



ASSOCIATION OF SUPERVISORS  
OF BANKS OF THE AMERICAS

# Guidelines of Principles for Effective Regulation and Supervision of Microfinance Operations

2010

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## PRESENTATION

The primary purpose of this document is to present guidelines of principles for international use that comprise best practices on the topic of regulation and supervision of microfinance operations executed by deposit-taking financial institutions.

This document was developed between March 2008 and March 2010 and was prepared by a Microfinance Working Group of Banking Supervisors, supported by two consulting firms that combined the experience of financial entities' regulators and supervisors, experts on regulation and supervision of microfinance institutions (MFIs), consultants on public consultation processes, as well as managers of microfinance institutions.<sup>1</sup> The document was developed in two stages:

The first stage, which was implemented by one of the consulting groups, included the following activities:

- i. Identification and review of specialized bibliography, focusing on studies that contribute to establish principles for the regulation and supervision of microfinance operations;
- ii. Development and application of a survey aimed at supervisors, about the state of regulation and supervision of microfinance institutions in order to identify sound practices in Latin America and the Caribbean;
- iii. Detailed analysis of international standards of banking regulation and supervision and their application to microfinance institutions and operations;
- iv. Review of the legal and regulatory framework for microfinance institutions in countries that are leaders in the region on this topic;
- v. Analysis of quantitative information on the status of microfinance in the region prepared annually by the Multilateral Investment Fund (MIF), member of the Inter-American Development Bank (IDB) Group;
- vi. Four consultative events with the Microfinance Working Group of the Association of Supervisors of Banks of the Americas (ASBA), comprised of representatives of bank

<sup>1</sup> This work was supported by funding from the Swiss Technical Cooperation Trust Fund for Consulting Services and Training Activities (STC) of the IDB.

supervisors from Bolivia, Brazil, Colombia, El Salvador, Peru, and the United States of America through the Federal Deposit Insurance Corporation (FDIC); and

- vii. Drafting of Guidelines of Principles to use as a base document to be disseminated through a broad consultative process with regulators and industry stakeholders.

The second stage, which was implemented by a second consulting group, included the following activities:

- i. Design and implementation of a consultative process with microfinance industry operators through the application of a comprehensive on-line survey. The survey was answered by 156 microfinance industry stakeholders in Latin America and the Caribbean. Additionally, the process included in-depth consultations through individual interviews with a group of experts, network directors, and microfinance managers in Latin American and the Caribbean;
- ii. Editing of the draft Guidelines of Principles to incorporate the results of the consultative process; and
- iii. Discussion of the Guidelines of Principles in two workshops. The first workshop took place during an event on Regulation and Supervision of Microfinance at the XII Inter-American Forum on Microenterprise (Foromic) organized by MIF that took place in Peru in September 2009. The second workshop took place on March 25 and 26, 2010 in Mexico City, with the participation of members of the Working Group and, those supervisors that were not part of the Group, experts, and industry representatives.

At the conclusion of the processes described above, the Inter-American Development Bank, through its representatives from MIF and ASBA's Microfinance Working Group, proceeded to the final editing of the document for its presentation, which contains an introduction and two chapters.

The first chapter analyzes the relevance of the application of the Core Principles for Effective Banking Supervision, as well as the Basel II principles issued by the Basel Committee on Banking Supervision, to microfinance institutions. The proposed recommendations are intended to be consistent and coherent with these principles, so that their eventual application can be analyzed during assessments of Basel Core Principles compliance by the World Bank and International Monetary Fund.

In the second chapter, a set of recommendations is presented, synthesizing the conclusions from the process developed in this document. This includes preconditions and principles for effective regulation and supervision of microcredit portfolios, as well as for the microfinance institutions. The recommendations aim to facilitate a harmonious development of microfinance. These recommendations are presented in the form of *Principles for Regulation and Supervision of Microfinance Operations*.



# 1

## **INTERNATIONAL BANK SUPERVISION STANDARDS AND MICROFINANCE INSTITUTIONS**

The principles of regulation and supervision of microfinance operations seek to complement the standards and laws by which a country's financial entities operate. International banking standards are applied in the majority of countries where there are microfinance operations, although not always with the rigor of established best practices. Therefore, microfinance institutions are subject to national standards and, in the majority of cases, international standards that lead to better management of the financial system. Such standards do not take into consideration the particular nature of these institutions and their microfinance operations. There is a need to broaden the Basel Core Principles (BCP) applicability conditions, by offering a complementary regulatory and legal framework that allows for the effective regulation and supervision of microfinance institutions, without imposing conditions that do not respond to the reality of their operations. Despite the fact that there are differences between microfinance institutions and traditional financial entities, these are fewer than the similarities. Therefore, the majority of the Basel principles are applicable to this sector.

### **1.1 Basel Core Principles (BCP) and microfinance institutions**

The regulation of financial entities has three main purposes: 1) to protect consumers; 2) to ensure efficient functioning of markets; and 3) to preserve the stability of the financial system. Regulation targeted at protecting consumers generally seeks to prevent abuses of client rights and includes standards of transparency, corporate governance, and other rules of market conduct. Regulation targeted at improving efficiency in the functioning of the financial market includes rules to prevent and correct market imperfections (such as information asymmetry, externalities or monopolistic behavior). These two purposes for regulation are usually applicable, with some nuances, to the entire range of entities that make up a financial system. On the other hand, regulation to preserve the stability of the financial system is usually limited to

Box No. 1

## Core Principles for Effective Banking Supervision

The Basel Committee issued the 25 Core Principles for Effective Banking Supervision (BCP) in 1997, with the objective that its application would be a first step in the process of strengthening domestic and international financial stability. Over time, BCP have become the standard for banking supervision in the majority of countries. With the goal of guaranteeing the relevance of the BCPs in light of advances in regulation and supervision, a revised version of these principles was approved in 2006.

The 25 revised principles can be grouped into seven categories:

- Institutional aspects (BCP 1): objectives, independence, power of the supervisor, transparency, and cooperation;
- Licensing and structure (BCPs 2–5): permissible activities and criteria for granting banking licenses, transfer of ownership, and significant investments;
- Regulation and prudential requirements (BCPs 6–18): capital adequacy, requirements for risk management, internal controls, and the prevention of abuse of financial services;
- Supervision methods (BCPs 19–21);
- Accounting and disclosure (BCP 22);
- Corrective power of the supervisor (BCP 23); and
- Consolidated cross-border monitoring (BCPs 24–25).

According to these principles, taking deposits from the public is an activity that is generally reserved for institutions registered and supervised, such as

banks (BCP 2). The Basel Committee has declared that the term “generally,” introduced in the BCP for the first time in 2006, acknowledges the presence of non-bank institutions that take deposits from the public and are not supervised like banks, under the condition that these non-bank institutions will not collectively have a significant share of the financial system’s deposits. The text of the BCPs explicitly establishes that this exception can be applicable, for example, to microfinance institutions that are not supervised.

The Basel Committee also defined the preconditions for effective supervision. Even though these are not under the direct control of banking supervisors, they are necessary to achieve effective supervision. The preconditions are classified into the following groups:

- Adequate and sustainable macroeconomic policies;
- Well-developed public infrastructure, including an adequate legal framework for the development of businesses; accounting and auditing practices consistent with international standards; an efficient and independent judiciary system; and a safe and efficient payment system;
- Market discipline based on flow of information between market participants and congruent public policies that foster a good business climate and do not generate moral risks; and
- Mechanisms to ensure financial security in the case of systemic problems.

those entities whose failures could generate high social costs.<sup>2</sup> Although some rules serve several of these purposes, the preservation of financial stability is the main purpose of prudential regulation, which is a basic standard in the Core Principles for Effective Banking Supervision (BCPs), issued by the Basel Committee on Banking Supervision. Box No. 1 outlines a brief introduction to these principles.

Microfinance institutions should be subject to a regulatory framework and prudential supervision, if they are generating risks by taking deposits from the public and investing them in risky activities.<sup>3</sup> Consequently, as a first premise, microfinance institutions that take deposits should be subject to a regulatory and supervisory framework that is consistent with international banking supervision standards. However, it is necessary to clarify that the BCPs are also consistent with the existence of non-banking institutions that take deposits from the public without being supervised as banks (such as savings and loan cooperatives, non-governmental organizations, and home savings and loan associations), as long as these institutions collectively do not have a significant share of the financial system's deposits. The BCPs mention explicitly that this exception could be applied to microfinance institutions.

Because a significant percentage of the institutions that perform microfinance operations in Latin America are regulated institutions that take deposits from the public, the effective supervision of the majority of these institutions requires a regulatory and supervisory framework that is rooted in compliance with international standards on banking supervision. In this sense, Latin American countries should continue with their efforts to increase compliance with the BCPs.

The evaluation of compliance with the BCPs is based on materiality criteria. The evaluation methodology acknowledges that the weaknesses in the regulatory and supervisory framework of some institutions are not reflected in a country's compliance rating with a core principle, if these institutions are not material to the stability of a country's financial system. In the majority of countries in the world, the participation of microfinance institutions in the financial system is low and the risks stemming from supervisory weaknesses are often not material to the financial system's stability. Therefore, in the context of an evaluation of compliance with the BCPs, these are not considered when establishing the degree of compliance with the BCPs in a country and generally are not taken into account in these assessments. At the same time, the methodology for evaluating compliance with the BCPs acknowledges that some core principles be not applicable to a particular financial system or to segments of a financial system's institutions, when the principle is associated with risks that are not material to this system or segment. Thus the failure to comply with some BCPs by some microfinance institutions in a country may not affect the compliance with the BCPs of the financial system as a whole, if the BCPs are not relevant to the soundness of microfinance institutions.

2 For a detailed discussion of the reasons for regulation, refer to Carmichael, Jeffrey y Pomerleano, Michael. *The Development and Regulation of Non-Bank Financial Institutions*. The World Bank, 2002.

3 The prospect of runs on banks, interruptions in the payment chain and violations of depositors' rights are associated with the taking of deposits from the public. However, the recent financial crisis in developed countries highlights that institutions that do not take deposits, such as investment banks, also can put the stability of the financial system at risk.

If a BCP compliance assessment would solely focus on a country's microfinance institutions, the assessment would require taking into account the relative importance of specific BCPs in relation to this market segment. For example, the absence of a supervisory framework for country risk would not likely have repercussions on the effectiveness of supervision of microfinance institutions. However, deficiencies in mechanisms for monitoring corporate governance and internal control systems are a fundamental weakness in the supervision of small microfinance institutions, which tend to have rather concentrated governance and management systems.

At any rate, in a microfinance institutions' compliance assessment with regulations and policies of the BCPs, the supervisor would need to take into account the particular aspects of the microfinance businesses when assessing each core principle. For example, the supervisor should confirm that each institution has adequate policies and procedures to rate its assets and to determine the related loan loss reserves. In this segment, it is essential that the rating and provisioning systems identify the microcredit component of a loan portfolio and define appropriate specific criteria for its rating and provisioning.

Unfortunately, it is impossible to generalize by stating that some BCPs are inapplicable to microfinance institutions in the region. The applicability of certain BCPs for microfinance institutions depends on how the business of microfinance is developed in each country and on the complexity of operations undertaken by entities operating in this segment. However, four principles (BCP 5, 12, 24, and 25) have very little relevance for microfinance institutions, whether they take deposits from the public or not, for the following reasons:

- BCP 5 (Investment criteria): Usually microfinance institutions in the region do not make large investments or have cross-border operations, so the existence of investment management criteria would have limited use.
- BCP 12 (Country risk and transfer risk): Microfinance institutions do not usually make international loans or investments, so they would not need systems to manage the country and transfer risk.
- BCP 24 (Consolidated Supervision) and BCP 25 (Relationship between the Supervisor of origin and destination): Microfinance institutions are not normally part of local or cross-border financial conglomerates, so the need for consolidated and cross-border supervision is limited. The exceptions in the region are those microfinance institutions that are part of international groups specialized in the microfinance business. The clearest example is the Procredit Group (for profit). This Group has specialized banks in 19 countries worldwide, including six countries in the region (Bolivia, Colombia, Ecuador, El Salvador, Honduras, and Nicaragua).

Aside from these four, compliance with the other core principles is essential for adequate supervision of the microfinance institution segment. However, the evaluation must consider specific characteristics of microfinance. These characteristics should be considered in the following principles:

- BCP 1 (Objectives and responsibilities of the supervisor): The responsibilities of the financial supervisor regarding microfinance institutions must be clearly defined in the legal framework and properly disseminated. If the country has opted not to supervise microfinance institutions, this should be clear to the public. Additionally, to the extent that non-supervised institutions affect the activities performed by supervised entities, there should be adequate mechanisms in place so that the supervisor can monitor financial risks and adapt the regulatory framework, if it is determined that the impact of these institutions on the rest of the financial system could be material. In the case of delegated or shared oversight, the responsibilities of the authorities must be clear and the coordination mechanisms must be appropriate.
- BCP 2 (Permissible activities): If there are deposit-taking institutions<sup>4</sup> and these are not prudentially regulated, they should represent an insignificant proportion of deposits in the system. However, the growth of deposit-taking microfinance institutions that compete with supervised entities without prudential supervision may generate risks to the system as a whole. To prevent this problem, the legal framework should limit deposits in institutions that are not supervised as banks (with lower leverage) or, in lieu of this, it should establish that these institutions will be supervised directly, if they reach a certain size enabling the supervisors to take action if necessary. The attention to this issue by supervisors can prevent the emergence of non-supervised risks. Also, the financial supervisor should have mechanisms to learn of the activities of unregulated institutions to ensure these do not perform regulated activities.
- BCP 3 (Licensing Criteria): Among the criteria for granting banking licenses is the supervisory authority's assessment of the strategic plans (especially of significant market research) and the verification that the proposed systems of corporate governance, risk management, and internal controls are adequate. The proposed structure should reflect the scope and complexity of the proposed activities. As a matter of scale, relatively small microfinance institutions often have concentrated structures and limited segregation of duties. While this may be inevitable, it is essential that supervisors ensure that these structures facilitate adequate internal control, risk management, and corporate governance. In particular, institutions must understand the risks of relying on one (or a few) key person(s) and control these risks appropriately.
- BCP 6 (Capital adequacy): In general, capital requirements should reflect the risk profile of banks. Compliance with this principle does not require that countries apply Basel II Capital Standards<sup>5</sup>. However, the implementation of Basel II would provide countries of the region, the opportunity to analyze the risks of microfinance operations and establish capital requirements that better capture these risks. The implications of Basel II for microfinance institutions are summarized in the following section.

4 Including contributions from partners in the case of cooperatives and other similar forms of organizations.

5 These standards were prepared for banks with wide international presence.

- BCP 8 (Credit risk): Since this is a critical risk of the microcredit business, an appropriate framework for its supervision should take into account the nature of microcredit and its business models. This includes explicit identification of microcredit in the regulatory framework, and the establishment of appropriate classification and provisioning criteria for this type of credit. Also, to control the risks of over indebtedness, the supervisor must ensure that institutions have policies and procedures to monitor the total debt exposure of their borrowers. In the Basel Committee on Banking Supervision document, this is considered an additional criterion, not an essential criterion for compliance with the BCP.
- BCP 13 (Market risk): Microfinance institutions have exposure to market risk, including interest rate risk related to the mismatch between their short-term assets and long-term liabilities. There is also foreign exchange risk for those institutions that have a currency mismatch on their balance sheet. This happens, for example, when financial institutions finance their loans in local currency with funds received in foreign currency.
- BCP 15 (Operational risk): This is also a fundamental risk of the microcredit business and as such, the operational risk oversight framework for microfinance institutions should recognize its special characteristics (they are mass markets with a significant number of loan officers), including, for example, fraud risk, human error, and procedures' failures common to different lending processes prevailing in this business.
- BCP 19 (Supervisory approach): This BCP requires that the supervisory authorities have a thorough knowledge of the operations of financial institutions individually, and of the system as a whole. This includes monitoring and evaluating trends, developments, and risks in the microfinance sector. Proper monitoring of risks in this segment requires having the ability to obtain a certain level of information about the activities of microfinance operators that, without being subject to control by the supervisor, can have an impact on the risks of the supervised segment.

A good level of compliance with the BCP is necessary, but may not be sufficient for adequate supervision of microfinance institutions in the region. No country with an inadequate system of banking supervision will have an adequate system of supervision for microfinance institutions. However, there are countries that rely on advanced regulatory and supervisory systems that have not developed adequate monitoring systems for their microfinance institutions.

## 1.2 Basel II and microfinance institutions<sup>6</sup>

In 2004, the Basel Committee on Banking Supervision issued the document “*International Convergence of Capital Measurement and Standards – A Revised Framework*,” better known as Basel II, the product of the revision process of the Basel Accord issued in 1988. The objective of the paper was to establish a new international capital standard for internationally active banks, so as to promote an appropriate competition framework in all jurisdictions of the member coun-

<sup>6</sup> See: “*International Convergence of Capital Measurement and Standards – A Revised Framework*”, Basel Committee; and “*Basel II Implementation: Practical Considerations*”, Basel Committee.

tries of the Committee. However, the Committee recognized that the first agreement - known as Basel I - had become a reference for supervisory authorities worldwide, who used its concepts to set regulations for all financial institutions, including those that only operate at a local level. Likewise, the Committee incorporated in its new standards, a needed combination between rules and the appropriate framework under which these must operate, making Basel II more than a capital standard. Thus, the document has 3 pillars:

- Pillar I - Establishes two alternative approaches to determine capital requirements to cover a financial institution's credit and market risks: the standard approach and the internal rating-based approach. It also introduces capital requirements for operational risk for which three alternative approaches are defined.
- Pillar II - Seeks to provide banks with enough capital to withstand risks and promote good risk management practices.
- Pillar III - Seeks to promote market discipline through the development of information disclosure requirements that would enable market agents to evaluate the institutions.

Basel II leaves to the discretion of the supervisors, the decision of the approach institutions under their jurisdiction will use to determine the required capital. It also suggests some criteria to determine to whom Basel II will apply: size of the entity; nature and complexity of its operations; international presence; interaction with international banks; risk profile and risk management capabilities; resources available for validation and monitoring; and a cost-benefit analysis due to the complexity of implementing Basel II. Under these criteria, most microfinance institutions in the region would not be required to apply more sophisticated methods. Thus, it is expected that, if countries move towards Basel II, microfinance institutions apply Basel I or the standardized approach of Basel II.

The main effects of implementing Basel II for microfinance institutions would be:

- On assets risk-weighting since, under the standardized approach, supervisors have some discretion to define them:
  - The microcredit portfolio does not usually receive a classification from rating agencies, thus, its risk weight would be 100% unless the regulator chooses to define it as a "*regulatory retail portfolio*" that would be assigned a weighting of 75%. The microcredit portfolio meets the requirements of a regulatory retail portfolio (loans to individuals, to small businesses and granularity) set by the Basel Committee.
  - High-risk portfolios without loan loss reserves could have a weighting exceeding 100%.
- The introduction of capital requirements for operational risk would probably have the greatest impact on microfinance institutions, as the capital requirement is set based on gross income. It would also have a significant effect on the microcredit business, which has higher administrative costs than the commercial loan business, and requires higher relative gross income to be profitable. For example, according to the Basic Indicator Ap-

proach, the capital requirement for operational risk would amount to 15 percent of gross revenues averaged over the last 3 years.

- It is possible that entities with which microfinance institutions compete could access capital savings, through the application of internal models, which could generate some competitive disadvantage.
- There is greater emphasis under Basel II on the responsibility of directors and managers of institutions to understand the risks to which their institution are exposed to and how these relate to their capital adequacy (Pillar II).
- Basel II requires institutions to have a policy of information disclosure and of material events, and a system to evaluate that policy (Pillar III).

The implementation of Basel II would provide countries in the region the opportunity to analyze the risks of microcredit and to establish capital requirements that best capture these risks. One particular issue to evaluate is the suitability of establishing a regulatory *retail portfolio* that includes the microcredit portfolio, which is weighted at 75% for purposes of calculating risk-weighted assets under Basel II. Applying this lower weighting may be recommended in countries where microcredit is properly identified, classified and provisioned for, provided that the supervisors have established that the institutions operating in this segment have appropriate risk management systems. Supervisors should review in advance whether this lower weighting is consistent with the behavior of microcredit portfolios in their respective countries. This modification could be made when implementing capital requirements for operational risk established in Basel II, so that the lower weightings for the microcredit portfolio would partially offset higher required capital for operational risk.

### 1.3 Rationale for complementary principles for regulation and supervision of microfinance

Although the need to regulate and supervise banks rigorously is rarely challenged, the implementation of a rigorous regulatory and supervisory system for microfinance institutions is a subject of debate. The majority of microfinance institutions are not material to the financial stability of their countries, but their presence and activity requires some complementary standards to the BCPs to ensure effective regulation and supervision. Aside from the prudential purpose of preserving financial stability, support for a complementary regulation and supervision framework can be found on the objectives of protecting consumers (depositors and borrowers), and correcting market imperfections (information to improve transparency and efficiency). Like all regulation, it has costs. In order to justify implementing a complementary framework, the benefits must outweigh the costs.

The strict regulation and prudential supervision of microfinance institutions is socially desirable, even if these institutions do not undermine the stability of the financial system. An inadequate regulatory framework for these institutions can encourage some institutions to take excessive risks, leading to, for example, over indebtedness of borrowers in that segment.

Excessive indebtedness of borrowers has a devastating impact on society, breaking down the payment culture and reducing the population's ability to generate wealth. Over indebtedness not only affects these microfinance institutions, but all other financial institutions as well, generating losses that could lead to a tightening in the microcredit supply and eliminate a significant credit source for an important segment of the population, with significant economic and social consequences. Even though the financial system's stability may not be at risk, this segment's prudential regulation is justifiable because it is desirable to have a sustainable microcredit supply, which at the same time calls for institutions that provide it in a prudent and sound manner.

If an institution (or a productive sector) can produce significant damage (social costs) with its market conduct, a regulatory framework to prevent such damage is justified to protect consumers. Additionally, the regulation of microcredit business should have an important component of consumer protection, but without reducing their decision making responsibility; that is to say, not affecting the payment culture or generating moral hazard risks. For example, the disclosure of credit costs and other terms of credit agreements to consumers, provides them with inputs to make their decisions, and it is essential for the adequate operation of the microcredit market and to prevent the social conflicts caused by over indebtedness. The supervisory authorities' evaluation of the clauses of a credit contract, to prevent and punish abusive practices, also favors the proper functioning of microcredit.

The correction of market imperfections is the ultimate goal of regulating the microcredit business. Mechanisms to correct various types of information asymmetry can support the efficient functioning of financial markets. For example, credit bureaus mitigate the information asymmetries that exist between financial institutions and their borrowers about the borrowers' ability (and willingness) to pay, enabling financial institutions to make informed credit decisions; thus, strengthening the microcredit supply. The sharing of information about the costs and conditions of credit, allows borrowers to make informed decisions about their indebtedness' capacity and who offers them the most appropriate product.



# 2

## **PRINCIPLES FOR EFFECTIVE REGULATION AND SUPERVISION OF MICROFINANCE OPERATIONS**

### **2.1 Scope**

This chapter presents a set of principles for the regulation and supervision of microfinance operations that apply to microfinance institutions and all financial entities with microcredit portfolios, including banks.

Except for what is mentioned in Chapter I, there is coherence between the following principles and the Basel Core Principles (BCPs). No aspect of these principles contradicts the BCPs, but rather they complement them.

It is desirable that the principles in these Guidelines be applied to non-supervised credit institutions that operate in microfinance, as they constitute sound practices that seek to minimize the risks they are exposed to. It is also recognized that in the case of non-regulated entities, the State's role is not to regulate and supervise, but rather to establish an environment of sound and ethical practices that would allow access to quality financial services to segments of the population that have been excluded from these services. Consequently, these Guidelines can constitute a model of sound practices for non-regulated entities and for the institutions that regulate them, as well as for whoever associates with or invests in them.

### **2.2 Preconditions for effective regulation and supervision of microfinance**

#### **Role of the State, Market Entry, and Interest Rates**

##### ***2.2.1 Role of the State***

The State should create conditions to facilitate the development, strengthening, and protection of the institutional soundness of microfinance institutions. Microfinance operations enjoy a stable legal and regulatory framework that allows the assumption of prudent risk. Standards applied to microcredit are no more lenient or permissive than those for

other types of credit. The State ensures transparency of information that enables users of microcredit operations to make prudent decisions. The State supports transparency in the industry, beginning with raising public awareness about the protection that the State offers depositors in regulated financial institutions. The definition of “microcredit”<sup>7</sup> is detached from concepts associated with labor, tax, or poverty-alleviation purposes, as well as from transfers of State resources or subsidies.

The State refrains itself from establishing portfolio quotas for financial institutions. The State avoids distorting contractual conditions, such as amount, price, terms, guarantees, and currency.

The State establishes a legal environment that supports the collection of debts and certainty in the settlement of guarantees. In addition, it has a clear tax treatment over financial products.

The State supports the development of an infrastructure that provides financial consumers with a single identification system.

The State aims to ensure that the supervisor has sufficient capacity and resources for the effective implementation of these principles in microfinance institutions.

The State knows of the operation and scope of work of non-supervised microfinance institutions and has the authority to integrate them into the supervised category when their characteristics, impact, or material nature deem it appropriate. The criteria for incorporating non-supervised microfinance institutions into the supervised category are clearly established in the existing regulation.

The State requires a clear identification between supervised and non-supervised institutions for public use that includes the differentiation of brands or names. No supervised institution uses a brand or common identity with non-supervised institutions. Non-supervised institutions state in their advertising that they are not monitored by the financial supervisor, nor authorized to take deposits from the public.

The State requires the adoption of a unified accounting system for the financial sector applicable to all institutions, whether they are supervised or non-supervised.

Within the judiciary branch of government, there are mechanisms for rapid resolution of minor disputes regarding financial services contracts. The judiciary also possesses a specialized expertise in the areas of commercial and financial laws.

### ***2.2.2 Freedom to set prices***

Microcredit loans are not subject to interest rate caps or prices for services. There are conditions that permit healthy and vigorous competition between financial entities. These

<sup>7</sup> The provision of credit to low-income individuals, informal, in the process of being included in the banking market, poor and very poor, which are usually present in some definitions of micro credit.

conditions include the availability and transparency of information that allows the public to compare different alternatives, such as formulas for calculating interest rates for microcredit operations.

### **2.2.3 Market access**

All financial institutions that provide microcredit do so to individuals who may lack commercial or tax registration, formal accounting, or guarantees that can be registered. Institutions establish their own policies and determine the universe of eligible clients. All microcredit operations of supervised institutions are guided by these principles.

Non-supervised credit institutions are permitted to grant microcredit loans, but not to take deposits under any circumstances. This includes deposits and non-compulsory contributions to savings and loan cooperatives. It also includes clients' cash collateral that is not deposited in the borrower's name into regulated financial entities by the credit institutions.

## **Minimum infrastructure**

### **2.2.4 Credit bureaus**

There are credit bureaus that are public, private, or a hybrid of both that rely on centralized national databases, and provide current and historical information to any person with a legitimate business interest. This includes information on an individual's amount of debt; payment status; and behavior in the financial system including operations with non-supervised credit institutions, public utilities, tax matters, and commercial credit. The creation of credit bureaus that are specialized in microfinance or that contain only negative information does not contribute to the development of this public good. Microfinance institutions and those operating in microcredit are obliged to report their debtors to a credit bureau, and consult the bureau before granting any credit facility.

Credit bureaus must keep adequate information security controls to guarantee the accuracy of reported information, and to minimize the risk that such information may be altered or misused.

### **2.2.5 Financial client protection**

There are laws or regulations on market conduct as well as on protection and defense of the user of microfinance services. These laws or regulations should clearly establish the rights and obligations of persons who request loans, make deposits, or have some type of contractual relationship with a financial institution. There is an obligation of all supervised financial entities with microfinance operations to provide timely, complete and relevant information on the conditions of a microfinance product to users before signing a contract or throughout its duration. This information includes the rights of clients of microfinance products and services, as well as the ways to file a complaint both before the

financial institution and the relevant agencies. It also includes the legal rights of the client who finds him or herself in a collection process.

There is transparency of documentation that prevents contractual abuse. The State has the right to review, object to or approve the text of model contracts or microcredit standards prior to their application, as well as to sanction violations of the obligation of providing information. The contracts are drafted in simple language.

Public campaigns are conducted on users' rights and obligations. Financial legislation or regulation requires financial institutions to instruct, explain or warn their customers about their rights and obligations associated with microfinance services contracts. The creation of a Financial System Advocate (Financial Ombudsman), as an independent person of irreproachable reputation with extensive knowledge of the financial system and with sufficient powers to exercise his or her functions, is promoted. The customer advocacy service can be provided at the aggregate level when in the opinion of the financial supervisor the number of financial transactions in an entity justifies this service.

Public and private entities related with the broad financial sector, implement financial education programs that allow clients to become knowledgeable of responsible financial administration practices.

### ***2.2.6 Financial information***

Financial institutions regularly draft and publish through mass distribution media (written and electronic) their financial statements in accordance with International Financial Reporting Standards (IFRS). As IFRS becomes effective in a given country, the supervised institutions will apply the accounting rules of the financial supervisor. In the event that microfinance institutions prepare financial statements in accordance with accounting standards prescribed or permitted by the financial supervisory body, the accounting and financial effect of the differences between the two accounting methods must be made public. Such entities and institutions subject themselves to external audit and publish their financial statements annually in accordance with International Auditing Standards.

### ***2.2.7 Product and price transparency***

All financial institutions in the supervised financial system disclose information regarding the types of products and microfinance operations that they offer, their requirements, conditions, and rate plans and; in the case of loans, the calculation of the net amount received by the borrower and the amount of the loan repayments. This information disclosure should be conducted by a financial institution using the methodology best suited for its credit culture, institutional culture and infrastructure; which should be made known to the supervisory authority before it is implemented. Given the physical proximity to the client, that is a characteristic of the microcredit methodology, this information disclosure and financial education should be provided through direct contact with the customer.

The effective interest rates charged and paid by financial institutions are regularly published and disclosed to the public. The methodology used follows the guidelines established by the supervisor.

The client knows the effective rate or cost of his credit and is able to compare it with the rates of other credit providers.

### ***2.2.8 Deposit Protection***

The savers in microfinance institutions have the same legal and economic rights as other savers in the supervised financial system. Deposit insurance coverage is based on criteria of reasonableness and equity with the objective of minimizing moral hazard. The deposit insurance system, explicitly or implicitly, only gives coverage to regulated financial institutions. The public is adequately informed of the coverage or lack of coverage of their deposits.

## **2.3 Regulation and supervision of microfinance institutions**

### ***2.3.1 Supervisory scope***

The financial supervisor's responsibilities regarding microfinance institutions are clearly defined in the legal framework and are adequately disseminated. If the country has non-supervised credit institutions, these should be made clear to the public. Additionally, there are appropriate mechanisms for the financial supervisor to monitor the risks of non-supervised microfinance institutions in a timely manner and to adjust the regulatory framework if it is perceived that the impact of these institutions on the rest of the financial system could be relevant. If there is delegated supervision or shared oversight, the responsibilities of the delegated entities are well defined and appropriate coordination mechanisms are in place.

### ***2.3.2 Public supervision***

Deposit-taking microfinance institutions are directly monitored by the financial supervisory body independently of their charter (joint stock companies, cooperatives, thrifts, non-profit civil associations or foundations, public or municipal firms).

### ***2.3.3 Microfinance institutions***

The licensing of microfinance institutions requires a legal framework that considers:

- i. A minimum capital for deposit-taking institutions sufficient to cover the risks of unexpected and expected losses up to a breakeven point, the costs of a reasonable information management infrastructure, and working capital needs. The initial capital of an institution should not necessarily be equal to the minimum requirement;
- ii. Absence of geographic restrictions to operate;

- iii. An operational framework that allows the institution to develop a wide range of asset and liability operations and microfinance services for the public;
- iv. Capital requirements equal to those set for other financial entities, but stricter for those institutions whose legal or ownership structure, in the supervisor's opinion, would present difficulties for adequate and timely capital replenishments;
- v. The prohibition to grant large loans to shareholders, management, or directors, or to divert large amounts on non-credit assets; and
- vi. Requirements for adequate corporate governance, early warning systems, internal controls, and risk management.

#### ***2.3.4 Licensing of microfinance institutions***

The supervisor must have an assessment process for all shareholders or partners (including associations and non-for-profit civil organizations) of microfinance institutions with a stake greater than 5%. These majority shareholders or partners will comply with the regulator's criteria of "fit and proper" according to the practices of the regulated financial system. These shareholders or partners will also have the financial solvency to increase or replenish the capital of the microfinance institutions, if necessary.

The licensing process of new microfinance institutions is no less strict than for other financial entities, and requires the determination of their feasibility based on market research. As a result of this research, specific products for that market are designed, developed, and implemented along with a microcredit methodology, technological infrastructure, human resources, and the corresponding internal controls and financial resources. A microfinance institution's initial paid-in-capital can only be in cash.

In the case of microfinance institutions created from the operations of a non-supervised credit institution, the supervisor should also consider the history, evolution, and successful performance of this institution; it should not allow the shareholders or partners to engage in activities that create conflicts of interest; and, in the event that the new institution acquires the portfolio generated in the non-supervised entity, the portfolio must be assessed beforehand by a qualified independent third-party as well as by the supervisor.

#### ***2.3.5 Exposure limits***

Legislation or regulation establishes a credit limit on microfinance institutions' individual loans that is lower than that of a commercial bank, measured as a percentage of its equity. Additionally, these regulations prohibit loans to the institution's owners, directors, or management.

### **2.3.6 Market information and risk**

The financial supervisory body, trade groups that bring together financial institutions operating in microcredit, or other organizations prepare and periodically publish comparative information on the following aspects of microcredit portfolios:

- i. Microcredit portfolio as percentage of total loan portfolio;
- ii. Loans past due more than 30 days (absolute values and percentages);
- iii. Written off loans (absolute value and percentages);
- iv. Annual rotation of loan officers;
- v. Loan loss reserves over total portfolio;
- vi. Effective interest rate charged (portfolio income as percentage of average portfolio);
- vii. Loan portfolio and deposits by city/region, by product, and by length of arrears (measured in amounts and number of clients); and
- viii. Location of agencies or points of service (tellers, ATMs, correspondents).

The periodic public rating of financial institutions' risk is promoted, by experienced firms of recognized prestige, which use methodologies with high quality standards, registered and supervised by the financial supervisor.

### **2.3.7 Integrated risk management<sup>8</sup>**

Legislation or regulation establishes specific norms for risk management practices in microfinance institutions. Regulation places emphasis on proportionality and specific aspects regarding credit, operational, governance, strategic, reputational, liquidity, and market risks in addition to the risks that are produced by the dynamics between these risks.

### **2.3.8 Credit risk management**

Legislation or regulation requires that microfinance institutions have an appropriate methodology to assess their potential clients' payment capacity, and that they have sufficient infrastructure to monitor their microcredit portfolios. This infrastructure should at a minimum include:

- i. Computerized information systems for microcredit administration;
- ii. Risk management policies on micro-borrowers' over indebtedness;
- iii. Systems to estimate sensitivity of arrears of microcredit portfolios in different adverse scenarios (stress tests); and
- iv. Appropriate incentives systems for credit officials.

<sup>8</sup> Whose portfolio can be comprised also by other types of loans (consumer, commercial, housing), and offer deposits and other financial services.

Legislation should establish capital requirements for specialized microfinance institutions to account for this risk.

### ***2.3.9 Operational risk management***

Legislation or regulation requires that microfinance institutions appropriately manage operational risks, which, given the nature of microfinance operations, represent the main risks of this industry. As such, they should require methodologies that allow for the:

- i. Identification of those risk events that have their origin in human error, processes, systems, and external events;
- ii. Measurement of the probability of occurrence and impact of such events;
- iii. Setting of mitigation measures and action plans for their implementation;
- iv. Implementation of monitoring and managerial information systems; and
- v. Development of risk events' databases.

In addition, the following should be required:

- i. Policies, procedures, and systems to control information systems' security risks;
- ii. Internal control systems for the prevention of errors and frauds, including an internal auditing function that reports directly to the Board of the microfinance institution;
- iii. Information verification procedures and controls that ensure information quality;
- iv. Institutional contingency plans;
- v. Support and legal counsel that prevent potential legal actions; and
- vi. Implementation of plans for personnel training.

Legislation should establish capital requirements for specialized microfinance institutions to account for this risk.

### ***2.3.10 Corporate governance risk management***

Legislation or regulation promotes the existence and application of sound corporate governance principles in microfinance institutions. These principles appropriately harmonize the interests of the institution and its owners, with the interests of its users and clients. There are codes of ethics and conduct that guide the behavior of the financial institutions' owners, directors, managers, and employees, as well as establishing their powers and competencies in order to prevent the concentration of power and conflicts of interest.<sup>9</sup>

<sup>9</sup> When the law does not prohibit or even considers the concession of loans to owners, directors, and management of the institution as a legal activity, the interests of the institution and its depositors may conflict with the interests of the related parties.

### ***2.3.11 Strategic risk management***

Legislation or regulation promotes sound corporate governance policies and practices in microfinance institutions that would ensure that they are managed in a competitive and sustainable manner, that they participate in market segments with demonstrated experience, that they have sound analysis of market segments and their environment, and that they promote innovation in a prudent manner.

### ***2.3.12 Reputational risk management***

Legislation or regulation establishes the obligation of microfinance institutions and of their directors, managers, and employees to preserve the institutional image and public confidence through compliance with applicable regulations and laws; fair, equitable, and non-discriminatory treatment of their clients; application of ethical principles, moral values; and the promotion of financial inclusion and education.

### ***2.3.13 Liquidity risk***

Legislation or regulation establishes the obligation of microfinance institutions to implement mechanisms that minimize liquidity risk, which comes from mismatches in cash flows as well as from not being able to close open positions in a timely manner, in a sufficient amount, and at a reasonable price. The management mechanisms should include measurement, monitoring, and mitigation of risks whose impact could cause failure to comply with financing requirements and application of funds in the institution. Given the need to apply a preventive approach, the institutions should rely on information that permits them to see their future mismatches and to develop contingency plans that allows them to act in response to adverse market situations.

### ***2.3.14 Market risk***

Legislation or regulation establishes the obligation of microfinance institutions to implement mechanisms that minimize the possibility of losses due to adverse movements in the price of their assets, the impact on their balance sheet to changes in interest rates or the impact of changes in the exchange rate when taking positions in different currencies. Also, regulations require that microfinance institutions will only be able to operate with services and instruments they have authorization for, and that they will have to request and obtain prior approval to operate with other instruments that are not authorized within their license.

The law should establish capital requirements for specialized microfinance institutions due to this risk.

### ***2.3.15 Over indebtedness limits***

Legislation or regulation establishes a limit for the repayment capacity that can be a function of the net income of a business unit. They also establish the obligation that all finan-

cial institutions have internally established in their microcredit operations a relationship or maximum limit between the amount of amortization payments of all obligations of a borrower and his/her regular net income. There is the obligation of limiting risk, based on the debtor's payment capacity and the consideration of the debtor's potential overindebtedness.

### ***2.3.16 Anti-Money Laundering and Counter-Terrorism Financing***

Legislation or regulation establishes the obligation of microfinance institutions to implement mechanisms that help them to "know their client" and to avoid the misuse of their products and services. Microfinance institutions should comply with the Anti-Money Laundering and Counter-Terrorism Financing rules.

## **2.4 Regulation of microcredit operations**

### ***2.4.1 Appropriate credit classification***

Financial legislation and regulations define and characterize different types of credit that financial institutions can grant, taking into account the sources of the cash flows that pay for the obligation including: sale of goods and services (microcredit and commercial credit); or salaries, pensions, retirement income, and the like.

A microcredit is a type of credit, which has specific information requirements for their credit files, loan loss reserves regime, interest income generation, write offs and expected losses.

### ***2.4.2 Microcredit definition***

There is a definition of microcredit containing important and differentiating elements of this particular type of credit operation: a small amount loan granted to small business owners, that will be paid back mainly with the cash flow from the business's sale of goods and services. These loans are granted using specialized credit methodologies based on thorough personal contact to, among others, assess and determine the potential client's willingness and repayment capacity.

### ***2.4.3 Maximum exposure limits***

Legislation or regulation establishes a maximum limit (for example, a multiplier of the gross domestic product per capita) for the definition of a microcredit. This limit should consider the total loan exposure of a borrower in the financial system including that with non-supervised credit institutions. This limit should be observed at the moment of loan disbursement and should not deter financial institutions from assessing the borrower's capacity and willingness to pay, nor of the potential need to require registered collateral or to seek accounting information of the business when available during the relationship with the client.

#### **2.4.4 Fundamental characteristics of microcredit**

Microcredit is processed, documented, assessed, approved, disbursed, and managed under special credit methodologies that differ from traditional corporate or consumer credit methodologies. It is inherent to microcredit:

- i. That credit applicants have small businesses;
- ii. That no exclusion of the applicant is made solely for lack of accounting, auditing, formal documentation or official records;
- iii. That there may be no collateral, as the applicant may not have one;
- iv. That there is a required consultation with a credit bureau, both for the applicant and the guarantors if any; and
- v. That a cash flow and a balance sheet are prepared by a loan officer although not necessarily for each loan operation.

#### **2.4.5 Minimum information requirements**

Legislation or regulation establishes microcredit borrowers' information requirements that must be on record in their loan files (physically and/or electronically). This information comprises at least the following:

- i. Copy of official identification document;
- ii. Certification or verification of place of residence or location of the business unit;
- iii. Declaration of income presented by the applicant;
- iv. Bank references, if any;
- v. Credit bureau information for the applicant and for his/her guarantor, if any;
- vi. Commercial references from members of the community, suppliers, clients, and nearby businesses even if informal;
- vii. Certification of collateral if the loan requires collateral;
- viii. Balance sheet and cash flow prepared or reviewed by the loan officer;
- ix. Presentation/submission and approval of the operation; and
- x. Copy of the loan contract.

#### **2.4.6 Loan loss reserves requirement**

There are rules establishing:

- i. That microcredit is considered an independent credit category, different from other types of credit (like commercial, consumer, or housing loans);
- ii. That different general ledger accounts are used to record up-to-date microcredit operations and past due loans (restructured, past due, and in legal collection); and
- iii. That the lack of repayment of one of the installments of the microcredit causes an accounting transfer of the whole loan to past due loans.

There are also specific rules for the rating of microcredit portfolios to determine their specific or generic loan loss provisions. The essential risk criteria established for the creation of specific loan loss provisions are:

- i. Number of days past due;
- ii. Number of rescheduling events;
- iii. Terms and payment plans of irregular payments;
- iv. No deduction of the value of any received collateral;
- v. In the event that shared clients are found to have worse ratings in other non-supervised financial institutions or credit institutions, the worse rating will be applied.

The determination of specific or general loan loss reserves can be made based on reference models for the calculation of expected losses applied to new and returning customers, with up-to-date or past due loans. The financial supervisory body has the power to define loan loss reserves for expected losses when it finds that the microcredit portfolio does not have adequate credit policies and procedures; information systems or internal controls; or if the classification process of the microcredit portfolio is not reliable. The supervisory body also has the authority to ask for additional capital requirements for unexpected losses and losses resulting from adverse fluctuations, as a result of the economic cycle.

#### **2.4.7 Interests and fees treatment**

Regulation establishes that:

- i. A microcredit stops generating income through interest and fees from the first day that the loan or one of its installments becomes past due;
- ii. Accrued interests on restructured or refinanced microcredit operations are only recorded at the time of cash collection; and
- iii. The fees are prorated and accrued during the term of the loan.

### **2.4.8 Microcredit write-off**

Regulation establishes a number of days after which financial institutions proceed to the write-off of past due microloans.<sup>10</sup> Microcredits to be written-off are fully provisioned for, although it will not be necessary that they be undergoing legal collection proceedings. These loans are reported to credit bureaus with which the microfinance institution operates.

### **2.4.9 Microcredit portfolio**

The legislation and regulation establishes that financial institutions must have the following to offer microcredit:

- i. A niche target market research substantiating their participation;
- ii. A credit methodology, defined as the set of activities that should be performed by a credit institution to reasonably resolve typical problems of information, selection, incentives, and contract compliance that arise in microcredit transactions;
- iii. A management and operations' team with experience and capacity in this sector;
- iv. A technological infrastructure allowing for daily control and monitoring of loans and loan officers;
- v. A statement of how the microcredit activity is incorporated into the institution's integral risk, governance, reputational, operational, credit, and liquidity risks' management policies.

## **2.5 Supervision of microcredit operations**

### **2.5.1 Specialized unit**

Microfinance institutions and microcredit portfolios of deposit-taking financial institutions are supervised by a specialized unit of the financial supervisory body. The supervisory body has at least one team able to evaluate the adequacy of the specific credit methodology used by financial institutions that operate in microcredit. The supervisory body has the authority to establish adjustments and corrections deemed necessary for financial institutions to properly operate in the microcredit market. The supervisory body has sufficient knowledge and experience in the microcredit business to be able to effectively evaluate an institution's integral risk, governance, reputational, operational, credit and liquidity risks' management policies.

<sup>10</sup> To calculate the effective arrears uniformly in all institutions and the comparison between them, consider that two institutions have a microcredit portfolio of 105, of which 5 are in arrears. Loan loss reserves amounting to 4, of which 2 correspond to the portfolio in arrears over 360 days, hence 100% provisioned. Entity A writes-off loans that are 360 days in arrears, recording in its books a portfolio of 103 with a 3% in arrears and provision coverage of 67%. Entity B that has no such write-off policy shows a portfolio of 105 with arrears of 5% and provision coverage of 80%.

### ***2.5.2 Preventing over indebtedness***

The financial supervisory body has procedures to permanently analyze, evaluate, and monitor the total debt and payment status of the borrowers of microfinance institutions to prevent over indebtedness.

### ***2.5.3 Off-site procedures for microcredit portfolio supervision***

In exercising its off-site supervisory duties, the financial supervisory body performs at least the following actions with relation to the financial institutions' microcredit portfolios:

- i. Establishes and applies specific warning signals;
- ii. Analyzes key indicators of portfolio management;
- iii. Conducts ongoing monitoring of the past due accounts in each institution and in the financial system as a whole;
- iv. Analyzes the individuals' exposure per microcredit and other types of credit to prevent excessive indebtedness;
- v. Performs analysis to detect any underestimation of the microcredit portfolio's risk level (for example, derived from inadequate reporting of restructured or refinanced loans and/or number of days in arrears);
- vi. Publishes and disseminates information that promotes competition in the microfinance market; and
- vii. Plans visits as a function of perceived risks.

### ***2.5.4 On-site procedures for microcredit portfolio supervision***

Exercising its duties of on-site supervision, the financial supervisory body undertakes, at minimum, the following actions in relation to financial institutions' microcredit portfolios:

- i. Evaluates the appropriateness of the classification of the microcredit portfolio;
- ii. Evaluates the soundness and compliance with the policies and regulations on corporate governance, operations, and risk management;
- iii. Verifies the correct calculation and generation of reports on the daily status of loans in arrears, through the application of computer-assisted auditing techniques on the database;
- iv. Verifies the reporting of rescheduled/refinanced loans through the application of computer-assisted auditing techniques on the database;

- v. Reviews, through sampling, the appropriate monitoring of non-performing loans carried out by the supervised institution's staff, in accordance with policies and procedures established by the institution;
- vi. Verifies, through sampling, that the supporting documentation complies with micro-credit policies and procedures established by the institution;
- vii. Verifies the correct calculation of loan loss provisions and the non registration of interest income and fees of past due loans; and
- viii. Through sampling selects a group of micro borrowers to be visited.<sup>11</sup>

11 One of the main risks of microcredit is linked to the "creation" of debtors by the loan officer.

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# Project Team

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## ABOUT THE MULTILATERAL INVESTMENT FUND

The Multilateral Investment Fund (MIF) is the largest provider of technical assistance to the private sector in Latin America and the Caribbean. As a member of the IDB Group, the MIF's overall focus is providing low-income households, and micro and small enterprises with access to financial services, basic services, and markets and capabilities. For more information, visit [www.iadb.org/mif](http://www.iadb.org/mif).

## **MISSION**

To develop, disseminate, and promote banking supervisory practices throughout the Americas in line with international standards. To support the development of banking supervision expertise and resources in the Americas, through the effective provision of training and technical cooperation services.

## **INSTITUTIONAL OBJECTIVES**

The Association of Supervisors of Banks of the Americas is formed by the entities in charge of banking supervision in each of the countries of the American continent and Spain. Its main objectives are:

- > Promote and maintain close communication among the Association's Members, in order to facilitate co-operation among them, and to promote the improvement of their respective capabilities;
- > Provide its members with a high-level discussion forum for the exchange of information, ideas, techniques, experiences and knowledge over their scope of competence;
- > Promote research as well as systematic and permanent training programs, with the purpose of establishing training standards in the region and providing technical co-operation services among its Members;
- > Promote co-operation and exchange relationships with non-member bank supervisors, with similar associations as well as with international and multilateral institutions, engaged in activities similar to those of the Association; and
- > Perform any general activity related to its purposes.