

REGULATION AND SUPERVISION OF MICROFINANCE

Abstract of CGAP Microfinance Consensus Guidelines ©2003

Guiding Principles on Regulation and Supervision of Microfinance

Powerful new “microfinance” techniques are being developed that will deliver formal financial services—for instance, tiny unsecured loans—to low-income clients who have previously not had access to such services. In order to reach its full potential, the microfinance industry must eventually be able to enter the arena of licensed, prudentially supervised financial intermediation, and regulations must eventually be crafted that allow this development. There is an emerging international consensus about principles that ought to guide regulation and supervision of microfinance.

- Problems that do not require the government to oversee and judge the financial soundness of regulated institutions should not be dealt with through prudential regulation. Relevant forms of non-prudential (or “conduct of business”) regulation, including regulation under the commercial or criminal codes, tend to be easier to enforce and less costly than prudential regulation.
- Thus, prudential regulation should not be imposed on “lending-only” microfinance institutions (MFIs) that merely lend out their own capital, or whose only borrowing is from foreign commercial or non-commercial sources or from prudentially regulated local commercial banks.
- In some countries—mainly transition economies—legal changes are needed to make it clear that non-governmental organizations and other private bodies may conduct a lending-only business without having to be prudentially licensed and regulated
- Depending on practical costs and benefits, prudential regulation in some cases may not be necessary for MFIs that take cash collateral (compulsory savings) as part of a loan contract, but do not take other savings (especially if the MFI is not lending out these funds).
- Financial cooperatives—at least large ones—should be prudentially supervised by a specialized financial authority, rather than by an agency that is responsible for all cooperatives.
- Designers of new regulation for microfinance need to pay much more attention than usual to issues of likely effectiveness and cost of supervision. In issuing financial intermediation licenses, the government invites public reliance and implicitly promises effective measures to mitigate depositor risk. Before issuing licenses, a government needs to be clear about the nature of such promises and its practical ability to honor them.
- In particular, design of microfinance regulation should not proceed very far without realistically estimating supervision costs and identifying a sustainable mechanism to pay for them. Donors who encourage governments to take on supervision of new types of institution should be willing to help finance the start-up costs of such supervision.
- Minimum capital for MFIs needs to be set high enough so that the supervisory authority is not overwhelmed by more new institutions than it can supervise effectively.

* CGAP, the Consultative Group to Assist the Poor, is a consortium of 29 international development banks and agencies that are active in supporting microfinance. CGAP commissioned these guidelines, which were developed in consultation with a wide range of experts in microfinance and banking supervision. For printed copies of the full document, contact CGAP at cgap@worldbank.org. It can also be downloaded from the CGAP website at www.cgap.org/publications/guidelines.html.

- Before regulators decide on the timing and design of prudential regulation, they should obtain a competent financial and institutional analysis of the leading MFIs, at least if existing MFIs are the main candidates for a new licensing window being considered.
- An existing microlending institution should not receive a license to take deposits until it has demonstrated that it can manage its lending profitably enough to cover all its costs, including the additional financial and administrative costs of mobilizing the deposits it proposes to capture.
- Supervision of microfinance—especially portfolio testing—requires some techniques and skills that are different from those used to supervise commercial banks. Supervisory staff will need to be trained, and to some extent specialized, in order to deal effectively with MFIs.
- For similar reasons, external auditors cannot reliably appraise the financial condition of MFIs unless they test portfolio with microfinance-specific procedures that go well beyond current standard audit practices.
- In developing or transitional economies, “self-supervision” by an entity under the control of those supervised is extremely unlikely to be effective in protecting the soundness of the supervised financial institutions.
- Where cost-effective prudential supervision is impractical, consideration should be given to allowing very small community-based intermediaries to continue taking deposits from members without being prudentially supervised, especially in cases where most members do not have access to safer deposit vehicles.
- To the extent possible, prudential regulation should be focused on the type of transaction being conducted rather than the type of institution conducting it.
- Where possible, regulatory reform should include adjusting any regulations that would preclude existing financial institutions (banks, finance companies, etc.) from offering microfinance services, or that would make it unreasonably difficult for such institutions to lend to MFIs.
- Most microlending is for all practical purposes unsecured. Normal limits on unsecured lending, or high provisioning of unsecured portfolio that has not fallen delinquent, are not practical for MFIs. Instead, risk control needs to be based the MFI’s historical collection performance, analysis of its lending systems and practices, and close monitoring of delinquency.
- Limitations on foreign ownership or maximum shareholder percentages may be inappropriate, or need flexible application, if local microfinance is at a stage where much of the investment will have to come from transforming NGOs and other socially-motivated investors.
- Reporting requirements need to be simpler for microfinance institutions and operations than for normal commercial bank operations.
- Credit reference services are powerful tools to lower lenders’ costs and expand the supply of credit for lower-income borrowers. However, they are not technically feasible in all countries.