Microfinance Regulation in Seven Countries: A Comparative Study

Patrick Meagher*
Pilar Campos
Robert Peck Christen
Kate Druschel
Joselito Gallardo
Sumantoro Martowijoyo

FINAL REPORT

Submitted to Sa-Dhan, New Delhi
by the IRIS Center, University of Maryland

May 31, 2006
[*Revised for publication*]

---

*Editor; Associate Director, IRIS Center. The contributions of co-authors are gratefully acknowledged, as is the valuable assistance provided by Clare Wolfowitz and Natalia Miteva. Any faults are the Editor's alone.

Table of Contents

Tables and Figures

Acronyms

ALCONA – Alianza Cooperativa Nacional (National Cooperative Alliance of Mexico)
ANC – African National Congress (governing political party in South Africa)
APPEND – Alliance of Philippines Partners in Enterprise Development
ASA – Association for Social Advancement (Bangladesh)
BANSEFI – Banco del Ahorro Nacional y Servicios Financieros (Mexico)
BCFC – Bank Counterpart Financial Consultants
BDC – business development center
BDSP – Business Development Service Provider; technical assistance provider for micro, small, and medium enterprises (MSME)
BI – Bank Indonesia, the central bank of Indonesia
Bimas – Bimbingan Massal, rice intensification program with subsidised credit component (Indonesia)
BK3I – Indonesian Credit Unions League, apex body of credit unions in Indonesia
BKD – Badan Kredit Desa, village banks in Indonesia
BKK – Badan Kredit Kecamatan, sub–district level MFIs in Central Java, Indonesia
BMT – Baitul maal wat tanwil MFIs practising shari'ah finance, founded by local Muslim communities (Indonesia)
BNDS – The state development bank of Brazil
BOG – Bank of Ghana
BPD – provincial development banks owned by provincial government (Indonesia)
BPI – Bank of the Philippine Islands
BPR – Bank Perkreditan Rakyat, rural banks serving small business and lower income groups (Indonesia)
BRI – Bank Rakyat Indonesia
BSP – the central bank of the Philippines
CAMEL – criteria to asses the performance of financial institutions (capital adequacy, assets quality, management, earnings, and liquidity)
CBO – community–based organizations
CDA – Cooperative Development Authority in the Department of Finance (Philippines)
CFA – Commercial and Financial Accountants
CFI – cooperative financial institutions
CIMA – Chartered Institute of Management Accountants
CNBV – The national financial regulator of Mexico (Comision Nacional Bancaria y de Valores)
COMACREP – Consejo Mexicano del Ahorro y Crédito Popular; advocacy organization for small savings and credit sector in Mexico
CPMF – financial transaction tax in Brazil
CRA – Community Reinvestment Act, USA
CRS – Catholic Relief Service, an international NGO
CUA – Credit Union Association
DOSRI – Related party (depositor, owner, shareholder or related interest)
DTI – Department of Trade and Industry (South Africa)
EACP – savings and loan institutions (Mexico)
FDP – Financial Institutional Development Project, a USAID project to promote the

development of rural financial institutions in Indonesia
FFP – Private financial funds (Bolivia)
FIDP – Financial Institutions Development Project
FIRA – a governmental financial wholesale institution (second tier) serving rural regions of Mexico
GEMA–PKM – The leading NGO association in Indonesia
GFI – government financial institutions
GHAMFIN – Ghana Microfinance Institutions Network
GoI – Government of Indonesia
KKMB – financial consultants to assist MSMEs (Indonesia)
KUD – multipurpose village coops supported by the Indonesian government
KUK – Kredit Usaha Kecil, small business credit in Indonesia
Kupedes – Kredit Umum Pedesaan, general purpose rural loan program (Indonesia)
LACP – Ley de Ahorro y Credito Popular (Savings and Popular Credit Law), Mexico
LBP – Land Bank of the Philippines
LDCP – Bank branch office (Philippines)
LDKP – Lembaga dana dan kredit pedesaan, village level MFIs founded by district/provincial governments (Indonesia, pre-1992)
LP3ES – Institute for Economic and Social Research, Education, and Information, a national NGO (Indonesia)
MABS – Microenterprise Access to Banking Services Project , a USAID–assisted project
MCPI – Microfinance Council of the Philippines, a private sector umbrella organization for microfinance institutions
MCPI – The Microfinance Council of the Philippines
MCR – minimum capitalization requirements for savings and lending institutions
MFI – Microfinance Institution
MFRC – Micro Finance Regulatory Council, South Africa
NABARD (the national agricultural and development bank)
NBFI – non–bank financial institution
NCC – National Credit Council (Philippines)
NCR – National Credit Regulator (South Africa)
NGO – non–governmental organization
NHFC – National Housing Finance Corporation, South Africa
NLR – National Loans Register (South Africa).
OJK – Financial Institution Authority (Indonesia)
OLEM – other loans especially mentioned
OMB – Opportunity Microfinance Bank (Mexico)
OSCIP – Public Interest Civil Society organization (Brazil)
P.E.S.O. – performance standards for microfinance institutions (Philippines)
PAHNAL – Patronato de Ahorro Nacional, BANSEFI predecessor (Mexico)
PCFC – Credit and Finance Corporation, a government–owned finance company
PEARLS – a financial performance monitoring system for cooperatives and MFIs
PERSAL – direct debit mechanism
PNM – a state–owned financial holding corporation (Indonesia)
POS – point of service
RB – Rural Bank

RMFI – rural microfinance institution
ROSCA – rotating savings and credit association
S&L – savings and loan company
SACP – Sector de Ahorro y Crédito Popular ((Popular Savings and Credit Sector, Mexico)
SAICA – South African Institute of Chartered Accountants
SAICSA – Southern African Institute of Chartered Secretaries & Administrators
SAP – Sociedades de Ahorro y Préstamo (savings and loan association, Mexico)
SARB – South African Reserve Bank
SBL – Single borrower limit
SCM – Microenterprise Credit Societies (Brazil)
SFP – Sociedad Financiera Popular (SOFIPO) (Mexico)
SHG – self-help groups
Simpedes – Simpanan Pedesaan, rural savings program of BRI (Indonesia)
SCACP – Sociedad Cooperativa de Ahorro y Crédito Popular (Popular Savings and Credit Cooperative Society, Mexico)
SOFIPO– Sociedad Financiera Popular (SFP) (Popular Financial Society, Mexico)
SOFOL – Sociedad Financiera de Objeto Limitado (non-bank lending institution) (Mexico)
SRPA – Social Reform and Poverty Alleviation Act
SUN – Surat Utang Negara, government bonds (Indonesia)
TPSP–KUD – serving points of KUD (village cooperatives) (Indonesia)
UED–SP – government-run MFIs (Indonesia)
UMKM – micro–small–medium enterprises (MSME) (Indonesia)
WOCCU – World Council of Credit Unions
YDBP – Largest NGO-MFI in Indonesia
YIS – Prosperous Indonesia Foundation (NGO)

Exchange Rates for 1 USD

CURRENCY	FEBRUARY 2006	FEBRUARY 2004	FEBRUARY 2002
Bolivian Boliviano	8.05	8.07	7.21
Brazilian Real	2.22	2.93	2.51
Ghanian Cedi	9,124.24	8,650.40	7,796.40
Indonesian Rupiah	9,372.07	8,418.40	10,330.00
Mexican Peso	10.46	11.15	9.17
Philippine Peso	52.18	56.13	51.33
South African Rand	6.12	7.05	11.48

Source: FXConverter, www.oanda.com

1. Introduction

Analyses of comparative experience can add value to deliberations on the legal-regulatory framework for microfinance in India. In undertaking to develop such a framework, policymakers must face a series of decision-points involving costs, benefits, and trade-offs among them. Fundamentally, the desire to expand financial access to lower-income populations and microenterprises springs from considerations of social policy, including poverty alleviation and empowering marginal households and entrepreneurs. By contrast, financial regulatory policy generally focuses on soundness and sustainable growth in a financial sector run primarily on commercial grounds. Bringing these two sets of considerations together, as microfinance policy inevitably does, requires careful thinking.

Microfinance has several features that distinguish it from other kinds of financial services – commercial banking in particular – and that need to be taken into account in the design of regulatory systems. These features include:

- The aim of serving microenterprises and poor households;
- High unit costs of lending;
- The effort to bring physical access to banking services to underserved clients;
- Frequently undiversified portfolios;
- The start-up pattern of many MFIs as NGOs with a social mission;
- Differences in cost structures and fund sources among for-profit, cooperative, and NGO MFIs;
- The relatively low value of MFI portfolios in relation to that of national financial sectors as a whole;
- The market risk to the microfinance sector when MFIs are not properly managed and monitored.

Due to the special characteristics of microfinance, a range of legal and regulatory norms may challenge the sector to scale up and professionalize, or may simply stifle its development. In each of the cases discussed in this paper, some attempt was made to tailor financial licenses, prudential norms, supervision systems, and other rules affecting microfinance operations – in order to ensure orderly growth.[1]

It is well to ask what a new or amended regulatory framework will add to the existing environment for small-scale finance. As this paper will make clear, the policymaker is on the most solid ground when she or he sees the answer in terms of addressing market failures – such as information constraints, transactions costs, risk allocation, and weak governance – rather than in terms of making the financial sector an arm of anti-poverty programming. Any regulatory intervention should be justified as the most cost-effective and realistic method for achieving the policy aim. In this spirit, the paper analyzes illustrative experiences in this field.

[1] See Meagher (2002) for a fuller discussion of the issues involved in the development of regulatory frameworks for microfinance.

The IRIS Center was asked to carry out a study of relevant cases, with emphasis on those where some success has been achieved. In this paper, we address the cases of Bolivia, Brazil, Ghana, Indonesia, Mexico, the Philippines, and South Africa.[2] These countries illustrate a range of strategies and a breadth of experiences – including many successes. The goal of the case studies is to provide the reader a clear understanding of the microfinance initiatives in these countries, with emphasis on the legal/operational framework for MFIs and the regulatory and supervisory framework for the financial sector as it affects microfinance activities. The case studies examine the key features of microfinance regulation and supervision in each country, their evolution, and their impact. Aspects of the cases presented here are chosen and emphasized based on our understanding of the issues and priorities now faced in India.

This research was commissioned by Sa-Dhan, with the aim of bringing international lessons to bear on the development of microfinance regulatory development in India. Sa-Dhan initially identified the research issues based on the concerns faced in India, and selected relevant cases jointly with IRIS. Next, IRIS proposed a research plan and protocol for collecting and analyzing the information, essentially a list of questions and several categories of data and regulatory norms. IRIS brought together an international team of experienced researchers and experts in this field. The team implemented the research protocol in the seven cases mentioned above. This involved updating and interpreting findings from recent visits to five of the countries, as well as contacts with resident experts in those countries. Budget constraints limited us to two direct visits to the field, one in Mexico and the other in Indonesia, where local experts joined the team and played an important role in the research. The present paper represents our attempt to organize the findings in the most useful way for policymakers and stakeholders in India.

The report is organized around a set of substantive issues, with discussion of the situation in these countries brought in under the relevant headings. We proceed as follows. The next chapter sets the stage by describing the size and characteristics of the microfinance markets in the seven countries. Where possible, we present data on growth trends contemporaneous with the introduction of reforms. Chapter three looks at the development of the regulatory framework for microfinance, discussing both the main features of the framework and the rationale and influences affecting its adoption. The following chapter focuses on approaches to microfinance supervision. There, we deal with the style, scope, and location of supervisory powers and responsibilities – including delegated systems. Chapter five examines sector promotion and development efforts that are part of the regulatory framework – or complementary to it. This includes various efforts to encourage banks to increase their outreach to low-income clients and to offer microfinance services. The subsequent chapter addresses the implementation and impact of regulatory regimes for microfinance. Here, we deal with the related issue of how NGOs and other pre-existing microfinance providers cope with transformation to

[2] The material on Bolivia and Brazil was drafted by Robert Christen; the sections on Ghana and the Philippines by Joselito Gallardo; the material on Mexico by Pilar Campos and Patrick Meagher; the Indonesia parts by Sumantoro Martowijoyo, Kate Druschel, and Patrick Meagher; and the South Africa material by Patrick Meagher based on a joint ECI-African and IRIS assessment completed in 2005.

regulated status – and how the system accommodates this. Chapter seven concludes with a review of key findings and lessons.

2. Size and Characteristics of the Market

Any comparative study of regulation must address the "bottom line": how well did markets perform under the various legal regimes, and how well did the system protect other public interests? We begin by looking at the first of these – the markets. In the seven case study countries, we examine the patterns within the financial services market regarding the types of institutions that are serving poorer households and micro entrepreneurs, and the basic financial services they are providing. These patterns are influenced by the variety of regulatory approaches discussed later in the paper. Each case addresses the size of the microfinance market, the number and relative importance (market share, assets) of the different providers of microfinance services, and the various types of financial products and services offered in the microfinance market (credit, savings, fund transfer, insurance, etc. provided by MFIs and by other institutions serving the market).

We address these questions in particular: What have the recent trends been in terms of growth (including the scaling-up of institutions) and innovation? Is there much diversity or disparity, along regional or demographic lines, in terms of quality and access to microfinance services? What are the main sources of capital for microfinance activities? How do microfinance activities fit within the overall financial sector, in terms of relative size and involvement by licensed institutions? And finally, what do these trends tell us when compared with the regulatory decisions made in these countries? (See Annex I at the end of the paper for a comparative survey of markets before and after regulatory reforms.)

Bolivia

Bolivia's microfinance system has been much discussed. Here we provide an overview of the main features and trends, showcasing the development of a deep financial sector with large-scale outreach to low-income groups via microfinance services.

The financial system in Bolivia had total assets of US$ 4.838 billion as of December 2004, which if divided by its GNP, would indicate financial deepening of almost 60 percent. Total loans equaled 3.3 billion dollars, for a ratio of just over 40 percent. In general Bolivia's regulated financial system consists of 11 commercial banks (three foreign and 8 national), five Private Financial Funds (*Fondos Financieros Privados,* FFPs), two specialized microfinance banks, 6 savings and home loan societies, and 15 credit unions. In addition, there are 14 NGOs that offer microcredit, private finance companies and dozens of un-regulated credit unions that round out the entire financial sector. Microfinance is offered by some of each type of financial intermediary, except for commercial banks.

Regulated intermediaries that specialize in microfinance represent 12 percent of the total loan portfolio of the financial system, and 38% of the total number of clients. These are primarily FFPs (finance companies that specialize in lending to small and microenterprises), the two specialized banks, and some credit unions. Unregulated

intermediaries represent only 3 percent of the total loan portfolio but 30% of its clients. The commercial banks total 70 percent of the total portfolio but only 20 percent of the number of clients. Savings and loans and credit unions have less than ten percent of each. Today, regulated MFIs have a total of 145 branches in urban areas, and 61 in rural areas, while unregulated MFIs have an additional 106 in urban and 117 in rural areas. Regulated cooperatives have approximately 37 branches all over the country. This adds up to a total of 503 branches in a country with a population of 6 million, or one branch for every 12,000 of population.[3]

Private Financial Funds (FFPs)

Private Financial Funds, authorized in Bolivia's credit law but not introduced and regulated until 1995, have been the primary vehicle through which microfinance has been mainstreamed into the regulated financial sector in Brazil. FFPs can offer a limited range of activities including leasing, consumer credit and other types of financial services (excludes checking accounts, credit cards, foreign trade, factoring, trusts, and guarantees), which are not limited to only include microenterprises.

Table 1 below provides a snapshot of the various financial institutions and their share of the market.

Table 1: Composition of the Bolivian Financial Sector

Institutions	No.	Total Loan Portfolio				In Micro credit (% Portfolio)	In Micro credit (% Clients)	Change 2003-04 %
		Total Assets USD 000	%	No. Clients	%			
Regulated MFIs	7	409,234	12%	255,534	38%	78.4%	74.76	27.9%
NGOs	14	94,664	3%	199,806	30%	85.0%	98.47	12.8%
Commercial Banks (1)	11	2,311,028	70%	134,091	20%	0.5%	1.38	-6.1%
Credit Unions (open)	15	210,618	6%	59,144	9%	40.2%	40.33	5.8%
Savings and Loans	6	276,433	8%	23,781	4%	4.5%	6.57	2,1%
Total Financial System	**53**	**3,301,977**	**100%**	**672,356**	**100%**	**15.5%**	**64.29%**	**1%**

(1) Does not include BancoSol or Banco Los Andes Procredit.
Total clients as reported to INFOCRED S.A.
Source: Analysis of data from the Bolivian Superintendency of Banks and Financial Institutions, *Boletín Informativo ASOFIN, Boletín de Autorregulación de FINRURAL*, and information provided by INFOCRED S.A. in Fernando G. Prado and Katya G. Collao, "La industria de las Microfinanzas en Bolivia: Diagnostico al 2004", May 2005.

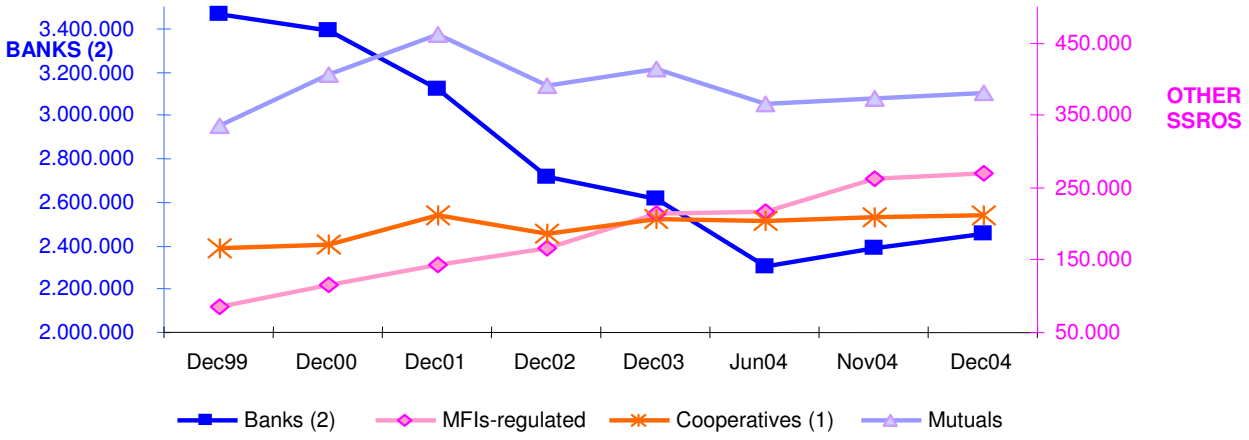
Types of Financial Services provided

While the development of microfinance has been credit driven, during the last few years regulated financial intermediaries dedicated to providing services to low income clients have begun to mobilize increasingly important amounts of savings from the general

[3] Prado, pg 31

public. Currently as much as 60% of microfinance loan portfolios are funded by deposits. This represents a fundamental broadening of their funding base, but more importantly, an increased recognition that savings are an important service in its own right. Most notably, this increase has come at a time when there has been widespread disintermediation from traditional commercial banks, which have seen both the absolute and relative share of the total national deposit share fall drastically (see Figure 1).

Figure 1: Evolution of Public Deposit-Taking (in US$)



Source: ASOFIN, "Presentación Institucional 2004", La Paz, March 2005. in Fernando G. Prado and Katya G. Collao, "La industria de las Microfinanzas en Bolivia: Diagnostico al 2004", May 2005.

Growth in the sector

Microfinance has been developing in Bolivia for almost twenty years and its evolution can be divided into distinct stages. The first stage is when a number of what later came to be the leading MFIs were founded in (1986) and operated as microcredit NGOs for a number of years. In 1992, the largest of these, PRODEM, applied for and obtained a license to operate as a private commercial bank. At that point the major four organizations were serving about 50,000 clients.

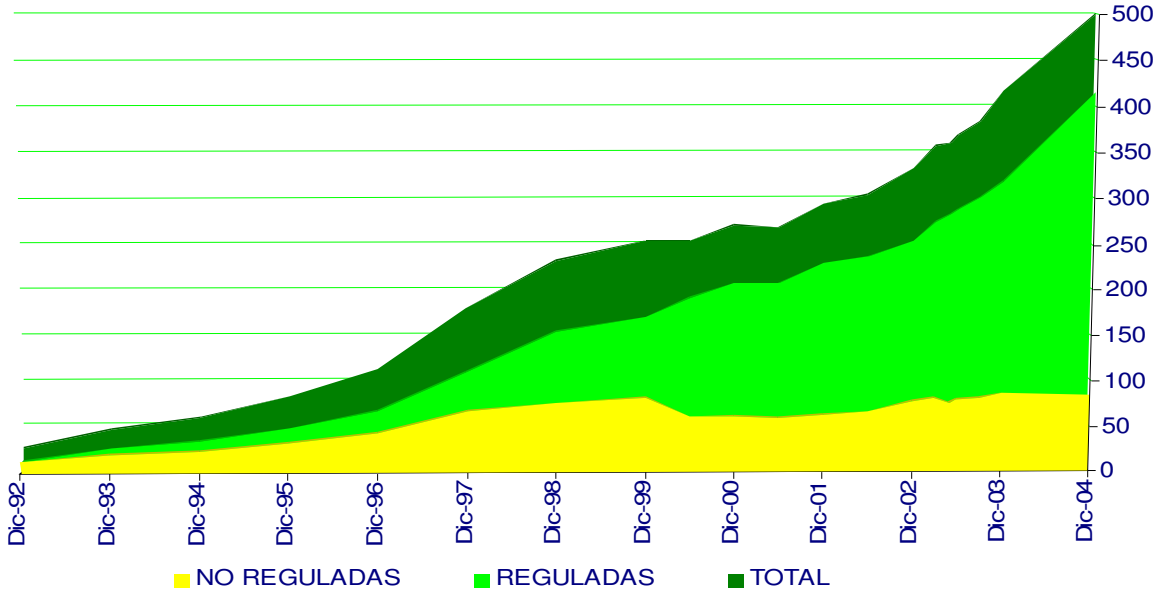
The second stage was the transformation of the leading NGOs into regulated financial intermediaries, a process that began in 1992. Over the next several years, the industry achieved relatively high growth rates, but also began to suffer from significant systemic risk due to the over-indebtedness of a large number of clients. During this period the Bolivian banking authorities generated the special non-bank license for finance companies (FFP) and the accompanying regulations, made their first rounds of adjustments to these, and faced their first serious systemic crisis (in the microfinance part of the financial sector).

The third stage of microfinance development in Bolivia begins in 1999 with a generalized macroeconomic crisis that seriously affected the sector, coming as it did on the heels of

the increasing levels of over-indebtedness of the previous years. The number of clients with microcredit operations fell dramatically for a few years (though the volume kept increasing as average loan sizes grew in response to competitive pressure, and profit motives). Lately, the microfinance sector seems to have finally consolidated after the crisis, and growth rates in terms of both clients and volume of operations on both sides of the balance sheet. During this period there have not been significant changes in the regulatory structure, rules and regulations, or the composition of the major players offering microfinance, especially when compared to the previous phase.

Figure 2 depicts the evolution of the microfinance loan portfolio in Bolivia.

Figure 2: Evolution of the Total Microfinance Loan Portfolio (US$ million)



Source: Fernando G. Prado and Katya G. Collao, "La industria de las Microfinanzas en Bolivia: Diagnostico al 2004", May 2005

Brazil

The story of microfinance in Brazil has mostly been one of unfulfilled promise. There are approximately 10 to 15 million households in the informal sector in the country, yet the microcredit industry has reached fewer than 300,000 of these households, or 2 to 3 percent of the total potential market. This is despite the fact that the first microenterprise credit program in the continent was started in Recife, Brasil in 1972, and despite the fact that the government has undertaken a number of initiatives to stimulate the sector over the past two decades. Growth has been slow for the last 25 years and only recently has begun to accelerate more rapidly.

Types of Financial Institutions

In Brazil, there are roughly four types of institutions offering microfinance services. Only one of these organizations is offering anything besides credit services. They are:

- State-owned development bank
- Public Interest Civil Society (OSCIPs)
- Microenterprise Credit Society (SCMs)
- Commercial banks

In 1997, the state-owned development Bank Banco do Nordeste opened its Crediamigo program. In its first full year (1998) Crediamigo took on as many clients as all other MFIs combined. Today, microcredit in Brazil is dominated by the Crediamigo program which currently reaches around 150,000 clients and features a total portfolio of just under US$ 60 million. At around US$ 250, it has one of the lowest average loan balances in the region, roughly 6 percent of GNP per capita. The program has been profitable for several years, and recently has recovered all up front investment in its startup.

As will be discussed in the development of regulatory status below, in the late 1990s and early 2000s, a political movement was afoot that placed micro-credit at the center of civil society development. This led to the creation of two distinct type of microcredit organizations, the OSCIPs (*Organização da Sociedade Civil de Interesse Público*) or Public Interest Civil Societies, and SCMs (*Sociedades de Crédito ao Microempreendedor*) or Microenterprise Credit Societies.[4] The OSCIPs can have a range of objectives, and are deemed to be not-for-profit organizations. The SCMs are formal for-profit financial entities regulated by the Central Bank of Brazil.

The specialized microfinance companies (SCMs) grew in number to about 40 in 4 years and then leveled off. Their total portfolio has continued to grow at substantial rates, between 30 and 50 percent annually, but their overall average size remains tiny at just over 300,000 U.S. dollars each. Forty-five percent of clients served by SCMs belong to the top three institutions and 76 percent belong to the top 10 SCMs, indicating a substantial concentration in the sector in relatively few entities. In general, these organizations are highly profitable (ROA 6-10%), charge very high rates of interest (80% apr), have high loan delinquency (PAR >30 days - 30%), and high write-offs. In this, they look more like consumer finance companies than the typical best practice microfinance organization, even though they are prohibited from making consumer loans by law. Indeed, many are subsidiaries of commercial entities engaged in factoring or related business.

[4] Law 9.790 of March 23, 1999, which came to be popularly known as the New Law of the Tertiary Sector, established the OSCIP. Decree No 3100 of June 30, 1999 provided details on its authorization, functioning and supervision. Reporting requirements are minimal, but for lines of credit through public entities, external audits are required. For details see especially 'OSCIP - *Organização da Sociedade Civil de Interesse Público - A Lei 9.790/99 como Alternativa para o Terceiro Setor. Comunidade Solidária*. Brasilia, July 2001.

Table 2: Microfinance Institutions in Brazil (1998-2005)

	1998	1999	2000	2001	2002	2003	2004	2005
CrediAmigo								
Clients (Nos. '000)	21.8	35.3	58.0	85.3	119.0	138.5	162.8	180
Active Portfolio (US million)	7.5	8.7	17.8	25.3	31.0	25.7	35.0	37.7
BNDES' Portfolio[1]								
MFIs (Nos.)	20	20	29	31	31			
Clients[1] (Nos. '000)	19.4	24	29.8	36.0 (35.3)	38.0 (37.0)			
Active Portfolio[1] (US million)	14.6	12.8	17.8	18.4 (17.5)	17.8 (16.5)			
Total Clients (Nos. '000) (these items)	41.2	59.3	87.8	121.3 (120.6)	157.0 (156.0)			
Total Active Portfolio (these items, US$ mln)	5.0	6.9	10.3	11.7 (11.4)	15.9 (15.5)			

[1] Data refers to microfinance institutions supported by BNDES. Numbers in parentheses show numbers net of SCMs (Microcred, Socialcred and Rótula).
Source: World Bank staff estimates based on data provided by the Central Bank of Brazil, Banco do Nordeste do Brasil and BNDES in Kumar, Anjali, "Access to Financial Services in Brazil", The World Bank, Washington D.C, 2005.

Types of Financial Services provided

It is significant, however, that these three types of institutions only offer credit services to poor households and micro entrepreneurs. The Brazilian government began to recognize the bottleneck this created and in recent years has promoted a number of regulatory amendments that have pushed commercial banks into the market.

In 1999 and 2000 a number of laws and resolutions were passed to increase access to financial services on the part of the general population, especially lower income sectors. Banks were allowed to establish 'Banking Correspondents,' for example, in order to widen access to financial services. With these changes, a number of commercial banks have stampeded the market and begun offering a wide range of services to poorer households, especially through the banking correspondent relationships.

Growth in the sector

If we subtract the Crediamigo program from the national total, the other 180 MFIs (minus any commercial banks) reach a total of 350,000 clients, for an average per institution of less than 2,000 clients. In fact, the largest half dozen MFIs have several thousand clients each and the remaining 170+ MFIs typically have about one thousand clients each. Growth in the sector, outside of the Crediamigo program has largely come from the addition of new institutions in new markets, rather than from the growth of older programs in their core markets. The overall growth rates of the leading 20 institutions

increased on average about 14 percent per year over the past half decade, though many traditional programs have actually reported declines in the number of clients served.[5]

Given the very slow growth in outreach among the MFIs, to fully reach the sector with NGOs would require the founding of several thousands of new entities. Given that only 180 have been founded over the past 5 years, it could take decades to reach significant market coverage. In addition, the subsidy to establish new organizations in Brazil (concessional interest rates for wholesale funding by a state development bank) is quite substantial. Sufficient funds have not been available for this, certainly not at the level required for the establishment of thousands of individual units. The latter would require sustainable commercial sources of funding, which have not been forthcoming.

Ghana

Despite many efforts to extend access to finance, Ghana still has a shallow financial system, with a ratio of M2[6] to GDP at 20.7 %. Access to financial services from banks is limited. For all of Ghana there is only one bank outlet for every 81,850 persons. In contrast, access is almost four times better in the Greater Accra region, with one bank branch for every 21,000 persons.[7]

Types of Financial Institutions

The Ghanaian regulatory approach has fostered a wide range of formal and informal microfinance institutions (MFIs) – rural banks (RBs), savings and loan companies (S&Ls), credit unions (CUs), non-governmental organizations (NGOs), community-based organizations (CBOs), small savings-credit associations and informal savings collectors and moneylenders.[8]

Commercial Banks

The commercial banking system, consisting of 20 banks, is dominated by a few major banks. It reaches only about 5% of households, most of which are excluded by high minimum deposit requirements. The three largest commercial banks control 55 per cent of the total assets of the banking sector. The five smaller commercial banks operate on a much smaller scale. The universal banks, merchant banks and development banks together share about 30 per cent of the total asset base of the banking sector. Ghana Commercial Bank alone holds about 25 per cent of total assets and 20 per cent of deposits. Foreign investors hold about 53 per cent of shares in eight (8) commercial banks and three (3) banks are state owned.

---

[5] Goldmark July 2002

[6] A measure of the money supply including currency, demand deposits, time and savings deposits, and non-institutional money-market funds.

[7] The population of Ghana was 21,030,000 with the capital city Accra at 1,000,000 and the Greater Accra region at 3,000,000 in 2002.

[8] For more information on financial performance of banks and rural banks, see the background document on Ghana.

A large proportion of the money supply (about 60%) circulates without intermediation by the commercial banking system. Thus the rural banks, savings and loans companies, and the semi-formal and informal financial systems play an important role in Ghana's private sector development and poverty reduction strategies.

Rural and Community Banks (RCBs)

The total assets of rural banks are equivalent to about 5.5% of the total assets of deposit money banks. Rural and Community Banks are unit banks owned by residents of the rural community through purchase of shares and are licensed to provide financial intermediation in the rural areas. Rural banks, created in 1976 to rapidly expand financial services in rural areas, have had a rough history. By 1992, only 23 of the 123 RBs qualified as "satisfactory" in 1992 when the classification started. However, this need was addressed with World Bank assistance and by 1996 the number of RBs classified as "satisfactory" had increased to roughly 50%. The number of RBs reached a peak of 133 in 1998, but fell to 111 in 1999 with the closure of 23 distressed banks and the commissioning of one new bank. These closures sent a strong signal to the remaining rural banks to maintain or improve their operations in order to achieve satisfactory status. Between 1999 and 2001 there was 64% increase in the number of satisfactory banks.

Savings and Loan Companies

After an NBFI Law was passed in 1993 that created this category of institution, the BOG eventually issued licensing requirements. The initial minimum capital was quite high, but rapid inflation solved this problem and by 1998, there were seven institutions. Minimum capital was raised in 2001 to combat inflation, however, which has stymied new entrants as they look for additional sources of capital.

The principal promoters or shareholders of S&Ls are entrepreneurs with no experience in financial services other than being customers, but with surplus funds and high motivation. The S&L category has also made possible the entry of private investment to serve market niches on a smaller scale than would be required for a commercial bank. One S&L was established to work primarily in local markets in collaboration with traders and susu collectors. The German firm Internationale Projekt Consult (IPC) also created an S&L to implement microfinance, and the Opportunity International affiliate has also initiated plans to transform into the S&L form.

Credit Unions

Credit Unions are cooperative societies offering savings and loan facilities exclusively to members. The first credit union was established at Jirapa in Upper West Region in 1955 by Canadian Catholic missionaries. By 1968, when they were brought under legislation and the Credit Union Association (CUA) was formed as an apex body, there were 254 CUs (64 rural) with some 60,000 members. At the end of 2001 CUA had 232 affiliates with 96,052 members, of which 170 were Credit Unions with a total of 86,500 members and 62 were "study groups" or pre-cooperatives with 9,532 members. Credit unions remain very small in Ghana with an average of only 414 members per CU, although their average loan size of US$153 is well above that for African MFIs, as well as for RBs .

Apex Institutions

The Association of Rural Banks (ARB) was founded in 1981 as an NGO with voluntary membership, and at the end of 2001 counted 115 members. The association was formed in response to the need to promote and strengthen the rural banking concept, through advocacy and training. The ARB provides training to directors and staff of RBs in Governance and Leadership, Management and Operations.

ARB has no statutory authority and influences its members through persuasion and training seminars. The association initiated the proposal for the ARB Apex Bank, licensed in 2001 to perform apex financial services for RBs and, eventually, to take over some supervisory and training functions.

Ghana's Credit Union Association (CUA) is a private association of cooperative societies, independent of the government. While CUA has attempted to establish a financial reporting system for its members, the quality of the data is poor and little used for management purposes by the member societies, whose capacity is quite limited.

The Ghana Microfinance Institutions Network (GHAMFIN) was established in the late 1990s by as a network of MFIs. Its membership cuts across the formal, semi formal and informal institutions and includes consultants, researchers and service providers to MFIs. Although not all MFIs are members, it does include the major associations that represent key groups such as the ARB, CUA, and cooperative federation of susu collectors. GHAMFIN aims to serve as the central point for knowledge, monitoring and performance benchmarking for the industry. These apex institutions have also helped to compile information on the general outreach of all financial institutions in Ghana.

Table 3: Market presence in Ghana
(number of branches, offices and retail outlets, Dec. 2001)

Type of Bank / Financial Institution	Total No. of Institutions	Head Office	Other Offices
Commercial and Other Banks	20	20	324
Commercial Banks	7	7	216
Development Banks	3	3	68
Universal Banks	7	7	37
Merchants Banks	2	2	3
Apex Bank (ARB)	1	1	*No data available*
Rural Community Banks	114	114	*Not permitted*
Non-Bank Financial Institutions	39	39	*No data available*
Savings & Loan Companies	12	12	*No data available*
Building Societies	2	2	*No data available*
Leasing Companies	5	5	*No data available*
Others	20	20	*No data available*
Credit Unions	232	232	*Not applicable*
NGO MFIs	30 - 40	*No data available*	*No data available*

Sources: Bank of Ghana website; Department of Cooperatives Annual Report 1999-2000; William Steel and David Andah, "Review of Rural and Micro Finance Regulation in Ghana: Implications for the Development of the Industry", World Bank, 2003.

Types of Financial Services provided

Rural banks and S&Ls provide "narrow" banking services – a limited range of deposits and loans. S&Ls and RBs are permitted to offer only savings and time deposits. RBs have begun relying on microfinance techniques for savings and credit. Loans are generally short-term (4-6 months) with weekly repayment, averaging around $50-75 but ranging up to several hundred dollars, with compulsory up-front savings of 20% retained as security for the loan, complementing group or individual guarantees as the other principal form of security (see Box 1 for four interrelated methodologies).

Box 1: Types of Group and Individual Savings and Credit Programs

Group savings with credit: A group of members (whether pre-existing or formed for this purpose) open a joint bank savings account and mobilize initial savings deposits to qualify for a loan. Group savings may be used as security against loans, and also are used to invest in T-bills for the group. Groups usually are made up of 3-4 sub-solidarity groups.

Group and individual savings with credit: Group members contribute to both a joint group account and their individual accounts. The group may be a "village bank" of 25-40 members; or as small as 5 members. While both individual and group savings accounts are used as collateral, the individual account includes the member's additional personal savings. Loan repayments are made by individuals but handled through the group account. Examples include Nsoatreman, Bosomtwe, and Lower Pra RBs.

Individual savings with group credit: Individuals lodge their savings through the group, which receives a loan for distribution to members after a qualifying period and collection of the required level of savings, and they continue to save into their individual accounts as they repay the loan. The group handles the collection of savings and repayments, acts as the interface with the loan officer, and bears group responsibility for recovery (though the loans are made to individual members). Example: Freedom from Hunger's Credit with Education program, operated through Brakwa, Lower Pra, Nsoatreman and Nandom RBs, Bulsa Community Bank, and Women's World Banking Ghana (Quainoo 1997, p. 47).

Individual savings with credit: direct lending to individuals, either those who had established a credible history as a member of a group but who need larger or separate loans, or in cases where a group approach is not suitable. Examples: Lower Pra RB; Nsoatreman RB's District Assembly Poverty Alleviation Program.

Source: Chord 2000.

Some RBs have developed linkages with informal savings (*susu*) collectors or community-based organizations (CBOs) associated with donor programs. RBs also use NGOs to perform ancillary services. Growing linkages between RBs, NGOs, CBOs and *susu* collectors provide an important foundation for greater outreach to rural poor clients. The RBs provide a decentralized network of licensed financial institutions in rural areas and the other MFIs provide grassroots orientation that permits reaching poor, remote clients with small transactions. The S&Ls' loan products are similar to those of RBs, and they have also instituted links with susu collectors and traders.

To facilitate savings collection, some RBs (such as Akwapem and Lower Pra) have introduced Mobile Banking: staff visit rural markets on certain days to collect savings and provide loans to groups or individuals with guarantors. They consider this to be a profitable formal adaptation of the *susu* system.

As regards financial services available from credit unions, individual members make predetermined periodic deposits[9] into their accounts and may borrow up to two times their savings balance. Most CUs require borrowers to provide security, in addition to being in good standing as regards their deposit commitments. The additional security is in the form of a guarantee from another member of the credit union who has adequate uncommitted savings balance. Some CUs use the *susu* method in the collection of deposits and loan repayments. CUA is an innovator in providing both credit insurance (which pays off the outstanding loan balance in case of the death of a borrower) and a contractual savings program (which matches savings, up to a limit, if held at death or to maturity).

Indonesia

Indonesia has a century-long history in microfinance that dates back to Dutch colonial times at the close of the 19th century. There are many varieties of formal, semi-formal and informal financial institutions, as well as subsidized government programs offering loans linked to sector development or poverty alleviation. NGOs play a less significant role in microfinance in Indonesia than in virtually any other country in the world.

Types of Financial Institutions

The Indonesian financial sector comprises commercial banks, rural banks, non-bank financial institutions (leasing, factoring, consumer financing, credit card), pawnshops, and various semi-formal and informal microfinance institutions (MFIs). Currently, a large number of institutional types offer microcredit, which Bank Indonesia defines as a loan below roughly US$ 5,000 (Rp. 50 million), provided by formal and semi-formal financial providers. (Indonesia Country Profile, BWTP.)

As of the end of 2001, the total number of MFIs was 52,809 (see Table 4 below), or around 7 times the number of branches of commercial banks. These MFIs collectively

[9] CUA regulations state a minimum of ¢20,000 (US$2.70) for a workplace society and ¢10,000 (US$1.40) for a community-based society.

served more than 18.6 million people (8% of the population), lent out $2,057 million (6% of bank lending) and mobilized savings at $3,102 million (3% of bank deposits). The microfinance Units of *Bank Rakyat Indonesia* (BRI) had the largest amount of deposits (80.5%) and the largest number of depositors (17 million), the largest share of outstanding loans (49.2%) and the second largest share of borrowers (10.2%). Despite these impressive numbers, there is much disparity among the regions, as most MFIs are located in western Indonesia, especially Java and Bali, and fewer in the eastern provinces. (Additional detail is provided in Table 7 at the end of this chapter).

Commercial Banks (including BRI Units)

The BRI Units (formerly *unit desa*) were established originally to implement a government-subsidized agricultural credit program. They were subsequently re-organized to offer commercial microfinance at scale, and they handle the largest portion of microfinance in Indonesia. (See the discussion of the BRI Units in chapter six below.)

Other commercial banks are following the BRI example and trying to enter the microfinance market using this model. At least two commercial banks have attempted to set up networks similar to the unit desa system, especially after the late 1990s financial crisis. While the Unit Desa average loan size is roughly US$ 75 (750,000 Rps.), these banks have not yet reached this far down.

Rural Banks (BPRs and BKDs)

There are two main types of rural banks in Indonesia. The first are BPRs, which are mostly privately owned, although some do participate in government funding schemes or maintain linkages with commercial banks. These rural banks were established in law in 1988.

Prior to that, many institutions operated as BKDs, or "village banks,"[10] all of which receive their seed capital from either village landowners or the village treasury. These BKDs are supervised by BRI and licensed by the Ministry of Finance. When the central bank established the BPRs in 1988, it was intended that the thousands of small BKDs would consolidate into large BPRs and then fall under the supervision of the central bank. This has only been happening in a piecemeal manner (see the discussion below, particularly in chapter six).

For these rural banks, most of their services are loans that are provided without any collateral, except for a 5% savings requirement. These banks do have a harder time collecting savings, however, due to competition with commercial banks. Most of the clients of these rural banks have lower income than BRI Unit clients.

[10] We use the term "village bank" for convenience, but it should be noted that these institutions and their operations are wholly distinct from the "village banking" approach to microfinance.

Non-Bank MFIs (LDKP)

Non-Bank MFIs, or LDKPs, were established by provincial or district level governments as microfinance providers. They are directly owned by government authorities and receive seed capital from both the local and central government (Ministry of Finance). Currently, most LDKPs finance their operations from accumulated capital. (They are now required to transform into BPRs – see the discussion below).

Credit Cooperatives

The credit cooperative system operates much as it does elsewhere, with funding through members' savings. However, government-sponsored village coops that were promoted during the Suharto administration were spoiled by government subsidies, and these institutions are in poor financial health.

Islamic MFIs (BMTs)

There are, in addition, a number of Islamic MFIs that have begun offering *Syariah* financial services (based on Islamic law, *shari'ah*) to low-income clients.

NGOs

There are very few NGOs operating microcredit services in Indonesia, although the few that do tend to be Grameen replicators. There is some ambiguity in the 1998 amendments to the Banking Law regarding whether these institutions operate legally.

Table 4: Microfinance Institutions in Indonesia

TYPE	UNITS/ OFFICES		BORROWERS		OUTSTANDING LOANS		DEPOSITORS		DEPOSITS		TOTAL ASSETS	
	No.	%	('000s)	%	(US$m)	%	('000s)	%	(US$m)	%	(US$m)	%
Comm.Banks' micro-loans, (6/05)[11]	8,069	14.9	14,271	48.0	14,036	82.8	n.a.	n.a	n.a.	n.a.	138,889	98.0
- BRI Units (4/05)[12]	4,046	(7.4)	3,211	(10.8)	2,134	(12.6)	31,271	72.0	3,288	68.8	n.a.	
Rural Banks (BPR):	4,482	8.3	395	1.3	21	0.1	466	1.1	51	1.1	32	0
- BKDs (6/05)[13]	2,062	3.8	2,331	7.8	1380	8.1	5,864	13.5	1223	25.5	1,841	1.3
- Non-BKD (6/05)[14]												
Non-Bank-Non-Coop(LDKPs) (7/04)[15]	1,620	3.0	1,326	4.4	45	0.3	n.a.	n.a.	42	0.9	n.a.	n.a.
-BKK (12/04)[16]	160		143.		26	0.2	295		18		40	
Credit Coop (12/04)[17]	1,596	2.9	885	3.0	116	0.6	481	1.1	33	0.7	139	0.1
- Credit-Unions (12/04)[18]	1,041		n.a.		958		480		0.94		1,227	
S & L Units (12/04)[19]	36,466	67.1	10,524	35.4	1,349	7.9	5,016	11.6	145	3.0	751	0.5
- BMT (7/04)[20]	3.038		1,200		20		n.a.		26		n.a.	
NGO-MFI (GB Replications)[21]	21	0	20	0.1	0.52	0	20	0	0.3	0	0.5	0
TOTAL	**54,316**	**100**	**29,752**	**100**	**16,948**	**100**	**>43,413**	**100**	**4,782**	**100**	**141,653**	**100**

Sources: see footnotes.

Table 4 above provides an overview of the performance of Indonesia's MFIs. A few clarifications are in order. It should be noted that the definition of micro-loans by BI includes loans up to US$5,000 (Rp. 50 million). In the past commercial banks were subject to a priority sector lending quota to reach SMEs (defined as loans under US $5,000), but that restriction has been lifted. BI currently requires banks to create their own lending quotas as part of their approved business plans. The average micro-loan from commercial banks presently is $983, or around 180% of income per capita. This level is hardly "micro" in comparison with the BKDs' average loans of $53, or one-tenth of per capita income. Note that the commercial banks' deposit figures were left out of

[11] BI-TPP Biro Kredit, Statistik Bulanan Kredit Mikro, Kecil dan Menengah (UMKM), Sept. 2005
[12] Gema PKM, Keuangan Mikro di Indonesia, 30 April 2005
[13] BRI, Laporan Kegiatan BKD Triwulan II 2005 (report to BI)
[14] BI-DPBPR, Informasi BPR, 30 Juni 2005
[15] Estimate by BI-DPBPR in Kompas, July 14, 2004
[16] BPD Central Java, Laporan Singkat Perkembangan BKK, Dec. 2004
[17] State Ministry of Cooperatives and SME, Data Perkembangan KSP dan USP, Dec. 2004
[18] Inkopdit, Data Perkembangan Kopdit per BK3D, 31 Dec. 2004
[19] State Ministry of Cooperatives and SME, Data Perkembangan KSP dan USP, Dec. 2004
[20] Estimate by BI-DPBPR in Kompas, July 14, 2004
[21] Estimate by Sumantoro Martowijoyo, based on information from FREN, association of Grameen Bank replication

this figure, as their deposit incomes do not constitute the 'microfinance' segment of the market.

Types of Financial Services provided

The financial products offered by these institutions are mostly loans and savings, with mandatory savings being the greater portion in the portfolios of BKDs, LDKPs, and coops. BPRs and the BRI Unit Desas provide both savings and time deposits, and the BRI Unit Desa savings product has proved immensely popular. None of the institutions provide insurance services, and the only one to offer any type of money transfer is the BRI Unit system.

Mexico

The financial sector in Mexico is dominated by commercial banks, which have shown little interest in microfinance. Bank savings are estimated to equal less than 10% of GDP; as little as 6% of rural population has access to accounts in financial institutions, as compared to 15-25% in urban areas (CGAP 2005).

The NBFIs that take deposits have historically been cooperatives, although NGOs also do so to a lesser extent. Legal changes in 2001 brought these under common standards, creating two institutional types of "Popular Savings and Credit Entities" (*Entidades de Ahorro y Credito Popular*, or EACPs) to offer microfinance services, especially deposit taking. (See Table 8 at the end of this chapter for data on Mexican microfinance.)

Types of Financial Institutions

There are approximately 500 institutions in Mexico that provide savings and credit services to low and medium-income families, the majority of whom do not have access to services provided by mainstream banks. These institutions serve around 3 million customers, with roughly 1600 branches around the country. The apex institution BANSEFI also provides savings services to an additional 2 million customers in 500 branches across the country.[22]

Banks

The health of the banking sector and its regulatory governance have recovered their strength after the financial crisis of the mid-1990s. There are currently 29 commercial banks operating in Mexico, with some 7,997 branches. Their deposit accounts total 37.4 million, net capitalization U.S. $23.9 billion, total liabilities U.S. $186.4 billion, and total assets U.S. $211.9 billion.[23]

One aspect of more disciplined governance has been the maintenance of high barriers to banking entry, and consequently a relatively small number of banking licenses. These

[22] Because the 2001 Law was the first time any type of MFI was brought under a formal regulated structure, no data exists on these institutions until very recently.
[23] CNBV, September 2005 figures (www.cnbv.gob.mx).

conditions, along with the stringency of prudential standards, appear to have reinforced soundness in the banking sector – at the same time discouraging bank 'downscaling' into microfinance (Trigo et al 2004). Another disincentive for both banks and MFIs has been the proliferation of programs providing directed or subsidized credit to rural areas (Gonzalez-Vega 2004), although there have been significant efforts to rationalize such programs in recent years. These concerns have not stopped some innovators from seeking bank licenses for purposes of providing microfinance services (see the discussion of Banco Azteca and Compartamos in part 5 below).

Popular Savings and Credit Cooperatives Societies (SCACPs)

These are legally recognized as part of the financial system in the 2001 Popular Savings and Credit Law and are member-based cooperatives. These societies have existed for a number of years and are quite popular throughout Mexico; they will now have to obtain an EACP license under the new law.

Popular Financial Societies (SOFIPOs or SFPs)

The 2001 Law on Popular Savings and Credit also created space for non-member-based institutions to gain a license to provide savings and credit services to poor households. It is meant to be a pathway for NGO transformation. There is a 10-person minimum for the number of owners, however, that is proving an obstacle for institutions wishing to obtain such a license.

Other Non-Bank Financial Institutions

There are several other types of NBFIs in Mexico, including Savings and Loan Societies (which must be replaced by one of the two institutions above by 2008), credit unions (which do not capture savings), and Limited Financial Societies (which are not authorized to capture savings).

Types of Financial Services provided

The institutions to be licensed as EACPs will offer both savings and loans. Banks are the only institutions offering more extensive services than savings and loans, although BANSEFI is managing a money transfer system for the organizations being licensed under the 2001 Law on Popular Savings and Credit. This system is providing a much safer and more efficient channel for remittances, a critically important source of household income support for many Mexicans.

Growth in the sector

Because the implementation of the 2001 Law has been delayed as supervisory matters are sorted out (see section on "Approaches to MFI Supervision"), it is not yet fully clear how these regulatory changes will affect the sector. The sector has grown 20% annually since the law was approved – but there is insufficient evidence to attribute this positive result to the new law's impact. The reform process may have contributed, but a host of other factors did so as well.

The Philippines

The Philippine experience in microfinance provides a number of valuable lessons for other countries striving to integrate microfinance into the financial sector. Market-oriented and commercially-focused microfinance in the Philippines is a relatively new development in comparison to a number of other countries in the Asia-Pacific Region, Latin America and even Africa. Despite this, these institutions have achieved strong outreach.

Types of Financial Institutions[24]

The main institutional providers of microfinance services – NGOs, thrift and rural banks, and cooperative financial institutions (mostly credit unions and multi-purpose cooperatives with savings and credit operations) – are estimated to have a total outreach of about 1,500,000 clients. Each category appears to have a more or less equal share of the total client base: NGO-MFIs with about 500,000, thrift and rural banks with about 550,000 and CFIs with about 450,000. Table 5 summarizes the available data on outreach in terms of number of borrowers, size of loan portfolio and volume of savings deposits of the main institutional providers.

Table 5: Main types of institutions providing microfinance services (Philippines)

Main Institutional Types	Number	No. of Branches	Microfinance Loans (millions)	No. of Borrowers	Savings Deposits (millions)
Supervised by BSP					
Micro Finance Thrift Banks	2	1	US $2,054	27,970	US $889
Micro Finance Rural Banks	4	8	US $4,877	45.493	US $4,330
Rural Banks	149	461	US $42,318	393,102	US $12,243
Cooperative Rural Banks	29	57	US $10,804	93,570	US $2,786
Regulated but not supervised by BSP					
Government Finance Company	1	Not available	US $51,215 #	1,396,346 *	Not permitted
Credit Union/Savings-Credit Cooperatives	Breakdown not available	Breakdown not available	Breakdown not available	400,000 (estimated)	Breakdown not available
Not regulated/ supervised by BSP					
NGO Micro Finance Institutions	17	Breakdown not available	US $40,752 §	532,747 §	Not permitted

*Sources of information: Bangko Sentral ng Pilipinas website – "Snapshot of Microfinance in the Banking Sector"; Microfinance Council of the Philippines – "Performance Monitoring Report on MCPI Members, December 31, 2004; Cooperative Development Authority website – "Status of the Cooperative Movement as of December 31 2003". Notes: # = wholesale loans to partner MFIs (Thrift Banks, Rural Banks, Cooperative Banks, Credit Unions, NGO MFIs, Lending Investors); * = number of active borrowing clients of partner MFIs; § = for the 17 top NGO MFIs that are members of MCPI.*

[24] For more information on the performance of these institutions, see the chapters that follow.

Thrift Banks[25]

Thrift Banks (TBs) are private shareholding banks with minimum capitalization ranging from Php 64 million for those with head offices outside Metro Manila, and ₱ 400 million for those with head offices within Metro Manila. The functions of TBs are similar to those of the commercial banks (KBs, minimum capitalization ₱ 2.8 billion), only in smaller scale. At least 40% of the TB's voting stock (60% for KBs) is required by law to be owned by Filipino citizens.

Rural Banks

Rural banks (RBs) are private shareholding banks with minimum capitalization ranging from ₱3.2 million in less developed municipalities to ₱ 32 million in the NCR. RBs were created by law primarily for the purpose of meeting the normal financial requirements of farmers, fishermen, or farm families, as well as cooperatives, merchants, private and public employees. All capital stock of RBs are required by law to be fully owned by Filipino citizens.

Cooperative Banks

Cooperative banks are banks established by primary and secondary/tertiary cooperatives for the main purpose of providing financial and credit services to cooperatives. Their minimum capitalization ranges from ₱10 million for Coop Banks in the cities of Cebu (Central Visayas) and Davao (Southeastern Mindanao); ₱ 20 million for local Coop Banks or those in Metro Manila; and ₱ 200 million for national Coop Banks. The capital stock of Coop banks should be 100% fully owned by Filipino citizens.

Credit Cooperatives

Credit cooperatives (coops) are classified in the BSP Manual of Regulations as non-bank financial intermediaries (NBFIs) although they are registered and supervised by the Cooperative Development Authority (CDA). Established under Republic Act (RA) 6938, coops may be organized by at least 15 persons who are citizens of the Philippines, having a common bond of interest and are residing or working in the intended area of operation. According to RA 6938, the primary objective of the cooperative is to provide goods and services to its members and thus enable them to attain increased income and savings, investments, productivity, and purchasing power and promote among them equitable distribution of net surplus through maximum utilization of economies of scale, cost sharing and risk-sharing without, however, conducting the affairs of the cooperative for any missionary or charitable purposes. A credit union or credit cooperative is a type of cooperative that specializes in providing financial services to its members. A cooperative may exist up to 50 years from the date of registration. The required minimum paid-up share capital amounts to US$ 37 (Php 2,000) per cooperative.

[25] Information for types of financial institutions from *BSP Manual of Regulations for Non-Bank Financial Intermediaries*, revised as of December 2003

Lending Investors

Lending investors (LIs) are non-bank financial intermediaries (NBFIs) governed under the BSP regulations for NBFIs. Lending investors are financing companies established by 20 or more lenders. LIs borrow money (e.g. through acceptances, promissory notes, certificates of assignments, trust certificates, repurchase agreements, etc.) for the purpose of relending or purchasing receivables or other obligations. The minimum combined capital accounts (i.e., total capital stock + retained earnings + profit & loss summary) of a LI range from ₱ 50 million to ₱ 300 million.

Types of Financial Services provided

An increasing array of microfinance products and services are being made available to low-income households, microenterprises and small businesses by a wide-ranging variety of supervised, regulated and unregulated financial institutions. Commercial banks (in both the universal and regular license categories) provide wholesale and commercial credit lines as well as check clearing, use of ATM networks, servicing of local money transfers and foreign remittances, and treasury management products for managing excess liquidity, to a range of MFIs including rural banks, cooperative banks, credit unions and other CFIs, NGO MFIs, and private lending investors. The institutions directly catering to microfinance clients offer short- and medium term credit facilities, access to lease finance through the subsidiaries of commercial bank partners, a wide variety of savings and time deposit products, certified checks, local money transfers and servicing of foreign remittances. One MFI group which includes an NGO-MFI, a Rural Bank and Mutual Benefit Association also offers group-term life, accident and disability insurance as well as a personal provident fund (contractual savings) product to its members.

South Africa[26]

South Africa's financial service providers have historically focused on the provision of credit, largely for consumption uses, and its approach to microfinance regulatory questions has been from this standpoint. The Micro Finance Regulatory Council (MFRC) was created in 1999 to monitor micro lending activity and to register micro lenders interested in achieving an exemption to the 1992 Usury Act for loans less than approximately US$ 940 (R6,000) and for a term less than 36 months.

Types of Financial Institutions

Any number of different types of financial institutions provide financial services to poor households in South Africa. Table 6 provides a glimpse into those institutions that are registered with the Microfinance Regulatory Council as of August 31, 2004, and their proportionate share in the micro-lending industry.

[26] Information on South Africa largely taken from ECI-Africa and the IRIS Center (2005), "The Evolution of the South African Microfinance Sector From 1992 to 2004: The Role of the Microfinance Regulatory Council." Available at http://www.microfinancegateway.org/content/article/detail/29199.

Table 6: South Africa – MFRC Registration Statistics at 31/08/2004

	Number Registered	Number of Branches	Gross loans	Loan accounts	Average size
MF sector as a whole	1,777	7,960	US $2.53bn	5,514,735	US $208
Banks	0.5%	34.6%	47.8%	2,107,812	US $280.7
Public Companies	0.3%	0.2%	0.4%	33,765	US $119.6
Private Companies	15.5%	36.2%	46.6%	2,690,100	US $287.2
Close Corporations	77.2%	26.1%	2.9%	528,273	US $94.4
Trusts	3.9%	1.6%	0.2%	37,384	US $94.6
Co-operatives	1.5%	0.5%	1.6%	64,467	US $448.2
Section 21 Co's	1.2%	0.8%	0.5%	52,934	US $360.3

Source: MFRC, 2004.

It is clear from Table 6 that there is a concentration in the micro-lending market with the commercial banks that constitutes 0.5% of the registered lenders with the MFRC, with 47.8% of the gross loans and 38% of the loan accounts. If private companies and banks are added, they represent 16% of registered entities, but 94.4% of the gross loans and 87% of the loan accounts. The development lenders represented by the Co-operatives and Section 21 Companies represent 2.7% of the registered lenders with only 2.1% of gross loans and a negligible percentage of the loan accounts.

In addition to the traditional micro-loan providers discussed above, there are also some parastatal institutions providing retail finance to this market segment (as opposed to the wholesale finance provided by institutions like Khula Enterprise Finance, Development Bank of Southern Africa, Industrial Development Corporation, National Housing Finance Company, Rural Housing Loan Fund and the section of the Land Bank that provides finances to co-operatives). The main retail finance parastatals are the Post Office Bank, Land Bank and Ithala Development Finance. While Post Bank and Land Bank operates with branches nationally, Ithala is geographically constrained to the KwaZulu-Natal province.

Types of Financial Services provided

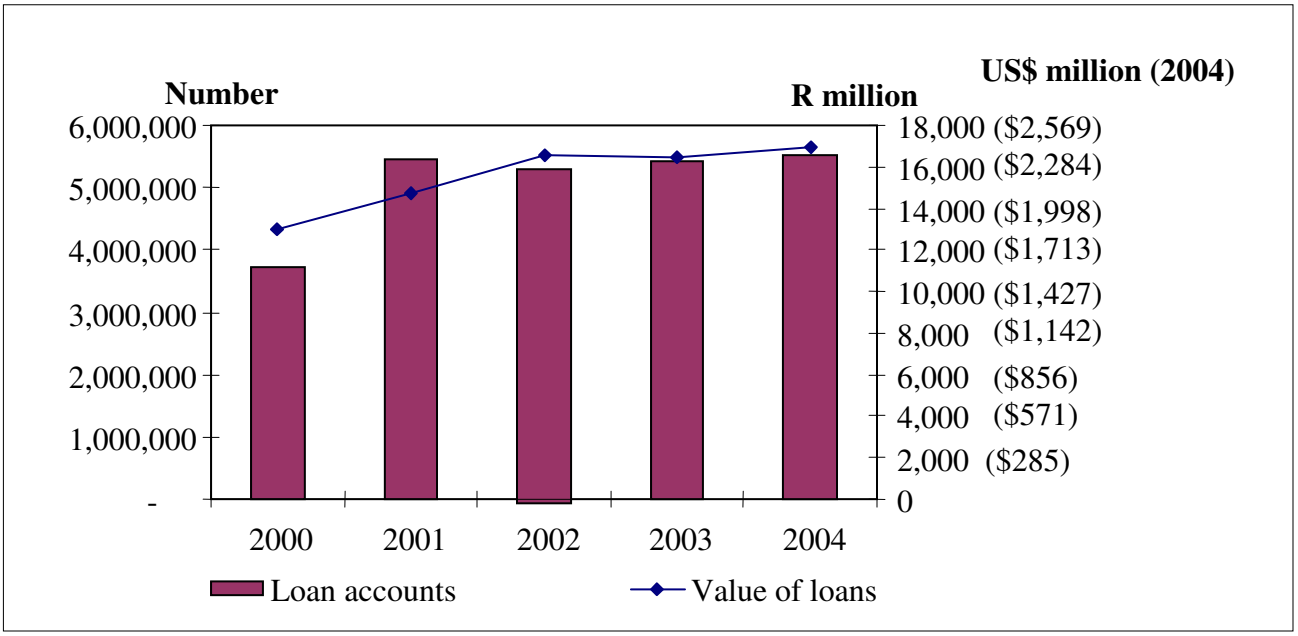
The focus in South Africa has long been the provision of credit, and various types of credit are offered by the range of institutions operating in the country.

Recently, however, there has been an increased emphasis on improved access to savings and other financial services. As in Brazil, the South African government recently relaxed administrative requirements for savings accounts below a certain amount. (In contrast, Bolivia has seen an increase in savings deposited at MFIs – without special savings accounts and with the added burden of meeting stringent prudential standards.)

Growth in the sector

What we do know is that there are a wide range of institutions that reach poorer households in some capacity or another. However, we can see from Figure 3 that there has been significant growth in the micro-lending industry since that time.

Figure 3: South Africa – Number of Micro-loan Accounts and Aggregate Loan Book



Source: MFRC 2004.

Throughout the entire 13-year period from the creation of the Usury Act Exemption to 2005, broad consensus holds that the proportion of SMMEs holding loans now is no greater than that in 1992 as a ratio of total possible demand. In gross terms, more credit has flushed into low and moderate income households, implying that a greater number of SMMEs have access to credit, if only through indirect and imperfect channels. There is little doubt that access to banking (a rough proxy for access to credit and finance for SMMEs) has grown significantly over the last decade. Informed estimates indicate that the adult population with some form of bank account has risen from 25 percent in 1994 to between 38 and 48 percent at present.[27] However, SMME credit data are scarce, often unreliable and incomparable, and a number of measurement complexities limit our ability to say with absolute confidence that access to finance has improved for SMMEs.[28]

However, arguably, more SMMEs do have more access to credit, since the volume of institutions and money available in the market has greatly increased. This argument refines the review of access down to questions of institutional types, credit and other financial product models, remaining legislative and/or regulatory barriers, and leakage

[27] AMPS and FinScope, 2003

[28] Data problems arise from a combination of misreporting (or non-reporting) of loan purpose, and the frequent commingling of household and small enterprise finances.

between products not particularly designed for SMME finance as well as the fungibility of money in households. In other words, there is no disputing that more money and more institutions exist in the credit market today than existed in 1992 and, thus, especially considering the reality of fungibility, SMMEs have theoretically enjoyed increased access to finance.

Conclusions on Market Characteristics

It is interesting to compare the experiences of these seven different countries in terms of their approach to regulating the microfinance sector, the types of reforms undertaken, and the types of services being offered. Annex I provides an overview of these experiences, and chapter 3 discusses in depth the content and genesis of the various reform initiatives.

Based on the discussion in this chapter and the later analysis of reforms, some patterns are evident in the relationship of regulatory reforms to the growth and development of the microfinance sector. The best results appear to arise from a combination of free experimentation by microfinance providers with a carefully managed process of bringing their activities within the mainstream of regulated financial services. This has been the case, for example, with the expansion of Bolivia's regulated financial sector to include lower-income targeted FFPs, the policies on MFIs and rural banks in the Philippines, and the expansion of BRI units and rural banks in Indonesia. In all three of these places, institutions providing financial services to the poor are reaching scale, and large surges in numbers of clients and portfolio growth have been since such reforms have taken place. In the Philippines this has been coupled by a full range of services being provided to the client – not only credit and deposits, but insurance and transfers as well. These three places are also where capital has largely been sourced outside the donor realm, including the use of deposits to fuel growth.

By contrast, experiences with microcredit-specific licensing in Brazil and rural bank proliferation in Ghana have been less than stellar. While there has been some growth in Ghana of the rural banks (and their balance sheets have become much healthier), they have not reached the scale seen in the above mentioned countries. Brazil's credit market remains small; one estimate is that it would take the creation of 2500 new MFIs to reach half of effective credit demand (Mezzera cited in Christen). Also, it remains to be seen whether Mexico's experiences with the LACP will lead to sustained development in the sector, although there has been significant growth since the onset of the reform process. This process does, however, provide increased focus on deposit-taking and innovative approaches to transfer services are also being created. Lastly, South Africa's approach of liberalizing the microlending market (and later attempting to rationalize and police it) produced rapid growth that has now attracted serious attention from the banks.

Allowing free experimentation has also led to an increasingly blurred line between the mainstream financial sector and microfinance providers. In the Philippines and Indonesia, the biggest providers are themselves licensed commercial banks. The most successful programs in terms of quickly reaching large scale have been those where deposit account requirements have relaxed and commercial banks have quickly gone down-market in their deposit services – as Brazil and South Africa have shown. As more

microfinance providers transform into regulated financial institutions and as more mainstream institutions enter the market, the distinction between what is and what is not a microfinance product becomes increasingly indistinct. Comparing the characteristics of our seven case study countries shows that when markets are allowed to experiment with innovative linkages – and when they are not stifled by restrictive requirements – institutions quickly reach scale, become healthier, and provide a diverse range of products to a range of clientele.

Table 7: Microfinance Market in Indonesia

TYPE	UNITS/ OFFICES		BORROWERS		OUTSTANDING LOANS		DEPOSITORS		DEPOSITS		TOTAL ASSETS	
	number	%	1000's	%	(US$ m)	%	1000's	%	(US$ m)	%	(US$m)	%
Comm.Banks' micro-loans, (6/05)[1] - BRI Units (4/05) [2]	8,069 4,046	14.9 (7.4)	14,271 3,211	48.0 (10.8)	14,036 2,134	82.8 (12.6)	n.a. 31,271	n.a 72.0	n.a. 3,288	n.a. 68.8	138,889 n.a.	98.0
Rural Banks (BPR): - BKDs (6/05) [3] - Non-BKD (6/05) [4]	 4,482 2,062	 8.3 3.8	 395 2,331	 1.3 7.8	 21 1380	 0.1 8.1	 466 5,864	 1.1 13.5	 51 1223	 1.1 25.5	 32 1,841	 0 1.3
Non-Bank-Non-Coop (LDKPs) (7/04) [5] -BKK (12/04) [6]	1,620 160	3.0	1,326 143.	4.4	45 26	0.3 0.2	n.a. 295	n.a.	42 18	0.9	n.a. 40	n.a.
Credit Coop (12/04) [7] - Credit-Unions (12/04) [8]	1,596 1,041	2.9	885 n.a.	3.0	116 958	0.6	481 480	1.1	33 0.94	0.7	139 1,227	0.1
S & L Units (12/04) [9] - BMT (7/04) [10]	36,466 3.038	67.1	10,524 1,200	35.4	1,349 20	7.9	5,016 n.a.	11.6	145 26	3.0	751 n.a.	0.5
NGO-MFI (GB Replications) [11]	21	0	20	0.1	0.52	0	20	0	0.3	0	0.5	0
TOTAL	**54,316**	**100**	**29,752**	**100**	**16,948**	**100**	**>43,413**	**100**	**4,782**	**100**	**141,653**	**100**

[1] BI-TPP Biro Kredit, *Statistik Bulanan Kredit Mikro, Kecil dan Menengah* (UMKM), Sept. 2005
[1] Gema PKM, *Keuangan Mikro di Indonesia*, 30 April 2005
[3] BRI, *Laporan Kegiatan BKD Triwulan II 2005* (report to BI)
[4] BI-DPBPR, *Informasi BPR*, 30 Juni 2005
[5] Estimate by BI-DPBPR in *Kompas*, July 14, 2004
[6] BPD Central Java, *Laporan Singkat Perkembangan BKK*, Dec. 2004
[7] State Ministry of Cooperatives and SME, *Data Perkembangan KSP dan USP*, Dec. 2004
[8] Inkopdit, *Data Perkembangan Kopdit per BK3D*, 31 Dec. 2004
[9] State Ministry of Cooperatives and SME, *Data Perkembangan KSP dan USP*, Dec. 2004
[10] Estimate by BI-DPBPR in *Kompas*, July 14, 2004
[11] Estimate by the Sumantoro Martowijoyo, based on information from FREN, association of Grameen Bank replication

Table 8: Microfinance Providers in Mexico

(figures in USD)

	Cooperativas de Ahorro y Préstamos[1] (Dec. 2001)	NGOs[2] (Dec. 2004)	Sociedades Financieras Populares[3] (Dec. 2004)	Sociedades de Ahorro y Préstamo[4] (Sept. 2005)	Credit unions (Sept. 2005)	Sociedades Financieras de Objeto Limitado (SOFOL; includes Compartamos) (Sept. 2005)	Banks (as of Sept. 2005)	Total[5]	% share of MFIs[6] in total
Number of institutions	400	28	2	9	180	32	29	671	65%
Total Assets (millions US$)	n.d.	$ 361.6	n.d.	$ 1,481.4	$ 1,610.9	$ 20,130.4			
Total outstanding loans	1,200,000 accounts	498,186 accounts	25,038 accounts	n.d. (total value of loan portfolio = U.S. $1,018m)	n.d. (total value of loan portfolio = U.S. $1,171.5m)	n.d.	n.d. (total value of private sector loan portfolio = U.S. $99,230.7m)		
Total Liabilities (millions US$)	n.d.	$ 243.7	n.d.	$ 1,323	$ 1,610.9	$ 17,879.8			
Total Deposits	2,500,000 accounts	48,179 accounts	35,000 accounts	n.d.	n.d. (total savings = U.S. $51.2 m)	0	37,360,306 accounts (checking, savings, and other, total)		
Number of clients	2,000,000	502,948	49,926	n.d.	n.d.	n.d.	n.d. (Less than 20% of the population uses the services of banks)		
Main financial products offered*	Savings, credit, and remittances	Basically credit	Savings, credit, and remittances	Savings, credit, and remittances	Credit and member deposits	Only credit for a defined purpose	All services		

Sources: Banco de México, CNBV, Bansefi, ProDesarrollo.

3. Developing the Regulatory Framework for Microfinance

In looking to comparative experience, policymakers should understand not only *what* other regulatory regimes provide, but also *how* those regimes came to be. In this part, we address both concerns, analyzing the development and adoption of new approaches to microfinance regulation and supervision in the case study countries. The focus here is on how and why the main problems were identified, and the driving forces that shaped the response to these problems – on the level of policy design and political dynamics. What were the main legal-regulatory problems, and how were they addressed? What political obstacles or constraints, if any, were faced? How were they dealt with, and how effectively? A summary of the themes and approaches across our seven sample countries is given at the end of this chapter.

One approach to tailoring the regulatory framework involves the creation of an MFI license as a distinct regulatory niche – whether free-standing or as a sub-set of an existing non-bank rubric, whether purely activity-based ("functional") or also contemplating specific institutional forms. This requires the design of tailored norms, standards, and supervision that are appropriate for MFIs – either for depositary institutions only, or in a tiered approach for institutions with different characteristics and products. The treatment of start-ups and constraints on entry to regulated status are important here. What kind of MFI license, if any, was created – and why (or why not)? What specific prudential standards were adopted for microfinance? Has creating the MFI license been an effective policy in light of market conditions, policy objectives, and alternatives? (See Annex II at the end of the paper for a comparative overview of regulatory frameworks, prudential norms, and supervisory practices for the seven case study countries.)

Bolivia

The microfinance movement in Bolivia was initiated by private non-profits that operated for a number of years until several were fully profitable, before the possibility of becoming regulated was even suggested. During this period of time the Bolivian banking authorities had become concerned about the loss of banking infrastructure due to the process of financial sector liberalization that had caused a dramatic restriction in the number of branch offices available to the general population. As microfinance grew, they began to consider whether these types of institutions could fill in the void.

The first initiatives in this regard happened almost simultaneously. Prodem, the leading NGO in Bolivia decided to seek a banking license as early as 1989, which it finally received in 1992. The licensed entity, Bancosol, was capitalized by Prodem (41%) which obtained permission from its grant funders to apply major donations it had received to equity shares in the bank, organizational investors interested in microfinance such as Accion International and Calmeadow, the equity investment arm of the Interamerican Development bank, and individual private investors (many of whom were board members). None of the investors were interested in Bancosol as a business venture, so projected returns were not expected to be taken out of the organization. This license was probably the first banking license granted to an NGO for the purpose of carrying out microfinance anywhere in the world that was not a 'special case, created by a special law'

such with Grameen Bank or any number of development finance institutions. Nevertheless, while Bancosol received a license to operate as a full service bank, at no point did it ever intend to offer a number of traditional banking services such as checking accounts or import/export operations.

Creating an NBFI License for Microfinance Services

About the time that the Banking Superintendent's office was considering a license for Bancosol, it was also looking for a way to create a new category of institution for microfinance as a number of other NGOs were also lining up for some kind of recognition that would allow them access to a broader funding base. This line of thinking was driven by the German consulting firm IPC, which attempted to replicate its successful *caja municipal* model from Peru. Simultaneously, interest arose in political circles to create a provincially based *banco departamental*, a full fledged bank that was limited in its operations to a small geographical area. Either of these two banks, whether owned by local governments, private individuals, or non-profits, would have received permission to operate in limited geographical areas, with a limited range of financial products. They would have had a lower minimal capital for their formation but would have had their size limited also. When the new president took office, the government scuttled both concepts on the basis that either form lent itself to the 'capture' of these new entities by narrow interest groups, and on the basis that the principal NGOs that wished to transform were seeking to be able to act on a national scale.

Instead, IPC was able to find a small line in Bolivia's credit law that allowed for the creation of 'Private Financial Funds' for which no regulations had ever been written. This provision had been inserted without any particular public debate and was not the primary focus of the microfinance community. It was initially meant to facilitate the creation of consumer finance companies at some future point, but had never actually been used. Its discovery by the microfinance community meant that the Bank Superintendent's office, which had the responsibility in the law for defining the nature of these 'funds', could create a new class of banking institution without taking the matter to Parliament. This has been the primary mechanism for bringing microfinance into the 'mainstream' regulated financial sector (especially since commercial banks do virtually no lending to microenterprises).

It is not clear that such an open ended article could have been created in the midst of a full scale public debate in Parliament about the merits of creating a special class of financial institutions to offer credit to the poor. It seems that elsewhere, the more public debates have led to the implementation of far more restrictive sets of rule and regulations, often encoded within the laws themselves that govern this activity. These rules tend to be far more restrictive in terms of the activities, governance structure, and reporting requirements than is strictly necessary. Most tragically, they also tend to repress interest rates that can be charged to end borrowers and tightly control the types of loans and clients that can 'benefit' from the new institutional type. This clearly runs against the grain in the development of a modern financial sector that tends to see commercial banks take on an ever wider market segment and offer a far more diverse set of products to a broader set of clients.

In May 1995, the government issued Supreme Decree 24.000 which created the necessary regulations for the operation of the FFPs and included such provisions as:

- Minimum capital of 1 million dollars (subsequently increased),
- Limited range of activities (excluding checking accounts, credit cards, foreign trade, factoring, trusts, guarantee of debts and investments in other institutions,
- Similar safety and soundness norms as commercial banks, maximum leverage ratio of 10:1
- Activities were not limited to microenterprise finance, also allowed for leasing, consumer credit, and other types of financial services (except for those explicitly excluded)

Three months later the Bank Superintendent granted an FFP license to IPC's NGO Procredito, which became Caja Los Andes. Over the subsequent five years, it granted 5 more FFP licenses, two to consumer credit organizations, and two to finance arms of businesses, and the rest to microenterprise credit NGOs. In recent years, it granted a bank license to Procredito which then transferred its assets from the FFP Caja Los Andes to the newly minted bank.

Brazil

The Brazilian government has undertaken a number of initiatives to encourage the development of microfinance and broaden access of the country's population to basic banking services. In the 1990s, the government passed legislation to permit the establishment of specialized microfinance companies, and companies that can undertake loan servicing arrangements, and launched an apex facility within the *Banco Nacional de Desenvolvimento Social* (National Social Development Bank) to fund these newly created organizations at subsidized interest rates. More recently, the new government of Lula (Luis Ignacio de Silva) passed legislation that allows banks to outsource key functions through 'banking correspondents' and challenged the banking sector to establish transactions capacity through POS located in lottery outlets, retail chains, post offices and other networks.

The first initiative, the establishment of specialized microfinance companies whose activities would be regulated by the Central Bank is the only one of the two that was primarily aimed at the traditional activities of the microfinance community – lending to informal sector enterprises and their owners. The second initiative should be viewed as an attempt to broaden the access of the general public to basic financial services; primary among these is payment of bills and simplified deposit accounts. While a substantial number of microsized loans have been made through the system, they seem mostly to have been made to salaried workers or pensioners. They have had a generally poor performance – especially in one of the banks where defaults have reached 27% due to a poorly chosen and executed lending technology.

The access initiative has the potential to change the entire environment for microfinance. It accomplishes two objectives: it dramatically reduces the transactions costs for both financial institutions and clients alike, and it gives a big push to the development of comprehensive national data bases of client repayment histories. These data, in turn, can eventually be input into scoring models that support credit decision making models for personal, consumer type loans – even for informal sector workers. While the access initiative was not built primarily to encourage microfinance for the informal sector, it will probably change the way credit programs operate and drive down their costs, while improving service quality. It also fits squarely within a framework where microfinance is conceived of as an integral part of the evolution of the commercial financial sector. We now turn to a more detailed analysis of the microfinance legislation; the access initiative is discussed in more detail later in the paper.

Legal and Regulatory Initiatives to Stimulate Microcredit[29]

After more than twenty years of operating in a low profile manner, the potential of microcredit to further Brazil's development goals came onto the national scene through the *Comunidade Solidária,* a public body created in 1995 to strengthen civil society initiatives in Brazil. The Communidade Solidária adopted micro-credit as its principal theme of political debate in 1997-98, and resumed this theme in 2001. It advocated a policy framework that would enable private non-profit MFIs to expand the supply of micro-credit. Largely through the efforts of working groups organized in this context, a number of legal impediments to the expansion of micro-credit were identified. Based on the recommendations of these groups, changes were introduced in the legal framework for lending to microenterprises over the next several years.

New forms of micro-credit institutions, excluded from the scope of the usury law, were established by regulation. Prior to the changes, microfinance could only be undertaken by a non-profit organization (NGO), and these were constrained by the one percent per month ceiling on interest rates imposed by Brazil's usury law on all private contracts, which were enforced once inflation was brought under control. NGOs were also constrained in terms of access to capital, to grants or credit lines from government or foreign donors. Two new legal entities were created in 1999, with considerably more flexibility in terms of both funding and lending, and outside the purview of the Usury law.[30] These were (i) the OSCIPs (*Organização da Sociedade Civil de Interesse Público*) or Public Interest Civil Societies, and (ii) SCMs (*Sociedades de Crédito ao Microempreendedor*) or Microenterprise Credit Societies.[31] It was hoped that the creation of these two institutional types would open microcredit activities up to private capital, and substantially increase the volume of credit to informal enterprises.

---

[29] The descriptions of the SCM and the OSCIPs are taken almost verbatim from Kumar, Chapter 2, Access to Financial Services in Brasil, World Bank, 2004

[30] *Medida Provisória* 1914-4 of June 28, 1999 excluded both OSCIPs and SCMs from the Usury law.

[31] Law 9.790 of March 23, 1999, which came to be popularly known as the New Law of the Tertiary Sector, established the OSCIP. Decree No 3100 of June 30, 1999 provided details on its authorization, functioning and supervision. Reporting requirements are minimal, but for lines of credit through public entities, external audits are required. For details see especially 'OSCIP - *Organização da Sociedade Civil de Interesse Público - A Lei 9.790/99 como Alternativa para o Terceiro Setor. Comunidade Solidária.* Brasilia, July 2001.

Box 2. Key Legal Characteristics of OSCIPs and SCMs

OSCIPs

- OSCIPs are non-profit organizations whose social objectives must fall within a specified list;
- They are exempt from Usury Law restrictions;
- They are subject to reporting requirements (including audited accounts of activities carried out under a Cooperation Agreement with a public entity) to the Ministry of Justice;
- Sources of financing are limited to donor funding, owners' investments and Government funding (including lines of credits from the Brazilian state-own development bank BNDES);
- OSCIPs can own an SCM as a subsidiary

SCMs

- SCMs are for-profit financial institutions deemed to be a part of the national financial system;
- They are thus exempt from Usury Law restrictions;
- They are also thus subject to the tax regime for financial institutions including income tax, CPMF, etc.
- As financial institutions, they are subject to reporting (non-audited accounts) and regulatory requirements of the Central Bank of Brazil, which supervises them;
- They are subject to minimum capital requirements (R$100,000, U.S.$45,045[32]); liquidity requirements; and restrictions on leverage (five times liquid assets);
- Sources of financing include all those allowed to OSCIPS, plus loan or credit lines from national and foreign financial institutions and from OSCIPs;
- They can extend loans and guarantees to individuals and micro-enterprises, up to R$10,000 (U.S.$4,505) per client, for professional, commercial or industrial use only; they are prohibited from extending consumer loans;
- They can operate Micro-credit Servicing Points (Posto de Atendimento de Microcrédito) with full flexibility in terms of location, opening hours, etc, and no additional capital requirement;
- They cannot collect deposits from the public, participate in the interbank deposit market, or issue securities for public offering.

Source: Kumar Anjali, "Access to Financial Services in Brazil", The World Bank, Washington D.C, 2005.

The first of these organizational forms, the OSCIPs, can have a range of objectives, which are not limited to microfinance. OSCIPs exist in many fields such as science, education, research, etc. Like NGOs, they are deemed to be not-for-profit organizations. Importantly, OSCIPs can 'sign Cooperation Agreements with the public sector to implement activities and projects of public interest', which implies that they could have access to public sector funds, in addition to donor funds and owner/sponsor funds. However, OSCIPs are not able to access funds from financial institutions or to mobilize deposits from the public. OSCIPs are subject to a low level of *non-prudential regulatory requirements*, such as some reporting requirements to the Ministry of Justice, but are not required to comply with any prudential regulations.

[32] Based on current (Feb. 2006) exchange rate of U.S. $1 = BRL $2.22.

The second institutional form created, the SCM, is much closer to a microcredit society, as they exist in many other countries.[33] SCMs are formal for-profit financial entities regulated by the Central Bank of Brazil. SCMs can take loans or lines of credit from foreign or domestic financial institutions, and in February 2001 their access to funding was further widened, together with permission to use instruments such as fiduciary alienation for extending credit.[34] However, issuing debt or mobilizing deposits remains restricted. Subsequent regulations issued in July 2001 added various *prudential* norms specifying operational limits on capital, leverage and risk. SCMs are required to comply with minimum start-up capital, ongoing capital adequacy, and limits on risk concentration. The regulations issued in July 2001 also permit SCMs, like banks, to operate through Microcredit Service Points (Posto de Atendimento de Microcrédito), and require them to submit information on their lending operations to the Central Bank's credit risk center - the Central de Risco de Crédito - which in principle could permit them in the future to obtain greatly enhanced credit information on prospective clients.[35]

In an attempt to increase the flow of funds to the microfinance sector, the government imposed a requirement on regulated banks that they must dedicate 2% of sight deposits to microcredit or 'credito popular,' to be invested either directly or through SCMs and OSCIPS. Additionally, the new government changed the rules to facilitate the opening of 'simplified savings accounts' for small balance depositors. And, it allowed the SCMs access to the Central Bank's credit information registry. Finally, it eased restrictions on carrying out financial operations with illiterate clients that had applied to regulated financial intermediaries.[36]

Though not strictly a regulatory matter, the Lula government initially tried to lower interest rates prevalent in the microfinance industry by putting in place a cap on on-lending rates by MFIs on those funds sourced at BNDS. Given the high level of participation of BNDS in the financing of most SCM and OSCIPs this restriction effectively reduced the income levels of MFIs across Brazil and became the cause of a major lobbying effort by the sector to have this policy reversed. Eventually (after two years) the interest rate cap was raised to 4% monthly for loans above 1,000 reals (400 dollars) and below 10,000 reals (4,000). Loans below that 1,000 level still carry a 2% monthly interest cap (credito popular). This eased the situation some for most MFIs. Although many carry a sizeable number of small loans on their books, the portfolio is concentrated above the cap limits.

In 2001 the law and following resolutions also allowed for the municipalities to create 'peoples banks' and other small local 'funds' to operate microcredit on a non-profit basis

[33] Central Bank Resolution 2627 of August 2, 1999 established the SCM. Guidelines for its authorization and functioning were issued rapidly after (Central Bank circular 2915 of August 5, 1999) and further circulars established reporting requirements to the Central Bank as well as public disclosure requirements for financial statements (Circular No. 2964 of 3 February 2000) and a standardized chart of accounts in COSIF (Carta-Circular No. 2898 of the Central Bank of 29 February 2000).
[34] Law 10.194 of February 2001 extended funding sources to include the SEBRAE, and also, companies registered with the CVM, and investment funds. OSCIPs were permitted to own SCMs.
[35] Resolution 2874 of the National Monetary Council of 26 July 2001.
[36] Gilson Bettancourt, Finance Ministry, PowerPoint presentation, 12/4/05

under an annual interest rate cap of 12 percent. A number of these were set up, but they are not considered to be particularly successful as they face the additional burden of a highly repressed interest rate, and therefore do not really get around the problems faced previously by NGOs. Their chief purpose seems to be that the legal form allows municipalities to provide microcredit directly. They are counted among the 180 MFIs indicated in Table 2 (see chapter 1).

Ghana

Ghana's regulatory approach has fostered a wide range of formal and informal microfinance institutions – rural banks, savings and loan companies (S&Ls), credit unions, NGOs, community-based organizations, small savings-credit associations and informal savings collectors and moneylenders. Observers perceive that Ghana has not yet succeeded in achieving strong financial performance, significant scale, and true commercialization of microfinance. It may be timely to assess whether Ghana's flexible, evolutionary and tiered approach is leading the development of microfinance in the right direction.

Overview of Institutional Forms for Financial Services

The financial system in Ghana includes commercial banks, insurance companies, discount houses, finance houses, leasing companies, savings and loans companies, credit unions and a stock exchange. Added to this are several rural banks widely dispersed throughout the country – in response to the absence of commercial bank branches and offices especially in remote rural areas. The main categories of institutions are as follows:

1. **Formal financial institutions** are incorporated under the Companies Code 1963 (Act 179), which gives them legal identities as limited liability companies, and subsequently licensed by the Bank of Ghana (BOG) under Banking Law 2004 (and regulations issued under the old Banking Law of 1989) or the Financial Institutions (Non-Banking) Law of 1993 to provide financial services. Most of the licensed commercial banks target urban middle income and high net worth clients.

   - Rural and Community Banks (RBs) operate as commercial banks under the Banking Law, but they cannot perform trust and foreign exchange operations (among others). RBs' minimum capital requirement is significantly lower than commercial banks, and their clientele is drawn from their local catchment areas. Some RBs collaborate with NGOs using microfinance methodologies.
   - Among the nine specified categories of non-bank financial institutions (NBFIs),[37] Savings and Loan Companies are most active in micro and small-scale financial intermediation using microfinance methodologies. S&L operations are restricted to a limited range of services.

[37] Including Credit Unions, which are in the law but have not yet been brought under the jurisdiction of BOG in practice, pending passage of new legislation?

2. **The semi-formal institutions are comprised of** credit Unions (CUs) and non-governmental organizations (NGOs). The institutions are formally registered entities, but are not licensed by the Bank of Ghana.
   - NGOs are incorporated as companies limited by guarantee (not for profit) under the Companies Code. Their poverty focus leads them to relatively deep penetration to poor clients using microfinance methodologies, albeit on a limited scale. Absent the license to take deposits from the public, NGOs fund their microloans from donor funds and accumulated surplus.
   - Credit Unions are registered by the Department of Cooperatives as cooperative thrift societies, accepting deposits from and making loans to members only. Although CUs are subject to BOG regulation under the NBFI Law, BOG has allowed CUs to be regulated by the Department of Cooperatives and the CU apex body Ghana Cooperative Credit Union Association, pending introduction of a new Credit Union Law.
3. The **informal financial system** covers a range of activities known as *susu* (individual savings collectors), rotating savings and credit associations (ROSCAs), and savings and credit "clubs" run by an operator. It also includes moneylenders, trade creditors, self-help groups, and personal loans from friends and relatives. Moneylenders are supposed to be licensed by the police under Moneylenders Ordinance 1957.

Banking Reforms[38]

As with most developing countries pursuing economic and structural reforms, Ghana has for some time been undergoing financial sector restructuring and transformation as an integral part of a comprehensive reform. As part of a comprehensive macroeconomic adjustment program with the support of the International Monetary Fund and World Bank, financial market liberalization in Ghana began in the early 1990s, under the Financial Sector Adjustment Program (FINSAP). The objective was to restructure distressed banks and clean up non-performing assets to restore banks to profitability and viability. The program set prices right, initiated structural reforms (including fiscal and monetary operations), and privatization, including banks. The government has made substantial progress in implementing the various recommendations under this program (and its 2003 update), including enactment of core legislation.[39]

Financial sector policy conducted through the licensing of banks sought to serve multiple objectives other than the fundamental goal of debt and equity intermediation. These objectives were:

a. to develop specialized segments of banking and financial services notably merchant banking, development banking, retail banking, mortgage banking, and rural-based banking and finance institutions, and

[38] Source: Bank of Ghana Governor, Mr. Paul Acquah.
[39] While the emphasis here is on the commercial viability of financial institutions, there is of course some tension between this goal and that of serving the poorest.

b. to develop national and local entrepreneurship and participation in the sector through the use of differentiated levels of capitalization and equity requirements. This second objective including servicing strategic national interest, more generally, by way of direct state ownership and intervention in banking activity, including extending banking services to achieve regional balance and equity.

The financial system that emerged is relatively diversified in the range of services and increasingly innovative new products. While small and medium sized private enterprises depend extensively on self-financed capital investments, the economy is dominated primarily by bank-intermediated debt finance. The reforms moved the financial sector from a regime characterized by controls to a market-based regime. The reforms liberalized controls on interest rates and bank credit. The Bank of Ghana, as central bank, shifted gradually from a direct system of monetary controls to an indirect system that utilized market-based policy instruments.

There continues to be strong commitment to financial sector development, particularly with Cabinet approval in 2003 of the Financial Sector Strategic Plan (FINSSP), aimed at broadening and deepening the financial sector. Private and public sector participants in the financial markets have shown strong ownership of the FINSSP reform program with a view to developing a financial market that is competitive, fair and with a high degree of integrity. The prospect of greater international competition and opportunity for Ghanaian financial market participants reinforces the need for timely modernization of local market institutions and practices. However, several weaknesses remain, including inefficiencies of state-owned banks, lack of long-term capital and continued lack of a level playing field for providers of financial services.

Evolution of Microfinance Policy

Ghana's experience in microfinance development, promotion and regulation has not favored a particular approach (linkages between community-based associations and licensed banks, or credit cooperatives versus NGOs), or methodology (e.g., group-based versus individual lending methodology). Ghana has evolved a tiered system of laws and regulations for different types of institutions, largely in response to local conditions, needs and institutional developments.

The Ghanaian government created the rural bank category in 1976 to expand savings mobilization, payment transactions and credit services to rural areas that commercial banks and development finance institutions were not serving. The government cocoa monopoly had changed payments to cocoa farmers from cash to special checks, which rural banks were then expected to service. To encourage and support the opening of more rural banks, the minimum paid-up capital was set at a level that was low and affordable to small shareholders, and sufficient to cover start-up needs for fixed assets, stationery and office supplies, rent and other expenses. Government got the Bank of Ghana to provide funding through preferred shares to cover working capital requirements for the initial six months. The rural banks resembled the unit rural banks in the Philippines (mid 1950s) and rural credit banks (BPR) in Indonesia (late 1980s), which were privately owned by investors-shareholders. However, Ghana's rural banks also

took features of municipal savings banks (as in Spain and Peru), in terms of ownership by residents of the community and a one member-one vote structure. Ultimately this created major problems for governance and for responding to calls for additional capitalization, especially as inflation and exchange rate depreciation eroded the capital base.

Credit unions were brought into the legal framework in 1968, the same year that the National Credit Union Association (CUA) was formed as an umbrella organization. With technical and funding assistance from the Canadian Cooperative Association, CUA has been trying to establish a uniform and standard financial reporting system for its members. CUA serves as a self-regulatory body for its 254 credit union members. Its regulatory norms and standards must be met by a member society as a condition for registration as a full-service credit union by the Department of Cooperatives.

Savings & Loan Companies were included as a category of non-bank financial institution in the early 1990s, partly as the urban-sector counterpart for the rural banks, but also as an avenue for traditional money-lenders to get integrated into the regulated financial system. (NGO-MFIs are not contemplated in the regulations, since Ghana has very few NGOs whose primary mission is microfinance.) Establishing the S&L category has proven to be a flexible means of regularizing three types of MFIs through:

- transformation of NGOs into licensed financial intermediaries;
- formalization of actual or potential informal money-lending operations; and
- establishment of small private banking operations serving an identified market niche.

However, the primary and secondary reserve requirements have been quite burdensome, and very likely contribute significantly to (a) higher costs of funds and therefore loans, and (b) reducing access to credit services as a result of higher interest costs.

Since 1995, Ghana has focused on poverty reduction as the core of its development strategy, but a consensus-based vision and strategy for microfinance development still has not been formally accepted and articulated by policy makers. In the late 1990s, with encouragement, urging and funding assistance from international and bilateral donors, local microfinance stakeholders (with the Ghana Microfinance Institutions Network, GHAMFIN, as the pivotal organization) undertook steps to develop consensus on a national vision, policy and strategy for microfinance development, to be taken up with key government officials and policy makers. At about the same time, a Microfinance Policy Unit was created in the Ministry of Finance to focus and coordinate the government's response to constructing a national microfinance policy and strategy.

The round of dialogues and consultative process with various private sector and public sector stakeholders culminated in 2000 in the preparation of a draft microfinance development strategy. However, the draft policy and strategy was never taken up and endorsed by the Cabinet before the impending change of government. Subsequently, the focus on poverty alleviation led the incoming new regime in 2002-3 to expand directed, subsidized credit programs that are not consistent with best practices in microfinance and undermine development of the microfinance industry. Reform and stability of the formal financial sector (commercial banks, NBFIs, insurance companies and general issues of

prudential regulation and supervision) still comprised the priority areas for government financial sector policy.

A proposed new credit union law would help clarify the supervisory and regulatory roles of CUA, the Department of Cooperatives and BOG. The law would also stipulate that all new credit unions must register with CUA. Absent the law (which has languished in draft form for 5+ years) credit unions can be established without informing CUA which worries that poor performance of new credit unions negatively affects the image of the credit union movement. CUA has raised concern about the lack of progress and attention given to the proposed law. GHAMFIN has recently expressed its preference to have a comprehensive microfinance regulatory framework, to include the de facto unregulated institutions (e.g. credit unions, NGOs and susu collectors), perhaps following the approach in Uganda.

Regulatory Framework for Microfinance

Regulations governing NBFIs did not differentiate between institutions according to the nature of their activities prior to 2001. BOG then issued a new set of Business Rules to implement the NBFI law, distinguishing between deposit-taking and non-deposit-taking institutions. The Rules establish new capital adequacy and solvency requirements (see the next chapter and the regulatory table in the Annex); define individual and group-based loans for microfinance and small business, with single-borrower limits for individual loans; and establish criteria for classifying microfinance loans into current and delinquent, provisioning standards for delinquent loans, and liquidity reserve requirements.

Adoption of the Business Rules reflects growing understanding by BOG of ways in which MFIs and other NBFIs differ from commercial banks and of the value of focusing regulation on the nature of the activities being undertaken. Better understanding of the requirements by the NBFIs has led to more accurate reporting, and some have brought in well-qualified people for their management and boards. BOG has since enforced penalties for breaches of regulatory requirements. NBFIs are required to give action plans and definite time frame for the implementation of recommendations. The Business Rules group NBFIs into four categories of licensed institutions for differential treatment (excluding credit unions, for which a separate legal, regulatory and supervisory framework was being prepared):

a. Deposit taking institutions (other than discount houses);
b. Non-deposit taking institutions in credit business;
c. Discount houses;
d. Venture capital fund companies.

Deposit-taking institutions are more tightly regulated, through higher levels of minimum initial capital, capital adequacy standards and mandatory holding of liquid reserve assets. Since the Rules apply only to “licensed institutions,” they appear to leave the door open for non-financial NGOs to engage in credit activities using their own funds. However, they do block mobilization of savings by other registered companies (such as the ill-fated

susu companies of the 1980s, and, more recently, businesses operating pyramid schemes, which BOG has actively shut down):[40]

Minimum Capital Requirements

The old Banking Act (1970) specified a minimum paid-up capital of ¢0.75 million (US$0.65 million) for Ghanaian banks and ¢2 million (US$1.76 million) for foreign banks. After a period of rapid inflation and currency depreciation, the 1989 Banking Law raised nominal minimum paid-up capital, but not enough to restore the dollar values until a further major increase in 2000 (Table 9). Another major increase followed in 2001, bringing the minimum capital requirements to ¢25 billion (US$3.3 million) for Ghanaian banks, ¢50 billion (US$6.7 million) for foreign banks, and ¢70 billion (US$9.3 million) for development banks as of 2002.

BOG was given discretion to set the paid-up capital for Rural Banks. The minimum capital requirement of ¢50,000[41] was based on the start-up needs for fixed assets, stationery, rent for accommodation, etc., while BOG provided the working capital requirement for the initial six months as preferred shares. In 1994 BOG decided that the shareholders of the rural banks should bear the full cost of capitalization, and stopped providing initial working capital. The minimum paid-up capital was then set at ¢20 million (US$22,000). The minimum capital requirement has been increased though not as drastically for RBs as for other categories, standing at ¢500 million (US$67,000) as of 2002 (see the table in the Annex). Only 30 RBs have been able to keep pace with the increase from ¢30 million to ¢100 million in 1999.

The Financial Institutions (Non-Banking) Law of 1993 prescribed a uniform minimum paid-up capital of ¢100 million (US$154,000) for all categories of NBFIs. This has since been reviewed administratively by BOG to differentiate the capital requirements of deposit-taking vs. non-deposit taking institutions. The increases in required minimum capital in 1998 and 2000 served to restore the value to the 1993 level in dollar terms but his represented a tenfold increase in cedi terms, which only 3 of 8 S&Ls have been able to achieve. In 2001, BOG further raised the minimum capital requirements for NBFIs to ¢15 billion (over US$2 million) for deposit-taking institutions and ¢10 billion (US$1.4 million) for non-deposit-taking institutions. The increase was proportionately greater for NBFIs than for commercial banks, suggesting that the intent may have been in large part to ease the burden of supervision by limiting the rate of entry and perhaps encouraging some consolidation.[42] So far, the regulatory authorities have refrained from closing down existing S&Ls that have not met the new requirements.

---

[40] As informal individual agents without corporate identity and business license, *susu* collectors and operators of *susu* clubs, as well as *susu* groups (ROSCAs) would appear to remain outside the law, and BOG officials have repeatedly indicated no interest in attempting to supervise them, but rather the need to observe their activities for possible infringement of the laws.

[41] Nearly US$20,000 at the overvalued exchange rate in the late 1970s, but considerably less at parallel market rates.

[42] As of 2001, applications pending for licensing included five S&Ls, eight finance houses, and some other NBFIs. The new requirements were being applied initially only to new applicants; existing NBFIs were given some time to comply, and some S&Ls were taking on or seeking new partners or equity funds.

Table 9: Evolution of Minimum Capital Requirements (Ghana)

Type	1993	1998	2000	2001	2002	1993	1998	2000	2001	2002
	Cedis (billion)					US dollars (million)				
Commercial banks:										
Ghanaian*	0.2	0.2	5.0	25	25	0.31	0.09	0.94	3.52	3.33
Foreign	0.5	0.5	8.0	50	50	0.77	0.22	1.5	7.04	6.66
Development banks	1.0	1.0	10.0	70	70	1.54	0.43	1.9	9.85	9.33
Rural banks	0.01	0.03	0.1	0.5	0.5	0.015	0.013	0.018	0.07	0.067
NBFIs:										
Deposit-taking	0.1	0.5	1.0	15	15	0.15	0.22	0.19	2.1	2.0
Non-deposit	0.1	0.5	0.5	10	10	0.15	0.22	0.09	1.4	1.3

Source: 2000 from Gallardo BTO report; 2001 from Addeah 2001 (updated).
Average annual exchange rates (¢/$): 1989 – 270; 1993 – 649; 1998 – 2314; 2000 – 5322; 2001 – 7104; 2002 – 7500 (first quarter).
*60% of shares owned by Ghanaians.

Indonesia

Indonesia's approach to regulating microfinance has been one of trying to make optimal use of its diversity of small financial institutions – mainly sponsored by the state or locality – while commercializing microfinance in line with the liberalization of the Indonesian economy and banking system. This meant, among other things, coping with the fallout from the Asian Financial Crisis of 1997-8, which hit Indonesia especially hard. Also, the diversity of options available to microfinance promoters left a number of gaps and possibilities of regulatory arbitrage open. Successive reforms aimed to address these openings and to rationalize the system. (See the table in the Annex for an overview of Indonesian regulations.)

Reforms Supporting Microfinance Banking

Indonesia implemented a series of financial reforms starting in 1983. The deregulation package of June 1983 freed interest rates on lending and savings, and abolished the credit expansion ceiling for banks. The phasing out of government's direct intervention in the banking sector was intended to improve the efficiency and the professionalism of the bankers. How interest rate liberalization enabled BRI Units to transform into successful commercial unit banking is well-documented (see Robinson 2002), and is discussed in a subsequent chapter.

The next banking deregulation was launched in October 1988 (*PAKTO 88*), by which the barriers to entry to the financial sector were lowered. This opened opportunities to set up new banks and new branch offices of existing banks, as well as decreasing the reserve requirement for commercial banks from 15% to only 2%. This policy was aimed at developing the banking industry to mobilize domestic savings and expand credit. This measure helped increase the number of banks within a relatively short period, prompting

savings to grow at an annual rate of 27.9% and lending at 26.8% from 1983 to 1989. This package also created a formal second tier of banks, the rural banks or BPRs (*Bank Perkreditan Rakyat*). Rural banks have their area of operation restricted to the sub-district (*kecamatan*) and are not allowed to provide demand deposits or to transact in foreign currency. They have much lower requirements for minimum paid-up capital than banks – only Rp. 50 million. This capital requirement has been adjusted several times, taking account of the locations of BPRs (see the table below for the current levels).

Table 10: Minimum Paid-Up Capital for New BPRs (Indonesia)

	Jurisdiction	Current Requirement	Future Requirement
1.	Special Province of Jakarta	Rp. 2 billions ($200,000)	Rp. 5 billions ($500,000)
2.	District/Municipalities of Bogor, Depok, Tangerang, Bekasi	Rp. 2 billions ($200,000)	Rp. 2 billions ($200,000)
3.	Karawang District	Rp. 2 billions ($200,000)	Rp. 1 billion ($100,000)
4.	Capital cities of provinces in Jawa and Bali	Rp. 1 billion ($100,000)	Rp. 2 billions ($200,000)
5.	Other District/municipalities in Jawa and Bali, and capital cities of provinces outside Jawa and Bali	Rp. 500 millions ($50,000)	Rp. 1 billion ($100,000)
6.	All other areas	Rp. 500 millions ($50,000)	Rp. 500 millions ($50,000)

Source: Adapted from BI data as published in Kompas, 7/24/2004. Figures in Rupiahs and USD, using exchange rate of 1 USD = Rp10,000.

Until the late 1980s, government had played a predominant role in establishing MFIs. Beginning in the late 19th and early 20th centuries, under Dutch colonial rule, local governments set up village banks (*Badan Kredit Desa* or BKD); provincial and district governments founded non-bank savings and loan institutions (generically *Lembaga Dana dan Kredit Pedesaan* or LDKP, but with different names across regions of Indonesia); and the central government established state pawnshops. Only after the banking sector reform package of October 1988 did the private sector become the most active force in setting up new MFIs. Nevertheless, to this day, the majority of the MFIs are publicly owned, mostly by village or sub-district and district governments. By eliminating almost all entrance barriers for the establishment of new BPR unit banks at the time, the Indonesian policy makers paved the way for a new "laboratory of microfinance," where private investors can experiment with various concepts and strategies on how to run a rural unit bank.

The Banking Act of 1992 brought important changes, which included simplifying banking categories into commercial banks (*bank umum*) and rural banks (BPR) and defining the scopes and activities of each category. The Act had important implications for the array of small financial institutions that had cropped up over the prior 100 years.

The law required all LDKPs (the various savings and loan institutions set up at provincial and district level) to have BPR licenses. The law also required all unlicensed "old" rural banks – founded before the 1988 banking deregulation package (e.g., market banks) – to apply for BPR licenses. Government Regulation No 71 of 1992 provided that (i) such institutions that already had a license from the Ministry of Finance were declared as BPRs; and (ii) institutions that were established prior to the enactment of the 1992 Banking Act, but were not yet licensed as BPRs, had to apply for a BPR license within a period of five years from the issuance of the regulation (i.e., October 1997). On the other hand, BKDs (village banks) were awarded BPR status by the Ministry of Finance and were exempted by BI from compliance with the new BPR system indefinitely. (When the original provision was enacted, it was estimated that 90% of 5,345 BKDs would have gone bankrupt.)

The three parties involved in the transformation of the rural financial institutions –BI, the Ministry of Finance, and the Ministry of Home Affairs – issued a joint decree in September 1994 on the licensing criteria for LDKPs. The aim was to set the stage for BPRs to operate properly in compliance with prudential banking standards, and to prevent the transformed LDKPs from being unsound BPRs that might cause public loss and economic disturbance. The criteria provided in the joint decree include (i) paid-up capital, reserves and profit of at least Rp. 50 million after deduction of bad debts, and positive profits in the last three successive years; (ii) educational and experience requirements for the Board of Directors; (iii) an office/building to carry on the BPR business, separate from any other activities; and (iv) opening for business every workday. The licensing criteria were in fact quite lenient as compared with those governing commercial banks and BPRs. However, due to human resource constraints and low capital accumulation, only 273 LDKPs out of 1,936 were eligible for BPR licenses in 1994 – a period when 1,135 new BPRs were licensed.

The financial crisis that began in 1997, and the Indonesian government's response to it, had major implications for the microfinance sector, as it did for many other areas. The depth of the crisis and the contraction of GDP shook the economic and political system from the top down, leading to the toppling of the Suharto regime, a set of ambitious political and administrative reforms, and the establishment of a bank rehabilitation agency to deal with the mountain of bad debts and financial scandals exposed by the crisis. The microfinance sector, particularly the BRI unit desa network, weathered the crisis much better than other financial institutions in Indonesia. In BRI's case, this was apparently due to more professional management, more regionally diversified portfolios, and depositors' "flight to safety" in response to the implicit government guarantee of BRI deposits (CGAP 2000). The other MFIs were somewhat insulated by their focus on marginal areas and populations, although some of the LDKPs and especially BPRs were affected by non-performance in subsidized credit programs. Among the other important post-crisis measures were further steps to bring market discipline (although subsidized credit and quotas continued), and the creation of a deposit guarantee scheme for the banking system – including the BPRs.

Current Efforts on Microfinance Policy

While major efforts focused on the development of microfinance banking (including the upgrading of LDKPs to meet BPR standards), the presence of a diverse array of non-bank providers has continued to provide important benefits. As mentioned previously, these providers include the village banks or BKDs, credit cooperatives including Islamic institutions or BMTs, Grameen replications and other NGO programs, and state pawnshops. There has been significant activity on the cooperatives side, with the decentralization of cooperative oversight to the districts (*kabupaten*), assisted by local offices of national sponsoring ministries, and the development of the BMT and *Syariah* banking concepts along with their spiritual oversight by Islamic leadership organizations. This is discussed further in a later section of the paper.

Indonesia has also seen efforts to develop a special regulatory niche for non-bank, non-cooperative microfinance providers. The idea of drafting a Microfinance Bill in 2001 came from BI, based on a provision in the Banking Act of 1992 (as amended by Act No. 10 of 1998), to the effect that any party mobilizing savings from the public must possess a license either as a commercial bank or as a BPR, unless such an activity is governed by other regulations. The other available regulation in effect is the Cooperatives Law (Law No. 25 of 1992 and Government Regulation No. 9 of 1995). Thus, MFIs that do not have licenses as banks or coops should in principle be licensed through a different regulation. The proposed law, according to BI, aimed to solve the problem of non-bank-non-coop MFIs, especially LDKPs, which currently conduct banking activities without a license. This idea was supported by some practitioners in microfinance, such as NGOs and Grameen Bank replicators, with the expectation that legalization would open access to funding.

An 'Initiative Team' was formed by BI in late 2000 to prepare a draft Microfinance Bill, sponsored by the Directorate of BPR Supervision of BI, and composed of Pro-Fi (a GTZ consulting team which is assisting BI in microfinance), Gema PKM (a newly founded campaigning microfinance movement led by Bina Swadaya, a major NGO), and some other stakeholders, such as the Ministry of Cooperatives and the Ministry of Finance. The draft stalled in 2003 when the Ministry of Finance and the Cabinet Secretariat determined that a combination of vague provisions and capacity shortfalls would make it difficult to implement the draft law effectively. Importantly, licensing and supervision had been assigned to the proposed Financial Institution Authority (OJK), which is not expected to be in place until 2010.

Recently, the focus of activities shifted away from the draft bill (which has been shelved) to the formulation of policies and strategies to develop microfinance. The government has set up a National Committee for Microfinance Development, on the occasion of the Microfinance Year of 2005, consisting of high officials and headed by a Deputy of the Coordinating Minister for Economics Affairs. Again, GTZ is working with this group and with interested stakeholders, notably the NGOs led by GEMA-PKM. The statement of National Microfinance Strategy proposes to (i) eliminate all restrictions to the development of microfinance, (ii) recognize the existence of various non-bank-non-coop MFIs, and (iii) legalize these non-bank-non-coop MFIs, including their activities in

mobilizing savings (within a limited area and threshold). Other initiatives are pending with the Ministries of Finance and Cooperatives. The Strategy covers BKDs, LDKPs, savings and loan cooperatives, and Grameen replicator programs with deposits of at least one million Rupiah. Supervision is again assigned to the future OJK. The Strategy also calls for the establishment of a microfinance Apex institution – essentially to link the BPRs to liquidity management and eventually to foreign funding and the payment system – with provincial apexes operating around the country. In parallel, a new law on NGOs has been passed that precludes NGO-MFIs from accepting savings, as of 2006.

Mexico

Mexico, somewhat like Indonesia, has a large number of microfinance providers operating under diverse legal rubrics (or in many cases none at all), and has faced the problem of rationalizing the frameworks in order to provide appropriate incentives and reduce regulatory arbitrage. As in Indonesia, NGOs have not played a leading role in the market, although in both cases they have an important influence on policy. In Mexico, as in Indonesia, policymakers are concerned to build on the existing array of structures – and to avoid doing harm. However, unlike its counterpart in Indonesia, the microfinance sector in Mexico has extremely limited scale. Only within the last several years has there been a serious effort to address these constraints through a reform of the legal-regulatory framework.

The Move Towards a New Framework

Before the enactment of the Microfinance[43] Law in 2001 (*Ley de Ahorro y Credito Popular* or LACP), there existed at least five different licenses for the same financial activities. The five types of institutions were: savings and loan associations (*sociedades de ahorro y prestamo,* or SAP), credit unions, limited-purpose financial cooperatives, *cajas solidarias* (cooperatives using group-based methodologies), and NGOs. Of these, only the SAPs and credit unions were subject to financial regulation and direct supervision by the national financial regulator (*Comision Nacional Bancaria y de Valores* or CNBV). The SAP as a legal form was created in late 1991. Both old and new cooperatives could use this form; essentially the choice to become licensed as an SAP was optional, and most cooperatives chose not to do so.

The initial efforts to adopt a law for the cooperative sector came in 1996. The leaders of the cooperative movement (led by the largest institution, *Caja Popular Mexicana*) recognized that about 90% of the institutions carrying on financial activities were not covered by financial regulations. (The key financial activity was capturing public savings: all types of institution included some net savers – though only 15% of the credit unions had any.) Most of the cooperative organizations had only a permit from the Finance Ministry (*Secretaria de Hacienda y Credito Publico*) to operate.

However, the main factor that awakened the interest of all involved actors was the failure of various non-bank intermediaries in the late 1990s. The worst such case affected nearly

[43] The term "microfinance" has a specific meaning in Mexico that differs from the general meaning employed here.

40,000 clients: the *Caja Crédito y Ahorro del Noreste*, an SAP known as "*El Arbolito*". This situation showed not only the necessity to regulate those institutions that were beyond the ambit of the financial authorities (about 90% of the sector), but also the need for a legislative reform – and above all, a more effective supervision process, given that the largest failure came from an institution directly supervised by CNBV. It should also be pointed out that the mainstream cooperative sector weathered the Peso Crisis of the mid-1990s much better than the banking sector. At the same time, there were huge losses from subsidized credit programs (e.g., some US $3 billion via Banrural) and from commercial bank defaults.

The CNBV admitted its inadequate management as regulator and supervisor of the SAPs and credit unions (as it had with the banks at the time of the financial crisis five years earlier). This situation was especially difficult for the CNBV in light of its obligation to directly supervise some 500 institutions. The solution devised by authorities and experts was a system of auxiliary supervision, using the existing cooperative federations to handle the work. The federations had existed since the 1950s, when the cooperatives took inspiration from the Canadian Dejardins model to organize themselves.

Importantly, apart from the failures just mentioned, there were cooperatives that had functioned for more than 50 years in good financial condition, dealing with more than a million households across the country. The only formal financial alternative for these households was (and largely continues to be) the *cajas de ahorro* and the NGO-MFIs.

The banking sector, for its part, had not generally served low- and middle-income households in Mexico. Bank credit had traditionally been very limited, concentrated in a small number of enterprises. Only 20% of the population had access to a bank, mainly through credit cards and savings and investment funds. In 1999, only 15% of municipalities in Mexico had a banking presence; the remaining 85% were served by cooperatives and NGOs. The closure of these institutions would have created enormous economic and social problems, as it would have meant the loss of the only source of (semi)formal assistance for most of the population.

The role of the banks had been so limited in private financing that there was a proposal from the World Bank in 1997 to subsidize outreach by bank branches to communities of 20,000 to 50,000 inhabitants. Only one bank was interested, but in the end it declined to participate and the World Bank program was cancelled. Banco Azteca, in operation for only a few years, is the first bank with real outreach to the middle- and lower-income segment of the population. Still, most of its branches are in large cities.

A problem in Mexico has been too many interventions in rural/micro finance, which has created inconsistencies and conflicting incentives. For example, FIRA has provided subsidies, guarantees, etc., to induce financial institutions to lend in particular rural areas, but this has deterred home-grown innovation – especially since the state has made itself the credit insurer of last resort, thus undermining innovation in risk management (Chemonics 2004).

The Reform Process

The situation was this. On the one hand, formal financial services were extremely limited for low and middle-income households; hence they kept savings in very insecure conditions. On the other hand, the SAP and credit union regulation and supervision were inadequate, which made savings insecure in this sector as well. In addition, commercial banks showed a complete disinterest in attending to this segment of the population. In light of this situation, there was a recognition of the need for a functional law that would mainly regulate savings activities. In light of capacity constraints at CNBV, and the cost of directly supervising 500 institutions, it was decided, as an alternative option, to adopt the type of auxiliary supervision system used successfully in Canada and Germany (and followed in the Mexican cooperative sector for decades). In 1999 a working group of about 50 persons was formed to develop a new framework, including representatives of the cooperative and NGO sectors, government, and international experts.

President Fox placed major emphasis on microfinance, beginning with his public statements soon after the 2000 election. Providing a basis for formal mass financial services became a top priority for his administration. In addition to serving low-income populations, his concerns included protection of public savings and reducing regulatory arbitrage (World Bank 2000). The Central Bank, CNBV, and related agencies started consultations with parliament, financial institutions, and the World Bank on the development of a new law. At this time, the *Consejo Mexicano del Ahorro y Credito Popular* (COMACREP) was formed – largely by leaders in the cooperative movement – as a representative organization to follow up on the microfinance policy framework before the inauguration of the new Congress. (Since that time, COMACREP has also continued its work as a representative body for the sector.)

The initial idea was to strengthen the legal-regulatory system for SAPs, essentially creating a better financial cooperatives law to rationalize and legitimize the sector. However, the NGOs and for-profit financial entities, including influential players such as the MFI Compartamos and the Prodesarrollo network, advocated for a legal framework to accommodate non-cooperative commercial MFIs that would be permitted to receive savings. At opposite ends of this debate were two camps: the hard-line cooperatives that wanted nothing to do with for-profit MFIs; and those in the NGO and for-profit camp who did not see the cooperative governance structure as workable and pressed for a separate law for non-cooperative MFIs. Other concerns were the regulatory and tax burden for MFIs, and the supervisory burden that would have to be either borne by CNBV or delegated to another structure. In the end, the involved stakeholders, including most cooperatives and NGOs, accepted a compromise bill that would provide for a cooperative and a non-cooperative MFI form within the same regulatory structure, and that would offload most of the supervisory work from CNBV onto the industry federations. Further, the working group pushed for consensus on the law by all sides, in order to lower the risk of dissention and demands for populist amendments when the bill reached Congress.

The LACP

The new law resulted from well over a year of analysis, roundtables, negotiations, and drafting. The LACP, enacted in April 2001 under pressure from the new president, provides for two types of savings and loan institutions – cooperatives and for-profit institutions – to be authorized by CNBV. (Generically, these are referred to as *Entidades de Ahorro y Credito Popular* or EACPs.) Because the government did not want CNBV to be directly responsible for supervising hundreds of small EACPs, the LACP provides for auxiliary supervision by federation structures. EACPs are members and affiliates of federations that, in turn, are members and affiliates of the confederations.

The law takes a gradualist approach, treating the longstanding financial cooperative sector together with for-profit providers under a "functional" NBFI law – i.e., a law that applies to all non-banks accepting deposits, unlike the prior law that distinguished institutional form. Further, the Mexican working group, with the support of the World Bank, decided it would make most sense to bring the valuable experience of the *cajas* into the regulated market. The policy decision was to offer all of them the opportunity to meet the regulatory standards and obtain an operating license under the new system. The consequence of this decision has been to retain a cooperative-oriented equity structure and federation network that the for-profit organizations have found to be unsuitable. Indeed, both the cooperatives and the institutions seeking to become SOFIPOs complain about the regulatory and supervisory costs imposed by the law. Still, the majority recognize that the law will be beneficial for their institutions and their clients. This is perhaps the main incentive for them to continue the process of authorization.

The LACP specifies two types of licenses: microfinance cooperatives (*Sociedades Cooperativas de Ahorro y Crédito Popular* – SCACP or SCP) and commercial microfinance institutions (Sociedades Financieras Populares or SFPs, also called SOFIPOs). Both are recognized as "popular" (micro) credit and savings entities (EACPs). The SCP form will be used by savings and loan cooperatives as a non-profit and associative organization. The SFP form will be used by organizations that attract/receive savings (like NGOs), not as a cooperative association but as a for-profit institution.

The main differences between the SCP and the SFP are that, in the SCP, the users are members of the institution, whereas the SFP requires a minimum of 10 shareholders, and the users are clients. Also, the SCPs are registered as civil associations that are exempt from tax on property rent. The SFPs, on the other hand, are registered as companies, and as such they are required to pay all taxes for their activity.

The topics of equity structure and the type of registration have been controversial among the future EACPs. In the context of the existing fiscal code, the choice facing future SFPs was to sacrifice the non-profit entity in order to reduce the number of members, thus permitting better decision-making and governance. The only alternative to full membership for clients was the for-profit company form (SFP), with its fiscal obligations – even though these organizations generally served a poorer clientele than that of the cooperatives, and were in practice non-profit.

For the cooperatives, according to COMACREP, this situation also created a problem, but of a more ideological than technical character. The productive cooperative sector shares statutes and ideology, as well as participation in international confederations, with the financial cooperatives; it is not happy that the latter have agreed to be governed by the same legal framework as for-profit institutions. This tension has grown since the majority of the existing NGOs are not seeking to transform, while new organizations want to form SFPs without being clear about their social orientation and vocation to serve the "popular" sector. Some institutions (generally the politically more radical ones) continue to press for a law exclusively for the financial cooperatives. Despite that, there also are also a large number of cooperatives that do not have a problem coexisting with for-profit firms, including sharing federations. It is hard to imagine that there may be changes in the LACP to make it a law exclusively for the cooperatives.

It was also recognized that the adaptation of the federations would be complicated because their role had been one of representation, not supervision. They would need training and capacity-building, as do the EACPs, in order to comply with the law and meet the quality standards set by CNBV. Thus, an organization was needed that would support the transformation of cooperatives and MFIs and the formation of Supervision Committees. Given that the government did not want to create another institution to implement this mission, and since savings was at the heart of the strategy, it was decided to transform the old *Patronato del Ahorro Nacional* (PAHNAL) into the *Banco del Ahorro Nacional y Servicios Financieros* (BANSEFI). The latter had three main roles: to develop the technological platform for the SACP, to provide TA to the institutions via national and foreign consultants, and to continue promoting savings through the branches of PAHNAL. Thus, contemporaneous with the LACP, the organic law of BANSEFI was approved.

The Philippines

The Philippines' experience in microfinance development, promotion and regulation has not favored a particular approach (linkages between community-based associations and licensed banks, or credit cooperatives versus NGOs), or methodology (e.g., group-based versus individual lending methodology). Instead the government and regulatory authorities seem to have made a deliberate choice in favor of permitting a wide range of intermediaries to participate and be involved in the provision of small-scale financial services.

Concerns about credit scarcity led to the rationalization of subsidized credit policy that most developing countries, including the Philippines, followed in the 1970s to 1980s. Rather than mainstreaming microfinance for the poor, the subsidized credit policy led to the collapse of government-supported and -directed credit programs for the poor, not only in the Philippines but also in many developing countries throughout the world. An evaluation (by the Asian and Pacific Development Centre) in 1996 showed the government's subsidized credit programs to be costly and unsustainable, resulting in gross inefficiencies, financial market distortion and a weakening of private sector incentives to innovate. A separate action research project (funded by the German government) concluded that government supported credit programs in the Philippines

ended up with accumulated loan arrears and loan losses, undermined the ability of banks to respond to changes in the rural financial market, and lacked a methodology to mitigate high transaction costs in lending to the poor. It was not until the early 1990's that the Philippine authorities finally undertook the necessary financial reforms.

In the early 1990s the government introduced a broad range of liberalization reforms in the trade, industrial, and the financial sectors aimed at boosting investments, increasing export revenues, and enhancing macroeconomic stability. A landmark measure that would significantly advance the cause of microfinance was the establishment of the National Credit Council (NCC) in October 1993, in response to a resolution by a consultative group comprising of representatives from non-government organizations, people's organizations, academia, concerned government agencies and government financial institutions recommending the rationalization of all government directed credit programs to ensure greater access to credit for the poor.

Microfinance Policy Development

Rural banks in the Philippines are essentially "unit" banks – licensed and prudentially supervised, operating within a specific geographical area (municipality or township), providing a limited range of basic banking services (savings/time deposits and loans) and privately owned with identifiable shareholders. Rural banks were introduced into the Philippines in the early 1950s, with the assistance and encouragement of USAID. The passage of the Rural Banking Act (1952) allowed the creation of privately-owned small regulated banks suitable for providing basic banking services to low-income rural households and businesses.

Credit unions and savings-credit cooperatives, as well as other types of member-owned and –managed cooperative societies began to be established in the early 1950s as well under the Cooperatives Development Law. During those early years the organization of many of the community-based mutual self-help organizations was promoted and supported by the clergy. Many of them were Dutch, Belgian, German and other European missionaries who were familiar with the Dutch and German cooperative movements. To this day, a good number of credit unions and savings-credit cooperatives continue to have their main offices within the parish compounds.

NGOs began to be organized to work with and provide services to the poor and low-income households in the late 1970s and early 1980s during the waning years of the Marcos dictatorship, and were viewed with suspicion by the administration. The government had been involved in organizing and funding farmers' associations, other cooperative forms including multi-purpose cooperative societies as vehicles for channeling agricultural and rural finance from government programs. The bulk of the government-promoted rural finance units did not outgrow their dependence on low-cost government funds and, not being self-sustaining, eventually closed soon after the end of the Marcos regime in 1986.

Through the end of the 1980s and into the early 1990s, the government began to introduce, with the urging and financial support of international and bilateral donors, a broad range of liberalization reforms in the trade, industrial, and the financial sectors aimed at boosting investments, increasing export revenues, and enhancing

macroeconomic stability. With technical assistance from the USAID-funded Credit Policy Improvement Project (CPIP), the NCC initiated the formulation and eventual adoption of a number of critical credit policy reforms over the next few years, culminating in the passage of the amended General Banking Act (2000). The policy reforms reversed the repressive financial policy of the past and ended government control of the credit market to the poor.

In particular, the new policies gave private microfinance institutions the means to deal effectively with micro and small enterprises, particularly those operating in the informal economy. For example, MFIs serving the poor were given the autonomy to set their credit terms and conditions and make adaptations to their lending approach. They were also offered the opportunity to access wholesale funding support from government financing institutions, along with capacity- building support. Moreover, the continuing dialogue among different private and public sector players and stakeholders created a better understanding by the regulators and the larger licensed banks of the financing needs of micro and small enterprises, and the nuances of small-scale finance.

NGO MFIs were not forced into oversight by the central bank in order to continue their poor-focused microcredit operations, and mandatory deposit schemes to partially collateralize microloans were viewed in a different light of "compensating balances" and not necessarily constituting funds used in financial intermediation. Further, NGO MFIs registered with the Securities and Exchange Commission came to be recognized as legitimate players in microfinance, although they are not supervised either by BSP or the cooperatives regulator (CDA). NCC acknowledges the special role by the Microfinance Council of the Philippine Islands (MCPI, a private sector umbrella organization of institutions involved in providing microfinance services) in providing self- regulatory oversight of NGO MFIs, and as the repository of information on microfinance NGOs (not all eligible microfinance NGOs are members).

Microfinance Strategy and anti-poverty policies

The National Microfinance Strategy and the Social Reform and Poverty Alleviation Act (SRPA, R.A. 8425) were adopted in 1997. The strategy and the law established a new basis for sharing of responsibilities between government and the private sector, particularly with regard to the provision of credit and other financial services to the rural sector, low income households and small businesses.

The National Microfinance Strategy provided for: (i) an enabling policy environment that would facilitate increased private sector participation in microfinance; (ii) a greater role for private microfinance institutions (MFIs) in the provision of financial services; (iii) adoption of market-oriented financial and credit policies, e.g., market-oriented interest rates on loan and deposits; and (iv) withdrawal and non-participation of government line agencies in implementation of credit and guarantee programs. The strategy was the product of multi-sectoral consensus among various stakeholders comprising representatives from non-government organizations, people's organizations, academia, concerned government agencies and government financial institutions recommending the rationalization of all government directed credit programs.

SRPA rationalized government directed credit and guarantee programs, emphasized savings mobilization, and provided capacity-building assistance to MFIs. It deliberately excluded any and all forms of seed funding, equity infusion and partnership funds from government to MFIs. Executive Order 138 (1999) transferred directed credit programs of government line agencies to government financial institutions (GFIs); discontinued interest rate subsidies, required GFIs to provide wholesale credit funds to avoid competition with primary-level MFIs, and directed the use of sustainable community-based private MFIs in the delivery of microfinance services.

Regulatory Framework

The Philippines' framework for microfinance regulation covers all types of MFIs – licensed banks, cooperative financial institutions (CFIs), NGO MFIs and others. This includes non-bank financial institutions, licensed pawnshops, and private lending investors). The main actors in regulation are the BSP which prudentially regulates banks and NBFIs, the CDA which regulates CFIs and other cooperative organizations, and the Insurance Commission which regulates and supervises insurance companies including mutual benefit associations offering insurance products and services. The focus of regulation is on portfolio quality, efficient and sustainable operations, outreach, and transparent information. Minimum capital requirements are tailored to institutional types and locations (see Table 11 below).

The basic premise of the national framework is that all deposit taking institutions, i.e. banks and CFIs, are subject to prudential regulation. Banks with microfinance operations remain under the regulation and supervision of the BSP. CFIs fall under the supervision and the regulation of the Cooperative Development Authority (CDA) in the Department of Finance. Non-bank financial institutions (NBFIs) are regulated but not are not subject to prudential supervision by BSP. This institutional category includes finance companies without quasi-banking functions, non-stock savings and loan associations, licensed pawnshops and private lending investors.

NGO MFIs that collect savings greater than compensating balances[44] (or mandatory deposits to serve as collateral for loans) should in principle be subject to regulation and supervision. In practice, however, NGO MFIs continue not to be regulated but are encouraged to submit standard reports and information to the MCPI. The MCPI does not have the power and authority to impose sanctions on member organizations, but exercises "moral suasion" and promotes microfinance performance standards through strategic relationships with the inter-agency National Credit Council in the Department of Finance) – which the BSP as a key member. These standards (known by the acronym P.E.S.O.) are detailed in the Appendix to this chapter.

[44] "Compensating balances" refer to mandatory deposits collected from borrowers and kept by microfinance institutions to serve as security for microfinance loans. In some (but not all) cases, MFIs do not intermediate the forced savings into loans but maintains the deposits in trust funds with a depository bank.

The People's Credit and Finance Corporation (PCFC), a government-owned finance company (subsidiary of Land Bank of the Philippines), is subject to BSP regulation as an NBFI. PCFC is a major provider of wholesale onlending funds, which a number of financial institutions tap to support their respective lending operations. Wholesale loan funds are available at commercial rates not only to NGO MFIs, but also to thrift banks, rural banks, cooperative rural banks, CFIs and private lending investors which meet the eligibility criteria set by PCFC. In this manner, PCFC exercises effective regulation using market-oriented mechanisms based on performance, sustainability and risk.

Table 11: Philippines—Minimum Capitalization requirements

Institutional Type	Minimum Capital Requirement (Philippine ₱)	Minimum Capital Requirement (US $)	MCR as % of MCR for Regular Commercial Banks
Supervised by BSP			
Commercial Bank – Expanded (Universal)	Pts 5,400 million	$ 100 million	192.8 %
Commercial Bank – Regular	Pts 2,800 million	$ 51.85 million	100.0 %
Thrift Bank – within Metro Manila	Pts 400 million	$ 7.41 million	14.3 %
Thrift Bank – outside Metro Manila	Pts 64 million	$ 1.18 million	2.3 %
Rural Bank – within Metro Manila #	Pts 32 million	$ 592,600	1.3 %
Rural Bank – within Cebu, Davao #	Pts 16 million	$ 296,300	0.6 %
Rural Bank – 1st/2nd/3rd class cities and 1st class municipalities	Pts 8 million	$ 148,150	0.3 %
Rural Bank – 4th/5th/6th class cities and 2nd/3rd/4th class municipalities	Pts 4.8 million	$ 88,800	0.2 %
Rural Bank – 5th/6th class municipalities	Pts 3.2 million	$ 59,250	0.1 %
Cooperative Bank - National	Pts 200 million	$ 3.70 million	7.1 %
Cooperative Rural Bank – Metro Manila	Pts 20 million	$ 370,300	0.7 %
Cooperative Rural Bank – Cebu, Davao	Pts 10 million	$ 185,200	0.4 %
Cooperative Rural Bank – Provincial	Pts 5 million	$ 92,600	0.2 %
Quasi-bank	No MCR	No MCR	Not applicable
Regulated but not supervised by BSP			
Finance Company	No MCR	No MCR	Not applicable
Credit Union/Savings-Credit Cooperative	No MCR	No MCR	Not applicable
Not regulated//not supervised by BSP			
NGO Micro Finance Institution	No MCR	No MCR	Not applicable

Notes: Current exchange rate of US$ 1=Pts 54; Sources of information: Bangko Sentral Ng Pilipinas – Manual of Regulations for Banks, Section X106.1, December 31 2002; # - applicable only to existing banks (no new licensing).

Central bank approach

The Bangko Sentral ng Pilipinas (BSP) was established as the central bank of the Republic of the Philippines pursuant to the provisions of the New Central Bank Act of 1993. BSP has focused its microfinance initiatives on establishing an enabling policy and regulatory environment, increasing the microfinance skills, know-how and capacity of its own technical staff and those of the banking sector, as well as promoting and advocating sustainable microfinance operations within the banking sector. The BSP has established a top-level Microfinance Committee, a Microfinance Core Group of Examiners and a dedicated Microfinance Unit. The BSP is one of the first central banks in the Asia-Pacific Region to have a permanent operating unit dedicated to microfinance.

Similar to its counterparts in other countries, the BSP's primary concern is the safety and soundness of the banking sector. Insofar as microfinance is concerned, the BSP's interest in other sectors such as the NGO and financial cooperatives segments is in the following issues: 1) transformation of non-bank MFIs into licensed and supervised banks, 2) establishing the infrastructure needed for microfinance development – e.g., developing uniform performance standards, and 3) promotion of best practices for sustainable operations among banks, NGOs and financial cooperatives involved in microfinance.

The General Banking Act (2000) handed BSP a specific mandate to recognize microfinance as a banking activity and to draft appropriate guidelines for microfinance operations within the banking sector. For example, the General Banking Act allows NGO MFIs to mobilize savings deposits without violating the provisions of the Act -- the volume of deposits generated was not to exceed the MFI's loan portfolio. In 2000 the BSP declared microfinance to be its flagship program for poverty alleviation. Its initiatives and programs have been in the areas of: 1) Policy and Regulatory Environment, 2) Training and Capacity Building within BSP and the banking sector, and 3) Promotion and Advocacy.

A major constraint to microfinance development is the lack of appropriate types of financial institutions that could effectively and sustainably reach out to the poor. BSP responded to the challenge through Circular 273 (series of 2001), lifting the moratorium on the licensing of new thrift banks (TBs), rural banks (RBs), and cooperative banks. The moratorium had been established earlier by BSP and the authorities in response to concerns of international development finance institutions on the number and variety of licensed banking institutions, relative to the perception of insufficient technical capacity for prudential supervision. The circular opened the opportunity for NGO MFIs to transform into formal banking institutions as new TBs or RBs. BSP classifies such newly established financial institutions as "microfinance-oriented banks" (MOB) when at least 50% of the bank's gross loan portfolio consists of microfinance loans. On the other hand, any existing bank engaged in microfinance whose microfinance portfolio is less than 50% of total portfolio is classified as "bank engaged in microfinance operations" (BEMO), and able to access the incentives that had been extended for involvement in microfinance.

Circular 272 (January 2001) recognized the peculiar characteristics of microfinance and directed its exemption from rules and regulations on unsecured loans (a ceiling of 30% of outstanding loans). The circular reinforced the provisions of the General Banking Act 2000, allowing MOBs and BEMOs the flexibility to deal with enterprises in the informal

economy. Finally, the BSP issued Circular No. 282 (April 2001) providing a rediscount window for MOBs and BEMOs. The rediscounting facility gave MOBs and BEMOs access to additional liquidity to support expansion of their microfinance portfolios.

South Africa

From 1992 to date, South Africa has mostly trodden a path of intermittent and reactive financial sector reform, rather than organized financial sector development. What it produced was an activity-based (functional) approach to the regulation (non-prudential) of microcredit. The key development was the establishment of the Microfinance Regulatory Council (MFRC) under an exemption to the usury law. Prior to the first exemption notice issued in 1992, the vast majority of the South African population did not have access to formal credit. The Usury Act limited pricing and effectively restricted the product offering in the market. Similarly, the Credit Agreements Act (under which hire purchase transactions were concluded) also attempted to limit interest rates. However, due to weaknesses in the legislation, there was also wide scale circumvention of the acts by suppliers in the market that were able to levy additional fees and charges to increase the effective interest rate to above the limits set, while staying within the letter of the law.

Emergence of the Usury Exemption and the MFRC

An early step, as the *apartheid* government was nearing its end, was to create the Usury Act Exemption of 1992. The stated policy goal here was to spur growth in lending to micro, small, and medium sized enterprises (SMMEs). The Exemption allowed lenders to charge unregulated interest rates on loans under R6,000 and for a term of less than 36 months. What actually emerged was a booming micro-loan sector, dominated by payroll and cash-based lending mostly to formally employed, largely urban individuals. The Exemption essentially licensed micro-lenders to create a separate, largely unregulated, tier of credit provision to people on the fringes of the banking system. The Exemption did not have an immediate impact – but then, a few pioneering lenders started implementing a new approach that showed the potential of the 30-day cash loan market. Based on this demonstration effect, the market expanded rapidly.

The original 1992 Exemption grew out of a particular set of circumstances, as well as an interpretation of needs and an approach that differed from that of subsequent periods. The original Exemption essentially licensed micro-lenders to create a separate, largely unregulated, tier of credit provision to people on the fringes of the banking system. The Exemption did not have an immediate effect. Then a few pioneering lenders started implementing a new approach to credit provision that showed the potential of the 30-day cash loan market. Based on this demonstration effect, the market expanded rapidly.

By many accounts, the 1992 Exemption Notice created a problem by dividing the market and thereby fencing lower income people off from the banking sector and formal credit options. Interest controls were removed without other constraints (such as debt recovery and capital access) being addressed. The result was that full conditions for the

development of an efficient market did not exist at a time when the market was growing very quickly.

By the mid-1990s, the advent of the first ANC government raised expectations and created increasing pressure for policies that would extend the benefits of credit liberalization to all – and create rules of conduct that would protect borrowers from sharp practices. The general legislative fragmentation created by the different rules applicable to each form of credit, especially the restrictive framework that impeded entry of competitors into the banking sector, was exacerbated by the Exemption Notice. In particular, this arrangement impeded development finance. An early response was to set up the parastatal development finance wholesalers – NHFC and Khula. The general perception has been that these institutions have not been a great success. Today, both NHFC and Khula suffer from a lack of sustainable clients, and in a way reflect the problems of Apexes in many settings, that of adding cost to the system without improving access and efficiency.

The push to establish MFRC came largely in response to widespread concern about high interest rates and abusive practices in the "cowboy" microlending market that boomed during the mid-1990s. There was a convergence of interest in creating a consumer credit regulator, among government, consumer advocates, and a number of financial institutions who were concerned about abuses as well as questions of sustainability in a market seemingly unconstrained by standards of good conduct. Added to this worry about conduct were lingering concerns about the arrested state of the market's development, and in particular the unmet needs for credit in priority areas such as enterprise, housing, and education. Banks were also concerned about the potentially negative reputation effects on the mainstream financial sector of this combined lack of conduct standards and development finance. At the same time, the government had a mass of urgent policy priorities to address.

As a part of the process of deepening the financial sector, the MFRC was established under the 1999 Usury Act Exemption Notice. The 1999 Exemption Notice made it a condition of micro-lender operations (i.e. extending credits up to a new maximum of R10,000 at rates above the statutory cap) that each institution register with a new regulatory agency that would be established as a legal person. Thus, the MFRC came into being as a section 21 company carrying out delegated regulatory functions within the market niche carved out by the new Exemption.

The MFRC's purpose is to supervise the operations of those institutions lending under its unrestricted interest rate window to facilitate more effective consumer protection and regularization of micro-lender operations in a growing market. The MFRC is a functional regulator – it focuses on a set of activities that it licenses and supervises, regardless of the organizational form or other financial license held by the lender. The key elements of MFRC's mandate boil down to these: (i) formalize the micro-lending sector, (ii) provide consumer protection, and (iii) improve information and understanding. Further, MFRC added to its mandate by expanding its focus in strategic ways to address glaring

deficiencies in financial sector development, which may have strictly fallen outside of their explicit charge, but clearly either impeded or undermined their core responsibilities.

Current Developments

Three different pieces of legislation have been drafted and are expected soon to become part of the South African financial services regulatory framework, namely the National Credit Bill, the Dedicated Banks Bill, and the Cooperative Banks Bill. Some market players have begun to assess the opportunities and threats proposed by them. The other legislative reform that could potentially have as much impact as any one of these bills, is changes to the structure and running of the payments system – in short, a ground swell of activity has pushed the four major banks, which effectively control all payments, and the SARB to look at opening access to the payments system to other kinds of financial service providers.

Dedicated Banks Bill

This bill provides new windows for financial services: the savings bank, and savings and loan bank. The bill's provisions create an institutional license category that could be filled by non-bank companies with the capital and outreach to compete with the banks in offering basic savings, transfer, and credit facilities. Under this law, success in mobilizing savings on a safe and sound basis will likely depend on the establishment of some form of deposit insurance, which to date has been resisted by the banks. However, there may well be sufficient interest by companies with client bases, e.g., large retailers and cellphone companies, to make possible the entry of a few key competitors.

There are at least three sets of provisions in the Dedicated Banks Bill that are likely to discourage any potential interest by those wishing to establish a savings and loan (S&L) (second tier) bank. First, an S&L's ability to intermediate savings is limited. It can extend unsecured loans only up to the amount of its qualifying capital and reserves, and it can extend secured loans up to a percentage – to be prescribed – of the value of the security (Art. 4(1)). Unless borrowers can put up valuable collateral, an S&L will be limited – as all non-banks are currently under the Banks Act – to its own capital as a source of loan funds. (Contrast this with banks, which can extend unsecured credit subject to risk-based capital adequacy and provisioning rules.) Secured loans, of course, can potentially be a highly valuable source of small enterprise finance. But this assumes the kind of efficient and flexible system of secured transactions available in a few of the developed industrial countries, but not yet in South Africa. So also with mortgaging systems, which have proven thus far unequal to the task of supporting investments in housing for the average South African – above all in the townships. If this situation is improved, then the bill's provisions in this area should not be a problem – but for now, they present difficulties.

National Credit Bill, National Credit Regulator

The centerpiece of South Africa's current strategy for enhancing credit access is the National Credit Bill. The Bill aims to formalize and rationalize the system that has existed since 1999, in the form of the 1999 Exemption Notice and its enforcement agency, the MFRC. The Credit Bill replaces the dual system of Usury Act and Exemption

Notice, and the further division of transactions by form (e.g. bank loans versus retail credit agreements), with a single set of norms. By setting up the National Credit Regulator (NCR) under a legislative act, the Bill eliminates those questions that arose about the *ultra vires* nature of MFRC actions with respect to the Exemption Notice and the Usury Act – i.e. all NCR powers are on a firm legislative footing.

The bill creates a unified credit law applicable (with a few exceptions) to those loans extended to natural persons. It creates a set of protections, including a standard of over-indebtedness and a prohibition on reckless lending, as well as interest rate caps to be determined by the Department of Trade and Industry (DTI), the ministry responsible for the MFRC. This approach has evoked lots of commentary. The lenders suggest that the bill goes overboard in its level of protection, and that the compliance costs will cause a contraction and consolidation in the credit market. All credit facilities will have to be reviewed in light of the reckless lending rules. Some interpret the bill as imposing requirements that will make revolving credit lines impossible, due to the required processes of giving quotes, and giving a cooling off period between replenishments. It is also feared that it will discourage mortgage lending due to over-indebtedness provisions. The large banks are in the best position to make the adjustments and to bear the costs of compliance – it's the smaller providers that will be worst-affected.

In brief, the bill proposes an important shake-up that will spread costs and benefits somewhat differently than at present. For purposes of this report, the important feature of the bill, one that has not been discussed at length, is the transformation (or absorption) of the MFRC into the National Credit Regulator. The following table summarizes the major steps in the evolution of the framework for microfinance in South Africa.

Table 12: Development of the Microfinance Regulatory Framework in South Africa

Time period/ regulatory regime	Issues and approaches
Pre-1992 – Usury Act, etc.	Financial exclusion of majority, role of apartheid, distortions due to Usury Act
1992-1999 1st Exemption Notice	Micro-lending boom raises need for consumer protection – DTI New regime (1994) must address need for development finance (SMMEs, housing, education) – DFIs
1999-present, 2nd Exemption Notice, MFRC	MFRC mandate: • Formalize micro-lending within Exemption • Consumer protection • Improve information & understanding
Usury Amendment Act 10 of 2003	Empowers MFRC to conduct inspections on both unregistered and registered lenders, using external inspectors. Provides for submitting questions to the High Court for declaratory order.
2005 into the future: Credit Regulator	*Unified credit law regime* Consumer protection: more solid legal foundation, more robust controls.

Source: ECI Africa and IRIS (2005).

Conclusions on Regulatory Development

The elaboration of frameworks for microfinance regulation in our sample countries has taken a variety of forms and produced a range of different systems. The main variables here are (i) the substantive approach and content of the regulatory framework, and (ii) the process of developing and adopting the framework.

In terms of substantive approaches, the sample countries divide into several categories. First are those that have tried to bring the formal financial sector closer to the people by creating new, limited licenses for providers of small-scale banking services. This is an approach with a venerable history across the world, and that has been used for the last several years in Indonesia, the Philippines, and Ghana, which all have licensed rural banks. In the latter two cases, the tiered financial services structure was further extended to include non-bank institutions with lower entry barriers and more limited licenses. In the cases of Indonesia and Brazil, the provinces and localities were supported in setting up their own limited banks. Governments in developing countries justifiably see the extension of financial services to low-income groups as a public good that could be provided directly by central or local administrations, or indirectly through financial or regulatory incentives. The key to success for some of these institutions, notably in Indonesia and Brazil, is local autonomy and a market-based approach. Larger institutions and programs, such as development banks and subsidized credit, have a history of undermining incentives for sustainability.

The competing substantive approach is to build on what already exists, either formalizing successful unlicensed providers or providing an improved regulatory tier for the transformation of cooperatives, NGOs, and others with microfinance activities. Bolivia chose this approach, setting up the FFP tier by means of banking regulations, and strategically licensing or permitting informal operations by NGO-MFIs so as to build a marketplace of sound, sustainable MFIs. Mexico has attempted to apply a similar logic to its large sector of financial cooperatives, adopting a law with the aim of building on the existing value of the sector while fostering consolidation and bringing the *cajas* under the same framework as for-profit MFIs. Brazil approached this formalization by creating two separate MFI forms, a for-profit and a non-profit form. South Africa, faced with the huge unmet financial needs of the majority population, created a safe haven for microlenders under a Usury Act exemption. It then strengthened the oversight of this rapidly expanding sector by setting up the MFRC as a non-prudential licensing and regulatory body.

In both of the above substantive approaches to regulatory development, the issue of proliferation versus rationalization of institutional forms arises. This is especially so with the latter (bottom-up or formalization) approach, or where the two approaches co-exist, as in Indonesia. In that case, there has been a great deal of experimentation and proliferation of forms, which has created some problems of regulatory arbitrage and weak supervision. Indonesia has tried to overcome this, for example, by encouraging consolidation among the different types of LDKPs and bringing them under the rural bank (BPR) regulation. Similarly, Mexico has addressed this issue through its 2001 legislation, which provides uniform treatment for all non-banks that intermediate funds – a move towards "functional" and away from institution-based regulatory treatment. South Africa has

faced the related problem of consumer, bank, and microlender credits being subject to different regulatory regimes. It has been developing an even more robust form of functional regulation by bringing all loans to natural persons under a single law and regulatory agency.

With respect to the process of reform, there are variations along two axes: the extent of public participation and the sequence followed. Regarding participation, Bolivia and Mexico illustrate the two extremes. Bolivia consciously avoided the use of legislation to enact reform because the Superintendancy felt that a technocratic approach, out of the public eye, would produce better results. A provision of existing law was found to serve as the basis for elaborating the necessary regulations (other countries, including Brazil, have followed this strategy). This approach gave the banking regulators a free hand to develop the market framework without having to operate in the political arena, and to deal with potentially unhelpful interventions by populist legislators. This is not necessarily a permanent fix, and it comes at the cost of democratic input and legitimacy, but it did enable the Superintendancy to put in place a policy that has proven its worth.

At the other end of the spectrum, Mexico pursued its microfinance reform through legislative action, aided by a high-profile presidential speech and an organized representative forum for stakeholder groups. Discussion of the legislation took about 18 months overall. The result was apparently a high level of consciousness and support from the interested public, and a legislative compromise to accommodate the interests of different kinds of microfinance promoters (cooperatives and for-profits). The legislation led to a prolonged, and ongoing, process of creating the systems and upgrading the institutions so that the law can be fully implemented. So far, only a handful of institutions are fully licensed to operate under the law. In other words, the legislation created a difficult and complicated set of implementation tasks for regulators and others – something a supervisory agency is unlikely to have taken upon itself. However, knowledgeable Mexicans are optimistic that, once fully implemented, the framework will be a success. Indeed, the labor and the discussion around implementation have raised consciousness and learning about the system more than anything else could have. In like fashion, South Africa has taken a very open, participatory approach to the development of its new microfinance policy framework. This too has occasioned delays (which have a cost), but may prove worth the effort in the end.

Last, there is the issue of sequence. The elements here include the announcement of a formal policy or strategy, the drafting and passage of legislation, and the development of regulations and implementing mechanisms. The order in which these are done varies. Bolivia seems to have skipped over the first two steps and proceeded directly to writing regulations. This perhaps oversimplifies, since the Superintendancy had to develop its own strategy and review the laws to determine how it should proceed. What it did not do was attempt to bring other parts of government or the public into its process of policymaking. Yet this is one of the potential virtues of a strategy. In Indonesia, there was an effort starting in 2000 to draft and pass a law for non-bank non-cooperative MFIs. When reviewed by the relevant agencies of government, the draft was determined to be unworkable. There needed to be some discussion within government and with

stakeholders of what was needed and how it could sensibly be implemented through legislation. As a result, Indonesia abandoned the draft law and shifted to a process of strategy development. The Philippines, South Africa, and others have also put effort into framing strategies in this area. The potential advantage here is support across government and by stakeholders – a significant advantage where reform is complex.

Chapter 3 Appendix: Philippines Microfinance Performance Standards (P.E.S.O.) [45]

The Regulatory Framework for Microfinance prescribes the minimum set of parameters for assessing the performance of microfinance institutions in the Philippines as shown below. The National Credit Council (NCC) defines these standards as follows:

1. **P = Portfolio Quality –** measures the amount of risk in the current outstanding portfolio. It provides information on the percentage of non-earning assets, which in turn decrease the revenue and liquidity position of the MFI**.** Two indicators are used:
   a. Portfolio at risk (PAR) ratio = balance of loans with at least one day missed payments, as a percentage of the amount of portfolio outstanding (including amounts past due as well as refinanced and restructured loans)[46]. **Standard: 5%**
   b. Loan loss reserve (LLR) ratio = balance of loans with at least one day missed payment, as a percentage of total required allowance. **Standard: 100%.** The LLR ratio indicates the degree of protection of the institution against expected losses due to delinquency. An allowance should be provided once the microfinance loan is considered at risk, since the likelihood of default increases as amortization payments are missed. Hence, allowance for probable losses is based on portfolio at risk. The basis for computing the total required allowance for loan loss reserves is as follows:
      - Current – 1%
      - PAR 1 to 30 – 2%
      - PAR 31 to 60 and/or loans restructured once – 20%
      - PAR 61 to 90 – 50%
      - PAR 91 & above and/or loans restructured twice – 100%
2. **E = Efficiency Indicators** – **measure** the cost of providing microfinance services to generate revenue. The indicators under this category show whether the MFI is able to deliver micro finance services at the least cost to the institution. They also indicate the ability of the institution to generate sufficient income to cover expenses related to the microfinance operations.
   a. Administrative efficiency= the total administrative costs (direct + indirect costs), as a percentage of average gross loan portfolio. This ratio allocates indirect costs[47] in proportion to the number of personnel directly dedicated to each cost center. **STANDARD: ≤ 10 %.**

---

[45] Source of information: National Credit Council, Department of Finance.

[46] The National Credit Council defines *restructured loans* as loans that have been renegotiated or modified to either lengthen or postpone the original scheduled installment payments or substantially alter the original terms of the loan. Refinanced loans are loans that have been disbursed to enable repayment of prior loans that would not have been paid in accordance with the original installment schedule. NCC treats and classifies *refinanced loans* as restructured loans. They are considered non-performing and therefore to be included in computing PAR until such time that said loans have been completely repaid.

[47] Total Indirect Costs - all personnel and non-personnel costs shared by both microfinance and non-microfinance operation. It includes salaries and benefits, rent, office materials and supplies, publications and publicity, transportation, travel and training for overhead staff, telephone and postage, insurance, utilities, repairs and maintenance, legal, audit and consultant fees, bank charges, taxes, and depreciation The formula for estimating Indirect Costs is: {(Number of Full-time MF Staff) / Total Number of Personnel)} x Total Indirect Costs

b. Operational self-sufficiency (OSS) = (Interest Income from Loans + Service Fees + Filing Fees Fines, Penalties, Surcharges) / (Financing Costs + Administrative Costs). **STANDARD: ≥ 120%.** Administrative costs include direct and indirect costs and should include loan loss provision expense. The OSS indicates whether or not enough revenues have been earned to cover the organization's costs.

c. Loan Officer Productivity = (number of active borrowers) / (number of account officers). **STANDARD: Group lending: ≥ 300 borrowers; Individual lending: ≥ 150 borrowers**

4. **S = Sustainability** – The set of indicators that measure the ability of the institution to generate sufficient revenues to cover the costs of its operations in the long run without any subsidy.

a. Financial self-sufficiency (FSS) = (Operating Revenue) / (Financial Expense + Loan Loss Provision Expense + Adjusted Expenses). **STANDARD: > 100%.** This indicator shows whether the organization is earning enough revenue to sufficiently cover in the long-run all operating costs and at the same time maintain the value of its capital and assets, without the need for subsidy.

b. Loan Portfolio Profitability = net operating income, as a percentage of average net loan portfolio. **STANDARD: > inflation rate during the period.** This indicator measures the proportion of net revenues generated from MF lending operations to total loan portfolio, to determine whether such ratio can sufficiently cover.

3. **O = Outreach indicators** – These indicators show the extent and depth of reach of the MFI. The extent of outreach is reflected by the growth in the number of the active clients (referring to those with outstanding MF loans with the institutions) and growth of microfinance portfolio. The depth of outreach is indicated by the ratio of the average loan size to the GNP per capita measure the scale of MFI activities.

a. Growth in Number of Active Clients = {(Ending No. of Active MF Clients) – (Beginning No. of Active MF Clients)}, as a percentage of Beginning No. of Active MF Clients. **STANDARD: Increasing.** This indicator measures the ability of the MFI to expand its operations through increases in their active clients.

b. Growth in microfinance loan portfolio = {(Ending MF Loans Outstanding) – (Beginning MF Loans Outstanding)}, as a percentage of Beginning MF Loans Outstanding. **STANDARD: Increasing.** This indicator determines the rate of expansion of the MF loan portfolio that may be a result of an increase in the number of clientele or in the loan size amounts granted or a combination of both.

c. Depth of Outreach = {(Total Loans Outstanding) / (Total Number of Borrowers), as a percentage of GDP per capita. **STANDARD: ≤ 20%.** This indicator measures the MFI's ability to provide microfinance services to the lower-income strata of the poor.

4. Approaches to Microfinance Supervision

An effective system of regulatory norms depends greatly on the quality of the agency charged with enforcement – in the microfinance case, the financial regulator or supervisor. The previous chapter looked at the development and design of regulatory frameworks. Each framework identifies a supervisory agency to be responsible for checking compliance and enforcing the rules. In this part of the paper, we examine approaches taken to supervision in the case study countries. The variations concern, for example, the structure and features of the supervisory body, level and kind of supervision applied to different institutions and activities, and oversight[48] of risk and fund management. The emphasis here is on strategies to avoid overloading central banks and bank supervisors with too many institutions to monitor. Is there a separate system of MFI supervision? Alternatives include self-regulation, delegation, and hybrid arrangements. The financing of supervision costs is also a concern. How were these issues handled in different cases, and how effectively?

Bolivia

The Bolivian banking authorities took a careful, practical, approach to building a regulatory framework and supervisory approach supportive of microfinance. A critical aspect of their strategy was to set up entry and prudential standards for FFPs that are in most cases the same as for the banks. The few exceptions include (initially) lower minimum capital, along with more stringent reporting requirements (including monthly and quarterly) and tighter concentration of risk standards. Based on this model, the Bolivian authorities proceeded on a case by case basis to approve both the entrance of MFIs into the regulated arena, and to grant them greater powers once inside. They regulated first by 'exception', and then adapted the rules to accommodate the different requirements of microfinance once these became clear. They applied general principles of regulation and risk based supervision to the extent possible in guiding their involvement with regulated MFIs as they came into the financial system, rather than devoting great effort to writing overly specific guidelines that might have stifled appropriate institutional development.

In all, the Bolivian Banking Superintendent can take great credit for wisely guiding the development of the microfinance sector within the overall financial sector. This accomplishment is more noteworthy since during much of the period in which microfinance was experiencing such growing pains, it needed to manage the complicated re-structuring of a number of commercial banks that potentially had a far greater impact on the overall health of the whole financial system. Additionally, the Superintendent's office had to bring a number of credit unions and savings and home loan associations into the regulated system as part of a package of legislative reform designed to strengthen both systems. The major components of this approach are as follows.

[48] We use this term as the equivalent of "supervision" or "monitoring."

Market-based approach to the development of the sector

The modern Bolivian Superintendent's office was born out of a process of financial liberalization and bore the brunt of restructuring the financial sector by liquidating non-functional state banks, merging and consolidating bankrupt commercial banks, imposing regulations to eliminate unhealthy practices such as insider lending, bringing credit unions into the regulated sector, and bringing foreign investors (banks) into the country. Whether by design, or the fact that it simply was so heavily burdened by the task of restructuring the financial sector, the Superintendent's office proceeded slowly, with great caution, and with a fundamentally minimalist strategy for guiding the development of regulated microfinance. It proceeded on a case by case basis to build the rules and regulations for each of the actors as they took the stage. They did not try to 'manage' competition in the sector, nor its effects.

While they have been quite conservative in granting permission for the licensed organizations to take on new types of activities, such as savings, until the organization has demonstrated its capacity to manage such services, it has been very hands off in terms of allowing product innovation within product types. It has not sought to determine just what a microcredit should look like, nor its terms and conditions. It has not insisted on certain guarantee structures, nor lending techniques. It has not controlled interest rates, nor loan sizes.

The Superintendent used a 'regulate by exception' approach, while learning about the activity. The Superintendent's office informally permitted operations on an exceptional basis until it learned about their parameters and subsequently issued formal letters authorizing them explicitly. For example, it informally permitted the operation of solidarity groups for over a year before formally granting permission to use solidarity guarantees for loans under 2,000 dollars. Only in 1998, six years after its commencement did the Superintendent issue a regulation that fully recognized the method as acceptable according to the intent of the banking law. There were a number of other issues, large and small, that the Superintendent agreed to let go, until experience could be gained and regulations written including currency mismatch, the working hours of branches, the formality of teller and treasury functions, the level of loan documentation required, among others.

While this approach certainly generated a higher level of anxiety among staff of the regulated MFIs, given that they were subject to the constant threat of the Superintendent suddenly finding them out of compliance, it did have the advantage of not over regulating, stifling innovation, and allowing a more robust development of the sector than had rules been written beforehand for all anticipated problems. Inevitably, a rules based approach would have allowed far less latitude to the MFIs and restricted their operations. This approach was made possible due to the great consistency and stability of top echelons of the Superintendent's office during most of the past 15 years.

This approach, in the hands of a less professional or more highly politicized Superintendent's Office would be quite problematic. The arbitrary nature of this practice of forbearance could obviously take on political overtones in many countries, and be

exercised in a less technical and neutral way than was the case in Bolivia. At every point, it can be safely said that the Superintendent's Office handled its brief in a thoroughly professional manner, with judgments based on technical criteria.

Market-building strategy

As further applications came in for FFP licenses, the Superintendent's office reviewed them on a case by case basis, even seeking the opinions of outside experts as to the level of competency shown by the sponsors of the proposed organization. In general it adopted a strategy where it only gave licenses to those applicants who were roughly as competent and well funded as those already approved. So, instead of sticking to the original entry level of equity of US $1 million, over time the level of equity required steadily rose to a level of several million – in fact more than that initially required of Bancosol to obtain a bank license ($3 million at the time). The level for obtaining a bank license was gradually raised to $8 million and FFPs who came in the later stages were asked to bring 4 to 5 million. The Superintendent felt that an organization that was less well capitalized could not compete in the market as it would not be able to support the level of investment in infrastructure required to offer a comparable level of service. In fact, applications from inexperienced or significantly under-funded promoters were turned down during this period, even though they met the minimum technical requirements for submitting an application.

The Banking Superintendent chose an appropriate scale for the market. The Superintendent's office always had a notion that the ideal number of microfinance FFPs would fall somewhere between 5 and 8, and was not anxious to generate a larger number that would be hard to supervise. It was being asked to select among the larger of some hundreds of unregulated credit unions for inclusion in the Superintendent's workplan. The Superintendency was receiving direct support from donor agencies at the time and could probably have paid for any amount of additional work involved. It seems that the decision to proceed in this manner had more to do with its view of the market, and the number of potential players that could operate profitably, than with budgetary constraints. After all, the Bolivian market for microfinance is limited to a couple of hundred thousand operations per year.

It did not need to increase its working budget substantially to take on this limited number of regulated MFIs, though it did assign a number of supervisors to the non-bank inspection area within the Superintendency. It outsourced the evaluation of the license applications to world class experts who wrote up their views on the appropriateness of the applicant and the business plan, in addition to opining on the strength of the institution and its track record. Briefly, it considered outsourcing part of the inspection function, but opted later to train its own staff – after which it hired ACCION International[49] to train in the CAMEL performance criteria applied to microfinance. It felt that its staff were better trained if they were rotated through both the bank and non-bank units during the course of several years and that the experience gained in each brought good skills to their review of the other.

[49] A leading international NGO in microfinance development.

The Superintendent does not have the tools to prevent malpractice by financial institutions; it can only respond to adverse movements in key financial performance ratios. The Bolivian Superintendent was aware of the bad practice employed by consumer lenders who came into the country whose chief technique was to lure established clients away from MFIs with larger loans, for longer terms, in addition to those they already had. This led to a crisis of over-indebtedness, and widespread default, ultimately driving the systemic risk from less than 1 percent to almost 15 percent in a few short years. The consumer lenders ultimately collapsed with loan defaults equal or surpassing 30 percent of the portfolio, but great damage was done to the credit reputations of tens of thousands of heretofore excellent microenterprise clients. The profits of MFIs suffered greatly and the sector almost did not recover since the over-indebtedness crisis was followed closely by a severe economic crisis (unrelated to the indebtedness) that did affect informal economic activities.

It is not clear that the Superintendent could have acted more aggressively to suspend the operations of the consumer lenders and prevent such damage. The tools at their disposal allow them to intervene through the mechanism of re-stating financial statements, forcing greater provisioning and recapitalization. The growth rates of the equity base of the consumer lenders covered the increasing defaults, at least for a time. The Superintendent did act in early 1999 to limit total indebtedness to 25% of an individual's salary. By then it was too late and it had to intervene in two of the largest consumer lenders. The entire cycle that caused so much damage lasted only a couple of years, from 1996 to 1999 – a period of time in which a consumer lending based business grew to a size equal or greater than that of the entire microfinance movement (150 million dollars) and then collapsed almost totally.

This is consistent with the Superintendent's market building approach to the microfinance sector. Rather than prescribe the exact products that can be offered and the operating parameters of organizations that can offer services in the market, it has preferred to intervene only when the problems of certain institutions threaten the health of the entire sector. Thus, many clients pay the price for learning the hard lesson that they should not take on too much credit. On the other hand the Superintendent has wanted to avoid the potentially greater cost of repressing innovation in products and delivery mechanisms which would have been a natural consequence of a more controlled approach.

On balance, the sector has now largely recovered from the double crisis. MFIs do not have the luxury of simply not lending to clients who had a bad debt during the over-indebtedness crisis due to competitive pressures. The sad irony is that the requirement of the leading MFIs that clients must pay their debts before accessing loans again actually means that the quality organizations have directly supported the collection efforts of the irresponsible lenders. Perhaps this is just the natural cycle of a market based approach, one where the clients who are new to the system must learn the hard way, what their limits are, and the consequences of misjudging their capacity to carry debt.

External relationships

The Superintendent's office was quite willing to dialogue and learn from the microfinance community. The Superintendent's office engaged the microfinance community in a series of discussions around its regulations as they were being developed, hired expert international consultants who were skilled in the appraisal of MFIs, performance benchmarks, and in writing legislation. They participated in events such as the Boulder Microfinance Training and sponsored a number of students who did their thesis research on topics related to the regulation of microfinance. They hired ACCION International to train their supervision staff in the CAMEL (Capital adequacy, Assets quality, Management, Earnings and Liquidity) exercise designed to appraise MFI management and financial performance. This investment, coupled with the relative stability of the core teams working in the area of non-bank regulation and supervision, has led to a deep understanding of the evolution of the sector, and a greater degree of comfort in letting it develop on a market driven basis.

The transparency and standards setting function of the Superintendent's office has had a far reaching impact, beyond just the regulated MFIs. Even before they received licenses to operate as regulated entities, applicants had adopted the reporting formats and procedures required by the banking authorities. To this day, the standard set by the regulated sector shapes the standards of the non-regulated sector. It would be safe to say that the Superintendent's office has had a profound impact on the manner in which information is collected and reported, the transparency of the entire industry, and in the competitive environment that has resulted. It is no accident that the Bolivian microfinance experience is among the most written about – performance information is relatively easy to obtain, and trustworthy.

Ghana

Ghana, in contrast to Bolivia, regulates and supervises a large number of small microfinance providers. The microfinance sector in Ghana is characterized by a diversity of institutions that operate under different regulatory regimes. The formal sector institutions consist of rural / community banks (RCBs), savings & loan Companies (S&Ls), and credit unions. RCBs are covered under the Banking Law, while S&L and Credit Unions are covered under the NBFI law. Microfinance NGOs and susu collectors are not subject to regulation by government agencies.

Structure of Supervision

The Bank of Ghana carries out supervision of microfinance from two departments: the Banking Supervision Department and Non-Bank Financial Institutions Department. The latter was established in 1994 to oversee the licensing of NBFIs under the new Law, supervise and regulate them, and provide advisory and promotional services. It was put under the Banking Supervision Department in 2002. Until 2002, a separate department was involved in promoting RBs and, to some extent, following up on supervision issues. The CUA and the Department of Cooperatives jointly carry out the periodic field

examination and supervision of credit unions, sharing in the costs of examination with the credit unions.

Ghana created the Rural Bank and the Savings and Loan licensing categories in response to the absence of access to banking services for a wide swath of the rural and low-income populations. These moves made it possible to establish narrow banking units especially in remote rural areas and to service the needs of low-income self-employed earners in the urban areas. However, the opening up of new licensed institutional categories occurred at points in time when the Bank of Ghana appears not to have had the technical capacity and resources for adequate and effective supervision. The main results have been deficient supervision by BOG and bank closures and the attendant dislocation to clients of RBs and S&Ls.

Operating limits on non-banks are meant to address the risks in this sector. For example, rural banks, credit unions and S&Ls are not directly included in the central check clearing and payments system. This is part of the trade-off that allows the entry of specialized financial institutions with lower minimum capital than commercial banks, and is intended to mitigate the risks of relatively weak internal controls (see the discussion of minimum capital in the previous chapter). BOG cancelled check-clearing services for RBs in 1992, and did not allow participation by NBFIs. The demand for check-clearing services is one of the key motivations for RBs to establish and join the new ARB Apex Bank, which is a member of the Clearing House and can service its members. At least one S&L issues checks that can be cashed only at its branches. BOG considers that S&Ls are licensed to operate as savings institutions and not as general deposit institutions, and it is not in favor of them issuing their own checks.

Liquidity Reserve Requirements

Banks and deposit-taking NBFIs are required to maintain liquidity reserves, consisting of primary reserves in cash and balances with other banks and secondary reserves in Government and BOG bills, bonds and stocks. To soak up liquidity and improve the solvency of RBs by reducing the substantial delinquent loans on their books, BOG raised the secondary liquidity reserve requirement of RBs from 20% to 52% in 1996 (the primary liquidity reserve of 10% was not changed). The combined reserve requirement of 62% served to restrain lending by RBs – although in practice most have held *more* than the required amount in T-bills and other reserve assets. In 2002 BOG lowered the reserve requirements according to a classification system based on loan recovery performance, enabling those with good recovery to extend more credit and forcing relatively high liquidity on those with weaker recovery (Table 13).

Table 13: Ghana—New Reserve Requirements for Rural and Community Banks (as percentage of deposits)

Classification	Loan Recovery Rate		
	A. 90% or more	B. 75-90%	C. Below 75%
Placements with ARB Apex Bank*	5	5	5
Primary reserves	8	8	8
Secondary reserves	20	25	30
Total	***33***	***38***	***43***

*Intended to facilitate check clearing
Source: Bank of Ghana.

Delinquency and Provisioning

Licensed institutions are required to monitor and review the credit portfolio and other risk assets at least once every quarter. BOG has specified prudential norms for microfinance and small business loans that take into account the characteristics of these activities. Micro and small enterprise loans are required to be reviewed once monthly and are to be classified into (i) current or (ii) delinquent. A delinquent loan is one on which payment of interest or scheduled payment of principal has not been received as of due date. BOG does not permit interest income to be accrued on delinquent loans accounts. Provisioning for delinquent microfinance and small businesses loans is made on a "basket" basis, rather than an individual loan basis. Basket-based provisioning involves making a blanket provision for the aggregate outstanding balances of loans grouped in each arrearage basket, without regard to any security available for individual loans. The prescribed rate of provisioning is shown in Table 14.

Table 14: S&L Provisioning Rates for Micro & Small Business Loans (Ghana)

.

Number of days delinquent	%
Up to 30 days	5
30 days and less than 60 days	20
60 days and less than 90 days	40
90 days and less than 120 days	60
120 days and less than 150 days	80
150 days and less than 180 days	100

Source: Bank of Ghana.

In addition to the specific loss provisions to be made for delinquent or non-performing microfinance and small business loans, BOG requires licensed MFIs to maintain a general loss provision of 1% of the aggregate outstanding of all the current or standard class of loan assets. Financial institutions are also required to separately disclose, in their financial accounts and reports, the specific and general loss provisions made for non-performing delinquent loans and standard/current loan assets. Assets of all banks, both major and rural, are classified into five grades of risk.

Supervision Tools

The methods employed by the BOG for its regulatory functions consist of off-site surveillance; on-site examination; follow-ups; and special assignments.

Off-site examination entails the analysis of prescribed reports submitted periodically by the bank or NBFI. The prescribed reports are meant to provide information on the performance of the S&L or the rural bank. The analysis aims to verify compliance and performance on an on-going basis, based on Capital adequacy, Assets quality, Earnings and Liquidity (CA'EL; management is omitted).

On-site examination entails the supervisory staff physically going through the books, records and data to assess the accuracy of the reports submitted and to review in detail the compliance and performance of the S&L or RCB based on CAMEL. The Banking Law enjoins this assignment to be undertaken at least once a year for each bank, while the NBFI Law is silent on frequency.

Follow-up on-site visits are undertaken to discuss supervisory concerns raised during examinations and to ensure compliance with recommendations.

Special Assignments involve on-site activities. To manage risks to control systems from RB Managers staying on for years without taking annual leave, BOG established a special pool of nine experienced commercial bankers to relieve RB Managers so that they can take their annual leave. A relief manager spends on the average 6 weeks at a rural bank. Special assignments may also be undertaken to investigate embezzlement, irregular payments, manipulation of customers' accounts, granting of unauthorized facilities, and illegal discounting of T-bills. Besides minimizing fraud and enhancing internal controls, these special assignments have helped raise the skills of RCB staff, improved credit administration and the submission of prescribed norms, restrained undue interference by Board members and local authorities, and raised customer confidence in RBs.

Enforcement mechanisms available to BOG include fines, suspension, revocation of license, criminal penalties and appointment of auditors and managers. Twenty-three distressed RBs have had their licenses revoked. BOG has been concerned about irregular submission of prudential reports, and has begun applying fines for late returns and reporting non-compliance due to negligence of the executive to the RCB Board. Some RBs hide behind poor communication systems to delay the submission of their reports. Despite numerous training exercises provided by the BOG, ARB and donor organizations, some RBs still have difficulties in completing the report schedules with adequate accuracy.

A number of non-governmental institutions play a role in microfinance standard-setting and delegated supervision. An Association of Rural Banks was founded in 1981 as an NGO with voluntary membership, with encouragement and funding from government and international and bilateral donors. The Association's primary purpose was to promote and strengthen the rural banking concept through advocacy and training. Having no formal regulatory authority, it influences its members through moral suasion, peer

pressure and training seminars. With further support from the World Bank and IFAD, the Association pushed for the establishment and licensing of the ARB Apex Bank.ARB provides apex financial services for rural banks and assists Bank of Ghana in some of the supervision tasks. (However, BOG declined in late 2005 to share supervision tasks with ARB).

Towards the late 1990s, international and bilateral donors worked closely with local stakeholders and practitioners to establish the Ghana Microfinance Institutions Network (GHAMFIN) as an umbrella organization. GHAMFIN's membership includes umbrella associations of institutions in microfinance – ARB and its Apex Bank, CUA, the cooperative federation of *susu* collectors as well as individual S&Ls, rural banks, some NGO MFIs, individual consultants, consulting companies and researchers. GHAMFIN does not have regulatory authority over its members' performance and operations but it aims to serve as the central point for knowledge, monitoring and performance benchmarking for the microfinance sector. A major drawback to GHAMFIN's effectiveness in achieving its goals is that it is not financially independent, but continues to rely on technical and funding support from the international donor community and government.

The Credit Union Association serves as a self-regulatory apex body for the 232 credit unions (as of 2002), and its norms must be met as a condition for full registration of a new credit union by the Department of Cooperatives.[50] CUA applies prudential norms that are similar to the operating and financial standards of the World Council of Credit Unions (WOCCU). As of 2002, BOG continues to refrain from applying the regulatory functions authorized by the 1993 NBFI Law. The proposed new Credit Union Law would help clarify the delegation of specific supervisory functions to CUA, which will report to a Supervisory Board with BOG membership rather than to the Department of Cooperatives as at present. CUA enforces its regulations by downgrading CUs that are seriously in breach of compliance. One credit union that was operating outside CUA's regulation has been forced to close down.

Performance of the Supervision System

The level of accuracy and punctuality in the submission of the returns has been observed to reflect how well the RCB is performing; well-performing banks tend to submit accurate reports on time. S&Ls and RBs with weak compliance invariably do not use the reports as tools for management information, regarding them simply as information the BOG seeks for its own use. Since prudential regulation seeks to ensure the safety, soundness and stability of the financial system, it does not cover some types of information such as growth in borrowers, percentage of female borrowers, number of loan officers, etc. needed by an MFI to assess performance in meeting its objectives.

[50] In 2000 only 159 of the 219 credit unions registered by the Department of Cooperatives were considered by CUA as full-fledged financial cooperatives; the remainder were undergoing a process of institutional and membership development in order to be certified by CUA as full-service credit unions ready for registration.

In 2000 only about two-thirds of NBFIs (with a focus on those taking deposits) were examined. The costs of supervising a large number of small NBFIs and rural banks are high in both staff resources and transportation. BOG has struggled to perform regular on-site examination -- 23 supervisory staff handle the 115 rural banks with ¢518 billion in total assets (2001), compared to the 30 supervisors handling the 17 major banks with ¢14,436 billion in total assets. The Banking Supervision Department covered 97% of the rural banks in 2000 and reached 100% coverage in 2001. The NBFI Department had 100% coverage of the S&Ls (¢78 billion in total assets) in 2000 and 2001.

In 2003, Bank of Ghana inspected all the RCBs, however in 2004 only 98 of the total 117 RCBs were inspected due to staff shortage. The ARB Apex Bank, established under a World Bank – IFAD project with technical assistance from GTZ, was licensed in 2001 to perform apex financial services for RCBs and eventually take over some supervisory and training functions (and ultimately as a mini "central bank" for RCBs). However, the ARB Apex Limited Regulations (which have yet to be endorsed by BOG or the Ministry of Finance) would confer the Apex Bank the power to "inspect, regulate and supervise rural and community banks, subject to the general supervisory authority of the Bank of Ghana". According to recent statements by the Apex Bank, the BOG is reluctant to share supervisory authority over RCBs, notwithstanding BOG's lack of staff and resources.

Regarding credit unions, BOG continues to refrain from applying the regulatory functions authorized by the 1993 NBFI law to the cooperative sector, in deference to CUA oversight. CUA's annual audit covered 92% of the CUs in 2001, and had reached 90% by the end of March 2002. Teams of two persons, consisting of a CUA staff member and another from the Department of Cooperatives undertake the audits. Credit Unions pay CUA ¢150,000 (US$20) per day for the annual audit, which takes a minimum of 4 days.[51] The amount is shared between CUA and the Department of Cooperatives in the ratio of 3:1 (CUA is responsible for all staff travel and transport costs). In 2002 CUA members ratified a resolution empowering CUA to sanction CUs and their staff.

Indonesia

Regulation and supervision of all banks, comprising commercial banks and BPRs, is based on the 1992 Banking Act (as amended) and carried out by Bank Indonesia (BI). The Bank Indonesia Act No. 23 of 1999, passed in the wake of the financial crisis, defines a legal structure whereby the central bank can act independently in carrying out its duties as the monetary policy maker. The Law provides that Bank Indonesia will eventually relinquish its role in bank supervision to a new unified financial supervisor (OJK) to be established, while BI will retain authority for regulation and licensing. Parliament passed an amendment that postpones the transfer of banking supervision from the original deadline of 2002 to 2010 at the latest; thus, to date BI still has both regulation and supervisory authorities. The various LDKPs and financial cooperatives are supervised by the provincial development banks and the local authorities, respectively. The costs of supervision in all cases are covered by the respective agency budget (BI, BPD, local government).

[51] 17% of the less well endowed CUs were allowed to pay less than the C600,000 minimum.

Regarding the plan for a unified supervisory agency, Siregar and Williams (2004) warn that prevailing conditions will make it difficult for this agency to be an effective and independent supervisory body. First, the pre-existing supervisory agencies that will be joined themselves have not fully established strong supervisory roles. Second, the agency's independence must be secure in the law and secure in practice. Bank Indonesia suffered from a lack of independence for most of its history (until a new Central Bank law was passed in 1999) and this legacy lingers. At a minimum, the new agency should have the power to require information from financial firms, and to assess the competence and integrity of senior management and the owners of financial institutions. Ideally, the supervisory board should also be able to take appropriate sanctions against failures to comply with regulations, including having the ultimate authority to revoke licenses and to conduct financial activities (BI has been reluctant to take these steps, see below). In addition, the senior management of the supervisory agency must be protected from arbitrary removal.

Microfinance Banking Supervision

Bank Indonesia directly supervises banks, which means that it has authority over the largest component of Indonesia's microfinance market, the BRI Units (formerly *unit desa*). The Units are part of a commercial bank structure directly overseen by BI. The division of supervisory labor between BI and BRI, a state bank with a policy mandate, was not always clear in the past. Under the former Banking Act of 1967, BRI had been given a mandate by BI to supervise all "secondary banks," comprising all rural banks and market banks, including BKDs, as provided in the BRI Law of 1968. BRI exercised this function with minimum efforts, and its oversight was considered lenient, with a simple loan classification and quarterly reporting requirement. As BRI started developing its *unit desa* (village units) in the 1970s, a World Bank report (1988) revealed there had been a conflict of interest and advised BI to take over the supervision. Recently, BRI has been partly privatized and is being managed along more strictly commercial lines.[52]

Also subject to BI supervision are microfinance banks, including the fully licensed rural banks (BPRs) and the locally-sponsored village banks (BKDs), which have been brought within the regulatory category of BPRs on special terms, in an effort to support village banking and make supervision more comprehensive. Due to lack of personnel and experience dealing with the BKD system (which is distinct from fully-licensed BPRs), BI has delegated this supervision task to BRI, with financial support to cover the cost. There is also a move to upgrade some of the institutions in yet another category, the district savings and loan banks (LDKPs), to become licensed as BPRs and therefore directly supervised by BI (see below).

In supervising BPRs, BI employs a weighted CAMEL rating system – 30% Capital, 30% Asset quality, 20% Management, 10% Earnings, 10% Liquidity. BI has in some ways been an active supervisor of these institutions; as of March 2004, 194 licensed BPRs were suspended from operations for failing to meet BI standards (Indonesia Country

[52] An example of this is BRI's reluctance to provide information as freely as it did in the past, based on concerns that it needs to protect its trade secrets and competitive posture.

Profile, BWTP). BI officials estimate that one supervisor deals with some 15 to 20 BPRs, with each institution getting at least one on-site inspection per year. Early on, BI did not have the capacity to supervise the more than 2,000 BPRs, and so it outsourced this function to public accountants. This function is being integrated into BI in stages, with the external accountants being replaced by a combination of permanent and temporary BI staff (BI staff, especially permanent employees, are recognized as well-qualified and well-remunerated).

However, the oversight of BPRs has not been problem-free. There is reported to be a significant amount of undercapitalization and weak governance in this sector, resulting in a number of closures, as mentioned above. Further, BI has not used its inherent authority to shut down unlicensed microfinance banks – although such a closure was reported recently in Solo, Central Java. This forbearance, whether due to conscious policy or incapacity, seems typical of microfinance regulation in most countries.

Box 3: BPRs in Central Java

There are 342 BPRs in the region. There have been six new BPRs in the past year. BPR customers are typically poorer than bank clients, including those of the BRI units. BPR interest rates are 22-30% annual on loans, 13-15% annual on deposits, and 10% on passbook savings. Loans above Rps. 500,000 require collateral, a requirement that is often met by the handover of a motorbike title document or an informal property deed.

The BPRs are monitored by eight sub-teams of supervisors in the regional BI branch in Semarang, with a ratio of one supervisor per 17-20 BPRs. They are subject to the CAMEL rating system and an 8% capital adequacy requirement. They report to BI monthly, quarterly, semi-annually, and annually; and report documentation includes a business plan, a report on compliance with legal lending limits (related borrowers), special reports, and an annual financial report published in a local newspaper. On-site supervision takes five days.

An additional factor in the supervision of BPRs is the deposit insurance system. Since 1998, government has provided a 100% (blanket) guarantee of all liabilities, including deposits. Law #24 on Deposit Insurance, 2004 provides for the continuation of the blanket guarantee until the end of the first quarter of 2006, then a phased reduction in coverage (a maximum of Rps. 5 billion down to 100 million) over the succeeding year. The original draft of the bill offered a lower guarantee for BPRs than banks, but then the BPRs lobbied for equal treatment. If the deposit interest rate for a one month deposit is above a stated maximum (banks 13%, BPRs 18% per annum), then the affected deposits will not be insured. A government company (LPS) has been given responsibility for deposit insurance, but it relies for supervision on the reports of BI.

Delegated supervision

The BKDs or village banks are supervised by BRI branches under an agreement with Bank Indonesia. For this function, BRI has retained external accountants, each of whom covers five 5 BKDs, and one BRI staff member oversees five accountants. The budget provided by BI for this supervision effort was Rps. nine billion for the last fiscal year,

and 11 billion for the current year. BRI does not charge the BKDs any supervision fees to cover costs. Several of the BKD standards are similar to those for BPRs: for example they both use the same 12 week loan loss provisioning schedule.

The district savings and loan banks, or LDKPs, were established and are regulated by provincial governments, with supervision delegated to the provincial development banks (*Bank Pembangunan Daerah* or BPD) – which are also owned by provincial governments. The LDKPs are formally outside of the legal framework for microfinance banks and cooperatives (Indonesia Country Profile, BWTP), although the Banking Law of 1992 required LDKPs to apply for BPR licenses. Thus, efforts are being made at the provincial level to restructure and upgrade them to the level of BPRs. In Central Java, the local LDKPs (called BKKs) were set up at the sub-district (*kecamatan*) level, and now are being merged into one institution based at the district (*kabupaten*) level, with the original units serving as branches. BKKs that have not become licensed rural banks (BPRs) are not legally allowed to take savings – though apparently some do anyway.

Currently, the promoted LDKPs have two "foster parents," namely BI and the BPD, while unpromoted LDKPs continue under one supervisor: either the BPD, or the local government's audit office (*inspektorat*). In Central Java, institutions of this type (BKKs) view the dual supervision as burdensome. In addition to this, the various decentralized levels of government do their own indirect monitoring.

BPDs are also full-service banks operating on the retail level. To eliminate the potential conflict of interest and unfair competition between LDKPs and the branch offices of the BPDs, there was an agreed segmentation of market, with the provision that LDKP's clients would graduate at a certain loan amount and become clients of the BPD branch offices. After the aid program supporting this activity phased out in 1993, only a few BPDs really continued this function, because most of them faced budget constraints and other problems associated with their status as commercial banks.

The quality of the provincial development banks and local LDKPs varies from region to region. The consensus appears to be that Bali has the best system, followed by Central and East Java. The BPDs were affected by the crisis of 1997-8, with many of them becoming insolvent and subsequently being recapitalized. Given their local setting and their numbers, the LDKPs are unable to draw on the pool of trained personnel that the banks use, and so the skills and systems at this level are somewhat rudimentary. The compensating advantage here, according to some observers, is that this forces the LDKPs to maintain a culture and environment that are comfortable for low-income clients.

Supervision of Non-Bank MFIs

Cooperatives and saving and loan units are regulated under the Cooperatives Law. They had been directly supervised by the Ministry of Cooperatives and Small-Medium Enterprises – even open-bond savings and loan coops, which have greater affinity to banks. Reforms since the late 1990s have helped to reduce the intervention of the government in the sector, to change the picture of Indonesian coops, and to begin integrating credit unions into the cooperative sector. The number of coop members has

increased drastically since 2000, creating competition for market share with the BRI Units.

A major shift has been the decentralization of cooperative oversight, in line with the broader devolution reforms since 1999. Savings and loan cooperatives are supervised by the district (*kabupaten*) administration, with the support of (or delegation to) representatives of sponsoring line ministries of the national government (e.g. ministries of agriculture or labor). The supervisors use CAMEL criteria, but the Ministry of Cooperatives is drafting new performance criteria. Cooperatives can be open bond, and take savings from all members, intended members, and members of other cooperatives. Under the new Ministry of Cooperatives criteria, there is a 5% capital adequacy requirement, and minimum capital is set at Rps. 15 million for a primary cooperative, 25 million for a secondary cooperative. The central Ministry of Cooperatives trains and certifies supervisors and can request data, but it no longer has line authority over the sector. Financial cooperatives had been under BI decades ago, but were then moved out – and bringing them back under BI is not being considered. To date, supervision of cooperatives has apparently been toothless. Islamic MFIs (BMTs), to the extent they are licensed, have taken cooperative form and are supervised in this manner, with added oversight of *Syariah* compliance by the Muslim spiritual leadership.

Credits unions are legally distinct from cooperatives, and have a tiered organizational structure under the National Credit Union Federation. There are three tiers: credit unions, regional bodies, and a national body. The national credit union federation can audit the regional body based on mutual agreement, and could audit the primary credit unions jointly with the regional body only if invited to do so by the primary level credit unions. In effect, there is little supervisory authority over primary and secondary credit unions.

Unlicensed BMTs, Grameen Bank replications, and other NGO-MFIs that have not yet transformed into a cooperative or BPR are in a grey area without supervision – apart from the need to report to the Ministry of Interior. Much depends on how effective their internal controls are. Some foreign donors are doing monitoring and evaluation of MFIs receiving their funds, and this increases the MFIs' attention to performance standards. Under the 2001 MFI Bill, these non-bank-non-coop institutions would be registered as MFIs, and their supervision and regulation would be handled by the proposed single regulator (OJK).

State pawnshops are also a major provider of microloans to relatively poor populations in Indonesia, since the Dutch colonial time. As of December 2003, they numbered 774 units, serving 14.3 million clients. Pawnshops are regulated as government entities and under the supervision of the Ministry of Finance. The development of pawnshops is impressive because of their fast and simple procedures, captured in the pawnshop slogan: "solving problems without creating other problems,"

Mexico

The LACP envisions a system of "auxiliary" (or delegated) supervision that relies on the federations for implementation. The federations have two main tasks. The more

important of the two is to form Supervision Committees, which are made up of ten members on average. The committees provide on- and off-site supervision in accordance with norms provided in the secondary regulation. The federations, in particular FINE, see the most difficult problems being the governance of the EACPs, the inertia of the cooperatives with respect to adjusting their past practices, the lack of human capital (many federations could not find supervisors who met minimum criteria), and compliance with the regulations. The other task of the federations is basically administration and technical assistance to the EACPs.

The addition of delegated supervision to the federations' responsibilities represents a major shift, with implications for their mission and human resource base. Most of the federations existed prior to the LACP, but there are also four new ones. Currently, ten federations have been authorized and 12 Supervision Committees certified – the latter are typical in financial cooperative systems, but in this case they will be conducting oversight on behalf of CNBV as well as the federation itself. Desjardins has a license from CNBV to certify Supervision Committees in the federations – and for this purpose it has trained and certified over 100 federation supervisors. Minimum qualifications of supervisors vary depending on the type of region served – with an accounting license required for urban federations, a technical certificate for rural areas. One of the major complications in this capacity-building process has been the resistance to harmonization of requirements due to the historically distinct accounting processes of each *caja* and federation.

The first fully operational federation is FINE, based in Queretaro (Central Mexico). It has 12 members and affiliates (a mix of cooperatives and SOFIPOs), 27 staff, and a seven-person Supervision Committee – all of whom have Desjardins certification. Funding comes from member dues. FINE had to eject one non-cooperating member institutions. The SOFIPOs entered FINE as affiliates, not members – they pay a fee for supervision. By FINE's account, CNBV has not been overly demanding, and is a bit uncertain about how to deal with the microfinance sector. Start-up approval required a great deal of time and paperwork – a burden that FINE understands as part of its pioneering "guinea pig" role.

The main risks of the auxiliary supervision scheme lie in the potential for conflict of interest on the part of the federation supervisors. To reduce these risks, the rules provide that the supervisors cannot have worked in a *caja* nor in any of its affiliates in the last three years, and must declare their relationship to the *caja* in case they have been clients. For this, the supervisors must sign sworn statements. Further, the supervisors are evaluated by Desjardins every six months (in future, Desjardins will turn this function over to a local organization). Last, the president of the committee cannot be dismissed without authorization by the CNBV.

The regulatory norms to be implemented through this scheme of supervision are inevitably complex, since they reflect both the general characteristics of microfinance services and difference in institutions' scale of operations. The norms direct the federation Supervision Committees, under the guidance of CNBV, to carry out oversight and set specific internal policies based on standards defined for four categories of

institutions. First of all, there are four levels of operations permitted to MFIs according to their geographic spread, and the size of client base and portfolio. Second, prudential standards are set up according to the institution's portfolio size (amount of assets). The top tier of prudential standards are similar to those applicable to commercial banks, while the lower three tiers take account of differing levels of microfinance operations. For example, minimum capital ranges from US $34,000 to $8.5 million (latter is 50% of the requirement for commercial banks), and prudential ratios such as capital adequacy are generally more stringent. The CNBV provides detailed guidance on federation-based supervision in its *Guia de Supervision Auxiliar*. This includes monthly, quarterly, and annual reports; annual audits; and on-site inspection.

The cost of supervision will be based on three criteria: risks, size, and intensity of supervision. Of the amounts to be paid by the EACPs, 80% will go to the federation, and 20% to the CNBV. The majority of federations are not following a strictly regional criterion for their members and affiliates. In this sense the Mexican system differs from the Desjardins approach, and it will likely raise the costs of on-site supervision (i.e., travel costs to sites across Mexico).

Also, the CNBV has been building up its capability to supervise this sector indirectly. When the LACP was passed in 2001, CNBV had no staff or tools for microfinance supervision. Now it has a dedicated unit with some 25 staff, with plans soon to add ten more, and a budget of approximately US $200,000 (currently subsidized, but projected to be covered by fees and penalties in future). With some *cajas* continuing to operate independently of any federation, and without any plan to comply with the LACP, the Ministry of Finance has worked to clarify CNBV's authority to shut them down, and has begun pressuring the CNBV to do so.

South Africa

We previously described how South Africa set up a non-profit agency, the MFRC, as a non-prudential regulator of its microlending market. The 1999 Exemption Notice calls for a "regulatory institution" with representatives of consumers and industry on its Board, and charged with enforcing market conduct and disclosure rules, addressing consumer complaints, educating the public about consumer rights, and publishing information on the industry.

In substantive terms, MFRC is a non-prudential regulator. As such, it applies consumer and related market behavior standards to microlending operations. Dealing only with credit provision, it does not conduct financial supervision in the sense of tracking financial ratios and risk-management systems (the latter functions are handled by the Reserve Bank of South Africa). In the discussion that follows, we look more closely at the main features of this, including registration, compliance monitoring, handling complaints, etc. Lenders registered with the MFRC do send periodic reports, but these relate to market operations and compliance with MFRC rules. The costs of this regulatory system are borne by the microlenders through fees that are set on the basis of portfolio size. MFRC receives some state funding, but this is largely for special initiatives; the agency's core regulatory functions are essentially self-financing (ECI-IRIS 2005).

The discussions that led up to the MFRC's founding also envisioned it as having the function, often associated with central banks and financial regulators, of ensuring the development of a responsible and sustainable micro-lending (or more broadly, small-scale financial services) industry. MFRC proceeded on the basis of its statutory mandate, but also attended to this market development function as a necessary complement – and thus has been viewed as advancing a "dual mandate." The MFRC and its proponents see the agency's sectoral development work as a strategic approach toward meeting the ultimate objective of sustainable access to financial services for the average South African. (Others feel that by interpreting its mission so expansively, MFRC has made it difficult for itself to meet the "core" mandate of consumer protection.) The main ways in which MFRC expanded its scope were in pursuing unregistered lenders and in setting up a National Loans Registry (discussed later in the paper).

Registration

The Accreditation and Compliance Department of MFRC handles this function. Upon MFRC's founding in 1999, it had to set up a system of application, checking, and expediting registrations. Since mid-2004, evidently as a result of MFRC's campaigns against unregistered lenders (see below), some 50 applications have been received per month. The Department responded to this influx by allocating two staff exclusively to new applications, and the remaining three largely to renewals. The number of currently approved entities ballooned by nearly 700, to 1708.

Complaints, Investigations, Enforcement

Around the world, agencies with statutory enforcement and complaints resolution mandates often end up taking a "retail" approach, i.e. devoting the bulk of their efforts to responding directly to all complaints and referrals. As a signal of serious intent, and as an early encouragement toward compliant behavior, this has its advantages. But, it is expensive, and is not always within the means of the agencies involved, especially small ones. Some agencies, where they are not legally prevented from doing so, have attempted to marshal their resources to deal with strategic issues and have maximum impact.

MFRC is in the latter category. While its complaint lines field all inquiries, these are filtered so that the numbers referred for action are kept within limits. MFRC has attempted to be strategic in several ways. First, it decided by 2003 that it did not make sense for it to become the "complaints department" of first instance for all institutions in the sector. Thus, MFRC analyzed complaints concerning the largest of its member institutions, and worked with them to establish their own complaints departments. In the latter cases, complaints are supposed to come to MFRC only when an acceptable solution has not been reached at the level of the institution.

Reported complaints have increased since 2001, due to a combination of lender behavior, borrowers' perceptions of rights and standards in the credit market, and borrowers' willingness to bring complaints before MFRC. An important area of legal enforcement concerns the retention of bank cards and PIN numbers as guarantee of repayment. This was outlawed in the 1999 Exemption Notice. It is by all accounts, still rampant, although

the number of such abuses reported to the MFRC is minimal. In principle, MFRC could have used its power of deregistration to deal with this, but it found this to be impractical. To do this consistently, MFRC would have been required to deregister a significant proportion of the sector. This would not have been politically feasible, and it would have defeated the objective of developing the sector. By MFRC's account, no lender has been deregistered for this infraction alone – and MFRC's statistics show that this ultimate punishment has been used very sparingly, i.e., six times since 1999. By fulfilling its mandate without over-utilizing its strongest enforcement weapons, MFRC has in a sense practiced the kind of practical, informal forbearance that regulatory agencies in other countries (e.g. Bolivia, Indonesia) have found indispensable.

Less numerous than card and PIN cases, though by most accounts more serious, are cases in which lenders have used, illegally, blank process documents – often as an integral part of a loan agreement. The possibilities of abuse with the signing of blank court process documents far exceeds those of a lender retaining a bank card and pin, which the borrower can cancel at his or her bank at any time. The MFRC has had to educate court officials to help improve court practices, and also follows up on a number of complaints in this regard. Consumer education has also focused on addressing this issue, emphasizing that blank documents should not be signed.

Enforcement activities that are not pursuant to the enforcement of the Usury Act itself (e.g. unregistered lenders) or the 1999 Exemption Notice (e.g. card and PIN retention) have been held up by a court decision striking down MFRC's interpretation of its authority. While investigations on registered lenders are being done under inspection powers provided by the Usury Act, the disciplinary action phase has been delayed until approval of a revised Exemption Notice.

Over-indebtedness and Reckless Lending

A major substantive thrust by MFRC has been to address over-indebtedness and reckless lending. To do this, MFRC had to come up with a definition of over-indebtedness – i.e., that point at which debt service obligations become unsustainable and affect the debtor household's standard of living. MFRC settled on a scale of 60%-80% of income required for debt service, with the lower end of the scale representing a serious risk of over-indebtedness, and the top of the scale indicating, essentially, a debt crisis. Reckless lending, in turn would be the extension of credit in circumstances where the lender is aware (or has reason to know) that the borrower is over-indebted. The development of the National Loans Register, discussed in more detail later in the report, was a very important part of MFRC's strategy to address this problem.

This area represents a strategic choice that MFRC had little or no ability to avoid, given the political concern surrounding it. In some other national contexts, the choice might not have been a sensible one. In South Africa, however, income and opportunity are very unevenly distributed, and the relative lack of financial literacy and economic sophistication of the average household argues for strong consumer credit protection. Further, given the near-automatic repayment mechanisms for payroll-based credits, the lenders face little deterrent to over-lending.

From a system-wide perspective, a tough line on reckless lending was perhaps not the top priority – greater benefits might well have come from introducing greater competition in financial services. However, MFRC did not have authority in that area, although it did contribute significantly to policy development there. Given that over-indebtedness was both inflicting pain on many ordinary households, and casting doubts on the legitimacy of a financial sector that already had burdensome historical legacies to overcome, the choice to get tough on reckless lending seems inevitable.

Should MFRC have taken a lower-key, more cooperative approach, instead of its more punitive stance? It seems doubtful that such an approach could have succeeded; moreover, it needed to establish its authority in this field and its willingness to enforce sanctions. Newly established agencies across the world often face such challenges. An effective response can include compromise, but only against the backdrop of a credible enforcement threat. Unfortunately, after the MFRC made some progress in this area, its revised 2002 rules (including the reckless lending provisions) were struck down, leaving it without investigation and enforcement powers – apart from those directly delegated by DTI under the Usury Act.

Compliance Monitoring

Another strategic effort by MFRC to leverage its resources has been its approach of coupling annual audits with lender compliance certificates. The latter enable the lenders to report regulatory non-compliance before it is discovered by auditors, and thereby gain the opportunity to work out a compliance plan with MFRC (and reduce the possibility of eventual sanctions). Any such plans or settlements need to be approved by the MFRC Board – a form of oversight that discourages abuse of discretion. MFRC statistics report that compliance has been improving, along several axes. MFRC also uses auditors contracted from the major accounting associations in its compliance work. A further effort along strategic lines has been to require lenders to use form contracts that have been approved by MFRC. This, in a sense, is preventive work that lessens the burden of enforcement later on. However, the approval of form contracts for all lenders has proven too burdensome for MFRC, and it has backed away from it.

The benefits of MFRC's compliance approach include timelier reporting by lenders, a decrease in infractions by large institutions, and an increase in the resolution of complaints in favor of MFRC – up to a current reported figure of 55%. Many observers point out that there is a large amount of lending activity outside this limited sample, and that compliance by smaller lenders seems to leave a great deal to be desired. There is wide consensus, outside MFRC as well as inside, that the retention of bank cards and PIN numbers continues to be rampant. Also, disclosure practices are frequently reported to be non-compliant. The consumer still cannot get a clear idea of the cost of credit – this is an especially severe problem in light of illiteracy and financial ignorance. Some say that lenders pay only "lip service' to the explanation of credit terms (similar to Truth-in-Lending). Still, MFRC's compliance audits, together with its responses to complaints and pro-active investigations, have helped encourage compliance. Rates and disclosures are standardized, and the procedures are widely understood, if not universally followed.

Unregistered lenders

Legislative amendments to Usury Act in 2003 empowered the MFRC to conduct inspections on unregistered lenders. As these powers were created by law, they survived legal challenges to the MFRC's revised rules. Since the amendment of the Act, MFRC has acted aggressively. For the year 2004, MFRC received a grant of R one million from DTI for its unregistered lender campaign.

Indicators of its performance here include the following numbers (MFRC statistics from April 2003 to December 2004):

- Cases launched (401) and concluded (343),
- Work in progress (58)
- Number of criminal prosecutions (21)
- Cases inspected and completed waiting prosecution (214) (leading to 15 prosecutions, 64 amicable settlements),
- Amount of fines paid (R 151,150),
- Fines often paid as alternative to imprisonment. In numerous cases, suspended sentences were also given as a deterrent. Unregistered lenders therefore either close down, register, or abide by Usury Act in the face of a jail sentence.

These numbers do not provide a comprehensive or conclusive statement of MFRC's outcomes in this area. They do indicate serious effort, and probably a strong signal to many lenders who might consider operating without a registration and in contravention of the Usury Act. However, the clarity and immediacy of this signal depend on the breadth of MFRC's reach, and where it has the greatest presence. No agency, above all a relatively small one, can offer comprehensive coverage. Thus, the numbers become more meaningful when interpreted in light of qualitative information on MFRC's strategic choices, i.e., has it been empowered to choose cases for maximum impact, has it done so, and with what result? As MFRC is an independent regulatory body, it cannot act as a prosecutor but must bring cases in the courts. As such, it has discretion over the choice of lawsuits to bring. Otherwise, it would have only limited control over the use of its resources, which could quickly get exhausted in pursuing all reports of unregistered lending.

What impact has MFRC had on the proportions of registered versus unregistered micro-lenders? The MFRC has conducted some field enquiries to determine the approximate numbers and trend in remaining unregistered lenders. On this basis, it has estimated that their numbers are insignificant. Other observers, however, question this conclusion, suggesting that it cannot be sustained, and in particular that it is extremely difficult to locate and quantify unregistered lending activity in the townships. All of this indicates the difficulty of performing and assessing enforcement efforts against unregistered entities – an effort that has been notably absent in many of the other microfinance supervision systems reviewed in this paper.

Hybrid Supervision and the Move to the National Credit Regulator

The provisions of the Credit Bill concerning the prospective National Credit Regulator resemble those of the 1999 Exemption Notice. Both agencies have as their major functions the promotion or development of the industry, conducting research and periodically reporting on their monitoring of the industry, and the more traditional regulatory functions of registration and enforcement. There is, however, a potentially important difference. The MFRC reflected more of a self-regulatory approach to the sector, while the NCR is to a greater extent a creature of government – hence more of a classic public sector regulator. The full extent of this difference has yet to be decided, since the enabling language of the Bill has not yet been translated into regulations. However, there are indications in the Bill of a different approach. Whereas the MFRC was required to have equal representation of the industry and of consumers on its Board, the NCR is to have a Board appointed entirely by DTI and other interested ministries.

It is worth discussing the range of options here, from ministerial control to full self-regulation. Among the options is an independent public regulatory agency; another is a hybrid arrangement in which a private entity carries out delegated public regulatory functions. In the former case, special provisions regarding appointment, accountability, and fiscal support are designed to ensure that the agency acts on an autonomous and professional basis, free of both political and industry interference. This is especially important where the agency combines the equivalent of legislative, executive, and judicial functions – albeit subject to legislative oversight and appeal to the courts.

At the far extreme of self-regulation, i.e. voluntary industry codes of conduct, the government is kept at arm's length and the industry determines the mode of policing, which may be more or less robust depending on the outside pressure that the industry faces. The other end of the self-regulation spectrum is closer to classic governmental regulation, but with some public-private division of labor. Here, there are a few variants. One is "statutory self-regulation," typically associated with the professions, where legislated standards are enforced by industry associations, and certification procedures reinforce professional standards and public confidence. Another variant, involving greater involvement by government, is "supervised self-regulation." The prime example here is the stock exchanges in the U.S., which police member behavior according to well-established industry rules, under continuous oversight by government regulatory, investigative, and judicial authorities – notably the Securities and Exchange Commission. This arrangement draws on the established customs and rules of the exchanges, backed up by official oversight. This "outsourcing" of regulatory policing has the advantages of flexibility and efficiency – although periodic scandals do arise, which often lead to a ratcheting up of regulatory standards (Priest, 1997).

MFRC sits somewhere in the latter part of the hybrid regulatory spectrum, exhibiting some features of the "statutory" and "supervised" self-regulation models. Both lender and consumer representatives have their complaints about the MFRC but admit that it has had a major role in ensuring greater formalization, integrity, and sustainability in the industry. This is, arguably, precisely because the MFRC was set up as a hybrid and not an arm of government. It has been able to encourage voluntary compliance by the industry, as a

self-regulatory body, at the same time as it wielded investigatory powers and official sanctions. In parallel, it has reached out to consumers to provide information, training, and a forum for grievances. Last, its position outside the government hierarchy (along with astute appointments), has enabled MFRC to resist political pressures to become a draconian enforcer charged with "shutting down loan sharks" wherever they exist.

Other Cases

In the cases of Brazil and the Philippines, detailed information on supervisory systems and practices were not fully available to us, and in any case would contribute little to the thrust of this chapter. Still, in the interest of completeness, we provide a few observations here. In Brazil, supervision of microfinance is relatively modest, since deposit-taking is restricted. Moreover, the exercise of supervision has had little impact on the outcomes. The rules concerning sources of finance, interest rates, loan sizes, and reporting (in the case of government funding) created a disincentive for growth in an already-underperforming sector. Thus, apart from burdensome reporting requirements in some cases, supervision has played little role in the sector.

In the Philippines, BSP has specialized supervision and examination departments for the thrift banks sector as well as for the rural banks and cooperative rural banks sector. The separate and specialized departments enable focused technical attention on the strengths, deficiencies and problems that banks in these sectors may be encountering. As in the case of other licensed and prudentially regulated banks, the banking institutions with microfinance orientation are subject to periodic reporting requirements, off-site monitoring and onsite examination and supervision for compliance with prudential standards. Moreover, they pay into, and are part of, the formal deposit insurance and protection system, which undertakes its own examination of reporting and control systems and soundness of deposit-taking and –management practices.

Following are some of the key prudential standards used for microfinance in the Philippines. Additional detail is contained in Annex II at the end of this report.

- **Capital adequacy.** Microfinance banks licensed as thrift banks, rural banks or rural cooperative banks are subject to the 10% minimum capital adequacy requirement mandated by BSP for all licensed and prudentially regulated banking institutions.
- **Asset quality.** The loan account aging, classification and provisioning requirements for microfinance loans (which follow international best practice standards) are adjusted to the particular characteristics of microfinance loans and, in this sense, are more demanding than the standards and guidelines for commercial and other loans in non-microfinance banking.

Conclusions on Supervision Approaches

The countries discussed in this chapter take a range of approaches to the supervision of microfinance activities. The main variables in play are these:

(i) the scale and scope of the supervisory task in terms of the kinds of activities overseen (e.g. intermediation or including credit-only), the issues under the supervisor's jurisdiction (e.g. prudential norms, consumer protection standards), and the numbers and types of institutions subject to supervision;
(ii) where supervisory power and responsibility are placed – with the central bank, bank superintendency, specialized regulator, delegated or self-regulatory body, central versus provincial or local government; and
(iii) the substantive standards and tools available to the supervisor, along with its capacity to enforce its decisions.

Concerning the scale and scope of the regulator's work, Bolivia once again defines one end of the spectrum. There, the Superintendency seized the opportunity to determine the scale of the sector through its cautious market-building approach. This permitted informal experimentation, up to a point, based on regulatory forbearance ("regulating by exception"), while institutions built up the capacity and experience to enter the formally regulated sector one-by-one. The Superintendency was able to vary the conditions for entry in order to create a market comprising a small number of solid, experienced providers. In doing this, the Bolivian authorities used their experience and discretionary powers to vary minimum capital and to recognize the value of solidarity guarantees. Bolivia is justly praised as an example of what an empowered supervisory body can accomplish when it stays in close touch with the sector and follows the market.

The other countries in our sample cluster toward the other end of the spectrum, i.e. a large number of microfinance providers, most of them small. This poses a challenge to the supervisory system, requiring it to secure sufficient resources for its work and to ration them by focusing on certain activities and institutions, and in some cases delegating some functions to other agencies. In this sense, Ghana seems to tax the capabilities of its supervisory agency more than other countries, requiring it directly to supervise a large number of MFIs, many of them quite small, and not all of them intermediating funds. Even so, credit unions in Ghana are overseen through a delegation of authority to the CU association. Together with a clean-up of the rural bank sector, this supervisory labor has severely stretched the Bank of Ghana supervisors and imposed significant costs. In order better to manage this area and focus resources where they are most needed, other systems have limited supervisors' oversight to those institutions that intermediate public savings (Mexico), created specialized supervisory agencies to deal with specific issues of concern (South Africa), or delegated supervisory responsibilities to other organizations.

Delegated supervision is a kind of hybrid involving elements of government oversight and self-regulation. This, too, can be arrayed along a spectrum defined by government involvement, autonomy of the supervisor, or influence by members of the sector. As with other elements of the regulatory framework, the mode and content of supervision need to be tailored to the needs of the sector and its stakeholders – which change over time. The outcomes of any choice along the spectrum will include the costs imposed on the sector and the public, the scope of any state deposit guarantees (implicit or explicit), and the

ability of the supervisor to impose its decisions – especially when these are unpopular or costly to the sector.

Ghana, Indonesia, Mexico, and South Africa all have some form of delegated supervision. The system in Ghana, whereby credit union supervision is delegated to an industry association, is essentially a system of self-regulation. A statutory self-regulation system such as Ghana's operates within an envelope of government-defined norms and oversight, but primary responsibility and the bulk of information and supervisory activity are in the hands of the self-regulatory organization. The systems in Mexico and South Africa bear some resemblance to this, but with more robust structural guarantees of the supervisor's professionalism and autonomy from the sector. In the Mexican case, this is provided by the Desjardins auxiliary model, in which federation-based supervisory committees report directly to the financial supervision authority. South Africa uses a non-profit company model where stakeholders sit on the supervision agency's board, but the latter is responsible to its ministry for fulfilling a mandate defined by regulation. In the Indonesian version, supervisory functions are contracted out to BRI, a majority state-owned commercial bank, and paid by Bank Indonesia. This is indirect supervision of a different sort – not by a sectoral association but by a higher-tier financial institution that may also play a direct commercial role in extending credit or providing correspondent services.

The cases thus illustrate the range of design options within this field of hybrid oversight. Two final points are worth noting. First, the hybrid options sit within a larger spectrum of state control and private initiative. At one end is state ownership in which the regulation, supervision, and operations are combined. This is the essence of the old state development bank model, which has been discredited and largely abandoned because of severe governance weaknesses resulting in bad performance. At the other end, notionally, is a pure *laissez-faire* approach in which market entry is unlimited and oversight is handled by the market itself. As with banks, microfinance requires finding the right mix or the right position in this spectrum in order to achieve the goals of outreach, access, sustainable growth, scale, and financial discipline. The ideal approach suggested by the case studies is an inductive approach in which the right mixture is achieved through constant communication between the sector and government (as well as other stakeholders), and the supervisory system follows and supports the market. In many countries, this ideal is approachable, but in others it may not be – whether due to the damage arising from prior abuses, or to the need for a more active public role in getting the sector established.

5. Microfinance Promotion and Market Development

Microfinance policy, as we stated at the outset, is fundamentally about expanding access. States have available to them a wide range of tools for pursuing this objective, from subsidies and quotas, on the more interventionist side of the spectrum, to the provision of information, infrastructure, and support for voluntary standards at the other of the scale. Regulation sits somewhere in the middle. It is a neutral public good, in the sense that it simply provides a governance structure in which microfinance can be provided on a sound basis. It is also a promotional tool, since it provides a 'seal of approval' to regulated and supervised entities, and with it an implicit state guarantee to savers. The proof of this is the widespread phenomenon of microfinance sectors *seeking to become regulated.* In each case presented in this paper, a question arises as to the appropriate balance in policy emphasis, between rigorous financial discipline and governance, on the one hand, and sectoral growth and expanded access on the other hand. Whether regulatory or other kinds of tools are used to promote expansion, these inevitably have implications for the regulatory system and the incentives it provides.

In this area, the case studies show approaches ranging from more market-oriented to more state-directed modes. In the former, privately-organized apex associations undertake promotion, and funding comes from a combination of non-profit and commercial sources. Here, policy priorities focus more on a supportive regulatory environment than on direct intervention. In state-directed approaches, by contrast, promotion may be undertaken by a government agency, with funding from state budgets or development banks. Intermediate approaches may involve mixed organizations providing some funding and promotion, with the state using bank lending quotas, interest rate subsidies, technical assistance, and other tools to expand access to microfinance. Often, regulation is deployed as a tool of market development, resulting in a mix of prudential, consumer protection, and promotional policies. This is especially, but not exclusively, true of special-purpose microfinance regulators and of apex bodies that house both regulatory and promotional responsibilities.

In this chapter, we discuss the promotion theme in six of the seven cases, highlighting the pros and cons of the different approaches. For Ghana, since insufficient detail was available to us, we refer the reader to the material in the previous chapter, which also touches briefly on the above theme.

An important specific approach is to design policies to increase the involvement of banks in the provision of microfinance services. Such different approaches as small-scale credit quotas or targets, facilitation of MFI-bank correspondent and agency relationships, and second-tier services by state banks can play a significant role in extending microfinance services. How relevant, and how effective, have these approaches been in deepening financial services markets and extending access to poor households and microenterprises? Do these approaches give sufficient emphasis to the downward integration of banks into microfinance services?

Bolivia

The microfinance industry developed in Bolivia from the ground up, and was not led by regulatory or government authorities of any sort. It was clearly established and operationally successful before the public sector took any note. When the 'public sector' woke up to the potential of microfinance, it did so in many places and ways. Congress took a populist view and exerted pressure for government programs, and for many unhealthy practices that were rejected out of hand by the successful MF providers who chose not to participate in these initiatives. The Bolivian public sector had been stripped of all its public banking institutions. Thus, politicians had no easy place to push money through - and were compelled to use the MFIs, most of whom were engaged in best practice.

As the MFIs themselves pushed to become regulated in order to tap into public funds (both from the government and, eventually, deposits from the general public) the banking authorities proceeded cautiously - having emerged from one banking crisis brought about by the hyperinflation, drastic financial sector liberalization, and typical bad banking practices. They were in no hurry to add another set of unhealthy institutions. They were concerned with being helpful in re-generating an extensive network of bank branches to replace those lost through consolidation and liberalization, but not at the expense of creating poorly performing entities. As such they always thought in terms of allowing a limited set of highly capitalized, well governed institutions. Simultaneously, the banking authorities were being asked to reform and restructure the cooperative movement, consisting of 300+ entities, most of whom were small, poorly run, and insolvent.

The banking authorities did not generally view their role in promotional terms, if we consider this to be the typical function carried out by an apex organization that concerns itself with providing the conditions, funding, rules, and structures for a new class of activity. The banking authorities responded to concrete expressions of interest by MFIs wishing to transform and looked for ways within the banking laws and regulations to accommodate the public interest in having these initiatives grow and prosper.

Inevitably, the authorities received pressure from all quarters to change policy in one direction or another. They received pressure to approve more licenses, or licenses from politically connected individuals for companies that would not have necessarily carried out the purpose for which the window was created. They received pressure from borrower groups lobbying to have debt forgiveness packages approved during a time of financial and economic crisis. They received pressure from individual MFIs to waive a number of rules that they found burdensome. They were able to navigate these competing pressures by force of a strong, technically grounded, substantially independent Superintendent; a long-serving staff of capable young professionals; the support of international organizations that strengthened the hand of the authorities with respect to budgets and in public policy discussions; and by the lobbying strength of the ‘best practice’ MFIs themselves who wished to preserve their environment relatively free of politically motivated interventions.

Brazil

Brazil in 1999-2000 passed a number of laws and resolutions to increase access to financial services on the part of the general population, especially lower income sectors. In particular, banks were allowed to establish 'Banking Correspondents' to carry out a number of functions:

- Open and manage simplified savings accounts
- Receive payments of bills, credit accounts, and deposits into savings accounts
- Make payment orders
- Take in loan applications, perform credit analysis and collections
- Any other services as deemed appropriate by the Central Bank

Later (2002), notaries were brought under the same legislation and all were permitted to initiate the promotion of financial services with the targeted client group. In 2003, other types of entities such as SCMs, OSCIPs and the 'municipal funds' were brought into coverage and allowed to become banking correspondents. Several of the major public and private banks were encouraged by the government to open service points and establish these transactions networks.

The results are particularly positive; in the first two years (2001-3) after the regulatory environment was modified to facilitate access the following achievements were obtained:

- The number of service points (POS) in the country was expanded from 14,037 to 31,317
- The number of municipalities that were unattended by any banking service dropped from 1444 to zero
- 3 million savings accounts were opened
- 57 banks (up from 42) participated
- 600 million transactions were channeled

In 2003 the simplified deposit account was created and special accounts were authorized which permitted low income clients, by simply swiping a plastic card, to access deposits, transfers from government programs and small loans. These accounts can be opened upon simple presentation of the national ID card. The maximum balance allowed in these accounts is 1,000 reals (or about 400 dollars). In the 2 years since this type of account was created, 6 million have been opened, primarily through the *Caixa Economica Federal*[53] and its 10 thousand outlets. The average balance in these accounts is about 20 U.S. dollars. While the transactions and deposit business channeled through this network seem to have been successful (at least in terms of overall volume), there are some reports of a rationalization of POS in specific locations due to low volumes of transactions.

[53] This is a public bank that funds itself through payroll deductions and is very active in the housing market. It is the largest financial institution in Brazil with total assets of 36 billion dollars, making it the second largest bank in Brazil and the 4th in Latin America. More importantly, it manages the network of publicly owned lottery outlets in almost every neighborhood in urban areas

Close to eight million simplified 'subsidized' microloans have been channeled through this system, though not necessarily to informal sector employees, with half going through the *Caixa Economica Federal*. The total amount lent is just over 100 million U.S. dollars, for an average loan of 150 dollars. Approximately 3.2 million of these loans are active. No certain data exist, but it seems that most of this lending has gone to salaried employees, retirees, and others with 'formal or fixed incomes', while perhaps as many as one million have gone to informal entrepreneurs through Banco Popular and Bradesco's *Correios* post office networks. The early experience on loans is mixed. At least one bank (Banco Popular) has experienced late payments rates above 30 percent.

Without a doubt, some important portion of the funds these few banks have applied to these micro loans have been applied against the 2% set aside requirement passed in 2003. All commercial banks must devote 2% of their sight deposits to loans to individuals with a maximum per person of 600 Reals (roughly 250 U.S. dollars) and to microenterprises of 1,000 reals (roughly 400 dollars). Loans made under this program are also capped at a 2 percent monthly rate of interest. Other than the half dozen or so banks that have decided to get into this program and directly offer these loans, the set-aside has not been used widely to make funds available to other microlenders who have preferred to continue to access BNDS funding, which is also capped at 2 percent per month.

The government has set out to lower interest rates in the consumer finance sector through these multiple efforts. It is probably still too early to say whether they have been successful. Portfolio quality is not certain, nor is it public knowledge, given the government's ownership of many of the banks involved. Financial sustainability is not reported either. It's not yet clear that once the government's initiative expires, whether the participating banks would continue to offer these services at these interest rates. Nor is it clear yet that consumer finance interest rates have come down as a result of these initiatives, though they do seem to have come down some as competition has heated up among lenders, most of which do not participate in the programs.

In all, the access initiative required the Central Bank to generate new laws, several decrees, and a significant number of resolutions numbering into the dozens. Each step along the way needed specific authorities, instructions, modifications and exceptions in order to facilitate the overall purpose. Not only were the government efforts in this area numerous, they were complex. This complexity has sometimes been resolved relatively quickly and successfully as in the case of POS for transactions, but in other cases, has provided a real disincentive, and consequently contributed to poor performance (targeted microcredit).

Indonesia

Bank Indonesia and the Government of Indonesia play a significant, but increasingly indirect, role in the development of rural and microfinance. Financial services have long been provided through government-owned and often subsidized sources. Starting in the late 1980s, there began a shift in the paradigm, which is reflected in BI's concentration on its core functions of monetary management, payment system, and banking supervision. With the objective of reducing inflationary pressures, measures were

announced in January 1990 to reduce liquidity credits from BI, and to price them increasingly at market-oriented interest rates. As liquidity credits for small and medium scale industries were phased out, commercial banks and rural banks (excluding foreign and joint venture banks) were required to allocate 20% of their loan portfolio to coops and small-scale industries. Then, Act 23 of 1999 called for Bank Indonesia to cease direct credit provision to small enterprises, and instead provide indirect supports through maintaining the stability of exchange rate, establishing a healthy banking system (including rural banks), supporting an Islamic banking system, regulating loan policy, and providing technical supports and facilities.

Thus, with the enactment of the Bank Indonesia Act of 1999, BI's role shifted from a (direct) developmental to an (indirect) promotional role. The latter is described in the text box below. While it still participates in credit guarantee schemes, Bank Indonesia's role in channeling funds has expired. Under the new law, the lines of liquidity were transferred to two designated state-owned commercial banks and the state-owned financial holding corporation *Permodalan Nasional Madani* (PNM) by the year 2000. The latter has become the coordinator of all "micro- and small-scale enterprise" (MSME) related credit schemes involving technical assistance and funding to banks and BPRs. The financial institutions pay 1% flat per month for the funds and are required to on-lend 50% of the credits to micro- and 50% to small enterprises. Also, in 2004, BI fully transferred its internal micro credit operations to Bank Mandiri.[54]

Bank Indonesia is involved in numerous other microfinance sector promotion activities. It provides training to banks in techniques to reach small and micro enterprises, including group lending. BI also processes information for the banking community, including baseline economy surveys and targeted lending methodologies for specific business sectors. These methodologies target linkages between small enterprises and large firms, with banks acting as facilitators.[55] .

In the strengthening of institutional capacity, BI is seeking to improve the intermediation function of the banks and the recovery of the real sector, by facilitating a dialogue forum between banking and the real sector. "Intermediation bazaars" are organized in some places as meeting points between banks and potential customers. Technical assistance is given both to banks and real sector firm through business development service providers.

[54] Total value of transferred funds was Rp208.3 billion; this portfolio represented 544 rural banks (Bank Indonesia, "2004 Economic Report on Indonesia").

[55] BI also provides a manual for small businesses, to walk them through the loan application and approval process, including how to assess the feasibility of their business. (Information on SI-PUK system on BI website, http://www.bi.go.id/Sipuk/en/index.asp.) In addition, IFC and Swisscontact are providing business development services jointly with BI's Task Force for Empowerment of Bank Counterpart Financial Consultants, which facilitates linkages between BDS providers and banks. (Bank Indonesia, "2004 Economic Report on Indonesia")

Box 4: The promotional role of Bank Indonesia

BI's activities in this area include regulation, institutional development, and technical assistance.

(1) Regulation to enhance credit to the MSME sector:
- New regulation concerning small-scale credit provided by commercial banks;
- Coordination with the government on poverty alleviation
- New banking regulation concerning the ability to collect credits based on the borrowers' repayment capacity.

(2) Institutional development and capacity-building of microfinance:
- facilitating a linkage program between commercial banks and BPR unit banks, in order to intermediate between commercial banks and MSME operators;
- increasing credit insurance as a collateral substitute for MSME operators;
- preparing a legal basis and an umbrella to strengthen and develop MFIs; etc.

(3) Technical assistance:
- Providing training for staff of commercial banks intending to enter into the linkage program
- Conducting regional economic surveys
- Providing sub-sector information systems and consultancy services (Abdullah (2004).

BI is planning shortly to initiate a pilot project on apex banks for BPRs, working with PERBARINDO (the BPR Association) to appoint a BPR to provide fund pooling and clearinghouse functions for all BPRs in an area (district). Bank Bukopin plans to work with a venture capital firm to manage its funds channeled to BPRs. (This kind of company is assumed to have more freedom in handling such a function than a bank, due to the absence of a legal lending limit).

Another tactic has been to promote pawnshops. In 2004, the Ministry of Finance designated the state-owned Pawn Company as an official institution in the extension of MSME credit; since then Rp200 billion has been disbursed to the Pawn Company. It has 797 branch offices and Rp7.6 trillion in loans outstanding, as of September 2004 (Bank Indonesia, "2004 Economic Report on Indonesia," p.104, 114)

As for NGOs, these were neglected and at times actively discouraged prior to the 1998 change in government. The *reformasi* period brought a new opening, but observers suggest that the government is becoming wary again due to the opposition activities of many NGOs. The leading NGO association, GEMA-PKM, is actively involved in discussions of microfinance policy, as well as in the promotion and capacity-building of Grameen and NGO providers. The NGO-MFIs view the prospect of having a regulatory niche as encouraging better performance and professionalization, as well as opening up sources of capital. The NGOs are advocating for a new version of the MFI law, as well as an apex funding and standard-setting body (similar to PKSF in Bangladesh), hoping that

this will promote the sector and its linkages to the banks, which currently are said to deal only with BPRs in their microfinance activities.

Microfinance Development via Commercial Banks: Bank Rakyat Indonesia

The story of Bank Rakyat Indonesia (BRI) and its *unit desa* system[56] is legendary in the microfinance world. To understand its success, and the appropriate lessons learned for India, however, we need to look at the history of credit provision to the poor in Indonesia. Financial institutions owned by government are numerous at the village and provincial level, as they were, until recently, at the national level as well. This included BRI, a government-owned commercial bank.

The BRI Unit Desa system was inaugurated in 1973, after a 4-year pilot phase, to extend the credit component of *Bimas*, a "green revolution" rice intensification program. Interest was set at the rate of 12% p.a., well below inflation rate, financed out of liquidity credit from the central bank bearing only 3% p.a. Aside from assuming 75% of the credit risk, the government was also paying BRI an administrative subsidy. Within a decade, some 3600 *unit desa* were founded throughout Indonesia, functioning primarily as channeling agents for Bimas. Normal banking procedures, such as individual loan analysis, were omitted, since the government officials were pushed to achieve lending targets, so that the Unit Desa had very limited discretion in the review and approval of the borrowers.
Not surprisingly, the Units suffered losses in all but one year from 1970 to 1984, and default rates rose to over 50% in the early 1980's. From 1976-1984, on-time repayment averaged only 57 percent. The system failed for a variety of reasons, including:

- Subsidized interest rates did not cover programmatic costs
- Savings were not collected at scale because there was a negative interest rate spread between credit and savings
- BRI did not select the borrowers itself, and credit often went to wealthier people
- Credit was based on agricultural crops and when these failed, borrowers did not repay
- The government did not promptly counteract the failures in the credit portfolio with refinancing.

In June 1983, the government began a series of measures that significantly deregulated the banking sector, especially removing ceiling on credit expansion and permitting the banks to set their own interest rates on lending and savings. Falling oil revenues and consequent fiscal cuts by the Indonesian government required Bimas to be discontinued. The Ministry of Finance encouraged BRI to move toward commercialization of the Unit system to provide basic banking services to the rural sector. The transformation required fundamental changes in many aspects, especially to make each unit a separate profit center with its own balance sheet and income statement. Performance-based incentives

[56] Information in this section is drawn from Margeurite Robinson (2002), *The Microfinance Revolution, Volume 2: Lessons from Indonesia* (World Bank and Open Society Institute, Washington, DC), pp 166-210, 262-362.

were introduced, and retraining program for Unit staff and other branch supervisors was undertaken.

In February 1984, the Units introduced *Kupedes* (general rural credit) as its basic program. Kupedes was designed to meet unmet demand as indicated in the field study and experience during the implementation of BRI's earlier small-scale credit programs. It was revealed that prompt availability and convenience of location were the most important factors preferred by the customers. In response to this finding, Kupedes procedures were redesigned to be as simple as possible, and many units sited close to rice production centers were relocated to the economic centers of their respective sub-districts. Soon after the introduction of Kupedes, a pilot project for savings mobilization was started. The nationwide implementation of *Simpedes* (Rural Savings) as a savings instrument of the Units began in 1986.

The Unit system managed to break even in 1986, and continued to gain bigger and bigger profits, so that it became the profit center of BRI. By 1996, the unit desas had a return on assets of 5.7% and a profit of US $177 million. BRI Units weathered the monetary crisis of 1997-2000, while BRI corporate lending was severely impacted by the crisis. The Units surprisingly experienced a rapid increase in savings during the crisis, as did BRI as a whole, mostly as a result of a "rush to safety" since several private banks had been closed down or taken over by IBRA (Indonesia's Banking Restructuring Agency).

The success of the unit desa system was based on a few key design factors (see the text box below). Loans were made available to all creditworthy applicants for any productive purpose. This required a complete re-design of the products and services being provided by the unit desas to create products that met the needs of economically active poor and lower-middle-class people. Also critical to success was the absence of subsidy in the credit program: the commercial bank was facing a "credible threat" that losses would no longer be covered by the government. Accordingly, interest rates were set at rates that would cover all the costs of the products, plus return a profit to the institution. Other lessons learned in the preceding years were taken into account. The unit desas chose their own customers, and hired well-trained staff. Loan terms are negotiated to correspond to the needs of each borrower, and incentives are given to borrowers who repay on time. In addition to an array of internal conditions that were necessary in order to turn the unit desas around, this success story also relied on a number of policy decisions by BRI and the government. Essentially, financial liberalization and a flexible approach to the prudential governance of microfinance operations made the difference.

Box 5: Ingredients of BRI "Unit Desa" System Success

The main factors were the following (see Robinson 2002):

- Ability to charge sustainable interest rates. Usury limits and interest rate caps would have limited BRI's ability to appropriately price its loans and savings products in order to be sustainable.
- Simplified requirements for opening new branches. Unlike banks, the microfinance units of commercial banks will have less capital and will be unable to meet the rigorous security requirements often demanded of commercial bank branches. Requiring the same standards as of other bank branches will mean fewer branches are opened.
- Modified reporting requirements. Because microfinance branches serve a larger number of clients with smaller volume (on an individual basis), branches should be allowed to report on the aggregate, rather than the individual reporting requirements often imposed on commercial bank portfolios. Supervision should be done on a sampling basis rather than looking at each individual loan.
- Modified loan classification. Because loan terms are quite different from traditional commercial loans, classification needs to be modified and based on automatic loan classification based on number of days overdue rather than requiring individual classification by a loan committee.
- Collateral requirements. Microfinance is often based on little to no collateral, and microfinance units in commercial banks should not be restricted in their use of collateral, or required to notarize the collateral.

Other Banking Initiatives

Bank Indonesia has also played a promotional role in encouraging commercial banks to lend to rural banks (BPRs) and in encouraging BPRs to lend to micro-, small-, and medium enterprises. Banking policy is targeted at increasing the amount of financial services available to MSMEs.

The deregulation package of January 1990 required commercial banks and rural banks (excluding foreign and joint venture banks) to allocate 20% of their portfolio to cooperatives and small-scale industries. Banks that did not reach this target paid fines. Many were unable to reach it, but were permitted to offer consumer loans of the same amount, and have this accepted as meeting the quota. These loans were mainly in the form of credit cards to salaried employees. Despite this shortcoming and the lack of sustained impact on financial access, the program did have the benefit of helping banks learn to deal in small loans. This program was halted in 2001, and since then, all banks are free to determine their own allocation of credits to micro, small and medium enterprises altogether as one sector in their business plan.

BI and GoI together have created a "2005 Road Map" to focus on institutional development, regulatory reform, and building strategic partnerships to move this agenda forward (Bank Indonesia, "2004 Economic Report on Indonesia," p.17). BI encourages commercial banks to increase financing to MSMEs, by asking to see it included in their business plans. It also provides technical assistance to enhance the linkage between commercial banks and BPRs, and between MSME and banks. BI defines micro-loans as

loans up to Rp50 million ($5,000), small-loans as loans of Rp50 million up to Rp500 million ($50,000) and medium-loans are loans of Rp. 500 million up to Rp5 billion ($500,000). BI's Commercial Banking Division set up a task force on linkage banking, which came up with the concept of commercial bank-BPR linkages. This was launched in August, 2005 with agreements linking 24 banks to over 1,000 BPRs in credit arrangements aimed at enabling BPRs better to serve MSMEs.

The broader question in any financial system is whether the competitive and regulatory structure encourages banks to accommodate the provision of microfinance services. In Indonesia, the regulatory framework seems to weigh against this: in such areas as accounting rules, loan loss provisioning, and operating rules, provisions tend to raise costs and push intermediaries into higher-income parts of the market. The treatment of unsecured loans may be an important disincentive; normal risk weighting is required to be 100% for any loan not based on a real property mortgage or cash in an account. Some institutions report working out other acceptable arrangements with BI, but most seem to adopt informal collateralization methods with low-end clients, such as informal fiduciary transfer of appliances and equipment or the handover of documents such as the *dasaran* or market stall permit. Generally, the banking framework seems to allow for substantial outreach, with units operating under branch offices able to operate on a very small scale, sending employees out to transact business in markets and other convenient locations. However, banks that have not reached sufficient scale to open branches are limited to traditional operations out of the head office.

BI tracks the total amount of credit extended to MSMEs and for what types of enterprises. In 2004 the ratio of MSME credit to total banking credit was 50.5% – roughly half of which were consumption loans (Bank Indonesia, "2004 Economic Report on Indonesia," p.108). The share of the micro segment of total outstanding loans of commercial banks in the last three years is fairly impressive – 18.8% in 2001, 22.4% in 2002, and 23.2% in 2003 (see Table 15). How does the definition of micro loans work as a means for poverty alleviation? While the average loan of the BRI Units is lower than Rp5 million, the BI definition of micro loans is loans up to Rp50 million ($5,000), approximately 10 times income per capita.

Table 15: Micro segment of Commercial Banks (Indonesia)

Year	**Micro-segment of Comm. Banks** trillion Rp. (million $)	**Total loans of Comm. Banks** trillion Rp. (million $)	**Share** (%)	**Total Loans of BPRs** trillion Rp. (million $)
2001	59.5 ($5.9)	316,0 ($31.6)	18.8	5.03 ($0.5)
2002	83.2 ($8.3)	371,1 ($37.1)	22.4	6.86 ($0.7)
2003	101.5 ($10.1)	438,1 ($43.8)	23,2	5.78 ($0.6)

Source: BI, Annual Report of 2003. Figures in Rupiah and USD (1 USD = Rp. 10,000).

Mexico

In Mexico, there has been growth in the microfinance market despite the pressures to accede to the LACP. According to COMACREP, the EACP sector is growing at a 20% annual rate. Fincomun grew 60% from 2003 to 2005, and the member institutions of ProDesarrollo grew 50% in 2003 and 2004. Compartamos expects to double in size over the next three years. As a result, banks have begun to enter the EACP market niche, although the number of dedicated microfinance banks and subsidiaries is still very small. Increased confidence created by the new regulatory framework and the prospect of improved supervision seems to be contributing to growth and improved quality of services.

The main sources of funding for the financial cooperatives are savings and fees for certain services such as remittances. Funding sources for the NGOs and SOFIPOs in ProDesarrollo come, in the main, from donors such as USAID, the IADB, CGAP, the Ford Foundation, and government programs. Some institutions also finance themselves from commercial sources; in this sense, the cooperatives have been less dependent on external resources than the NGOs and prospective SOFIPOs.

The Mexican government currently has about 30 different programs concerning microfinance and MFIs. The most prominent of these in the current administration is the PRONAFIN program of the Ministry of Economy. It has directed lines of credit to most of the NGO-MFIs, including Compartamos. This explains a part of the rapid growth in these institutions. In addition, there are a number of second-tier banks that extend credit to cooperatives and MFIs.

The most important vehicle for governmental initiatives to develop the microfinance sector is BANSEFI, the transformed state bank that serves the sector. It was created to promote the sector and to accelerate the process of EACPs consolidating and reaching scale; it provides fee-based services, but does not intermediate or expose itself to the credit risk of EACPs (CGAP 2004). BANSEFI manages EACP liquidity, consolidating and investing it in commercial banks and government securities – securing a higher rate than the MFIs could individually. By the end of 2003, 93 EACPS had invested $55.8 million in BANSEFI.

The design and approach of BANSEFI are unusual for a state bank. It has a three-fold mission: 1) to promote a "savings culture;" 2) to serve as a second-tier bank for the microfinance sector, providing back-office services, a large-scale network, and deposit services for MFIs; and 3) to help the EACPs achieve compliance with the 2001 law, by administering a World Bank-funded program of technical assistance. We earlier mentioned that BANSEFI came into being through the transformation of PAHNAL, a state savings and development bank. It was set up in 2001, in parallel with the passage of the LACP, in response to the failure of earlier outreach programs and the need for a new approach. The current plan is for BANSEFI to be privatized; a 51% share is to be sold – with nearly half of this share going to the EACPs. However, as of this writing, no decision has been announced concerning the price, the distribution of branches and service points, and other key parameters.

One of BANSEFI's most important activities is linking EACPs to information technology, service points and transfer services via *L@Red de la Gente*. This is a BANSEFI-organized commercial association among institutions seeking to accede to the LACP, and that now have obtained a sufficient financial rating based on standards used by CNBV. There are some 64 member institutions now, with 1160 branches (including BANSEFI and its branches), covering more municipalities than any individual bank. The services of L@Red de la Gente are principally the development of the remittances market and linkage to government programs. Concerning the former, the network partners with ten remittance companies, in order to provide service at scale and reduce the cost of the service. It had handled $53.6 million in remittances by the end of 2003. Also, L@Red administers funds under certain government programs, through savings accounts. In handling these functions, it has introduced many customers to banking (CGAP 2004). L@Red is financed through the collection of 10% of members' financial services fees (BANSEFI technical note).

BANSEFI and L@Red de la Gente represent an important step forward in Mexico's approach to promoting and supporting the microfinance sector – not least because they are separate from the regulation and supervision of the sector. However, this separation is not complete. On the one hand, BANSEFI can play a positive role in ensuring the integrity of its client institutions, even though it has no formal supervisory role. On the other hand, the federations will continue to house development functions even as they restructure to handle auxiliary supervision. The checks and balances built into the supervision rules, along with the training and certification of federation-based supervisors, provide structural protection for the integrity of the supervision function. Yet the broader incentives of the federations are still to focus on the promotion (rather than the discipline) of members – particularly the largest members.

The Philippines

The Philippines has a varied array of microfinance promotion activities, emanating from government, civil society, the private sector, and both domestic and international institutions.

Industry Associations

The Philippines has had a multi-tiered banking and financial system stratified according to capitalization levels, geographical/market area coverage, and permitted financial services. Commercial banks belong to an industry association – the Bankers Association of the Philippines. Similarly, thrift banks and rural banks each have their own industry associations – the Chamber of Thrift Banks, and the Rural Bankers Association. Lively and regular dialogue between BSP and the industry associations facilitates feedback and development of consensus on proposed new regulatory or supervisory measures (e.g., application of risk-based asset classification or increases in capitalization), the exercise of "moral suasion", and more recently, the promotion of microfinance and familiarization with the nuances of microfinance for commercial bankers.

Coordination of donor support

USAID provided funding and technical assistance in reforming and modernizing credit policy for microenterprises and small businesses, under the Credit Policy Improvement Program, culminating in the creation of a multi-agency coordinating unit – the National Credit Council – housed in the Department of Finance. NCC was instrumental as the focal point for developing and firming up consensus among public, private and international stakeholders on the national strategy and policy on microfinance.

Developing retail banking capacity for microfinance. The Rural Bankers Association, with support from the BSP, is the focal point for implementing the USAID-assisted Microenterprise Access to Banking Services Project (MABS). The program provides focused training for rural banks in developing and rolling out products for microfinance and rural finance, as well as MIS facilities.

Credit cooperatives. Another area of support from USAID and other international donors was in the areas of standard accounting procedures and formats for credit cooperatives and the adoption of standard measures (such as those in the PEARLS system) for reporting on the operations and performance of credit cooperatives – not only by the credit cooperatives themselves but also by the sector's regulatory and supervisory agency, the CDA.

Microfinance standards

The Microfinance Council of the Philippines (MCPI) started as the Philippine Coalition for Microfinance Standards, an association of microfinance practitioners, NGO microfinance institutions, rural banks, credit union federations, public and private financial institutions and BSP officers interested in adopting and promoting best practice standards in microfinance operations. The coalition was supported by local and international donors.

BSP's microfinance advocacy program is being focused both on potential practitioners as well as institutional partners for existing microfinance institutions. The BSP has completed a regional advocacy program where a basic seminar will be conducted in ten regions of the country reaching nearly 1500 participants. Another major advocacy initiative is BSP's Chairmanship of the Philippine National Committee for the United Nations International Year of Microcredit.

South Africa

The financial sector development role that MFRC has played since 1999, and in particular over the last two to three years of its tenure, is substantial. The MFRC has deftly supported, and in some cases led, a wide-ranging review and development of new legislation and other market infrastructure towards a better functioning and more rational financial services sector. In particular, it has interpreted and enhanced its originally relatively narrow mandate to embed public and private sector confidence in the legitimacy of the small loans sector.

MFRC: Information and Education

Compared to the situation in 1999, much more is now known about the microfinance sector, and this is largely MFRC's doing. There are two main approaches here. One involves analyzing the returns of MFRC member lenders and issuing quarterly statistical reports on this basis. Here, the regular publication of industry data has made a dramatic difference. However, questions do arise about the quality of the information, since MFRC in practice (though not in theory) has few options to verify lender-reported data or to sanction its non-provision or inaccuracy. The agency tried to attack this through lender audits that would use samples of lenders' loan portfolios to check the accuracy of data that MFRC was capturing through the quarterly returns. These samples came from the largest lenders that accounted for some 80% of the market. The second approach taken by MFRC is to sponsor research in areas within its expanded dual mandate that warrant it. This is not strictly part of its mandate, and we therefore discuss it in the section below.

The function of providing training and communication to consumers was delegated by DTI to MFRC at the latter's founding. The challenge at that point was to transform DTI's approach of farming this out to NGOs, by developing a model of effective outreach and teaming with relevant organizations to carry it out. MFRC tested out new approaches through pilot initiatives, then worked through a combination of law firms, legal clinics, and NGOs. Services include advice and training to consumers on budgeting, and provision of support for debt rescheduling, legal representation to reverse erroneous judgments, reaching settlements with creditors, and dealing with administration orders imposed on insolvent debtors – the latter are apparently triggered unnecessarily in many cases, with high fees required from the consumers under administration.

In addition to borrowers, MFRC also directs its public education efforts at lenders and at government (i.e. policy advocacy). Its outreach takes the form of workshops, brochures, and advertisements. A particular focus has been black micro-lenders, whom MFRC approached in an effort to help them get to organized among themselves, to employ good practices, to register with MFRC, and to cope with their relative disadvantage (compared to banks) in terms of enforcing repayment. More than 200 black micro-lenders have been registered in connection with this initiative. MFRC has produced consumer-oriented materials on a range of topics. While some observers feel that they are too "legalistic" and have limited impact, our review of the materials suggests that they are of high quality. However, it is possible that, given the difficulties faced in building consumer awareness and understanding, alternative approaches need to be explored, e.g. communications that are more closely tailored to the cultural and cognitive realities of low-income communities.

National Loans Register

MFRC understood that an implication of both the core consumer protection mandate and the industry development mandate was the need for much better credit information systems. Having these in place would enable the setting of over-indebtedness standards and help reduce the risks to lenders. Thus, MFRC stepped into the gap with its National Loans Register initiative. It seems clear that something like the NLR was needed in the

circumstances. The issues were who would take the initiative to get it established, and what model would be used?

Possible options would have included a voluntary, private sector model that set a requirement, such as that loans must be registered in order for the creditor's interest to have legal priority over third parties. This is the essence of the system in the U.S. and other industrial countries. The model chosen, which requires checking the NLR as a condition of the enforceability of a loan agreement, takes a more direct approach. On its face, this seems to provide similar incentives, but in fact it is more coercive, directing the lender to check the register rather than setting up an institutional framework in which the lender has a strong incentive to do so.

The South African approach is linked to specific features of the environment, notably the near-automatic repayment of payroll-based loans and the queue-jumping of banks in dealing with debit orders. These features suggested the need for a more directive approach – one driven more by consumer protection needs than commercial incentives. Apart from the requirement imposed in MFRC's 2002 rules, it was the threat posed by MFRC's reckless lending investigations, and the sanctions that adverse findings could bring, that pushed the industry towards compliance. As a result, as in other areas discussed here, there is much more information, more widely shared, than in the past. This serves the collective interests of lenders and borrowers, as the NLR helps coordinate lender behavior and imposes objective limits on indebtedness.

The requirement that lenders use the NLR, contained in the 2002 revised MFRC rules, was struck down by the courts with the rest of those rules. One of the more striking outcomes is the increase in NLR filings since then – indicating that lenders may have determined it to be in their continued self-interest to use the system. Thus, the kinds of commercial incentives discussed above appear to be coming into play in South Africa. This is partly due to the design of the system. Rather than set up a separate public credit registry, as a number of countries have done, MFRC chose a private sector model that links the two large credit reporting firms that serve the banks and larger micro-lenders (TransUnion ITC and Experian) to second-rung credit bureaux that deal with the smaller micro-lenders. MFRC has access to this information, and monitors activity and reports aggregate statistics.

Financial Sector Charter

This is an initiative that moved forward independent of the MFRC. The banking industry has focused its response to popular pressure for expanded services and "black economic empowerment" on the Financial Sector Charter. The Charter embodies an agreement among the major players in the financial sector – banks, insurance companies, brokers and exchanges – on a set of service provision and empowerment targets in such areas as banking services to low income populations, black employment and ownership in the financial sector, and support for black entrepreneurship. Financial services companies are expected to pursue these targets, to report periodically on their progress to a monitoring body set up under the Charter, and to be graded on their performance in the form of a public "scorecard." The mechanism here is one of self-regulation on the basis of a

voluntary code – but with the threat of CRA legislation hanging in the background should the sector not perform satisfactorily.

It is also not clear what the cost will be of meeting the Charter targets. In the U.S., while the Community Reinvestment Act has forced some service extension and empowerment activities, some analyses see it as anti-competitive. The costs of compliance have been more easily borne by large banks than by their prospective competitors in the relevant neighborhoods – with the result that actual financial services to these communities have in many cases suffered. Similarly with the Charter, the dominant players in the sector will be best able to afford to comply. Again, this may bring benefits in terms of outreach and black representation, but the Charter is also likely to be anti-competitive (despite exemptions for very small institutions).

Conclusions on Market Promotion and Development

The cases discussed in this chapter illustrate diverse approaches towards the development of the microfinance sector, and the role of regulation and promotional activities in that development. Previous chapters discussed the elaboration of regulatory frameworks and supervisory approaches. There, we saw the state, the market, and other stakeholders playing a variety of roles. The resulting approaches differed in the extent to which they focused on following the microfinance market, ensuring that all players in the market were well-capitalized and disciplined in their operations, promoting entry and growth in the market, and encouraging or directing the banks to serve the market. In the present chapter, we looked more closely at ways in which the sample countries have engaged in promotion of the market – and how this affects other priorities such as market-friendly regulation and safety and soundness.

The main issue here is whether government gets involved in promoting the market, and most importantly in what way this implicates or affects the regulatory functions. Once again, Bolivia stands out as the paradigm case of keeping promotional concerns separate from regulation and supervision. The microfinance sector there grew organically, as it were, based on NGO programs and without government involvement. Once the MFIs began achieving scale and sustainability – and the political and economic order in Bolivia had changed over – there was great public and governmental interest in directing the sector to expand in certain ways. The banking Superintendency successfully resisted the intrusion of these interests into its market-building strategy, while separate state-financed promotion activities rose and then to a great extent fell victim to weak governance and unrealistic expectations.

Most of the other countries in our sample have experimented with market promotion either through the regulatory framework or in ways that require accommodation by the regulatory system. Many have found this unfruitful and are backing away from it. Two main concerns arise in this kind of approach. First, how does the promotional emphasis impact safety, soundness, and sustainability? Second, *cui bono*? In other words, are there sectoral interests driving the promotion effort in a direction that may not be fully consistent with the public interest? The two questions are, of course, closely related. When a particular constituency such as the NGO microfinance providers, perhaps in

alliance with their international sponsors, is lobbying for the formalization and regulation of their activities, the proposed reform (like any other) warrants careful scrutiny. The question here is whether the proposal serves the broader interests of financial sector soundness, sustainable growth in microfinance services, and enhanced access by low-income groups and small entrepreneurs. This requires a dispassionate cost-benefit analysis, a difficult task for a lobbyist or for an agency under severe pressure from local promoters and influential donor agencies.

Substantively, promotion by government carries a number of risks. Where it is done through the regulatory framework, it may result in entry conditions and prudential standards that encourage risky and unsustainable expansion. Since supervision tends to be associated with a government guarantee (whole or partial, explicit or implicit) of deposits, regulation provides a virtually automatic promotional advantage to entities within the regulated sector. Offering the benefit of regulation too readily, on terms that do not pressure MFIs to achieve scale and high capitalization, creates the risk of rapid influx by untested institutions, and with it moral hazard and the prospect of failures and losses that impose costs on the public – or at least a loss of credibility by the regulator. This appears to have been the case in Ghana's rural bank sector until recently. Of course, this analysis applies more strictly to prudential regulation than other forms of oversight, such as consumer protection and regulatory reporting by credit-only institutions. In South Africa, the MFRC has in effect a dual mandate to regulate and promote the microlending sector. The two elements fit together in this case, since MFRC is not a prudential regulator and so extends no guarantee, and since MFRC determined that its best promotional strategy is to be a tough regulator.

Where market promotion is kept separate from regulation, there remains the question of which style of promotion is used. Is it aimed more at near-term expansion or longer-term sustained growth and innovation? Subsidized credit, credit guarantees, and microcredit quotas – usually imposed on banks – aim more at near-term growth. The use of these methods carries significant risk of undermining sustainability, but can play a role in "jump-starting" activities and in helping banks gain experience in microfinance if handled properly.

Lending quotas have been used in a number of countries, but they are in some cases being superseded by other incentives for bank downscaling, including voluntary standards. A country that continues to use quotas is Brazil, where they are coupled with interest rate caps – a doubly costly and risky approach. Indonesia used such quotas aggressively – a 20% quota as compared with Brazil's 2%. But Indonesia has backed away from them after disappointing results (including lots of evasion). It has moved to a model in which banks are required to include their small-scale lending in the business plans that they present to BI – and the latter exercises moral suasion to encourage downscaling. South Africa discussed using a more robust version of this, based on the U.S. Community Reinvestment Act, but has decided to use voluntary standards and reporting instead. The Philippines has placed significant emphasis on microfinance standards, in an effort led by the sector and supported by BSP.

A related category of initiatives concerns savings. An example is the simplified savings account for small savers – these may originate with banks, or may be established as a legislative requirement or voluntary standard of service. Another is the encouragement or facilitation of bank correspondent and linkage programs, where MFIs place deposits in banks or act as service extension agents.

A different kind of promotion is the provision of supportive systems and infrastructure. For example, South Africa, recognizing the centrality of credit information to growth in the sector, as well as the limited reach of then-existing credit bureaux, established the National Loan Registry. Although it was an initiative of the MFRC, the registry sustains itself through user fees. Its establishment is a public good that would not have been provided but for the initiative of the MFRC. An even more robust infrastructure initiative is being carried out in Mexico. There, BANSEFI provides a range of second-tier banking services and technical assistance to the sector, and took the initiative to establish *L@Red de la Gente*, which also operates on a fee basis. The important point about these efforts is that, instead of directing or subsidizing particular allocations of credit, they provide a public good that lowers transaction costs for all allocation decisions across the whole sector. Indeed, the quality standard for all promotional efforts might be summarized as follows: meeting their goals equitably and without regulatory distortion.

6. Implementation and Impact of Microfinance Regulation

We now examine how the policy changes analyzed above were actually put into practice, and what impact they appear to have had. The implementation process may involve the amendment or removal of rules that are not consistent with the new policy, the dissemination and encoding of new standards across the sector, and the creation or redesign of implementing agencies. In instances where new structures are set up, there may need to be a whole range of design decisions made concerning such issues as reporting frameworks, as well as training provided to a new cadre of supervisory personnel. How were these processes handled in the cases studied, and how effectively? What, in practice, was the legal-regulatory framework that ended up being implemented? What was the impact of this on access to financial services, market growth and development, safety and soundness, achievement of policy objectives, and cost-benefit? In this regard, we continue the discussion of market outcomes from chapter 2.

On a related point, we also touch on how microfinance programs run by NGOs (broadly defined) were brought within (or otherwise dealt with by) the financial regulatory system as implemented. The spectrum of treatment here runs from full exemption or neglect to strict application of financial regulation – with intermediate points including partial or temporary forbearance, a transitional status, and assistance or incentives for transformation into a regulated institution. With respect to the cases studied, was a transition path or mechanism developed, and how effective was it in terms of cost-benefit (institutions transformed over what time period and at what cost, as compared to alternatives)?

Bolivia

The development, implementation, and impact of Bolivia's microfinance regulatory policies in the 1990s have been much written about. In this section, we review the main outcomes and lessons. We include an extended discussion of the role and treatment of NGOs, given their predominance in the Bolivian microfinance sector.

Implementation and Impact

The Superintendent has been very successful within the domain in which it has been allowed to move, but less successful in getting banking legislation modified. The Superintendent's office was allowed, almost by accident, to create en entire regulatory structure for microfinance with virtually no interference from Parliament or a 'law' because of the phrase in the existing law that allowed for the creation of a new class of institution (but that did not in any way specify its nature). This allowed the banking authorities to proceed on sound technical ground, with virtually no political interference or pandering to political agendas. As a result they have been able to proceed carefully, and have been able to resist the political pressures that come from time to time.

The Superintendency has been less successful at influencing the legal environment that affects microfinance negatively. For example, banking secrecy laws do not allow for the sharing of credit information from banks to a private credit bureau. Fortunately, the

Superintendent has been able to accomplish all that is essential to the safe development of the industry, though a centralized credit bureau that combines information from both regulated and non-regulated entities would be a major improvement.

Impact on Banks

The Bolivian Bank Superintendent has always been of the view that it would apply the same regulations to any bank that chooses to undertake microfinance as it would to the regulated MFIs. This is the essence of 'functional' regulation. The Superintendency has written regulations so that they apply to loan portfolios of regulated institutions composed of 'microloans' of a certain size or character, and, it has re-written pre-existing regulations for other classes of regulated entities so that the latter might also offer microcredit on equal terms. For example, all microloans are to be provisioned for according to the same schedule, irrespective of the institutional type through which they are offered. The same applies to the documentation requirements in the loan files, the reporting of loans to the central data base, the exception on limits to the value of 'unsecured' lending that apply to microloans and other smaller regulations. Additionally, all institutional types are required to report in a similar fashion on their portfolios, and receive supervision visits that look at the portfolio with the same set of tools.

In this way, it has basically leveled the playing field for banks who would want to enter the market. Additionally, it has demonstrated over and over again that it is willing to work with any competent and interested party that might run afoul of the letter of a regulation, through a process of forbearance, if it feels that that organization can bring a quality offering to the table. While banks entered and left the consumer credit market (along with the finance companies) they have not chosen to enter microenterprise lending in any significant way, in spite of a favorable environment for doing so.

Non-credit Services

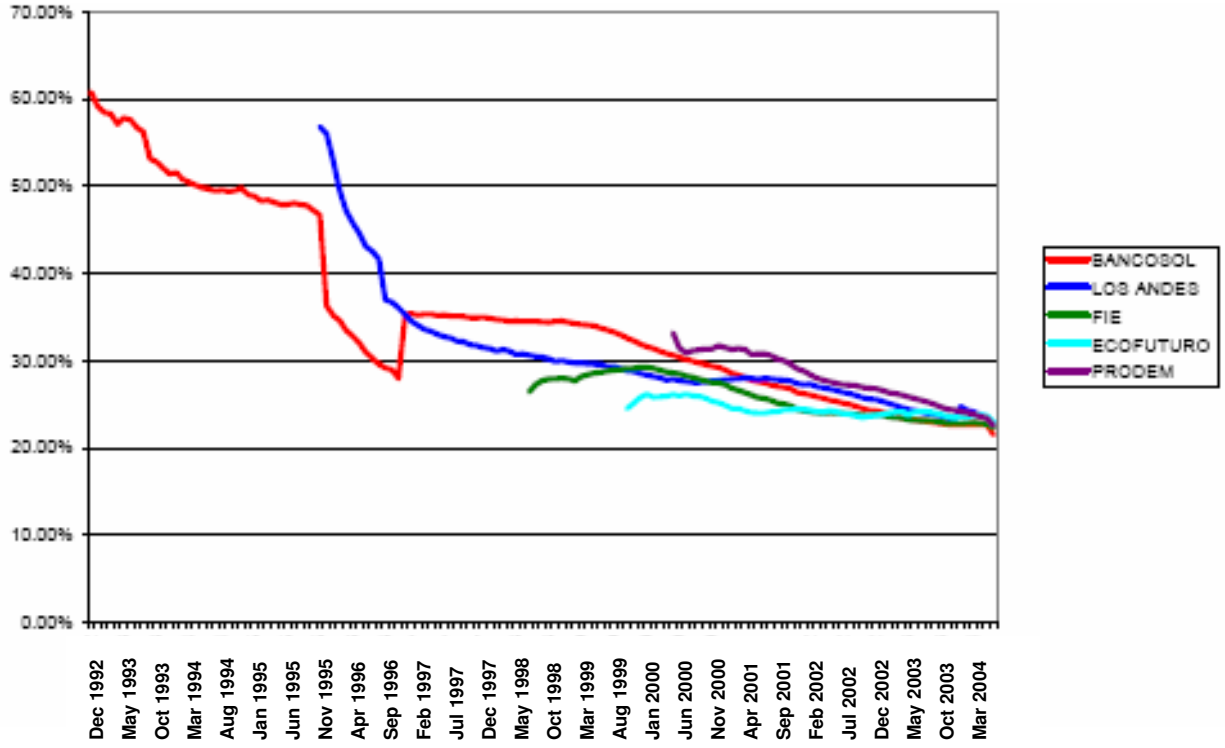
Savings, money transfers, and insurance products have been quite slow to develop. In part this is due to the fact that virtually none of the transforming NGOs seriously considered deposit mobilization from the general public as a prime source of funds. They were far more focused on obtaining lines of credit from (soon-to-be) government apex facilities. An early failed foray by Bancosol into savings mobilization further reinforced the image of savings as a difficult product to offer and delayed its uptake by another few years. Bancosol expanded too aggressively its deposit service throughout its branches before its MIS was fully capable of handling substantial volume. The system collapsed, causing delays of days in savings withdrawals, which in turn led to long lines of upset clients attempting to pull their savings back out.

In a parallel fashion, the Superintendent's office was hesitant to let the FFPs into the savings mobilization game until they had some sort of track record or MIS that would provide confidence that the service could be reliably handled. The MIS of most FFPs continued to be credit driven and vastly underdeveloped on the deposit side. Since it was not a priority, and such complete systems are costly, this insistence by the Superintendent reinforced the slow pace of adoption.

Impact on Market Development

The Graph below shows the evolution of the effective interest rate for a number of the leading regulated MFIs in Bolivia over the course of several years. In all cases it has declined as competitive pressures built and the market became saturated.

Figure 4: Bolivia – Evolution of Effective Interest Rate



Source: Claudio V. Gonzalez and Marcelo I. Villafani, "Las Microfinanzas en el Desarrollo del Sistema Financiero de Bolivia", The Ohio State University, La Paz, Bolivia, August 2004.

As a result, Bolivia has developed a robust, competitive microfinance sector where product offerings have multiplied, microcredit is freely available to all but the most remote, interest rates have steadily declined, and systemic risk has stabilized after the sector weathered a severe economic recession. In this process, it has learned more about microfinance than virtually any other similar agency in any other country in the world.

Role and Treatment of NGO-MFIs

Regulated microfinance institutions in Bolivia grew out of very high quality non-profit microlenders. Before the Superintendent approved any of the bank or FFP licenses the applicant institution had many years of world class performance under its belt. In fact, when the first licenses were approved for Bancosol and Los Andes, they were considered to be the strongest NGO lenders in the world (outside of Bangladesh). They had a reputation for virtually perfect repayment, were profitable, were very professionally managed by charismatic leaders, and had strong Boards of Directors. Except for Prodem,

most of the subsequent applicants were of lesser stature, but were required to perform at or near the average level of already licensed FFPs before obtaining recognition. Prodem, the latest to be approved, was considered as strong, if not stronger than the original set of applicants. In this way, regulation followed the development of the industry, and very much responded to the need of leading institutions to become regulated to broaden their funding base. At the time of their approval, most of the non-profits were performing at a level where their financial results met or exceeded those in the commercial banking sector.

Unlike NGOs in many countries, the leading microcredit organizations had boards of directors that included many of the leading businessmen (and women) of Bolivia. Many had ties to large Bolivian banks, and others were members of the business community elite. As a group, they were relatively active board members, and as such, were effective in projecting sufficient integrity that the Bank Superintendent's office was able to approve license requests without overwhelming concern for the track record and reputation of each organizations 'sponsors'. Additionally, all of the Bolivian NGOs had close ties to international networks specialized in microfinance techniques, which gave the Superintendent's office a far greater sense that if the licensees strayed from their initial path and got into trouble, there would be experienced board members who would steer them back to the right path.

This combination was particularly important to the Superintendent's office because of the intrinsic 'double bottom line' of these specialized finance companies – a double bottom line that could easily confuse acceptable financial results with social impact, thus permitting a sub-par performance on critical financial indicators as long as social objectives were obtained. This has not been a problem over the past 15 years the system has operated. If anything, the 'double bottom line' institutions have outperformed the single bottom line consumer finance companies, even on the sole indicator of profitability.

The regulated MFIs have grown while the unregulated have been starved for lending funds. The regulation of a large segment of the microfinance industry has excluded those that have not chosen to transform from large sources of funding. As a result, the unregulated sector has not grown in its overall number of clients and has shrunk in it relative market share. The Bolivians believe that the substantial cost involved in the transformation process has been necessary to ensure that the transformed entities became solid participants in a revitalized financial sector. Two major NGOs have not wished to transform, although they might well have performance indicators that would be of relatively comparable nature. They have not wanted to assume the for-profit status of the FFP. As a result they have far greater difficulty accessing funds since the APEX is not open for NGOs.

APEX Funding Organization

While the general mantra in relation to whether or not to regulate a new class of financial intermediaries in order to promote microfinance suggests that it should only be done if these are designed to capture deposits from the general public, the Bolivian case suggests

that this may also provide useful support to an apex institution and increase the flow of funds to the sector from institutional investors. For many years, the regulated MFIs did not really take full advantage of their legal structure to capture deposits from the general public (they could have worked a lot harder to get Superintendent's permission), but instead relied on the credibility of their regulated status to mobilize funds from private and public institutional investors.

While the argument has tended to be that the investors in MFIs ought to bear the due diligence risk, in Bolivia, it was felt that the Bank Superintendent would be a more capable technical agent for making assessments relative to the overall health and management of an MFI, than the government owned APEX. While the APEX organization has commissioned ratings and engaged in other exercise of its due diligence role, it undoubtedly rests in some important degree, for loans made to regulated entities, on the shoulders of the supervision reports. The Banking Superintendent is the only player in the market that takes a serious look at the quality of the loan portfolios in a due diligence process – since it has that responsibility.

This role, i.e. supporting the growth in funding to the sector, has been critical in allowing microfinance to grow to the level it has obtained today. The banking authority has been a critical counterweight in an often times highly politicized environment (witness the debtors union and political pressure for loan forgiveness during the overindebtedness crisis when the debtor's union actually took over the offices of the Superintendent).

NGO Ownership of Banks

In all cases of microenterprise NGOs except for Procredito, the original NGO continued activities, in many cases lending to poor clients while at the same time owning a for-profit 'banking' company. In one case, the FFP is owned by 4 distinct NGOs, each of whom carry out financial operations on their own books with clients they deem as not profitable enough for the FFP. In each case the transfer of loans from the NGO to the bank was accomplished through a careful process that guaranteed that the licensed entity was capable of fully assuming the operations – and was not done abruptly. Within a relatively short period, Prodem separated itself operationally from Bancosol (while retaining its shares for a while) and eventually sought and obtained its own FFP license under its own name.

While the Bolivian MFIs have not faced serious consequences from this structural flaw, the antecedents do exist that suggest that this ownership arrangement is far from recommended. The case of Finansol in Colombia showed how a sloppy management team can shift loans from the finance company to the NGO and back in order to deceive bank supervisors. Ultimately this practice, among others, led to the complete collapse of the organization, with a cost of several million dollars.

This has not happened in Bolivia because up until this point, all of the MFIs have apparently operated on good faith. There is, however, nothing in the ownership structure of these organizations that would prohibit this from happening in the future should a different style of management take over.

At the time these arrangements were accepted, the argument was made that the NGOs were still developing less profitable markets and the public good was well served by allowing them to continue to receive grant funding toward that end. In retrospect, it seems that non-regulated MFIs have filled in the spaces not taken by the regulated MFIs, and there doesn't seem to be any imperative for the original owners of the transformed MFIs to transact loans out of parallel structures. The risks are too high, and too difficult to control, even though in the Bolivian case, they have not yet surfaced in a dangerous way.

Brazil

By any measure, the series of regulatory measures taken to increase the flow of funds into microlending has fallen short of initial expectations in developing this market. Clearly, some sort of regulatory response was necessary to build a microcredit sector in Brazil, given the legal restrictions NGOs faced prior to their passage, and the fact that regulated financial institutions showed no interest in lending to microenterprises. These new institutional forms were clearly a major step forward for microcredit in Brazil, and many microenterprise credit NGOs have modified their legal framework in order to benefit from the ability to tap external sources of finance. For example, this involved in some cases splitting up existing organizations into two entities -- an NGO rendering non-financial services (training and consulting) and an SCM for all financial operations. A significant number of institutions have been founded and funded, but not nearly enough to respond adequately to the demand for microfinance services. Taken together, the 180 different MFIs operating under the diverse set of institutional frameworks do not have substantially more clients than the single largest program in the country, Crediamigo, which operates within the structure of a regulated financial institution.

None of the traditional NGO lenders in Brazil transformed into for profit SCMs, unlike the experience elsewhere in the world where that transformation has been undertaken by a number of industry leaders in any given country. The fact that, excluding the Crediamigo program, 180 programs do not reach more than 200,000 clients illustrates that Brazil has not yet found a model capable of reaching the 15 million microentrepreneurs in it economy.

Policy Limitations and Outcomes

Many have argued that the overly restrictive approach taken by the Central Bank in Brazil to licensing all types of microfinance organizations, when combined with an overly bureaucratic process for their funding by the BNDS, has led to the slow growth both in their number and scale.

Initial interest rate caps eliminated all possibility of start up organizations reaching profitability within a reasonable time period. This restriction was not changed for months after the promulgation of the law. The caps were set at 2 percent a month while Brazilian MFIs have traditionally operated at levels that would require interest rates of between 4 and 8 percent a month to break even.

While a number of the leading organizations had been funded on a limited basis by the Interamerican Development Bank, any further funds would need to be generated within Brazil. Given traditional MFI's poor financial performance, the only source most could turn to would be government. In addition, the restrictions placed on the allowable sources of funding created a sector that would be entirely dependent on government for its operations and therefore subject to effective control on interest rates.

Restrictions on the types of services allowed in these microfinance organizations put them at a severe competitive disadvantage with respect to banks or finance companies that might wish eventually to get into the sector and that face no such limits. In urban Brazil, more and more regulated financial intermediaries are offering a variety of services to lower income clients, many of whom operate in the informal sector. Many have obtained access to deposit accounts, credit cards, checking accounts, and store cards. In general, clients are interested in obtaining a range of financial services.

The MFIs considered the tax burden they would pay to be excessive, especially in light of the repressed interest rates. Though the tax rates are comparable to those charged to banks, MFI interest rates are capped, and thus income is capped at any given level of portfolio. The new legal entities were not granted a level playing field when it came to developing a business model in spite of the apparent equality in their tax treatment if they were borrowing from the government to fund their portfolios at repressed interest rates. Though the government still allowed a substantial spread (around 18%) traditional MFIs have not yet been able to bring their operational efficiency down to levels that allow them to be profitable within these constraints.

Caps on the maximum loan size allowable in microfinance institutions led to a situation where they were unable to cross subsidize smaller loans with larger loans. The cap was set at about 3 times GNP per capita. Major gains in financial efficiency across Latin America have resulted from a dramatic increase in average loan size. While many institutions have retained their focus on the poor, the fact that they can invest 50 to 80 percent of the total volume of their portfolio in the wealthiest 25 percent of their clients provides a cross subsidy that brings total costs down by half and allows the more mature organizations to work within spreads that are considered more reasonable by banking regulators and the general public. While Crediamigo has grown and become far more profitable without increasing overall average loan size, they are currently cross subsidizing smaller loans upon which the 2% cap applies with larger loans to which no cap applies. This creates negative incentives to grow at the bottom end of the portfolio, in the same way as the size cap creates a disincentive for the MFIs to scale up.

The documentation requirements required exceeded those for microloans made by other types of institutions such as NGOs or banks and put these specially licensed organizations at a competitive disadvantage. Documentation requirements generally add cost, without adding effectiveness. Regulators need to find other ways to control for portfolio quality and resist the temptation to over regulate. This is another case where the creation of a stand alone institutional framework to carry out microfinance actually places

a significant additional cost to the operation that would otherwise not be present were they placed in a large financial intermediary where the issue would not be raised because the loans were not adding to the overall risk profile of that entity.

For example, unsecured microloans offered by a large bank do not necessarily change its overall level of portfolio riskiness – so a regulator can afford to just lump them in with whole other classes of loans and develop a generic provisioning table, without feeling like it needs to get involve much in how these loans are made. On the other hand, if the institution is wholly dedicated to unsecured lending, the regulator inevitably feels less comfortable and ends up putting more restrictions and rules in place.

Delays in disbursements of funds committed by the BNDS led to poor service quality as loans to clients were consequently held up, leading eventually to poor repayment incentives. In many cases, expected funds did not arrive at any point. In microfinance, a lack of liquidity leads directly to repayment problems as clients realize that the MFI is not a reliable source of funds. This quickly destroys any business model, particularly if the entity is prohibited from seeking funding from any other source.

In sum, the creation of regulatory windows has formally facilitated the expansion of microfinance in Brazil by overcoming the illegality that affected this activity before the generation of the required legal framework. On the other hand, it has not led to an explosion of microfinance activity that promises to transform the supply of financial services to the general public that is engaged in the informal sector economy. The average number of clients of each of the new entities formed is so small as to be irrelevant in the face of overwhelming demand.

It is not fair to place all the blame for this on the Brazilian regulators. While they undoubtedly put in place a far too restrictive set of rules, the major blame most certainly lies with the microfinance sector itself. This sector has underperformed for decades, failing to produce models that could successfully attend to demand, even in local markets. While the operators have always pointed to the impact of external factors in their poor performance, the fact remains that we do not see in Brazil the same level of creativity in seeking solutions to basic challenges to growth and sustainability.

When regulators develop their frameworks, the process is enhanced when they respect the work done by those who they are about to regulate. In this case, it seems that the regulators sought to find a whole new set of actors to engage in microfinance at a different scale. Unfortunately for them, microfinance has not yet been established in Brazil as a profitable business, so they didn't really find many takers, and the initiative failed to prosper. It didn't help that the government funder proved to be too bureaucratic to disburse funds in a timely fashion to those few initiatives that might have qualified. This is a clear case of putting the cart before the horse – it is hard to regulate what doesn't exist, and it is tough to establish a market based approach to generating a financial business when those for whom it is intended don't see the profit opportunity.

Ghana

In prior sections of this paper, we saw that Ghana's regulatory framework helped usher in a significant array of different types and sizes of microfinance service providers. Even with a broad increase in activity over time, Ghana continues to have a very shallow financial services market. In this part, we look briefly at efforts to implement and use the legal framework to deepen the market.

Ghana has focused on poverty reduction as the core of its development strategy since 1995, but a consensus-based vision and strategy for microfinance development still has not been formally accepted and articulated by government and its policy makers. The tiered system of laws and regulations for different types of institutions has evolved largely in response to emerging urgent local conditions, and the need for changes and adjustments in responses to international commodity developments. Microfinance development, promotion and regulation have been shaped virtually as reactive (rather than pro-active) measures to emerging needs. Ghana's experience in microfinance development demonstrates that an enabling policy environment and regulatory framework is indispensable for the creation of a wide range of sustainable microfinance institutions with growing outreach.

Changes in the minimum capitalization requirements for S&Ls and for RBs have been frequent and have made planning by NGOs for transformation into licensed status more difficult and risky. BOG further raised minimum capital for NBFIs to ¢15 billion (over US$2 million) for deposit-taking institutions and ¢10 billion (US$1.4 million) for non-deposit-taking institutions; the increase was proportionately greater for NBFIs than for commercial banks. The intent may have been in large part to ease the burden of supervision by limiting the rate of entry and perhaps encourage some consolidation, aside from trying to correct for the adverse effects of inflation and currency depreciation on capital levels. The capital adequacy level, mandated at 6% of risk assets, is significantly below the levels that can be found in a number of other countries which, in fact, require 10% or more for deposit-taking MFIs.

The organization and ownership structure for rural banks is inherently weak. Ownership-at-large by residents of a community, with a cooperative-based control structure (one person-one vote, regardless of the number of shares owned) translates into extreme difficulties for raising additional capital when conditions require, as well as for fixing accountability and decision-making.

Non-governmental agencies have helped fill gaps in oversight and market promotion. The apex organization for rural banks, ARB Apex Bank, is able to provide check clearing, fund transfer, depository and emergency liquidity funding to member banks. It is also functioning as an auxiliary to BOG in the supervision of member rural banks and can do much more (with the consent of BOG) to raise the level of technical capacity in the supervision and examination of rural banks as well as in examiners' understanding of the rural and microfinance business carried out by rural banks. In addition, the Ghana CUA has promoted the adoption and use of PEARLS by member CUs. It has also worked effectively with the Department of Cooperatives in carrying out joint supervision, audits

and onsite examination of credit unions in order to assess and promote the financial soundness and stability of the credit unions, which continue to play a major role in providing access to financial services in rural areas.[57]

GHAMFIN has developed a monitoring system based on the methodology of the MicroBanking Bulletin, and piloted its application with a small sample of rural banks. It is likewise carrying out a geographic mapping of different types of MFIs. The benchmarks and performance standards are planned to be reference points that can be used by the unregulated MFIs (especially NGOs) for self-regulation and by donors, BOG and MOF in tracking the growth and performance of the sector. Ghana does not have many NGOs whose primary mission is microfinance, except for Sinapi Aba Trust, whose client base has grown from 1,750 in 1996 to 23,200 by March 2002, and which as been heavily supported by Opportunity International, UNDP, USAID, DfID, the French Development Agency and a major UK foundation.

In summary, the ad hoc, evolving and reactive approach followed in Ghana does not appear to have served or contributed, as much as expected, to the growth of sustainable microfinance. The sector remains badly fragmented and only a handful of MFIs (formal and informal) seem to have achieved significant outreach and sustainability levels. A new World Bank project is reported to be under preparation, to support strengthening of BOG. Among the goals are technical assistance to review the structure of the Banking Supervision Department and the fit of various departments in the overall organizational structure, including reviewing salary structure within BOG; support to enacting several laws critical for implementation of reforms; and clarifying regulation and supervision responsibilities among BOG, Cooperatives Department and CUA for credit unions, and BOG and ARB Apex Bank for rural banks.

Indonesia

We saw earlier in this paper that Indonesia's diverse array of microfinance providers have been successful in reaching low to moderate income populations, mobilizing and intermediating significant amounts of money, and achieving growth and sustainability with little dependence on subsidized capital. In this section, we look at the implementation of Indonesia's regulatory framework, focusing on two aspects. First, the banking reforms of the early 1990s, and subsequent efforts to strengthen their implementation, attempted to rationalize the system, moving microfinance towards the formal micro-bank (BPR) institutional form. We look at their impact, particularly on existing institutions. Second, while NGOs have not played the lead role in Indonesian microfinance, there have been several efforts to legalize or transform them so that they can offer formal microfinance services – and we discuss these as well.

[57] An important cooperative with savings and credit operations, aside from domestic and export marketing services is the Kuapa Kokoo Farmers Union, with an estimated 45,000 members. The Union operates a licensed cocoa buying company, exports directly to the UK and other countries under the Fair Trade system, and owns part of the Divine Chocolate Company.

The Impact of Enforcement of the BPR System on Existing MFIs

The profusion of microfinance institutional types coincides with a diversity of regulatory niches and oversight mechanisms. This has created a dilemma for policymakers. The great majority of non-bank non-cooperative MFIs are operating in a grey area. Depositors in BPRs are protected by the Banking Law and by the deposit guarantee scheme defined in 1998 after the financial crisis. However, small savers in thousands of existing unregulated - or not properly regulated - non-bank MFIs are not covered by any deposit protection scheme, and many appear to be subject, at best, to a quite lenient application of prudential norms (Abdullah 2004). This also seems to be true of most cooperatives (non-BMT) and credit unions, whose financial health is not publicly known.

There have been two main responses to this. For several years now, efforts have been underway to create a policy and legal framework to fill the gap in oversight of non-bank non-cooperative MFIs (discussed previously). A prior effort to formalize and harmonize parts of the microfinance sector started with the financial reforms of the early 1990s. The bank deregulation program, culminating in the Banking Act of 1992, required all unlicensed "old" BPRs (founded before the 1988 financial reform package, PAKTO 88) to apply for a BPR license by the end of October 1997. The same requirement was extended to the district savings and loans, i.e., the various LDKPs, and initially to the village banks or BKDs. Under the law, all licensed BPRs must comply with criteria such as the following: CAMEL performance rating, standardized monthly reporting, the obligation to operate daily, and other related standards similar to those for commercial banks.

For promoters of new BPRs, and for the market banks and other entities that were offering the microfinance banking services of a BPR, this was a difficult but justified entry barrier to set. What was the impact? During the first five years of the new licensing framework, more than 1000 BPRs (rural banks) were established, and numbers peaked in 1999 when the number of BPRs reached 2400. This rapid growth was not sustainable, and Bank Indonesia was not able to properly regulate and supervise them. As a result, BI has had to close down some 200 BPRs over the past few years (Abdullah 2004), and more recently, the increased capital requirements (see the previous discussion) are forcing the smaller, often older BPRs to face the prospect of consolidation or closure. Even with some setbacks, including the difficulties faced by the "old" BPRs, the impact of formalizing and bringing microfinance banking into the BPR system has clearly been positive.

With regard to the older, established local MFIs (LDKPs and BKDs), the story is somewhat different. During the deregulation reforms, the government and Bank Indonesia made it clear that that MFIs not registered as BPRs were not allowed to conduct "banking activities," and the Banking Act of 1992 (as confirmed in a later amendment) prohibited any party without a banking license (or other authorization) to collect savings from the public. Thus, these institutions had to transform. Martowijoyo (2001) reports negative impacts on the performance and sustainability of these MFIs during the early 1990s. The new requirements had the following effects. First, the organizational transformations implied in meeting the standards were daunting:

- the new standards required a level of learning and knowledge higher than that of the average MFIs official, due to its complexity and sophistication as compared to their own previous system, including terminologies used in commercial banking and unfamiliar financial computations;
- they required a complete change in accounting systems for the purpose of monthly reporting and performance rating; and
- the requirement to be open for business daily (for a BKD), created the need for additional personnel, and drastic changes in organizational and cost structure, as well as work culture.

For the BKDs, at least, these standards were unworkable and threatened the sustainability of a great number of them. However, the BKDs were granted BPR status, and application of the main prudential requirements of the Banking Law of 1992 was suspended. Although the suspension remains in place, it is essentially a form of discretionary forbearance and could legally be withdrawn at any time. If this happened, the cost of transformation and the impact of enforcing the rules would likely drive the large majority of BKDs into bankruptcy or closure by the regulator.

For the LDKPs that were unable to graduate to BPR status by the 1997 deadline, i.e., the majority of this group (whose numbers exceeded 2200), the result was an uncertain future in illegal status. For the subset of LDKPs operating in Central Java (the BKKs, numbering just over 500), research suggests that the new standards discouraged expansion and efforts to pursue new customers, and fostered a tendency to shift the target market segment to toward higher-income groups – as indicated by increasing average loan amounts. A large part of the problem arose from the difference between CAMEL and the rating measures used previously. Some indicators that formerly were goals for BKKs and determined their performance rating – such as new borrowers, loan circulation, savings, and the number of village posts – were no longer considered in the CAMEL rating (Martowijoyo 2001). Although the unlicensed BKKs were not forced to close, they are currently undergoing a restructuring and consolidation process led by the provincial development bank (BPD). As mentioned previously, the individual (sub-district) BKKs (both licensed and unlicensed) will be merged as branches into larger district-based institutions that will be upgraded, licensed as BPRs, and supervised by both BI and the BPDs. This effort (assuming it is well-implemented) will bring benefits of scale, safety, and sustainability – but given past experience, it may also create pressure to meet the added costs of these measures by moving up-market or increasing interest rates.

Path for Transformation of NGO-MFIs to Regulated Status

It has already mentioned that the role of NGOs in microfinance is less prominent in Indonesia. Some NGOs have been involved in microfinance through group lending since the 1970s, such as Bina Swadaya, LP3ES, Duta Bina Bhuana (Bali), and others. However, there is apparently little motivation for these NGOs to transform into regulated MFIs, especially BPRs, which would require significant upgrading of capital, systems, structure, and human resources. Also, along with the general problem that changing an

NGO to a banking institution requires a commercial ownership structure, BPRs are legally prohibited from accepting foreign capital.

The NGOs have tried different strategies for transforming their microfinance activities. Instead of transforming their self-help-groups or their microfinance units into BPRs, some NGOs founded BPRs with separate invested capital and human resources, such as Bina Swadaya, which owns 4 BPRs (90% ownership, with some additional individual shareholders owning 10%), and Duta Bina Bhuana, which owns 6 BPRs. To get around the foreign investment barrier, CRS set up a limited liability company, PT Ukabima, to be an equity investment company assisting BPRs. In 2000, PT Ukabima invested capital in a BPR in Klaten, Central Java, to launch a pilot project for solidarity group lending, named Special Loan Window for the Poor Without Collateral. PT Ukabima also provides capacity building to BPR partners.

Bank Purba Danarta, in Semarang, is the only NGO to have transformed into bank. During the bank deregulation effort of 1988-1992, BI stated that the NGO could no longer provide savings and loan services, but had to become a regulated institution. The promoters decided to become a bank rather than a BPR in order to offer full service to their clients. Three major businessmen stepped in with capital, and the transformation took some three years.

In the last decade, Grameen Bank replications have also been developing in Indonesia. Most of them have apparently made no effort to become regulated. However, the newest and largest Grameen Bank replicator, YDBP, had a different experience. When it followed an advice of a BI official to apply for a BPR license, it found out later that BPR status would inhibit its operation. First, the law prohibits a BPR from receiving share capital from foreign parties, so it cannot get financial assistance from Grameen Trust. Second, BPR regulations restrict credit extended to related parties – but all of the groups formed by MFIs could be considered as "related parties". The remaining 21 Grameen Bank replicators have chosen to remain silent, go on with their activities, and not to bother with becoming BPRs or coops.

The question that arises from these experiences is what position Bank Indonesia has taken towards unregulated microfinance providers. It has taken no action yet to prosecute MFIs violating the Banking Act by mobilizing savings from the public. Also, on the part of government, there is no effort to motivate NGOs to become regulated institutions. This has also frequently been the case in the past with district and village banks (LDKPs and BKDs) that have not become licensed BPRs. This pattern of forbearance, however, is not applied consistently and appears to be reaching its limit – as indicated by BI and other official efforts to bring unlicensed institutions, including some NGOs into regulated status.

The story of the BMTs (i.e., MFIs formed by local Muslim communities) is quite different, since these have consistently chosen to formalize as cooperatives. In the mid-1990s, when BI was involving BMTs in its linkage banking program, the younger generation who manage the BMTs soon realized, through their contact with BI officials,

that their organizations were violating the Banking Act by mobilizing savings. Many of them then demanded that BI issue letters confirming that their BMTs were operating under the auspices of BI. They were accorded a "transitional status" while determining what legal form they should choose. Now, the majority of BMTs have become cooperatives (savings and loan or multipurpose), with a very few becoming BPRs. This story shows not only the prevalence of regulatory forbearance, but of regulatory arbitrage as well – i.e., choice of institutional form based wholly on considerations such as initial capital requirements and other mandatory regulations, such as monthly reporting, strict performance ratings, and supervision.

Last, a Law on Foundations (*yayasan,* the usual form of NGO in Indonesia) was passed in 2001 and went into effect in 2002, prohibiting NGOs from being involved in income-generating or economic activities. Existing NGOs have five years to comply with the law – which means spinning off microfinance activities into formal legal institutions such as BPRs, which many NGOs lack the capital to do. This has been a major impetus behind the proposed microfinance law (Indonesia Country Profile, BWTP).

Mexico

Mexico enacted its legislation on MFIs, the *Ley de Ahorro y Credito Popular*, in 2001. Yet, the passage of the law seems to have been the beginning rather than the end of the process of bringing microfinance under a coherent regulatory framework. There have been two extensions of the compliance deadline, and in fact very few microfinance providers are licensed to operate under the law as yet. The move toward implementation is a complicated one with lessons for policymakers elsewhere. This will be the main focus in the discussion that follows; we will also briefly examine the role and treatment of NGOs in this process.

Implementation of the Microfinance Law

While implementation of the LACP has advanced significantly, only a few institutions have been authorized to operate under the law – including only two SOFIPOs. In this process of implementation, two extensions of the deadline for institutions' compliance with the law and authorization have been needed. The first deferred the original deadline from June 2003 to June 2005. In view of the necessity for greater technical assistance to some entities, mainly the smallest and most rural ones, as well as the learning curve that CNBV and the federations have had to pass through, the planned deadlines were insufficient. The intention in both the original and modified timetable was for the EACP transformations to occur under the current administration (until 2006), so that political changes would not lead to backsliding in the sector.

The second change gave the microfinance institutions until 2008 to transform into licensed EACPs, under a conditional extension (*proroga condicionada*) to be authorized on a case-by-case basis by the CNBV before the end of 2005. Obtaining the authorization requires fulfilling a series of requirements set by CNBV, such as participating in BANSEFI TA programs and achieving a passing financial rating. Reportedly, 62 out of 400 entities in the BANSEFI program met this standard in 2003, and in 2005 the number

rose to 150. While there is some reason to question the credibility of a deadline that has twice been extended, those close to the process seem to believe that the current dispensation is credible since it is both sufficient for the necessary transformations and subject to CNBV's conditions. At the same time, few seem to believe that CNBV would forcibly shut down institutions that do not qualify or do not meet the deadline (especially in 2006, an election year).

In fact, before individual EACPs can operate, a necessary requirement is that federations be authorized to supervise them. Currently, as mentioned above, there are nine authorized federations (and 12 Supervision Committees). Under the LACP, an MFI's membership in a federation is voluntary, but supervision is obligatory, and so it must be contracted and paid for through an affiliate relationship with a federation if the MFI does not become a member. A federation must have a Supervision Committee authorized by CNBV to handle auxiliary supervision, and an early warning system to detect risk or irregularity (BANSEFI technical note). For those federations that have already obtained their authorization, it took between two and three years of continuous work to achieve the necessary qualification and certification. It will be difficult for more federations to be created, both because of the time and effort involved, and because federations need a minimum of ten members. Further, the federations are envisioned as belonging to confederations, where the EACP deposit guarantee fund is to be kept and managed – one of these has been authorized to date. In parallel, BANSEFI is strengthening CNBV's capacity to supervise EACPs via this auxiliary supervision structure.

The microfinance sector has been politically at odds over the content of the LACP and its implementation. For example, MFIs are differently situated with respect to how urgent their need is to be authorized. Those entering the market or transforming from credit-only operations cannot accept savings until they are authorized, while SAPs can continue with the operations that have been authorized under prior law (including intermediation), until the final deadline. The possibility has been raised that influential cooperatives might use political influence or legal proceedings (a writ of *amparo*) to block the implementation of the law – or indeed to repeal or amend the law in a more populist direction. The main political obstacles to implementing the LACP come from the more radical wing of the cooperative movement led by ALCONA, which represents about 100 *cajas de ahorro*. Among its concerns is that it does not wish to be placed in the same legal regime as for-profit entities such as the SOFIPOs authorized by the LACP, and that the law will impose the costs of secondary regulation. The sector of productive cooperatives has criticized the financial cooperatives for having joined up with the SOFIPOs.

These controversies highlight the difficulties surrounding the emergence of "pure" versus "mixed" federations. The former are federations comprised exclusively of cooperatives, while the latter supervise the SFPs (for-profits) as well as having as having SCPs (cooperatives) as members. The structure and governance of federations is based on a cooperative model, and behind most of the existing federations is a large founding cooperative that plays a leadership role. Those SFPs obtaining fee-based supervision services from the federations will have no representation on the federation boards of directors, and their for-profit orientation is considered at odds with the SCPs' interest in

advancing the cooperative movement. As suggested above, some of the cooperatives are, if anything, even more opposed to joining in federations with for-profit MFIs.

There has been some effort to create federations that accommodate the for-profits. ProDesarrollo attempted to establish a federation of SOFIPOs only, but failed. More promisingly, there is now an authorized mixed federation – FINE, comprising some 22 SOFIPOs and 9 cooperatives. FINE suggests that SFPs are the easier type of organization to start, and that most of the growth in MFIs during the next several years will be in that sub-sector. In addition, the cooperatives, especially older, more traditional ones, face a difficult challenge in transforming to comply with the LACP.

A perhaps more fundamental question is whether federation-based supervision can work properly. Self-regulation does not have a strong track record. Auxiliary supervision systems such as the one in Mexico have been used effectively in Canada and Europe. In the Mexican case, the EACPs purchase shares in a federation to become members and to capitalize it; a problem thus arises if a federation has to give a poor rating, and thereby risks losing member capital or supervision business. The key question is whether the Supervision Committees will have enough insulation from member-based pressures (formally, the Supervision Committees are responsible to CNBV and Desjardins), as well as enough technical know-how and authority, to make their decisions stick. Time will tell, but the process of getting federation-based supervision set up seems to be making progress in the right direction. As the federations were being built up, there were concerns about a crowd of retail institutions working in conditions of insufficient financial discipline (Chemonics 2004), although progress on training and setting up the auxiliary supervision system is addressing this.

Some observers suggest that too little has gone right with Mexico's current microfinance reform process, and that the long delay in implementation threatens to de-legitimize the whole exercise. For example, BANSEFI and CNBV have been in conflict, first over the regulations, then more recently over the speed of authorizations – with BANSEFI favoring the faster emergence of more entities, and CNBV taking a cautious approach. Another recent controversy emerged when one of the Mexican states imposed interest rate caps, and the federal government forced the repeal of the measure based on exclusive national authority over financial policy. A further setback has been the lack of the expected strong interest in the for-profit SOFIPO form. Some, including NGOs and finance companies that had wished to transform, are finding the equity structure and the federation governance unattractive – although SFPs, unlike cooperatives, are permitted to have foreign investment. Nevertheless, the World Bank takes the view that the implementation of the LACP is "ahead of schedule" – citing the numbers of *cajas* achieving a financial self-sufficiency rating, and other advances.[58]

[58] Interview with World Bank representative, Mexico City, November 2005.

Box 6: Prospects for successful reform implementation in Mexico

The following points summarize the current prospects, both positive and negative:

1. The supply of microfinance services is expanding, in part due to the enactment of the LACP.
2. Despite the expansion of services provided by banks and SOFOLes (non-depositary finance companies), it is recognized that SACPs reach more remote and marginal localities (especially in rural areas) where there is little likelihood of competition from other providers in the near term.
3. The technical assistance and capacity building for the Supervision Committees have left an important human capital benefit that could not have been foreseen when the process of developing the law started some six years ago.
4. It is unclear what incentives the *prórroga condicionada* is creating, especially among cooperatives that do not wish to comply with the law or wish to modify the law in light of a more radical cooperativist vision.
5. It is widely believed that the new entities (not the transformed entities) entering the system will mainly be SOFIPOs.
6. It is unclear if the CNBV will have the capacity to shut down those institutions that do not opt for the *prórroga*. It is possible that some will seek to use the *amparo* legal writ, and that legislators will support this as a political strategy during the coming election year.
7. Despite these risks, there is a shared view that the large majority of MFIs will comply with and support the law.
8. The majority of future EACPs, despite their criticisms of certain aspects of the law and its implementation, believe that it is positive and that the benefits will outweigh the costs.
9. It is unclear how the sale of BANSEFI will proceed. If it is not completed before the end of the current presidential term, there is the risk that it will continue as a first-tier bank in the hands of the next government.
10. Despite all the efforts expended on it, the effectiveness of auxiliary supervision remains to be seen. Since it is the last opportunity for formal supervision for the

Path for Transformation to Regulated Status

To carry out the work of upgrading MFIs to meet regulatory standards, Mexico created BANSEFI from the former PAHNAL. BANSEFI gives technical assistance to institutions seeking to comply with the law and to come within the regulatory framework for EACPs, and also enables the establishment of the necessary technological platform for the microfinance sector. The cost of BANSEFI's initiatives is being covered by a US $140 million World Bank loan ($90 million for the technological platform, and the remainder for TA, training, and outreach). The TA is provided by international experts contracted and paid by BANSEFI. There are now about 400 institutions in the TA program.

The majority of institutional transformations are those of unregulated *cajas de ahorro* becoming formalized and regulated. Few institutions are transforming from NGOs to EACPs – in large part because most NGOs do not accept savings, but also because they

are a much smaller portion of the market than *cajas de ahorro y crédito* and do not play the important role in microfinance that NGOs have had in other countries. At the time of the development of the LACP, there were only 15 NGO-MFIs in Mexico interested in the issue of regulation. Currently, there are about 30. The relative paucity of NGOs stems largely from the fact that for 70 years, the ruling party (the PRI until 2000) was the main organizer of civic initiatives, limiting the scope for independent organizations.

The key reasons why many NGOs do not wish to adhere to the LACP framework are these: 1) the equity framework of the SOFIPO form, which requires a minimum of ten shareholders (thus diluting the control of any founding NGO); 2) the costs of regulation and supervision; and 3) the credit-only orientation of most NGOs, which means they need not comply with the LACP. There was some interest in drafting an NGO-MFI section in the LACP, but this was never done. The NGOs that are members of ProDesarrollo, however, express disappointment in not having the opportunity to take part in the TA and IT network initiatives of BANSEFI as a result of their not having a cooperative structure or taking deposits.

The issues faced by transforming entities offer further illumination. Fincomun, a SOFIPO, made a complex transformation from its former status as a credit union. As an early transformer, it faced a number of issues of "first impression," including gaps in the regulatory structure as regards the governance of EACPs. It had to work closely with CNBV and it reports that the process was expensive. The chief benefit is the new entity's ability to take public deposits, which credit unions are not authorized to do. After its transformation, Fincomun reports having grown 60%, with a current client base of 85,000 in 35 branches, and an array of products from debit cards to insurance. Another case is that of CAME, a village banking NGO transforming into a SOFIPO. Its prior finances as an NGO were based on donor funding, but in becoming a company it would have to have at least 10 owners. It worked with CNBV, which agreed that CAME could own as much as 30% of the new SOFIPO, and that the latter could have up to 3 NGO owners. As an NGO, CAME kept group savings at BANSEFI – but approval under the law will allow intermediation, a change favored by its village banking groups.

The Philippines

The policies and regulatory framework for microfinance established in the Philippines have begun to have an impact, as suggested in our examination of the market, above. In this section, we discuss some of the implementation strategies of the financial regulators, and the responses by the sector in terms of using the institutional forms made available in the legal framework. What were the key regulatory factors in helping move the market forward?

Key Implementation Steps

The enactment in the early 1990s of key poverty alleviation-oriented policy measures facilitated development of strategic financial alliances between the People's Credit and Finance Corporation as a primary institution for credit facilities for the poor, on the one hand and the MFIs on the other hand, for the implementation of the Rural

Microenterprise Finance Project (RMFP). PCFC had been established in September 1994 under Administrative Order 148 and registered in 1995 as a finance company with the Securities and Exchange Commission (SEC), and subsequently came under the wing of Land Bank of the Philippines as a subsidiary. PCFC had initial capitalization of Php 100 million in common shares, augmented by an additional Php 900 million in preferred shares in 1998 from the National Livelihood Support Fund (NLSF), a poverty-oriented funding facility administered by the Land Bank of the Philippines.

RFMP was a loan facility from the Asian Development Bank and International Fund for Agricultural Development to finance microenterprises of poor households. The facility prescribed the Grameen Bank Approach as a lending methodology. PCFC's intervention was deemed necessary since commercial banks were still reluctant to lend directly to microenterprises due to perceived costs and risks in microlending, while GFIs had proven to be ineffective and costly as credit retailers.

The establishment of a microfinance-focused regulatory framework cleared the way for PCFC to work out its alliances with MFIs. For example, the General Banking Act allows NGO MFIs to mobilize savings deposits without violating the provisions of the Act -- the volume of deposits generated was not to exceed the MFI's loan portfolio. By linking up with PCFC, NGO MFIs could supplement their internally generated funds and expand their lending while retaining compliance with legal provisions under the General Banking Act. The regulatory framework gave PCFC, other GFIs and private banks the flexibility to design their own lending guidelines. By integrating the microfinance performance standards into lending guidelines, MFIs gained equal opportunity to seek access to wholesale funds and technical assistance support from PCFC, its parent Land Bank and other commercial banks.

One of the constraints to microfinance development was the lack of appropriate type of financial institutions that could effectively reach out to the poor in a sustainable way. The response of BSP to the challenge of putting in place institutions focused on reaching the poor in a sustainable manner to lift the moratorium on the licensing of new thrift banks, rural banks, and cooperative banks. The moratorium had been established earlier by BSP and the authorities in response to concerns of international development finance institutions on the number and variety of licensed banking institutions, relative to the perception of insufficient technical capacity for prudential supervision. BSP opened the opportunity for NGO MFIs to transform into formal banking institutions and for existing banks to establish new thrift or rural banks (see chapter 3). Although microfinance banks still comprise a small portion of the banking system, the entry into microfinance by rural banks, thrift banks, and coop banks is significant for constituting the start of microfinance mainstreaming and commercialization. BSP also moved quickly, in concert with the microfinance industry, to promote and adopt international best practice standards for microfinance (see the prior discussion of P.E.S.O.).

Further, capitalization requirements for "narrow" and community-oriented specialized banks have not been constituted as barriers to entry for microfinance-oriented licensed and prudentially regulated financial intermediaries. The minimum capitalization

requirements for microfinance-oriented thrift or rural banks are only a small fraction (ranging from 0.2% to 2.3%) of the minimum capital requirement for commercial banks. A necessary condition to this ease of entry is the fact that BSP had the technical staff in organized supervision and examination departments specialized in the tiered categories of thrift banks and rural banks.

Clear definition (and understanding) of the characteristics of microenterprise activities and transactions, and of microfinance clients and the loans they require, is essential for commercialization of microfinance through the involvement of microfinance-oriented as well as regular commercial banking institutions. To encourage the expansion of microfinance services and integration of the microfinance sector into the financial system, administrative regulations (through circulars) issued by BSP have made wholesale and sub-wholesale loans of regular commercial and thrift banks to microfinance institutions as eligible for compliance with priority-sector credit quotas (e.g., agriculture, agrarian reform, SME credits). Moreover, BSP has opened its rediscounting window for the refinancing of eligible microfinance loans. Two of the major end-results are (a) government has been able to keep its involvement in microfinance and priority-sector credits to a minimum and on an indirect basis, and (b) microfinance continues to develop and grow, while remaining a principally private-sector activity.

BSP Capacity-Building

To complement its efforts at establishing a conducive policy and regulatory environment BSP has been pursuing an active capacity building program as an essential component of its objective to integrate microfinance fully into the financial system. BSP's program is aimed at increasing the capacity and skills of BSP supervisors and examiners, management officers and employees, as well as their counterparts in the banking sector, through comprehensive and focused training programs.

For the banking sector, the BSP has included microfinance as part of the Basic Rural and Thrift Banking Courses offered by the BSP Institute, which reaches nearly 2,000 participants. In June 2004, the BSP launched the series of seminars for banks engaged in microfinance focusing on the importance of internal controls, performance standards and best practices for sound micro finance operations. Three such seminars have been conducted reaching nearly 80 banks.

The BSP's capacity for effective microfinance regulation and supervision is also increased by internalizing and institutionalizing microfinance, through the creation of a Microfinance Committee, a Microfinance Unit and a Microfinance Division of Examiners in the Supervision and Examination Department IV (Rural Banks).

Experimentation with Different MFI Forms

Within the multi-tiered structure of the Philippine banking and financial system, there have been some fruitful experiences with the use of different institutional forms by microfinance promoters. Following is a discussion of three illustrations that offer insights into the impact of the Philippines' approach to microfinance regulation.

Thrift bank license. Opportunity Microfinance Bank was formed from the concerted efforts and strategic alliance between Opportunity International and four important NGO MFIs in the APPEND network that are supported by OI. The underlying concept was (a) to contribute the performing assets of the NGO MFIs into the new bank as capital, with the permission of BSP, and (b) to use the branches of the four NGO MFIs as branches of the new microfinance-oriented thrift bank.

In the long term OMB was to be the "financial storehouse" of APPEND, taking on all financing functions/activities of the network and the individual partner-NGOs. The investing NGOs meanwhile would continue training, building capacities, developing products and undertaking transformation activities for the clients of OMB. The NGO partners of OMB were to be developed as business development centers with the assistance of APPEND. Also these NGOs were to be "hatcheries" of new branches which when viable would be sold and turned over to OMB. A crucial component in this plan is the consolidation of the viable branches of the investing NGOs into OMB.

Incorporated Non-bank MFI. TSPI Development Corporation is the original model for the NGO MFIs in the APPEND network, but it opted not to be a direct shareholder in OMB and, instead, pursue its microfinance mission as a non-profit MFI. TSPI's incorporated status permits it to receive grants and borrow from commercial sources, but not to mobilize deposits from the public. Thus, increasing access to resources is critical to expansion in operations and outreach. TSPI has structured a number of strategic partnerships with institutions to help it reach its outreach and product diversification goals. These institutions include Land Bank of the Philippines, Bank of the Philippine Islands, Association for Social Advancement – Bangladesh (ASA), United Coconut Planters Life Insurance Co., and Great Pacific Life Insurance Company. Its continuing relationship with Opportunity International has also been instrumental in executing plans to expand geographical presence.

The client base numbered 92,000 in 2003, served through 55 branches — 16 in Metro Manila and the rest in peri-urban and rural areas of several provinces on Luzon Island, providing individual and group-based microcredit products to a mostly entrepreneurial and working-poor client base. The value of the loan portfolio outstanding amounted to P312 million (US$ 5.7 million), total assets amounted to P433 million (US$ 7.8 million) and the fund balance/equity standing at P183 million (US$ 3.3 million) at end-February 2004. In contrast to the unexpected difficulties of OMB in effectively using the branches of its investor NGO MFIs for microfinance business, TSPI has been able to expand to market areas that fit its market niche and orientation.

Rural bank license. The Centre for Agriculture and Rural Development Foundation (CARD) has one of the largest member-client bases among NGO MFIs in the country. The group decided to focus its operations and product/service delivery among the poor women clients it serves, by segmenting operations into three affiliated vehicles. The ongoing microcredit business was spun off and concentrated into CARD Rural Bank, which also has the legitimate capability to mobilize and accept voluntary retail deposits.

The current and performing loan assets that were transferred to the rural bank were valued on an arms' length basis by a third party, and contributed as capital for the rural bank with the permission of BSP. The mixed developmental and group-formation microcredit business continues to be carried out by the CARD NGO. The third specialized entity is CARD Mutual Benefit Association, which specializes in providing CARD members and clients insurance services and provident fund products as an entity duly licensed and supervised by the Insurance Commissioner.

Results

The timeline for development of regulated microfinance in the Philippines stretches over a period of some 8 years, from 1993 through 2001. Microfinance was integrated into the regulated formal financial system through existing laws, without having to enact a specialized microfinance regulatory framework. It is also important to point out that dialogue and consensus building included microfinance practitioners and institutions, umbrella organizations for the Rural Banks and Thrift Banks, as well as key officials from government financial policy agencies – the Department of Finance, which also served as the secretariat for the inter-agency National Credit Council, the Cooperative Development Authority, and the Bangko Sentral.

Some of the key results of BSP initiatives in microfinance are the following:

a. There are now 6 microfinance oriented banks with more than 50% of their operations dedicated to microfinance. In addition there are 178 existing rural and cooperative rural banks engaged in various degrees of microfinance operations. These banks reach nearly 550,000 clients with total outstanding loan portfolio of Pts.3.3 billion. (as of December 2004). A third microfinance-oriented thrift bank has also been licensed, Dunggonon Thrift Bank, which is affiliated with the sustainable successful NGO-MFI, Project Dunggonon of the Negros Women for Tomorrow Foundation (the bank is not yet operational)

b. BSP has granted rediscounting access to 15 microfinance-oriented banks since the opening of the rediscounting facility. Total rediscounts amounted to Pts.277 million involving 33,000 micro-borrowers. At present, the total outstanding balance of the rediscounting facility is Pts.17 million (as of March 2005).

c. The NGO MFIs that have opted *not* to transform into licensed banks have continued to access wholesale commercial loans from banks and other financial institutions, including Peoples Credit Finance Corporation, the government-owned finance company which provides wholesale funds for rural and microfinance at commercial rates and according to clearly established eligibility criteria.

South Africa

By most accounts, South Africa's Microfinance Regulatory Council has succeeded in implementing its mandate and having a positive impact on the market. Indeed, MFRC added to its mandate by expanding its focus in strategic ways to address glaring deficiencies in financial sector development, which may have strictly fallen outside of their explicit charge, but clearly either impeded or undermined their core responsibilities.

Some see a tension between these two aspects of its work, suggesting that the expanded work compromised its core mandate. However, in general, the strategic work and its synergies with MFRC's efforts within the core mandate seem to have enhanced its performance.

In the area of *formalization*, the MFRC has used the leverage provided by the 1999 Exemption Notice to bring significant numbers of microlenders into formal registered status. For over three years, the MFRC struggled to carry out its mandate here, since it had at most only the implicit authority to require microlender registration. It had no statutory authority, and its efforts were resisted in the courts, until an amendment to the Usury Act was passed in 2003, enabling it to enforce the Act by delegation. Applications soared starting in mid-2004, evidently as a result of MFRC's campaigns against unregistered lenders. The key results of its efforts are as follows:

- Some 1,900 lenders have been registered (along with thousands of branches); MFRC argues that there has been a decrease in the ranks of unregistered lenders, but this is not firmly established.
- More than 200 Black (i.e. indigenous) South African micro-lenders have been registered. At the same time, there are indications that many more such lenders exist and have not registered, especially informal township based lenders.

Consumer protection is the central, and least controversial, aspect of MFRC's mandate. The MFRC provides a platform for complaints resolution and a mechanism for borrowers to seek help. Even critics of the agency seem to agree that this is a breakthrough. The first consumer complaints related mostly to retention of bank cards, which became illegal along with the creation of the MFRC. Combating this and other illegal collection methods (e.g. the use of blank "process," or confession of judgment, forms) has proven difficult. Other consumer protection concerns included high rates, disclosure, abuses by agents and brokers, and reckless lending. As a result of MFRC introducing a prescribed loan summary in 2000 (comparable to "Truth in Lending" disclosure requirements in the U.S.), there has been a trend of increasing transparency in pricing.

Here are the key results in this area:

- MFRC has played a major role in "cleaning up" the industry, providing an avenue for clients to seek recourse, and fomenting major changes in microlender behavior towards more responsible lending practices. It has raised the bar in terms of ethical behavior by lenders.
- Rates and disclosures are standardized, and the procedures widely understood, if not followed universally.
- There has been a major influx of banks into the sector, driven in part by the reduction in reputational risk.

MFRC's *information* role, addresses both the financial literacy of consumers and policy-relevant knowledge of the microfinance sector. On the latter point, the MFRC is charged with reporting statistical returns and trends. It has gone beyond this narrow mandate,

supporting, and in some cases leading, the review and development of new frameworks for reforming the financial services sector. Following are the major results in this area:

- MFRC has played a central role in the collection of sectoral data and the analysis of trends in the market. There are, at the same time, questions about the quality of MFRC's data -- although the data are clearly better than what had been available previously.
- MFRC has made strong efforts to inform and educate the public. Despite MFRC's public information campaigns and its efforts to ensure the use of standard contracts and disclosures, there are constant complaints that borrowers do not understand the terms of their loans.
- MFRC has produced critically important research, creating a much better standard of knowledge about the microfinance sector. It has used much of this research to press on major policy issues (e.g. credit law reform), injecting sound information and analysis into a political discourse that tends to be dominated by anecdote and polarizing rhetoric. As compared to the situation in 1999, much more is now known about the microfinance sector, and this is largely MFRC's doing. It has also used this research to improve its own regulatory function.

The MFRC took a further step beyond its core mandate to establish the National Loans Register. MFRC understood that an implication of both the core consumer protection mandate and the industry development mandate was the need for much better credit information systems. Having these in place would enable the setting of over-indebtedness standards and help reduce the risks to lenders. Once the NLR was in place, MFRC felt it had the information necessary to begin cracking down on reckless lending, i.e. credits that create over-indebtedness (defined as a percentage of household income).

The requirement that lenders use the NLR was struck down in a court decision invalidating the 2002 revised MFRC rules. One of the more striking outcomes is the increase in NLR filings since then – indicating that lenders may have determined it to be in their continued self-interest to use the system. This is partly due to the design of the system. Rather than set up a separate public credit registry, as a number of countries have done, MFRC chose a private sector model that links the two large credit reporting firms that serve the banks and larger micro-lenders (TransUnion ITC and Experian) to second-rung credit bureaux that deal with the smaller micro-lenders. MFRC has access to this information, and monitors activity and reports aggregate statistics.

In summary, the MFRC has played an important role in the emergence of a R17 billion market (from less than R1 billion in 1992, and around R10 billion in 1999, at the time of MFRC's inception). There is evidence that nearly 30% of this consumer credit has gone towards developmental purposes (i.e. enterprise, housing, and education). Other evidence suggests that the MFRC has helped create access for an estimated three million people who did not have access to formal finance before. The impacts include the following:

- Major changes in micro-lender behavior towards more responsible lending practices and concern for lenders' reputation.

- The influx of banks into the sector, which appears to be driven in part by the reduction in reputational risk.
- A quantum leap in information and understanding with respect to the sector.

Nonetheless, while it is clear that access to credit, particularly consumer credit, has increased significantly since 1992, it is equally clear that the original intention of expanding access to MSME finance has not been directly achieved (although it probably has increased indirectly through leakage at the household level from a dramatically increased pool of funds circulating within poor and low income households).

MFRC's actions in respect of disclosure, fair practices, and so on have contributed to a decrease in rates in the 30-day loans market. Although, the most important factor in bringing down prices (albeit to levels still far above what a vocal group of advocates feels is fair) may be that people are now interest rate sensitive, which represents a major step towards the ideal that clients should be informed and act as the first order monitor of prices and supplier behavior. However, the term lender market presents a different and less optimistic story, where rates seem to have increased, rather than decreased, resulting mostly from a lack of effective competition in that market segment.

Some have suggested that MFRC's efforts encouraged consolidation, since the more marginal players were unable to meet all the regulatory requirements. Once the banks decided to enter the sector, they were very quick to aggressively grow their market share, taking advantage of their preferential access to the payment system. This has led some to complain that MFRC in fact had an anti-competitive effect on the market, and in particular that compliance costs may have discouraged black micro-lenders from entering the market. Further, microfinance bank failures in 2001-2 helped reinforce the division of the market between very large lenders (mainly banks), and very small ones – with little middle ground. Much of this results from secular trends that were only tangentially related to MFRC.

Last, while it is significant that MFRC has successfully implemented its mandate and helped usher in a more dynamic and well-governed microcredit market, the question remains whether it offers a useful model for other countries such as India. Ultimately, South African policymakers admit that the MFRC was a "second-best" option made necessary by the explosion of microlending after the 1992 Exemption Notice. Something more like a "first-best" option, the creation of a narrow bank tier (Mutual Banks) in the early 1990s essentially failed. Efforts have since been made to encourage banks to downscale into microfinance. These efforts appear to have been less influential than the motivation of some far-sighted bankers to set up profitable microfinance operations. The rigidity of the banking law (limiting any form of deposit taking to full-scale banks) and the legacy of *apartheid* – with the agenda it created of breaking down old barriers including constraints on access to finance – play a major role in making South Africa a special, if not idiosyncratic, context. Still, the experience of the MFRC does suggest that a hybrid, non-prudential regulator with well-defined legal powers and strong leadership can play a central role in creating an orderly, fair, and profitable microfinance market.

Conclusions on Implementation and Impact

The discussion of cases in this chapter indicates the dimensions of the time and labor involved in bringing a new framework to implementation – and in reaping the benefits. Again, experience varies widely. In some cases, implementation is virtually continuous with the adoption of the framework, and both the costs and unanticipated results are modest. In other cases, adoption marks the beginning of a long, costly, and risky process of elaborating rules, expanding supervisory capabilities, transforming institutions, and sorting out political conflicts.

There may, also, be unexpected bumps in the road that delay implementation or reduce the benefits. This applies both to regulatory agencies that need to gear up to play their role effectively, and to institutions and promoters intending to start up or to transform existing MFIs. Upon implementation, it sometimes becomes clear that institutions that had been expected to transform in fact have little incentive to do so (Brazilian for-profits, Indonesian NGOs). Or, the tension between financial soundness and outreach to the underserved turns out to be greater than anticipated (apparently the case in Indonesia from 1992), and so the initial policy goals are not met. A further possibility is that personnel or budgets for the increased supervisory load are insufficient or arrive too slowly – with the result that implementation is delayed. A delay need not be fatal, and may provide a valuable learning opportunity, as in Mexico, if handled properly. Where delay could be damaging is if unsupervised or even unregistered entities operate freely, creating risks and undermining incentives for compliance.

The antecedents of successful implementation and achieving impact seem straightforward: the quality of the reform enacted and the quality of the regulators and supervisors. The more complexity inherent in the reform, and the more insulated the process of reform is from the realities both of the market and of supervising microfinance, the more problems can be anticipated. Problems are not always signs of failure. Mexico has had problems with implementation, despite lots of input into its reform from stakeholders and experts, in part because its reform is an ambitious undertaking. A worse result would be a lack of interest on the part of market players in formalizing under the new regime – as has been the case in several of the countries studied. Reforms developed with the right mix of technocratic guidance, sectoral input, and learning from relevant experiences can be designed to anticipate implementation needs. As for the quality of regulators and supervisors, the examples of Bolivia and South Africa in particular show how this can make (or break) a reform.

7. Conclusion

The experiences just reviewed offer a host of potentially useful lessons to policymakers and the microfinance community in countries such as India. Here, we attempt to distill major findings and broad lessons from our case studies.

Review of Case Study Findings

First, we bring together the main points from each of the case studies. The seven illustrative countries exhibit an ample range of approaches to the regulation and supervision of microfinance activities. Among the key points are the following.

Bolivia: This case, one of the best-known in the field, illustrates the importance of a patient market-development strategy implemented by a highly capable supervisory agency. The Supervisor allowed experimentation, collected and shared timely market information, and engaged the sector in ongoing dialogue while elaborating its technocratic regulatory approach to microfinance. The latter consisted of setting high standards for the FFP niche, and gradually bringing MFIs into the regulated sector – with the prospect of increasing their range of services from that point. Both the Supervisor and the sector avoided promotional schemes and subsidies. This 'minimalist' market-building approach helped bring about a 20-fold increase microfinance portfolios in the 1990s, and steady downward pressure on interest rates. Having weathered the consumer credit crisis of the late 1990s, the sector enjoys steady growth and a high level of sustainability. The gradual introduction of deposit services in the sector led to an expansion of savings, which now cover some 60% of the overall loan portfolio.

Brazil: This is a case of disappointed expectations resulting from a restrictive policy framework overlaid on a relatively underdeveloped sector. Even with usury law exemptions, the two authorized MFI forms are credit-only. The dominance of government financing sources brings with it subsidized loan capital and interest rate limits – and with this, a lack of progress towards sustainability in the sector. The growth of commercial microfinance offers a sign of hope. The SCM sector, however, is concentrated and suffers from relatively high arrears. A more positive development is the expansion of bank involvement in microfinance, which can bring about a more sustained increase in services due to cross-subsidization of different client groups and advantages in risk management. This development may have been helped along by Brazil's policies on banking correspondents and simplified accounts. Still, overall microfinance growth has been painfully slow.

Ghana: Here is a quite distinct case, illustrating the differences between Africa and other regions. Ghana has a highly active small enterprise sector, with the bulk of assets held informally. Yet, the financial system is extremely shallow. It is further disadvantaged by severe limits on governmental capacity, including in the central bank. Thus, Ghana's early forays into microfinance policymaking were unsuccessful. In particular, the framework for rural banking led to rapid entry and expansion that brought large numbers of small institutions under Bank of Ghana supervision – far outstripping its available

capacity. Further, BOG had apparently no interest in sharing supervisory authority. These factors inevitably led to failure and restructuring in the sector, with subsequent policy severely tightening entry and prudential standards. During the same period (from the mid-1990s), the government articulated an anti-poverty strategy with a focus on microfinance. Unfortunately, this encouraged subsidized credit programs rather than a focus on developing a framework for sustainable market development. More recently, having restored order to the sector, the BOG issued new rules that reflect greater understanding of the sector and that may provide for growth with discipline.

Indonesia: This is another celebrated case, a microfinance sector with some 44 million depositors, 30 million borrower, and U.S. $141 billion in assets. Much of this stems from the success of the BRI Unit system, essentially a (majority state-owned) commercial bank with extensive outreach through a unit system converted from an old agricultural finance program in the 1980s. Even apart from this well-known story, Indonesia has a diversified microfinance sector with a wide array of providers – from village banks (BKDs) to local microfinance banks (LDKPs) and rural banks (BPRs). There have been some weaknesses in governance and oversight in these sectors, but since the early 1990s, Indonesia has been addressing these by harmonizing standards (using the BPR model), and delegating supervision while building mainline supervision capacity in BI. This dispersed and decentralized system provides deep outreach to the most distant communities and to the poor (if not the poorest). Current efforts focus on continued harmonization of standards for BKDs and LDKPs, consolidation of the latter, and elaboration of a microfinance strategy highlighting NGO providers – which have hitherto been of marginal importance.

Mexico: One might characterize this as an intermediate case, one where there are growth trends and promising regulatory developments that have not yet reached fruition. Mexican microfinance has taken a range of forms, predominantly financial cooperatives (savings and loan coops, credit unions, and others), but also small credit-only finance companies and NGO-MFIs. In 2001, government and advocates from the sector launched a high-profile policy initiative that shortly led to a law (the LACP), and then to a complex implementation process that continues to date. The law provides a set of uniform 'functional' norms for deposit-taking MFIs (popular savings and credit institutions) that can have corporate or cooperative structure. The MFIs are to be supervised in an 'auxiliary' system modeled on the Raffeisen and Desjardins models, with autonomous supervision committees housed in member-based MFI federations. Further, a former state development finance agency was converted into BANSEFI, an agency that coordinates and supports the upgrading of MFIs to meet the requirements of the law, and that houses *L@Red de la Gente*, a commercial network enabling MFIs to access, among other things, a common IT and funds transfer platform. Much of the regulatory system is in place, although work is ongoing. The sector has seen 20% growth during this period of policy development, with total assets estimated at U.S. $22 billion and the client base at 3 million.

The Philippines: In this case, there is again a diverse array of microfinance providers including rural banks, NGOs, and a range of NBFIs. The challenge here has been to counteract a previous policy emphasis on state intervention through heavy regulation and

subsidized credit provision. Since the mid-1990s, the Philippines has articulated a microfinance policy and enacted an amended banking law enabling MFIs to take deposits and to set the terms of their financial services independently (among other things). A number of agencies have stepped in to push forward the processes of market development and strengthening of sectoral governance. This includes the BSP, which has played a lead role in tailoring certain regulatory norms to support MFI operations, providing market infrastructure, and, very importantly, building sufficient internal supervisory capacity to deal effectively with the sector. BSP has also delegated some responsibilities, notably putting the credit unions under the supervision of their apex institution, and less formally encouraging standard-setting and creditor oversight of the NGO-MFIs. Other agencies include the National Credit Council, which has guided microfinance policy, the MCPI, which has helped generate voluntary standards for NGO-MFIs, and PCFC, which has played a key role in wholesale financing for the sector. Through all this, the Philippines has developed a market with some 1.5 million clients and U.S. $1.3 billion in loans – with relatively low barriers to entry, and notably without a specific law on microfinance.

South Africa: This is perhaps the most unusual case in the paper. In the run-up to majority rule in the early 1990s, South Africa decided to legalize the existing informal moneylending industry, which was growing rapidly, under an exemption to the usury limit. This led to even more explosive growth, with attendant problems of abusive practices, over-indebtedness, and a widespread perception that the sector was overcharging and failing to meet the investment needs of the majority population. In response, South Africa in 1999 revised the usury exemption and made its application subject to compliance with stringent regulatory standards applied by a new Microfinance Regulatory Council. The MFRC has been an active (non-prudential) regulator, pushing the limits of its jurisdiction in the interest of helping develop a sound market through the strict application of standards. Among its areas of activity are registering new microlenders, pursuing unregistered lenders, enforcing consumer protection rules, addressing over-indebtedness, and setting-up and running a National Loan Registry. The MFRC has also played a major role in information, research, and policy advocacy. Partly as a result of its efforts, South Africa is now considering a new legislative framework providing for a higher-profile credit regulator, consumer credit standards that apply to all financial transactions, and a new law on narrow banks to serve the lower end of the market. Under these policies and the MFRC's stewardship, South Africa has developed a microlending market comprised of some 5.5 million loan accounts and U.S. $3 billion in outstanding loans.

Lessons

Each of the previous chapters ended with a review of lessons pertaining to the set of issues under consideration. Here, we identify some broader points emerging from the study. Among the principles that the above cases illustrate is "build on what's there," or alternatively, "do no harm." Well-intended initiatives to rationalize the framework for microfinance, or to promote faster growth in the market, can make life difficult for existing providers or even undermine them. This may in certain instances be desirable, but it often is not. Equally often, it is unintended, and it can end up creating a net

reduction in financial access for the less well-off. This means that policymakers need to give due attention to the preservation and cultivation of value in the market based on existing forms and experiences that have the potential to support a growing and sustainable sector.

A cautious approach is needed especially where there is a large existing array of microfinance providers. One such approach is to "regulate by exception," i.e. to allow activities to proceed and grow under the umbrella of discretionary forbearance, until regulators come to an understanding and a strategy for addressing the activities from a policy standpoint. Another principle here is to ensure that the legal and regulatory framework is sufficiently adapted to existing microfinance models and methods, and those likely to evolve from them. What about when there is little microfinance activity – can regulatory reform "lead" the market? There are instances of this in other fields, including a few in microfinance, but the risk of wasting effort on unworkable schemes is high in this area.

The preceding discussion suggests the need to balance entry barriers such as minimum capital and structural requirements that promote consolidation and stability, against tailored norms of risk management, operational requirements, and the like that match MFIs' scale and cost structure, and that facilitate service provision to the lower end of the market. Here again, forbearance or at least leniency plays a role. By refraining from a crackdown on informal – even illegal – microfinance activities, regulators and policymakers can encourage experimentation. This comes with the risk of abuse and adverse incentives (for formalization), but if monitored with some care, it appears to be productive. Yet there are instances where unlicensed activity is abusive or otherwise harmful, and where regulatory authorities need (and all too often seem to lack) the tools to crack down on this.

The development of policy frameworks in this area calls for a balance between open public debate on legislation, on the one hand, and a more technocratic regulatory approach on the other hand. Taking these issues to the public too soon frequently leads into populist debates and restrictive policies, while a "stealth" approach through rule-making can produce more technically sound results but also risks a backlash and reversal. In most cases, close collaboration with the microfinance sector and with relevant experts is critically important. Successful reforms depend on building intelligent stakeholder input into the policy framework, and testing the feasibility of regulatory systems against experience and the business sense of practitioners. The feedback mechanism here can be more formal, such as an administrative forum for public notice and comment, but less formal and more intensive dialogue in such forms as working groups may be most productive.

There are several pitfalls involved in public deliberation. One kind of problem is to press for an overly ambitious solution. For example, the rapid establishment or formalization of a large number of MFIs under the direct authority of the central bank could quickly outrun the expansion of necessary supervisory capacity. The guiding principle here is that the creation of new categories of institutions in the microfinance market should be

matched by the regulatory and supervisory resources to monitor them properly. Otherwise, there is a risk of rapid unsupervised expansion, and then a rash of failures, abuses, or regulatory closures. Another problem is introducing too much complexity too quickly. The result here would be a chaotic learning process by all concerned, or a lengthy delay in implementation as a host of details gets worked out – not ideal but preferable to the former.

The issue of interest rate controls frequently arises in efforts to regulate microfinance services. Usury laws have been common in the past, and are still in force in many countries and provinces (in both industrial and developing countries). Moreover, some countries place interest rate caps specifically on small-scale financial services, sometimes in conjunction with the provision of funds for on-lending. With their inevitably high unit costs, microfinance providers face a difficult if not impossible task in conducting their operations within such limits. A wealth of studies and the consensus of experts indicate that interest rate caps either have little impact (if set high enough) or are actively harmful (if set low enough to be binding, see ECI and IRIS 2005). MFIs operating under interest rate limits often cannot cover their costs, or can do so only with subsidized access to funds.

In either case, interest rate limits undercut incentives for the development of a sustainable microfinance market. This appears to have happened in Brazil with the MFI forms authorized in 1999 (rate caps attached to development banking funding, the predominant wholesale financing source for microfinance). Elsewhere, state and donor funding tied to interest rate caps has had similar effects, but has usually not been as pervasive. In South Africa, microlending has been legalized under a limited exception to the usury limits – but caps continue to apply otherwise and are expected to be part of the new regulatory regime being devised. Small lending boomed under the exception, but not beyond it; stakeholders hope that rates in future will be set high enough to alleviate political concerns without undercutting the market.

The use of policy mandates and subsidized credit to encourage the extension of microfinance services should be approached with great caution and in general kept to a minimum. These tools are employed all too often, and they frequently result in failure to meet the policy objective, or worse, market distortions that potentially undermine sustainable financial deepening. These tools tend to set up incentives and indicators that encourage, for example, meeting quantitative targets in ways that may be incompatible with sound microfinance development. Even more obvious, financial repression in the form of interest rate controls and the like can cause significant distortions and end up discouraging the spread of microfinance. On the other hand, approaches such as credit quotas and subsidies have had a compensating benefit in introducing financial institutions to low-end markets. A similar, and perhaps less risky approach, is to create demonstration effects whereby profitable microfinance operations attract banks and other providers to test the market. One useful method is support for and encouragement of microfinance linkages to the commercial banks – if (and only if) this can be designed in a way that is non-coercive and compatible with the incentives of all parties.

This is by no means to suggest that the state should not have a role in microfinance. However, it does mean that careful attention should be paid to addressing public needs and market failures, and in designing solutions that are minimally intrusive, comport with market discipline, and support effective governance. There are a number of intelligent, productive roles that the state can play – from linking microfinance operations to state banks, to training and capacity-building, building information systems such as a credit bureau or loan registry, consumer protection enforcement, and active leadership in addressing legal-regulatory gaps or constraints at provincial and local levels.

The development of legal and regulatory frameworks for microfinance is, like all policy endeavors, a question of trade-offs. The touchstone is the achievement of sustainable financial deepening, extension of services to the unbanked and the less well-off, and growth. Microfinance-specific policies and regulations are by no means always the optimal response – but, especially in developing contexts with high percentages of people lacking access to financial services, they sometimes are. The key trade-offs, then, concern how much of an increase in access can be gained, at what cost, using which policy tool – banking reform, formalization of moneylenders or village banks, removal of binding legal constraints, opening up new sources of capital from foreign investors and others, or the creation of a new window or type of microfinance institution.

References

General

Carmichael, Jeffrey, and Michael Pomerleano (2002). *The Development and Regulation of Non-Bank Financial Institutions.* Washington, D.C.: The World Bank.

Christen, Robert Peck, and Richard Rosenberg (2000). "The Rush to Regulate: Legal Frameworks for Microfinance." CGAP Occasional Paper No. 4.

Christen, Robert Peck, Timothy Lyman, and Richard Rosenberg (2003). "Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance." Washington, DC: Consultative Group to Assist the Poor.

Jansson, Tor, Ramon Rosales, and Glenn D. Westley (2004). "Principles and Practices for Regulating and Supervising Microfinance." Washington, DC: Inter-American Development Bank.

McGuire, Paul B., Conroy, John D. and Thapa, Ganesh B. (1998). *Getting the Framework Right- Policy and Regulation for Microfinance in Asia.* The Foundation for Development Cooperation, Australia.

Meagher, Patrick (2002). "Microfinance Regulation in Developing Countries: A Comparative Review of Current Practices." The IRIS Center at the University of Maryland.

Priest, Margot (1997), "The Privatization of Regulation: Five Models of Self-Regulation," *Ottawa Law Review*, vol. 29, 233-302.

Staschen, Stefan (2003). "Regulatory Requirements for Microfinance." Eschborn, Germany: GTZ.

Trigo Loubiere, Jacques, Patricia Lee Devaney, and Elisabeth Rhyne (2004). "Supervising and Regulating Microfinance in the Context of Financial Sector Liberalization: Lessons from Bolivia, Colombia, and Mexico." Report to the Tinker Foundation. Available [online] at http://www.accion.org.

Van Greuning, Hennie, Joselito Gallardo and Bikki Randhawa (1999). "A Framework for the Regulation of Microfinance Institutions." World Bank Policy Research Working Paper No. 2061.

Bolivia

Regulatory Framework from microfinance Operations in Bolivia (author unknown)

Problemas y Prioridades en Regulación y Supervisión de Instituciones Microfinancieras: El caso Peruano (author unknown)

Bourns, Nathanael, *Sobreendeudamiento en las Microfinanzas Salvadoreñas. Development Alternatives Inc.* March 2005, San Salvador, El Salvador.

FONDESIF, *Proyecto Desarrollo del Sistema Financiero (DSF)*, Boletín Técnico N°2, Las Microfinanzas Bolivianas en tiempos de Crisis, December 2002, La Paz, Bolivia.

González, V Claudio, Villafani Mauricio, *Las Microfinanzas en el Desarrollo del Sistema Financiero de Bolivia*, The Ohio State University, August 2004. La Paz, Bolivia.

González,V Claudio, *Servicios Financieros Rurales: Un Enfoque Integral, cuaderno N°3*. March 2002, La Paz, Bolivia.

Gomez, Arelis, Tabares German, Vogel Robert, "Regulation and Supervision of Microfinance Activities: The Bolivian Case Study," International Management and Communications Corporation (IMCC), November 2000.

Gómez, Soto Franz, *Evolución de Depósitos en Fondos de Microcréditos en Bolivia; Tendencias y Volatizad.* December 2003.

Internacional Consulting Consortium Inc., Bolivia: *Ampliación del Marco normativo De las Microfinanzas: Las cooperativas Comunales y organizaciones privadas de Microcrédito.*

Marconi, Reynaldo, Mosley Paul, "Bolivia during the global crisis 1998-2004," Department of Economics University of Sheffield, June 2005, United Kingdom.

Nogales, Xavier, *La Superintendencia de Bancos y Entidades Financieras en Bolivia*.

Prado, G. Fernando, Collao G. Katya, *La Industria de las Microfinanzas en Bolivia,* Diagnostico al 2004, May 2005.

Soriano, S. Alejandro, *Las Microfinanzas y El Mercado de Valores*.

Trigo, Loubiere Jacques, Lee Devaney Patricia, Rhyne Elisabeth. "Supervising & Regulating Microfinance in the Context of Final sector Liberalization. Lessons from Bolivia, Colombia and México." August 2004 Tinker Foundation.

Varios, Autores, *Historia del desarrollo de las microfinanzas en Bolivia.*

Brazil

Bettancourt, Gilson, Finance Ministry, PowerPoint presentation, 12/4/05.

Bittencourt, Gilson, *Microcredito E Microfinanzas No Governo Lula*, Ministerio da Fazenda.

Banco Postal, *Banco Postal N° 1, 2, 3.* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Brusky Bonnie, Fortuna Joao Paulo, "Understanding the demand for microfinance"

In Brazil: a qualitative study of two cities, BNDES Microfinance, July 2002.

Conselho da Comunidade Solidaria, *A Expasao do Microcrédito no Brasil*, October 4, 2001, Granja do Torto, Brasilia.

Da Silva, Sergio Darcy, *Democrizacao do Crédito no Brasil*, Junio de 2004

Dias, Coelho Franklin, *A Expansao das Microfinancas no Brasil* , Fundación Ford.

De Matos, Franco, *Avaliacao comparativa das atividades de Microcrédito Brasil e Bolivia,* PROLAM/USP, Junio de 2002.

Guimaraes, Iván, Mezzera Jaime, *Crédito Para los pequeños Emprendimientos no Brasil,* January 2003, Brasilia, Brasil.

Gallagher, Terrence, *IV seminario Banco Central sobre Microfinanzas, Datos disponibles, estudios De mercado.* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Gama, Stelio, *Banco Central Do Brasil*, 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Kumar, Anjali, "Access to Financial Services in Brazil," The World Bank, Washington, D.C.

Lima, Paulo, *Aproximando os Bancos das Microfinancas: Acceso a crédito,* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Marden, Soares P., *Estructura Legal e Regulamentar que Sustenta as diversas formas de Operar con microfinancas no Brasil.* Banco Central do Brasil.

Meagher, Patrick, "Microfinance Legal Regulatory Environments, An assessment tool for policy and programming decisions," 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Mezzera, Jaime, "Microcredit in Brazil: The gap Between Supply And Demand," MicroBanking Bulletin, November 2002.

Nichter, Simeon, Goldmark Lara, Flori Anita, "Understanding Microfinance In the Brazilian Context," BNDES Microfinance, July 2002.

Nogueira, Diogo Pedro, *Panorama Recente e as transformacoes no setor,* Núcleo de Economia Local, Brasil.

'OSCIP - Organização da Sociedade Civil de Interesse Público - A Lei 9.790/99 como Alternativa para o Terceiro Setor. Comunidade Solidária. Brasilia, July 2001.

Parente, Silvana, *O Mercado Financeiro E A Populacao de Baixa Renda*, CEPAL, January 2003.

Socialcred, *Sociedades de Crédito ao Microempreendedor.*

Rocha, Robson, *Banco Publico Com Rede Exclusiva de Correspondientes Bancarios, Banco Popular de Brasil*, 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Salviano, Cleofás, *Correspondentes bancarios: Ampliacao do Atendimento a populacao.* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Valdir, O. Antonio, *O Projecto do Banco Popular do Brasil.* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Ximenes, Carlos, *Microcrédito: Um mundo de oportunidades, mas ainda pouco exploradas.* 1st International Microfinance Regulation and Supervision Meeting, Salvador Brasil, June 1st, 2005.

Ghana

Steel, William F. and David O. Andah (2002). "Rural and Micro Finance Regulation in Ghana: Implications for Development and Performance of the Industry". Report prepared for Financial Sector Board and Africa Region, Financial Sector Group, World Bank, 2002 (Draft).

Republic of Ghana:

The Banking Act 2004

Banking Law 1999 (PNDCL 225)

Bank of Ghana, Guidelines for Banking Licenses 2005

Financial Institutions (Non Banking) Law 1993

Business Rules for Non-Bank Financial Institutions 2002

Bank of Ghana, Requirements for Non Bank Financial Institutions Licences 2005

Bank of Ghana, Guidelines for Rural Banking Licence 2005

Cooperative Societies Act 1968

Acquah, Paul A. (2005). "Liberalizing Ghana's Financial Services Sector: The Role of Overseas Banks." Bank of Ghana Governor's presentation at the Commonwealth Business Council, Banking and Financial Services Symposium, London, June 2003.

_____, (2005). "The Monetary Policy Setting in Ghana: Issues and Prospects". Bank of Ghana Governor's Annual Isser-Merchant Bank Lecture, Accra, June 2005.

Gallardo, Joselito S. (2002). "Impact of the Regulatory Framework on Microfinance Development in Selected Countries of the Africa Region: Key Issues", Sector Study for the Africa Region and Financial Sector Operations and Policy Department, World Bank, September 2002 (Draft).

_____, (2005). "Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana and Tanzania", Sector Report for the Africa Region and Financial Sector Operations and Policy Department of the World Bank, World Bank Policy Research Working Paper No. 3585, April 2005, with Korotoumou Ouattara, Bikki Randhawa and William F. Steel.

Al-Bagdadi, Hayder (2002). "Microfinance Associations: The Case of the Ghana Microfinance Institutions Network (GHAMFIN)". Report prepared for Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, Eschborn 2002.

Indonesia

Abdullah, Burhanuddin (2004). "Defining the Role of Central Banks in Creating a Conducive Environment for Microfinance." In "Proceedings of the High-Level Policy Meeting on Microfinance and Rural Finance in Asia." ProFi website.

Bank Indonesia (2002). "Summary of Regulations Concerning on Rural Banks." Jakarta: Directorate of Rural Bank Supervision.

Bank Indonesia (2004). "2004 Economic Report on Indonesia." Jakarta: Bank Indonesia.

Bank Indonesia and GTZ (2000). "Legislation, Regulation and Supervision of Microfinance Institutions in Indonesia."

Bank Indonesia, Annual Report of 2003.

CGAP and World Bank (2004). "Scaling up Poverty Reduction: Case Studies in Microfinance." Washington, DC: CGAP/ The World Bank Group.

Chaves, Rodrigo A., and Claudio Gonzalez-Vega (1996). "The Design of Successful Rural Financial Intermediaries: Evidence from Indonesia." *World Development* 24:1, pp. 65-78.

Credit Association (APRACA) and Deutsche Gesellschaft Fur Technische Zusammenarbeit (GTZ) Gmbh.

Economist Intelligence Unit (2005). "Country Finance: Indonesia." New York: Economist Intelligence Unit.

Holloh, Detlev (2001). "Pro FI Microfinance Institutions Study." Bank Indonesia, Pro FI, and GTZ.

"Indonesia Country Profile." Banking with the Poor website.

Kompas, 7/24/2004 (p.12, Doc.1).

Robinson, Marguerite S. (2002). *The Microfinance Revolution, Volume 2: Lessons from Indonesia.* Washington, DC: World Bank and Open Society Institute, Washington, DC.

Martowijoyo, Sumantoro (1999). "Commercial Rural Financial Institutions Versus Subsidized Credit Programs in Indonesia." Paper presented at the Third Annual Seminar on New Development Finance, Ohio State University-Goethe Universitat. Frankfurt, Germany.

Martowijoyo, Sumantoro (2001). "The Impact of the Application of the Bank Perkreditan Rakyat System on the Performance of Rural Financial Institutions". Unpublished summary of doctoral thesis, Gadjah Mada University, Yogyakarta. Indonesia.

Martowijoyo, Sumantoro (2002). "Badan Kredit Desa: The Traditional Village Banking of Indonesia." Paper presented at the Seminar on Poverty Alleviation Through Micro Finance: Potentials and Constraints. Kuala Lumpur, Malaysia.

Patten, Richard, Jay Rosengard, Don Johnston, and Widjojo Koesoemo (2003). "Improving Access to Financial Services to Low-Income Rural Households and Microenterprises in Indonesia: The Potential for Further Development of Local Government-Owned Financial Institutions." Prepared for GTZ.

Siregar, Reza Y. and James E. Williams (2004). "Designing an Integrated Financial Supervision Agency: Selected Lessons and Challenges for Indonesia." Center for International Economic Studies Discussion Paper No. 0405. Adelaide: University of Adelaide, Australia.

Meyer, Richard and Geetha Nagarajan (1999). "Rural Financial Market Development in Indonesia; Mixing Markets and Mandates." Chapter 11 in *Rural Financial Markets in Asia: Policies Paradigms, and Performance*. Oxford University Press.

Robinson, Marguerite S. (2002). *The Micro Finance Revolution. Volume 2: Lessons from Indonesia.* Washington, DC: International Bank for Reconstruction and Development/ The World Bank.

Steinwand, Dirk (1997). "Assessment of Linkage Banking Projects in Asia. Case Study 1: PHBK, Indonesia." Draft Report of the Asia Pacific Rural and Agricultural Credit Association.

Mexico

APEC (2002), "Microbanking Development, Regulation and Supervision," Chapter 2 of *Economic Outlook*, Singapore: Asia Pacific Economic Cooperation Secretariat.

BANSEFI. Technical Note No 1: Strategic Aspects of the Governmental Policy to Increase Access to Financial Services .

CGAP and World Bank (2004). *Scaling up Poverty Reduction: Case Studies in Microfinance.* Washington, DC: CGAP/ The World Bank Group.

Chemonics International, Inc. (2004), "Mexico Rural Economy Strategy—Rural Financial Markets in Mexico: Issues and Options," Report to USAID/Washington, mimeo.

Inter-American Development Bank (2003). "Mexico: Rural Financial System Consolidation Program." Loan Proposal ME-0243. Washington, DC: Inter-American Development Bank.

Inter-American Development Bank (2002), "Regulation, Development and Perspectives of the Microbanking Sector in Mexico." Paper prepared for Inter-American Forum, Rio de Janeiro, Brazil, September 9, 2002.

Jansson, T., R. Rosales, and G. Westley, (2003), *Principios y Practicas para la Regulación y Supervisión de las Microfinanzas*, Inter-American Development Bank, Washington, DC.

Klaehn, Janette, Brigit Helms, and Rani Deshpande (2005). "Mexico: County-Level Savings Assessment." Consultative Group to Assist the Poor (CGAP).

Loubiere, Jacques Trigo, Patricia Lee Devaney, and Elisabeth Rhyne (2004). "Supervising & Regulating Microfinance in the Context of Financial Sector Liberalization." Report to the Tinker Foundation.

World Bank (2001). "Mexico Rural Finance: Savings Mobilization Potential and Deposit Instruments in Marginal Areas." Report No 21286-ME. Washington, DC: World Bank.

Philippines

Bangko Sentral ng Pilipinas.

Manual of Regulations for Banks (2004).

Manual of Regulations for Non-Bank Financial Institutions (2005).

"Snapshot of Microfinance in the Banking Sector, 2005".

Espenilla, Nestor A. (2004). "Philippines: Creating an Enabling Policy Environment for Microfinance". Presentation at the Regional Symposium on Microfinance Policy and Regulatory Environment: Experience and Perspective of the East Asian Region, Islamabad, December 13-14 2004.

Microfinance Council of the Philippines, Inc. (2004). "Performance Monitoring Report on MCPI Members". December 31, 2004

Cooperatives Development Authority. Memorandum Circular No, 02-04 (series of 2002). "Performance Standards For Credit and Other Types of Cooperatives with Credit Services in the Philippines (Coop – Pesos)".

_____, (2004). "Status of the Cooperative Movement as of December 31 2003".

Gallardo, Joselito S. (2002). "A Framework for Regulating Microfinance Institutions: The Experience of Ghana and the Philippines", World Bank Policy Research Working Paper No. 2755 (January 2002).

_____, (2005). "Strategic Alliances to Scale Up Financial Services in Rural Areas", Sector Report – Assessment of strategic alliances between institutions which expand outreach to rural and low income households and small businesses, and broaden access to financial and other services. In-depth analysis of the mechanics of strategic alliances between institutions in the Philippines, Guatemala and selected other countries, World Bank, April 2005 (forthcoming as a Policy Research Paper), with Bikki Randhawa and Michael Goldberg.

Quinones, Benjamin R. Jr. (2005). "Breaking the Barriers of Microfinance: The Philippine Case". Case review/paper prepared for the Foundation for Development Cooperation (under a Food and Agriculture Organization and Ford Foundation project).

South Africa

Coetzee, GK and W Grant. (2001). "Microfinance in South Africa over the last decade: The Silent Revolution." Paper read at the Frankfurt Seminar for Development Finance, Frankfurt.

Department of Trade and Industry (2003). "Fair, Clear, and Competitive: The Consumer Credit Market in the 21st Century." White Paper presented to Parliament by the Secretary of State for Trade and Industry. United Kingdom.

Department of Trade and Industry (2004). "Tackling Over-Indebtedness: Action Plan 2004." London: Department of Trade and Industry.

Devlin, J. (2002). "Monitoring the success of policy initiatives to increase consumer understanding of financial services." *Journal of Financial Regulation and Compliance* 11:2, p. 151.

Du Plessis, P.G. (1995). *The Small Loans Industry in South Africa 1995.*

Du Plessis, P.G. (1998). *The Micro Lending Industry in South Africa 1997.*

ECIAfrica Consulting. (2000). Interest rates study – for DTI

ECIAfrica Consulting (2004) "Financial Literacy Scoping Study and Strategy," FinMark Trust

ECIAfrica Consulting (2004) "Indebtedness Assessment," MFRC

ECI Africa Consulting and IRIS Center (2005). "The Evolution of the South African Microfinance Sector from 1992 to 2004: The Role of the Microfinance Regulatory Council." Woodmead: ACI Africa Consulting.

Falkena et al (2004) "Financial Regulation in South Africa," SA Financial Sector Forum

FinMark Trust (2003), Finscope

Hawkins, Penny (2003), "The Cost, Volume and Allocation of Consumer Credit in South Africa". Report prepared of the Credit Law Review; mandated by the Department of Trade and Industry and MRFC.

HSRC (2003), "Household Indebtedness in South Africa, 1995 and 2000." Employment and Economic Policy Programme, HSRC.

Ithala Development Finance Corporation Limited annual reports, (2000, 2001 & 2002).

Land Bank Annual reports, (1999 and 2000).

Meagher, Patrick and Betty Wilkinson (2001) "Filing the gap in South Africa's Small and Micro Credit Market: An analysis of major policy, legal and regulatory issues."

Micro Finance Regulatory Council, (2003) "Submission to the Portfolio Committee on Finance on Indebtedness". 17 June 2003.

Micro Finance Regulatory Council, (2003), "Household Indebtedness in South Africa in 1995 and 2000."

Micro Finance Regulatory Council, (2004) "Survey on the Total cost of credit: an analysis of 34 lenders registered with MRFC."

Micro Finance Regulatory Council, Annual reports (2000, 2002 & 2003).

Daniels, Reza. (2001) "Consumer Indebtedness among Urban South African Households: A Descriptive Overview", DPRU Working Papers.

Shisaka Development Management Services (2004). "Township Residential Property Markets," Finmark Trust.

Strauss Commission Reports (1996), Interim and Final report of the Commission of Enquiry into the Provision of Rural Financial Services.

Annex I: Size and Characteristics of the Markets (Before and After Regulatory Reform)[59]

	Reform and Regulatory Treatment of Microfinance	Types of institutions	Level of outreach/growth	Types of services
Bolivia	Pre-reform: No supervision or regulation of microfinance Reform: Allowed for licensing of a microfinance bank in 1992. Regulations written in 1995 for NBFIs that reach lower-income markets (Private Financial Fund, FFP) – not a separate microfinance law.	Pre-reform: NGOs Post-reform: FFPs, two commercial banks, credit unions, some NGOs	1992: Total mf loan portfolio approx. US$25m 1999: Total mf loan portfolio approx. US$500m	Post-reform: Savings and credit. Deposits fund 60% of regulated MFIs loan portfolio
Brazil	Pre-reform: No supervision or regulation of microfinance Reform: Creation of two specific types of microfinance institutions in 1999 and 2001; relaxation of requirements to open a savings account in 2004 Post-reform: Limited supervision of credit-only microfinance	Pre-reform: Some NGOs; government development bank program (CreditAmigo) Post-reform: Regulated microcredit organizations (non-profit) and microcredit companies (for-profit), commercial banks, CrediAmigo	Growth rate of 20 leading MFIs averages 14% per year. Microcredit companies: 40 licensed, annual portfolio growth rate between 30 and 50%. CrediAmigo has 180,000 clients as of 2005 with US$56m (R$130m) portfolio.	Credit; savings account with commercial banks becoming more popular with relaxed requirements

[59] *Source:* data reported in chapters 2-6 above, and MCPI (Philippines) website: www.microfinancecouncil.org.

	Reform and Regulatory Treatment of Microfinance	Types of institutions	Level of outreach/growth	Types of services
Ghana	Pre-reform: Poor supervision of rural banks; no NBFI licensing Reform: Reform of rural banks 1990-1994; NBFI Law passed in 1993; Banking Law revised in 2004 Post-reform: Increased supervision of rural banks; NBFI licensing and regulation – differentiated by deposit-taking vs. non-deposit taking regulations; system of self-regulation by member bodies being established for rural banks and credit unions	Pre-reform: Informal sources of finance Post-reform: Rural and community banks, NBFIs, credit unions, some NGOs, informal sources	Pre-reform: Failing rural banks with few clients CUs: 457 in 1976 with 48,705 members; Post-reform: healthier rural banks with a greater number of clients; CUs: 232 in 2001 with 96,052 members;	Pre-reform: Deposits and loans from informal sources Post-reform: Group and individual savings and credit; linkages with CBOs and informal savings collectors; mobile banking
Indonesia	Pre-reform: Failing state-owned financial institutions running directed credit programs; poor supervision of the financial sector as a whole Reform: Financial deregulation in 1983; banking reform in 1988 which created rural banking tier. New banking law ratified in 1992 required many other forms of banks to transform into rural banks. Microfinance Bill being discussed. Post-reform: Supervision of banks and rural banks by Bank Indonesia (BI), BRI doing some supervision as well. Off-site CAMEL-based supervision; no microfinance-specific regulatory treatment.	Pre-reform: government-directed credit programs Post-reform: BRI Unit Desas, rural banks, government-owned MFIs, cooperatives, Islamic MFIs, NGOs	Post-reform: Approximately 54,000 MFI units serving 29.8 million borrowers. Estimated total savings in MFIs = US$4.8 billion	Post-reform: Deposits, loans. Transfers only through BRI. No insurance

	Reform and Regulatory Treatment of Microfinance	Types of institutions	Level of outreach/growth	Types of services
Mexico	Pre-reform: Little regulation or supervision of the microfinance sector Reform: 2001 passage of the Popular Savings and Credit Law. Supervisory structure currently being established, with supervisors based in MFI federations playing the lead role.	Pre-reform: Many credit cooperatives and a few NGOs serving the market Post-reform: All must be licensed under the new law; licensing delayed by setting up of supervisory system	Post-reform: 20% annual growth rate in the microfinance sector. 500 institutions serve 3 million customers.	Credit and savings
Philippines	Pre-reform: No regulation or supervision dealing with mf. Reform: National Microfinance Strategy adopted in 1997; gov't provision of credit ended in 1999; General Banking Law of 2000 mandated BSP to regulate mf. Post-reform: Appropriate guidelines for mf, supervision focused on portfolio quality. Not institution specific. BSP structured advocacy campaign	Pre-reform: Some NGOs Post-reform: Thrift and rural banks, coops, NGOs	End 2001: 192,802 MCPI[60] borrowers End 2004: 732,384 MCPI borrowers; est. 1.5m clients total	Pre-reform: Credit Post-reform: Credit, leasing, deposits, ATMs, transfers, insurance
South Africa	Pre-reform: Informal lenders and others serving the credit market Reform: Deregulation of interest rates for micro-lending in 1992; creation of Microfinance Regulatory Council (MFRC) in 1999 to supervise the industry; functional regulation. Regulations for opening a savings account relaxed in 2005. Post-reform: Lenders must register with MFRC and abide by rules; regulation by central bank dictated by institutional form, not whether or not involved in micro-lending.	Banks, various NBFIs, co-operatives, parastatals	As of 2001, 3.7 million loan accounts, US$2bil. (R11.5b) in gross loans As of end 2004, 1,777 registered microlenders, 5.5 million loan accounts, US$3bil. (R16.9b) in gross loans	Credit; some savings products being introduced by banks

[60] Microfinance Council of the Philippines Islands. Members are mostly NGOs and a few microfinance rural banks.

Annex II: Regulatory Frameworks for the Seven Countries[61]

A. Bolivia

BOLIVIA	Commercial Bank	NBFI	Coops/ Credit Unions
General Approach to Regulating			
Legal basis for regulating (Law)	Law on Banks and Financial Entities (1993); Central Bank of Bolivia Law (1995); Property and Popular Credit Law (1998); Law for Normative Strengthening and Financial Supervision (2001); Solidarity Bond Law (2002)	Law on Banks and Financial Entities (1993); Central Bank of Bolivia Law (1995); Property and Popular Credit Law (1998); Law for Normative Strengthening and Financial Supervision (2001); Solidarity Bond Law (2002); Supreme Decree #24000 (1995)	Law on Banks and Financial Entities (1993); Central Bank of Bolivia Law (1995); Property and Popular Credit Law (1998); Law for Normative Strengthening and Financial Supervision (2001); Solidarity Bond Law (2002); General Law for Cooperative Associations (1958); Supreme Decree #24000 (1995)
Definition or description of institution	Authorized financial entity devoted to intermediation and the provision of financial services to the public	Non-banking financial entities, whose principal objective is channeling resources to micro and small-scale borrowers in urban and rural areas	All societies constituted under the General Law of Cooperative Societies that have as their objective to promote savings and grant loans to their members.
Regulator(s) and role of regulator(s), supervisor(s)	National Economic Policy Council (CONAPE) approves prudential norms and coordinates Superintendent of Banks and Financial Entities (SBEF) and Superintendent of Stocks, Superintendent of Pensions, Stocks and Insurances (SPVS). SBEF supervises all institutions.	National Economic Policy Council (CONAPE) approves prudential norms and coordinates Superintendent of Banks and Financial Entities (SBEF) and Superintendent of Stocks, Superintendent of Pensions, Stocks and Insurances (SPVS). SBEF supervises all institutions.	National Economic Policy Council (CONAPE) approves prudential norms and coordinates Superintendent of Banks and Financial Entities (SBEF) and Superintendent of Stocks, Superintendent of Pensions, Stocks and Insurances (SPVS). SBEF supervises all institutions.
Required legal form of organization	Corporation	Corporation	Limited liability company
Capital and Reserves			
Minimum capital	US $7.6 million (61.3 million BOB)	US $870,000 (7,020,813 BOB)	Category 1: US$207,000 (1,670,469 BOB) Category 2: US$896,000 (7,230,630 BOB) Category 3: US$869,000 (7,012,743

---

[61] *Source:* Microfinance Regulation Resource Center, www.microfinancegateway.org/resource_centers/reg_sup unless otherwise specified.

BOLIVIA	Commercial Bank	NBFI	Coops/ Credit Unions
			BOB) Category 4: US $7.6 mill (61.3 mil BOB)
Capital and Reserves (cont.)			
Capital adequacy/ gearing ratios	10% net equity	Net equity 8% of total assets/risk-weighted contingencies	Category 1: minimum 20% Category 2: 15% Category 3 and 4: 10%
Risk-weighting of assets	0%: Cash, deposits with Banco Central de Bolivia (BCB) and investments in securities issued by BCB/Treasury, credits from central banks of other countries, prepaid contingent credits, credits guaranteed with cash deposits in bank itself. 10%: Credits guaranteed by the Treasury 20%: Credits guaranteed by banks rated first-class and credits granted by the financial entity to these banks and those cash items on collection 50%: Housing mortgage loans, exclusively for acquisition, construction, remodeling and improvement of occupied/rented house 100%: All assets, operations and services that represent a risk, or any type of financial liability	0%: Cash, deposits with Banco Central de Bolivia (BCB) and investments in securities issued by BCB/Treasury, credits from central banks of other countries, prepaid contingent credits, credits guaranteed with cash deposits in bank itself. 10%: Credits guaranteed by the Treasury 20%: Credits guaranteed by banks rated first-class and credits granted by the financial entity to these banks and those cash items on collection 50%: Housing mortgage loans, exclusively for acquisition, construction, remodeling and improvement of occupied/rented house 100%: All assets, operations and services that represent a risk, or any type of financial liability	0%: Cash, deposits with Banco Central de Bolivia (BCB) and investments in securities issued by BCB/Treasury, credits from central banks of other countries, prepaid contingent credits, credits guaranteed with cash deposits in bank itself. 10%: Credits guaranteed by the Treasury 20%: Credits guaranteed by banks rated first-class and credits granted by the financial entity to these banks and those cash items on collection 50%: Housing mortgage loans, exclusively for acquisition, construction, remodeling and improvement of occupied/rented house 100%: All assets, operations and services that represent a risk, or any type of financial liability
Loan loss provisioning, write-off	-5 days overdue: 1% 6-30 days: 5% 31-60 days or refinanced once: 20% 61-90 days or refinanced twice: 50% Over 90 days or refinanced 3 times or	1-5 days overdue: 1% 6-30 days: 5% 31-60 days or refinanced once: 20% 61-90 days or refinanced twice: 50% Over 90 days or refinanced 3 times or	1-5 days overdue: 1% 6-30 days: 5% 31-60 days or refinanced once: 20% 61-90 days or refinanced twice: 50% Over 90 days or refinanced 3 times or

BOLIVIA	Commercial Bank	NBFI	Coops/ Credit Unions
	more: 100%	more: 100%	more: 100%
Risk Management Guidelines			
Guidelines on business activities :			
• **Financial Services Permitted**	All financial services	Loans, deposits, and other banking activities	Category 1 and 2: Deposit-taking, loans, domestic payments and money transfer services, certain payment services, and foreign exchange for their own operations Category 3: Similar operations to those of Private Financial Funds (FFPs), except no financial leasing Category 4: Financial services in local and foreign currency, except those listed below.
• **Financial Services Prohibited**	Not Applicable	Factoring, foreign trade operations, capital investment activities in securities enterprises; checking accounts and credit cards not permitted without Superintendent of Banks and Financial Entities (SBEF) authorization	Category 3: Financial leasing Category 4: Travelers cheques and credit cards, forwards and futures in foreign exchange, endorsements, bonds and other collateral operations, open, and letters of credit No loans to individual borrower that exceed 3% of net worth (secured) or 1% (personal guarantees)
- Consumer protection			
– Interest rate restrictions	Minimum rate of interest on fixed time deposits equal to LIBOR. Obliged to use the "reference rates of interest" set by Banco Central de Bolivia (BCB)	Minimum rate of interest on fixed time deposits equal to LIBOR. Obliged to use the "reference rates of interest" set by BCB	Minimum rate of interest on fixed time deposits equal to LIBOR. Obliged to use the "reference rates of interest" set by BCB
– Other operational rules	Hours of operation are regulated.	Hours of operation are regulated.	Hours of operation are regulated.

BOLIVIA	Commercial Bank	NBFI	Coops/ Credit Unions
	Optional Saturday hours; no operations on Sunday.	Optional Saturday hours; no operations on Sunday.	Optional Saturday hours; no operations on Sunday.
Concentration of risk	No lending more than 200% of net worth; non-collateralized loans to a single borrower not to exceed 5%; collateralized loans to a single borrower not to exceed 20%	Max credit to single borrower or group = 3% net worth, based on personal guarantee = 1%, credit to financial inst = 20%	No lending more than 200% of net worth
Connected/ insider business	No lending to related parties	No lending to related parties	Not applicable
Supervision Methods	Annual inspection	Annual external audit, monthly offsite follow-up & quarterly report, evaluation of credit technology, review of sample files, client visits No delegation of supervision	Annual inspection
Supervision costs and fees	There are fees	There are fees	There are fees
Disclosure and reporting requirements	Annual audit	Annual and quarterly reports	Annual and quarterly reports
Depositor Protection Mechanisms (e.g., deposit insurance or lender of last resort)	Deposit insurance of 100%	NA	NA

B. Brazil

BRAZIL	Development Bank	NBFI (Microcredit SCMs)	Coop/Credit Union	Non-profit (Microcredit NGOs)
General Approach to Regulating				
Legal basis for regulating (Law)	Financial System Law No. 4595 of 1964	Central Bank Resolution no. 2627 (2001)	General Law on Cooperatives, Law No. 5764/71 of 1971, Regulation 3.106 of June 25, 2003 Also subject to the Financial System Law No. 4595 of 1964	"New Law of the Tertiary Sector" - Law 9.790 (1999), Decree No. 3100 (1999)
Definition or description of institution		Formal for-profit financial entities Can be owned by Civil Society Organization with a Public Interest (OSCIPs)	Not-for-profit cooperative financial institutions created to meet the basic financial service needs of low and middle income citizens	Not-for-profit organizations whose social objectives must fall within a specific list (including provision of credit)
Regulator(s) and role of regulator(s), supervisor(s)		Central Bank of Brazil (BCB)	BCB Routine oversight usually delegated to the two main cooperative credit networks (Sicoob and Sicredit)	OSCIPs must meet reporting requirements for the Ministry of Justice but are not subject to prudential regulation and supervision.
Required legal form of organization		Closed companies with at least 50% ordinary shares or limited liability societies	Cooperative society; must specify that it is a credit cooperative	
Ownership restrictions		No state ownership May be controlled by Civil Society Organization with a Public Interest (OSCIPs) with prior BCB approval		
Source of Funds (what's required or prohibited)		Can access public sector funds, donor funds, Civil Society Organization with a Public Interest (OSCIP) funds, private investor funds, lines of credit from foreign or domestic financial institutions, and funding from Brazilian Services to Support Micro and Small Enterprises (SEBRAE)		Cannot borrow from other financial institutions

BRAZIL	Development Bank	NBFI (Microcredit SCMs)	Coop/Credit Union	Non-profit (Microcredit NGOs)
Capital and Reserves				
Minimum capital	Entry capital provided in Central Bank notification of 29 Aug 2001	US $36,000 (105,843 BRL)	As of 2000, US $1,000 (2940 BRL) (up to US $100,000/294,000 BRL), will rise to US $21,000 (61,742 BRL) by 2005. Prudential guidelines specified in Resolution No. 2771 of August 2000	
Capital adequacy/ gearing ratios		Maximum debt-to-liquid assets ratio is 5 times	No capital adequacy requirements; leverage requirements restrict credit cooperatives affiliated to a cooperative system to ten times liquid capital and independent cooperatives to five times liquid capital. Prudential guidelines specified in Resolution No. 2771 of August 2000	
Loan loss provisioning, write-off		Provisioning of 0.5% to 100% depending on classification	Provisioning of 0.5% to 100% depending on classification Prudential guidelines specified in Resolution No. 2771 of August 2000	
Reserves, Liquidity requirements			No reserve requirements with the Central Bank of Brazil (BCB), although 90% of demand deposits and 25% of time deposits must be placed in liquid instruments.	
Risk Management Guidelines				
Guidelines on business activities :				
• **Financial Services Permitted**	Loans, check-cashing, savings, insurance, housing loans	Loans, guarantees to individuals and organizations. Can invest in financial markets within limits stipulated in license.	All cooperatives can offer demand and term deposits for members, loans, obtain loans and grants from domestic or foreign financial institutions, including concessional loans, offer collection and custody services, and partner with other	Loans, check-cashing. Can access public sector funds, donor funds, and private investor funds

BRAZIL	Development Bank	NBFI (Microcredit SCMs)	Coop/Credit Union	Non-profit (Microcredit NGOs)
			financial institutions to gain access to	
• **Financial Services Permitted (cont.)**			the payment system. Cooperatives affiliated with a central cooperative or cooperative bank can also issue credit cards and letters of credit, provide insurance products, and access public sector funding.	
• **Financial Services Prohibited**	credit cards, bonds, debentures	Issuing debt, deposit-taking, consumer loans, mortgage loans, participating in the interbank deposit market, insurance services, and publicly issuing securities	Foreign exchange, leasing, factoring, or housing finance.	Deposit-taking, insurance and pawn services, housing loans, credit cards
Consumer protection				
• **Interest rate restrictions**	Not subject to Usury Law	Not subject to Usury Law, but BNDS funding comes with rate caps	Not subject to Usury Law, but BNDS funding comes with rate caps	Not subject to Usury Law; but NGOs not registered as microcredit NGOs (OSCIPs) subject to 12% per annum ceiling.
• **Other operational rules**		Can open "Micro-Credit Service Points" (branches) with full flexibility; detailed notice to regulators required.		
• **Concentration of risk**		Maximum loan size = US $3,600 per client Cannot own shares in any financial institution or other entity licensed by Central Bank of Brazil (BCB)	Max exposure to a single member cannot exceed 25% of liquid capital, 20% max to an affiliate of a central cooperative, 10% to a member of an affiliated cooperative and 5% per member of an unaffiliated cooperative.	
• **Connected/ insider business**	Loans can not be made to management, relatives, and shareholders holding more than 10% of equity.			
Reporting and Supervision				
Supervision Methods	Off-site inspection of financial statements, benchmarking institutions against their peers. On-site evaluations of risk management practices, reviews of financial reports, and analysis of capital		Credit cooperatives are officially supervised by the Central Bank of Brazil (BCB), but supervision is increasingly being delegated to the two main cooperative networks, Sicoob and Sicredit. Each offer differing supervisory methods.	External audits required, but only in order to access public sector funding. Not subject to any other supervision

BRAZIL	Development Bank	NBFI (Microcredit SCMs)	Coop/Credit Union	Non-profit (Microcredit NGOs)
	adequacy and provisioning.			
Supervision costs and fees				
Disclosure and reporting requirements	Balance sheets must be submitted bi-annually	Audited financial statements not required. Microfinance institutions (SCMs) and branches must report credit data to Central System of Credit Risk	Balance sheets must be submitted bi-annually	NA
Depositor Protection Mechanisms (e.g., deposit insurance or lender of last resort)		No deposit guarantees	No deposit guarantees	

C. Ghana[62]

GHANA	Commercial Bank	Rural Bank	NBFI – S&L	NBFI – Credit Union	NGO-MFI
General Approach to Regulating					
Legal basis for regulating (Law)	Banking Law 2004; Companies Code 1963	Banking Law 2004; Companies Code 1963	Banking Law 2004; Financial Institutions (Non Bank) Law 1993 & Business Rules; Companies Code 1963	Business Rules-Financial Institutions (Non Bank) Law 1993; Cooperative Societies Decree 1968	Law on Trusts; Companies Code 1963
Definition or description of institution	Registered and licensed commercial bank	Registered and licensed rural bank	Registered and licensed savings & loan company	Mutual assistance society owned by members	Not-for-profit charitable trust or foundation
Regulator(s) and role of regulator(s), supervisor(s)	Bank of Ghana, Banking Supervision Dept.	Bank of Ghana, Banking Supervision Dept.	Bank of Ghana, Non Bank Financial Institutions Dept.	Dept of Cooperatives + Credit Union Association	None
Required legal form of organization	Registered corporation limited by share capital.	Registered corporation limited by share capital	Registered corporation limited by share capital.	Cooperative thrift society	Not-for-profit corp. limited by guarantee
Ownership restrictions	No person other than a body corporate incorporated in Ghana shall be eligible to apply for a license to do banking business	No person other than a body corporate incorporated in Ghana shall be eligible to apply for a license to do banking business	No person other than a body corporate incorporated in Ghana shall be eligible to apply for a license to do banking business	Established by at least 15 members who are natural persons 18 years or older and are citizens of Ghana	None
Source of Funds (what's required or prohibited)	Individuals – not exceeding 30% of total shares. Corporate bodies – not exceeding 50% of total shares.	Individuals – not exceeding 30% of total shares. Corporate bodies – not exceeding 50% of total shares.	Individuals – not exceeding 30% of total shares. Corporate bodies – not exceeding 50% of total shares.	Any member may own shares not to exceed 25% of the total, but each member is entitled to only one vote regardless of number	Not applicable

[62] *Source:* research by Joselito Gallardo.

GHANA	Commercial Bank	Rural Bank	NBFI – S&L	NBFI – Credit Union	NGO-MFI
				of shares owned.	
Capital and Reserves					
Minimum capital	US$ 3.3 -6.7 million. In case of a Ghanaian bank, not less than US $3.3 million, of which not less than 60% contributed by resident Ghanaians. In the case of foreign ownership of banking business, it is not less than US $6.7 million of which not less than 60% of the required capitalization be brought into Ghana in equivalent convertible currency	¢ 500million (US$ 67,000)	All institutions which operate under the Financial Institutions [Non-Banking] Law, 1993 [PNDCL. 328] require not less than US$1.4 million as minimum capital for non-deposit-taking business and US$2.0 million for deposit-taking business. In the case of foreign ownership not less than 60% of the required capitalization shall be brought into Ghana in convertible currency.	US$1.40 – 2.70 share capital per member	Not applicable
Capital adequacy/ gearing ratios	10% of risk assets	10% of risk assets	10% of risk assets (deposit-taking NBFI); 10:1 gearing ratio (non deposit taking NBFI).	10% (follows "PEARLS")	Not applicable
Forms of capital recognized	Paid-in common stock; preferred shares	Paid-in common stock; preferred shares	Paid-in common stock; preferred shares	Members' share capital contributions in cash	Grants and donations, capitalized surpluses
Risk-weighting of assets	Beginning to implement BIS / Basel guidelines	Beginning to implement BIS / Basel guidelines	Beginning to implement BIS / Basel guidelines	Not applicable	Not applicable
Loan loss provisioning, write-off	Current = 1% OLEM, >30 days = 10% Sub-standard, > 90 days = 25% Doubtful, > 180 days = 50% Loss, > 540 days = 100%	Current = 1% OLEM, >30 days = 10% Sub-standard, > 90 days = 25% Doubtful, > 180 days = 50% Loss, > 540 days = 100%	General reserve = 1% Specific reserves basket-based) for past due loans: ≤ 30 days = 5% 31 – 60 days = 20% 61 – 90 days = 40% 91 – 120 days = 60% 121 – 150 days = 80% ≥ 181 days = 100%	Follows "PEARLS"	Not applicable, but follows international best practice standards
Reserves, Liquidity requirements	Primary = 9% + Secondary = 35%	Primary = 10% + Secondary = 52%	Primary = 10% + Secondary = 15%	15% of members' deposits (follows "PEARLS")	Not applicable, but follows global best practice standards

GHANA	Commercial Bank	Rural Bank	NBFI – S&L	NBFI – Credit Union	NGO-MFI
Risk Management Guidelines					
Guidelines on business activities :					
• **Financial Services Permitted**	(a) acceptance of deposits and other repayable funds from the public; (b) lending; (c) investment in financial securities; (d) money transmission services; (e) issuing and administering means of payment including credit cards, travelers checks & bankers' drafts; (f) guarantees and commitments; (g) trading for own account or for account of customers in, (i) money market instruments, (ii) foreign exchange, or (iii) transferable securities; (i) participation in securities issues and provision of services related to those issues; (j) advice to undertakings on capital structure, acquisition & merger; (k) the keeping and administration of securities; (l) credit reference services; (m) safe custody of valuables; (n) electronic banking; and (o) other services as BOG may determine.	(a) Acceptance of deposits from the public; (b) lending; (c) Inward money transfer services; (d) other services as BOG may determine.	Deposit-taking and lending to individuals, groups, business enterprises, consumer credit and hire-purchase financing.	Financial co-operatives formed to mobilize savings from and lend to its own members.	Provision of micro-credits to individuals and to groups
• **Financial Services Prohibited**	No person(s) shall carry on the business of banking (whether as principal or agent) except by or under the authority of licence issued in accordance with the Banking Act, 2004 (Act 673). A bank shall not directly engage in any commercial, agricultural or industrial undertaking unless it establishes for that purpose a subsidiary company of the bank registered in Ghana.	No person(s) shall carry on the business of banking (whether as principal or agent) except by or under the authority of licence issued in accordance with the Banking Act, 2004 (Act 673).	No person shall carry on the business of a non-bank financial institution unless it is licensed by the Bank of Ghana.	No business and financial dealings with non-members	No deposit-taking and other banking services except provision of credit
• **Consumer protection**	Consumer Protection Disclosures	Consumer Protection Disclosures	Consumer Protection Disclosures	CUA guidelines	Not applicable
– Interest rate restrictions	None	None	None	None	None
– Other operational rules	Equity capital invested in a subsidiary company not to exceed 15% of bank's net worth;	Equity capital invested in a subsidiary company not to exceed 15% of bank's net worth;	Equity capital invested in a subsidiary company not to exceed 15% of net worth;		

GHANA	Commercial Bank	Rural Bank	NBFI – S&L	NBFI – Credit Union	NGO-MFI
– Other operational rules (cont.)	Where the bank has more than one subsidiary company the equity capital invested in those subsidiary companies not to exceed 25% in the aggregate of the bank's net worth. A bank shall not build, purchase or take a lease of immovable property except for *(a)* provision of premises or housing the business or staff of the bank; or *(b)* provision of staff amenities. Opening / closure of branches, offices, service outlets subject to prior BOG approval.	Where the bank has more than one subsidiary company the equity capital invested in those subsidiary companies not to exceed 25% in the aggregate of the bank's net worth. A bank shall not build, purchase or take a lease of immovable property except for *(a)* provision of premises or housing the business or staff of the bank; or *(b)* provision of staff amenities. Opening / closure of branches, offices, service outlets subject to prior BOG approval.	Where there is more than one subsidiary, equity invested in subsidiary companies not to exceed 25% in the aggregate of net worth. Opening / closure of branches, offices, service outlets subject to prior BOG approval.		
Concentration of risk	Financial exposure to any one person or a group of persons not to exceed, in aggregate, 25% of bank's net worth. Aggregate of unsecured financial exposure shall not exceed ten per cent of the bank's net own funds.	Financial exposure to any one person or a group of persons not to exceed, in aggregate, 25% of bank's net worth. Aggregate of unsecured financial exposure shall not exceed ten per cent of the bank's net own funds.		Not applicable	Not applicable
Connected/ insider business	No exposure to directors, officers, significant shareholders & related interests except with prior written BOG approval, if unsecured. If exposure is secured (cash, real property, eligible stocks) the limit is 10% of bank's net worth.	No exposure to directors, officers, significant shareholders & related interests except with prior written BOG approval, if unsecured. If exposure is secured (cash, real property, eligible stocks) the limit is 10% of bank's net worth.	No exposure to directors, officers, significant shareholders & related interests except with prior written BOG approval, if unsecured. If exposure is secured (cash, real property, eligible stocks) the limit is 10% of bank's net worth.	Not applicable	Not applicable
Reporting and Supervision					
Supervision Methods	Offsite monitoring and reports, onsite examination and audits	Offsite monitoring and reports, onsite examination and audits	Offsite monitoring and reports, onsite examination and audits; special assignments	Onsite examination by CUA + Department of Cooperatives	Not applicable

GHANA	Commercial Bank	Rural Bank	NBFI – S&L	NBFI – Credit Union	NGO-MFI
Supervision costs and fees	Data not available	Data not available	Data not available	Assessed on credit union; shared 3:1 by CUA & Dept of Coops.	Not applicable
Disclosure and reporting requirements	Weekly, monthly, quarterly, semi-annual and annual prudential reports; published statements	Weekly, monthly, quarterly, semi-annual and annual prudential reports; published statements	Weekly, monthly, quarterly, semi-annual and annual prudential reports; published statements	Audited annual reports approved by general assembly of members and submitted to CUA + Dept. of Cooperatives.	Annual reports, as may be required by donors and Inland Revenue
Depositor Protection Mechanisms (e.g., deposit insurance or lender of last resort)	No explicit deposit insurance system; implicit guarantee by Government	No explicit deposit insurance system; implicit guarantee by Government	No explicit deposit insurance system; implicit guarantee by Government	Deposits protected via Credit Union Association program	Not applicable

D. Indonesia[63]

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
General Approach to Regulating								
Legal basis for regula-ting (Law)	Banking Act (BA) 7/1992 as amended by BA 10/1998	BA 7/1992 as amended by BA 10/1998	BA 7/1992 as amended by BA 10/1998	Provincial/Dis-trict Regulations. For BKK the newest is Provincial Regulation No. 19/2002	Cooperative Law (CL) 25/1992 & Gov't Regulation (PP) 9/1995	CL 25/1992 & PP 9/1995, Presidential Instruction 18/1998	CL 25/ 1995, Presidential Instruction 18/1998	Deposit taking NGOs must adhere to Banking Act (BA) or Cooperative Law, NGOs should follow Foundation (*Yayasan*) Law, S&L groups should register w/ local Coop office
Definition or descrip-tion of institution	Full service banks	Area (province) restricted second- tier banks	Village community banks originated in Dutch colonial time	Sub-district or village level NBMFI founded by provincial/ district govt.	Coop or unit/division of multi-purpose coop dealing inclusively with saving and lending	S&L coop patterned after credit union model	Sharia MFIs founded by local Muslim communities	Credit-only NGO-MFIs (a.o. 20 Grameen Bank replications)

[63] *Source:* research by S. Martowijoyo.

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Regulator (s) and role of regulator (s), supervi-sor(s)	Regulator: BI, for all aspects of banking business through regulation and circulars, and technical assistance, prudential supervisor: BI (off-site & on-site)	Regulator: BI, for all aspects of banking business through regulation and circulars, and technical assistance, prudential supervisor: BI (off-site & on-site)	Regulator: BI, but BKD is exempted from all requirements for BPR, supervisor: BRI on behalf of BI (regular on-site, quarterly reports from BRI Head Office to BI)	Regulator: Provincial/District Govt. Supervisor: Provincial Development Bank (BPD) or Provincial/District Audit Office.	Regulator: State Ministry of Coops &SME. (regulation, guidance, technical assistance) Supervision: provincial/ district gov't office dealing with coops.	Regulator: State Ministry of Coops &SME. Supervision: provincial/distric t gov't office dealing with coops.	Regulator: State Ministry of Coops &SME (regulation, advice, TA to provincial/ district gov't) Supervision: provincial/ district gov't office dealing with coops.	Regulator as NGO: Ministry of Justice. Supervisor as NGO: local social/political affairs office
Required legal form of organiza-tion	Limited liability company (PT), local government enterprise (PD)	Limited liability company, local government enterprise, or coop	Limited liability company, local government enterprise, or coop	Local government enterprise (perusahaan daerah, PD)	S & L coop (koperasi simpan-pinjam, KSP) or division or unit of multi-purpose coops (koperasi serba-usaha, KSU)	S & L coop	S & L coop or multi-purpose coops	Foundation
Owner-ship restric-tions	Private, government, provincial gov't, no restriction	Private, local gov't, Foreign parties prohibited	Village gov't only	Provincial and/or district govt., Provincial Development Bank (BPD)	Gov't institutions, local communities, association of merchants/ microentrepreneurs. No legal restriction	Private, local communities. Inclusive membership within area and national league, but no legal restriction	Private, local communities, Muslim NGO/ foundation No legal restriction	Private

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Source of Funds (what's required or prohibited)	Shares, gov't /provincial gov't funds, foreign investment, savings, deposits, securities.	Shares, gov't funds, savings, time deposits. Prohibited: demand deposits, foreign investment	Village treasury, BRI loans, accumulated earnings, mandatory savings, voluntary savings. Prohibited: time deposits, demand deposits, foreign investment	MoF seed capital (in 1970s), provincial & district budget, BPD shares & loans, savings, time deposits, reserves.	Paid-up capital, donations/participations , members' savings, borrowings, bonds & securities.	Same	Founders shares, donations, members basic& mandatory savings, passbook savings, banks loans, government's loans.	Sponsor's donations/grants , members' mandatory savings
Capital and Reserves								
Minimum capital	Rp. 3 trillion	From Rp500m (areas outside Jakarta &vicinities and outside capital cities of provinces in Java & Bali) to Rp5 b (Jakarta),	None (no new BKD is allowed)	None at national level (no new LDKP is allowed). For BKK: minimum capital Rp. 1 trillion (PR 19/2002)	Paid-up capital: Rp. 15 million for primary coop, Rp. 50 million for secondary coops	Same	Same	None
Capital adequacy/ gearing ratios	8% of productive assets	8%, 15% for opening a branch	None (exempted)	Type A BKK: total assets >Rp15 billion, type B >Rp5 b to Rp15 b, type C up to Rp. 5 b (Provincial Regulation No 19/2002)	4% of productive assets	4%	4%	None

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Forms of capital recognized	Core capital: paid-up cap., shares, donations, reserves, retained earnings, profit. Complementary capital: reserve from reevaluation of fixed assets, provisions for loan loss, long-term borrowings, subordinated borrowings.	Paid-up capital (PT), basic & mandatory savings and donations (Coop), 50% of paid-up cap should be used for working cap	Net Worth, Retained Earnings, Profit	Shares of provincial gov't 50%, district gov't 42.5%, and BPD 7.5%	Owners Equity: basic & mandatory savings, reserves, donations/participation, Borrowed Capital: from members, other coops or other coop's members, bank/ financial institutions, issuance of bond and notes, other legal sources.	Same	Same	None
Risk-weighting of assets	From 0%-100% for cash, BI Certificate, deposits with other banks, loans, fixed assets and equipments, and other assets	From 0%-100% for cash, BI Certificate, deposits with other banks, loans, fixed assets and equipments, and other assets	None (exempted)	Follow BI rule	Estimated risk of non-performing loans: sub-standard loans – 50%, doubtful loans – 75%, bad loans – 100%. Write off is not regulated	Same	Same	None

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Loan loss provision-ing, write-off	1% for current productive assets (BI certificate is not included), 5% for special-attention loans, 15% for sub-standard, 50% for doubtful, 100% for bad debts. Deduction of the value of collateral ranging from 100% (cash collateral) to 50% (fixed assets). Write-off not regulated but must be reported	0.5% for current productive assets (BI certificate is not included), 10% for sub-standard, 50% for doubtful, 100% for bad debts. Deduction of the value of collateral ranging from 100% (cash collateral) to 75% (fixed assets). Write-off not regulated but must be reported.	None (exempted)	Follow BI rule. Write off requires approval from Governor/Bupati	Minimum 1% of risk-weighted assets	Same	Same. Some BMTs know CGAP's provisioning of PAR (portfolio at risk) from international donor	None
Reserves Liquidity require-ments	Adequate liquidity monitored through cash flow report, Reserve Requirement 5-8% from third party funds	Adequate liquidity monitored through cash flow report. No RR	The whole profits are retained /accumulated	Reserves 20% of net profit	The % of reserves taken from profit is determined by Members Meeting	Same	Same	Reserves for emergencies (death or sickness)
Financial Services		Savings, time deposits, loans	Mandatory savings, voluntary savings, loans	Savings, loans	Savings and time deposits	Same	Same in Sharia terms	Mandatory savings and loans within the groups

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Prohibited Financial Services		Demand deposits, foreign exchange	demand deposits, foreign exchange	BPD argued that BKK got a special permit from MoF in 1984	All other services	Same	Same	
Consumer protection	Deposit Insurance quarterly report on settlement of clients' complaints	Deposit Insurance, quarterly report on settlement of clients' complaints	None, reputation of the village head	None	None	None	None	None
Interest rate restric-tions	None, but for deposits not to exceed Deposits Insurance limit	None, but for deposits not to exceed Deposits Insurance limit	None	None	None, but interest on savings must be approved by Members Meeting			None
Other operational rules	Encourage-ment to lend to MSME and to BPRs (linkage)	Certification of Directors	None (exempted)	None	None	None	None	None
Concen-tration of risk	Legal lending limit for unrelated parties is 20%	Legal lending limit for unrelated parties is 20%	None (exempted)	Follow BI rule	Determined by Members Meeting	Determined by Members Meeting	Determined by Members Meeting	None
Connected/ insider business	lending limit to affiliated parties is 10% of capital	lending limit to affiliated parties is 10% of capital	None (exempted)	Follow BI rule	Determined by Members Meeting	Determined by Members Meeting	Determined by Members Meeting	None
Supervi-sion Methods	Monthly reporting, regular yearly or special case on-site supervision.	Monthly reporting, regular yearly or special case on-site	regular (2-3 monthly) on-site by BKD Supervisor from BRI Branch	Monthly report, implementation of business plan, yearly financial statement, published financial statement.	Quarterly and yearly reporting. For coops with business volume >Rp. 1 billion per year, audited financial statement is required.	Same. (supervision of primary credit union is done also by regional league (BK3D))	Same.	Internal supervision by project's supervisor

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Supervi-sion Methods (cont.)				On-site supervision by provincial/district auditor office on behalf of Supervisory Board, technical supervisor by BPD	On-site examination done by provincial/ district office dealing with coops, and performance rating by licensed coop supervisors.			
Supervi-sion costs and fees	BI	BI	BI	Borne by provincial& district and BPD budget	Borne by provincial& district budget. TOT for coop supervisor by State Ministry of Coops	Same	Same	Borne by project implementer and groups

INDO-NESIA	Commercial Bank (incl. BRI Units)	Rural Banks		Non-Bank-Non-Coop MFI (LDKP)	Cooperatives			NGO-MFI
		BPR	BKD		S & L Cooperative or Unit	Credit Union	Islamic cooperative (BMT)	
Disclosure and reporting require-ments	Regular: monthly reports, Legal lending limit report, quarterly published financial reports, deposit insurance report, settlement of customers complaints, information on debtors, semester implementation of business plan. Irregular: change in ownership, change in capital base, change of boards, change of address	Regular: monthly reports, Legal lending limit report, semester published financial reports, deposit insurance report, settlement of customers' complaints, information on debtors, semester implementatio n of business plan. Irregular: change in ownership, change in capital base, change of boards, change of address	Regular (weekly) reporting to BRI Branch	Monthly & yearly report, implementation of business plan, published financial statement , other irregular reports	Quarterly & yearly reports, audited report (for high class coop)	Same	Same	Regular savings & lending reports in the regular meetings
Depositor Protection Mecha-nisms (e.g., deposit insurance or lender of last resort)	Deposit insurance	Deposit insurance	None	None	None	Internal scheme	None	None

E. Mexico

MEXICO	Commercial Bank	MFIs (EACPs)		Government lending funds and special purpose institutions (BANSEFI)
		Popular Financial Partnerships	Savings and Loan Cooperatives	
General Approach to Regulating				
Legal basis for regulating (Law)	Law of Credit Institutions (Credit Inst. Law), 1990 Law of the Bank of Mexico, 1993	Popular Savings and Credit Law of 2001 (LACP) General Law for Mercantile Associations, 1934	Popular Savings and Credit Law of 2001 (LACP) General Law of Cooperative Associations, 1994 Commercial Legislation and the Federal Civil Code	Organic Law of the National Savings and Financial Services Bank 2001 (BANSEFI Law) Organic Regulation of the National Savings and Financial Services Bank, 2001 (BANSEFI Reg.) Law of Credit Institutions (Credit Inst. Law)1990 Bank of Mexico Law, 1993
Definition or description of institution	Two types of banks: Multiple bank institutions and development bank institutions. Banking activity refers to acquiring resources from the public through deposits and reallocating them back through credits. (See Credit Inst. Law, Art. 2)	Provide savings and loans; facilitate access to credit for its members; support the financing of micro, small and medium enterprises; and in general, foment the social and economic well-being of its members and the communities in which they operate. (See LACP, Art. 4) Partnerships will be assigned different operational levels affecting the size and scope of operations; levels determined according to the institution's assets and liabilities, the number of members or clients, the geographical location, and the technical and operational capacity of the institution. (See LACP, Art. 32)	Provide savings and loans; facilitate access to credit for members; support the financing of micro, small and medium enterprises; and in general, foment the social and economic well-being of members and their communities. (See LACP, Art. 4) Cooperatives will be assigned different operational levels affecting the size and scope of operations; levels determined according to the institution's assets and liabilities, the number of members or clients, the geographical location, and the technical and operational capacity of the institution. (See LACP, Art. 32)	Promote a savings culture and collaborate with other government agencies in the distribution of subsidies; provide wholesale funds for microbanking intermediaries; provide technical assistance, and information campaign to promote the microbanking network. (IADB 2002)
Regulator(s) and role of regulator(s), supervisor(s)	National Banking and Securities Commission (CNBV) supervises banks. CNBV is accountable to the Ministry of Finance. (World Bank Regulation and Supervision Database)	CNBV is the supervisory body that regulates intermediaries and federations. There is also an auxiliary system of supervision granted to federations (groupings of cooperatives or popular financial partnerships). Federations enforce laws and provide supervision and oversight duties	CNBV is the supervisory body that regulates intermediaries and federations. There is also an auxiliary system of supervision granted to federations (groupings of cooperatives or popular financial partnerships). Federations enforce laws and provide supervision and oversight duties	CNBV, Secretary of the Interior and Public Credit, Bank of Mexico

MEXICO	Commercial Bank	MFIs (EACPs)		Government lending funds and special purpose institutions (BANSEFI)
		Popular Financial Partnerships	Savings and Loan Cooperatives	
		through a Supervision Committee. (IADB 2002)	through a Supervision Committee. (IADB 2002)	
Required legal form of organization	Fixed capital corporation (See Credit Inst. Law, Art. 9)	Corporations with variable capital (See General Law for Mercantile Associations, Art. 1)	Cooperative (with a minimum of 100 members for level 1 operations and 200 members for level 2 operations), with variable capital; can take a limited liability form of limited liability (See General Law of Cooperatives, Arts. 11&14).	Government-owned bank
Ownership restrictions	Maximum percentage of bank capital owned by a single owner and/or by a related party is 5%. (World Bank Regulation and Supervision Database)	Individuals and corporations cannot hold directly or indirectly, more than 3% and 10%, respectively, of the institution's equity. (See Popular Savings and Credit Law of 2001 (LACP), Art. 44)	Natural persons cannot own more than 3%. (Jansson, et al 2003)	Federal government must own 66% of the Bank. (See BANSEFI Law, Art. 12)
Capital and Reserves				
Minimum capital	US $19,000,000 (Jansson et al 2003)	There is a broad range of minimum capital requirements (from US $34,021 to US $8.5 million) based on operational level. (APEC 2002)	There is a broad range of minimum capital requirements (from US $34,021 to US $8.5 million) based on operational level. (APEC 2002)	Capital will be represented by 66% of "Series A" capital (capital provided only by the Federal Government) consisting of US$57.9 million ($660 million pesos). The remaining 34% of the "Series B" capital shall be contributed by the Federal Government and individuals and legal entities. (See Organic Law of the National Savings and Financial Services Bank 2001 (BANSEFI Law), Art. 12 and Reg. Arts. 7&9)
Capital adequacy/ gearing ratios	8% (World Bank Regulation and Supervision Database)	8-11% solvency ratio; the more capital, the less the ratio. (Jansson et al 2003)	8-11% solvency ratio; the more capital, the less the ratio. (Jansson et al 2003)	
Forms of capital recognized	Initial disbursement of capital can utilize borrowed funds. Initial capital must utilize cash or government securities.	Share capital, fixed capital	Share capital, variable capital	
Loan loss provisioning, write-off		Largest institutions follow banking norms. For lower tiers, required provisions for days in arrears are as follows: 0 days = 1%, 1-7 = 4%, 8-90 = 50%, 91-180 = 90%, >180 = 100%.	A loan loss reserve should be created in an amount no less than 50 percent of the balance of the matured portfolio or 1 percent of the direct and contingent credit portfolio. (General Rules for the Organization and Operation of Savings	

MEXICO	Commercial Bank	MFIs (EACPs)		Government lending funds and special purpose institutions (BANSEFI)
		Popular Financial Partnerships	Savings and Loan Cooperatives	
			and Credit Societies, 1992.) Largest institutions follow banking norms. For lower tiers, required provisions for days in arrears are as follows: 0 days = 1%, 1-7 = 4%, 8-90 = 50%, 91-180 = 90%, >180 = 100%.	
Reserves, Liquidity requirements	Banks are required to hold 20% of their liabil-ities in cash deposits with the Central Bank. (World Bank Regulation and Supervision Database). Must set aside annually at least 10% of its net profits, until such fund reaches the paid in capital. (See Law of Credit Institutions (Credit Inst. Law), 1990, Art. 99A)	At least 10% of short term liabilities must be invested in liquid assets (APEC 2002). 10% of profits must go to a reserve fund until it is equivalent to 10% of total capital. Fund must be invested in highly liquid government securities. (See Popular Savings and Credit Law of 2001 (LACP), Art. 13)	At least 10% of short term liabilities must be invested in liquid assets (APEC 2002). 10% of profits must go to a reserve fund until it is equivalent to 10% of total capital. Fund must be invested in highly liquid government securities. (See LACP, Art. 13)	Reserve fund must make up at least 10% until such reserve reaches the level of initial paid in capital and up to 20% of debt in foreign currency. (See BANSEFI Law, Art. 34 and Reg. Art. 32)
Risk Management Guidelines (Guidelines on business activities)				
• **Financial Services Permitted**	Receive deposits (on site, demand, term), provide credits and loans, issue bank bonds, issue subordinated debt, accept credits and loans, expedite credit cards, etc. (See Law of Credit Institutions (Credit Inst. Law), 1990, Art. 46)	Depends on operation level, including: on site, savings, term, and retrievable deposits, receive loans and credit from national and international credit institutions, provide liquidity loans to MFIs, receive credit from the affiliated Federation, provide leasing contracts for computer and transportation equipment, provide real estate leasing contracts, provide guarantees, receive and execute payment orders in domestic currency, grant loans, invest in securities, provide credit cards, etc. (See Popular Savings and Credit Law of 2001 (LACP), Art. 36)	Depends on operation level, inclu-ding: on site, savings, term, and retrievable deposits, receive loans and credit from national and inter-national credit institutions, provide liquidity loans to MFIs, receive credit from the affiliated Federation, provide leasing contracts for computer and transportation equipment, provide real estate leasing contracts, provide guarantees, receive and execute payment orders in domestic currency, grant loans, invest in securities, provide credit cards, etc. (See LACP, Art. 36)	Issue and guarantee stocks, guarantee third party liabilities, establish savings programs, acquire credit, issue participation certificates on fideicomisos, provide financing for public funds. (See Organic Law of the National Savings and Financial Services Bank 2001 (BANSEFI Law), Arts. 8&11.)
• **Financial Services Prohibited**	Using bank's property or securities as a guarantee. (See Credit Inst. Law, Art. 106)	Cannot provide loans outside of its social objective or Operational Level assigned to it by the Commission. Cannot receive stocks and certificates of paid in capital as guarantees for loans provided to its members. (See LACP, Arts. 33&36)	Cannot provide loans outside of its social objective or Operational Level assigned to it by the Commission. Cannot receive stocks and certificates of paid in capital as guarantees for loans provided to its members. (See LACP, Arts. 33&36)	Receive deposits (on site, demand, term), accept credit and loans, issue bonds and subordinated debt, provide discounts and credit and loans, issue credit cards and assume obligations of third parties, issue letters of credit, etc. (See Credit Inst. Law, Art. 46)

MEXICO	Commercial Bank	MFIs (EACPs)		Government lending funds and special purpose institutions (BANSEFI)
		Popular Financial Partnerships	Savings and Loan Cooperatives	
• **Consumer protection**				
• **Interest rate restrictions**		No limits on deposit or loan interest rates. Intermediaries adopt market-based interest rate policies (APEC 2002)	No limits on deposit or loan interest rates. Intermediaries adopt market-based interest rate policies (APEC 2002)	
• **Other operational rules**		Cannot engage in an agreement using terms and conditions that differ from industry practice. (See LACP Art. 33)	Cannot engage in an agreement using terms and conditions that differ from industry practice. (See LACP Art. 33)	
Concentration of risk	Commission stipulates maximum percentages of risk concentration. (See Credit Inst. Law Art. 51)	Set by central bank and CNBV	Set by central bank and CNBV	
Connected/ insider business	75% of the Administration Council must authorize transactions with related parties. Related parties are: those who own directly or indirectly 2% or more of the bank's capital; members of the Administration Council; spouses of the above-mentioned parties; those that have the authority to bind the bank, etc. (See Credit Inst. Law Art. 73)	Irrevocable lines of credit contracted with related parties cannot exceed 50% of paid-in capital (including capital reserves and accumulated profits). Related parties are: natural and legal persons that own directly of indirectly 2% or more of the Cooperative; members of the Management Council; spouses or anyone with family ties; anyone that has the authority to bind the institution; any legal persons including officers, directors, and spouses that directly or indirectly hold more than 10% of equity. (See LACP Art. 35)	Irrevocable lines of credit contracted with related parties cannot exceed 50% of paid-in capital (including capital reserves and accumulated profits). Related parties are: natural and legal persons that own directly of indirectly 2% or more of the Cooperative; members of the Management Council; spouses or anyone with family ties; anyone that has the authority to bind the institution; any legal persons including officers, directors, and spouses that directly or indirectly hold more than 10% of equity. (See LACP Art. 35)	
Reporting and Supervision				
Supervision Methods	Commission conducts on and off-site inspections. (See National Banking and Securities Commission Law (CNBV Law) 1995, Arts. 5&19 and Law of Credit Institutions (Credit Inst. Law), 1990, Art. 133)	There is a system of auxiliary supervision in which the MFIs are directly supervised by their respective Federations, which in turn are supervised by the National Banking and Securities Commission (CNBV) (APEC 2002) CNBV conducts on and off-site inspections. (See CNBV Law, Arts. 5&19)	There is a system of auxiliary supervision in which the MFIs are directly supervised by their respective Federations, which in turn are supervised by the CNBV (APEC 2002) CNBV conducts on and off-site inspections. (See CNBV Law, Arts. 5&19)	Supervised and regulated by two commissioners appointed by the Secretary of the Comptroller and Administrative Development and one commissioner appointed by the Series B advisors (those holding certificates of Series B equity). Commissioners can request monthly information describing the Bank's financial situation and its status of results; examine the operations,

MEXICO	Commercial Bank	MFIs (EACPs)		Government lending funds and special purpose institutions (BANSEFI)
		Popular Financial Partnerships	Savings and Loan Cooperatives	
				documentation, registration and other issues. (See Organic Law of the National Savings and Financial Services Bank 2001 (BANSEFI Law), Art. 27)
Supervision costs and fees	Supervised entities must cover costs (See CNBV Law, Art. 18)	Supervised entities must cover costs (See CNBV Law, Art. 18)	Supervised entities must cover costs (See CNBV Law, Art. 18)	
Disclosure and reporting requirements	Banks must produce consolidated accounts; off balance sheet items must be disclosed to the supervisors but are not required to be disclosed to the public. Risk management procedures must be disclosed to the public. (World Bank Regulation and Supervision Database)	Provide their Federations information and documentation related to the auxiliary inspection function. (See CNBV Law, Art. 58) Monthly, quarterly,, and annual reports to be submitted to regulating agencies, per the CNBV document, *Guia de Supervision Auxiliar*. Annual audits and on-site inspection required.	Provide their Federations information and documentation related to the auxiliary inspection function. (See CNBV Law, Art. 58). Monthly, quarterly,, and annual reports to be submitted to regulating agencies, per the CNBV document, *Guia de Supervision Auxiliar*. Annual audits and on-site inspection required.	Annually: Must submit financial plans, general budgets for expenses and investments, and its operational programs to the Secretary of Interior and Public Credit. (See BANSEFI Law, Art. 32)
Depositor Protection Mechanisms (e.g., deposit insurance or lender of last resort)	Deposit insurance protection system is funded by the government and the banks and managed by the Institute for the Protection of Savings Accounts. Limit per account is US $400,000 investment units. (World Bank Regulation and Supervision Database)	"Protection Fund," managed by Confederations, covers individual savings ranging from US $1,360 and US $3,402. (APEC 2002)	"Protection Fund," managed by Confederations, covers individual savings ranging from US $1,360 and US $3,402. (APEC 2002)	NA

F. Philippines[1]

PHILIPPINES	Commercial Bank	Thrift Bank	Rural Bank	Coop Rural Bank
General Approach to Regulating				
Legal basis for regulating (Law)	General Banking Act 2000; BSP Act 1993	General Banking Act 2000;Thrift Banks Act; BSP Act 1993	General Banking Act 2000; Rural Banks Act; BSP Act 1993	General Banking Act 2000; Rural Banks Act; BSP Act 1993; Cooperatives Code
Definition or description of institution	Registered and licensed commercial bank	Registered and licensed thrift bank	Registered and licensed rural bank	Registered and licensed cooperative rural bank
Regulator(s) and role of regulator(s), supervisor(s)	Bangko Sentral ng Pilipinas – regulator and supervisor; Philippine Deposit Insurance Corp. – auxiliary regulator; Securities & Exchange Commission – registrar	Bangko Sentral ng Pilipinas – regulator and supervisor; Philippine Deposit Insurance Corp. – auxiliary regulator; Securities & Exchange Commission - registrar	Bangko Sentral ng Pilipinas – regulator and supervisor; Philippine Deposit Insurance Corp. – auxiliary regulator; Securities & Exchange Commission - registrar	Bangko Sentral ng Pilipinas – regulator and supervisor; Philippine Deposit Insurance Corp. – auxiliary regulator; Securities & Exchange Commission - registrar
Required legal form of organization	Corporation limited by share capital, registered with Securities & Exchange Commission	Corporation limited by share capital, registered with Securities & Exchange Commission	Corporation limited by share capital, registered with Securities & Exchange Commission	Corporation limited by share capital, registered with Securities & Exchange Commission and with Cooperative Development Agency
Ownership restrictions	≥ 40% by Filipino citizens[2]	≥ 40% by Filipino citizens	100% by Filipino citizens	100% by Filipino citizens
Single shareholder limits	Individual, family, corporate or business group may own up to maximum 40% equity of a domestic bank or banks.	Individual, family, corporate or business group may own up to maximum 40% equity of a domestic bank or banks.	Individual, family, corporate or business group may own up to maximum 40% equity of a domestic bank or banks.	Individual, family, corporate or business group may own up to maximum 40% equity of a domestic bank or banks.
Source of Funds (what's required or prohibited)	Common stock, preferred shares, long-term bonds, money-market issues, wholesale (CDs) & retail deposits	Common stock, preferred shares, long-term bonds, money-market issues, wholesale (CDs) & retail deposits	Common stock, preferred shares, long-term bonds, money-market issues, wholesale (CDs) & retail deposits	Common stock, preferred shares, long-term bonds, money-market issues, wholesale (CDs) & retail deposits
Capital and Reserves				
Minimum capital	US$ 51 – 100 million	US$ 1.1 – 7.4 million	US$ 60 K – 600 K	US$ 92 K – 3.7 million

[1] Data and information compiled from Bangko Sentral ng Pilipinas website - Manual of Regulations for Banks, Manual of Regulations for Non-Bank Financial Institutions; Microfinance Council of the Philippines, Inc., Cooperatives Development Authority – Memorandum Circular No, 02-04 (series of 2002).

[2] Except for branches/subsidiaries of foreign banks

PHILIPPINES	**Commercial Bank**	**Thrift Bank**	**Rural Bank**	**Coop Rural Bank**
Capital adequacy/ gearing ratios	≥ 10% of RWA [3]	≥ 10% of RWA	≥ 10% of RWA	≥ 10% of RWA
Forms of capital recognized	Paid-up common capital, perpetual & non-cumulative preferred shares, retained earnings, undistributed share dividends, reserves	Paid-up common capital, perpetual & non-cumulative preferred shares, retained earnings, undistributed share dividends, reserves	Paid-up common capital, perpetual & non-cumulative preferred shares, retained earnings, undistributed share dividends, reserves	Paid-up common capital, perpetual & non-cumulative preferred shares, retained earnings, undistributed share dividends, reserves
Risk-weighting of assets	0%, 20%, 50%, 75% (micro & SME loans), 100% as defined by BSP (under BIS guidelines)	0%, 20%, 50%, 75% (micro & SME loans), 100% as defined by BSP (under BIS guidelines)	0%, 20%, 50%, 75% (micro & SME loans), 100% as defined by BSP (under BIS guidelines)	0%, 20%, 50%, 75% (micro & SME loans), 100% as defined by BSP (under BIS guidelines)
Loan loss provisioning, write-off	General reserve = 1%, for current & unclassified loans Specific Reserves – Loans Especially Mentioned Past due 30-90 days = 5% Sub-standard, 91-120 days Secured = 10% Unsecured = 25% Doubtful, 121-180 days = 50% Loss, 181+ days = 100%	General reserve = 1%, for current & unclassified loans Specific Reserves – Loans Especially Mentioned Past due 30-90 days = 5% Sub-standard, 91-120 days Secured = 10% Unsecured = 25% Doubtful, 121-180 days = 50% Loss, 181+ days = 100%	General reserve = 1%, for current & unclassified loans Specific Reserves – Loans Especially Mentioned Past due 30-90 days = 5% Sub-standard, 91-120 days Secured = 10% Unsecured = 25% Doubtful, 121-180 days = 50% Loss, 181+ days = 100%	General reserve = 1%, for current & unclassified loans Specific Reserves – Loans Especially Mentioned Past due 30-90 days = 5% Sub-standard, 91-120 days Secured = 10% Unsecured = 25% Doubtful, 121-180 days =50% Loss, 181+ days = 100%
Reserves, Liquidity requirements on deposit/ deposit-substitute liabilities	10% of average liabilities	10% of average liabilities	15% of average liabilities	15% of average liabilities
Risk Management Guidelines (Guidelines on business activities)				
• Financial Services Permitted	All banking and financial services including credit card , consumer & mortgage loan financing, trusts, investment management, remittances, payments, ATM & electronic banking, money market instruments and placements	Savings & time deposits; short and medium-term loans and credits including mortgage loan financing, payments.	Savings & time deposits; short and medium-term loans and credits including mortgage loan financing, payments.	Savings & time deposits; short and medium-term loans and credits including mortgage loan financing, payments.
• Financial Services Prohibited	Insurance underwriting business. Non-bank financial services (e.g., lease financing, securities broker & dealership, etc.) to be carried out	Insurance underwriting business. Trust, investment management, foreign trade financing, foreign	Insurance underwriting business. Trust, investment management, foreign trade	Insurance underwriting business. Trust, investment management, foreign trade

---

[3] RWA = risk-weighted assets

[4] Some thrift banks and rural banks are permitted to offer checking accounts, based on size of capital and quality of operations (prior authorization by BSP and membership in Philippine Clearing House Corporation are required).

PHILIPPINES	Commercial Bank	Thrift Bank	Rural Bank	Coop Rural Bank
	through separate subsidiaries	exchange, lease financing, checking accounts [4]	financing, foreign exchange, lease financing, checking accounts	financing, foreign exchange, lease financing, checking accounts
• Consumer protection	Disclosure - Truth in Lending Law	Disclosure - Truth in Lending Law	Disclosure - Truth in Lending Law	Disclosure - Truth in Lending Law
– Interest rate restrictions	None	None	None	None
– Other operational rules	Branch opening / closure	Branch/LCDO opening / closure; geographic limits on operation based on license issued by BSP	Branch/LCDO opening / closure; geographic limits on operation based on license issued by BSP	Branch/LCDO opening / closure; geographic limits on operation based on license issued by BSP
Concentration of risk	Single borrower limit (SBL) ≤ 15% of unimpaired capital + surplus	SBL ≤ 15% of unimpaired capital + surplus	SBL ≤ 15% of unimpaired capital + surplus	SBL ≤ 15% of unimpaired capital + surplus
Connected/ insider business	Each related party (DOSRI) loan ≤ 25% of bank's net worth	Each DOSRI loan ≤ 25% of bank's net worth	Each DOSRI loan ≤ 25% of bank's net worth	Each DOSRI loan ≤ 25% of bank's net worth
Reporting and Supervision				
Supervision Methods	Offsite monitoring & reports; annual onsite examination (risk mgmt, assets & portfolio quality, internal controls)	Offsite monitoring & reports; annual onsite examination (risk mgmt, assets & portfolio quality, internal controls)	Offsite monitoring & reports; annual onsite examination (risk mgmt, assets & portfolio quality, internal controls)	Offsite monitoring & reports; annual onsite examination (risk mgmt, assets & portfolio quality, internal controls)
Supervision costs and fees	≤ ¼ of 1% of average total assets	≤ ¼ of 1% of average total assets	≤ ¼ of 1% of average total assets	≤ ¼ of 1% of average total assets
Disclosure and reporting requirements	Weekly, monthly, quarterly, annual reporting to BSP, external audit reports + quarterly publication of condensed balance sheet, NPLs, DOSRI and ROE.	Weekly, monthly, quarterly, annual reporting to BSP, external audit reports + quarterly publication of condensed balance sheet, NPLs, DOSRI and ROE.	Weekly, monthly, quarterly, annual reporting to BSP, external audit reports + quarterly publication of condensed balance sheet, NPLs, DOSRI and ROE.	Weekly, monthly, quarterly, annual reporting to BSP, external audit reports + quarterly publication of condensed balance sheet, NPLs, DOSRI and ROE.
Depositor Protection Mechanisms	Up to US$2,000 per depositor, at ½ of 1% of average deposit liabilities	Up to US$2,000 per depositor, at ½ of 1% of average deposit liabilities	Up to US$2,000 per depositor, at ½ of 1% of average deposit liabilities	Up to US$2,000 per depositor, at ½ of 1% of average deposit liabilities

G. South Africa

SOUTH AFRICA	Commercial Bank	NBFI (microlenders)	Coops/ Credit Unions
General Approach to Regulating			

SOUTH AFRICA	Commercial Bank	NBFI (microlenders)	Coops/ Credit Unions
Legal basis for regulating (Law)	Banks Act (1990, as amended) and Usury Act, 1968	Usury Act (No. 73 of 1968), Notice 713 of 1999 in terms of Section 15A of the Usury Act (referred to as the Exemption Notice) Banks Act (No. 94 of 1990); Rules of the MFRC (as effective from 1 July 2002, referred to as Rules) and MFRC Circulars	Notice 1422 of 2000 (referred to as Exemption Notice) in connection with Banks Act (No. 94 of 1990) Cooperatives Act, 1981 (Act No. 91 of 1981)
Definition or description of institution	Universal banks as well as specialized institutions	Credit-only microfinance institutions who are members of MFRC and comply with their rules	Closed co-operatives, i.e. financial co-operatives carrying on business with members only
Regulator(s) and role of regulator(s), supervisor(s)	Reserve Bank of South Africa	Microfinance Regulatory Council (MFRC) or other authorized regulatory institution for all MFIs within Usury Act exemption.	A SACCO must be a member of a self-regulatory body approved by the Registrar of Banks, the Savings and Credit Cooperative League of South Africa (SACCOL)
Required legal form of organization	Public company registered as a bank	Private or public company, close corporation cooperative, trust, NGO, mutual bank, or bank. (Almost 80% of registered lenders are close corporations.)	Incorporation as a trading co-operative
Ownership restrictions	No person shall hold more than 15% of controlling shares unless permission is given by the Registrar of Banks	Determined by the law governing each organizational structure	Members only may hold shares, and membership is limited by "common bond rules," i.e., available only to individuals related through neighborhood residence or workplace commonality.
Capital and Reserves			
Minimum capital	US $33.5 million (250 million ZAR)	None	
Capital adequacy/ gearing ratios		None	Both institutional capital and net institutional capital should be at least 10% of total assets
Risk-weighting of assets	Loans fully secured by real property mortgages: 50% risk-weighting; all other loans risk-weighted at 100% regardless of type of security.	NA	
Loan loss provisioning, write-off		NA	1-12 months past due: 35% Write-off at 12 months
Reserves, Liquidity requirements on deposit/	Must hold liquid assets of no more than 20% of liabilities (liquid assets include Reserve Bank notes and coins, balances	NA	Must reserve 10% minimum of gross income. 70-80% of total deposits must be loaned

SOUTH AFRICA	Commercial Bank	NBFI (microlenders)	Coops/ Credit Unions
deposit-substitute liabilities	held with the Reserve Bank, treasury bills, and short-term bills issued by the Land Bank).		out to members. Fixed assets can not exceed 5% of total assets.
Risk Management Guidelines			
Guidelines on business activities :			
• Financial Services Permitted	Public deposit-taking; lending	Max. loan = approx. 10,000 ZAR (US $1,200) Max. repayment term = 36 mo	Accepting funds against shares, savings deposits, term deposits, loans, life and loan insurance.
• Financial Services Prohibited	Unsecured lending; lending against the security of its own shares; issuing no par value shares, preference shares or debt instruments without the Bank Registrar's permission; issue negotiable certificates of deposit	Retail or wholesale deposits, retention of bank card & PIN number	Holding member deposits amounting in the aggregate to more than US $1 million (10 million ZAR)
• Consumer protection			
– Interest rate restrictions	The Usury Act limits interest rates, and currently sets the rate at 23% for amounts less than US $1,000 (10,000 ZAR) and 20% for amounts above.	Lenders accredited with the MFRC are exempt from interest rate ceilings as put forth in the Usury Act.	SACCOs are currently subject to the Usury Act, but SACCOL is applying for exemption status similar to MFRC.
– Other operational rules		Loan term disclosure rules, fee regulations, cooling-off period, limits on collection methods, must use standard written loan agreements approved by the MFRC.	Clients must be members of a geographical or workplace community. SACCOs must have a business arrangement with a link bank, i.e., maintain an account with the bank, have a bank/client relationship with the bank and get support, training and advice from the bank; all issued shares must be fully paid up.
Concentration of risk	Cannot lend in an amount exceeding 10% of capital without approval from the Board of Directors. Cannot be exposed to more than 25% of a prescribed amount to a single entity without notifying the Registrar	Maximum loan amount 10,000 ZAR (US $1,200)	
Connected/ insider business	Can not lend more than 10% of liabilities to any associates of the Bank.	NA	
Reporting and Supervision			
Supervision Methods	Offsite inspection of statements; on-site inspection	MFRC supervises MFI adherence to standards of management & consumer protection, deals with complaints, gathers & publishes information on the industry, makes annual report to	Self-supervision by trade association, but supervision is mostly ineffective.

SOUTH AFRICA	Commercial Bank	NBFI (microlenders)	Coops/ Credit Unions
		Department of Trade & Industry (DTI); MFRC performs inspections using outside auditors and can inspect with or without notice.	
Supervision costs and fees		MFRC funded by fees from MFIs; payment depends on type of lender (highest fees are for small and medium-sized lenders). Fines have to be paid for late reports to MFRC (depending on category of lender and number of days overdue).	
Disclosure and reporting requirements	Annual audited reports	• Annual audit report and re-registration • Quarterly statistical returns including loan analysis, breakdown of total charge of credit, and borrower information, on-site record-keeping requirements, reporting of credit data to National Loans Register	• Monthly reports on loan information, income statement and balance sheet submitted to SACCOL • Yearly financial statements; audited if membership shares exceed US $131,600 (1 million ZAR
Depositor Protection Mechanisms (e.g., deposit insurance or lender of last resort)	Loan insurance exists, although the system is near collapse because of the strain the HIV/AIDS epidemic has put on the insurance industry.	NA	Central Finance Facility helps with short-term liquidity constraints. SACCOs must pay a one-time entrance fee (US $13 [86 ZAR] plus US $0.13 [0.86 ZAR] per member), purchase shares equal to 1% of the SACCOs' total assets each financial year, and mandatory deposits of 9% of total assets each financial year. All SACCOs are required to have loan insurance, which can be purchased from SACCOL (although this mechanism may be dropped in the future because of the effect the HIV/AIDS epidemic has had on the system).