

Regulation and Supervision of Microfinance in Nicaragua

Hans Nusselder

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I. Introduction

Since the end of the 1990s, the debate on the future of microfinance in Nicaragua had intensified when the possibility emerged of creating a legal framework for this sector. This article will deal with the question of how this framework may benefit the evolution of this sector and what foreseeable difficulties should be addressed for the incorporation of microfinance institutions (MFIs) into the formal financial sector. In the case of Nicaragua, the banking sector has gone through a painful process of restructuring and consolidation. Whereas this was also the case elsewhere in Latin America, some countries have also established a legal framework specifically for the microfinance sector. This reform process has not yet been completed, and changes to the legal framework are now being evaluated in the light of new practices initiated during the last decade.

While the mainstreaming of microfinance in the formal financial sector is relatively recent, the challenge to protect the integrity of the financial system and the interests of depositors remains the same. What makes the difference from the seventies and eighties is that the number of conventional banks, serving a minority of clients with greater prosperity, has declined. On the other hand, the number of microfinance entities that serve the poor has expanded enormously in Nicaragua (Blijdenstein et al., 2002). The regulation of MFIs has led some observers refer to the need to increase the minimum equity level required in relative terms, but to reduce this in absolute terms (Schmidt, 1999). However, the consequences in terms of costs and benefits for supervising authorities and public resources have so far received little interest.

This article is composed of four sections after this introduction. Section II presents an overview of the main elements included in the legal framework of the microfinance sector, such as the legal base and objectives, subjects and implementation modes. Section III analyzes in greater detail the costs and benefits of supervision, taking into account the differences between commercial banks and regulated MFIs. Section IV discusses the present context of the legal framework for the microfinance sector in Nicaragua. Section V presents the conclusions of the analysis as well as a number of challenges that lie ahead for the sector as a whole.

II. The regulation of microfinance

a. Base and objectives

The term regulation refers to the set of rules used by the State, through the use of its coercive powers, to restrict the actions of participants in the financial markets (Gonzalez Vega, 2001). It is a framework that players in the industry must respect when carrying out their financial operations. In establishing the legal framework, the State circumscribes the playing field and thereby guarantees the integrity of the financial system, in particular where its payment functions are concerned. On the other hand, the term supervision relates to the mechanisms of active surveillance used to

verify and enforce the application of this framework in ongoing financial business. This is the operational side of the system that is designed to ensure observance of the established set of laws.

The prime objective of regulation is to protect the financial system against harmful practices considered excessively risky. These practices could undermine the national payment system. At stake is the prospect of one banking crisis spilling over into the solvency and liquidity of other institutions, which might create a domino effect. The second objective is to *protect small depositors*, who are not aware of the risks assumed by the financial institutions. These two objectives require the presence of a supervising authority that is both impartial and independent of the interests of any particular actor in the financial sector. In the same context, there is often a third objective of the regulation, i.e. that is to maintain *competitiveness in the financial sector*. The operation of a sufficient number of participants is necessary to ensure free allocation of capital and provision of payment services to the real sector of the economy, while allowing free competition for clients (Valenzuela and Young, 1999; Fiebig, 2001).

When it comes to regulation and supervision, prudential and non-prudential aspects are vitally relevant but distinct. A non-prudential regulation has to do with general requirements, such as registration and licensing of the institutions, information about their ownership, publication of financial statements, external audits, delivery of information on delinquent clients (credit bureau), as well as rules on the application of interest rates. Non-prudential aspects refer more to the conduct of business than to its viability (CGAP, 2002). Rules of non-prudential nature are important, but they do not compel the supervising authority to issue a verdict on the financial health of the institution.

Responsibilities related to prudential regulation and supervision are radically different. At this level, the soundness of actors operating in the financial system is at stake. The application of defined standards in the financial balance, accounting and other guidelines are necessary to determine the fitness of the financial institution. These aspects require an elaborate system for the delivery of useful information, as well as on site inspections that go beyond regular auditing exercises. It is obvious that the cost of the prudential supervision is much higher than the cost of a non-prudential regime.

Although the State is the first and natural actor in areas of regulation, it is not the only one. Other parties are the owners of the institution (interested in defending its equity, especially when they have invested resources of their own), apex institutions formed by the intermediaries themselves, as well as providers of external working capital. These four types of regulators need to interact, as they require similar information from the same institutions, although with differing interests. However, there is a problem in the field of responsibilities: the regulation and supervision of the State **cannot** replace the policies and controls of either the owners or external financial sources (Fiebig, 2001).

This subject is directly related to the administration and property structure of the institutions. When financial institutions receive large amounts of private capital they tend to have a tougher supervision structure, unlike institutions with public interest investors and/or with numerous small shareholders. Accountability mechanisms may even be more problematic in the case of not-for-profit financial entities. Their internal procedures are usually slower and less focused on resolving urgent problems of solvency and liquidity.

b. Subjects of regulation and supervision

There is no standard approach for regulating and supervising financial intermediation in developing countries. In Latin America a segmented regime is common, which means that institutions are divided into categories. Commercial banks form part of the regulated entities and they are authorized to carry out the entire range of financial operations at national and international levels. Other credit institutions (financial corporations), which receive funds from the public but are not allowed to manage current accounts, are authorized in some countries but have been eliminated in others such as El Salvador.¹ Microfinance institutions constitute a third segment, at times licensed to receive deposits from the public. The latter is the case in Bolivia (Private Financial Funds) and Uganda (Microfinance Institutions Authorized to receive Deposits). A fourth category is MFIs which only grant loans and do not receive savings, at least not voluntarily.

In fact, only the first three types of entities are subject to external regulation and supervision, depending on the type of operations performed. A segmented regulation entails in many cases, a different approach for each group. General banking laws coexist with special laws for non-bank institutions. Credit unions often occupy a special position. In some cases they are subject to some sort of state supervision (Ecuador and Costa Rica), while in other countries supervision has been relegated to apex institutions (Guatemala, El Salvador and Peru). This is not to say that all credit unions are incorporated into a legal framework, because supervision often depends upon a minimum level of equity.

Beyond their typical diversity, regulated financial institutions embody different economic goals. Credit unions have their statutes basically formulated under a non-profit principle. However, in practice they wish to offer services to their associates at an externally acceptable price, but to an internally acceptable cost. Financial corporations and commercial banks, including those specialized in microfinance, pursue profits on paper and in practice.

As a matter of fact, a commercial approach has been predominant in the microfinance market during the last two decades. Its evolution towards an “industry”, for example in Bolivia, would not have been possible if the public and social interest alone had been maintained (Rhyne, 2001). Therefore, the development of a legal framework might consider the regulation of microfinance as an activity. From a transversal perspective, commercial as well as not-for-profit entities should be able to perform microfinance intermediation, albeit in a wider array of financial services. It is the risk profile of microfinance that has to be regulated, rather than specialized institutions themselves (Valenzuela and Young, 1999).

In many Latin American countries, community MFIs operate outside the formal financial sector, be it village banks (Costa Rica, Haiti), Cajas Rurales (Honduras) or municipal or departmental associations (Guatemala), which are specialized in granting

¹ In El Salvador, the Law for Non-Bank Financial Institutions deals with microfinancial institutions (Book 4º, Art. 157): “... It will be possible to constitute savings and loans corporations, with a share capital equal or higher than ten million colones (USD 1.4 million), whenever they are dedicated to the promotion of small and medium businesses. Such corporations can be authorized to grant all types of loans, intermediate international resources and those from the Multisectorial Investment Bank, and receive savings deposits from their beneficiaries”.

loans. Some of them are also involved in the mobilization of savings, both compulsory as well as voluntary. In most cases, the self-selection process of the members virtually turns credit unions into closed institutions. The saving volumes they mobilize may be substantial. However, until now there are no examples of community based intermediaries which, having grown to scale, have been legally regulated.

Consequently, the type of savings captured is closely related to the type of intermediary (Table 1). In the case of commercial banks, the situation is quite simple, since they alone receive voluntary savings from the public. In the case MFIs, credit unions and community based finance groups, the situation is more diffuse due to both the source (public vs. members) and to the type of savings (voluntary vs. compulsory). In gray areas national authorities have adopted diverging positions, ranging from a permissive attitude (Bolivia) to an absolute ban on any type of non-bank savings mobilization. The overall trend among national monetary authorities is to forbid deposits captured by non-banks. The reason for this is that the latter may lose their clients' resources and so the institution is at risk, but also too small to be supervised efficiently.

Table 1: Savings by type of intermediary

	The public (voluntary)	Members (voluntary)	Member clients (compulsory)
Banks and finance companies	Yes	Yes	No
Savings and Loans cooperatives.	No	Yes	Yes (El Salvador) No (Costa Rica)
Microfinance institutions	No	Yes (FFPs, Bolivia) No (EDPYMEs, Peru)	Yes (EDPYMEs, Perú) No (Foundations in El Salvador)
Community entities	No	Sometimes	Sometimes

Those in favor of greater flexibility claim that institutions with a proven) track record should, within an established framework, be allowed to receive savings from their clients. Regarding unregulated entities, some sources believe that it would be a mistake to ban community entities from receiving savings just because they are too small or too distant to establish effective supervision (Wright, 2000). In a rural setting, it would then be preferable to allow an intermediary to receive deposits within communities, rather than take away the opportunity to save altogether (Christen and Rosenberg, 2000).

Following this argument, the risks posed to the integrity of the national financial system that may stem from compulsory savings, are generally considered to be low. There are various considerations :

- a) In most cases, depositors of compulsory savings owe money to the same institution. The possible default of the institution reduces the client's financial risk;
- b) Compulsory savings are usually very modest and their restricted access usually makes that requests for a massive refund are unlikely; and
- c) Intermediaries with compulsory savings constitute a small part of the national financial system and the risk of a contagious string of bankruptcies is limited.

It is for these reasons that in circles of CGAP (2001), it is considered sensible to leave sufficient latitude for the free development of organizations that offer microsaving services. Entities entitled to mobilize savings would include the following:

- a) Local organizations that promote savings among members at the community level with personal knowledge of the clients they serve and who are in control of their operations;
- b) Organizations withholding compulsory savings as collateral for loan repayment; and
- c) Organizations that develop pilot programs based on experimental methods, in which savings are entirely backed by means of an external guarantee.

Even though these organizations promote savings among a specific group of clients, it would be better to leave them out of a legal framework. But in cases where saving mobilization is carried out at a larger scale and the border between members and non-members clients gets blurred, there would be arguments for making them accountable to an external supervisor (Valenzuela and Young, 1999). Conclusive rules do not exist in this respect. Rather, there seems to be a trade-off mechanism between the benefits of protecting depositors and the direct cost of the supervision. Moreover, the fact that they are supervised may create obstacles to innovation and competitiveness in the sector (Hardy, Holden and Prokopenko, 2002).

Some consensus is emerging that regulation should be as simple as possible, so that regulated institutions may continue to be innovative. Guidelines issued by supervising bodies are easier to modify than adopting laws through the parliamentary approach. By the same token, there is a preference to limit the range of regulated institutions to three categories: commercial banks, credit unions and an additional type of non-bank intermediary (Gonzalez Vega, 2002).

As far as non-bank MFIs is concerned, there are serious doubts as to whether or not credit-only institutions should be subject to prudential regulation and external supervision (Hanning and Katimbo-Mugwanya, 2000). The arguments for questioning the need to regulate credit-only MFIs are: first, there is no risk of depositors being potentially harmed, since they are non-existing in the case of credit-only institutions; second, there is no real threat to the national payment system in case of a defaulting MFI; third, the supervision of an MFI is expensive, both to the supervising entity as well as to the supervised institution.

On many occasions, however, representatives of the MFI sector have demonstrated their interest in achieving some type of a regulatory framework. Their motives include:

- a) The willingness to become officially recognized by national authorities, which serves as “certification” to both their clientele and external funding sources;
- b) The belief that regulation and some status of recognition will contribute to improve their financial performance; and
- c) The prospect that, once in a system of supervision, MFIs will be able to diversify financial services, in particular saving services, offered to their clients.

Moreover, among donors there is a marked inclination to promote a framework for regulation and supervision. The reason for this is to extend the number of specialized

MFI and thereby serving a larger clientele among donor target groups. Donor agencies are also increasingly keen to rely on a kind of “watchdog” for the sector, which could assist in monitoring intermediaries, which in many cases they are unable to supervise themselves. Legitimate as they may be, these motives do not seem to relate directly to the original purpose of regulation.

c. Regulation and supervision modes

By and large, there are four different forms of regulation and supervision in the financial sector. Currently, these models are all in consideration for the MFI sector, each of them with a more or lesser degree of delegation of responsibilities (Berenbach and Churchill, 1997; Wright, 2000; CGAP, 2002):

- A. *Regulation within the present framework:* MFIs with a proven track record and complying with requirements applied to commercial banks, can decide to become regulated institutions. There are examples such as Grameen (Bangladesh), Banco Solidario (Ecuador) and Banco Confia (Nicaragua). The minimum amount of equity is generally higher than USD 5 million, a level considered high in some cases and prohibitive to aspiring MFIs in others. Moreover, the credit technology applied by MFIs – mostly based on loans without publicly registered collateral – leaves little room for a substantial number of MFIs to become formally regulated institutions. There are some experiences (Chile) in which the banks have used the existing framework to initiate micro-credit operations, thus increasing their clientele (Christen and Rosenberg, 2000).
- B. *Self-regulation:* This alternative assumes that institutions – individually or collectively – will commit themselves to provide information to a selected body on a truthful, uniform and consistent basis. This would assume: a) the presence of an audit mechanism to verify the authenticity of financial statements; b) the presence of an appropriate framework for internal controls and risk management; and c) an institutional structure designed and functioning to check performance, render accounts and apply sanctions. This model has been implemented in the credit union sectors in Guatemala and El Salvador.
- C. *Combination of self-regulation and delegated supervision:* This option is a rather hybrid approach which combines, on the one hand, the responsibility of MFIs to comply with a set of criteria for information and financial performance, and on the other, the national supervising body contracting an audit or consulting firm to carry out the routine in-house analysis. In this way, investors and depositors would be able to receive public information and be better prepared to make decisions on how to allocate their resources.
- D. *Specific regulation for microfinance institutions:* Some countries (Peru, Bolivia, Uganda) have introduced a regulatory framework especially designed for the MFI sector. In some cases, specialized technical units have been created either within the Superintendency or with an external body, under responsibility of the former.

Although each alternative has pro and con elements, there are more arguments against the self-regulation of model B (Gonzalez Vega, 2001). There are no successful experiences known to date. More importantly, there is an inherent problem of conflicting interests among the parties responsible for supervision of institutions. Self-regulation does not preclude that in one way or another the supervised entity might have a stake in the supervising body. Model C is also not free of obstacles to objective and impartial supervision, especially when the supervised entities are indirectly

represented in the supervising entity. The exposure to conflicting interests is more worrisome as the consequences of supervision become more drastic, e.g. when recapitalization is required or *in extremis* a close-down of the MFI. Both possibilities are costly, to the owners of the institution as well as to the supervising entity. The latter eventually is obliged to use the foreign currency reserves of the central bank.

III. Costs and benefits of supervision

Although over the last decade valuable experience has been gained in the supervision of microfinance institutions, until now there is little known evidence on its cost-benefit structure. The cost of supervision obviously depends on the system selected and will probably prove to be more expensive in the case of a delegated supervision than if performed directly by the Superintendency.² In the specific case of the MFI sector, there would be reason to compare the cost of supervising individual intermediaries to the cost of supervising the commercial bank sector (Fig. 1).

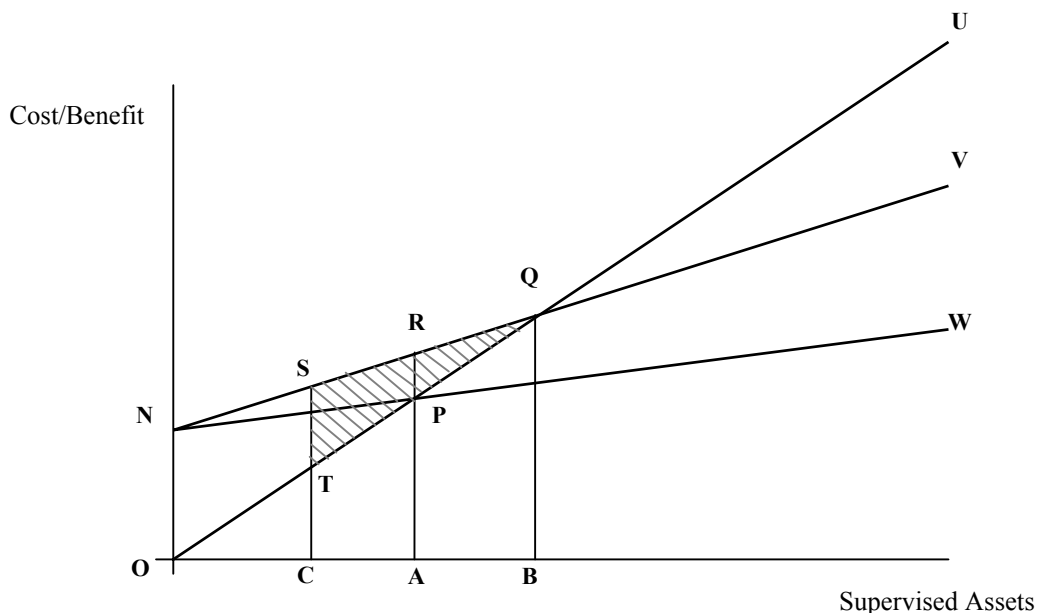


Fig. 1: Costs and benefits of the supervision of financial institutions

For analyzing the difference between the two segments, let us consider a simple cost structure of a supervising body, where the X-axis represents the volume of supervised assets (basically the credit portfolio), while the cost and benefits of supervision are shown on the Y-axis. The supposed benefit, measured in supervision fees – and indirectly the volume of savings and public resources protected – is expressed as a straight line in OU. The cost of supervising the commercial bank sector is represented by the line NW, which shows that the fixed cost of supervision is high (due to costs of authorization, information systems and other parts of its operating capacity). The slope

² The cost also depends upon the character of the supervision executed: on site inspections to detect risks will cost more than off site observations, followed by recommendations and monitoring of corrective actions. The on site supervision includes checking the quality of the assets, the performance of management and the internal control systems. Special attention is granted to the full performance of external audits. In 1999, the cost of a supervision in Bolivia reached USD 42,000 per year, budgeted for 36 days of off site inspection and 70 days of on site inspection. The fee charged by the Superintendency is 0.1% of the total assets. Trigo (1997), Monje et al. (1999) and Rhyne (2001).

is rather gentle due to the low marginal cost of supervised bank assets. When the volume of supervised assets surpasses OA, the benefit exceeds the cost of the supervision after point P. This explains why supervising authorities in Latin America prefer to increase the required minimum level of assets – and thereby the level of minimum equity – beyond the OA, so as to ensure a net positive result of supervision.

The situation is different in the supervision of MFIs, who basically face the same level of fixed costs at ON. However, the variable cost for the supervision of microcredit is considerably higher – just as this is the case in managing their loan portfolio – due to the large number of operations subject to be overseen.³ The result is that the break-even point is not reached in P, but in Q. This requires a level OB in the size of the operations, implying that MFIs should possess a correspondingly higher solvency level – in absolute terms – than conventional banks.⁴ If they had only a level OA in assets, the supervision of MFIs would produce a deficit to the extent of PR.

The main problem in the segment of microfinance is that the majority of specialized MFIs, possibly interested in becoming regulated, do not have the minimally required level of equity. In terms of the previous graph, the volume of assets subject to supervision is not OB, but OC which is less than half of it. Consequently, the supervision would produce an even higher deficit, to the extent of ST, since the level of fixed costs is invariable.

The graph describes the normal situation of supervision. When it comes to insolvency or eventually bankruptcy of the intermediaries, the public cost is much higher, particularly in the case of conventional banks. However, the prospect of suffering losses in which regulated MFIs might incur, illustrate the positions of the respective parties:

- Supervising authorities seek to put the required minimum level of supervised assets beyond the break-even point of cost and benefits. At the same time they wish to minimize the risk of having to use public funds to bailout an intermediary. Another option would be to try to partially compensate the cost of supervising MFIs with resources from the segment of commercial banks, whose supervision is not as costly.⁵
- MFIs aim to reduce the required level of supervised assets, while also minimizing the regulation cost and the cost of being supervised. Although they might be willing to pay for the cost of supervision, MFIs would obviously be better off if these are transferred to the supervising bodies, donors or clients.

Apart from these opposed interests, there are external stakeholders of microfinance (donor agencies and institutional investors) who would prefer to see intermediaries increasing their outreach while improving performance. Nonetheless, few stakeholders are prepared to bear the costs of supervision, since this activity is not often carried out in proximity of ultimate target groups. As is known to be the case in Nicaragua, the

³ The observation in that sense was that the total cost of supervising the assets of an MFI Institution is thirty times more expensive than in the case of the assets of a commercial bank (CGAP, 2002).

⁴ If the Schmidt (1999) requirement of a relatively larger level is added to the requirement of solvency in absolute terms, the microfinance sector would require the need to double their equity levels.

⁵ In Ecuador the Superintendency oversees 27 credit unions the cost of which is compensated by income generated by supervising the commercial banks.

target groups determine the rationality of donor support strategies in many instances (Blijdenstein et al., 2002). This creates a vacuum in financing sources for a viable scheme of effective supervision.

IV. Regulation in Nicaragua

a. Context

The financial system in Nicaragua, even after experiencing a period of restructuring and consolidation between 1997 and 2001, remains relatively weak in Central America. Its volume of total assets in 2002 amounted to USD 1,920 million, while the total liabilities hovered around USD 1,800 million, the lowest in the region. In 1997 – before the restructuring process started – the banking density, measured by number of branches open to the public, was of one branch for every 33,000 inhabitants, while the average in the region was 19,000 inhabitants.

The reorganization of the banking sector, which in many cases consisted of closing down state-owned banks,⁶ contributed to a drop in international reserves of about USD 130 million between the end of 1999 and the end of 2001. As a result, aggregate domestic credit fell from C\$ 14,100 million (USD 1,230 million) in June 2000 to C\$ 9,000 million (USD 630 million) in June 2002, then picking up to a total of C\$ 10,300 million (USD 710 million) by the end of 2002. Although aggregate savings deposits proved to be less volatile, monthly fluctuations reflect significant volumes of private savings lost in the course of the restructuring process.⁷

Although the relation between savings, investments and volume of domestic product in developing economies is ambiguous, intricate and inconclusive, it is striking that the position of Nicaragua in the mobilization of savings is just starting to improve, compared to other countries in the region. In the case of Nicaragua, two elements gave reason for concern:

- First, private savings were negative during the second half of the 1990s and it was not until this decade that they became positive and on the rise.
- Second, in spite of the consolidation of the banking sector, the spread between lending and borrowing rates increased between mid-2000 and the end of 2002 from 8.9 to 16.7%. This trend does not seem to reflect greater competitiveness and efficiency in the banking sector, but rather the opposite.

However, requirements for starting banking operations in Nicaragua have become stricter. As a matter of fact, the reform to the General Banking Law (No. 314) was introduced in 1999, before the most serious banking crises occurred. The new law stipulates a minimum share capital of C\$ 120 million (USD 8.2 million), both for banks and non-banks. This level is higher than required in the other four countries of the

⁶ Banks owned totally or in part by the government were closed, such is the case of BANADES (National Development Bank), Banco de Crédito Popular, BANIC (Nicaraguan Credit Bank) — and private banks such as Pribanco, Banco Sur, Interbank and Banco del Café. Moreover, Banco Mercantil was merged with Bancentro (Central American Credit Bank) using the name of the latter.

⁷ Between July and August 2000, when two private banks went bankrupt, the total volume of deposits decreased from C\$ 19,200 to 17,000 million, that is more than 11%, reflecting a loss of USD 188 million (more information in the website of BCR Nicaragua)

region where the minimum varies between USD 5 and 7 million. At present, individual shareholders cannot own more than 20% of the share capital, while loans to an individual borrower are limited to a maximum of 15%.

After the string of bank defaults, interventions and closures, the Superintendency of Banks was enabled to strengthen its apparatus and scope of operations. The norms for assessing credit portfolios and provisions for delinquent loans became much stricter. In order to reduce possibilities for fraud, the banks were obliged to publish the names of their directors and shareholders. On top of this, the National Assembly adopted, in December 2000, an insurance scheme for bank deposits up to a maximum of USD 20,000.

b. The regulation of microfinances

Although MFIs have been in operation since the beginning of the 1990s⁸, their operations have not been recognized within the legal framework, at least not in positive terms. As of 1999, the possibility of raising savings in unregulated institutions was prohibited.⁹ In the same year, the legislature did introduce Law No.374 for the Regulation of Loans between Individuals, putting an interest rate cap to those MFIs that have “as their main objective the provision of financial services to the public, as long as there is no regulatory framework in force”. Every month The Central Bank now publishes the maximum interest rate, as a weighted average of the banking sector. Law No. 374 has led to a reduction of nominal lending rates charged by MFIs, on average to less than 18%. This was the legislature’s *de facto* response to the public concern that MFIs charged excessive interest rates. Therefore, it came to the defense of the microcredit borrowers of MFIs whose interests supposedly had to be protected.

Law No. 374 refers to the creation of a legal framework especially designed for the microfinance sector, on which discussions had been ongoing since the past decade. ASOMIF (the Nicaraguan Association of Microfinance Institutions) has presented several proposals, recently in the form of a Bill for the Promotion and Regulation of Microfinance.

The proposed Bill for Microfinance deals with the organization, registration and operation of MFIs created as associations and foundations, established with not-for-profit objectives. Contrary to earlier versions, financial corporations are no longer considered as actors in the sector, the activities of whom shall respond to “the public and social interest” (Art. 1). The required minimum entry level for an MFI is in the Bill established at a minimum of C\$ 2.5 million (USD 170,000). Equity reserves would be fed mainly by the MFIs’ net surplus, since “microfinance institutions will not be allowed to distribute surpluses among associates, directors, employees or third parties, and shall invest all of them in activities that fit the purposes of the institution” (Art. 9).

In asset management, MFIs would be able to award loans, accept bills of exchange, grant fiduciary guarantees, carry out investments (not listed in detail), perform discounts, factoring and financial leasing, as well as to act as fund managers on behalf

⁸ Microfinance was initiated in Nicaragua in the course of Support Program for Microbusinesses (PAMIC) that started in 1992, through a network of associations and foundations known as the PAMIC Network..

⁹ A relatively large MFI with operations in the rural areas, was instructed in 1999 to return an estimated amount of USD 200,000 to its depositors since savings mobilization was considered illegal outside of the regulated financial sector.

of third parties.¹⁰ MFIs would be allowed to offer loans to individuals or corporations up to a maximum 5% of their equity. The Banking Law (Art. 46) would be applied to establish the interest rate which includes the ability to “freely agree upon interest rates”. Therefore, interest rate cap introduced by Regulating Law 374 would no longer apply. Regarding liabilities, MFIs would be allowed to receive and hold **from their borrowers**, fixed term deposits under conditions approved by the Superintendency. They would also have access to second tier credit funds and programs especially designed for small entrepreneurs, among others.¹¹

Regulation and supervision activities would be assigned to a Microfinance Regulating Committee. The new Committee would be attached to the Superintendency of Banks and composed of one member from the Superintendency, one representative of non-profit MFIs (ASOMIF) and a third member from the Ministry of Industry (MIFIC). This Committee would keep the Registry of MFIs and approve of non-prudential rules in general (Art.24) which would be compulsory to all institutions. The Committee would also approve of regulations related to a system of supervision and the rating of MFI One or more audit firms specializing in microfinance would be entrusted to carry out external and periodic inspections.

The Committee would have a Secretariat, headed by the Secretary whose functions would be to keep Registry of MFIs up to date and to take care of administrative and technical functions. The cost of this unit, however, would have to be borne by MFIs. The Regulating Committee itself would be entitled to issue guidelines, warnings or sanctions in case of non-compliance on the side of MFIs. In unusual conditions, such as imminent insolvency or recurrent non-compliance of the entity, the Committee would have the power to demand a Plan of Normalization. In extreme cases, this could lead to the suspension of the MFI and withdrawal of its operating license.

When assessing the proposed Bill for Microfinance, one should admit that its adoption would unmistakably contribute to an improved public standing and recognition of microfinance activities. The implicit elimination of the interest rate cap contained in Regulating Law 374, would be very positive. In fact this law has not only produced higher up-front fees, but also a marked imbalance between regulated and non-regulated institutions. Another favorable element is the gradual elimination of the “taboo” on the mobilization of savings. Capturing deposits would be carried out under certain legalized conditions and would depend more on the abilities of the intermediary than on legal constraints.

However, the proposed Bill for Microfinance is also surrounded by question marks. Microfinance intermediation seems exclusively reserved to not-for-profit entities (associations and foundations). This would imply that commercial banks and non-bank corporations would be implicitly excluded from the activity. If this were indeed the case, the logical outcome would be the existence of two segments of microfinance without a level playing field for all actors alike: banks, financial entities, credit unions and other MFIs.

¹⁰ The latter introduces the concept of trust fund (fideicomiso) which as yet does not have a legal base in Nicaragua.

¹¹ It is the case of FNI (Nicaraguan Investment Financial Corporation) and FCR (Rural Credit Fund) both owned by the State. Until now, unregulated MFIs do not have access to FNI resources.

Since microfinance would be the exclusive domain of non-profit entities, it is unlikely that private investors would prefer to get involved with MFIs, as they would be kept out of the distribution of any financial surplus. This would contradict the experience in countries such as Bolivia (Banco Sol, Caja los Andes) and Ecuador (Banco Solidario), where private investments on a commercial footing with the prospect of receiving dividends proved to be important for the development of the sector.

The ban proposed by the Bill for Microfinances on raising savings from the public “under no circumstances” raises doubts about the purpose of the new Law. If there are no depositors to be protected, or risks posed to the national payment system, then why implement a regulation scheme at all? This would only make sense if limited exclusively to non-prudential regulations. However, the Bill for Microfinance refers to a “deficit in minimum share capital”, as an abnormal case in which a normalization plan would be justified. The Bill thereby does include a prudential norm, which in its self would require the creation of a supervising agency.

The national Association of MFIs would play a predominant role in the prudential supervision, as it would assume the responsibility for the functions of the Secretariat. But its “administrative, executive and technical activities” may perilously expose the Association to a conflict of interests: on the one hand it already fulfills the role of an interest group acting in the interests of its members. But on the other hand it would be responsible for supervising operations. In the best case this would lead to frictions with affiliated first tier organizations who would have to pay for the fees charged by the supervisor: estimated in other countries at around USD 40,000 or 2% of fixed assets.¹² In cases worse than that, competing first tier MFIs might indirectly obtain a say in whose doors would remain open and whose would have to be closed.

Another question relates to the future of MFIs that would not be registered but would continue intermediation without being explicitly licensed. If these MFIs do not have a future, it would be appropriate to clarify their prospects with a strategic plan for the entire sector. The objective of such a plan would be to promote mergers and acquisitions between MFIs. A sector plan, once approved and from the drawing board put into practice, would require a firm position from national stakeholders. In the face of multiple donor agencies, each of them with a vested interest in MFIs, a Regulating Committee needs a strong hand if it decides to suspend the operating license of only one entity. A policy of registration and licensing would, therefore, also require a “code of conduct” for donor agencies that work with public resources from overseas.

In synthesis, the Bill for Microfinances proposes what theoretically has been advised against: in particular the prudential supervision of credit-only MFIs, and the self regulation with delegated supervision. This mechanism is not free of conflicting interests between the supervising agency and the MFIs. On the other hand, what is externally advised is not proposed in the Bill: a sector approach for microfinance as a regulated activity (instead of limiting it to just a segment interested entities), more room to maneuver when dealing with small savings services, and last but not least a viable payment scheme for the supervision, according to the capacity to pay among all regulated institutions.

¹² The delegated character will, unlike the case of e.g. Ecuador, not lead to any cost sharing with the supervision of commercial banks.

V. Final Observations

In microfinance discussion the saying goes “do not regulate what you cannot supervise” (Hannig in Valenzuela and Young, 1999). Regulation and supervision require effective capacity to fulfill the corresponding duties. However, the theoretical discussion about regulation and supervision raises questions beyond the technical viability of this service. If the criterion is to strengthen the microfinance sector in Nicaragua, fundamental questions emerge in relation to the scheme proposed. Among others these relate to its ambiguity (prudential character or not), but also to shortcomings (hybrid supervision with a double role for the Association of IMFs) that have been conspicuous in the Bill for Microfinances.

Considerations that are not in favor of a prudential legal framework for microfinance in Nicaragua, relate to the weight of the microfinance sector which is insufficient to threaten the security of the national payment system. Also, there are no savings from the public which need to be protected. For these reasons, as far as public interests are concerned a parallel cannot be drawn with commercial banks. But a case can be made to promote the competitiveness of the regulated financial sector. If that is the purpose behind the Bill, then the question arises why it would exclusively apply to the category of non-profit organizations. It would be more expedient to view microfinance as a regular business activity on a level playing field, to be performed by any entity, for profit or not.

A brief analysis of the cost and benefit structure of a supervising entity confirm the *prima facie* evidence, in the sense that prudential supervision for MFIs would be much more costly than for commercial banks. Transferring this cost to supervised MFIs could easily provoke either insolvency or a dramatic increase in costs of credit. The latter would obviously be charged to the borrowers. This would hardly be appreciated in a country where MFIs, at present are not viewed as beneficial and unselfish. Also, they do not presently receive legal protection. Extra financial costs would thus only add insult to injury.

A regime of prudential supervision for microfinance in Nicaragua would only bear fruit if an enabling environment is in place in accordance with market principles, geared towards a balanced expansion of microfinance. Some of these factors are the following:

- The elimination of the interest rate cap introduced by Regulating Law 374 as a goodwill sign that MFIs are not viewed as “antibodies” to the financial system.
- A gradual authorization to raise savings from the public as a complementary instrument for the development of MFIs. This should be done within a framework to foster a saving culture promoted by the State (Thirlwall, 1999). This would provide greater depth to the national financial system.
- A strategic plan for the development of microfinance in the country, aimed at greater autonomy of MFIs and consolidation of the sector. This would amount to a lower number of entities operating at a larger scale. It is obvious that this would require a mechanism for harmonization, planning and coordination (Wright, 2001), that in Nicaragua is absent to date.

- Acceptance of the fact that the supervision of microfinance institutions is an activity with a relatively high cost that cannot be supported exclusively by the supervised entities, the Government or donor agencies. A cost sharing mechanism should be devised to reduce the fixed and variable costs of supervision (requiring from the start a considerable volume of extra investments) as well as a mechanism for the generation of income, shared by the State and the private financial sector.

There are basically two foreseeable scenarios for the future regulation of microfinance. The first is one of stagnation, in which many entities would depend upon external financing without any possibility to diversify financing sources, unable to transfer costs to their clients or achieve expansion through economies of scale. According to this scenario, the regulation of MFIs in the formal sector would be excluded due to a watertight separation between commercial banks and the chronically subsidized MFIs.

A brighter scenario would be a steady reduction of the gap between the commercial regulated sector and the un-regulated segment of MFIs, through a prudential system for commercial banks and some kind of step-by-step regime for non-bank institutions. A non-prudential regulation (including a credit bureau compulsory to all intermediaries) would be a critical first step. A second step would be the introduction of a supervision scheme for a limited number of larger sized MFIs with ample coverage and a proven track record. In order to expand the frontier of microfinance towards larger outreach and better performance, the legal framework for the sector needs to be built on the existing potential and earlier experiences. There is no need to invent a fifth wheel for the wagon.

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