EGYPT MICROENTERPRISE FINANCE

REGULATING EGYPTIAN MFIS: THE SRO OPTION

A COMPARATIVE STUDY OF SELF REGULATORY ORGANIZATIONS

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ACRONYMS

AMFITIL	Association of Microfinance Institutions in Timor-Leste
ASBA	Assiut Businessman's Association
BOD	Board of Directors
CEO	Chief Executive Officer
CGAP	The Consultative Group to Assist the Poor
CIPF	Canadian Investor Protection Fund
CNBV	Comision Nacional Bancaria y de Valores
EMF	Egypt Microenterprise Finance
EMFN	Egyptian Microfinance Network
FEPCMAC	Federacíon Peruana de Cajas Municipales de Ahorro y Crédito
FOCMAC	The Peruvian Fund
FINE	Federación Integradora Nacional de Entitades
IDA	Investment Dealers Association
MFI	Microfinance Institution
MFRC	Microfinance Regulatory Council
NCR	National Credit Regulator
NGO	Non-Government Organization
NLR	National Loans Register
NCR	National Credit Regulator
NSBA	North Sinai Businessman's Association
SRO	Self Regulatory Organization
USAID	United States Agency for International Development
WOCCU	World Council of Credit Unions

EXECUTIVE SUMMARY

In 2005 a group of donors, including USAID, funded the development of *The National Strategy for MicroFinance*, a participatory project that looked to build consensus among Egypt's decentralized microfinance stakeholders, and set a national agenda for future initiatives. *The National Strategy* made several recommendations for the Egyptian industry, one being "the establishment of an independent member driven and supported self regulatory organization (SRO)" to bring microfinance institutions up to a minimum level of performance.

Considering EMF's high regard for both *The National Strategy*'s collaborative process, as well as its findings, this study intends to provide counsel to EMF management and other industry stakeholders on the project's potential involvement in the development of an Egyptian SRO.

This study reviewed the cases of the Investment Dealers Association (IDA) in Canada, the Microfinance Regulatory Council (MFRC) in South Africa, auxiliary federations in Mexico, the Federación Peruana de Cajas Municipales de Ahorro y Crédito (FEPCMAC) in Peru, and the Association of Microfinance Institutions in Timor-Leste (AMFITIL) in East Timor to learn from their practices and experiences. In addition to surveying these cases, this study explored challenges common to SROs around the world through interviews with senior regulatory specialists at CGAP and the World Council of Credit Unions, and looked at the challenges unique to Egypt through the author's own experiences.

While *The National Strategy* is commendable in its goal of raising the minimum level of performance of the country's MFIs, recent findings, including the *Microfinance Consensus Guidelines* on regulation and supervision, published by CGAP in 2003 suggest the creation of an SRO in a country such as Egypt may not be the most effective tool for reaching this goal, at least for the foreseeable future.

Challenges

Given the following recurring challenges, self regulation is inherently difficult:

- Having a watchdog that is controlled by the parties being watched is aconflict of interest and the benefits of participation do not outweigh the threat of sanctions;
- Developing countries are especially susceptible to allowing business interests to trump the noble principles of systematic and impartial supervision;
- The lure of collecting fees for regulatory and supervisory service can skew enforcement decisions;
- Large or influential MFIs can dominate SROs and undermine objective supervision, and the SROs may be unwilling to embarrass or sanction members;
- Supervision is very burdensome given the high transaction costs of overseeing many small institutions.

The Egyptian context also presents the following unique challenges:

- The EMFN is newly established and still in the early stages of development;

- Due to its infancy, the EMFN lacks the necessary credibility with the government, potential members, and the public, to be perceived as a strong regulatory body;
- Until the EMFN is highly valued by its members, the threat of SRO sanctions will not deter members from noncompliance;
- A member-driven regulatory body will have a difficult time both convincing Egypt's small and medium sized MFIs that it will sanction noncompliant large and influential MFIs, as well as actually carrying out such unpopular measures;
- The country lacks a critical mass of profitable MFIs, a historical prerequisite for successful self-regulation.

Recommendations

1.) Considering the case studies, the common and Egyptian challenges, and the CGAP "consensus guideline" that "self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations,"[1] EMF would make best use of its resources by exploring regulatory alternatives to developing an SRO.

2.) EMF should promote transparency and consumer protection, values espoused by SROs, directly to senior management of participant institutions through the use of commercially oriented messages such as:

- In a competitive market customers will take their business to the most credible, pro-consumer institution;
- Transparency is a necessary step for attracting external investment, and thus serves the institution's self-interest.

In addition, EMF should foster further competition in the industry by encouraging formally regulated commercial banks to downscale into microfinance operations, putting positive pressure on existing NGO-MFIs to self-regulate in the absence of an actual SRO.

Furthermore, EMF might tap socially driven partner institutions' commitment to community development by identifying opportunities for them to demonstrate their mission statements by duly protecting their clients.

3.) EMF should improve the enabling environment for microfinance in Egypt by advocating for changes in current regulatory barriers and by supporting the EMFN in its formative months, rather than developing a new regulatory framework/body.

4.) If the EMFN is interested in protecting consumers, it might do so through a short-term, well-defined consumer education campaign.

5.) In the absence of top-down regulation, it is consumers who can deliver the greatest consequence to ill-performing institutions by taking their business elsewhere. The EMFN might encourage responsible behavior among institutions by investing in strategic grassroots efforts to educate clients on what to demand from MFIs.

[1] Christen, R., Lyman, T., and Rosenberg, R. "Microfinance Consensus Guidelines: Guiding principles on regulation and supervision of microfinance institutions," CGAP, July 2003.

6.) If, despite this study's findings, the EMFN is still interested in developing an SRO, the following conditions should be in place before moving forward[2]:

- The EMFN should be financially sustainable prior to regulating/supervising;
- The EMFN should develop its technical capacity and human resources prior to rolling out an SRO, given the burden of supervision;
- The EMFN should have delegated authority from the GOE to enforce regulations;
- The EMFN should have legal financial liability if one of its supervisees fails;
- The EMFN should widely publicize the strength of the supervision to create public visibility.

[2] Branch, Brian. Email interview. March, 2007.

INTRODUCTION

With the Egyptian microfinance industry on the brink of significant growth, leaning towards more sophisticated products, seeing the rise of a national network, and increasingly in the public eye, it is both timely and appropriate that USAID and the Egypt Microenterprise Finance activity consider options for regulating the country's 200 plus non-governmental microfinance institutions (MFIs).

Purpose of Regulating Microfinance Institutions

Financial regulation, or the development of principles, rules, standards, and compliance procedures, along with the accompanying supervision, or enforcement, can serve many purposes, including encouraging competition and efficiency, protecting the integrity of a payments system, and protecting clients[3]. Many industry players often express an interest in promoting regulation for a variety of reasons. These voices range from MFIs who see regulation as a step in promoting their credibility and improving their operations, to donors who see regulation as a mechanism for speeding up the industry's sustainability, to governments who see regulation as a tool for protecting borrowers and depositors.[4]

Microfinance institutions can be subject to prudential regulation, non-prudential regulation, or no regulation at all depending on the environment they operate in and the services they offer. The most obvious determinant is often whether or not institutions accept savings deposits, as doing so requires prudential regulation. The following section describes the differences between prudential and non-prudential regulation, and explains what an SRO is.

Prudential Regulation

Prudential regulation involves the government overseeing the financial soundness of an individual institution, and is used to prevent unsafe institutions from risking depositors' money, and damaging public confidence in the overall financial system. Prudential regulation involves monitoring and protecting the core health of an institution, and given this depth, can be relatively difficult, intrusive, and expensive to implement.[5]

The commercial banking industry is a useful example of effective prudential regulation in action. In this model, governments create and enforce laws that banks must abide by to remain in business. The laws seek to protect depositors' money, and prevent industry-wide crises in cases of individual bank liquidation.

Prudential regulation is not necessarily the most appropriate option for the microfinance industry. The Consultative Group to Assist the Poor (CGAP) stresses the principle that countries should avoiding turning to prudential regulation for

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[3] Ledgerwood, Joanna. Microfinance Handbook: An Institutional and Financial Perspective. Washington, D.C., The World Bank: 1999.
[4] "The Rush to Regulate: Legal Frameworks for Microfinance," CGAP Occasional Paper No. 4, Washington, D.C., 2000.
[5] Christen, R., Lyman, T., and Rosenberg, R. "Microfinance Consensus Guidelines: Guiding principles on regulation and supervision of microfinance institutions," CGAP, July 2003.

purposes other than protecting depositors' safety and the soundness of the financial sector as a whole, given the onerous task of supervision. In addition, international experience has shown that the onset of prudential regulation can have unintended negative effects on the industry. For instance, it can lead to the enforcement of non-cost-recovery interest rate caps, limited innovation and competition among MFIs, and the growth of unsafe deposit-accepting institutions if supervision is weak or stretched too thinly.[6]

Non-Prudential Regulation

Non-prudential regulation seeks to govern institutions' business operations, and is not concerned with protecting the credibility of the financial system as a whole. In the case of microfinance, business operations can include the formation and operation of microlending institutions, consumer protection, fraud and financial crimes prevention, credit information services, reporting and disclosure standards, interest rate polices, and sources of capital. Non-prudential regulation tends to be easier to administer than prudential regulation since it does not involve government authorities taking responsibility for the financial soundness of the organization.[7]

Self Regulatory Organizations

Self-Regulatory Organizations, the topic of this paper, are one mechanism for implementing non-prudential regulation. SROs are voluntary, member-driven bodies that set their own operating standards, and have varying degrees of supervisory authority. SROs are frequently relied upon in the securities industry because of the substantial need for consumer protection. Examples of securities SROs are the National Association of Securities Dealers (NASD) and national stock exchanges such as the NYSE in the United States, or the Investment Dealers Association (IDA) in Canada. The American Arbitration Association (AAA), and American Medical Association (AMA) are examples of effective SROs in other industries that set performance standards, protect member interests, and seek to strengthen their respective fields.

The Egyptian Context

Egypt is home to approximately 200 NGO-MFIs, and 3 commercial banks that extend microfinance services (The National Bank for Development, Banque du Caire, and Bank Misr) to the working poor. For the sake of simplicity, this paper will refer to non-bank NGO-MFIs as simply MFIs, given their predominance in the Egyptian microfinance industry. EMF's partner MFIs represent a telling cross-section of industry, given their diversity in volume, maturity, and profitability. They range in size from the North Sinai Businessman's Association (NSBA) a young institution with just under 3,000 clients, to the Assiut Businessman's Association (ASBA), which boasts more than 160,000 active clients. Due in part to the long-term abundance of donor funds in Egypt, however, the country lacks a "critical mass" of profitable institutions.

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[6] Regulation and Supervision of Microfinance presentation, CGAP Direct, June 2003.
[7] The Microfinance Gateway: Basics of Regulation (http://microfinancegateway.org/resource_centers/reg_sup/basics#2), March, 2007.

MFIs are currently unregulated in Egypt. Although a growing number of institutions are joining the rising Egyptian Microfinance Network, microfinance operations remain highly decentralized, and with most institutions independently operating in geographic or informational silos.

In 2005 a group of donors, including USAID, funded the development of *The National Strategy for MicroFinance*, a participatory project that looked to build consensus among decentralized microfinance stakeholders, and set a national agenda for the development of the microfinance industry, including providing recommendations for sector-wide initiatives. One recommendation to come from *The National Strategy*, under the proposed Macro Level plan, is “the establishment of an independent member driven and supported self-regulatory organization (SRO) to enhance the development of the sector by implementing a set of non-prudential regulations and ensuring MFIs’ self-enforcement for compliance with the specified performance standards.” The report underlines that a key determinant in an SRO’s sustainability would be recognition by various donor agencies (i.e. including reporting to the SRO as part of the funding criteria for MFIs) to provide the organization with more legitimacy among MFIs, and to encourage membership.

STUDY OBJECTIVE

Given EMF's high regard for both *The National Strategy*'s collaborative process, as well as its findings, this study intends to provide counsel to EMF management and industry stakeholders on the project's involvement in the development of the proposed self-regulatory organization.

The objective of study is to examine international models of SROs, and discuss the prevailing structures and functioning mechanisms. From these findings, this study will make recommendations on the most applicable form of SRO, if any, to the Egyptian context.

Lastly, this study will educate EMF management and industry stakeholders about lessons learned in self regulation experiences from around the world.

STUDY METHODOLOGY

The methodology used to conduct this study included a thorough literature review thanks in large part to the valuable resources posted on CGAP's website and The Microfinance Gateway, and interviews with internationally recognized microfinance regulation specialists from CGAP and the World Council of Credit Unions.

This study explores the case of the former Microfinance Regulatory Council (MFRC) in South Africa as an example of an SRO exercising clearly delegated authority. The Mexican auxiliary SRO federations case is included because of the similarities between the Mexican and Egyptian microfinance industries: both large countries have a major spread in the size and scope of MFIs in operation, a potential challenge to effective self-regulation. The Peruvian federation FEPCMAC is included to underscore the heavy burden of proper supervision, and the Association of MFIs in East Timor is included because it shares similar status, objectives and organizational makeup with the EMFN, a potential umbrella organization to an Egyptian SRO.

Due to the limited number of examples of well-functioning microfinance SROs in the world, this study also presents the example of the Canadian Investment Dealers Association as a way to showcase the potentially replicable elements of a strong SRO.

Findings from the comparative study are found in Section I, first presented in a table which summarizes the all of the SROs under review, followed by individual case study narratives which expand on the points listed in the table.

Section II provides analysis of the finding from the comparative study.

Section III is an overview of challenges faced by SROs, based on international lessons learned, and also discusses challenges presented specifically by the Egyptian context.

Section IV makes recommendations to EMF management on next steps, as well as general recommendations for the budding EMFN.

SECTION I
Comparative Study

The table below summarizes the comparative study of various SROs. In addition to presenting SROs operating in the microfinance industry, the Investment Dealers Association of Canada (IDA) is included given its wide recognition as well-functioning SRO.

	Structure	Affiliation	Function	Sustainability	Success Factors
Microfinance Regulatory Council (MFRC) ***South Africa***	• BOD oversees CEO, made up of consumer and lender reps, • CEO oversees 5 departments: (Invest./Prosctn, Edu/Comm, Complnts/Enforcmt, Fin/HR, Accreditation/Compliance)	• Recognized by government • Created National Loans Register	• Regulates lenders exempt from interest rate cap supervision • Protects micro-borrowers • Sets MF standards	Established in 1999, the MFRC was in existence for 7 years prior to being absorbed by the NCR.	• Hybrid model of delegated responsibility • Education and Communication department to educate public
Auxiliary Federations ***Mexico***	• General Assembly supervises federation structure • Federations staffed by reps from member MFIs • Federations have special supervision committees	• Recognized by CNBV (Mexican banking authority)	• Create additional distinct regulations • Supervise member institutions • Administration and technical assistance	Although the shift to federations is hard to assess given its newness, many challenges suggest this model may need to be adjusted to be sustainable	• Relieved cost/human resource burden from overextended CNBV
Federation (FEPCMAC) ***Peru***	• Reports to finance ministry • Houses consulting, auditing, training, public awareness, and finance departments	• Recognized by bank superintendency • Peruvian Fund • Consulting services	• Some supervision for bank authority • Technical assistance • Channel donor funds	In 90s lack of internal controls lead to fraud, and superintendency revoked many delegated powers	• Relieved cost/human resource burden from superintendency
Association of MFIs in Timor-Leste (AMFITIL) ***East Timor***	• President elected by members • Secretariat functions rotating on a voluntary basis • Currently no BOD, nor permanent staff	• Registered as a local NGO	• Create regulation to improve industry performance • Raise coordination, info sharing, and visibility of MFIs	Although just 3 yrs old, the lack of perman't staff, delegated authority, a BOD, and a biz plan hint that this model may need to adjust to be sustainable	• Developed a strong Code of Conduct to regulate members, though supervision of Code remains uncertain
Investment Dealers Association (IDA) ***Canada***	• BOD oversees CEO, district council, and committees • CEO oversees 3 departments: (Member Regulation, Corporate/Members Services, and Public Affairs)	• Recognized by provincial securities regulators • Sponsors investor protection fund with 4 other SROs	• Monitors members capital adequacy and business conduct • Represents members' views in policymaking	Established in 1916, as a formal association to improve the savings and investment process, the IDA is still running well 90 years later.	• Delegated responsibility by provincial governments • Demand from investors for protection • Robust enforcement unit • Decentralized and diverse

THE MICROFINANCE REGULATORY COUNCIL (MFRC)
South Africa

The MFRC was developed to supervise micro-lending institutions exempt from South Africa's interest rate regulation, to protect borrowers, and to set standards for the country's growing microfinance industry. In June, 2006, the MFRC was absorbed by the National Credit Regulator (NCR), a body responsible for regulating the South African credit industry as a whole. The information presented below describes the MFRC prior to being subsumed by the NCR.

Structure

The MFRC is headed by a board of directors which oversees the CEO. The board is comprised of eight general members with financial and banking backgrounds, as well as four consumer representatives, and four lender representatives. The CEO oversees five technical departments: Investigation and Prosecutions, Education and Communication, Complaints and Enforcement, Finance and Human Resources, and Accreditation and Compliance.[8]

Affiliation

The MFRC, which is delegated regulatory and supervisory authority from the Department of Trade and Industry, created and supports the National Loans Register (NLR), a private credit information system mandatory for all MFRC users.

Function

The primary function of the MFRC is to fill the regulatory gap created by South Africa's Usury Act Exemption Notice, which excuses microlenders from interest rate ceilings and standard financial supervision. In this role, the Council brings structure to what was initially perceived as an unruly and dangerous industry. The council is additionally charged with protecting borrowers, setting standards and educating microfinance stakeholders. In addition, the MFRC developed the aforementioned NLR.

Sustainability/Success Factors

The MFRC was in existence for seven years before being absorbed into the National Credit Regulator as part of a wider set of financial reforms. While active, the Council is credited with making micro-lending institutions more responsible, encouraging banks to enter the industry through reducing the risk to their reputation, and broadly disseminating information to industry stakeholders and the general public.

As an organization with delegated powers, the MFRC is neither purely voluntary nor a government entity. This hybrid status has been both a factor for success and for frustration. It has been helpful in keeping political pressures at bay and building public confidence in the industry through member participation. At the same time, the possible lack of clear communication of the Council's role to the public has

[8] www.mfrc.co.za, March 2007.

subjected it to criticism from microfinance industry stakeholders who find it overly intrusive, and consumer representatives who find it "too lenient with the industry on rates, disclosure, and over-indebtedness." [9]

The existence and work of the MFRC's Education and Communication department was a key factor in building consumer and industry understanding about microfinance issues. In 2003, for example, this department conducted nearly 150 external presentations and workshops, educating employers, NGOs, trade unions, and the government about microfinance regulation.

AUXILARY FEDERATIONS

Mexico

As part of a long line of institutional failures, when a large savings and loan association, supervised by a too thinly stretched national financial regulator, crashed affecting 40,000 clients, the Mexican government undertook legislative reform to more effectively supervise MFIs. The result was the creation of the Ley de Ahorro y Crédito Popular (Savings and Popular Credit Law) which delegates regulatory and supervisory authority to more than ten auxiliary federations. The federations are self-regulatory organizations, and report back to the national banking authority.[10]

Given the common regulatory role of Mexican federations, it makes sense to group them together for the purpose of this study. Examples of federations include Federación Centro Sur, Federación Integradora Nacional de Entitades (FINE), Federactión Noreste, Federación UNISAP, and Federación Victoria Popular[11].

Structure

The federation structure is supervised by an overarching General Assembly, comprised of its member institutions. Individual federations, such as FINE in Queretaro, have administrative and regulatory staff, as well as a special Supervision Committee. Federation staff come from member institutions, though supervisors cannot have worked in a cooperative nor in any of its affiliates in the last three years.[12]

The federations compete with each other for member institutions, and anecdotal evidence suggests that small MFIs have been able to play one large cooperative's SRO off against that of another large cooperative to negotiate the best deal for membership, supervision, etc.

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[9] Meager, Patrick. "Microfinance Regulation and Supervision in South Africa," The IRIS Center, April, 2005.
[10] "Microfinance Regulation in Seven Countries: A Comparative Study," The IRIS Center, for Sa-Dhan, May, 2006
[11] Gaboury Anne, Quirion Marisol. "Why we can no longer afford to ignore financial cooperatives in the effort to increase access to financial services," Développement international Desjardins.
[12] Loubière, Jacques Trigo; Devaney, Patricia Lee; Rhyne, Elisabeth. "Supervising & Regulating Microfinance in the Context of Financial Sector Liberalization: Lessons from Bolivia, Columbia and Mexico," August, 2004.

Affiliation

As auxiliary institutions with delegated power, Mexican federations report to the *Comision Nacional Bancaria y de Valores* (CNBV), the national banking authority previously responsible for directly regulating and supervising savings and loan associations. The CNBV takes 20% of the fees collected by the federations for supervision services, and is working with the Ministry of Finance to shut down *cajas* (cooperatives) operating independently from the federations, and non-compliant with the Savings and Popular Credit law.

Function

The auxiliary federations are responsible for creating and enforcing additional regulations beyond those dictated by the CNBV and Mexican law, and to staff Supervision Committees.[13] Such committees carry out enforcement of federation regulations through on- and off-site checks. Lastly, the federations are responsible for offering some technical assistance to support to their member institutions with complying with regulation.

Sustainability/Success Factors

Although the shift from the direct supervision of the CNBV to the multiple auxiliary federation system has only been in existence for about two years, several challenges suggest that this model will have to be modified to become sustainable. The existence of multiple competing SROs has created an environment where small cooperatives are able to negotiate preferred arrangements, as mentioned above. Furthermore Mexico has seen large institutions create their own SRO, affording themselves with the ability to self-regulate as convenient, since their smaller member institutions do not carry enough clout to be an effective counterbalance. Lastly, the conflict of interest of having member institutions making up the Supervision Committees presents a challenge for impartial enforcement.

The delegated federation system has however been effective in relieving the national banking authority from the burdensome duty of supervising the approximate 500 institutions offering financial services.

[13] In a 2004 report to the Tinker Foundation, Loubière, Devaney, and Rhyne suggest, “It is advisable to restrict the authority to issue rules, prudential regulations, manuals and supervisory procedures to the CNBV in order to maintain consistency and quality control,” however it is unclear if this recommendation has been carried out.

FEDERACIÓN PERUANA DE CAJAS MUNICIPALES DE AHORRO Y CRÉDITO (FEPCMAC)
Peru

The Federación Peruana de Cajas Municipales de Ahorro y Crédito (FEPCMAC) was founded in 1987 to serve as the national and international representative of the municipal savings and credit bank system, and to promote the creation of new credit and savings institutions. [14] *Although the federation's shortcomings are not well documented, instances of fraud, corruption, and internal struggle caused the superintendency to significantly revoke its powers, including the right to sanction, in the late nineties. The information presented below discusses the federation in its current state.*

Structure

The FEPCMAC reports to the bank superintendency under the Ministry of Finance, and has the following internal departments: consulting, auditing, training, public awareness, technical and financial cooperation, and finance and administration.[15] Members pay dues to the federation to cover some of the costs of supervision (the remainder fulfilled by donor funds). [16]

Affiliation

The FEPCMAC is delegated authority from the bank superintendency. The federation is additionally affiliated with the Peruvian Fund (FOCMAC) and interdisciplinary consulting firms and donors.

Function

The FEPCMAC's mandate is to audit and control the operations of municipal credit and savings banks, however in practice is primarily responsible for the former. In addition to monitoring member activities and submitting this information to the superintendency, the federation supports members with offering training and technical assistance, conducting public awareness and knowledge dissemination activities, and channeling donor funds and consultancy support to member institutions.

Sustainability/Success Factors

In the 1990s the FEPCMAC suffered a significant blow when a lack of internal controls and technical capacity to supervise its member institutions "gave rise to incidences of fraud within the federation."[17] After several staff were released and/or resigned, the Peruvian banking superintendency revoked many delegated powers, leaving the federation with a much smaller role than was originally designed. This withdrawal of delegated powers suggests that the original model of a proxy

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[14] Burnett, J., Cuevas, C., Paxton, J. "Peru: The Cajas Municipales de Ahorro y Crédito," World Bank/Sustainable Banking for the Poor: Washington, DC, 1999.
[15] www.fpcmac.org.pe, March, 2007.
[16] Meagher, Patrick. "Microfinance Regulation in Developing Countries: A comparative review of current practice." IRIS Center at the University of Maryland, October, 2002.
[17] Hannig, Alfred and Katimbo-Mugwanya, Edward. "How to Regulate and Supervise Microfinance: Key Issues in an International Perspective," FSD Series No. 1.

supervisory body was not sustainable. In its current reduced state, FEPCMAC conducts regular audits of members, but lacks the authority to enforce regulation, and must rely on the superintendency for sanctions, and ultimate supervision.[18]

As an umbrella organization, FEPCMAC is well-suited to direct donor funds and technical assistance initiatives.

ASSOCIATION OF MICROFINANCE INSTITUTIONS IN TIMOR-LESTE (AMFITIL)

East Timor

The Association of Microfinance Institutions in Timor-Leste was established in 2003 after the country's official Banking and Payments Authority stressed its disinterest in supervising NGO-MFIs, and its stance that formal prudential regulation of the microfinance sector would be "premature and possibly counterproductive, while overly stretching [its] already limited supervision capacity."[19]

Structure

AMFITIL is headed by a member-elected President who oversees a voluntary and rotating member-based Secretariat. Currently a very informal body, the association lacks a permanently staffed secretariat independent from member firms, a Board of Directors, bylaws, operating procedures, and a business plan. Limited reference materials make it unclear whether the association intends to develop any or all of these elements.

AMFITIL currently has 11 members who are to report performance data to the secretariat on a regular basis, however "capacity constraints" have kept some members from regularly reporting.[20]

Affiliation

AMFITIL is registered as a local NGO, and although the association occasionally works in consultation with the Banking and Payments Authority, it bears no delegated supervisory or enforcement powers. It is unclear if AMFITIL is affiliated with other organizations or associations.

Function

Developed to fill the regulatory void left by the government of East Timor, AMFITIL serves three main functions. It seeks to improve the performance standards of MFIs through the development of a Code of Conduct, and a self-regulatory performance monitoring system; to increase coordination among industry stakeholders; and to build awareness by educating stakeholders, disseminating information with the industry and general public, and raising the visibility of microfinance in a country that remains general in the dark about this form of financial services.

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[18] Staschen, Stefan. "Regulation and Supervision of MFIs: State of Knowledge." August, 1999.
[19] Hansen, Lene and Agus, Novanto. "Financial Services Sector Assessment in Timor-Leste," *Final Report*. January, 2005.
[20] Conroy, John, "Timor-Leste Access to Finance for Investment and Working Capital. Prepared for the World Bank and the Government of Timor-Leste."

Sustainability/Success Factors
It has been challenging for AMFITIL to play a serious and sustainable self-regulatory role, primarily given the association's informal structure, and lack of delegated enforcement authority. Regarding the former, voluntary temporary members cannot realistically be responsible for championing and seeing through SRO initiatives, given competing professional demands on their time, and lack of true accountability for their actions (or inactions). Furthermore the lack of written procedures and a business plan raises questions about the sustainability of the association.

With regards to the lack of delegated enforcement authority, while the members did successfully develop of a commendable Code of Conduct and thus some microfinance regulation, the association lacks the supervisory side of the coin, necessary to enforce such rules. The best code of conduct can be for naught if controls aren't in place to enforce it, considering it is not always in members' self-interest to comply. Without delegated authority, or at least a systematic enforcement department to back up regulation, AMFITIL risks being perceived as a house of cards by both the industry and government alike.

THE INVESTMENT DEALERS ASSOCIATION (IDA)
Canada

The IDA services the Canadian securities industry by regulating investment dealers' capital adequacy and business conduct. Established in 1916, with 200 member firms, it is regarded as a highly effective self-regulatory organization that has withstood the test of time.[21]

Structure

The IDA is headed by a board of directors who oversees IDA's numerous technical and administrative committees (Audit, Capital Markets, Compliance and Legal Sanction, Nominating, Member Regulation Oversight, etc.), the President and CEO, the National Advisory Committee, and the District Councils. The President and CEO supervises the vice presidents of the Regulation, Corporate and Member Services, and Public Affairs departments.

Affiliation

The IDA, which is delegated authority from provincial regulators, partners with four other major securities SROs to form the Canadian Investor Protection Fund (CIPF). This fund protects customers in the event that a member firm goes bankrupt. The CIPF covers separate customer accounts, within certain guidelines, up to $1 million per account.[22]

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[21] www.ida.ca/, March 2007.
[22] www.fin.gc.ca/fin-eng.html, March 2007.

Function

The primary responsibility of the IDA is to educate and protect investors through monitoring its members firms' capital adequacy and business conduct. The organization conducts regular audits to ensure financial and sales compliance, and enforces regulation through measures such as fines, suspensions and expulsion from the association. In addition to member supervision, the IDA represents its members' interests in national policymaking.

Sustainability/Success Factors

Having been in business for more than 90 years, the IDA is clearly a sustainable organization. The association owes its success to several factors. Provincial governments delegate authority to the IDA, giving it clout in the public arena, as well as official backing. In addition, otherwise vulnerable Canadian investors have shown a demand for the IDA's service, by recognizing the IDA "seal," encouraging firms to apply for and maintain membership. The association's regulation is also well-supervised, a key factor in sustainability, by a robust and systematic Enforcement Department. This department is comprised of an Investigation group, consisting of investigators, analysts and complaint inquiries officers and the Enforcement Counsel group, consisting mainly of legal counsel. Together the two parties carry out the disciplinary process.

A final contributing factor to IDA's sustainability is its reliance on a diverse and decentralized network of committees to carry out tasks. By decentralizing responsibility, and staffing teams with people from a variety of different business backgrounds, the association is able to be highly responsive and take a holistic approach to solving problems.

SECTION II
Analysis

In considering the cases of the MFRC, Mexican federations, FEPCMAC, AMFITIL, and the IDA, certain similarities and best practices emerge in the categories under review by this report.

Structure

It is most common for SROs to be lead by a president or executive director who reports to a board of directors, and who supervises technical departments. Typical technical departments are: 1.) Monitoring and Enforcement, 2.) Public Awareness and Education, 3.) Member Services, and 4.) Finance and Human Resources. Through these departments, SROs are equipped to handle their member institutions with both the carrot and the stick, while meeting internal operational demands and external educational and visibility demands.

Affiliation

SROs tend to be most effective when they are affiliated with official government bodies. The cases of the IDA, MFRC, and to a lesser, extent the Mexican federations, show that when the government delegates authority to SROs they are more effective in regulating and supervising members (assuming that the SRO has the internal capacity to undertake this job).

In addition, given the need for SROs to be "plugged in" to the industry they are representing and regulating, it's beneficial for them to be affiliated with other sector-wide networks, initiatives, and/or events, as demonstrated by the IDA and MFRC. This allows the organization to build public visibility while keeping abreast of industry trends.

Function

The examples of SROs presented in this study generally share common functions of creating and enforcing regulation to improve performance standards, building public awareness about the industry, advocating on behalf of members, and disseminating information among stakeholders. Some SROs, such as FEPCMAC and the Mexican federations also get involved with offering training and technical assistance to members.

SROs additionally serve the function of protecting the end client, as depicted primarily by the IDA and MFRC.

Sustainability/Success Factors

Of the five SROs examined in this study, only Canada's IDA can be considered a sustainable organization, with its 90 year lifespan, provincial backing, and ability to instill confidence in the consumers it protects. Although the remaining four organizations possessed some factors for success such as government-delegated authority and designated enforcement departments, history has shown that it is incredibly difficult for a developing country to create an effective and sustainable microfinance self-regulatory body. An unsuccessful SRO can cause a ripple effect of damages, when not only does it not perform its stated function, but its shortcomings either attract unwanted government attention (in the form of severe regulation) or pollute the industry by “burning” investors and/or customers who will be hesitant to enter back into the industry in the future.

For an SRO to be successful it should have government-delegated authority and a designated supervisory and enforcement department, as mentioned above. It should also be financially sustainable to the point where cashflow from member fees does not distort supervisory decisions, have robust technical capacity and human resources to handle the burden of supervision, and have legal financial liability should one of its supervisees fail.

SECTION III
Challenges

Challenges faced by SROs

International experience has shown that although self regulation of financial institutions occasionally works in well developed countries, as evidenced by the case of the IDA in Canada, it is extremely challenging to implement in developing countries. The reasons are many, the most noticeable being intrinsic to their very design. As Richard Rosenberg writes in *The Rush to Regulate*, “Having a watchdog that is controlled by the parties being watched presents an obvious conflict of interest. The immediate benefit to the participating institutions is not great enough to induce them to hold a rigorous line when problems arise.” Developing countries have proven to be especially susceptible to allowing business interests, financial, political or otherwise, to trump the noble principles of systematic and impartial supervision.

In addition to the major structural challenge presented, SROs are prone to corruption and/or ineffectiveness given the temptation of charging fees for regulatory services. If a network or umbrella organization is not fully financially viable when it undertakes regulation and supervision responsibilities, this new source of cash may pollute or skew enforcement decisions and actions.

SROs are also faced with the challenge of handling the diversity of their member institutions’ size and political ties. Large or influential organizations can dominate the SRO and undermine objective supervision. The SRO may be unwilling to embarrass or sanction the weakest of its members, thereby reducing the standards to the lowest common denominator. Medium institutions may also simply fail to submit information on a timely basis, or ignore supervisory directives, testing the organization’s ultimate capacity (both technical and in terms of resources) to support its staff’s enforcement efforts.[23]

Lastly, developing an SRO is challenging given the high transaction costs of supervising many small institutions. Just as microfinance institutions must manage costs of lending to low volume borrowers, SROs must manage the costs of supervising low volume institutions which are sometimes unable to pay expensive membership fees.

[23] Branch, Brian. Email interview. March, 2007.

Challenges presented by the Egyptian context

In addition to the many common challenges to developing an SRO, the Egyptian context presents several unique difficulties given the current state of the microfinance industry and the budding Egyptian Microfinance Network (EMFN). As an umbrella organization for the microfinance industry the EMFN might be a natural home for the SRO, however given its early state of development it is not yet suitable to undertake such a role.

Since the EMFN is still in its formative stages, the network currently lacks enough credibility with the government, potential member institutions, and the general public to be perceived as a strong regulatory body. Furthermore, as EMFN focuses on basic network activities, it does not yet possess the technical, financial, and human resources to effectively start-up an SRO. Failure of either traditional network initiatives or regulatory initiatives could pollute the reputation and credibility of the other party, should they indeed be linked. The EMFN needs to establish a strong foundation in its original role before considering the demanding act of regulating and supervising the microfinance industry. Lastly, until the network is highly valued by its members, the threat of SRO sanctions to non-compliant MFIs will not be an effective deterrent.

Egypt is also a particularly challenging environment for an SRO to thrive in, given the wide range of microfinance institutions in operation. A member-driven regulatory body will have a difficult time both convincing small and medium sized MFIs that it will sanction noncompliant large and influential MFIs, as well as actually carrying out these unpopular measures.[24]

Lastly, given the long-term reliance on donor funds, Egypt lacks a high number of profitable MFIs. CGAP recommends that microfinance should not be regulated before a critical mass of profitable institutions emerges, because effective microfinance regulation has tended to follow rather than lead the development of a strong industry.[25] Potential member institutions of an SRO need to move towards a more market-driven approach before becoming good partners in such an endeavor.

[24] McAllister, Patrick. "Trust Through Transparency," The SEEP Network, March 2003.
[25] Regulation and Supervision of Microfinance presentation, CGAP Direct, June 2003.

SECTION IV
Recommendations

Recommendations for EMF

EMF and USAID should be commended for exploring the option of developing an Egyptian SRO, given the rationale laid out in the *Egyptian National Strategy for Microfinance*. In light of recent findings however, including CGAP's *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance Institutions* published in July, 2003, EMF is advised not to spearhead efforts to create a self regulatory organization.

1.) Given the cases presented in this study, the challenges presented by the Egyptian context, and the overarching consensus guideline that "self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations,"[26] EMF would make best use of its resources by focusing efforts elsewhere.

2.) In certain circumstances, the spirit behind self-regulation is commendable, with SROs espousing values of transparency and consumer protection.[27] If EMF is interested in promoting these qualities, the activity's MFI Advisors might stress their importance directly to senior management at partner institutions as part of a larger institutional development initiative. These messages will resound best with senior management if presented from a commercial perspective, such as:

- In a competitive market customers will take their business to the most credible, pro-consumer institution;
- Transparency is a necessary step for attracting external investment, and thus serves the institution's self-interest;
- Strong internal control departments reduce the risk of fraud and financial controls, contributing to an institution's reputation in the domestic and international communities.

In addition, EMF should foster further competition in the industry by encouraging formally regulated commercial banks to downscale into microfinance operations, putting positive pressure on existing NGO-MFIs to self-regulate in the absence of an SRO.

Furthermore, MFI Advisors might tap socially-minded partner institutions' commitment to community development through a message such as:

- MFIs best demonstrate their mission statement when they duly protect their consumers.

3.) As EMF seeks to improve the enabling environment for microfinance in Egypt, it would be best served to focus on advocating for changes in current legal and

[26] Christen, R., Lyman, T., and Rosenberg, R. "Microfinance Consensus Guidelines: Guiding principles on regulation and supervision of microfinance institutions," CGAP, July 2003.
[27] Rhyne, E. "Taking Stock of Consumer Protection in Microfinance – a Non-Regulatory Approach," October, 2003.

regulatory barriers, and supporting the national network in its formative months, rather than developing a new regulatory framework and/or body.

Recommendations for the EMFN

Given the national network's natural proximity to discussion about industry regulation and supervision, this study makes some additional recommendations for consideration by the EMFN.

1.) If consumer protection is at the heart of the network's consideration of self regulation, it might achieve this end goal by taking an alternate route. For example, a short-term and well-defined consumer education campaign could arm borrowers (and savers, as relevant) with the questions they should ask to protect themselves prior to signing a contract with an MFI.

2.) In the absence of top-down regulation, it is consumers who deliver the greatest consequence to ill-performing institutions by taking their business elsewhere. By investing in grassroots efforts (potentially in strategic locations) to educate clients on what they should be demanding from financial institutions, the network can encourage responsible behavior among institutions.

3.) If despite the findings presented in this study, the EMFN is still interested in developing an SRO, the following conditions should be in place before moving forward[28]:

- The EMFN should be financially sustainable prior to offering regulatory and supervisory services to prevent new cashflow from distorting SRO decisions and actions;
- The EMFN should develop its technical capacity and human resources prior to rolling out an SRO, given the burden of supervision;
- The EMFN should have delegated authority from the Government of Egypt to enable it to enforce regulations;
- The EMFN should have legal financial liability if one of its supervisees fails;
- The EMFN should widely publicize the strength of the supervision to create public visibility.

[28] Branch, Brian. Email interview. March, 2007.