance till now and there is an urgent need to gain practical experience.

The financial crisis in Indonesia highlighted the role of protective measures and compelled the government to take rapid action. A major element in the program to restructure the banking sector is the Indonesian Government Guarantee, which alongside deposits also covers a whole range of the banks' liabilities (cf. Presidential Decree No. 26, 1998). The aim is to restore confidence in the banks. This depositor security was not, however, extended to rural banks, the BPR, until the end of 1998. In the interval, deposits in the Jakarta area were shifted from the private BPRs to government institutes, but deposit withdrawals from commercial banks were much larger. The strongpoint of the BPRs is that they hold no foreign liabilities and are more immune to contagion. Outside Java they even succeeded in soliciting additional deposits. This

³³Such as the proposal of the Strauss Commission in South Africa (1996: 86).

demonstrates that saver confidence, particularly in rural areas, does not just depend on safeguarding their deposits; other factors also play a role. Enlarging depositor security to include the BPRs has enabled them to acquire additional deposits in urban areas as well. The extensive government guarantee of deposits must ultimately be underwritten by the tax payer or by printing money at the cost of higher inflation. It is not subject to any supervision whatsoever and must therefore be regarded more as a temporary emergency measure in an acute crisis.

4.1.3 Recommendations for preventive measures

The *conditio sine qua non* for a prudential regulation of MFIs is keeping its target-group orientation. The danger particularly with preventive measures is that MFIs are pressured by inappropriate regulations to imitate the traditional business practices of banks (Berenbach/Churchill 1997: 69). This would run counter to the aim of deepening the financial system by integrating microfinance. The best way to ensure this target-group orientation is to create a regulatory framework tailored to the special risk profile of MFIs.

Preventive measures include quantitative regulations on authorization of the financial institution and during regular business (ratio management) and qualitative regulations on business activities largely connected with risk management (cf. van Greuning/Gallardo/Randhawa 1999: IV.).

The major figures for ratio management are summarized in Table 4. Interpreting performance indicators is very complex, so we shall confine ourselves here to general remarks on selected ratios in MFIs compared with traditional financial institutions.³⁴ The **minimum capital requirement** for banks usually places a high barrier to entry for MFIs, as they are rarely able to raise the customary amount for traditional financial institutions and because due to the small loan amounts an inordinate number of clients would be necessary to attain an adequate leverage.³⁵ The scale of competition in microfinance can be relatively easily controlled via minimum capital. Rock warns against subjecting too many MFIs to regulation, because there is a shortage of experienced managers, because the supervisory institution could not cope and because large MFIs could cut costs through economies of scale (Rock 1997c: 111f.).

Another question is what shape minimum capital must take. For many MFIs stemming from existing financial NGOs a hundred per cent cash requirement ought to be difficult to meet. Consideration should therefore be given to whether or not at least part of the net present value of the existing loan portfolio (i.e. less provisions and allowance for expected inflation) should be acknowledged in the capitalization of a MFI (Jansson/Wenner 1997: 13), as was the case with PRODEM/BancoSol, for example (cf. Chap. 4.2.1.1).

³⁴A standard reference for analyzing financial ratios, for example, is Christen 1997b.

³⁵Jansson/Wenner (1997: 11f.) show in a model calculation that with a capital requirement usual for banks (and customary leverage) eight times as many clients are needed as was the case with BancoSol. See also Berenbach/Churchill 1997: 60; Rhyne 1997.

The situation is different for the **minimum capital adequacy ratio**, the ratio between own funds and risk-weighted assets as defined by the Basle capital accord.³⁶ This ratio ought to be higher than the 10 per cent recommended by the BIS. With most MFIs (apart from NGOs) it is in fact considerably higher, as they are unable to raise so much outside capital (Ledgerwood 1999: 24).

Arguments for a higher capital ratio are:

- ♦ The specific risk profile of MFIs (cf. Chap. 2.3.2), particularly the high management risk;
- ♦ The much higher percentage of administrative costs in MFIs, so that a given share of bad loans in the portfolio results in faster decapitalization than in traditional financial institutions and a sufficient 'buffer' in phases of financial difficulty is therefore particularly important;
- ♦ The inability of owners to replenish capital if needed (no 'deep pockets');
- ♦ Higher disincentive to opportunistic behavior due to a high asset-to-equity ratio, since the owners bear greater losses.

Precisely this last point, however, shows that in addition to the **size** of equity capital in MFIs attention must also be paid to its **source**. Owners must have a sufficient self-interest to exercise their duty of internal control. Financial NGOs or MFIs majority-owned by NGOs borrow above all from donors on favorable terms. It is impossible to draw a clear distinction between equity capital and outside capital here and this is termed 'quasi-equity' (cf. Ledgerwood 1999: 23f.) The donor representatives in the supervisory board do not normally bear financial risk and do not exert the necessary pressure on management to observe sound business practices (Christen 1997a: 40). Rock concludes from that: "Supervisory agencies must create mechanisms that place at risk something else of value to the board member, such as reputation to replace the lack of significant amounts of individual equity (1997c: 113)." The Corposol case, however, (see Chap. 4.2.1.2) gives grounds to doubt whether upholding reputation is a sufficient incentive. An alternative would be to require participation by private investors such as local businessmen and generally permit NGOs to hold a minority interest only in a MFI (Berenbach/Churchill 1997: 70). Also, the owners selected must have 'deep pockets' (CGAP 1996). Credit unions have owners, but due to their specific governance structure they do not usually aim at maximizing profits. Larger cooperatives in particular suffer from opportunistic behavior by management and the supervisory board and are therefore also in need of effective external control.³⁷

For formal banks a whole range of different liquidity ratios are used that usually collate different balance-sheet items with each other. These are insufficient for high-growth MFIs since they relate solely to the past. A problem is that MFIs usually have very restricted access to short-term

³⁶Christen points out that most MFIs do not even have the different classes of assets so that risk weighting plays no further role. The equity multiplier would therefore be an acceptable simplification (1997b: 101ff.).

³⁷In this connection, Van Greuning/Gallardo/Randhawa talk about 'open-common bond savings and credit cooperatives or credit unions' (1998: 12).

liquidity support. Generally, liquidity management of MFIs should be closely geared to cash flow (accounting with NGOs for example for delays in payment of donor funds) and span a long time horizon to account for the expected growth of the MFI.

Another point under the heading ratio management is maintaining requisite **provisions** and **writing off** non-performing loans. Both incur costs for the financial institution and diminish the value of assets and hence also the asset-to-equity ratio. Due to higher volatility of loan portfolio quality and the shorter loan periods, reserves should be generally more conservative and write-offs made earlier than in traditional financial institutions, while catering for different loan terms.³⁸ The usual classification of loans poses problems, however, since they are almost always allotted the highest risk category as non-secured consumer credits under current banking regulations. As has already been stressed, though, repayment rates can be very good, despite lack of bankable collateral, when using an appropriate lending technology. So, at least upwards of a certain loan amount, consideration should be given to accepting alternative security arrangements, such as personal guarantees, movable securities or issuing group loans (Jansson/Wenner 1997: 22ff.).

Another important factor for the regulatory institution may be monitoring performance indicators over time. When granting a licence, it can for example require a MFI to provide evidence of a 'track record', i.e. of successful past performance, as envisaged by the regulation proposal in Uganda (BoU/GTZ 1998). Another option is 'phasing', i.e. easing regulations over time.

These ratios need not necessarily be stipulated in law or in administrative regulations. It is important to agree on certain industry norms and to have an effective enforcement mechanism. Possible institutional designs are dealt with in Chap. 3.4.

³⁸Such as Berenbach/Churchill 1997: 72; CGAP 1996; Jansson/Wenner 1997: 22ff.

Table 4: Some major regulatory requirements for MFIs

Requirement	Description of requirement	Desired effect	Profile with MFIs compared with traditional financial institutions
Capital requirement	Minimum absolute amount of equity capital as of licensing and in regular business (frequently as cash payment)	Buffer to absorb financial shocks and instrument to control competition in the microfinance sector	Lower
Asset-to-equity ratio	Ratio of equity capital to risk-weighted assets	Also acts as a buffer and induces beneficial diversification effects, lessens the incentive for opportunistic behavior	Higher than the Basle capital accord recommendation (10 per cent), both size and source of funds important
Liquid asset ratios	Various ratios, e.g. ratio between liquid assets (cash and short-term investments) and balance sheet total or short-term liabilities (sight deposits)	Safeguarding liquidity at all times	Depends heavily on national context and is subject to seasonal fluctuations; in high-growth MFIs alternative ratios (cf. Christen 1997b: 159f.) and longer planning horizon
Provisions and write-offs	In per cent of average balance sheet total, general and specific (depending on the number of days overdue) provisions	Compensation for loan losses; adjustment of performance indicators for accrued and impending losses	Generally more conservative because of high volatility and short loan periods; also acceptance of substitute collateral technologies

Source: Own compilation after Jansson/Wenner 1997 and Christen (1997b).

Particularly important with MFIs are risk categories that cannot be gauged simply with ratios: management risk, ownership and governance risk and new industry risk (cf. Table 2). Here qualitative standards for business activity play a large role, so-called risk management. Possible requirements for MFIs which contribute to curbing these risks are:

- ♦ Preparation of a feasibility study and the presentation of a business plan;
- ♦ Introducing a MIS so that management is informed on time of the threat of portfolio deterioration and to lessen danger of fraud;
- ♦ Standards for the qualification of management (such as know-how in traditional banking as well as microfinance business);
- ♦ Supervisory board membership of representatives of the different stakeholders in a MFI, with both, financial and development-policy interests represented and a client majority disallowed;

- ♦ Restricting permissible business activity, e.g. by banning foreign currency transactions or time deposit-taking; rules on establishing branch offices, such as regional limits, minimum opening hours or specified services provided are frequently prohibitive for MFIs, because their target groups are often located in unlicensed regions and the costs for providing all specified banking services are too high. A possible innovative method is to set up small, mobile branch offices with limited services to extend a MFI's outreach without incurring unreasonably high additional costs (Jansson/Wenner 1997: 36f.);
- ♦ Controlling liquidity management methods: MFIs should not be expected to keep to strict liquid asset ratios, as these vary greatly with context (Christen 1997a: 36);³⁹
- ♦ Strict rules on the introduction of new finance technologies and products, as experience by other MFIs is rarely available: The superintendency could, for example, stipulate an obligatory test phase here (Berenbach/Churchill 1997: 73);
- ♦ Ban on insider business: With insider business there is the danger that loans are granted for other than economic reasons or owners try to recover their equity capital by borrowing from the MFI and thus undermine capital requirements (Chavez/Gonzalez-Vega 1992: 27). The situation is different, however, for credit cooperatives or village banks, which are owned by their clients. With these, lending to insiders is normal and cannot therefore be prohibited, but it is beset with known problems, such as personal gain by family members;
- ♦ Regulating the relationship between founder NGOs and MFIs: When a MFI is founded by a NGO, the relationship between both should be regulated to ensure their mutual independence in organizational, personnel and accountancy terms and that the supervisory institution can assess the MFI separately. Major principles here are: transparency, armslength transactions, honest transfer pricing and operational independence (Berenbach/ Churchill 1997: 70).

4.1.4 Accountancy rules and reporting/disclosure requirements

Many MFIs still have a lot to learn in preparing annual accounts up to the standards required by the regulatory institution and for internal auditing. That is why complying with the relevant related regulations will incur high initial costs.

Berenbach and Churchill recommend that with MFIs all revenue be recorded on the more conservative cash basis rather than an accrual basis, since exact periodic booking would be too costly without adequate computer equipment. In addition, arrears would appear directly in the profit and loss account (1997: 67). With larger MFIs and particularly MFIs also starting to mobilize savings, computer facilities are imperative for cash flow analysis (to calculate liquidity risk) and for a periodic income statement (for profit analysis).

³⁹In Germany too, the Federal Banking Supervisory Office doesn't impose any sanctions when certain ratios are not kept to; it merely enters into discussion with the bank.

To be able to judge the performance of a MFI, the figures in the balance sheets and the profit and loss account must be adjusted for inflation and subsidies received. This is also the only way to compare it with other MFIs. On the one hand, inflation raises the face value of real assets, while reducing the value of equity capital on the other (Christen 1997b: 35). Subsidies can be implicit or explicit. Valuating implicit subsidies is done with the help of shadow prices (e.g. with soft loans using the commercial interest rate), but the amount will frequently be in dispute (ibid.: 38). Yaron's (1992) subsidy dependence index is very useful for calculations in this area.⁴⁰

It is important that the financial ratios are not geared solely to the past. So-called trigger indicators can be examined as warning signals of an impending deterioration in performance. It is, for example, useful to conduct a sensitivity analysis in relation to important macroeconomic variables such as inflation and exchange rates. Rapid growth of an MFI can also give grounds for a particularly strict supervision, since it can result in a rapid deterioration in loan portfolio quality (Berenbach/Churchill 1997: 73).

Regulations stipulating a ceiling for the percentage of loans lacking bankable collateral pose an unwarranted barrier for MFIs with their technology of character-based lending.⁴¹ Other security arrangements such as peer pressure, repeat access to loans (reliability principle), the use of indisposable securities or other repayment incentives should be accorded equal status for MFIs (Berenbach/Churchill 1997: 72). In an empirical study for Latin America and the Caribbean Jansson and Wenner have shown that this is still not the case for most supervisory institutions (1997: 29f.).

Reporting and disclosure requirements for MFIs must be adjusted accordingly. Keeping detailed records for every single loan is not viable in cost-benefit terms as it is much too costly compared with the loan amount.

4.1.5 Supervisory methods

Implementing the supervision of all MFIs by the central supervisory authority has very seldom proved to practicable and affordable "Superintendencies must develop low-cost methodologies for supervising MFIs (CGAP 1996)." As a consequence of this capacity problem supervision is either limited to a subgroup of MFIs only and/or second-tier institutions are commissioned. One advantage of delegating supervisory tasks to a second-tier institution can be more flexible adjustment of regulations and a closer relevance to needs and conditions in the microfinance sector. This proximity can, however, also give rise to conflicts of interest in second-tier

⁴⁰Christen proposes the following five performance indicators: outreach, asset quality, earnings (ROA, ROE), capital adequacy and operational efficiency (1997a: 34ff.). Outreach can provide information on the target group and assist in interpreting the other indicators. So it is quite easy for MFIs to improve their financial ratios by seeking more prosperous clients. This, however, violates the criterion of outreach. Asset quality provides information on the risk attached to earnings. Equity capital is 'the first line of defense' (ibid.: 35) in the case of financial difficulties. Operational efficiency is a necessary condition of full cost recovery and indicates possible inefficiencies.

⁴¹Frequently not even usual security arrangements such as sureties and transfer of ownership are accepted as securities - just mortgages.

institutions and an uncritical assessment of the MFIs as a result. An essential disadvantage as seen by Berenbach and Churchill is that this way the government regulatory authority does not build up capabilities to supervise MFIs even in the long term (1997: 63). Provided supervision by the second-tier institution functions well, however, this will not be necessary at all.

Indonesia is an example of delegating supervisory tasks (Berenbach/Churchill 1997: 64). In this case, a government institution, the Bank Rakyat Indonesia (BRI), is entrusted with supervising its Unit Desa system. Commissioning a private institution to monitor MFIs, however, would still appear to be a thing of the future. In Bolivia, outside observers recommend that the banking supervisory authority assign a part of its workload to the private sector (Rock 1997d: 47). An effective way of doing this might be to take microfinance experts under contract (CGAP 1996). In addition to their professional qualifications, care should be taken to ensure that they are not exposed to difficult conflicts of interest, as former NGO employees would be, for example.

Regardless of the nature of the supervisory institution, off-site examination of a MFI should entail scrutinizing the entire portfolio and possible statistical trends in subgroups (e.g. by branch office or loan officer).⁴² A mature MIS can replace on-site inspection for the most part (Berenbach/Churchill 1997: 65f.). It is important that the supervisory institution gains an exact picture of the lending process by establishing a close relationship to the loan officers and assessing procedures at first hand (e.g. by accompanying loan officers to their clients) (Rock 1997c: 112). It is essential today to check the computer programs used. Samples for inspection should be as representative as possible; it would not make sense to start with the largest MFI and examine a certain segment of the total portfolio (Jansson/Wenner 1997: 27f.).

Considering the lack of experience in regulating microfinance all requirements should be treated with a certain degree of flexibility. Where a MFI is in financial difficulties, there is no point in centralizing decision-making, since the information advantages of the loan officers is key in character-based lending. "Weak management can usually be countered by returning to greater personal accountability, incentives systems, and quality of the management information system rather than by authoritarian measures (Christen 1997a: 45)."

A widespread view is that the costs of supervision can be borne by the MFIs themselves (Berenbach/Churchill 1997: 66; Christen 1997a: 46). It should, however, be borne in mind that they already pay considerable costs for adjusting to regulation. A subsidy component is warranted at least for building up new capacity for MFI supervision.

⁴²For the CAMEL instrument as a supervisory method in microfinance, see Saltzman/Rock/Salinger 1998.

4.2 Specific experience with different regulatory approaches⁴³

So far, we have summarized relevant general experience irrespective of the regulatory approach. But of course it is impossible to generalize for all countries and all institutional types. Chavez and Gonzalez-Vega (1992: 19f.) talk of an 'idiosyncratic risk', if a financial institution is exposed to a risk in a different manner than other financial institutions. This is why it is not possible to simply replicate a successful regulatory framework.

4.2.1 Regulation by banking law

Although the existing regulatory framework for MFIs poses a high barrier, there are some examples of successful licensing of MFIs in the formal financial sector. These include BancoSol in Bolivia and K-Rep in Kenya. Finansol's record in Colombia is more mixed. In the following, these institutions will only be described in so far as they are relevant for our study.

4.2.1.1 BancoSol, Bolivia

Founded in February 1992, Banco Solidario (BancoSol) is the first private commercial bank in the world to do business solely in the microfinance sector.⁴⁴ It stems from the NGO PRODEM, which was established in 1985. PRODEM was very successful and was able as early as 1990 to recover all costs (incl. imputed costs for equity capital and adjusted for subsidies received - so-called financial self-sufficiency), but finance from donors and self-finance did not suffice to meet demand in lending business. As a NGO, PRODEM was unable to increase its capital base by taking deposits. As there was no special regulatory framework for MFIs in Bolivia at this time, BancoSol was founded as a commercial bank. The problems involved in issuing a bank licence were solved as follows:

- ♦ Three main sources were available for raising equity capital amounting to US\$ 3.2 million: PRODEM's loan portfolio, capital from international donor organizations and private Bolivian citizens. Almost US\$ 5 million was raised in this way. This was facilitated by the keen interest of international donor organizations, the possibility to use the loan portfolio for capitalization and the readiness of private people to invest in a MFI. In many other cases, however, such a high minimum capital requirement would pose a grave problem for a NGO. Because of its low average loan amounts, BancoSol can obviously not attain the usual leverage for a bank.
- ♦ Tasks had to be allocated between the founder NGO and the bank. A big advantage in subsequent collaboration was that PRODEM from this time on concentrated on rural areas

⁴³In addition to the literature sources cited, additional information from GTZ headoffice and field staff was obtained for this chapter.

⁴⁴Here and in the following: Rock 1997b and 1997d: 49-55; Krutzfeldt 1997.

in Bolivia while BancoSol took over the more lucrative urban clientele from PRODEM.⁴⁵ PRODEM was also in charge of BancoSol's research and development activities. New branch offices were set up by PRODEM with assistance from donor funds and later taken over by BancoSol, if they were profitable.

- ◆ For the Bolivian banking superintendency, Superintendencia de Bancos y Entidades Financieras (SBEF), deepening the financial system by promoting the microfinance sector was an important task. In a mutual learning process it was prepared to familiarize itself with the lending technology of MFIs. Misgivings about taking up deposit business, though, could not be allayed until equity capital was increased to almost US\$ 5 million.

A number of provisions in banking law, however, placed an exceptional burden on BancoSol:

- ◆ Article 45 of the Banks Act stipulates that a bank may only grant loans secured by a personal guarantee up to twice equity capital. In June 1996, 27 per cent of BancoSol's loan portfolio was unsecured - in breach of this provision. The regulation that loans under US\$ 2,000 need not be secured was no help to BancoSol, as its group loans counted as single loans in the eyes of the superintendency. So in total the loan extended to a group usually exceeded this limit. This is an obvious example of a regulation that does not do justice to the exceptional character of MFIs: "The prioritization of collateral over alternative guarantees in risk assessment will limit the growth of microfinance institutions, or worse, it might induce some institutions to adjust their guarantee requirements and thus deny access to many microentrepreneurs (Krutzfeld 1997)."
- ◆ Reporting and disclosure requirements were also ill adapted to the needs of a MFI. The business and financial status of each client, for example, had to be graded according to precise conditions. For short-term microloans this meant unreasonable costs and hampered the unbureaucratic granting of subsequent loans.
- ◆ The compulsory collection of non-performing loans through legal proceedings was extremely costly for BancoSol. It demanded a more liberal implementation of the regulations and the option of a loan extension to enable possible repayment.
- ◆ Opening new branch offices was only possible under Bolivian law, if they kept customary national opening hours and proffered all financial services. The outcome, however, was that many branch offices needed to reach the target groups would have been unprofitable.

At the end of 1998 the situation changed radically. For one thing, PRODEM sold its 35.4 per cent interest in BancoSol to the parastatal British organization, Commonwealth Development Corporation (CDC). Withdrawal from BancoSol was a precondition set by SBEF, so that PRODEM could itself apply for a licence as a Fondo Financieros Privados (FFP, cf. Chap 4.2.2.1). This cut off all connections between the founder NGO and the bank. In addition, in

⁴⁵The very costly lending in rural areas could continue to be subsidized this way.

December 1998, new regulations entered force that rendered key aspects of microlending more flexible. The most important are:

- ♦ Microloans for which a certain lending technology is used, as well as consumer loans with a period under 24 months and whose monthly installments do not exceed 25 per cent of monthly income no longer count as non-secured loans whose volume may not exceed double the equity capital.
- ♦ Regulations on loan analysis and records have been made more flexible but are still quite demanding for MFIs.
- ♦ In debt collection legal proceedings can also be taken against the whole group of borrowers, which means substantial cost savings.
- ♦ Moreover, branch offices are now permitted to open for only one day a week and mobile banking services are allowed.

Despite all these restrictions and obstacles - primarily at the outset - BancoSol has managed to reach breakeven point. Considerable success has also been achieved in the meantime in savings mobilization. BancoSol's credit standing is so high that it has even succeeded in issuing debentures on the US market.

It has therefore also broken new ground for other MFIs and the banking sector which will also benefit from the less restrictive regulations of banking law. There is also considerable risk attached to this pioneer role, however, since the process of formalization has incurred high sunk costs for BancoSol which entail a certain dependence on the future behavior of the superintendency. BancoSol's formalization is not a model for startups. For one thing, equity requirements usually pose an insurmountable obstacle. For another, the case of the Fondo de La Comunidad, which had raised the necessary equity capital but still received no bank licence, shows that the banking supervisory authority has reservations about awarding licences to MFIs. In the view of the banking supervisory authority, it is better to close the gap between the unregulated MFIs and commercial banks through the Fondos Financieros Privados (FFP) described in Chap. 4.2.2.1.

4.2.1.2 Finansol, Colombia⁴⁶

Finansol in Colombia resembles BancoSol in some respects. Finansol also stemmed from a NGO that had been in successful operation for several years. Corposol was founded in 1988 (at that time as ACTUAR Bogotá) and underwent such massive growth that the loans secured by personal guarantees of the founders and by loan guarantee funds of commercial banks no longer sufficed to cover capital requirements. At that time it would have had to raise US\$ 13.7

⁴⁶All information from: Berenbach 1997: 61-67, Berenbach/Churchill 1997: 43-48, Labie 1998; Rock/Castello/Azarcon 1997: 93-96 and Steege 1998.

million in equity capital to obtain a bank licence (as compared with BancoSol in Bolivia, which only needed US\$ 3.2 million). So Corposol decided to buy up an existing finance company (compañía de financiamiento comercial), so that with its license as a regulated financial institution Finansol could take deposits immediately (in November 1993) and refinance itself from the capital market. All it needed was US\$ 2.6 million and it did not have to apply for a new licence.

In 1995, Finansol underwent a serious crisis, from which it finally emerged as a new financial institution called Finamérica.⁴⁷ Massive repayment problems depleted the equity base. In June 1996 the banking superintendency (Superbancaria) even banned all further lending operations for six months. Only through joint efforts by the superintendency and major creditors could a remedy be found. Corposol was closed down, Finansol recapitalized and a new president appointed.

We can learn the following lessons from this crisis:

- ♦ The operational, financial and 'cultural' separation of the founder NGO and the MFI is vital. At the end of 1995, Corposol held 71 per cent of the shares in Finansol and exerted a strong influence on the MFI's management. Intransparent business relations between Finansol and Corposol seriously hampered external supervision of the loan portfolio by the superintendency, owners and supervisory board. Corposol and Finansol did not bear full responsibility for their decisions, the one organization finding fault with the other.
- ♦ Repressive elements in the regulatory framework can have particularly serious consequences for MFIs and prompt regulatory avoidance. As part of a plan to fight inflation, for example, the Colombian government first restricted balance sheet total growth of financial institutions to 2.2 per cent a month. As a consequence, to circumvent this requirement, Finansol regularly transferred a part of its loan portfolio (preferably the one with bad loans) to Corposol, since NGOs were unaffected by the regulation. When the restriction was lifted in 1995, portfolio growth surged in the same year from 11 billion to 35 billion pesos. This extreme growth contributed substantially to the subsequent crisis. Restricting growth, then, can be a sensible measure, but it should not be so easy to circumvent as in the case of Corposol. In any case, rapid growth should arouse special attention from the supervisory body.
- ♦ Second, legislation on usury in Colombia prohibited charging cost-effective interest rates. Finansol resorted to charging a training fee, although the training was carried out by Corposol. This is an example of the counterproductive impact of interest ceilings: MFIs are forced to earn income for cost recovery by other means than interest revenue. Both regulatory rules made the relationship between Finansol and Corposol less transparent. It was impossible to separate their financial positions.

⁴⁷The government is much more involved in Finamérica via the Instituto de Fomento Industrial. A new supervisory board has been appointed and the target group now also includes small enterprises; cf. Labie 1998.

- ♦ Paying loan officers (who remained employees of Corposol) by volume of loans granted created the adverse incentive to grant as many loans as possible without paying proper attention to the borrower's ability to repay. Aside from the number of loans granted, however, salary should also account for repayment rates. The extreme growth of Finansol is thus also a sign of a dubious lending technology that provides loan officers with the wrong incentives.
- ♦ Strong growth of a MFI can make for additional problems, if new products are introduced without thorough prior testing and the additional personnel needed is not sufficiently trained (so-called new industry risk). Both of these were the case with Finansol. Exceptional care must therefore be taken by the superintendency when dealing with rapidly expanding MFIs.
- ♦ In hindsight, the question was raised as to why ACCION, whose network included Corposol, or the Superbancaria did not intervene earlier and avert the impending crisis in time. ACCION's policy is to let the subsidiaries operate on their own as much as possible. When ACCION finally carried out a CAMEL diagnosis in May 1995, the crisis was already far advanced. In the eyes of Superbancaria, it was a successful, healthy institution. The reason for this was that only aggregate data was examined, from which a professional auditor would not diagnose any crisis symptoms. So in this case the early-warning indicators of the supervisory authority failed.
- ♦ The 'too big to fail' or 'too prominent to fail' principle applies to MFIs as well. When prominent microfinance support organizations (such as ACCION International in the case of Finansol, later also Calmeadow and FUNDES) are involved, they will all try to avert the bankruptcy of the MFI. Greater importance is probably attached to the danger of a loss of prestige in the international microfinance community than the loss of capital invested. Through a systematic evaluation of the crisis experience (cf. Steege 1998) ACCION managed to wrest something positive from it - to learn from the mistakes made.

4.2.1.3 K-Rep Bank, Ltd., Kenya⁴⁸

The third example is also a bank stemming from a NGO. K-Rep was founded in 1984 as a NGO and advanced to become the largest MFI in Kenya. The conversion into a formal bank in 1996, the K-Rep Bank, Ltd., was motivated by K-Rep's inability as a NGO to mobilize savings from the general public. On the one hand, these were supposed to provide an important source of finance for lending business. On the other, starting savings mobilization was also desirable from the clients' point of view, as at that time there was a lack of savings facilities for poor sections of the population. The savings mobilized from these groups so far have not found their way back to the savers via loans; instead they have been channeled via commercial banks to wealthier

⁴⁸All information from: Carpenter/Mutua/Oketch 1997, Mutua 1997 and GTZ 1998: 65-77.

borrowers.⁴⁹ The following specifics are of general interest, although it is too early to assess the effectiveness of individual regulations:

- ◆ In contrast to Finansol, there was a clear allocation of tasks between the K-Rep Bank and the NGO from the outset. The NGO focuses on development policy goals and retains the tasks of training, advice and dissemination of information. It finances itself from fees and donor contributions. The bank in contrast is in charge of providing financial services and largely pursues financial aims. It has no legal obligation to accept contracts from the NGO; all transactions are conducted at 'arm's length' and governed by written contracts. Strategic decisions can be coordinated through K-Rep Holding Ltd., which spans both organizations.
- ◆ The equity requirement of US\$ 1.5 million on foundation posed no obstacle to K-Rep when applying for a bank licence. The real challenge was to find more investors in addition to the NGO K-Rep, because under Kenyan law a single shareholder may not hold more than a 25 per cent share. K-Rep managed to solicit different finance companies with experience in microfinance and with an international banking background (the World Bank subsidiary IFC, FMO and Triodos Doen from the Netherlands), to enlist the development bank Shorebank Corporation with its American know-how and the AfDB with African expertise and to involve the employees with a 10-per cent share held by the labour association KWA. Balancing these different interests would appear to enable an effective control by the owners, so that the ownership and governance risk is not too high. The investors have a long time horizon and 'deep pockets', i.e. they are able to inject further capital if necessary. In the seven-member supervisory board the chairman and one other member are representatives of the NGO K-Rep, which is in turn completely controlled by the holding. This is to ensure that the bank retains its target-group orientation.
- ◆ Another strength is the early inclusion of the central bank and experienced bank managers and the intent to benefit from experience in other countries. For example, central bank and K-Rep staff traveled to Bolivia to talk to representatives of BancoSol and the banking supervisory authority there. At the Kenyan central bank especially, doubts about having a NGO as the major shareholder had to be allayed. Here, it correctly perceived the danger of unsatisfactory control, since the NGO has no owners in the real sense. Interchange with other successful MFIs can help limit the new industry risk.
- ◆ There are other points at issue between the K-Rep Bank and the central bank, where the bank feels at an unfair disadvantage in its capacity as a MFI. This includes the issue of branching in dangerous and very poor areas, where, however, most MFI target groups are located and the question of accepting substitute collateral. The present approach is to discuss each single issue with the central bank and seek a compromise. The disadvantage of this is that no general solutions are negotiated. Every new MFI applying to be registered

⁴⁹Savings and credit cooperatives may engage in deposit business without being subject to banking regulation but only with their own members (Carpenter/Mutua/Oketch 1997: 87).

as a bank will have to negotiate its adjustments to the regulatory framework anew. This high barrier to entry for MFIs may also be a reason why the K-Rep Bank is still an exception in the Kenyan financial system. In the express view of its Managing Director Kimanthi Mutua, this negotiation-intensive procedure should not be understood as a model for other MFIs (GTZ 1998: 76).

A striking common factor in these three examples is that each is the largest MFI in the country that had already achieved a measure of success. For all three also a certain adjustment of the regulatory framework for formal banks was needed to fit the specific features of MFIs. Regulation of MFIs under banking law cannot therefore serve as a general model for the mass of MFIs. Rather, it is a second-best solution, where no other regulatory framework is available but regulation is necessary or desirable.

4.2.2 Regulation by a special MFI law

Some countries have chosen to adopt a special law for MFIs to cater for the specifics of MFIs.⁵⁰ Two countries are particularly interesting in this regard: Bolivia and Peru. A similar approach was adopted in Francophone West Africa which shows that this regulatory approach is not without dangers, either. In particular the issue must be settled as to whether NGOs should be authorized to engage in savings mobilization and if so, what regulatory rules can guarantee consumer protection and the soundness of the financial system.

4.2.2.1 Fondos Financieros Privados, Bolivia⁵¹

By licensing BancoSol the Bolivian superintendency was able to gain initial experience with the special features of MFIs. The Ley de Bancos y Entidades Financieros promulgated in 1993 laid down a relatively rough framework for regulating financial institutions. This approach represents a functional regulation, since the law regulates certain activities, but not certain institutional types. It proved unsuitable for MFIs, however, because its high equity requirements, for example, placed them at an unfair disadvantage as compared with traditional financial institutions. In April 1995 the Bolivian Congress adopted a decree to introduce a new category of financial institution, the Fondos Financieros Privados (FFP). The following features are worth mentioning:

- ♦ The FFPs are also subject to the general regulatory framework of the Ley De Bancos y Entidades Financieros, but some points are specified in more detail in the decree. Like all other financial institutions, they are monitored by the banking supervisory authority

⁵⁰Savings and credit cooperatives in many countries are already subject to regulation under special cooperatives legislation. Since, though, the supervisory authority is responsible for all cooperatives alike, i.e. for many purely trading cooperatives, it lacks the expertise. In addition, the law does not take the special requirements of financial institutions into account (cf. WOCCU 1993).

⁵¹All information from: Rock 1997d, Jansson/Wenner 1997: 14f., Trigo Loubière 1997: 59ff., Rock/Castello/Azarcon 1997: 96-100 and Berenbach/Churchill 1998 54f.

(SBEF). They belong to the non-bank institutions and are legally stock corporations (sociedades anónimas).⁵² This makes it relatively easy for them to increase their equity capital. Major shareholders are generally private investors with a development focus and NGOs from which FFPs have emerged. The financial interest in a high return also plays a large role, however. The aim of creating FFPs was to fill the existing gap in the regulatory framework as up to then there were no finance companies in Bolivia. In addition, the FFPs were supposed to grant investment and consumer loans and offer savings facilities to small and micro enterprises.

- ◆ A positive aspect is that FFPs only need to raise US\$ 1 million in qualifying equity capital, a third of the amount specified for banks. At 10 per cent, their risk-weighted asset-to-equity ratio equals that of the banking sector and is thus the same level as prescribed by the BIS for traditional banks since the end of 1998. Considering the particularly high risk in microfinance this quota is too low.
- ◆ A whole range of financial services are allowed, including traditional lending, savings and time deposit taking, leasing and factoring. To limit the risk of FFPs, however, they are not permitted to accept sight deposits, conduct import/export transactions, conclude direct investments and manage investment funds.
- ◆ As already mentioned, the qualification of management is of paramount importance in microfinance. Hence the requirement that management must have experience in microfinance.
- ◆ Other preventive regulations are rules on portfolio diversification. For example, the maximum loan that can be granted to a single client without physical collateral (garantía real, including transfer of ownership as security on a debt) is one per cent of the equity capital of the FFP, three per cent with physical collateral. In addition, insider business is generally forbidden.
- ◆ Personal guarantees movable goods such as precious stones and other valuables and group liability are also accepted as loan security, which caters for the special lending technology of MFIs. The same rules apply for provisioning to FFPs as to banks. Yardsticks are not just the number of days that payment is overdue, but also the loan amount. So far no distinction has been made between consumer and investment lending which would be impossible with many MFIs anyway.

In July 1995, the Caja De Los Andes was founded as the first FFP. It emerged out of the NGO Pro-Credito founded in 1991, which was dissolved as a lending institution (unlike Prodem when BancoSol was founded). Its success in lending business appears to confirm the regulatory approach of FFPs. Since May 1996 it has also been engaged in savings business, though

⁵²This legal form was chosen under pressure from the banking supervisory authority because this was the only way it saw to secure a clear ownership structure with sufficient control by the owners.

mainly with institutional investors, that is in wholesale deposit taking. Remarkably, it has set aside more provisions for non-performing loans than stipulated. At the end of 1998 there were five FFPs, only two of which were engaged in microfinance, however (along with the Caja de Los Andes, the Centro de Fomento de Iniciativas Económicas, FIE). Three NGOs (PRODEM, ECOFUTURO and Agrocapital) have applied for a licence to the SBEF and one NGO (SARTAWI) is preparing to do so.

Large use has also recently been made of the FFP regulatory framework by consumer financiers. A frequent variant is for a commercial bank to set up a FFP as a subsidiary and equip it with the necessary equity capital. The subsidiary then specializes in granting non-secured consumer credits with aggressive sales strategies (e.g. telephone marketing). Instead of a thorough credit rating and effective loan collection, these FFPs charge high interest and exorbitant default interest.⁵³ This way they are able to afford a high loan loss rate.⁵⁴ The overindebtedness of the borrowers poses a growing problem, which also results in higher repayment problems with BancoSol and the Caja de Los Andes. This profit-taking effect runs counter to the original intention of the superintendency to create a balanced regulatory framework for MFIs. On the contrary, the established MFIs face undesirable competition that jeopardizes the soundness of this market sector due to the worsening problem of overindebtedness.

The SBEF reacted at the end of 1998 by tightening rules on lending for more discriminate and more appropriate treatment of MFIs on the one hand and to limit the scope of consumer financiers on the other. By distinguishing now between four different loan types, each with its own specific requirements, microloans are treated differently from so-called commercial loans. Under certain conditions (as so-called *debidamente garantizado*), microloans and consumer credits do not come under the otherwise applicable regulation requiring that a maximum of twice the equity capital may be allocated for loans. Provisioning requirements have also been made far more stringent. Thought is being given to setting up a uniform risk clearing center to stem overindebtedness. Subsuming the FFP regulations and the provisions for the Cooperativas de Ahorro y Credito in a joint banking law (entitled, *Ley de intermediación financiera*) will streamline regulations to create the same initial conditions for all financial institutions.

4.2.2.2 CMAC and EDPYME, Peru⁵⁵

Peru adopted a special regulatory framework for MFIs at a very early stage. First in the early 80s an institutional type was created modeled on the German savings bank system, the Cajas Municipales de Ahorro y Crédito (CMAC). As with the German savings banks, the regional

⁵³There is a ban on usury in the civil code (*codigo civil*), but evidently hardly anyone complies with it. In addition, default interest is not regulated through this.

⁵⁴The biggest consumer financier, Acceso FFP, has a rate of non-performing loans of about 20 per cent.

⁵⁵All information from: Rock 1997e, Jansson/Wenner 1997: 14f., Berenbach/Churchill 1997: 49-54 and Rock/Castello/Azarcon 1997: 89-93.

principle applies, which precludes direct competition amongst several CMACs in one region. An umbrella organization, the Federation Peruana de CMAC (FEPCMAC), resembling the German Savings Banks and Giro Association, performs appraisal, advisory and training tasks.

In 1994 a second regulatory framework for MFIs was created primarily conceived for NGOs seeking to convert to regulated financial institutions. This institutional type is called Entidad de Desarrollo para la Pequeña y Microempresa (EDPYME). The following experience was gained with these two regulatory frameworks for MFIs:

- ♦ CMACs were very successful in mobilizing the savings of microentrepreneurs despite the adverse national economic climate in the early 80s. This applies till today, however, to savings and time deposits only, as CMACs are only allowed to do business with sight deposits upwards of a certain amount.
- ♦ Adopting the structure of the German savings bank system was supposed to guarantee effective regulation and supervision by delegating a part of the control function to private, financially and administratively independent FEPCMAC, thus easing the superintendency's workload (cf. 4.1.5).⁵⁶ Its job is to provide information on the performance of CMACs to the superintendency (SBS). The SBS, however, still conducts audits as well. The FEPCMAC can contribute its information advantages thanks to its close proximity to CMACs, while the SBS wields the necessary power of sanction. Rock talks about "an intelligent division of labor that has effectively monitored the financial activities of the CMACs system for most of the last ten years (1997e: 79)." Some corruption cases have, however, come up in recent years at the FEPCMAC, indicating in turn the need for effective supervision of the second-tier institution by the superintendency.
- ♦ A major contributory factor to the creation of the EDPYMEs was the pressure of outflow of funds from the APEX organization COFIDE (Corporacion Financiera De Desarrollo). This was not permitted to refinance unregulated financial institutions, so it could only conduit the sizable funds from the government and international donors to the few existing CMACs. For NGOs seeking formalized status, EDPYMEs offer a suitable institutional setting. Equity requirements, for example, are very low at US\$ 256,000 (as with CMACs), no records are required for loans under US\$ 10,000 and the asset-to-equity ratio is not determined by risk weighting but by means of a simple equity multiplier of 1:10.
- ♦ Both institutional types are regulated and monitored by a special department within the Peruvian central bank (SBS). In addition to the usual financial ratios, methods of lending, internal control systems, staff qualification, etc. are checked. The scope of permissible business activities depends on the size of equity capital. For example, both types of financial institutions can take up deposit business (savings books and time deposits) if their equity capital exceeds US\$ 1.4 million. At or upwards of US\$ 2.8 million in equity

⁵⁶Worth mentioning is the close advisory assistance provided to the FEPCMAC by the German consulting IPC, which undertook a part of the control tasks itself.

capital even sight deposits may be taken. This way, MFIs can also develop within the regulatory framework.

- ♦ By acquiring a formal status as a EDPYME, it is easier for the NGO to refinance via the capital market. To take up savings business a MFI requires special approval from the SBS but because of sufficient refinance facilities till now no MFI has applied. Due to easy refinancing via apex organizations such as COFIDE, EDPYMEs are less interested in converting from credit-only institutions to fully-fledged financial intermediaries in microfinance. Deposit business with the general public is 'crowded out' and thereby the approach to develop a self-supporting financial system independent of permanent inflows of capital is missed. The superintendency also takes on a task here that is actually the duty of investors (government or donors). Their prime task should be, however, to ensure depositor security.
- ♦ The regulatory framework for EDPYMEs is non-committal in many regulations. This is to ensure the necessary flexibility, as the superintendency has no experience with regulating NGOs. The low requirements have even prompted a consulting firm and a pharmaceutical company to seek registration as EDPYMEs. A large variety of institutions would, however, hinder effective supervision.

With the creation of these two institutional types, Peru has succeeded in offering MFIs an appropriate regulatory framework.⁵⁷ However, with direct supervision of both CMACs (albeit with assistance from FEPCMAC) and EDPYMEs by the banking superintendency SBS, this is quite a costly method, which also calls for sound microfinance know-how on the part of the SBS. For other countries the question arises whether the central bank or banking superintendency have the capabilities and know-how for a comparable regulatory approach.

4.2.2.3 West Africa⁵⁸

The West African Economic and Monetary Union UEMOA⁵⁹ saw an urgent need to take action in the MFI sector on the one hand to safeguard savings mobilized in large amounts particularly by savings and credit cooperatives but also other MFIs and on the other to gain an overall picture of the different kinds of savings and lending business and organize this market. In July 1996 the Council of Ministers of UEMOA adopted the Loi PARMEC.⁶⁰ Positive elements in the law are as follows:

⁵⁷A third institutional type are the Cajas Rurales de Ahorro y Crédito (CRAC), which cannot be looked at in more detail here.

⁵⁸The following information stems from: Chidzero/Galludec 1997.

⁵⁹Union Economique et Monetaire Ouest Africaine. Members are Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal and Togo. Guinea Bissau is soon to become the eighth member.

⁶⁰Projet d'Appui à la Réglementation des Mutuelles d'Epargne et de Crédit

- ◆ For credit cooperatives a relatively detailed regulatory framework has been created that stipulates the organizational structure of the MFIs as well as risk management for depositor security via 'prudential ratios'.
- ◆ Via a multi-tier organizational structure grassroots cooperatives can group to form a union, these then join a federation and the federations can associate to form confederations. This way every level can be supervised by the next higher one. The formation of networks and associations as interest groups and the liquidity balance between the different levels is promoted. The Loi PARMEC regulates the structure for all levels in the same way. Via the so-called organes financiers, the higher levels can also engage in retail business. These are, however, subject to banking legislation.
- ◆ The finance ministries, which are responsible for banking regulation, are obliged to set up special monitoring units, so-called CAS/SMEC.⁶¹ As envisaged by major donors, these are supposed to provide advice in setting up decentralized financial systems. Setting up and training these units is supported by TC funds in some countries, such as in Mali by a GTZ project. There is, however, a danger that the officials responsible may abuse their power to approve or reject a licence for a MFI for personal advantage.

On the other hand, this regulatory approach also illustrates that a regulatory framework for MFIs should not impose narrow, rigid confines and the restricted capacity of regulatory authorities must be taken into account:

- ◆ The PARMEC law only regulates mutual financial institutions, which have a precise fixed structure and must comply with certain requirements.⁶² All other MFIs either come under the regulations of banking law or must conclude a bilateral agreement with the Ministry of Finance, otherwise they face sanctions that can include prison sentences. This agreement holds for five years with possible prolongation and grants the finance ministry an audit privilege for MFIs. The long-term aim is to make all MFIs subject to the specified structure in the Loi PARMEC. For many, particularly non-cooperative MFIs, however, this is not practicable, because the reporting and disclosure requirements are too extensive and many rules do not fit in with the conditions of life in rural areas.⁶³
- ◆ The law ties lending to the amount of mobilized savings and not equity capital. The reason for this is that credit cooperatives have little equity capital in general. A conservative lending policy is best, at least during the development phase, since there is frequently source of finance apart from savings. In the long term, though, this regulation acts as an impediment to further expansion of the sector, e.g. after a second-tier structure has been built up.

⁶¹ Cellule d'Appui et de Suivi des Structures Mutualistes ou Coopératives d'Epargne et de Crédit.

⁶² The rules include: voluntary and unlimited membership; 'one member, one vote'; limited dividends on shares; no set ratio between savings deposits and loans.

⁶³ For example, all members of the executive board are obliged to present a police certificate of conduct.

- ♦ The individual agreement with the finance ministry is not an acceptable alternative, since it is only temporary and stipulates no specific regulations for MFIs. This law stifles institutional innovation by elevating a narrow model to a norm and confers an unfair competitive advantage on cooperative MFIs (in addition through tax exemption).
- ♦ The prescribed four-tier structure for the cooperative system would permit the delegation of supervisory tasks to a lower level (federation or cooperative), but this is not actually practiced enough, so that in most countries the finance ministries lack the requisite resources. They also lack the necessary expertise to regulate cooperatives.

4.2.3 Self-regulation

A third regulatory option is self-regulation. Experience is above all available here from savings and credit cooperatives.⁶⁴ No systematic evaluation of this experience has, however, been made so far. Approaches in self-regulation of the whole microfinance sector have been adopted above all in the Philippines and South Africa. So far, though, it is almost impossible to forecast what status self-regulation will acquire in relation to government regulation and what shape the enforcement mechanisms of the regulatory framework will take. So there is no clear demarcation between self-regulation and regulation by a special MFI law.

4.2.3.1 Philippine Coalition for Microfinance Standards, Philippines⁶⁵

In the Philippines non-banks are not subject to regulation. NGOs must simply register with the Securities and Exchange Commission, which is a simple formality with no further implications. Cooperatives have their own regulatory framework with the Cooperative Development Authority as the supervisory institution, but this lacks the staff and technical equipment for effective control. Minimum standards have already been set in this area as well. Since 1953, in addition to commercial banks there exist rural banks, which are monitored by a separate department within the Philippine central bank and are allowed to conduct deposit business. Another institutional type are the savings and loan associations, which are also directly regulated and supervised by the central bank. Most NGOs emerged under the Marcos regime as opposition, at times also, illegal organizations and are therefore typically remote from government. Alongside lending and (actually illicit) savings business, they also primarily run social projects partly financed by 'savings' in the shape of member contributions.

As of 1991, the Magna Carta for Small Enterprises requires all lending institutions to allot 5 to 10 per cent of their loan portfolio to small enterprises. This quota is supposed to improve capital

⁶⁴Examples of successful self-regulation of savings and credit cooperatives tend to be rare, according to a discussion in the DFN in November 1998. Cf. contributions by Dale Adams (18.11.98) and Richard Rosenberg (20.11.98).

⁶⁵All information from: Luang/Vasquez 1997 and PCMS 1998.

access for NGOs.⁶⁶ An evident essential prerequisite for this is raising standards in microfinance; otherwise directed lending is counter-productive. For this reason, a tactical coalition called the Philippine Coalition for Microfinance Standards has been formed with representatives of NGOs, the central bank and other microfinance experts from business and science, which is basically open for formal banks as well.⁶⁷ Its declared goal is to review the Philippine NGO sector and develop standards for microfinance business. At present, no detailed figures are available on the contribution of MFIs to lending and savings mobilization and their financial performance. Their contribution and their financial sustainability ought, however, to be rather low.

This regulatory approach must rate as a favorable development. Remarkably, the MFIs have joined together of their own accord,⁶⁸ so the approach is self-regulatory in this respect. By developing standards the Coalition hopes to raise the efficiency, outreach and sustainability of financial NGOs and make them more attractive for investors. Membership of a selfregulatory system ought to be construed as a positive signal by investors. The task of supervision is supposed to be performed by the Coalition itself. Based on the available literature, however, some questions remain to be settled. The role of savings for the target group is recognized (Core Principle 2), but the problem of governance structure in a NGO due to lack of control by the owners and the consequences for the safety of savings deposits are not addressed. Under discussion is whether NGOs, which are not subject to any statutory regulation, should also be permitted to mobilize savings. No later than commencement of deposit business with savers primarily seeking a safe, permanently accessible financial investment and less concerned with the NGO's social mission, external regulation is imperative for reasons of depositor security. Provided the enforcement problem has been solved, this can also be a self-regulatory system. This has not been the case to date, however. There is a particular danger of a conflict of interest in the Coalition, where it acts as an adviser on the one hand and on the other is obliged to impose sanctions on non-compliance with minimum standards.

A positive aspect is the involvement of the central bank and the attempt to initiate a mutual learning process (Berenbach/Churchill 1997: 29). This may give self-regulation the necessary 'teeth', which has been successfully done in South Africa, for example (see following chapter).

Increasingly, NGOs or foundations are splitting off their microfinance portfolios and registering as regulated financial institutions (rural banks, savings and loan associations) to be able to mobilize savings from the general public as well. So this business appears to be a profitable niche in the market where there is an unsatisfied demand for savings facilities. A detailed study is, however, needed to establish whether the relevant regulatory frameworks are tailored to the special features of microfinance business. In any case, a stricter separation of the social and

⁶⁶The Philippine financial sector is relatively strongly regulated in other respects as well. Luang/Vasquez have identified no fewer than 111 special or directed lending programmes for certain sectors.

⁶⁷Information on the coalition can be found in the Internet on the home page of the Virtual Library on Microcredit: <http://www.soc.titech.ac.jp/icm/network/phil-cover.html>.

⁶⁸The formation of the Coalition may have also partly been induced from the outside via the financial and content support of USAID, though.

financial concerns of NGOs is desirable.

4.2.3.2 AMEDP and MLA, South Africa⁶⁹

A hallmark of South Africa is the coexistence of a modern 'first world' financial sector and a large informal and semi-formal 'third world' financial sector. The phase of deregulation, which started as early as the 80s, resulted in the establishment of an independent central bank (South African Reserve Bank, SARB) and the promulgation of a new Banks Act in 1990. The Department of Banking Supervision in the Reserve Bank headed by the Registrar of Banks supervises the banks. This Banks Act is conceived along functional regulatory lines, i.e. it applies to all types of financial institutions alike. The constitutive element of a financial institution is the mobilization of private savings for onlending. This means, however, that many semi-formal and informal financial institutions are obliged by law to comply with the Banks Act's provisions. Since this is neither verifiable nor practicable, the stokvels (the South African term for RoSCAs), savings and credit cooperatives and employees' savings clubs were exempted as so-called common-bond institutions from the Banks Act.

The following elements of South Africa's regulatory framework are of particular interest.

- ◆ The Banks Act defines the business of a bank in terms of two functions: "namely, that of accepting deposits as a regular feature of the business in question, and that of acting as a financial intermediary in the employment of funds accepted by way of deposits." (SARB 1996: 21). Expressly excluded, however, are savings of members of cooperatives and forced savings as security for the lending business. In this way, Category B (members' money) and C (the public's money) financial institutions are treated differently. The regulations for forced savings take account of the fact that the clients are usually net borrowers, so that there is no danger of a run.
- ◆ The upshot of the functional regulatory approach of the Banks Act was, however, high entry barriers for MFIs, since it only took the nature of business into account as the sole criterion, but did not discriminate by size, client features, lending technology, etc. All deposit-taking institutions must therefore meet the regulatory requirements for formal banks. This problem was recognized and the remedy was to exempt common-bond institutions.
- ◆ Exemption for the common-bond institutions from regulation under the Banks Act is contingent on their joining the relevant umbrella organization (Savings and Credit League of South Africa, SACCOL, or the National Association of Stokvels of South Africa, NASASA). Apart from this compulsory membership, exemption is tied to further conditions (e.g. maximum size and duties of reporting and disclosure), which are equivalent to indirect regulation. The rationale for the special treatment of common-bond

⁶⁹On the following cf.: Willemse/Goldblatt 1997 and Staschen 1999.

institutions is that member-based institutions (Category B) permit control by the members or owners, i.e. external regulation is rendered superfluous by sufficient internal control (due to a 'common bond'). However, umbrella organizations turn out to be toothless tigers in external regulation as long as they for their part are not controlled by the banking superintendency.⁷⁰

As the NGO sector is still not very advanced in South Africa, retail deposit taking is not on the agenda for the foreseeable future. Nevertheless, there is keen interest in the microfinance sector to establish a prudential regulatory framework for MFIs. Efforts in this direction are largely being made by two competing lobby groups: the Alliance of Micro Enterprise Development Practitioners (AMEDP) largely representing the interests of NGOs and the finance companies (profit-oriented, unregulated MFIs) and the Association of Micro Lenders (MLA) as a lobby for microlenders (professional moneylenders). Both have two main reasons for regulating the sector:

- ♦ The present exemption for loans under ZAR 6,000 (approximately US\$ 1,000) from the interest ceiling of the Usury Act should be abolished, since it is politically inopportune to leave particularly the poorest borrowers unprotected from usury. This, though, would largely preclude profitable microfinance business, since it requires higher interest rates. AMEDP and MLA want to ensure consumer protection differently, namely by selfregulation of the industry. The aim is to convince political decision-makers of the superiority of this approach. This presupposes, however, that this regulatory framework can also guarantee consumer protection from exploitation without statutory intervention.
- ♦ Refinancing MFIs through so-called wholesale deposits (with the exception of the development finance institutions Khula and NHFC) is prohibited by the Banks Act.⁷¹ Members of a self-regulatory system hope for exemption from this ban and better access to capital as a result. The justification for this is that banks or institutional investors are better able than small savers to overcome the asymmetrical distribution of information between them and MFIs and control how their money is employed.

While the MLA is for self-regulation of the industry and wants to take over the task of regulation and supervision itself, the Alliance sees a conflict of interest in having the job of 'player' (sponsor of MFIs) and 'referee' (regulatory and supervisory institution) performed by one agent. It therefore favors so-called hybrid regulation, where the government supervisory agencies (SARB, the Department of Trade and Industry) are represented in the board of the private regulatory institution. A governance structure for the regulatory institution which is incentive compatible should be set up in this way and also confer the necessary power of enforcement on it. A

⁷⁰A viable sanction option of SACCOL is to report credit cooperatives which are not members of SACCOL or infringe its rules to SARB for breach of the Banks Act.

⁷¹According to Porteous (personal mail), a demarcation between retail and wholesale deposits by deposit amount is being considered (his suggestion for a limit is ZAR 1 million). In addition the term 'wholesale' can pertain to the identity of the lender, i.e. all lenders who are not individuals. Therefore it includes refinance via the capital market.

proposal to this effect was prepared in 1997 by the consulting firm Deloitte & Touche on behalf of an advisory panel (including practitioners, representatives of Khula and NHFC, the Registrar of Banks). This proposal was shelved for a long time for lack of interest on the part of the SARB and the ministries. In early 1998 the Alliance therefore also set about trying to establish a self-regulatory institution. This was one reason why the support of the government banking supervisory authority could be enlisted for a hybrid regulatory approach in mid-1998.

Presently a Micro Finance Regulatory Council is being set up involving the MLA, AMEDP, Khula, NHFC and a representative each from the Reserve Bank and the Department of Trade. So all major stakeholders are included. The Regulatory Council will be empowered to impose sanctions on infringements of its regulations, including the prohibition of further business activity. At the same time, the Department of Trade and Industry has published a revised version of the Usury Act for commentary which enlarges exemption to include loans of up to ZAR 50,000. This exemption, however, is to apply only to members of the Regulatory Council. In addition, this would not entail a general deregulation of interest rates; instead, the Regulatory Council would fix an interest cap depending on the amount and kind of loan (consumer, housing loans, etc.). This would make for an arrangement where a large part of regulatory responsibility is delegated to a private institution, with, however, a sufficient power of sanction to confer credibility on this 'hybrid' regulation thanks to participation by the government supervisory authority.

5. SUMMARY AND OPEN QUESTIONS

We stress again here that all recommendations from Chap. 4 must be treated with a certain caution, since they are generalizations of very specific experience from individual countries. Innovative approaches in particular must be tested in practice before they can rate as better practices or best practices for policymakers with necessary adjustments in other countries as well. A next step is to scrutinize such innovative approaches in more detail by means of additional country studies.

The major findings can be summarized briefly as a set of theses.

When considering regulating and supervising MFIs two questions need answering to identify specific needs in the microfinance sector: What institutional shape should the regulatory framework take and what definite regulatory requirements need to be set? On institutional design, we can put forward the following theses:

Thesis 1: The most common method so far - offering MFIs the same regulatory framework as for formal banks as the only option - has not proved effective. This approach of being regulated within the existing regulatory framework has been chosen by some MFIs, but its clear weaknesses have come to light. However, regulation with functional banking legislation appears feasible, provided this accounts for the special features of MFIs in discriminating regulatory measures.

Thesis 2: Regulation by means of a special law for MFIs is in danger of stifling institutional variety and innovation in microfinance. This can be prevented by a tiering approach. Competitive neutrality can only be achieved by discriminate treatment or functional regulation of different institutional types.

Thesis 3: Self-regulation in its pure form, i.e. without direct or indirect statutory influence, suffers from a large enforcement problem. This can, however, be mitigated (e.g. by statutory privilege for members of a self-regulatory system). Competition amongst several self-regulatory institutions poses a problem, because the necessary market transparency for an informed selection by clients is usually lacking, threatening to lower standards.⁷²

Thesis 4: A multi-tier system, with each tier controlled by the next higher one, can help cut costs and make use of information advantages. Conceivably a self-regulatory institution could be controlled by an apex organization or directly by the banking supervisory authority. Of importance is an incentive compatible governance structure at all levels.

Thesis 5: MFIs must be regulated, if they start mobilizing deposits from the general

⁷²South Africa is an example for this: MLA has no effective enforcement mechanism, but claims to be able to guarantee minimum standards for its members. Clients cannot distinguish between MLA and AMEDP for lack of the necessary information.

public including non-members. Also member-based institutions should be regulated, if they exceed a certain size. Depositor security should be accorded top priority with MFIs.

Thesis 6: Small MFIs in the informal sector must not be forced to submit to regulation, even if they mobilize local savings (e.g. RoSCAs, but not NGOs). Here the costs of regulation far exceed the benefits. The informal character of MFIs preclude government regulation.

Thesis 7: Regulation of credit-only institutions may be desirable to raise standards in the microfinance sector, but there is no imperative for government to take action. Private actors should play the leading role in this area. Voluntary self-regulation of the sector could be an option, for example.

Thesis 8: The task of supervising MFIs can be delegated to an (possibly also private) institution. The banking supervisory agency frequently lacks the necessary knowledge of the microfinance sector and the requisite capabilities. For specific regulatory requirements, we can posit the following theses:

Thesis 9: Due to their distinctive institutional features and business characteristics, the prudential ratios of MFIs differ from those of traditional commercial banks. Adjustments are needed for example in equity requirements, rules on provisions, write-offs of nonperforming loans and reporting and disclosure duties.

Thesis 10: Controlling risk management procedure and institutional structures is more important than controlling ratios (risk management instead of ratio management). Possible requirements are access to a liquidity pool, test phases for new products, certain minimum qualifications for management and staff, standards for MIS, etc. The aim should be to accord internal control as high a status as possible.

The following main questions are unsettled or at issue:

- ◆ Which role should apex organizations play in regulation and supervision?⁷³
- ◆ How can a self-regulatory institution acquire the necessary authority to impose sanctions when regulations are breached? How can 'free riders' be discouraged?
- ◆ According to what criteria can we distinguish institutional types in microfinance? How can we prevent a fragmentation of banking legislation while nevertheless accounting for the special features of individual institutional types?
- ◆ How should the microfinance portfolios of formal banks be treated?

⁷³Cf. the very critical view on apex institutions of Gonzalez-Vega (1998). This paper only touches on the regulatory influence of apex institutions, however.

- ♦ What alternatives are available to a repressive usury law, if the 'evil moneylender' cannot be ousted from the market simply by expanding supply?
- ♦ What cost-saving but effective ways are there to regulate credit-only institutions as well?
- ♦ Should member-based institutions such as savings and credit cooperatives receive special treatment or do they have the same external regulation needs as other MFIs?
- ♦ How can the problem of unsatisfactory internal control due to NGOs' unfavorable governance structure be solved?
- ♦ Which procedure is best in countries where governments and/or banking supervisory authorities show no interest in MFI regulation? How can repressive state regulation be dismantled or prevented?⁷⁴

Donors should proceed with caution when providing advice in the regulation and supervision of MFIs. Insufficient experience has been gained with regulation tailored to the special needs of MFIs to make clear and general recommendations. Future case studies should concentrate on countries where special regulatory legislation exists for MFIs or a system of selfregulation has already been established.

Initiatives in regulation can have adverse effects, if all they do is convey the impression that the microfinance sector must submit as speedily as possible to regulation modeled on the formal banking sector, while the necessary knowledge on the special features of the sector and the resultant specific regulatory needs is lacking. The first thing to do therefore is to raise awareness of the problem and then consider regulation of MFIs in line with the specific setting.

Donors too can be subject to a conflict of interests, if they advise on regulation of MFIs at sector level and support the development of efficient MFIs at institutional level as well. They should therefore confine themselves to one of these two roles.

By assisting regulatory and supervisory institutions donors can promote development at sectoral level and not just at institutional level in line with the financial system approach. Setting up an incentive compatible regulatory framework can raise the efficiency of MFIs and improve their assimilation into the financial system (through new refinance sources, access to a lender of last resort, membership of a deposit guarantee system, etc.).

⁷⁴These issues come under the heading of political economy, thus far exceeding the purely economic or legal matters involved in prudential regulation.

6. REFERENCES

- Akerlof, G. 1970. "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism". *Quarterly Journal of Economics*, Vol. 84, pp. 488-500.
- Bank of Uganda and GTZ. 1998. Proposal for BoU Policy Statement on MFI Regulation. Draft. Kampala.
- Berenbach, Shari. 1997. "Colombia". In Churchill, editor, pp. 59-67.
- Berenbach, Shari and Craig Churchill. 1997. Regulation and Supervision of Microfinance Institutions: Experience from Latin America, Asia and Africa. The MicroFinance Network Occasional Paper No. 1. Washington, DC.
- Besley, Timothy. 1994. "How Do Market Failures Justify Interventions in Rural Credit Markets?". *The World Bank Research Observer*, Vol. 9, No. 1, pp. 27-47.
- Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung. 1994. Sektorkonzept 'Finanzsystementwicklung – Förderung von Sparen und Kredit'. Bonn.
- Carpenter, Janney, Kimanthi Mutua and Henry Oloo Oketch. 1997. "Kenya". In Churchill, editor, pp. 85-96.
- CGAP. 1996. Regulation & Supervision of Micro-finance Institutions: Stabilizing a New Financial Market. Note No. 4. August 1996. Washington, DC: The World Bank.
- Chavez, Rodrigo A. and Claudio Gonzalez-Vega. 1992. Principles of Regulation and Prudential Supervision: Should They Be Different for Microenterprise Finance Organizations? Economics and Sociology Occasional Paper No. 1979. Columbus, Ohio: Ohio State University.
- Chavez, Rodrigo A. and Claudio Gonzalez-Vega. 1994. "Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organizations". In Otero, María and Elisabeth Rhyne, editors, *The New World of Microenterprise Finance. Building Healthy Financial Institutions for the Poor*. West Hartford, Connecticut: Kumarian Press, pp. 55-75.
- Chidzero, Anne-Marie and Gilles Galluddec. 1997. "West Africa". In Churchill, editor, pp. 97- 104.
- Christen, Robert Peck. 1997a. "Issues in the Regulation and Supervision of Microfinance". In Rock and Otero, editors, pp. 29-48.
- Christen, Robert Peck. 1997b. *Banking Services for the Poor. Managing for Financial Success. An Expanded and Revised Guidebook for Microfinance Institutions*.
- Churchill, Craig, editor. 1997. *Regulation and Supervision of Microfinance Institutions*. Case

-
- Studies. The MicroFinance Network Occasional Paper No. 2 Washington, DC.
- Churchill, Craig, editor. 1998. Moving Microfinance Forward: Ownership, Competition, and Control of Microfinance Institutions. The MicroFinance Network. Washington, DC.
- Coetzee, Gerhard and Steven Goldblatt. 1998. Regulation and Supervision of Microfinance Institutions: Experiences from South Africa. Paper presented on the CGAP Conference "Savings in the Context of Microfinance". Kampala, Uganda, 10.-13. Februar 1998.
- Diamond, Douglas W. 1984. "Financial Intermediation and Delegated Monitoring". Review of Economic Studies, Vol. 51, pp. 393-414.
- Diamond, Douglas W. and P.H. Dybvig. 1983. "Bank Runs, Deposit Insurance, and Liquidity". Journal of Political Economy, Vol. 91, No. 3, pp. 401-419.
- Dichter, Thomas W. 1996. "Questioning the Future of NGOs in Microfinance". Journal of International Development, Vol. 8, No. 2, pp. 259-269.
- Fruman, Cécile and Mike Goldberg. 1997. Microfinance Practical Guide for World Bank Staff. Sustainable Banking with the Poor, Consultative Group to Assist the Poorest.
- Gonzalez-Vega, Claudio. 1995. Non-bank Financial Institutions and the Sequencing of Financial Reform. Economics and Sociology Occasional Paper No. 2244. Columbus, Ohio: Ohio State University.
- Gonzalez-Vega, Claudio. 1998. Microfinance Apex Mechanisms: Review of the Evidence and Policy Recommendations. Columbus, Ohio: Ohio State University.
- Graham, Douglas H. 1998. Regulation and Supervision of Deposit-taking Micro-finance Institutions. Paper presented on the CGAP-Conference "Savings in the Context of Microfinance". Kampala, Uganda, 10.-13. Februar 1998.
- Greenbaum, Stuart I. and Anjan V. Thakor. 1995. Contemporary Financial Intermediation. Fort Worth, Texas: Dryden Press.
- GTZ. 1997. Savings in the Context of Microfinance. Eschborn: GTZ.
- GTZ. 1998. Proceedings of the Africa Conference 'Savings in the Context of Microfinance'. Kampala, Uganda, February 1998. Eschborn: GTZ.
- Jansson, Tor and Mark Wenner. 1997. Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean. Inter-American Development Bank, Sustainable Development Department, Microenterprise Unit. Washington, DC: Inter-American Development Bank.
- Kane, Edward J. 1988. "How Market Forces Influence the Structure of Financial Regulation". In
-

REFERENCES

- Haraf, William S. and Rose Marie Kushmeider, editors, *Restructuring Banking and Financial Services in America*. Washington, DC: American Enterprise Institute, pp. 343-382.
- Krahnert, Jan Pieter and Reinhard H. Schmidt. 1994. *Development Finance as Institution Building: A New Approach to Poverty-Oriented Banking*. Boulder and Oxford: Westview Press.
- Krutzfeldt, Hermann. 1997. "The Experience of BancoSol". In Rhyne.
- Lapie, Marc. 1998. *Assessment of Microfinance Institutions Sustainability: What Have We Learned from the Corposol – Finansol Case?* Presentation at the Second Annual Seminar on New Development Finance, Goethe University of Frankfurt, 21.-25. September 1998.
- Ledgerwood, Joanna. 1999. *Microfinance Handbook An Institutional and Financial Perspective. Sustainable Banking with the Poor*. Washington, DC: The World Bank.
- Luang, Eduardo C. and Malena Vasquez. 1997. "Philippines". In Churchill, editor, pp. 35-42.
- Marquard, Jeffrey. 1987. *Financial Market Supervision. Some Conceptual Issues*. BIS Economic Papers No. 19. Basel: Bank for International Settlements.
- McGuire, Paul B., John D. Conroy and Ganesh B Thapa. 1998. *Getting the Framework Right: Policy and Regulation for Microfinance in Asia*. Brisbane: The Foundation for Development Cooperation.
- Merton, Robert C. 1995. "A Functional Perspective of Financial Intermediation". *Financial Management*, Vol. 24, No. 2, Summer, pp. 23-41.
- Mutua, Kimanthi. 1997. "Panel on Supervision and Control". In Rhyne.
- Philippine Coalition for Microfinance Standards. 1998.
<http://www.soc.titech.ac.jp/icm/network/phil-cover.html>, 29.03.1999.
- Rhyne, Elisabeth. 1997. *An Introduction to Key Issues in MicroFinance, Theme1: Supervision and Regulation*. MicroFinance Network,
<http://www.bellanet.org/partners/mfn/theme1a.html>, 29.03.1999.
- Richter, Rudolf. 1991. "Bankenregulierung aus der Sicht der Neuen Institutionenökonomik". In Jürgen Siebke, Hrsg., *Finanzintermediation, Bankenregulierung und Finanzmarktintegration*. Schriften des Vereins für Socialpolitik, N.F. 204. Berlin: Duncker & Humblot, pp. 43-64.
- Rock, Rachel. 1997a. "Introduction". In Rock and Otero, editors, pp. 2-28.

-
- Rock, Rachel. 1997b. "Banco Solidario, S.A: A Regulated Institution". In Rock and Otero, editors, pp. 65-88.
- Rock, Rachel. 1997c. "Conclusions and Recommendations". In Rock and Otero, editors, pp. 107-116.
- Rock, Rachel. 1997d. "Bolivia". In Churchill, editor, pp. 43-57.
- Rock, Rachel. 1997e. "Peru". In Churchill, editor, pp. 69-83.
- Rock, Rachel, Carlos Castello and Vivienne Azarcon. 1997. "Other Microfinance Institution Experiences with Regulation". In Rock and Otero, editors, pp. 87-105.
- Rock, Rachel and María Otero, editors. 1997. *From Margin to Mainstream: The Regulation and Supervision of Microfinance*. ACCION International.
- Rombach, Erich M. 1993. *Finanzintermediation und Bankenregulierung*. Hallstadt: Rosch-Buch.
- Saltzman, Sonia B., Rachel Rock and Darcy Salinger. 1998. *Performance and Standards in Microfinance: ACCION's Experience with CAMEL Instrument*. ACCION International.
- Smith, Clifford W. and Jerold B. Warner. 1979. "On Financial Contracting: An Analysis of Bond Covenants". *Journal of Financial Economics*, Vol. 7, pp. 117-161.
- Staschen, Stefan. 1999. *Regulation and Supervision of Microfinance Institutions: Case Study South Africa*. Eschborn: GTZ.
- Steege, Jean. 1998. *The Rise and Fall of Corposol: Lessons Learned from the Challenges of Managing Growth*. Bethesda: Development Alternatives.
- Stiglitz, J.E. and A. Weiss. 1981. "Credit Rationing in Markets with Imperfect Information". *American Economic Review*, Vol. 71, pp. 393-411.
- Strauss Commission. 1996. *Final Report of the Commission of Inquiry into the Provision of Rural Financial Services*. 18 September 1996. Pretoria.
- Trigo Loubière, Jaques . 1997. "Supervision and Regulation of Microfinance Institutions: The Bolivian Experience". In Rock and Otero, editors, pp. 49-64.
- Van Greuning, Hennie, Joselito Gallardo and Bikki Randhawa. 1999. *A Framework for Regulating Microfinance Institutions*. Policy Research Working Paper No. 2061. Washington, DC: The World Bank.
- Willemse, Rudolph and Steven Goldblatt. 1997. "South Africa". In Churchill, editor, pp. 105- 113.

REFERENCES

WOCCU. 1993. International Digest of Laws Governing Credit Unions. Madison: WOCCU.

Yaron, Jacob. 1992. Assessing Development Finance Institutions: A Public Interest Analysis. World Bank Discussion Paper No. 174. Washington, D.C..

Zimmer, Klaus. 1993. Bankenregulierung: Zur Begründung und Ausgestaltung der Einlagensicherung. Eine ordnungstheoretische Analyse auf der Grundlage der Modernen Institutionenökonomie. Baden-Baden: Nomos.