

## Regulation & Supervision of Microfinance Institutions: Stabilizing a New Financial Market



The Focus Series is CGAP's primary vehicle for dissemination to governments, donors, and private and financial institutions on best practices in microenterprise finance.

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In November 1995, ACCION International brought together twenty-one high-level officials from bank regulatory institutions in fifteen Latin American countries and the United States, along with 200 development professionals, to address issues related to supervision and regulation of microfinance institutions (MFIs).

### Why is MFI Regulation Necessary?

There is a huge unmet demand for financial services in the microenterprise sector. Despite some success stories, MFIs probably reach fewer than 5% of the potential clients. Serving this market will require access to funding far beyond what donors and governments can provide. Thus, many MFIs want to expand their outreach by raising funds from commercial sources, including deposits. Some commercial banks are also looking to extend their financial services into the microenterprise market.

Most of today's MFIs are significantly different from banks in institutional structure, and the business of managing a micro-loan portfolio differs in important ways from the business of managing a conventional bank portfolio. MFIs and microloan portfolios cannot be safely funded from commercial

sources, especially public deposits, unless appropriate regulation and supervision regimes are developed.

### Key Issues

#### Interest rate limits

MFIs have much higher costs than conventional banks. Legal limits on loan interest rates, if enforced, will usually make commercially viable microfinance impossible.

#### Who should be regulated?

In most countries 85% of MFIs are not financial intermediaries—i.e., they are lenders only, and do not take deposits from the public. There is probably no strong reason for public prudential oversight of such MFIs, since protection of depositors is usually viewed as the principal rationale for such oversight.\*

#### Financial standards

How stringent should standards for microfinance be? Analysis during the conference demonstrated that there is no blanket answer to this question: compared to conventional banking business, microfinance will require norms which are stricter in some specific aspects, and more flexible in others.

### Asset Quality

Microloan portfolios frequently show lower delinquency than normal commercial bank portfolios. At the same time, MFI delinquency tends to be more volatile, especially where management becomes distracted from a consistent focus on repayment performance. Systems to track and respond to delinquency are particularly crucial to MFIs and they should probably provision their overdue loans somewhat more aggressively than conventional banks. On the other hand, conventional portfolio protection measures may not be appropriate for microfinance. For instance, automatic imposition of high provisions on uncollateralized loans would make most microfinance impossible, because most MFI borrowers cannot provide conventional collateral. Additionally, it will be inappropriate to require elaborate loan documentation or involved credit approval procedures because the financial viability of MFIs depends on minimizing the processing cost of their tiny loans. Furthermore, case-by-case loan reviews will be impractical. Regulators will need to be flexible in considering alternatives, such as (a) reliance on historical performance of portfolios, (b) statistical sampling of arrears, or (c) focus on the adequacy of management information systems and policies—including staff incentives—for dealing with arrears.

### Minimum Capital Requirements

Some theorists of financial regulation downplay the importance of minimum capital requirements as a safety factor, viewing them rather as a rationing device to prevent the supervisory authority from being overwhelmed with more institutions than it can handle. The social importance of encouraging microfinance provides a reasonable argument for fixing lower minimum capital requirements in this arena. On the other hand, regulators must recognize that most MFIs do not have private owners with deep pockets who can be expected to provide rapid infu-

sions of fresh capital in emergencies. This latter circumstance should be considered in fixing capital adequacy norms.

### Capital Adequacy

There are strong arguments against allowing MFIs to leverage their equity capital as aggressively as commercial banks, for the present at least. In addition to the risk factors mentioned above, two other considerations should be addressed. First, most countries have relatively brief experience with microfinance: in the absence of decades of empirical data about MFI performance, regulators may wish to begin cautiously in fixing leverage ratios. Second, because MFIs operate with relatively high costs and lending rates, a given percentage of non-performing portfolio will decapitalize an MFI faster than it would a commercial bank. Taking all these factors into account, several analysts at the conference suggested an initial capital/asset ratio no lower than about 20% for MFIs, subject to downward adjustment as the institution and the industry gain experience.

### Financial Performance

At present, most MFIs receive direct or implicit subsidies. In evaluating an MFI's capacity to operate profitably with increasing proportions of commercial-cost funding, superintendents must make adjustments which account for the effect of subsidies on historical financial performance.

### Liquidity Requirements

MFIs are exposed to high levels of liquidity risk. Seasonal factors influence many of their clients; they tend to depend on donors, whose funding can be unpredictable; and their non-donor liabilities tend to be short-term. Depending on the availability of quick liquidity in local financial markets, it may sometimes be prudent to set relatively high liquidity standards for MFIs.

## Regulated MFIs: A Bolivian Example

Licensed in 1992, Banco Solidario (BancoSol) became the world's first private commercial bank specializing in microcredit. BancoSol holds only 1% of the assets of the Bolivian banking system, but it serves over one third (65,000) of the system's total number of borrowers. Its equity is held mainly by donors and other socially-motivated investors. Because it is leveraging that equity about five times, it has a portfolio of \$38 million, far larger than that of any unlicensed MFI in Bolivia. BancoSol is regulated by the Superintendency of Banks, with capital and financial reporting requirements comparable to traditional banks. However, BancoSol is allowed to maintain much simpler loan documentation, and is not required to classify its non-guaranteed loans in a high risk category.

Under a 1993 banking law, Bolivia has begun licensing a new class of intermediaries: Private Financial Funds (PFFs). This legal vehicle was designed to provide financial services to micro- and small enterprises, as well as loans to individuals for purchases of durable goods. Solvency and reserve requirements are the same as for banks. Minimum capital for PFFs is \$US 900,000, compared with US\$2,900,000 for banks. PFFs cannot offer checking accounts, foreign trade operations, or trust services. Unlike conventional banks, PFFs are permitted to accept non-traditional collateral such as jewelry or furniture. Finally, PFF licenses will be given only to institutions whose management has extensive experience in microfinance. *Caja de Los Andes* is the first, and currently the only, PFF in Bolivia.

## Enhancing the Effectiveness of Oversight

### Fraud Prevention

Experience shows that the altruistic origin of most MFIs does not exempt them from the risk of serious fraud. The first line of defense against such fraud is internal audit procedures carried out by the MFI itself. Superintendencies should develop the capacity to review such procedures, perhaps through mechanisms such as random client-level monitoring of loans.

### Insolvency

Regulators must have the authority and will to protect the system by imposing sanctions on insolvent institutions. Having several licensed microfinance providers can reduce the pressure to bail out failures.

### Internal Superintendency Structures

As the microfinance industry develops in individual countries, superintendencies will need to organize themselves to regulate it. Some are creating specialized MFI departments. A less costly alternative might be to contract out reviews to experts familiar with MFI operations.

## The Bank Superintendent's Perspective

At the ACCION conference, a smaller working meeting of bank superintendents stressed several themes:

- *Some traditional banking rules can't be applied to MFIs.* The regulators understand, for example, that it is impossible to ask for more than one page of documentation from a client when granting micro-credit.
- *Transparency of financial accounting is no less crucial for MFIs than for banks.*
- *Superintendencies must develop low-cost methodologies for supervising MFIs.* Among the approaches discussed were 1) supervision delegated to outside experts, under superintendency guidelines; 2) self-regulation mechanisms that provide MFI managers with guidelines and incentives to monitor themselves; and 3) entry standards, such as management track record (especially in maintaining low delinquency), demonstrated profitability, and ability to do long-term planning.
- *Good regulations are useless unless the superintendency has the authority and capacity to supervise and enforce.* Donors should consider support to superintendencies as an important tool in building viable microfinance.

## Towards a New Paradigm

This conference represented a first step towards defining a framework for prudential oversight of microfinance institutions. ACCION has formed a working

committee among several conference participants to advance the process.

The immediate challenge for the microfinance field is to push for a wider understanding that, over the long term, effective regulation and supervision will be crucial to the stability and expansion of microfinance. Developing effective rules and tools to protect depositors—especially poor depositors—will require thoughtful innovation on the part of practitioners, regulators, and policy-makers.

\* Many NGOs require savings deposits as a condition to granting loans. Such deposits should probably be thought of as part of the cost of the loan, rather than as true financial intermediation requiring public intervention to protect the depositor. Likewise, public supervision is probably neither needed nor practical for community-level groups which accept voluntary deposits from a few dozen members, who know each other and who control the group's lending decisions.

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