

Self-Assessment Tool for Microfinance Legal and Regulatory Reform

Literature Overview

As part of its efforts to develop a self-assessment tool that regulators, financial institutions, policymakers, donors and other stakeholders can use to discuss and decide on reform priorities to build a more inclusive financial sector, the IRIS Center surveyed existing relevant literature. All topics were selected based on the fact that regulators and donors would want to consider them as they examine the extent and shape of microfinance regulation and supervision. The review starts with a short description of information from the general financial regulation and supervision literature to provide a sense of best practice and emerging trends. It goes on to discuss the implications of financial regulation and supervision in the context of microfinance, either as a separate sector or as an integral part of the broader financial sector. This includes a look at how the emerging trend of risk-based supervision, especially as proposed in Basel II, would affect the regulation and supervision of microfinance activities, especially for developing countries, and how central banks perceive their role as regulators of microfinance. Finally, the review briefly describes earlier efforts to assess regulatory environments for microfinance, targeted mainly at practitioners and donors, rather than regulators.

Banking Supervision: Global Guidance

One would expect that banking supervision is a mature and established field with global ‘best practice’ available to interested applicants. This is true only to a limited extent. Earlier arguments for free banking – a financial sector without licensing and supervision, governed by ‘the market’ (Selgin, 1985 and 1988) – are not seriously considered in current policy debates.¹ The usefulness of bank licensing and supervision has, in principle, been accepted by those debating central banking today. However, recent progress in banking supervision has raised new questions that are less theoretical and therefore more important to the application of banking supervision.

Risk-based supervision has emerged as the newest technology for tracking banking systems in the new era of globalization, increased innovations in products and services, and overall financial liberalization. Generally, risk-based supervision is a system that focuses on the quality of risk-management systems of the financial institution and enforces a regulatory authority’s ability to recognize systemic risks to the banking system. It saves regulatory resources and allows financial institutions to take on riskier ventures, as long as they offset this risk with appropriate pricing and reserves. Supervisors then treat each financial institution individually, based on their risk management capacity. Traditional forms of supervision continue to be employed, especially with less stable institutions experiencing solvency problems. Risk-based supervision allows regulators to develop one uniform system for supervising financial

¹ Related to the free banking debate are considerations about the role of central banks in money creation and the issuance of currency. These considerations are beyond the scope here.

institutions rather than different supervisory approaches for unique institutional types (Fitzgerald and Vogel, 2000).

Basel's Core Principles for Effective Banking Supervision (1997) incorporates this approach in several of its recommendations, particularly those related to evaluating country and transfer risk and establishing reserves against it; assessing market risk; and appraising the financial institution's risk management procedures, including board and senior management oversight. Other elements of a risk-management system include managing credit, liquidity, operational, interest rate and foreign exchange risk. Institutions need to demonstrate an ability to identify, measure, control and monitor changes in these risks. The revised Basel II takes risk management further through the three pillars of banking supervision: minimum capital requirements (including the credit risk/internal ratings based approach), supervisory review process (with a heavy emphasis on risk assessment), and market discipline.(Basel 2004)

Taking on a risk-management approach, rather than avoiding or off-setting risk, would further create a situation in which financial institutions could comfortably reach lower-income populations, as long as the risk of doing so was managed properly. Unsecured lending can be managed well within this spectrum, provided the regulatory authority has the capacity to accurately assess the institution's management of the risk (Fitzgerald and Vogel, 2000).

Whether this can be done in the context of developing economies is a source of debate. Brownbridge and Kirkpatrick (2000) assert that the risk of systemic crises in the less developed countries' (LDCs') banking systems abounds due to weak prudential systems, shortages of skilled supervisors and rampant regulatory forbearance. Furthermore, best practice models of supervision rely on accurate financial information and rule of law that promotes impartiality, which has often been lacking in countries with weak accounting and legal frameworks and higher amounts of corruption.

The World Bank has put together a database of banking laws and regulations in some 107 different countries (See the Global Banking Law Database at http://www.worldbank.org/research/projects/bank_regulation.htm). Barth, Caprio and Levine (2001) survey 107 countries to find that stricter regulation of the banking sector is not related to better performance. In fact, entry restrictions, capital requirements and other regulatory tools are argued to be related more to government corruption than to financial sector governance. This study, however, is based solely on commercial banking sectors and does not implicitly include other types of financial institutions.

Mastrangelo (2003) reviews USAID's strategy and options for financial sector development support. Her perspective is a macroeconomic one, and activities under the labels of 'access to finance for SMEs and for the poor' as well as microfinance are added as separate considerations of the 'international financial architecture'. In justifying her approach, she writes that 'micro- and small and medium (SME) finance programs are concerned with extending the reach of financial services in the interest of general

economic and private sector development, not with the inherent stability or performance of financial sectors per se.’

One can hardly argue that outreach is not a core variable for assessing a financial systems’ performance. While individual financial institutions may decide on their own target markets, and should not be faulted for choosing a narrow one, a financial system that excludes many must be found at fault. Furthermore, it seems plausible to argue that the long term stability of a financial system is assured by wide participation in it, thereby creating a popular stake in its stability. The role of regulatory reform in promoting financial stability, economic growth and enhanced access do not create conflicting objectives.

Regulation of Microfinance as a Separate Sector: Why Regulate?

The microcredit movement developed during the 1980s and 1990s as a grassroots force offering a new approach on poverty reduction and on banking principles. If not outright rebellious, it nonetheless saw itself as a radical departure from the perceived ‘big business’ focus of private banks and the incompetence of government and donor lending. As microcredit turned to microfinance, and the movement became more institutionalized and less rebellious, the need for accommodation with the financial sector and regulatory requirements became more accepted. Now, many stakeholders agree that regulation can play a positive role in developing microfinance and that, in the long run, regulation is inevitable. Despite this broad acknowledgement, there is plenty of disagreement about the desirable form and nature of microfinance regulation (Meagher, 2002).

Opinions range from those who argue to keep all of microfinance outside the scope of regulation to those who believe that all microfinance institutions (MFIs), even those not taking deposits, should be subject to full licensing and supervision requirements. Others assert that formal financial regulation is too burdensome for pro-poor institutions to take on, and still others argue for complete regulatory coverage of all financial activities regardless of size or shape. Also, some regulatory regimes have entrenched features that require conditional opt-out mechanisms to exempt MFIs, which can result in regulation.² In practice, however, most stakeholders identify a need for regulation of some microfinance activities and adapted levels of prudential requirements.

The special features of microfinance that need to be accommodated within the regulatory structure include:

- its attempt to deepen financial markets to serve microenterprises and poor households;
- its high unit costs of lending;
- its approach of physically taking banking services to clients who have few other options to receive financial services;

² An example is the South African usury law. It limits interest rates for lenders to levels below microcredit viability. Hence an exemption clause was created, requiring registration and supervision of microcredit providers (Coetzee, 1998).

- the relatively undiversified and sometimes volatile nature of MFI credit portfolios;
- the fact that most MFIs began as unregulated credit NGOs, with a focus on social goals rather than financial accountability and sustainability (e.g. allowing for NGO transformation);
- the difference in institutional orientation, with some MFIs clearly profit-oriented while others are committed to providing services to the poorer segments of the population on a non-profit basis, creating very different cost structures and funds sources;
- the fact that MFIs deal in savings and credit transactions with relatively low value in relation to the system as a whole -- and as a result are unlikely to have problems that cause broad systemic instability (Jansson, 1998); and
- the market risk posed within the microfinance sector when MFIs (especially large ones) are not properly managed and monitored.

At the same time, any regime that is adopted must cope with the special problems of regulating and supervising MFIs. These include: the absence for most MFIs of owners' capital to draw on to meet capital calls, the fact that MFI lending modalities make audits and corrective steps, such as lending moratoria, difficult at best, and the potentially high costs of MFI supervision (Christen and Rosenberg, 2000). Meagher (2002) provides a detailed overview of the areas of traditional financial regulation that may need to be adjusted for microfinance, including prudential ratios, supervision and reporting systems, entry and graduation requirements, and operating rules.

Regulators have in fact become involved in the microfinance market for a host of reasons beyond protection against excessive risk, especially to protect ordinary depositors. In some cases, donor agencies have encouraged regulation to help them select MFIs for funding. In others, microfinance industry associations have encouraged regulation to strengthen the reputation of the industry and discourage fraud or other bad practices. In still other instances, microfinance legislation has been required to enable MFIs to begin operations and grow. Some suggest that this new focus on microfinance regulation has led, inappropriately, to the regulation of non-depository institutions which do not represent the kind of risk to the payment system or to depositors that regulators are mainly concerned about (Vogel et al, 1999). However, one might also argue that the result of sound regulation has been to deepen the microfinance market, enhance the institutional vehicles for provision of microfinance services, and create competition and new services, as it has in Bolivia (Rhyne, 2002).

Christen and Rosenberg (2000) warned against a 'rush to regulate'. This paper set out most of the concepts that permeate the literature to this day. It seems to be constructed of two parts, one developing a picture of regulation in the mature stage, the other concerned about processes, speed and sequencing on the way there. The only noticeable disagreement among practitioners on the ground with Christen and Rosenberg is with their argument that credit-only microfinance does not need supervision. A small group of researchers, and a larger group of supervisors, intend to expand supervision to credit-only

MFIs, although this may partially reflect different definitions of prudential and non-prudential regulation.

Jansson (1998) illustrates the factors that set MFIs apart from commercial banks in Latin America and analyzes the mostly negative impact that their inclusion in banking supervision has had. One may speculate why this is the case. In Latin America, financial regulators expanded their rule to MFIs before their colleagues in Asia and Africa, with ambiguous results. Further, Latin American regulatory agencies are relatively capable, powerful institutions, and maybe as a result, the inclusion of microfinance in their responsibility was not a major push for reform (i.e. overhauling the regulatory framework), but rather the extension of an existing and inappropriate system to microfinance. The strength of the commercial banking sector and its supervising agencies may have inhibited more fundamental reform. In Africa, many central banks lack capacity to appropriately supervise existing commercial banks, and financial regulations are inadequate. Possibly as a result, microfinance regulation is more easily conceptualized as regulatory reform outside Latin America.

Trigo et al (2004) however, show that regulation has led the microfinance market in three different Latin American contexts (Bolivia, Colombia, and Mexico). They note that where regulation existed before the market did, the market grew faster and stronger than otherwise. Furthermore, the existence of universal banking licenses helped to widen the provision of financial services to the poor to a range of financial institutions, no longer containing the practice to small NGO-founded organizations.

Regulation of Microfinance as a Separate Sector: How to Regulate?

Avoiding over-regulation is at least as important as putting well-tailored rules and systems in place. Seasoned observers warn that the regulation of microfinance often creates problems, due to a mismatch between regulatory and lending technologies, as well as attempts to use the regulatory framework for objectives other than avoiding excessive risk (Gonzalez-Vega, 1998). Therefore, microfinance regulation should be “light-touch,” focusing on market safety and soundness principles applicable to the financial markets as a whole.

The idea of a tiered structure running from commercial banks down to non-profit NGO-MFIs has been taken up by many regulators in the past five years and is most fully presented in Van Greuning et al (1999). In that study, the tiers are defined according to the institutions’ source of funds: the public’s money (deposits), members’ money (in the case of cooperatives), and “other people’s money” (donor funds). It is thus the activities on the *liability* side of the balance sheet that trigger the need for registration, regulation, and/or supervision of the institution. Differences in funding sources and the corresponding risks that must be managed create a need for internal controls, and when the institution’s activities in fund mobilization pass a certain defined threshold, the institution should be subject to mandatory external regulation and supervision. Each threshold or tier matches more stringent regulation and supervision with a wider field of activity and risk. Graduation to higher tiers would require MFIs to strengthen their

operations, reach significant scope, and achieve financial self-sufficiency. Graduation brings an expansion of authority, such as the ability to accept deposits of a certain type or size, permission to handle financial transfers, authorization (after registration with the securities agency) to issue shares to be publicly traded, or permission to obtain wholesale finance from commercial banks and other sources.

Some experts take a skeptical view of the utility of setting up a separate “regulatory window” for microfinance. They suggest that the goal of microfinance *promotion*, which often motivates the opening of these windows, is not compatible with the regulatory goal of a sound financial system. The real problem, in this view, is a shortage of licensable MFIs – i.e., techniques, capacities, organizations, and capital have not developed sufficiently. Alternatives to the “window” approach include reliance on delegated supervision or rating agencies, regulating by exemption (i.e., providing ad hoc exceptions to institutions that do not meet licensing requirements), and facilitating alliances with already-licensed institutions – e.g., requiring MFIs to transfer any deposits to commercial banks and not to put them at risk (Christen and Rosenberg, 2000). How the concept of the “window” actually would work is hard to say, since the various alternatives also describe a kind of regulatory niche or tier that could be described as a “window.” What the authors may be suggesting is that creating a regulated MFI tier to supplement the bank and non-bank tiers already in existence will not, per se, create a stable and growing microfinance market. Stated this way, it is difficult to argue with the proposition.

Regulation of Microfinance as a Separate Sector: Who is Regulated?

As regulators and microfinance practitioners struggle to understand the intersection between financial regulation and microfinance, two main questions are continually posed: Which institutions should be regulated? How should the thresholds for more stringent regulation be defined? It is widely agreed that informal small-scale organizations, such as ROSCAs, are best left out of any system of registration and regulation, so as to avoid stifling financial innovation at the lowest levels. Many commentators take a further step, suggesting that institutions that do not take savings do not warrant regulation. However, many countries do regulate credit-only institutions, and indeed the need for transparency, market stability and control of unfair practices suggests that some regulation may be needed.

A more nuanced argument is that *prudential* regulation should be applied only to deposit-taking institutions, since they are the only ones that intermediate deposits from the general public. Credit-only institutions, in this view, could simply be governed by general legal and regulatory norms applicable to firms and lenders – and these would be “supervised” if at all, by their owners, investors and creditors.³ Prudential supervision signals to third parties that the government essentially stands behind or takes responsibility for the soundness of approved institutions. In addition, regulation and supervision are scarce, expensive public goods, and they often create opportunities for

³ Alternatively, as in South Africa, these credit institutions could be overseen by a non-prudential regulator charged with policing operations in the microfinance market to deter fraud, predatory lending, and other irregular practices (Meagher and Wilkinson, 2001).

corruption (Christen and Rosenberg, 2000). Regulation and supervision need to be targeted in such a way that their benefits, in terms of depositor protection and the safety of the financial system, generally outweigh the costs and risks involved. This inevitably means that only certain classes of institutions receive full regulatory scrutiny, while others face less stringent control, and some will not be regulated at all (Christen et al, 2003; World Bank Institute, 2004).

Both for purposes of permitting innovation and of conserving regulatory resources, it makes sense to apply no more than minimal requirements to MFIs that do not have significant deposit balances from their members and do not accept deposits from non-members. The minimal requirements could include registering with the central bank and sending regular reports, complying with non-financial regulations such as securities laws, and adhering to rules of transparency and consumer protection in dealing with borrowers. Reporting rules and perhaps regulatory oversight could be intensified for those credit-only institutions that have grown large in terms of membership, loan balance and market share.

Receiving deposits or quasi-deposits from members or investors usually triggers more careful regulatory treatment. Full prudential regulation and supervision, including regular reporting and examinations, is applied in the majority of well-functioning financial systems only to institutions taking retail deposits from the public – in some cases, only to those taking *demand* deposits. Again, the liability and capital structure determines whether prudential regulation and supervision apply, although other factors such as size may define the strictness of non-prudential rules.

Regulation of Microfinance as a Separate Sector: Who Regulates?

Closely related to the definition of regulated institutions is the designation of the regulatory and supervisory agencies. Typically, these functions are handled separately, whether by different arms of the central bank, or by a ministry of finance and a bank supervision department. For institutions that do not fit the category of full prudential regulation and supervision, alternatives include a hybrid combination of non-governmental agencies supervising MFIs according to official regulations, a non-governmental entity serving independently as both regulator and supervisor, and “self-regulation” by an association of MFIs. It is widely recognized that central banks have neither the training nor the resources to supervise the entire MFI sector. Assuming appropriate capacity development in banking supervision departments, one might envision a division of labor in which central bank supervisors retain ultimate responsibility for the entire sector but only directly supervise apex institutions and the largest MFIs accepting public deposits.

Below this level, several approaches are possible, from benign neglect to delegation of supervisory powers to a private institution, such as an apex institution or a microfinance industry association. Self-supervision by associations is widely agreed to have failed due

to problems of self-dealing and regulatory capture (Christen and Rosenberg, 2000).⁴ The market incentives of creditors have a somewhat better track record, although this depends on the source of creditor funds, with donor-funded institutions being less effective in this regard. MFIs borrowing from apexes, commercial banks, or other formal entities for on-lending to their clientele are subject to creditor monitoring. Central bankers sometimes either leave this segment to be governed by market incentives, or require these large-scale creditors to report on their MFI debtors, perhaps in return for a share of regulation fees or some other incentive.

Supervision of MFIs by an apex organization is often viewed as a valuable adjunct or substitute for direct supervision by financial regulators. However, the research on this suggests that apexes are a less than perfect solution (Gonzalez-Vega, 1998). Apexes are most effective in well-developed microfinance markets where, in any case, there is a plethora of profit-making competitors that make apexes redundant. Apexes in theory have informational advantages over commercial wholesale lenders who might be reluctant to lend to relatively unknown MFIs. However, apexes have conflicting incentives. There is a potential conflict between the apex's lender and supervisor roles (Christen and Rosenberg, 2000). Especially in cases of default by one of its debtors, the apex is likely to pursue its interests as a creditor to the detriment of other interests (e.g. those of depositors), which might be better protected by a pure regulator. Limiting apex supervision to non-depository institutions would alleviate, but not eliminate, this conflict.

There is at least as big a conflict between apexes' commercial and promotional roles. Apexes are often expected not only to mediate funds, but to develop and promote the microfinance market, which usually involves moving large amounts of concessionary donor funds through their microfinance network, as well as providing training and other capacity building support. As a result, apexes face difficulty focusing on the financial bottom line to the same extent as commercial lenders, since they will also be judged on their promotional and developmental results. This creates a moral hazard problem, where their attempts to impose strict monitoring and especially to enforce loan agreements with MFI borrowers are not credible – and default does not bring harsh consequences. This means that apexes are frequently not effective creditor-supervisors of MFIs. A further result of this lack of bottom-line focus is that apex-based microfinance development may not be sustainable, since it is developing the ability to attract and repay commercial finance sources that most clearly enables MFIs to become self-sustaining (Gonzalez-Vega, 1998).

Regulators' Perception of Microfinance Regulation

It has become clear that regulators in a variety of situations are turning to reforms of the financial sector, as they face Basle II, growing and changing markets, and the

⁴ Self-dealing refers to the regulator or the bank director engaging in behavior constituting a conflict of interest, such as granting favors or preferred status to related parties, sometimes in return for bribes or other benefits; regulatory capture occurs when the regulator comes under undue influence from the regulated industry (for example, when companies contribute funds to political parties in exchange for beneficial changes to the regulatory framework).

development of a wider range of financial services for the poor – across institutions, no longer found solely in the NGO-MFIs. Several countries have begun to document their experiences, while others have promoted strategies to reform the financial system in a way that transparently incorporates the microfinance sector in that vision.

Mudenda (2002), the head of non-bank supervision at the Bank of Zambia under whose responsibility microfinance supervision falls, makes the case that the lack of regulations results in ‘a risky, rapidly growing, ungoverned sector with significant gaps in accountability, transparency, stability and efficiency.’ She makes an ambiguous case for the supervision of credit-only microfinance institutions. Draft regulations published by her department follow this idea through, imposing tight licensing and supervisory requirements on all MFIs (Bank of Zambia, 2004). It is not surprising that central bankers, at times, are tempted to see microfinance regulation as a vehicle for the expansion of their power. In fact, this observation is compatible with the findings of Barth, Caprio and Levine (2001). However, this is not necessarily representative of financial regulators. In some countries, such as South Africa, central bankers want nothing to do with microfinance, while most regulators’ approach is somewhere between those extremes.

Some central banks have been actively engaged in thinking about their role in the promotion of expanding financial services to the poor. Bank Indonesia (2004), recovering from the late 1990’s financial crisis, has put forth a plan to revamp the Indonesian banking system that incorporates lower-end financial services throughout. Rural banks, retail lenders and banks with limited scopes, which generally serve the “microfinance market” in Indonesia form the foundation of this system. In implementation, Bank Indonesia will focus on increasing the competitiveness of rural banks and will develop a risk-based supervision system across its entire financial system, including those offering microfinance products.

Since 2002, the Bank of Ghana (BOG) has engaged in a Rural Financial Services Project (with World Bank, IFAD, and AfDB funding) whose aim is to strengthen the capacity of Ghana’s Rural and Community Banks, promote linkages between these banks and more informal providers of financial services and strengthen central bank oversight of this sector. The largest component is the creation of an Apex Rural Bank to provide financing and technical assistance to the system of rural banks. More information is at <http://www.bog.gov.gh/rpapers/rfdoc.htm>. The research director at the BOG has also advanced some thoughts about the use of universal banking as a reform strategy to promote development financing and increase enterprise growth (Addison, no date)

Bank of Mongolia has similarly put rural and micro finance explicitly into its long-term strategy for financial sector development. In its “Policy Reform Actions to Facilitate Implementation of the Government’s Medium-Term Strategy for the Development of the Financial Sector,” it lays out the need for de-coupling payment system mechanisms from banking in the short-term as agricultural and rural financial institutions go through a reform and strengthening process (see <http://www.mongolbank.mn/policy.htm>).

Pakistan's State Bank has gone so far as to organize an International Conference on Microfinance, jointly held with the Pakistan Poverty Alleviation Fund and Pakistan Microfinance Network in December 2004. They will promote discussion on microfinance legal and regulatory choices made throughout the Asian region, including the legal structure set up by Pakistan. Furthermore, widening the client base of Pakistan's financial sector is one of the top ten priorities in the State Bank of Pakistan's five-year reform strategy (Hussain, 2004).

The Filipino central bank has assigned special priority to deepening the financial sector to poor micro entrepreneurs. Quarterly status reports on the financial sector include updates on the building of a suitable regulatory environment for microfinance, including guidance for all financial institutions on how to account for risk and potential loss of micro-loans. It also credits this focus on microfinance with strengthening many of the smaller banks in the Philippines. (See its website at <http://www.bsp.gov.ph>)

The Bank of Uganda's Working Paper Series focuses almost entirely on microfinance and the role of micro and small enterprises in promoting economic development (see its website at <http://www.bou.or.ug/WorkingPapers.htm>; Nannyonjo and Nsubuga, 2004)

Bangladesh Bank has formed a special committee to discuss microfinance regulation for the numerous un-regulated providers of microfinance in the country. It is unclear whether this unit will reach an agreement with all the country's stakeholders in the near-term (see its website at <http://www.bangladesh-bank.org/>).

In Thailand, a bank restructuring plan has been laid out for the period 2004-2007 that would re-arrange all institutions into two separate windows. Windows would exist for commercial banks – which conduct a range of financial services and have higher capital requirements – and retail banks – which serve retail and SME customers only and have smaller capital requirements. Other non-bank financial institutions (NBFIs), such as finance companies, must then transform into one of the two types of banks (Bank of Thailand, 2004).

The above examples highlight the ways certain central banks have begun thinking about the topic. First, the top priority for financial regulation is to protect the system's safety and soundness, especially as it affects the payments system and depositors. Thus, defining tiers in the system primarily with respect to the types of liabilities they hold can make sense depending on the market environment. In addition, there can be a need for further categorization based on size measures, which can be used as thresholds for registration and some regulatory requirements. Finally, linking size and liabilities with permissible activities seems sensible, with large-scale or more sophisticated financial services limited to those institutions capable, in terms of size and resources, of providing them responsibly.

The second criterion to keep in mind is the feasibility of administering and implementing such a structure. A poorly designed structure, such as a proliferation of tiers aimed at promoting growth in various existing niches, could easily invoke the exact opposite

reaction from what was intended: a stifled and repressed financial system with little outreach of the poor.. While the regulatory regime should be designed to facilitate responsible growth, this must inevitably involve competition, consolidation, the failure of some institutions, and the disappearance of some market niche providers. The structure needs to balance such considerations as innovation, learning, competition, scale, and stability.

Regulate Microfinance as an Integral Component of the Financial Sector?

Jansson (1998) convincingly makes the point that the extension of stock banking law in Latin America was not an advisable strategy. Contrary to what many practitioners assume, this point does not prove that banking law has to be detrimental to microfinance. Rather, inflexible and restrictive banking regulations can damage microfinance. In fact, since recent developments in banking supervision are not yet implemented in developing countries, the focus on microfinance could be a catalyst for more general reform and capacity building in financial regulation. If policy makers approach the regulation of microfinance separately from financial sector reform, this opportunity will be lost.

Vogel et al (2000) illustrates how the utilization of risk-based supervision in financial regulation is the best route for fully integrating microfinance into the regulatory and supervisor environments. They believe that ‘bank examiners are not, and should not be, auditors,’ calling instead for judgment of risk factors instead of mere compliance verification. No consideration is given to the capacity of developing country regulators who, in the majority, operate as enhanced auditors. They conclude that modern, risk-based supervision is perfectly capable of accommodating microfinance in the mainstream and that ‘attempts to define different standards for microfinance’ are a ‘mistake because it will lead to endless proliferation of different standards and different supervision techniques for each market niche.’

To effectively regulate microfinance as a separate sector, an operational definition must be found that ensures that all microfinance organizations are legally covered, and that no other financial institutions operate under a microfinance ‘window’ or exemption, while only adhering to the microfinance mission by letter, not practice. Furthermore, it is not obvious why MFIs may not fit into existing, generic license categories in many countries. For example, in Indonesia, institutions that serve the low-income population have largely chosen from among existing financial institutional types: BRI is a commercial bank, and there are hundreds of rural banks and village credit institutions. These institutions may serve any market segment and “microfinance” is not a legally defined term that sets any of these institutions apart in their licensing.

Whether the advent of risk-based supervision will hail the demise of tiered regulatory structures that place microfinance in niche ‘windows’ will also depend to a significant degree on the capacity central banks have to incorporate the demanding Basel II requirements and to fully integrate microfinance into that system.

Basel II requirements no longer focus on meeting ratio requirements, but instead on understanding how financial institutions estimate and mitigate risk. This requires frequent and transparent dialogue between financial institutions and regulators, and the staff of the central banks must be well versed in the types of activities each financial institution engages in to effectively analyze risk management skills. It poses a significant challenge to developing countries. World Bank researchers have been working to develop steps or stages, the middle ground in the transition to Basel II that is attainable for poorer countries with less capacity in their central banks (Powell, 2004). Even if regulators can build the capacity within their own staffs to effectively implement this system, the political discipline required when things go awry is generally missing in many developing countries (Chami et al, 2003).

Existing Tools to Assess Regulatory Environments for Microfinance

In 2001, Tim Lyman produced a diagnostic kit for assessing the regulatory environments in Central and Eastern Europe and Central Asia. The target audience of this piece is the practitioner community, particularly those that may be starting a new organization or looking to transform into a new type of institution. The toolkit is broken into the types of law to be analyzed, including those governing MFI legal forms: NGOs, associations, foundations and other non-profits, other types of commercial companies, cooperatives or credit unions and any other specialized financial institution. Banking regulation is treated as a separate category. Non-financial regulation, such as collateral and tax law, are also treated in the toolkit, and emphasized as larger potential obstacles in the region. The toolkit does not address the implementation or enforcement of the legal structure or the capacity of the regulator to do either of these things; nor does it offer a system for identifying areas for reform.

CGAP (Christen, et al, 2003) has produced guidelines targeted at donors on regulation and supervision that have been incorporated into a World Bank Institute training kit dubbed “Microfinance Regulation and Supervision: Framework and Guiding Principles.” Each of these provide CGAP’s approved approach to regulating and supervising microfinance, of which two main themes are: do not prudentially regulate institutions unless they provide savings (non-prudential regulation is fine); do not create a regulatory environment for microfinance unless a substantial market of healthy MFIs already exists.

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