

# Regulation and Supervision of Microfinance: A Conceptual Framework

*Draft—For Discussion Only*



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## **MICROENTERPRISE BEST PRACTICES**

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# Regulation and Supervision of Microfinance: A Conceptual Framework

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by

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## INTRODUCTION

Interest in the regulation and supervision of microfinance institutions has been driven primarily by the desire of sustainable and growing microfinance institutions that are not currently regulated to mobilize deposits from the general public. Having become sustainable and seeking to expand their outreach, these microfinance institutions are less likely to receive funding from donor agencies in the amount and time needed to meet the desired levels of expansion. One alternative that has been pursued by various microfinance institutions is borrowing from banks. Accion International, for example, has fostered this approach by using guarantees to develop such borrowing relationships between its affiliates and commercial banks. Many others, however, have preferred to investigate the possibility of mobilizing deposits from the general public.<sup>1</sup>

The attraction of deposit mobilization as a source of funding has three main origins: (1) deposit mobilization appears to leave funding decisions in the hands of the microfinance institution; (2) deposits appear to be a cheaper source of funds than bank loans; and (3) there may be economies of scope between lending and deposit mobilization to the extent to which the borrowing and depositing clienteles overlap. In any case, there are a number of sustainable microfinance institutions in a variety of countries looking toward deposit mobilization as the primary source of funds for their growing loan portfolios.

Since virtually every country in the world requires the licensing and regulation of institutions that mobilize deposits from the general public, the issue of regulating and supervising microfinance institutions has become an increasingly important item on the microfinance agenda, especially for the more successful and aggressive institutions. Such origins can be expected to have some undesirable side effects, which can in fact be observed. First, the debate about what is to be done tends to have focused excessively on the characteristics of microfinance institutions, particularly their non-profit origins, to the relative neglect of the risk characteristics of clients and loan products. Second, there has been a natural interest on the part of microfinance institutions that want to mobilize deposits, and some of their supporters in government and donor agencies, in creating a regulatory environment that is more lenient in dealing with microfinance institutions than with other financial intermediaries. Third, in some instances the role of the deposit (bank) regulatory agency has been extended to institutions that do not yet mobilize deposits in order to help them on their way to qualify or to assist them in obtaining funding from other sources. Fourth, some of those who are not so enthusiastic about the new more market-oriented practices of microfinance have used the attention devoted to regulation and supervision as an opportunity to raise issues relative to regulating microlending, especially usury ceilings on interest rates. Finally, the origins of interest in the regulation and supervision of microfinance in the desire of microfinance institutions to mobilize deposits has led to a neglect of the impact of regulation and supervision on banks that might want to undertake microlending as a major activity. Given the size of the typical bank compared to the typical microfinance institution and the fact that most of the largest microlenders are banks (e.g., Grameen, BRI, Bancosol),

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<sup>1</sup> Issuing paper in securities markets, possibly based on the securitization of loan portfolios, is another option, but one that has rarely been pursued.

many knowledgeable observers of microfinance have concluded that major increases in outreach will need to come from banks.

The purpose of this concept paper is to re-visit key issues in the regulation and supervision of microfinance institutions, in view of current trends and developments in Latin America, Africa and Asia. First, the paper discusses the basic principles in financial regulation with emphasis on the need to keep regulatory agencies focused on deposit taking institutions. Second, it discusses current approaches to microfinance regulation and in particular the prevalent emphasis on institutional differences over the special characteristics of microfinance clients and products. Third, it reviews laws and norms and their application by regulatory agencies. Fourth, it discusses and proposes risk-based supervision as a framework that establishes common terminology and approaches for evaluating the management of risk in financial institutions. Finally, the paper outlines the issues to be considered in evaluating the outcome of microfinance regulation and supervision in the country case studies.

## **A Basic Principle**

Because the primary origin of interest in the regulation and supervision of microfinance has been the desire of some unregulated microfinance institutions to mobilize deposits from the general public, debate about the topic has tended to take a partial view, emphasizing certain issues excessively and neglecting others. To orient the subsequent discussion, it is thus important to reiterate the basic principle of regulation and supervision of financial intermediaries together with some principles that come from financial economics in general. The basic principle of regulation and supervision is that its overriding objective is to protect the financial system from unsound (e.g., excessively risky) practices by deposit taking institutions and thereby to protect a country's payments system and, secondarily, to protect small and uninformed depositors.<sup>2</sup> Adding other objectives will inevitably detract from the basic objective, at least because this will spread the resources of the regulatory agency more thinly and, in some cases, more severely if the added objectives conflict with the basic objective.

A key corollary is that such regulatory agencies should not be involved in the regulation and supervision of financial institutions that do not mobilize deposits from the general public.<sup>3</sup> Microfinance institutions that do not presently mobilize deposits but plan to do so in the future have sometimes favored regulation of themselves as a kind of training for the future, but there is no reason that such training could not be contracted on a paid basis (e.g., through local auditing firms or banks), and having the regulatory agency undertake this function could easily detract from its basic regulatory objective. Some donors and government

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<sup>2</sup> In combination with deposit insurance, regulation and supervision can protect from “runs” on otherwise sound banks when an unsound bank fails.

<sup>3</sup> It is important to consider what mobilizing deposits from the general public in fact entails. For example, requiring compensating deposits against loans is not deposit mobilization because the “depositor” is a net debtor to the lending institution. Whether the “common bond” concept under which credit unions are generally supposed to operate can be interpreted to mean that they should not fall under such regulation because their depositors are not part of the “general public” is an open legal, and hence regulatory, issue in many countries.

funding agencies have promoted the supervision of microfinance institutions that do not mobilize deposits because this can facilitate the selection and monitoring of microfinance institutions for channeling their funds, but again this can detract from the regulatory institution's basic function. Moreover, there is no reason that donors and government funding agencies could not pay for the supervisory work needed to select and monitor microfinance institutions by hiring local auditing firms (or possibly the regulatory agency itself in a distinct capacity) or undertake the task themselves internally. In some cases, microfinance institutions may themselves have attempted to promote the regulation of microfinance institutions that do not mobilize deposits in order to improve the image of the microfinance industry as a whole for their individual benefit. However, the existence of such "externalities" is a main reason for the existence of industry organizations that undertake self-regulation and is not the business of government regulatory agencies.<sup>4</sup>

Except in so far as it affects risk taking by deposit taking institutions, there is no reason for a regulatory agency to be concerned with lending behavior. In particular, there is no reason for a regulatory agency to be concerned in any way with the lending practices of microfinance institutions that do not mobilize deposits. Attempting to deal with fraud in lending and to control interest rates are two areas where regulatory agencies have often become involved with detrimental results. Fraud in lending can as well be handled by institutions whose primary purpose is to deal with fraud. Controls over interest rates (usury laws) have been shown to be rarely enforceable effectively and, when enforceable, to be counterproductive in that they make credit completely unavailable to high cost and high risk potential borrowers. In fact, a key element in the sustainability of microfinance institutions has been their ability and willingness to charge market rates of interest that can cover all the institution's costs including a margin for profit. Some observers have complained that microfinance institutions charging such high interest rates are monopolists who are no better than the usurious moneylenders that they are supposed to replace. However, it is not clear what their source of permanent monopoly power might be and, in countries such as Bolivia where the number and outreach of microfinance institutions have been growing, competitive pressures

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<sup>4</sup> A potentially important issue is whether default by a microenterprise finance intermediary, with resulting losses for its depositors, would have more serious consequences for its sister institutions than default by a traditional commercial bank. When a bank fails, even a fairly sizeable bank, a significant contraction of the overall financial system rarely occurs, as long as depositors have adequate confidence in the government's macro-financial policies and especially in the government's commitment to bank depositors. This is not meant to suggest that such commitments to bank depositors are a good thing. In fact, widespread confidence in implicit government insurance of bank deposits has often forced governments to bail out failing banks at considerable cost to taxpayers, and with increased likelihood of similar events in the future. Depositors in a particular country have usually observed that banks fail from time to time, but ultimately depositors rarely lose their savings. However, there is unlikely to be any such history of commitment by a government to depositors at microenterprise finance intermediaries. Moreover, depositors who would use microenterprise finance intermediaries might well be new to such intermediaries if not to depositing in general. It is thus plausible that the failure of a single microenterprise finance intermediary might lead depositors to desert other microenterprise finance intermediaries en masse, possibly producing a collapse in a country's entire microenterprise finance system. In spite of this possible danger, there is little likelihood of significant damage to a country's overall financial system, even though the damage to the microenterprise sector could be substantial.

have driven microlending interest rates down over time.<sup>5</sup> Truth in lending laws may help quicken the spread of competitive pressures, but it has proven difficult to write such laws that are comprehensible and enforceable.

## **Two Approaches to Dealing with Risks in Microfinance:**

### *(1) Focusing on Institutional Risks*

As indicated above, the origins of interest in the regulation of microfinance have focused attention primarily on unregulated microfinance institutions that want to transform themselves into regulated institutions in order to mobilize deposits from the general public. The special characteristics of these institutions have thus become a primary focus, if not the focus, of any adjustments in the regulatory framework that might be required to accommodate microfinance. This, in turn, has led to concerns about the non-profit origins of the vast majority of microfinance institutions and, in particular, the characteristics of board members and the ability to raise additional capital if and when needed. It has also focused discussion on capital adequacy requirements and, in particular, whether it is appropriate to create the possibility of institutions with lower minimum capital and more limited banking powers (e.g., no demand deposits, no operations in foreign exchange, etc.) to specialize in microfinance.<sup>6</sup> It is thus important to consider these issues in greater depth, as is done directly below, but it is equally important to ask equivalent questions concerning the extent to which existing regulations may also dissuade commercial banks from carrying out microlending and, more basically, if microfinance is essentially different from other forms of financial intermediation, or is just a variant of basic banking—a question considered in subsequent sections.

While the Basle agreements have established a broad consensus on appropriate ratios of capital to risk assets, minimum capital requirements for becoming a deposit taking institution have been set so high in some countries that they seem impossible for a microfinance institution to achieve initially. One response to this barrier has been to create the possibility of limited power microfinance institutions with lower minimum capital requirements, but it might first be useful to ask if minimum capital requirements for full service deposit taking institutions have been set appropriately. In some countries, requirements seem to have been set very high to limit entry, and hence competition, or perhaps to limit the work load of the regulatory agency, while in other countries very low limits have allowed a proliferation of

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<sup>5</sup> It is important to note that significant changes have been made in the overall financial sector in Bolivia which has resulted in increasing competition and lower interest rates throughout the market. For more details on the Bolivian financial sector and commercial financial institutions that have entered the microfinance market, see forthcoming *Microenterprise Best Practices Commercialization of Microfinance Case Studies on Banco Economico and Financiera Fa\$Sil*.

<sup>6</sup> In some countries, banking laws include the possibility of financial institutions with more limited powers and lower capital requirements, such as the finance companies (“financieras”) in many Latin American countries that cannot capture short term deposits but have most other banking powers. However, the experience with these finance companies has not been particularly good in recent years, as many failures have occurred in times of crisis in countries where capital requirements have been set low, and few finance companies have been formed where they have been set high.



small (often highly failure prone) institutions. One could apply a “political economy” type of analysis to the relative power of different pressure groups to understand such outcomes, but it seems more useful in the present context to ask what are criteria that financial economic analysis might offer for establishing minimum capital requirements. It would seem needlessly risky to set minimum capital requirements lower than what would be needed to support a full service deposit taking institution of the size that would exhaust the major economies of scale, and needlessly anticompetitive to set them higher.<sup>7</sup> With respect to microfinance institutions that want to be regulated to be able to mobilize deposits, the issue to be resolved is thus what the range of significant economies of scale might be for such institutions, so that undercapitalized institutions are not permitted to appear that are condemned to fail if they cannot quickly obtain more capital to grow to an economic size.

A potentially complicating factor is that most microfinance institutions, because of their non-profit origins and the characteristics of board members, may have more limited capacity than commercial banks to increase their capitalization levels quickly should they find themselves fully leveraged and, simultaneously, incurring significant operating losses. This may seem ironic given that many microfinance institutions have initially been heavily capitalized, but the fact is that most of them have been capitalized by grants from governments or donor agencies and not by private investors. If a microfinance institution runs into difficulty, it does not necessarily have clearly interested owners who might act quickly to rescue it with inputs of additional capital. Even if a government or donor agency were disposed to rescue a microfinance institution that it had previously helped to establish, its capacity to do so quickly, before irreparable harm had been done, might be questionable given the long process that is typically required for approval and disbursement.

Bank superintendencies throughout the world have grown increasingly insistent that bank owners be capable of making capital contributions as quickly as necessary to avoid potential bankruptcies. Nonetheless, regulatory agencies may find that donor agencies and NGOs, both local and international, that provide technical support to microfinance programs have a continuing interest in the solvency of the particular programs that they have supported. Bankruptcy of a microfinance institution may adversely affect the image of supporting donors or NGOs. Moreover, the approach of some NGOs has been to recruit leading local citizens to serve on the boards of directors of the microfinance programs that they support, and these individuals may be especially eager to avoid the damage that an insolvency might do to their image. In addition, while donors and NGOs may not be able to act as quickly as desirable to provide capital to microfinance institutions that are suddenly found to be in serious difficulties, they may act beforehand to try to prevent such problems. For example, ACCION International has developed a monitoring system for its microfinance programs throughout Latin America to detect potential problems before they reach the insolvency stage.<sup>8</sup>

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<sup>7</sup> For example, if capital requirements are 8 percent of risk assets, and a size of at least US\$40 million of risk assets is needed to exhaust major scale economies, it would not be prudent to set minimum capital requirements at less than US\$5 million, and would needlessly stifle competition to set them much higher.

<sup>8</sup> Of course, no monitoring system will be perfect either in detecting or dealing with potential problems, as shown by ACCION’s experience with Corposol/Finansol in Colombia and by the frequent failures of regulated financial institutions in countries around the world.

In addition to the ability to contribute capital, there are likely to be other required characteristics for the principle owners, directors and high-level managers of microfinance institutions that want to formalize themselves in order to take deposits. Regulatory agencies routinely apply rules concerning character (honesty) to all holders of such positions at a bank, and expertise in banking is also required of some proportion. There would seem to be no reason that the same criteria could not be used for microfinance institutions applying to be regulated, unless microfinance intermediation is seen to be substantially different from banking in general. If microfinance intermediation is indeed thought to be a highly different activity from other types of banking, then logical consistency suggests that all institutions applying for deposit taking licenses would need to show special expertise for each specific market niche that the new institution is expecting to fill.

The risks facing an institution specializing in microlending may differ from a typical bank according to the characteristics of these clients and/or the products offered to them. Moreover, even the idea of a “typical” bank may be misleading in that some banks specialize in personal (consumer) loans, others in commercial lending, others in small and medium business loans, and still others in corporate or wholesale banking. Thus, bank regulators must either specialize according to the kind(s) of market(s) that the banks they supervise target or else seek some underlying principle(s) that are applicable to the regulation of deposit taking institutions in general. This is a very important issue, to which more attention is given later. It is so important because it suggests two quite distinct options, either: (1) a possibly endless proliferation of different regulatory specializations according to the development of new specialized market niches; or (2) a focus on underlying principles and basic techniques that can be applied universally to all deposit taking institutions. Before pursuing this issue further, however, it is important to review what are seen to be the key differentiating characteristics of microfinance clients and products.

### *(2) Focusing on Client and Product Risks*

The most typical microfinance product is a very small loan, usually short term (almost always less than one year, unless the client is of long standing, and often less than 90 days). Originally, there were widespread attempts to specify a maximum loan size that could be counted as satisfying government or donor microfinance program requirements, usually US\$300, but it has since come to be recognized that the size of micro loans bears some relationship to GDP per capita in a country, and also that loan size will increase over time for any given borrower, so that average loan size will also increase for any institution over time as repeat borrowers become a larger proportion of total borrowers.<sup>9</sup> Most banks have developed lending procedures with significant fixed costs, procedures that are in fact efficient for larger loans because they yield relatively low total costs, but these relatively high fixed costs make small loans unattractive. A view thus arose that small loans were necessarily high cost, as well as high risk. However, the advent of viable microfinance institutions has shown that high fixed lending costs are not necessarily immutable and that

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<sup>9</sup> The possibility of loans of increasing size has been recognized by most microlenders as one of the strongest incentives to promote timely loan repayment and, hence, that capping loan size can be a strong incentive not to repay.

innovative technologies can be found to lower these fixed costs substantially. In addition, viable microfinance institutions have often achieved rates of loan recovery that are equal to or better than those of successful banks, thereby also calling into question the perceived high risk of micro loans. To understand how sustainable microfinance institutions have developed low-cost, low-risk lending technologies that are substantially different from traditional bank lending technologies, it is next necessary to describe some key characteristics of the microfinance client, that is, the microentrepreneur.<sup>10</sup>

Two potentially problematic characteristics of microfinance clients are lack of traditional kinds of information about client businesses and lack of potential collateral to secure loans. Microfinance clients almost never have audited financial statements because this would be too costly and of little use to them. In fact, they often do not have written records of any kind. Moreover, given the close linkages between the household activities and the business activities of the typical microentrepreneur, written business records would give only a very partial picture of the financial circumstances of the microentrepreneur. In addition, often in the “informal” sector, microentrepreneurs rarely file tax returns or may not have any kind of registration or license indicating that they are even in business. Here, the old saying that “what you see is what you get” may well apply. In fact, what you see may well be more than what you might get from the viewpoint of collectable security. Even if a microfinance client might have something with marketable value that a lender might, in theory, try to sell to satisfy part or all of a debt, it may not be possible to ascertain if the thing is in fact owned by the microentrepreneur and not subject to prior claims, albeit informal ones. Trying to formalize and register the collateral as security would almost certainly make the loan prohibitively expensive for the microborrower, if not for the lender as well.<sup>11</sup> If a loan officer for micro loans thus cannot expect to use collateral and formal documentation significantly in the loan decision process, it is difficult to see how it could be of much use to an examiner from a regulatory agency.

It is clear from the key characteristics of microfinance clients described above why loan products are most often small in size and short in term.<sup>12</sup> Moreover, these characteristics also determine what are the most widely used and successful lending techniques. Just because the traditional types of information contained in formal documents and collateral are often not available does not mean that information is not crucial for successful microlending.

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<sup>10</sup> During the period that some more aggressive microfinance institutions were moving toward sustainability, many banks became increasingly interested in consumer finance (e.g., credit cards and small personal loans) as a profitable new market niche. However, in spite of the fact that loan products for these two markets are quite similar (i.e., small and short term), the characteristics of the clients are quite different (e.g., self-employed with variable and uncertain incomes as compared to salaried with stable and secure incomes), and hence the source of information that lenders look for to assess the likelihood of repayment are likewise different.

<sup>11</sup> The difficulty of registering and collecting on collateral of movable assets may be more a problem of the registry system than the clients per se and investments to improve such systems may have important effects on the provision of financial services to the microenterprise sector.

<sup>12</sup> Actually, the reason for the predominance of short-term loans is not as clearly obvious as the reason for small loans. It derives not only from the demand by microclients for short-term working capital loans but also from the widely-used technique of microlenders of keeping in continuing close contact with their microborrowers (and through the possibility of short-term loans of increasing size as a key incentive for timely repayment).

Loan officers almost always construct simple cash flow statements (and sometimes even balance sheets and income statements), but instead of looking for the microborrower to provide such documents, the loan officer usually elicits information for the cash flow statement through a series of questions that cover not only business but also household activities. In addition, the loan officer will be very interested in the appearance not only of the business but also of the household (and the latter is facilitated by the fact that microenterprise activities are often carried on either in or adjacent to the home). Furthermore, with successful microlenders, a trained and experienced loan officer (which (s)he must be before being sent off alone) can often approve a microloan on the spot, without recourse to higher level managers or loan committees. This technique is used for two main reasons: (1) timeliness has been found to be highly valued by microfinance clients; and (2) higher level managers and loan committees cannot contribute effectively to the decision process. Much of the information collected by the loan officer is based on appearances in the home and business location, and it is also relative to the hundreds of other microentrepreneurs that a trusted loan officer would have already visited in his(her) career, so that it would be very difficult to convey such information in a way that could effectively be re-assessed by higher level managers or a loan committee.<sup>13</sup>

Because decision making is to be left largely in the hands of the loan officer does not mean that the loan officer is to be abandoned. As already indicated, (s)he must be trained, including substantial supervised experience, and given responsibility accompanied by the incentives (rewards and punishments) that signify true responsibility. The other key to a decentralized system is the ready availability of information required for decision making and also for monitoring and control. Just as successful microfinance institutions have developed the information and monitoring and control systems required for decentralized decision making and accompanied these systems with appropriate responsibilities and incentives, so regulatory agencies might focus on these key elements in deciding whether a microlender that wants to mobilize deposit is able to manage risks adequately.

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<sup>13</sup> The difficulty of conveying perceptions of a wide range of appearance elements relative to a loan officer's past experiences with good and bad microfinance clients is a main reason that credit scoring models which have been used so widely and successfully in consumer finance have not been applied to microfinance. The information taker for a consumer lending credit scoring model could more accurately be classified as a clerk rather than a loan officer. In addition, the use of credit scoring models could absolve the loan officer from responsibility for lending decisions ("the model made the decision, I didn't"), and clear assignment of responsibility to the loan officer, followed by appropriate rewards or punishments, is another crucial component of successful microlending. In any case, credit scoring models can in fact be quite simple and inexpensive to create, if the lender has the kind of data about borrowers (and non-borrowers) that it should have to be successful. Therefore, various microlenders and their supporting organizations are said to be exploring the potential of credit scoring models.

A better understanding of successful microlending processes could change the primary task of the regulatory agency from examining thousands of individual microloans to analyzing how a microlending institution that wants to undertake deposit mobilization is providing its loan officers with training, responsibility and incentives and, in turn, monitoring, evaluating and controlling their performance.<sup>14</sup>

## REGULATORY LAWS AND NORMS AND EXAMINATION PRACTICES

Given the interest in the regulation of microfinance institutions that want to mobilize deposits from the general public, it is not surprising that there is a growing literature on this topic. Moreover, given the origins of this interest (from specialized microfinance practitioners), it is also not surprising that this literature has focused primarily on the special characteristics of microfinance institutions, secondarily on the special characteristics of microfinance clients and the loan products most attractive to them, and only very little on the regulatory problems facing banks that might want to orient themselves in a major way to microfinance clients. This literature also consists mainly in case studies of individual countries and comparative studies drawing on the experiences of various countries. Another revealing characteristic of this literature is that it is heavily focused on the analysis of laws and norms and not on the ways in which these laws and norms are implemented by regulatory agencies. For example, there are always discussions of laws and norms with respect to capital requirements, including different requirements that might apply to microfinance institutions that do not offer a full range of banking services, collateral requirements, requirements for other types of documentation that are supposed to be found in the lender's credit files, classification standards based on the repayment status of loans together with the observance of collateral and documentation requirements, and provisioning requirements for loans that are less than fully satisfactory. There is rarely, however, any discussion of how these laws and norms are applied by bank examiners in practice.

There are at least two reasons for the lack of attention to examination practices. First, and perhaps most important, regulatory agencies are rarely eager to have outsiders review their examination practices even if the intent of the outsiders is to improve on current practices.

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<sup>14</sup> Loan delinquency at a microlender can be highly volatile, and marked deterioration in loan recovery has sometimes been observed in a matter of months. Furthermore, microlenders, even those with the most innovative lending technologies, typically have much higher administrative costs than banks, often several times as high. Successful microlenders have been able to cover these higher costs by charging higher interest rates that reflect market conditions for their microfinance clients. Nonetheless, when a microlender is suddenly beset with a high level of loan delinquency, it can lose a higher percentage of its equity more quickly than a bank with a similar level of loan delinquency because of the high administrative costs with no interest income to offset them. The potentially greater volatility of microlender delinquency rates, together with the greater threat to equity, suggests a possible need for more frequent reporting than for banks. It may also suggest closer attention by regulatory agencies to the monitoring and control mechanisms that a microfinance institution has in place to detect delinquent loans early and to deal with them quickly. On the other hand, for regulator agencies to require that loans without tangible guarantees or extensive documentation including audited financial statements automatically be penalized, as in the case of commercial bank regulation in many countries, would tend to eliminate most of the potential clients that microenterprise finance intermediaries are trying to reach.

Banking secrecy laws may severely limit circumstances under which outsiders can observe examinations because this may appear to imply that these outsiders thereby have access to information deemed confidential under the laws and norms governing bank regulation and supervision. In addition, officials of bank regulatory agencies may be concerned that these outsiders may discover problems in the banking system which had not previously been noted and, worse yet, that outsiders may ascribe such problems to inadequacies in bank examination practices.<sup>15</sup> Second, from the perspective of those doing the country case studies and comparative analysis, examining bank examination practices is a highly labor intensive activity requiring actual participation in bank examinations. Moreover, study costs can be especially high in the case of microfinance examination practices because of the extreme scarcity of individuals who have the requisite experience and expertise in both microfinance and bank regulation and supervision.

Even though there are virtually no studies that contain first hand analysis of bank examination practices as they pertain to microfinance, it can nonetheless be supposed that this may be a serious problem area. Leaving aside for the moment the question of whether off-site monitoring of microfinance can be very effective without the accumulation of a substantial body of experience for comparative purposes, which does not yet exist because of the relative newness of the activity, the standard approach to on-site bank examination, even as carried out by regulatory agencies that are highly regarded in general, may not be appropriate for microfinance. The vast majority of bank examiner time and effort in an on-site examination traditionally is devoted to examining credit files. In particular, a stratified sample is drawn in which credit files for all loans over a certain size are examined, a high percentage of loans in the next size category are covered, and so on until only a very small percentage of credit files of loans in the smallest category are examined. The result is that, for a bank with a typical loan size distribution, more than half of total loan amounts outstanding may be covered, and thus a similarly high proportion of all risk assets, since loans are the main category of risk assets. While such a procedure and allocation of time and effort may work well for the typical bank, this approach is clearly inappropriate for a bank that specializes in microlending (or for a microfinance institution). First, without a very large sample, and hence a large allocation of time and effort, only a very small percentage of total loan amounts outstanding will be examined.<sup>16</sup> Second, since microlending decisions are not based in a major way on traditional collateral or other formal documentation such as audited financial statements, bank examiners will find little of interest in microloan credit files, perhaps just some very basic information on the microentrepreneur together with the loan officer's judgement about past cash flows and estimates of future ones.

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<sup>15</sup> The difficulties that the World Bank and even the International Monetary Fund are reported to have encountered in analyzing bank regulation and supervision in Asian countries during the current financial crisis may well be an example of this sort of behavior.

<sup>16</sup> This is consequently a very costly approach to microloan examination, and its use may be a major reason why supervisory agencies are rarely enthusiastic about dealing with microfinance. In countries like the U.S. and the Philippines where there are large numbers of small banks, using the traditional approach described above results in a disproportionate share of examination time and effort being devoted to examining banks with a very small proportion of total deposits in the system. While small loans and small banks are not the same thing, they are often found together (e.g., because bank capital limits loan exposure to individual clients), and both lead to relatively high costs for bank examinations.

Instituting appropriate examination practices can thus be as important as laws and norms for adequate regulation of microfinance. Moreover, while regulatory agencies typically provide examiners with detailed procedures manuals to govern the way that examinations are carried out, there is always room for discretion, especially in summarizing the results of the examination and in deciding whether certain areas need special follow-up attention or any corrective actions need to be taken. Indeed, the view held by most experienced regulatory officials is that an examiner is not fully capable until (s)he has been examining banks for five or ten years, which implies that a good deal of discretion is involved; otherwise, all that would be required is a newly-trained examiner with an up-to-date manual. The fact that there are as yet no standardized approaches to examining institutions specializing in microfinance could thus easily make officials of these institutions fear that untested procedures might lead examiners to seemingly arbitrary findings and judgements and hence subject these institutions to greater scrutiny or even to penalties. While it is not adequate to say that by reading laws and norms and even examination manuals it will be possible to judge the quality of microfinance regulation, neither is it adequate to argue that pointing out that current examination practices are inappropriate can solve the microfinance regulation problem. Just as the old political saying that “you can’t beat someone with no one” points out, new approaches and practices must be offered that can hope to cope with the problem. Otherwise, banks will continue to be wary of entering the field of microlending, while microfinance institutions will be similarly wary of becoming regulated financial intermediaries even if this is the only way to mobilize deposits from the general public.

As discussed above, one of the main characteristics of successful microlenders is loans with low administrative costs for the lending institution and low transaction costs for the borrower. This, in turn, implies that decision-making must be decentralized and that loan delivery must likewise be decentralized to the vicinity of the borrower. Such decentralization places heavy reliance on adequate systems, not only to convey information between the field and headquarters on all aspects of loans and borrowers, and especially on the repayment status of each loan, but also for monitoring and control purposes. For example, each loan officer in the field must have immediate access to the information required to map out coordinated visits to potential borrowers and to existing borrowers who have payments overdue or about to come due and to prioritize these visits based on information on the institution’s current and perspective overall liquidity position. At the same time, officials at headquarters must have immediate access to information from the field to put together the required aggregate information and to monitor loan officer performance in an environment where information can be verified and is protected from self-interested tampering. The importance of such information systems for effective and efficient operating, monitoring and control purposes suggests that these systems might be the main focus of examinations by regulatory agencies. Rather than examining individual loan files, it could be far more productive to examine whether information systems are up to date, accurate and accessible, yet adequately protected from unauthorized entries.<sup>17</sup>

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<sup>17</sup> When microfinance institutions have experienced sudden surges in problem loans, well-functioning information systems have been crucial for early detection and, in fact, have usually traced the problem to specific loan officers rather than to a significant number of borrowers suddenly being faced simultaneously with new economic problems.

**BACK TO THE BASICS WITH RISK-BASED SUPERVISION<sup>18</sup>**

There is little argument over the fact that microfinance products and services, especially microlending, are different than traditional banking products and services. Debate continues over exactly what those differences are and, as a consequence, many attempts have been made to describe them. As part of the debate, the argument is often made that risks are different for microfinance and therefore there is a need for a different regulatory approach and different sets of rules for microfinance institutions. Part of the debate derives from the lack of a common terminology and subtle differences in the use of terms. For example, are the risks in microloans different from the risks in other traditional types of bank loans? The answer is, not really. Ask the question another way, is the risk profile of microlending different than the risk profile of other types of traditional bank lending, and the answer is yes. The difference is in the risk profiles not the set of risk factors. This sounds like a subtle difference, but it is crucially important for understanding the debate over the approach regulators should take in supervising microfinance institutions and the microfinance operations of commercial banks. Although the set of risk factors is basically the same for traditional bank products and services and microfinance products and services, the mix and weight of these risks are different and result in very different risk profiles. As pointed out above, regulators currently supervise financial institutions that have many different market niches. It can be argued that microfinance is just another market niche with its own set of distinct characteristics but that it shares a common set of risk factors with other more traditional products and services.

All bank and microfinance products and services have multiple risks in their profiles. One of those risks is always operational risk. To understand the differences in risk profiles for different products and services it is necessary to break them down into their component parts. For example, there are six risks that account for an overwhelming majority of losses in financial institutions. The first and most obvious is credit risk. The others are operational risks (which includes costs), interest rate risk, liquidity risk, market risks and foreign exchange risks. Market and foreign exchange risks are virtually nonexistent in microfinance. Once the component risks have been identified it is necessary to measure them on an individual and portfolio basis. For example, in a microfinance institution the credit risk associated with one microloan is very little (not the same as low) due to the size of the transaction, but the credit risk for the entire portfolio could be high, depending on the systems and processes in place. For a wholesale commercial bank, one that makes only large loans, the credit risk associated with individual loans could be high, as well as the portfolio risk. However, in the case of the wholesale commercial bank, transaction (operational) risk may be low because of the number of eyes that look at each loan and check and double check the numbers, whereas in the microfinance institution transaction risk may be high for the opposite reasons. Therefore, by understanding the risk profiles for the two examples, it would be appropriate for a regulator to take a different approach in the two institutions. In the microfinance institution, more focus on systems and processes would be appropriate because of the small risk associated with individual transactions. In the commercial bank,

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<sup>18</sup> See Annex 3 for an explanation of traditional supervision compared to risk-based supervision.



more focus on individual loan transactions would be appropriate because of the higher risk associated with each loan, although operational risks would not be ignored.

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all, if not all, financial products and services, large and small. In the two examples above, the types of risks are the same, but the emphasis put on evaluating them would differ. The desegregation of the risks that make up the risk profile of individual products and services is at the heart of risk-based supervision. By un-bundling the risks that make up each product and service, managers and bank supervisors are better able to understand risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. In other words, they are better able to understand the risks and the risk management systems. It is the responsibility of the management of each financial institution to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls and monitors risks. Regulators should then require that weaknesses be corrected.

Risk-based supervision is a relatively new approach to supervising regulated financial institutions. While it is currently practiced by few regulators around the world, it is rapidly being acknowledged to be the preferable approach to bank supervision. There is a need to familiarize more regulators, especially in countries with microfinance institutions contemplating deposit taking activities, with respect to the possible benefits of risk-based supervision. This could minimize the perceived differences in approaches needed to supervise traditional commercial bank activities compared to microfinance institution activities, whether the microfinance activities are in banks or in stand-alone institutions. It would also be helpful, for the sake of the debate over the supervision of microfinance institution activities, if there were greater understanding that, while most financial products and services share a common set of risk factors, they can have very different risk profiles. The difference is in the risk profiles, not in the set of risk factors.

## **EVALUATING THE OUTCOME OF MICROFINANCE REGULATION AND SUPERVISION**

In the literature on the regulation and supervision of microfinance, conclusions as to efficiency and effectiveness have been based almost exclusively on a reading of the relevant laws and norms, and perhaps examination manuals, for the country in question or for a set of countries if the study is a comparative one. The foregoing discussion suggests that actual examination practices should also be a major factor in drawing conclusions. What is instead emphasized here, however, is that conclusions about possible improvements in microfinance regulation and supervision should rather be drawn primarily from the behavior and performance of microfinance institutions and banks entering the microlending field. The main purpose of adjusting the regulation and supervision of microfinance is so that more microfinance services will be provided and so that the institutions providing microfinance services will not take excessive risks. Hence, the deposits of the general public will be at least as well protected as they were before any changes in regulation and supervision.

In this regard, for microfinance regulation to be deemed effective it must show (a) that more banks are actually providing microfinance services; (b) that more NGOs have transformed into formal financial intermediaries; (c) that those transformed NGOs are consequently able to reach a larger clientele; (d) that savings mobilization constitutes a major source of funding for those transformed NGOs; (e) that actual examination practices keep aligned with laws and norms; and (f) the costs and practices of microfinance supervision are congruent with the risks and volume of operations involved.

The following types of information would thus be required for a country case study or a comparative study of a number of countries in order to assess whether actual improvements in microfinance regulation and supervision have in fact taken place:

1. Changes/adjustments in laws, norms, practices and their application.
  - a) Addressing commercial banks and their potential interest in providing microfinance services;
  - b) Addressing the interest of non-regulated microfinance institutions in mobilizing savings; and
  - c) Addressing the practices of the regulatory entity.
2. Number of banks providing microloans before and after adjustments.
  - a) Number of microloans granted and outstanding;
  - b) Amounts granted and outstanding.
  - c) Costs; and
  - d) Externalities.
3. Banks encountering difficulties before and after adjustments.
  - a) Those with difficulties offering microloans compared to those not offering;
  - b) Amounts involved;
  - c) Type of difficulties; and
  - d) Externalities.
4. Number of microfinance institutions becoming regulated before and after adjustments.
  - a) Number of deposit accounts and amounts of deposits outstanding;
  - b) Size distribution of deposits indicating market niche;
  - c) Growth of loan portfolios of microfinance institutions becoming regulated and taking deposits compared to those not doing so;
  - d) Costs; and
  - e) Externalities.
5. Number of regulated microfinance institutions with difficulties before and after adjustments.
  - a) Those with difficulties offering microloans/savings accounts compared to those not offering;
  - b) Amounts involved;
  - c) Type of difficulties; and
  - d) Externalities.

6. Current supervisory practices vis-a-vis laws and norms.
7. Effectiveness of changes in protecting depositors.
8. Costs of supervision vis-à-vis risk and volume involved.
9. Issues /difficulties faced by the regulatory body before and after adjustments.
  - a) In supervising microfinance institutions which mobilize savings;
  - b) In supervising microfinance institutions which do not mobilize savings; and
  - c) In supervising microloans by commercial banks.
10. Lessons learned.

## CONCLUSIONS

The main conclusions are summarized as follows:

Prudential regulation and supervision should be applied only to deposit taking institutions. Hence, micro-finance NGOs that do not take deposits should not be regulated except under the general laws that deal with fraud and so forth, and this should not be the job of Bank Superintendencies.

Regulation and supervision of microfinance institutions have two basic issues to be dealt with: how to regulate microlending by banks (and other existing supervised financial institutions which may include finance companies, cooperatives, etc.) ; and how to regulate NGOs that want to begin to take deposits. Too much focus has been on the latter, and especially on certain characteristics of non-profits (NGOs), to the neglect of the former, and especially how to evaluate the risks associated with microlending.

Techniques of microlending have significant differences from traditional bank lending techniques. This, together with the institutional differences between micro-finance NGOs and for-profit commercial banks, has led to attempts to define different standards for micro-finance. However, this is a mistake as it will lead to endless proliferation of different standards and different supervision techniques for each market niche in finance.

Risk-based supervision can provide a more basic and unifying approach by focusing on risk management in all cases and by developing different risk profiles from the same underlying risks.

There has been an excessive focus on analyzing laws and norms relative to an analysis of how supervision has been carried out in practice. This is probably because it is much easier to do the former. Yet, good case studies must include the latter which requires the consent of the Superintendency being analyzed and teams that have expertise in both micro-finance and regulation.

The point of the case studies is to see how far regulation and supervision have progressed in providing an enabling environment for micro-finance. It is clearly not the job of regulation and supervision to promote micro-finance; but it is important that it not hinder the sustainable provision of microfinance. Thus, in the case studies, evaluation should be based on a “healthy” expansion of micro-finance and certainly not just on an arbitrary reading of laws and norms.

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**ANNEX 1**  
**RECOMMENDED CASE STUDIES**



**Latin America:**

The Latin American case studies will focus on the results, both positive and negative, of the introduction of changes to the regulatory environment in the countries selected. The studies will analyze and document lessons learned on both sides of the spectrum: commercial banks involved in microlending and NGOs transforming into formal financial intermediaries on the one side, and the implications to Superintendency regulation and supervision on the other. Issues under analysis will include: changes to regulatory laws and norms and examination practices, number of institutions involved in microfinance as a result of these changes, factors contributing to results to date, cost implications for both microfinance institutions and the Superintendency, as well as changes and effects on the supervisory practices of the Superintendency.

IMCC recommends Bolivia and Peru for case studies of the best practices in regulation and supervision of microfinance. Other countries such as El Salvador, Dominican Republic and Colombia are currently reviewing some issues in microfinance regulation and supervision. Efforts towards significant changes in these countries remain uncertain.

**Bolivia:**

Bolivia offers the best practices in microfinance regulation and supervision. Changes to regulatory laws, norms and practices were introduced in 1994 to allow for the expansion of microfinance services through formal financial intermediaries. As a result, NGOs involved in microlending which meet defined financial standards can transform into Private Financial Funds (PFF). A PFF was a new formal financial entity created by the government to allow for the transformation of NGOs into formal financial intermediaries. PFFs were legally authorized to offer an array of financial services including savings accounts and time deposits. About seven NGOs have already become PFFs and five other have submitted applications. In addition, some consumer credit companies have entered the market under the PFF structure. Moreover, Bancosol, a spin-off of the NGO PRODEM, is the first commercial bank in the country created exclusively to provide microfinance services. Bancosol currently has about 150,000 clients. Various financial companies, among them Financiera Los Andes, are also providing microfinance services. Finally, a number of commercial banks are also offering microfinance services. The Superintendency is currently developing customized regulation for microfinance institutions to be implemented by mid March 1999.

**Peru:**

In contrast to Bolivia, Peru offers lessons learned regarding regulation and supervision of non-deposit taking institutions such as the EDPYMEs. The EDPYME (Entity for the Development of Small and Micro Enterprises) is the Peruvian counterpart of the PFF. However, the EDPYME cannot mobilize savings. About six NGOs have transformed into EDPYMEs and 20 others have submitted applications. Peru has also created a venue for NGO transformation into formal financial intermediaries. The Government has fostered the creation of MIBANCO, which similar to BANCOSOL, will target small and micro borrowers

and savers. Other commercial banks, including Banco Wiese, are also involved in microfinance services.

### **El Salvador:**

The Central Bank has submitted to the National Assembly a proposal to modify bank legislation. Among other issues, the Central Bank proposes to raise the minimum capital requirement for commercial banks from the current 50 million colones (about \$5.7 million) to 100 million colones (\$11.4 million). It also proposes to eliminate financial companies (better known as “financieras”) and among them Financiera Calpia, one of the successful Latin American formal microfinance institutions. If approved, all financieras will have to increase their capital base to \$11.4 million, a figure that results prohibitive for most. The new minimum capital requirement would also make it prohibitively expensive for non-formal programs to formalize. Due to extensive lobbying by interested groups in the sector, an additional proposal for non-bank financial intermediaries has been expanded to include a category for non-formal microfinance institutions. At first, this proposal was focused mainly on cooperatives and "cajas de crédito". Self-regulation and alternative methods of supervision are contemplated for the non-bank sector. The World Bank has been advising the Salvadoran Central Bank during this process.<sup>1,2</sup>

### **Dominican Republic:**

The Bank Superintendency supported and facilitated the transformation of one NGOs ADEMI, into a commercial bank as well as the start-up of a new commercial bank, Banco de la Pequeña Empresa whose principal shareholder is the NGO FONDOMICRO. Both institutions are dedicated to serving the micro and small enterprise sectors. BancoAdemi is at present working closely with the Bank on an appropriate loan classification system that would minimize the effects of the traditional bank regulation in their microfinance operations<sup>3</sup>. At the same time, the Asociacion de Instituciones Rurales de Ahorro y Credito (AIRAC), the federation of credit unions in the country, is also working with the Superintendency on the implementation of a regulatory mechanism for the credit unions with funding from the IDB/MIF<sup>4</sup>.

### **Africa:**

The case studies in Africa will take a different view at microfinance supervision and regulation than their counterpart studies in Latin America. The lessons learned from the case studies in Latin America will be applied and provide guidance to the case studies and recommendations to the African countries. In this regard, the case studies for Africa will focus primarily on the formal financial intermediaries involved in microfinance and the

<sup>1</sup> Ruth Junkin, Catholic Relief Services, El Salvador.

<sup>2</sup> DAI has recently begun managing the USAID Strengthening Rural Financial Markets project which will focus on increasing expansion and institutional strengthening of microfinance service providers in El Salvador. Such activity may help to support access to Supervisory Authorities and financial service providers in this country.

<sup>3</sup> Mac Benjamin, World Bank.

<sup>4</sup> Jeff Poyo, Development Alternatives Inc., DAI.

regulatory and supervisory issues affecting their performance. The studies will take a look at the regulatory and supervisory environment, analyze whether it is conducive to successful microfinance and present recommendations.

The African countries which present the greatest potential for case studies are Tanzania, Uganda, Kenya, South Africa and, to a lesser extent, Ghana, Zimbabwe, Mozambique and Zambia. Among these countries, IMCC proposes country studies on Tanzania, Kenya and South Africa.<sup>5</sup> Each country is in a different stage of development of their financial systems as well as in the discussions regarding prudential supervision of microfinance institutions. IMCC expects that the findings from each country study will complement each other and provide a more complete perspective on the trends and potential for successful microfinance supervision and regulation in Africa.

### **Tanzania:**

The National Bank of Commerce, a government-owned bank with the largest branch network in the country and deep financial troubles, has spin-off into two banks: The National Microfinance Bank and the National Bank of Commerce. As part of the process, the branches were split between the two banks. The government did not close down the non-performing branches because most were serving the rural areas. In the split, however, the Bank of Commerce retained the best performing ones. It is expected that both banks will be privatized in the near future, but currently they remain government controlled while the branches develop a healthier portfolio and become profitable<sup>6</sup>.

At present, the National Microfinance Bank has mainly micro deposits and a very small loan portfolio. The Central Bank of Tanzania is both interested and involved in providing the environment that would make the Bank successful. A case study on regulation and supervision would be timely and would provide important guidance in light of the Latin America experience.

Meanwhile, PRIDE, the only successful NGO in terms of size and performance in the country, is discussing the possibility of transforming into a formal financial intermediary, though not necessarily a bank. PRIDE is not yet profitable, but the institution is expanding rapidly. The discussion on transformation is still in the initial stages. Nonetheless, it has been supported and fostered by a board member who holds an influential position at the Central Bank.

In sum, Tanzania presents an interesting case study. On the one hand, it is important since the success of the Microfinance Bank depends, among other things, on an appropriate regulatory environment. On the other hand, the case study will provide guidance to the Central Bank, based on the positive and negative experiences of Latin America and other African neighbors on the subject.

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<sup>5</sup> Robin Young is following up on potential case studies in West Africa given BCEAOs present structure and possible changes.

<sup>6</sup> Robin Bell, Development Alternatives Inc.

**Uganda:**

The Centenary Bank has been providing microfinance services to small and micro entrepreneurs for the past three to four years under technical assistance from IPC. Results have been positive for the past year in terms of outreach and portfolio performance. At the same time, two or three NGOs, among them PRIDE, the largest and best performing one in the country, have been discussing the possibility of transformation into non-bank formal intermediaries. A larger number of NGOs, however, is interested in mobilizing savings. The Central Bank of Uganda is proposing to deal with the situation by working with the Association of Microfinance Institutions of Uganda to take on a supervisory/monitoring role<sup>7</sup>.

The Central Bank is supportive of the Centenary Bank microfinance window but has made no attempts to introduce changes to the regulatory environment. The potential transformation of PRIDE has been commented but not given serious consideration as the institution's current situation deems the discussion premature. GTZ is providing technical assistance to the Central Bank on the microfinance regulatory issues. As in other African countries, in Uganda the discussions on a regulatory framework for microfinance institutions favor a tiered regulatory structure with special provisions that make it feasible for (financially sound) NGOs to become formal financial intermediaries without becoming commercial banks.<sup>8</sup>

**South Africa:**

The Standard Charter Bank of South Africa, while not specifically targeting micro and small business, has been providing small loans for the past few years. The bank has an extensive ATM network with a customer service representative specially assigned to teach clients how to use it. In addition, ABSA Bank, the largest commercial bank in South Africa by asset size, has tried to launch a type of microfinance initiative called NuBank. Many other initiatives are also underway.

South Africa is the country with the most advanced and stable financial system in Africa. Competition among the large number of banks currently operating in the country has resulted in a deepening of financial services, particularly into consumer lending via credit cards. Prudential regulation for microfinance institutions is not presently an issue for the Superintendency, but the country's solid financial system offers the greatest potential for a successful microfinance regulation in Africa.<sup>9</sup>

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<sup>7</sup> W. Steel, World Bank.

<sup>8</sup> Would be useful to contact USAID's PRESTO project implemented by MSI, which is working on strengthening microfinance institutions in Uganda.

<sup>9</sup> Robin Young following up with Rolland Pearson in South Africa regarding other initiatives such as proposed self regulation of MFIs by the Alliance, etc.

**Kenya:**

The Cooperative Bank of Kenya, a private bank owned by the cooperative system, has recently started a microfinance pilot program tailored after the BRI (Indonesia) under the technical assistance of Bannock Consulting, a member of the DAI Group. The Coop Bank is working with the full cooperation of the Central Bank for the microfinance program. Meanwhile, the Board of K-Rep, the most successful NGO in the country and one of the best-known microfinance institutions in Africa, is already negotiating its transformation into a commercial bank with the Central Bank of Kenya. The central offices for the future bank are already under construction. USAID/Kenya funded MicroPED project, managed by DAI, is working in close collaboration with K-Rep.

While the Central Bank has shown interest in the supervision and regulation of microfinance institutions, there have not been any attempts to introduce changes to laws, norms and practices. The Coop Bank is still discussing with the Central Bank issues related to the bank examination of the microfinance portfolio. Given current developments with commercial bank involvement in microfinance and NGO transformation into formal intermediaries, and given DAI's standing behind the major players, Kenya offers a great arena for a case study.

**Ghana, Zimbabwe, Mozambique and Zambia:**

Alternative countries for case studies are Ghana, Zimbabwe, Mozambique and Zambia. The following paragraphs highlight relevant developments in these countries.

In Ghana, the Central Bank is discussing the need for changes in the regulatory environment. The Government controls an extensive network of “Rural Banks”, most of which are involved in microfinance. The Rural Banks operate under a special regime of the Banking Act with lower capital requirements and stricter reserve requirements. In addition to the Rural Banks, there are nine categories of “Non-Bank Financial Institutions” under a separate Act. The Savings and Loans category have already attracted microfinance institutions that want to take savings. Women’s World Banking Ghana, a former NGO, became licensed as an S&L a few years ago. Most S&Ls are also involved in microfinance. Among the best known is Citi Savings and Loans. Credit Unions are another category of NBFIs. Previously registered under the Ministry of Cooperatives, credit unions were brought into the financial side by the NBFi law. But since most could not meet the capital requirements and have other problems inherited from their cooperative background, the bank of Ghana is encouraging their apex body, the Credit Unit Association, to undertake some supervisory functions. At present, the Government is developing a plan that involves a restructuring of the financial system and prudential regulation of microfinance activities<sup>10</sup>.

In Zimbabwe, the Government is working on getting the state bank involved in microfinance. The Commercial Bank of Zimbabwe, which was heavily involved in the BCCI scandal of few years ago and almost went bankrupt, is working with CARE to develop a microfinance

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<sup>10</sup> W. Steel, World Bank.

program. The government is now trying to rebuild the Bank by developing a new clientele and portfolio through microfinance.

In Mozambique, the Bank Superintendency is currently working on a plan aimed at defining a regulatory framework for NGOs involved in microlending. About 50 NGOs currently fall under this category. The efforts have been led by the international donor community in the country. The main objective is to press NGOs into accountability, financial performance and information disclosure. There are not, at the moment, any discussions on the potential role of these microfinance institutions as formal financial intermediaries.

In Zambia, the Central Bank, in collaboration with IRIS Center of the University of Maryland, is working on a legal framework for the operations of microfinance institutions in the country. The Bank seeks to “provide for the registration and legal operation of microfinance institutions under specific regulatory provisions designed to attract investment and provide appropriate protections”. Other related issues under discussions are the nature of ownership and accountability in microfinance institutions and the assignment of the regulatory role to a specific body. Discussions are leaning towards a regulatory scheme in which certain NGOs’ microfinance activities are recognized and all deposit-taking and certain lending operations above a defined size threshold are subjected to phased regulation. It is expected that the new legislation would allow microfinance institutions to operate with relative stability and transparency while opening up multiple sources for on-lending. USAID/Zambia sponsors these efforts. The IRIS team is at work on a review of the Zambian legislation to be presented as part of a larger financial sector reform package in early 1999<sup>11</sup>.

### **Asia:**

Case studies conducted in Asian countries will have a similar applied research approach to those conducted in Africa, building from lessons learned in Latin America. As in the case studies for Africa, they will focus primarily on formal financial intermediaries involved in microfinance and the regulatory and supervisory issues affecting their performance. The studies will take a look at the regulatory and supervisory environment, analyze whether it is conducive to successful microfinance and present recommendations.

The countries that offer the best potential for case studies in Asia are the Philippines and Indonesia. Due to the current political unrest in Indonesia, IMCC recommends the Philippines as the best option for a case study.

### **Philippines:**

The Philippines has a wide range of different types of financial institutions, among them universal banks, commercial banks, thrift banks and rural banks. Many of these institutions are involved in small lending, especially consumer lending. At present, the Bank Superintendency of the Philippines (BSP) is very interested in “assisting credit for the poor” through its regulatory functions. Under this framework, both IMCC and DAI have been carrying out various studies on microfinance topics in close collaboration with the BSP. This

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collaboration ensures access to the supervisory process of the BSP and its full cooperation with the proposed case study. The case study for the Philippines will take a close look at the supervisory practices of the Superintendency, their influence in micro and small lending, as well as the potential for risk-based supervision.

**Indonesia:**

The Central Bank of Indonesia is currently in the process of amending its banking act to provide for the supervision and regulation of microfinance institutions. The Bank, under technical assistance from GTZ, is working on a project titled “Small Financial Institutions” to be launched in 1999. The project is concerned with both microfinance banks and NGOs. It proposes self-regulation through an association of microbanks. Indonesia is also interesting due to its experience with BRI and other smaller banks such as the BPRs (private rural banks) which offer microfinance services.



**ANNEX 2 (A)**  
**CASE STUDY OUTLINE FOR LATIN AMERICA**



1. Environment: Social/Government/Economic (Brief description to provide background of the country's social and economic environment -1 page)
2. Description of Regulatory Environment / Microfinance (5 pages)
  - 2.1 NGO's transformation (PFF):
    - Requirements for transformation
    - (Capital, Ownership, Other)
    - Permissible Activities
    - Compliance/Reporting/Supervision
  - 2.2 FFIs doing microfinance
  - 2.3 Superintendency
    - Regulation on interest rates
    - Regulation on legal reserves
    - Loan classification system and reserve requirements for Microloans.
    - Disclosure of information requirements
  - 2.4 Externalities
    - Effects of competition, liquidity forcing commercial banks into market deepening.
    - Government subsidized interest rates through “special programs”
3. Results:
  - 3.1 PFFs:
    - How many actually transformed?
    - How many more in the process?
    - If there are not sufficient numbers, how come, given a "new conducive" regulatory environment?
    - Has the volume of operations increased? (outreach)
    - Average loan size (type of client reached), depth of outreach
    - Financial performance? Profitability?
    - Savings mobilization and retained earnings as a source of self-funding
    - Reliance on donor funding
    - Costs associated with compliance and supervision / Taxation
    - Governance and ownership structure influencing operations
  - 3.2 FFIs:
    - How many in microfinance because of regulatory framework?
    - How many more in the process?
    - If there are not sufficient numbers, how come, given a "new conducive" regulatory environment.?

- What extend (number of clients) and depth of outreach (average loan size /type of client reached)?
- Financial performance? Profitability?
- Costs associated with supervision of microloans?
- What changes to administration in order to make MF feasible?

### 3.3 Superintendency:

- Problems encountered:
  - PFFs
  - FFIs
  - Superintendency itself:
    - Staff skills, capacity, sufficiency
    - Supervision tools
    - Enforcement capacity
    - Legal capacity to introduce needed changes
- Costs/effectiveness associated with supervision of microloans?
- What changes to administration in order to make MF feasible?
- What have all these changes meant to them?
- How many more PFFs expected to be approved?

## 4. Findings and Conclusions

### 4.1 PFFs

### 4.2 FFIs

### 4.3 Superintendency

**ANNEX 2 (B)**

**CASE STUDY OUTLINE FOR AFRICA AND ASIA**





1. Socioeconomic Environment (1-page description)
2. The Financial System (2-page description)
3. Microfinance Institutions
  - 3.1 Commercial Banks with microfinance windows
    - How many?
    - How many more in the process?
    - Performance? Profitability?
    - Compliance with regulation and supervision: treatment of microloans
    - Costs associated with compliance with supervision
    - Governance and ownership structure influencing operations
    - Savings mobilization
  - 3.2 NGOs in the process of or with potential for transformation
    - How many?
    - How many more in the process?
    - Performance? Profitability
    - Characteristics of the transformation: capital requirements, permissible activities, compliance with reporting and supervision
4. The regulatory and environment: opportunities and constraints to successful microfinance (10-page description).
  - 4.1 Superintendency
    - Approach to supervision of microlending by commercial bank
    - Views/actions towards supervision and regulation of microfinance activities
    - Current laws and practices governing supervision
    - Staff skills, capacity, sufficiency
    - Enforcement capacity
    - Legal capacity to introduce changes
    - Costs implications
5. Findings and Recommendations
  - 5.1 Main Findings
  - 5.2 Applying lessons learned from Latin America and Asia
  - 5.3 Recommendations







**ANNEX 3**  
**SUPERINTENDENCY QUESTIONNAIRE CHECKLIST**



Please fill out a separate questionnaire for each type of financial institution to the extent necessary to reflect differences in superintendency practices among different types of institutions. This is important because when this information is aggregated we want to be sure that we are comparing like information for like institutions to the greatest extent possible.

Obtain an organization chart of the superintendency and briefly describe the duties/responsibilities/activities, especially the activities, carried out for each box on the organization chart.

To what extent does the superintendency control usury ceilings on interest rates?

Does the superintendency (especially if it is within the central bank) sometimes mix regulatory concerns with the implementation of monetary policy?

List the types of licensed and/or regulated financial institutions that are permitted to take deposits and/or make loans, i.e., banks, thrifts, credit unions, finance companies, NGOs, etc.

Please provide a breakdown of financial institutions by:

- Number of institutions by type and total assets for each type of institution.
- The number of new entrants by type in 1996, 1997 and 1998.
- The types of activities that are expressly granted or prohibited by law or regulations.

Try to determine the number of NGOs that have transformed into formal financial intermediaries in 1996, 1997 and 1998. Please discuss.

Try to determine the number of banks that have started providing microfinance services since relevant changes in laws and supervisory practices. Please explain, including timeframes.

Does the superintendency have definitions for microfinance or microlending? If so, what are they?

Determine if the superintendency considers microfinance essentially different from other forms of financial intermediation, or just a variant of basic banking.

Describe any special program initiated or conducted by the superintendency for the specific purpose of promoting microfinancial services: (Include Regulations Circulars, and actual practices.)

Does the superintendency tend to be more lenient in dealing with microfinance institutions than with other financial intermediaries?

Does the superintendency attempt to deal with fraud in lending at non-deposit-taking institutions?

Does the superintendency specialize their examinations and supervision according to the kind(s) of market(s) that the banks they supervise target?

Does the superintendency provide training for its examiner and staff?  
 (For each yes answer, please provide a description of the training, including subject matters covered, the length of the training, where the training is conducted, costs for training, costs for travel, where the funds come from or how the programs are funded, etc. – please be as specific as possible.)

Examiners	Formal	y	n
	Informal	y	n
	In-house	y	n
	Outside	y	n
Staff	Formal	y	n
	Informal	y	n
	In-house	y	n
	Outside	y	n

Does training include microfinancial services training?

What educational and professional certifications are required to be a bank examiner?

Educational:

Professional:

What are the legal requirements for the frequency of examinations, by type of institution?

How often are examinations actually done based on available resources?

To what extent do examiners consider the adequacies of management and operational systems in the management of microfinance and microlending?

To what extent does the superintendency help institutions that do not yet mobilize deposits on their way to qualify for licensing or to assist them in obtaining funding from other sources.

Can it be determined to what extent this activity might detract from the regulator’s primary regulatory responsibilities?

What approach does the superintendency use to examine banks and financial institutions under their supervisions? Bottom-up, top-down, risk-based or a combination? (See Annex 3 for descriptions supervisory approaches.)



What type of institution rating system is used by the superintendency, i.e., CAMEL, and how is it used?

How are examination resources allocated?

Based on legal requirements?

By the size of the institutions?

Based on an assessment of risks to the financial system?

What approaches are acceptable to the superintendency for reducing the adverse consequences of risk taking in financial institutions? (See Annex 3)

Risk avoidance

Employment of risk mitigation techniques

Offsetting risks

Try to determine the if actual examination practices have been kept aligned with laws and norms. Please discuss.

What are the Superintendency's attitudes toward microfinance?

What are examiners' attitudes toward microfinance?

Please discuss the loan documentation requirements of the superintendency with regard to:

Collateral

Financial information

Notary

Tax returns

Other (describe)

Does the superintendency accept work done by others, or do they only rely on information generated by examiners?

Does the superintendency have a special unit to rehabilitate problem banks?

Does the superintendency have enforcement tools to help it in its efforts to rehabilitate banks such as:

Assessment of civil money penalties to discourage and punish egregious unsafe and unsound behavior?

The ability to issue cease and desist order to stop unsafe and unsound behavior?

Other? Describe:

Do examination reports:

Identify problems?

- Define the problems?
- Discuss the root cause of the problems?
- Assess the resources available to resolve the problems?
- Recommend solutions to the problems?

If the institution is beyond rehabilitation, what are the options for closing it?

What are requirements for entry for each type of licensed and/or regulated financial institution, i.e., banks, thrifts, credit unions, finance companies, NGOs, etc.:

- Capital requirements
- Management requirements
- Financial condition of institutions wanting to convert (Regulatory due diligence)
- Assessment (costs) made by the superintendency
- Ownership
- Permissible activities

Does the superintendency routinely apply rules concerning character (honesty) and competency to new bank organizers and proposed management? What about change in ownership and/or change in management in troubled institutions?

Requirements for mergers

- Capital requirements
- Management requirements
- Financial condition of institutions wanting to convert (Regulatory due diligence)
- Assessment (costs) made by the superintendency
- Ownership
- Permissible activities

Try to determine if costs and practices of microfinance supervision are congruent with the risks and volume of operations involved. Please discuss.

Can it be determined if donors and government funding agencies pay for the supervisory work needed to select and monitor non-deposit-taking microfinance institutions by hiring local auditing firms (or possibly the superintendency itself) or do they undertake the task themselves internally or do they use industry organizations that undertake self-regulation?

What are the assessments (costs) imposed by the superintendency on regulated institutions?

By type of institution:

How often does the superintendency require financial information from supervised institution?

Quarterly	Semi annual	Annual
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Does it include:	Balance Sheet?
	Income information?

Asset Quality information?  
Deposit volatility information?

Does the superintendency have automated systems to analyze this information?

Does the superintendency have a special unit or individuals to analyze this information?

Please provide any other information that provides insights to things the superintendency does, or plans to do, which may have the effect of encouraging or discouraging microfinancial activities.



**ANNEX 4**

**TRADITIONAL SUPERVISION COMPARED  
TO RISK-BASED SUPERVISION**



Supervision of financial institutions is both an art and a science. Traditional forms of supervision and risk-based supervision are not mutually exclusive. The methodologies used in traditional supervision and risk-based supervision are like tools in the hands of craftsmen; understanding their purposes and knowing when and how to use them are desirable skills.

At the risk of oversimplifying the difference in approaches, traditional supervision focuses more on quantifying problems and minimizing risks in individual financial institutions, while risk-based supervision focuses more on the quality of management and risk management systems in individual institutions plus the recognition of risks to the banking system (systemic risks) caused by the environment in which the banking system operates.

The outcome of traditional supervision often results in identifying symptoms of problems, quantifying problems and correcting the symptoms as they exist today, with an emphasis on minimizing risks. The outcome of risk-based supervision, on the other hand, is an evaluation of the quality of management and risk management systems and systemic risks in the economic environment in which an institution operates. It addresses problem causes, and recommendations are usually meant to improve risk management techniques within an institution, thereby improving the management of an institution. In addition, risk-based supervision is usually more open to innovative methodologies for taking and managing more variations of risks, such as the risks associated with microfinance.

Traditional supervision usually provides historical information and a “snap shot” of an institution’s condition as it appears at a point in time, while risk-based supervision provides insights regarding current and future performance. Traditional forms of supervision are transaction oriented and can be more labor intensive than risk-based supervision, thereby straining scarce resources of most regulators, and sometimes providing results that are less useful. Risk-based supervision focuses on management and systems and how well an institution manages risk. Transactions are sampled to validate system assessments, including management information systems.

One of the easiest ways to explain the differences between traditional supervision and risk-based supervision is to use an analogy. Evaluating the health of a financial institution is similar to evaluating the health of a person. If a person is thought to be in generally good health and goes to a doctor for an annual physical check-up, the doctor will check the vital signs, the functions of vital organs, check for ailments common to the patient’s age, gender, etc., inquire about life style, eating habits, exercise, family history, etc., and will make a judgement about the health of the patient and health risks factors that may affect the health of the patient. The doctor usually will not spend a lot of time and resources to run tests for possible ailments unless there are symptoms, high risk factors or other cause to suspect health problems. On the other hand, if the patient is known, or thought, to be in poor health or at high risk, the doctor will run many more tests in order to assess the health of the patient. Where health problems are detected, extensive testing will probably be done to evaluate the extent of the problems, the extent of the harm that has been caused and the treatment necessary for healing. To be a competent doctor requires a considerable amount of knowledge, training, experience and good judgement.

The examination of a financial institution should be similar to the physical examination of a person. If an institution is thought to be in generally good health, the supervisory approach taken should be different than if the institution is known, or thought, to be in poor health or at high risk. If an institution is thought to be in generally good health, a risk-based approach is appropriate. The vital signs (the adequacy of capital, liquidity and compliance with regulations) would be checked, functions of vital organs (performance indicators for the major functions of the institution, i.e., the loan portfolio, asset/liability management, liquidity, earnings, etc.) would be tested, risk factors would be evaluate, symptoms of problems assessed and systems and management practices would be tested. Regulators should not spend a lot of time and resources to run tests for possible problems unless there are symptoms or causes to suspect problems. The key phrase is “in well managed institutions.” On the other hand, if an institution is known, or thought to be, in poor health or at high risk, a more traditional or bottoms up approach would be appropriate. The regulator should do transactional testing in order to assess the health of the institution. Where problems are detected, extensive reviews should be done to evaluate the extent of the problems, the extent of the harm that has been caused and the actions necessary for rehabilitation. Audit activities may even be necessary to define and quantify problems. Like the doctor, to be a competent bank supervisor requires a considerable amount of knowledge, training, experience, and good judgement.

There are three distinct approaches to bank supervision -- bottom-up, top-down and risk-based. The term “traditional supervision” usually refers to bottom-up supervision. Risk-based supervision is an enhancement of top-down supervision. The following is a very brief description of each.

### **Bottom-up**

Bottom-up supervision requires a great deal of technical knowledge and skill but is the least sophisticated approach to financial institution supervision. It is labor intensive and strains the resources of most regulators that employ it, in part because it usually does not differentiate between high, medium and low risk activities.

This approach is primarily audit based. Usually the same procedures and approaches are applied to all institutions almost equally. The primary focus is on the accuracy of the balance sheet, including the loan loss reserve, the income statement and the adequacy of traditional internal controls that are primarily designed to prevent fraud. The primary objectives are balancing journals, reviewing large numbers of individual transactions, such as loans, and quantifying problems based on the aggregate of transactions reviewed. This approach has merit for determining the current condition of a financial institution and quantifying current problems, but provides little insight into future performance and does not put the onus of accurate record keeping and problem identification and correction where it rightfully belongs, on management and the directorate. Because it often addresses the symptoms of problems instead of causes, it frequently leads to remedies that cause institutions to reduce risks as opposed to employing techniques to manage risks better. Reducing risks is a form of avoiding risks that has a tendency to reduce the variety and volume of products and



services offered to the public. This includes credit to borrowers that may be small and considered less creditworthy.

### **Top-down**

Top-down supervision was developed in the 1970's. This approach relies on an overall financial analysis and review of policies, procedures, systems, and management practices. These are documented and tested for integrity. Unlike the bottom-up approach, transactions' testing is done to test compliance with stated policies, procedures, systems and practices. For example, if a loan policy defines certain underwriting criteria, a sample of loans would be reviewed to determine compliance with the criteria. These same loans would be tested for credit quality. If problems are found, they are defined and corrective actions are directed towards correcting systematic deficiencies rather than individual transaction deficiencies. If credit quality of the sample loans is found to be deficient but in compliance with underwriting standards, then changes in the underwriting standards may be appropriate. At this point there is no attempt to quantify problems unless the examiner suspects the problems are significant in terms of the safety and soundness of the institution. In the "top-down" approach, systemic problems are identified and defined, and the root causes for the problem are addressed. If problems are identified that, in the opinion of the superintendency or the examiner, significantly impact the safety and soundness of an institution then a "bottom-up" examination may be necessary to quantify the problems and determine the precise condition of the institution.

### **Risk-Based Supervision**

Risk-based supervision enhances top-down supervision in three ways. It focuses supervisory resources on the areas of highest risk within individual financial institutions. It uses a common framework and common terminology, developed specifically for risk-based supervision, to assess risks and evaluate management practices, policies and procedures in the context of managing risks, i.e., optimizing returns while minimizing the adverse consequences of risk-taking. And, it incorporates an assessment of management's ability to deal with risks beyond the control of management, such as competition and systemic risks in the economic environment in which the financial institution operates. As in "top-down" supervision, systemic problems are identified and defined, and the root causes for the problem are addressed. If problems are identified that, in the opinion of the superintendency or the examiner, significantly impact the safety and soundness of an institution then a "bottom-up" examination may be necessary to quantify the problems and determine the precise condition of the institution.

Risk-based supervision requires an understanding of the risk profile of the institution under examination in order to identify areas of greatest risk and therefore deserving of greatest attention. Once the areas (in terms of products/services/activities) of greatest risks have been identified, the examiner reviews the risk management systems and practices of the institution. There are the four basic components of a risk management system: (1) identifying risks; (2)

measuring risks; (3) controlling risks; and (4) monitoring risks. Minimizing risk is a form of risk avoidance and is very different from minimizing the adverse consequences of risk-taking which entails managing, not avoiding, risks.

Actions taken by the institutions to minimize the adverse consequences of risk-taking fall into three categories: (1) risk avoidance (not taking certain types of risks or placing limits on the amounts of certain risks the institution is willing to take; this approach is the easiest to understand and enforce); (2) mitigating risks (this involves taking risks but putting in place controls, processes, experienced people and practices that reduce the chances of loss); and (3) offsetting risks (this usually entails pricing products/services/activities high enough to cover anticipated costs and losses). It can also entail using the income from one product/service/activity to subsidize another product/service/activity. This is usually the case that occurs with the introduction of a new product/service/activity.

All institutions should not be treated the same by regulators. The greater an institution's demonstrated ability to manage risk, the more tolerant a regulator should be to variation of risk, such as microlending, higher levels of risk and alternative approaches to managing risks. As this relates to microfinance, regulators should be less concerned with all loans in all institutions meeting the same pre-determined documentation and collateral standards and more concerned with methodologies used to manage risks in portfolios of microloans. For example, traditional loan underwriting standards are based on collateral and financial analysis. Traditional forms of supervision focus on collateral and financial support for individual loans. The more successful microlending institutions seem to have found alternative methods for managing microlending risks through better systems and a blending of financial and behavioral analysis. Since risk-based supervision focuses on an institution's ability to manage categories of risks it is less concerned uniformity among institutions.

Traditional supervision tends to substitute the regulator's judgement for what constitutes sound practices for management's judgement. Risk-based supervision is heavily dependent on regulators' judgement, but allows for more creativity and innovation depending on an institution's ability to manage risks.

Bank examiners are not, or should not be, auditors. Examiner should be financial, risk, system, compliance and management analysts. Assuring the accuracy of bank records is the responsibility of bank management, and assuring adequate audit coverage is the responsibility of the directorate. Regulators should use their powers to assure bank management and directors fulfill their respective responsibilities. To do otherwise strains scarce regulatory resources and runs counter to regulators' responsibilities to assure that the financial institutions, for which they are responsible, are properly managed.

