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The candid voice for microfinance investment

# Microfinance 101 Regulation and Supervision: What Works

## Introduction

As the emerging asset class of microfinance[1] spirals slowly to the surface, MicroCapital looks at one of its main stumbling blocks: regulation and supervision. Vijay Mahajan, CEO of the BASIX Group, a microfinance institution (MFI) in India, refers to regulatory frameworks as one of the "triple helix" of constraints to microfinance expansion: regulation frameworks, financial resources, and the institutional capacity of most micro-banks, any of which may be the ruling constraint at a given time. BASIX, one of the first MFIs in the world to attract commercial equity investment internationally and within India, has been a major influence for successful changes in Indian policy framework[2].

As in mainstream financial sectors, predictable regulatory standards for microfinance reduce uncertainty and increase the attractiveness of the investment. The challenge is to strike a balance between preventing abuse of markets and consumers, and encouraging industry expansion.

This paper will

- explore the unique challenges of microfinance regulation;
- advocate "regulation by risk";
- consider balancing financial system integrity with costly microfinance regulation that inhibits investment;
- review the hugely positive role that rating agencies have played in facilitating transparency and risk assessment for investors and regulators alike.

We will also take you to Peru, a burgeoning market for microfinance in which regulators seemed to have figured out how to control risk while promoting investment in microfinance.

## What's wrong with the regulations we already have?

Some may be tempted by the relative ease of imposing a country's existing financial laws and regulations on MFIs, but most are poorly suited to the unique aspects of microfinance. For example, most micro loans are unsecured and made to people without a documented credit history or identity. This could signal a higher reserve allocation, or may not even be legal in some countries. To the surprise of many, microcredit losses have been relatively low at well-run MFIs, with recovery rates above 95 percent at some MFIs even in poor economic climates; whereas, many others have failed completely. Transaction costs are steep for both MFIs and customers, and business is often conducted at odd hours and in unusual places. Back office systems may not be automated and thus extremely labor intensive to maintain.

There is no "one-size-fits-all" solution. Regulating microfinance is country-specific, and while there are several best practices and consensus guidelines to guide policy makers, implementation is complicated by the realities of an individual country's political economy and the nature of emerging markets.

Lack of transferability of mainstream financial regulations is not necessarily bad. In many countries, ***the field has been able to grow and mature because of tacit government approval by failing to impose existing laws on MFIs.***

***In countries that have implemented microfinance regulation smoothly and effectively, regulation has tended to follow, rather than lead, development of the industry[5].***

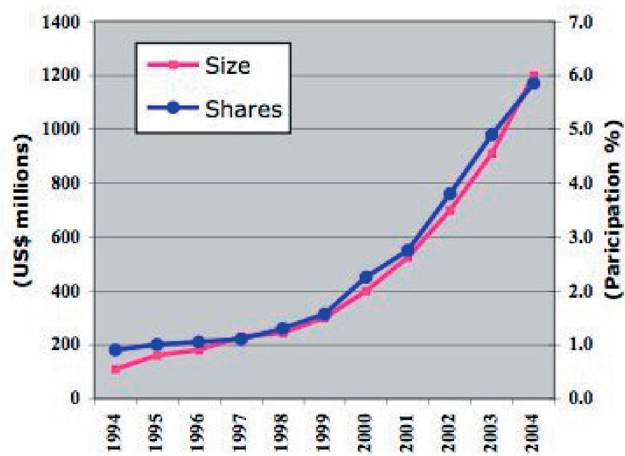
## Regulation by risk

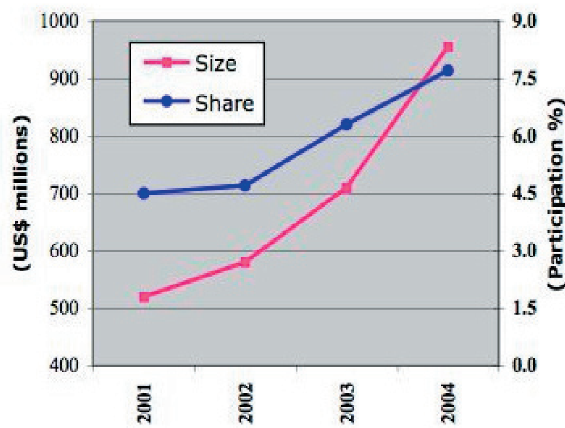
In industrialized nations, regulatory scrutiny tends to correlate with risk. If you engage in a high risk activity (real or perceived) with potential systemic repercussions, you will likely develop a close, personal relationship with the regulators. Conversely, if you operate in an unremarkable way with little chance of disrupting markets or financial systems, your activities will normally attract little attention. Regulation by risk is a practical approach for microfinance, as well.

To maintain a level playing field, it makes sense to focus microfinance regulation and supervision on the activities themselves, regardless of the type of institution that delivers them. For example, oversight of micro-loans to poor borrowers should essentially be the same whether the loans are extended by an MFI (already broadly-defined), consumer finance company or commercial bank that offers the same product. Tax treatment of microfinance activities should also ensure a level playing field that does not unduly favor nonprofit providers who offer the same products and services as a commercial entity.

### What Works: Peru

For a taste of how regulation and supervision should work in practice, we turn to Peru. Strong loan demand paired with inadequate domestic funding has drawn socially-oriented investors to the region of Latin America since the early 1990s. Since 1998, nearly all of the growth in Latin American microfinance has been fueled by private investment[3]. At the head of the class is Peru. Mix Market, a World Bank web-based microfinance information platform, lists 31 different microfinance funds currently investing in Peruvian microfinance. MFIs have been the fastest-growing financial institutions in Peru over the last decade[4].




*Extracted from: Ebentreich, Alfredo, "Microfinance Regulation in Peru: Current state, Lessons Learned and Prospects for the Future" (p. 8)*

## Comparative Approaches to Regulation and Supervision*

| | Degree of MFI Regulation | | |
|---|---|---|---|
| | **Regulate activity only** | **Adapt existing non-bank financial institution or cooperative license** | **Create new license** |
| **Type of Regulatory Body** | | | |
| **Regulatory authority housed with government (e.g. Ministry of Finance)** | NA | NA | PARMEC (West Africa Monetary Union), Morocco, Romania |
| **Independent public regulator (e.g. central bank)** | Colombia<br>Philippines | Ghana<br>Indonesia (rural)<br>Azerbaijan | Kyrgyzstan, Tajikistan, Peru, Bolivia, Kenya, Pakistan, Uganda, Bosnia, Brazil, Nicaragua, Nepal |
| **Hybrid regulator** | South Africa | Indonesia (village credit institutions) | NA |
| **Self-regulation (member-owned body)** | NA | Mexico | NA |
| **Laissez-faire** | Bangladesh | NA | NA |

**Adapted from the Microfinance Gateway Regulation and Supervision Resource Center website. Not an exhaustive listing.*

### Prudentially speaking...

"Prudential" and "non-prudential" regulatory policies address the overall risk posed by the institution or activity being regulated. **Prudential regulations** protect an institution's financial soundness to prevent loss of small depositors' money and damage to financial system confidence. Such prudential regulation is relatively difficult, intrusive and expensive because it involves understanding, monitoring and protecting the health of individual institutions. Examples of prudential regulation are capital, liquidity and loan loss reserve requirements. Prudential regulation is only needed for MFIs that accept retail consumer deposits or are large enough to pose a threat to the financial stability of other institutions. The goal is to protect the integrity of the financial system as a whole, and protect small depositors who are not independently able to assess the soundness of a financial institution.

**Non-prudential regulations** focus on transparency and disclosure and may be largely self-executing, and handled by agencies outside the central bank or finance ministry. Non-prudential measures include disclosing effective interest rates, screening out unsuitable owners and managers and requiring transparent reporting. This approach is appropriate for credit-only MFIs that do not accept retail deposits.

**Self-regulation and external audits:** in nations whose central banks and governments have not put their regulatory houses in order, some MFIs have developed their own self-regulatory bodies to promote discipline and transparency. According to Robert Peck Christen, Timothy R. Lyman, and Richard Rosenberg, authors of "Guiding Principles on Regulation and Supervision of Microfinance", "self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations"[6]. It is also appealing to think that MFI supervision can be delegated to external audit firms. Again, experience has shown that external audits of MFIs, while promoting transparency and disclosure, seldom include testing that is adequate to provide a reasonable assurance as to the soundness of the MFI's loan portfolio, which is by far the largest area of risk. This is true even with respect to internationally recognized audit firms[7].

***The absence of credible alternatives to prudential and non-prudential oversight should not create a sense of urgency in establishing special microfinance regulations.*** Supervisory capacity in most developing and transitional industries is limited, and supervisors often have their hands full with a troubled banking system. It would be pointless to establish a comprehensive set of regulations without the ability to enforce them. In addition, premature or restrictive regulations stifle innovation[8].

### Less is more

Policymakers seek a delicate balancing act between attracting private sector investment and protecting financial system integrity[11]. ***The key is to avoid using burdensome prudential regulations and to manage the risk presented by the specific microfinance activities[12].*** This is a crucial point, because the consequences of an improper degree of regulation and supervision can be profound.

At the **lax end of the spectrum**, MFIs operate in regulatory limbo, with an unclear legal status, minimal oversight, questionable transferability of assets, inability to enforce contracts and unprotected minority investor rights.

At the **heavy-handed end of the spectrum** are systems that attempt to eliminate (versus manage) risk. These regimes impose interest rate controls, require excessive capital and reserves, restrict ownership to insiders or locals, distort competition through unequal tax treatment and require expensive compliance measures.

## The New Peruvian Framework

Policy support for the microfinance sector in Peru is fairly high. The regulatory framework will soon allow all regulated MFIs to take deposits, does not place restrictions on interest rates and does not hinder foreign investment. The vast majority of the sector is regulated, as the non-regulated MFIs tend to have relatively small portfolios, and are not permitted to accept deposits. Refreshingly, non-profit (NGO) MFIs that choose not to convert under the new framework are levied a value-added tax on interest earned.

The public regulation of formal MFIs by the *Superintendencia de Banca y Seguros* (SBS) is considered high quality and professional by MFI managers and analysts[9]. The regulatory framework for MFIs is similar to that of commercial banks. For example, MFIs are required to report the same financial information as commercial banks, such as credit, interest rate and foreign exchange risk. SBS also requires MFIs to have internal and external audits at least once a year. Strict SBS supervision has positively affected loan portfolio quality as delinquency rates for regulated non-bank MFIs have fallen from greater than 10% in December 2000 to 5.7% by the end of 2003, while loan loss provisions cover 130% of portfolio at risk. A financial crisis in the industry is unlikely since the government guarantees all deposits in the financial system below $20,000, which covers practically all MFI savers.

Good reporting gives Peru an advantage over most Latin American countries. Over 90% of Peruvian microfinance operations are registered and report to SBS. Peru also leads Latin America in submitting its microfinance sector to the scrutiny of traditional financial analysis[10].

The **self regulatory body,** Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME), requires of reporting NGOs the same financial tracking and disclosure standards as formal institutions, except they report every three months as compared to monthly. While self-regulation is better than no regulation at all, it is less effective than that of the SBS. Unlike SBS, COPEME lacks the capacity to conduct on-site inspections and is unable to levy penalties for poor management. For good reason, the government is encouraging NGO conversion to the new regulatory framework.

## Elements of Microfinance Regulation:

*Legal status:* Absence of basic registration and licensing requirements impedes the growth of the microfinance industry and its appeal as an investment. The most disappointing example is China, where despite impressive progress in other sectors, microfinance remains in its infancy for lack of an enabling framework. Time-limited licensing as practiced in the West Africa Monetary Union also creates uncertainty: if an MFI does not follow the standard cooperative model, it must operate under a revolving five year memorandum of understanding.

*Secured transactions:* Financial laws of emerging economies may not address an MFI's legal authority to pledge and enforce security interests, restricting the transferability of its assets in capital market transactions such as loan securitization. Without a clear rule of law allowing perfection of liens, assets could wind up being pledged more than once.

*Loan terms:* Individual borrower lending limits for microcredit are sometimes stated as a certain dollar amount that does not vary with changes in economic conditions, such as inflation. This means an MFI cannot grow with its customer, or diversify into related products such as home mortgages. A more enabling approach is to have flexible limits that move with GDP per capita or an MFI's core capital.

*Interest rates:* Public prejudice against exploitative interest rates is strong in many countries[13]. Yet, experience shows that interest rate controls may serve local political interests but ultimately hurt the poor by cutting off access to credit. When an MFI cannot cover its costs, it will die, or worse, turn to permanent subsidies. This reduces availability of credit for poor borrowers, who are then at the mercy of the truly usurious. Strong consumer protection laws such as Truth in Lending type disclosures and consumer education would better help the poor to make informed choices.

*Tax burden*: In markets where for-profit and nonprofit MFIs compete for the same business, the playing field will be uneven when there is unequal tax treatment of the same activity. Policy should distinguish taxes on financial transactions from taxes on net profits that arise from such dealings. Specifically, taxes on financial transactions such as a value added tax on lending or a tax on interest rate should be equalized across the industry. Moreover, rules for net income or profit taxes such as tax-deductibility of expenses (such as provisioning for bad loans) should apply consistently to all types of institutions, regardless of whether they are prudentially licensed[14].

*Capital and reserves:* A certain threshold capital requirement is an effective hurdle for new licenses. However, if excessive capital and reserve requirements are based on a misperception of risk, then growth is hindered by a minor hidden tax that further distorts the playing field.

*Minority interests:* Minority investor shares may be protected from misappropriation through transparent disclosures, laws protecting small investor rights and the ability to enforce claims in court, or with a regulatory body. Minority investor rights can also be protected by placing board members and having access to shareholder lists, annual reports and board meeting minutes.

*Cost of compliance:* There are implicit costs in being a prudentially regulated MFI, including permissible funding sources, loan limits, interest rate caps and capital and reserve requirements, along with explicit costs such as reporting, audit, higher taxes and upfront legal and administrative costs (e.g. automation of back office systems). Often it is not cost effective for an MFI to become a regulated entity and is only warranted if the institution wants to attract retail deposits, which require sophisticated balance sheet management.

*Restrictions on ownership:* Governments may impose limits on proportional ownership to diversify an MFI's capital base and improve the odds of a successful capital call, if needed. Limits on foreign investors range from absolute prohibition (e.g. rural Philippines, Ethiopia) to a certain percentage (e.g. 49% in El Salvador), despite evidence that banks in developing countries with some foreign ownership outperform domestically owned banks[15]. Restricting repatriation of profits by outside investors also effectively curbs foreign direct investment. While over the long term strong domestic capital markets are essential for financial sector development, current restrictions on overseas investors are stifling the growth of the microfinance industry[16]. International investment funds may be better positioned to absorb risk than domestic investors, and early investors may have a "demonstration effect," acting as a catalyst to jump start growth and pave the way for new investment sources.

**Peru Attracting Foreign Investment**

Peru's regulatory framework is friendly to foreign investment. Regulations against fraud are strict and to a great extent enforced. There are no constraints on ownership by foreign investors, who are subject to the same conditions applicable to national financial institutions. When withdrawing their money, foreign investors in microfinance must follow the same procedures that commercial investors do. There is no restriction on repatriation of capital, and foreign investors are guaranteed the right to remove the full amount of their capital in freely convertible currency without prior authorization from the government.

## The role of microfinance rating agencies

Perhaps the single most important development in microfinance investment to date is the participation of mainstream and specialty rating agencies. Pairing independent rating agency review with non-prudential licensing, transparency and governance requirements may be as fruitful, if not more so, than intrusive prudential regulations. Rating agencies have also begun to rate specific securities issued by MFIs.

Making the case for rating agencies is Greg Casagrande, founder, chairman and president of South Pacific Business Development, an MFI that has attracted commercial funding from institutions such as Deutsche Bank, WestPac Bank and ANZ Bank. In his opinion, investing in microfinance is not much different than purchasing a public utility bond. Chances are you (the investor) have neither the resources nor the expertise to evaluate every aspect of the public utility business and the company's operations; instead, you would rely in large part on the facility's rating. Similarly, microfinance investors need not concern themselves with analyzing individual loan files and a dizzying array of financial performance ratios when analysts with training and experience in the nuances of microfinance are better equipped to do so. In this way, microfinance rating agencies have done more to promote investor-friendly microfinance than virtually anyone else to date.

Alas, most microfinance agencies are too small to afford a credit rating by a major firms. To date, the mainstream rating agencies (Moody's, Standard & Poor's and Fitch) have rated just a handful of large MFIs, such as ProCredit of Germany, Compartamos of Mexico, Mibanco of Peru and Acleda of Cambodia[17].

| Rating Agency | MFIs Rated |
|---|---|
| M-CRIL | 267 |
| MicroRate | 203 |
| Ecuability | 172 |
| PlaNet Finance | 153 |
| Apoyo & Asociados | 86 |
| ACCION International | 56 |
| Microfinanza srl | 50 |
| Class & Asociados | 20 |
| Fitch Ratings | 20 |
| CRISIL | 18 |
| Equilibrium | 13 |
| Feller Rate | 8 |
| Pacific Credit Rating | 7 |
| BRC Investor Services | 5 |
| JCR-VIS Credit Rating | 5 |
| Standard & Poor's | 3 |

source: www.ratingfund.org (12/9/05)

To fill the void, specialty rating agencies such as MicroRate, M-CRIL and Planet Rating offer an alternative source. Most specialty agencies are heavily subsidized, although Planet Rating is an independent, for-profit entity recently spun off from PlaNet Finance, an NGO.

The oldest specialty rating agency, MicroRate, dates to 1996. According to its website, MicroRate has analyzed over 203 MFIs in Latin America and Africa. Planet Rating has done 153 ratings "missions" in 35 countries worldwide. These agencies have begun to scratch the surface, but much work remains to be done. These are relative newcomers to the ratings game and the credibility of ratings comes from a solid track record over time.

## A world of enablers and disablers

The top 200 MFIs have received most of the attention from investors and raters over the past few years, and there is a huge need to build retail capacity in the industry among the next tier of MFIs with less than 3,000 clients that have potential. As MFIs demand private investment to fuel expansion and innovation, governments and central banks must decide whether they will enable, or disable, this process. Investors looking for leaders in this area can start with Latin American countries like Peru (see sidebars).

The best regulation includes investors and MFIs in the development. Regulators can also learn from past mistakes in traditional financial sectors by adopting ***dynamic guidelines that contain sunset provisions and evolve with emerging economies and financial sectors.***

## Conclusion

The state of regulation and supervision may appear to be in terrible disarray, but given the slow evolution of the microfinance industry in general, policy is where we might expect since in most countries less than 10 percent of low income households have access to basic savings and credit services[18]. Remember, regulation follows, it doesn't lead.

Until the relevant structures are in place to meet the demand for financial services for the bulk of the population, investors must content themselves with those precious few market leaders that understand the business of microfinance and how to protect both your investment and its citizens' confidence.

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[1] For purposes of this paper, "microfinance" is defined to include financial services such as savings, credit, insurance and remittances targeted to the poor, often in very small increments.

[2] "BASIX" Online posting. <http://www.schwabfound.org/schwabentrepreneurs.htm?schwabid=719&extended=yes>

[3] MicroCapital Institute. "The Commercialization of Microfinance in Latin America" (p.2) Online posting. <http://www.microcapital.org/Whitepaper-Blog.htm>

[4] Ebentreich, A. "Microfinance Regulation in Peru: Current State, Lessons Learned and Prospects for the Future" Essays on Regulation and Supervision Series., Published by the Consultative Group to Assist the Poor (CGAP) and The IRIS Center at the University of Mary land, April 2005. (p.8)

[5] Rosenberg, R., Lyman, T., Ledgerwood, J. "Regulation and Supervision of Microfinance" CGAP Donor Brief No. 12, May 2003. (p. 2)

[6] Peck Christen, R., Lyman, T. and Rosenberg, R. "Guiding Principles on Regulation and Supervision of Microfinance" CGAP Microfinance Consensus Guidelines. March, 2002. (p.29)

[7] Ibid, (p.30)

[8] Duflo, E. and Imboden, K. "The Role of Governments in Microfinance" CGAP Donor Brief No. 19, June 2004. (p.1)

[9] Kane, S., Nair, D., Orozco, D. & Sinha, S."Peru Microfinance Investment Profile," Published by Princeton University, January 2005. (p.28)

[10] Conger, L. and Jansson, T. "Investment Funds: Doing Well by Doing Good" Published by the Inter-American Development Bank. 2001. (p. 19)

[11] Druschel, K. "The Ultimate Balancing Act: Investor Confidence and Regulatory Considerations for Microfinance." Published by the IRIS Center at the University of Maryland. July 2005. (p. 6)

[12] Ibid, (p. 15)

[13] Peck Christen, R. et al. 2002. (p. 13)

[14] Ibid. (p. 14-15)

[15] Druschel, K. 2005.(p. 30)

[16] Ibid, (p. 30)

[17] Easton, T. "The Hidden Wealth of the Poor: A survey of microfinance" *The Economist*, November 3, 2005. Online Posting <http://www.economist.com/displaystory.cfm?story_id=5079324>

[18] Women's World Banking (SWWB) "Expert Group +10: Building Domestic Financial Systems That Work for the Majority" April 2005. (p.2) Online posting. <http://www.swwb.org/English/PDF/Expert_Group_Booklet.pdf>

**About MicroCapital**
MicroCapital is a news and research initiative on international microfinance investment housed in Prisma MicroFinance, a for-profit microfinance institution (MFI). Since microfinance is currently dominated by governments and charities, objective information with a business orientation is scarce and buried under academic jargon. We seek to provide candid information on microfinance as an emerging investment class. Feedback is welcomed. Special thanks to Laura Brix, Sonia Weiss and Robert Southern for this publication.

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