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POLICY RESEARCH WORKING PAPER 2755

A Framework for Regulating Microfinance Institutions

The Experience in Ghana and the Philippines

Joselito Gallardo

How does a country's legal and regulatory framework affect the sustainability of microfinance? Does a tiered approach to regulation help to integrate microfinance into the formal financial system? And are there lessons to be learned from the experience of Ghana and the Philippines with a tiered approach?

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Summary findings

An earlier Policy Research Working Paper (Hennie van Greuning, Joselito Gallardo, and Bikki Randhawa, "A Framework for Regulating Microfinance Institutions," WPS 2061, February 1999) presented a regulatory framework that identifies thresholds in financial intermediation activities that trigger a requirement for a microfinance institution to satisfy external or mandatory guidelines—a tiered approach to regulation and prudential supervision. The model focuses on risk-taking activities of microfinance institutions that must be managed and prudentially regulated.

Gallardo reports on the results of the field testing and assessment of the tiered approach, focusing on the experience of Ghana and the Philippines. The two countries both have a wide range of informal, semi-formal, and formal institutions providing financial services to the poor, but differ in how they regulate financial intermediation activities by microfinance providers.

In his assessment and a comparative analysis, Gallardo focuses on key issues in the regulatory and supervisory environment for microfinance—and in the legal system and judicial processes—being addressed by government authorities and microfinance stakeholders in both countries. He gives particular attention to the thresholds at which intermediation activities become subject to prudential regulation and regulatory standards for capitalization and capital adequacy, asset quality and provisioning for nonperforming loans, and liquidity management.

Gallardo seeks to identify the key elements and characteristics of the microfinance regulatory experience of Ghana and the Philippines and to draw the lessons that may be useful for other countries interested in establishing a regulatory environment conducive to the development of sustainable microfinance institutions.

The experience of Ghana and the Philippines shows that a transparent, inclusive regulatory framework is indispensable for enabling microfinance institutions to maintain market specialization and to pursue institutional development that leads to sustainability. Clear pathways for institutional transformation facilitate the integration of microfinance institutions into the formal financial system.

This paper—a product of the Financial Sector Development Department—is part of a larger effort in the department to explore ways to provide more financial services to the poor. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Tomoko Ishibe, room MC9-747, telephone 202-473-8968, fax 202-522-3198, email address tishibe@worldbank.org. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at jgallardo@worldbank.org. January 2002. (36 pages)

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ACRONYMS

ASCA	Accumulating Savings and Credit Association
BancoSol	Banco Solidario, S.A (Bolivia)
BKK	Badan Kredit Kecamatan (Village rural fund and credit institution – Central Java, Indonesia)
BOG	Bank of Ghana
BPR	Bank Perkreditan Rakyat (People's Rural Credit Bank, Indonesia)
BRAC	Bangladesh Rural Advancement Committee
BRI	Bank Rakyat Indonesia
BSP	Bangko Sentral ng Pilipinas (Philippines)
CARD	Center for Agriculture and Rural Development (Philippines)
CCA	Canadian Cooperative Association
CDA	Cooperatives Development Authority (Philippines)
CFIs	Cooperative Financial Institutions
CUA	Ghana Credit Union Association
FENACREP	Federación Nacional de Cooperativas de Ahorro y Credito del Perú
FINCA	Foundation for International Community Assistance
GHAMFIN	Ghana Microfinance Network
LDKP	Lembaga Dana Kredit Pedesan (Village Rural Fund and Credit Institution, Indonesia)
LPD	Lembaga Perkreditan Desa (Village Savings and Credit Institution -- Bali, Indonesia)
MFI	Microfinance Institution
NBFI	Non-Bank Financial Institution
NGO	Non-Governmental Organization
PDIC	Philippine Deposit Insurance Corporation
PRODEM	Fundación para la Promoción y Desarrollo de la Microempresa (Bolivia)
ROSCA	Rotating Savings and Credit Association
S & L	Savings and Loan Company (Ghana)
SHG	Self Help Group
SME	Small and Medium Enterprise
WOCCU	World Council of Credit Unions

Exchange rates (Local currency to US$):
Ghana Cedi [¢] 6,500.00 = US$1
Philippine Peso [₱] 50.00 = US$1

ABSTRACT

Responding to the rapid growth of various types microfinance institutions (MFIs) around the world and the gap in knowledge on whether and how these institutions should be regulated, a team from the World Bank comprising Hennie van Greuning, Joselito Gallardo and Bikki Randhawa produced a Policy Research Working Paper No. 2061 (February 1999) entitled, "*A Framework for Regulating Microfinance Institutions*". The paper sought to provide a framework for addressing regulatory issues which impact the operations and the institutional development of MFIs. The paper was viewed as a work in progress on which further adjustments could be made, based on analysis of selected country experiences from the field.

The two countries selected for this field testing and assessment were Ghana and the Philippines, which have a wide range of informal, semi-formal and formal MFIs providing financial services to the poor, but have legal systems and regulatory frameworks which differ in how financial intermediation activities by MFIs are regulated and/or supervised. Subsequent in-depth work on issues in developing sustainable rural/microfinance in Indonesia presented an opportunity to deepen the assessment of how the legal and regulatory environment is important to sustainable microfinance.

The assessment and comparative analysis carried out focus on the key issues in the legal system and judicial processes, as well as on the regulatory and supervisory environment for microfinance which are being addressed by the governments and microfinance stakeholders in the countries.

Ghana, the Philippines and Indonesia all have a comparatively wide range of informal, semi-formal and formal institutions whose principal line of business is the provision of microfinance services. The legal and regulatory environment in these three countries have, for many years, permitted the establishment of specialized banking and financial institutions with limited financial intermediation services to geographical areas with defined limits. In more recent years, the government authorities in Ghana and the Philippines have moved forward to articulate a vision and strategy for microfinance and its role in poverty alleviation programs, and made corresponding adjustments in their banking and financial laws and regulations to take advantage of the outreach possible through MFIs.

The tiered regulatory approach has clearly benefited the development of sustainable microfinance in the Philippines and Ghana, by clearly identifying pathways for non-government organizations (NGOs) and semi-formal MFIs to become legitimate institutions under the regulatory framework with greater ability to access financial resources from commercial markets. Among the risks that a graduated and tiered regulatory framework might present is that of regulatory arbitrage, whereby organizers of a financial institution seeking a license might choose to be constituted under an institutional format which is subject to least possible external regulation and supervision, as well as the lowest possible amount of capitalization at entry. Regulatory arbitrage does not appear to have been experienced by the Philippines or Ghana with respect to the MFIs obtaining status as licensed specialized banks.

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I INTRODUCTION

1. In response to the rapid growth of various types microfinance institutions (MFIs) around the world and the gap in knowledge on whether and how these institutions should be regulated, a team from the World Bank comprising Hennie van Greuning, Joselito Gallardo and Bikki Randhawa produced a Policy Research Working Paper, No. 2061 (February 1999) entitled, "*A Framework for Regulating Microfinance Institutions*". The paper sought to provide a framework for addressing regulatory issues which impact the operations and the institutional development of MFIs.

2. That Policy Research Paper has been widely disseminated internally among staff within the World Bank as well as externally to its client countries, other donor agencies and network organizations of MFIs. The feedback received has been very favorable on the innovative framework proposed. The framework discussed in the paper has been used for training purposes both within the Bank and outside.

II OBJECTIVES AND FOCUS ON THE ASSESSMENT AND COMPARATIVE ANALYSIS

3. The country case studies are an opportunity for in-depth comparative analysis of the countries' experiences in implementing a microfinance regulatory framework, and thus provide a basis for refining the framework itself. The criteria used in selecting the countries are: (a) existence of a significant microfinance industry and a variety of semi-informal and formal channels for microfinance, and (b) ongoing dialogue among microfinance stakeholders on issues in the legal and regulatory framework for microfinance.

4. The two countries selected for this field testing and assessment are Ghana and the Philippines. Subsequent in-depth work on issues in developing sustainable rural/microfinance in Indonesia presented a singular opportunity to deepen the assessment of the legal and regulatory environments in Ghana and the Philippines by bringing in relevant aspects of the Indonesian experience. All three countries – Ghana, the Philippines, and Indonesia – have a wide range of informal, semi-formal and formal MFIs providing different financial services to the poor, as well as legal systems and regulatory frameworks which differ in coverage of financial intermediation activities by MFIs.

5. The assessment and comparative analysis carried out focus on the following key issues in the *legal system and judicial environment*:

   - Procedures and requirements for legitimizing status as an MFI, such as organizational format for becoming established, and rules and regulations for registration.
   - Standards to be met and requirements to be complied with in order to obtain status as a licensed microfinance institution, including the range of institutional formats within a tiered structure.
   - Procedures stipulated and requirements to be satisfied in order to access non-deposit wholesale commercial funds, e.g., through large-value certificates of deposit, commercial paper issues or securitized instruments.
   - Characteristics of the legal structure and judicial system which permit or prevent assets to carry the burden of debt.

6. The assessment and comparative analysis carried out focus on the following key issues in the *regulatory and supervisory environment*:

   - The principal prudential standards required to be observed and complied with by licensed or

authorized banking and financial intermediary institutions.

- The primary methods by which observance and compliance are carried out, including frequency of offsite mandatory reports and onsite examination.
- Sanctions and penalties for non-observance or non-compliance.
- Rules for entry and exit as licensed banking and financial intermediary institutions.

III NEW DIRECTIONS IN PROVIDING MICROFINANCE SERVICES: INTERNATIONAL BEST PRACTICE

7. The late 1970s witnessed a growth in financial services targeted to the poor, through initiatives spearheaded by NGOs such as Grameen Bank in Bangladesh and the affiliates of ACCIÓN International in Latin America. These initiatives were followed in the 1980s by major efforts of ACCIÓN and other NGO networks such as Women's World Banking. In addition, the Foundation for International Community Assistance (FINCA), the Bangladesh Rural Advancement Committee (BRAC) and the Bank Rakyat Indonesia (BRI) Unit Desas (village banks) were reporting success in reaching the poor with financial services. During this period of growth in the number and range of MFIs, various myths about providing the poor with financial services were dispelled -- including that the poor cannot save and cannot afford non-subsidized interest rates. In the 1990s, best practices in microfinance made important strides in such areas as key indicators for measuring an institution's success, particularly outreach and financial sustainability.

Box 1. Lessons Learned from the Global Experience on Microfinance

- The financial systems approach is important for sustainable microfinance with outreach. The approach emphasizes an enabling environment for policy and regulation and supportive financial infrastructure. The approach also depends on developing a range of financial intermediaries committed to achieving financial sustainability within a reasonable time, and to providing a variety of financial services other than credit.
- The diversity of demand for microfinance services requires a broad range of strong financial intermediation institutions which can expand outreach to households in different layers of poverty and in resource-poor urban and rural areas.
- The primary concern of microfinance clients is access to microfinance services compatible with their requirements, rather than the cost of such services. Demand for savings services by poor households may be as strong as demand for credit facilities. Thus, expanding the access to savings services can have a significant impact on an institution's sustainability.
- Financially viable microfinance institutions limit their operational focus to providing only financial services. It is important to distinguish between and to separate financial intermediation (through microfinance) vis-à-vis social intermediation (through social safety nets) in the design of support programs.

8. The global experience demonstrates that MFIs change and develop as the scale and scope of their operations grow beyond delivery of credit services to include savings, deposit and other financial services. In addition, that growth prompts innovative approaches to achieving and maintaining financial sustainability. Expanding outreach requires increasing funding resources and exposes the limits to grants and donor funds. Commercial funding sources can usually be accessed when the policy and legal environment are appropriate, and only if the MFI has the appropriate legal status and financial standing.

9. In Bolivia, the microfinance NGO Fundación para la Promoción y Desarollo de la Microempresa (PRODEM) sought to scale up and transform into a licensed commercial bank in order to fund microfinance operations from retail and wholesale deposits. Through BancoSol PRODEM was able to quickly expand its client base from 14,300 active/repeat borrowers in four PRODEM branches/offices in 1991 to more than 80,000 active loan accounts and 50,000 savings deposit accounts in more than 3 dozen branches/offices of BancoSol by 1998. BancoSol (Banco Solidario, S.A. (Bolivia))has captured about 20% of Bolivia's potential market for microfinance. The PRODEM/Bancosol experience induced several developments that have been beneficial for Bolivia's poor households and its microfinance industry.[1]

   - First, the Bolivian bank regulatory authority recognized the importance of the regulatory environment on microfinance development and made room for new category of regulated MFIs – the Private Finance Fund.
   - Second, BancoSol's success in the banking industry induced other commercial banks to adjust their market positioning and product offerings in order to compete with BancoSol.
   - Finally, the successful experience encouraged other Bolivian NGO-MFIs such as AgroCapital and ProMujer to develop their own institutional transformation to regulated institutions.

10. The successful transformation achieved by PRODEM/BancoSol served to encourage other NGO-MFIs around the world like K-REP (Kenya), ADEMI and ADOPEM (Dominican Republic) to design their own transformation to gain the capability to fund expansion by mobilizing deposits and accessing the capital markets. Transformation has enabled a Philippine NGO, the Center for Agriculture and Rural Development (CARD), to move its client base of 23,000 women in rural villages into its CARD Rural Bank subsidiary which has expanded outreach on a sustainable basis to almost 40,000 repeat borrowers and savers in less than four years.

11. The Bangladesh MFI Grameen Bank has a very extensive outreach. Equally well known is the *unit desa* network of BRI. While BRI is a state-owned commercial bank, the *unit desa* microfinance operation has had the management and operating autonomy typically found only in private sector-owned banks – there are no subsidies from the central government, and no cross-subsidies from BRI's other commercial banking operations. The *unit desa* microfinance system has more than 2 million active loan accounts and more than 12 million depositors. In many respects, Egypt has a similar approach and experience with the microfinance program of its National Development Bank. In both the cases of Indonesia and Egypt, it is important to note that (i) the microfinance programs in the state-owned institutions were given management and operating autonomy more commonly associated with private sector-owned institutions; and (ii) the government institutions and the policy that informed the microfinance operations eschewed subsidy mechanisms.

12. A principal lesson from the experience of successful MFIs in other countries is the importance of *sequencing*. In this context, the priority area to address is the policy environment, legal system and regulatory framework for microfinance. When the vision and strategy for microfinance are well defined and articulated, the capacity development needs of different microfinance players are more easily identified and an action program for building up the institutional capacity crafted. These prior steps facilitate the entry of donors who can focus their technical assistance programs to the identified needs of players with the potential for outreach and financial sustainability.

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[1] *Reference: From data and information available in various CGAP Focus Notes.*

IV IMPACT OF THE LEGAL AND REGULATORY FRAMEWORK ON SUSTAINABLE MICROFINANCE

13. Improving the access of low-income producers and the poor to basic financial services is viewed as an ingredient of the World Bank's efforts to promote economic growth and reduce poverty. The World Bank's approach emphasizes a market-driven approach in which the financial sustainability of financial intermediaries becomes paramount. In many cases that market approach is possible because of the use by MFIs of group lending and other techniques to offset borrowers' lack of collateral. The World Bank's overall strategy for helping countries develop micro, rural and small and medium enterprise (SME) finance includes a number of key measures in the overall legal and regulatory framework, in building up institutional capacity and in the introduction of financial systems infrastructure: [2]

Box 2: The World Bank's financial sector priorities for developing microfinance

1. Removing legal provisions (e.g., interest ceilings) or adapting regulatory provisions (e.g., banking regulations) inconsistent with financially sustainable rural and micro finance.
2. Establishing registration and titling systems and foreclosure laws to allow the use of assets (lands, crops, cattle, small equipment) owned by rural and poor urban households as loan collateral.
3. Continuing the development of specialized nonbank financial intermediaries (e.g., microfinance institutions, leasing companies, private equity funds) for SME finance.
4. Harnessing modern technologies (electronic banking, credit and payment cards) and/or non-financial institutions (postal service) to provide basic, innovative payment and financial services for rural areas, micro-enterprises and SMEs.

Source: "Strategy for the Financial Sector", Financial Sector Board, The World Bank, Washington, DC, February 2000.

14. The regulation and supervision of MFIs should be an integral part of a strategy to develop a market-based financial system. Microfinance is not limited to borrowing, but also includes other financial services such as savings, insurance, transfer facilities, etc. Savings facilities are a particularly important question when considering prudential regulation of MFIs because the prospective microfinance target group is usually many times larger in deposit business than in lending.

15. A clear and transparent regulatory framework is necessary because MFIs' traditional fund sources usually cannot keep pace with their lending business, and thus need to have access to external finance to complement their own resources and those from donors in order to reach as many prospective borrowers as possible. Possible sources of funds are loans from other financial institutions, private savings or – in an advanced microfinance sector – securities issues on the formal capital market. MFIs could thereby advance from credit-only institutions to fully-fledged financial intermediaries. Heretofore, mobilization of savings from the general public has almost always been contingent on MFIs complying with existing banking law. Access to the capital market, in turn, is contingent on MFIs complying with securities regulations.[3]

<u>The Rationale for Regulation and Supervision</u>

[2] *"Strategy for the Financial Sector", Financial Sector Board, The World Bank, Washington, DC, February 2000.*

[3] *Stefan Staschen, "Regulation and Supervision of Microfinance Institutions: State of the Knowledge", GTZ: Eschborn, August 1999.*

16. A primary reason for regulating and supervising traditional financial institutions is consumer protection for public depositors in financial institutions. Moral hazard issues arise because the interests of financial institutions vis-à-vis the interests of consumers per se are not necessarily compatible. Individual depositors and investors may not be in a position to judge the soundness of a financial institution (the issue of asymmetric information), much less to influence that institution's management. Thus, an impartial third party which such as the state or one of its agencies is required to regulate and control the soundness of a country's financial institutions. Since bank failures and problems tend to be contagious and affect other banks regardless of their soundness, the protection of the whole banking and payment system becomes an additional objective of regulation and supervision.

17. A country's legal framework and governing principles of financial intermediation define the roles of its banking and financial sector regulatory authorities (such as the central bank, ministry of finance, or bank superintendency), setting out rules for entry and exit of financial institutions, determining and limiting their businesses and products, and specifying criteria and standards for the sound and sustainable operation of the industry. Regulation (which usually refers to non-prudential regulation but may include prudential supervision in its broad general meaning) is not limited to rules set by the state alone. Regulation may include forms of auxiliary regulation and self-regulation by governing boards of financial institutions, their networks and associations, or apex organizations. Prudential supervision encompasses all measures by which regulators enforce compliance by licensed financial institutions with a given legal and regulatory framework, because licensing implies that the financial authority is vouching for or is prepared to assume responsibility for the soundness of the regulated financial institution which the public may be dealing with.

Global Experience in Regulating Microfinance

18. Banking laws in many countries compartmentalize and segment markets and institutions, constraining innovations and making MFIs' institutional development difficult. While the global experience demonstrates the potential for operational growth of MFIs, the range of institutional channels is segmented by the legal and regulatory environment. The framework for banking laws should be structured to provide MFIs a clear view of the thresholds to attain on the path to institutional development and transformation -- even if not all MFIs choose to follow that path.

19. The vast majority of NGO MFIs will remain as retail delivery channels for microfinance programs and a few may reach sustainability without ultimately transforming into a licensed bank. Some MFIs may be better off remaining as low-leverage, slow-growth but effective service institutions linked to larger institutions in meeting the needs of their existing clients.[4] Any decision to transform, evolve, or maintain a status quo is dependent on an MFI's strategic plans for its future. However, the experience of microfinance practitioners in many different settings throughout the developing world underscores the proposition that the future for sustainable microfinance lies in a regulated, licensed environment – because there is no other environment that will permit massive, sustainable delivery of an increasing variety of financial services to the poor to effectively link them to the more developed sectors of an economy.[5] Table 1 below on the operational characteristics of sustainable MFIs, serves to illustrate this point further.

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[4] *Cuevas points out that entry into the regulated financial sector (through institutional transformation) depends on the nature and extent of existing incentives and deterrents in the MFI environment and on the MFI's perceived potential and actual ability to reach the market "niche" by becoming regulated. See Carlos Cuevas, "Enabling Environment and Microfinance Institutions: Lessons from Latin America", Journal of International Development, 8, March-April 1996.*

[5] *See Christen and Rosenberg, The Rush to Regulate.*

Table 1. Selected Characteristics of 64 Financially Self-sufficient MFIs (In %)

Organizational formats	*Capital/assets*	*Operating self-sufficiency*	*Dollar average loan*	*Depth**	*External funds/ loans Φ*
Bank	21.0	118.6	527	62.5	166.6
Non-bank	27.4	110.4	958	62.4	70.3
Credit union	42.1	122.5	1,306	91.6	88.6
NGO	58.5	130.8	490	38.8	26.6

* Depth = Average loan balance per borrower/GNP per capita.

Φ External funds/loans = Borrowed funds @ commercial rates/average loan portfolio.

Source: The MicroBanking Bulletin, Issue No. 6 (April 2001), Tables C and D.

20. MFIs have large numbers of clients but low overall account balances compared with traditional financial institutions. While MFIs' share in total assets of the financial system is relatively small, direct measurements of MFIs' relative position in the overall financial system do not take into account the sector's volume of deposits in total banking system deposits, since MFIs maintain their operating accounts and clients' deposits in the banks. Their outreach, measured by the percentage of the population doing business with MFIs, can be quite large. As the clients belong to poor segments of the population a bankruptcy of either the MFI or its depository bank would have adverse consequences. The argument that regulation and supervision in microfinance are less important because of its small place in the financial system misjudges the exceptional receptiveness of this segment and its possible contribution to financial systems development.

21. The existing legal and regulatory frameworks in many of the World Bank's client countries have been unable to support the sustainable growth and commercial integration of microfinance programs into the formal financial system. In addressing this problem, a number of governments have begun to address the issue of a transparent and inclusive regulatory framework under which microcredit can be legitimately provided by MFIs, and so that a continuum of MFIs can be developed and strengthened. These governments have realized the advantages and benefits of a "tiered" banking and financial system (including its regulation and supervision), which facilitates the establishment of smaller, specialized MFIs.

22. The countries which have moved towards a tiered financial and regulatory structure include Bolivia and Peru in Latin America; and Uganda, Ghana and Zambia in Africa. A number of countries in Eastern Europe -- e.g., Albania, Bosnia and Georgia – are restructuring their banking laws and prudential regulations to establish a tiered approach to accommodate specialized financial institutions with capitalization requirements much lower than those for regular commercial banks. In Southeast Asia, the Philippines and Indonesia have had tiered banking structures, although the existing regulatory framework still does not make it possible for a range of MFIs to be integrated into the regulated financial sector. India also has in place basic statutes that would permit the establishment of smaller regulated financial institutions with a regional focus.

23. However, it is important to consider the benefits versus the costs associated with establishing and implementing a regulatory framework for microfinance. Regulation and supervision entail costs, not only for the regulator but also for the regulated institution. For instance, BancoSol's management estimates that complying with the bank superintendency's reporting requirements during its first year of operations generated a cost equivalent to 5% of the loan portfolio, even though this had declined to about 1% of loan portfolio as of last year.[6] In Peru, supervision fees collected by the credit union

[6] *Cited in Christen and Rosenberg, The Rush to Regulate.*

federation FENACREP are enough to inspect only 40 of its 130 member credit unions each year.[7] Thus, the price of regulation has to be carefully adjusted to the benefits it is expected to produce. Over-regulation may result in financial repression, limiting the efficiency of financial intermediation and increasing costs for consumers. The growing research and literature on microfinance regulation highlight the importance of a clear regulatory framework to support sustainable microfinance, and call attention to some important considerations especially of timing and phasing. First, not all MFIs need to be regulated and supervised, as can be seen in the tiered structure for MFIs and for regulation, based on their intermediation activities. Second, there needs to be a critical mass of institutions suitable for prudential regulation/supervision, to justify the commitment of public resources to the undertaking. Third, the approach to regulation differs from country to country, and there is no single universal regulatory model that should be adopted because of different macroeconomic environments and stages of microfinance development.

Financial Intermediation Activities as the Basis for Regulation

24. Differences in the organizational and operating characteristics of the various types of MFIs leave them vulnerable to certain risks. The risk-based approach to financial regulation shows that while there may be no major variances in the structure of their assets, MFIs are differentiated by the structure of their liabilities -- i.e., how their assets and operations are funded and the adequacy of capital in leveraging additional resources to fund operations. Linking the wholesale funding, limited deposit-taking and unrestricted deposit-taking activities to an institution's qualifying capital base results in *limits* to the asset build-up that MFIs can prudently undertake, without having to instruct them on how to carry out their businesses. The authorization to mobilize funds from the public in turn carries related requirements to comply with prudential standards and guidelines on certain asset-side activities, e.g., limits on concentration in loan exposure to sectors, restrictions on insider and related-party loans, provisions for possible loan losses, etc.

25. Regulation based on typology of financial institutions rather than on intermediation activities creates incentives for *regulatory arbitrage*. Organizers of financial institutions seek out licensing categories which requiring the least initial capital commitment and the lowest degree of mandatory regulation. All participants in the financial system including microfinance stakeholders benefit from a transparent regulatory framework which establishes the continuum where MFIs can progressively evolve into formal financial institutions. The regulatory framework model identifies *thresholds* of financial intermediation activities which would *trigger* a requirement to satisfy *external or mandatory* regulatory guidelines.[8] As financial institutions, it would be prudent for all of the different types of MFIs to observe *internal or voluntary* guidelines for risk management. Table 2 below accents the key features of the regulatory framework model -- identifying the fund generating activities that trigger a need for mandatory external guidelines and summarizing the proposed regulatory measures and agencies to carry them out.

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7 *See Glenn D. Westley, Can Financial Market Policies Reduce Income Inequality? Technical Papers Series, MSM-112. Washington, DC: Inter-American Development Bank, October 2001.*

8 *See H. van Greuning, J. Gallardo and B. Randhawa, A Framework for Regulating Microfinance Institutions, World Bank Policy Research Working Paper No. 2061, February 1999, Washington, DC.*

Table 2: Regulatory Thresholds for Activities of Microfinance Institutions [9]

Type of institution	*Ownership*	*Main sources of funds for operations and loans*	*Activities that trigger regulation*	*Form of external regulation*	*Regulatory authority*
Informal Community-based Thrift & Credit Self-Help Group – funding from community members and loans from NGOs and MFIs	Community and village residents	- Fees and assessments on members - Members' savings deposited with SHG	None	None	None
Category A: Other People's Money (NGO) – Funding from donor funds	Local and foreign donors through a Trust	Grants and donated funds	None – provided micro-finance loans do not exceed donated funds	Registration as Non-Profit Society or Trust	Registrar of Societies and/or Trusts
Category A: Other People's Money (Microfinance NGO) – Added funding via commercial loans/securities issues	Grants and donations converted to share capital	- Grants and donated funds - Concessional and commercial borrowings (wholesale deposit instruments)	- Generating liabilities from commercial - Concessional sources to fund operations and loans	- Registration as limited liability company - Rating by Credit Rating Agency - Licensing by bank authority as non-bank finance company	- Registrar of companies - Central bank authority or superintendency - Securities regulatory agency
Category B: Members' Money – funding from members' contributions	Members joined by recognized closed common bond	Share capital contributed and savings deposited by members	Accepting deposits from members, and making loans to members	Registration as a financial cooperative [Large institutions may fall under jurisdiction of Banking Law]	- Registrar of Cooperatives, or of Societies or - Central bank authority/ superintendency for larger cooperative institutions
Category C: The Public's Money – funding from retail public deposits	Individual and institutional investors, and shareholders	- Contributed share capital - Commercial borrowings - Wholesale deposits - Retail public deposits	- Accepting wholesale - Retail public deposits for intermediation into loans and investments	- Registration as limited-liability company - Licensing by banking authority as NBFI, or limited-service or full-service bank	- Registrar of companies - Central bank authority, or superintendency

[9] *Source: Adapted from Chart 1 and Table 2, H. van Greuning, J. Gallardo, and B. Randhawa, A Framework for Regulating Microfinance Institutions, World Bank Policy Research Working Paper No. 2061, Washington, DC, February 1999.*

V BACKGROUND ON MICROFINANCE IN GHANA

Macroeconomic and Policy Environment

26. Ghana has a population of about 18 million, which has been growing at about 3% per year. Recent statistics (1999-2000) indicate that 63% of the population live in rural areas and 37% in urban areas. Gross domestic product (GDP) stood at US$7.558 billion, with an annual growth rate of 4.5%. However, inflation has continued to be a problem: the end-of-period inflation rate was 13.8% in 1999, and estimated at 23.0% in 2000. Ghana's per capita GNP of US$390 is much lower than the average per capita income level of US$520 for Sub-Saharan Africa. Ghana's financial structure is fairly shallow: the degree of monetization of the economy, as measured by the M2/GDP ratio, stands at 19%. Because the level of international reserves stands at only 1.5 months of imports, Ghana's economy is markedly vulnerable to external shocks.

27. Ghana has focused on poverty reduction as the core of its development strategy. This approach galvanized in 1995 when the first version of *Ghana – Vision 2020* was launched and institutional arrangements began to be put in place to promote and analyze poverty reduction. The Government had prepared (as of July 2000) a *Development Strategy for Poverty Reduction*, an Interim Poverty Reduction Strategy Paper (Interim PRSP) to take up with the World bank and the IMF.

28. The overall policy framework for microfinance is informed by the poverty reduction strategy, which seeks to balance growth and macroeconomic stability with human development and empowerment in such a way as to positively impact the reduction of the country's poverty levels in the medium term. The strategy identifies the main sources of poverty, and aims to explicitly measure all sectoral strategies and programs in terms of the extent to which they contribute to reducing poverty. The overall strategy emphasizes the reduction of inflation and the need to sharply reduce the fiscal deficit, as a key step to reduce the extent of the public sector's crowding out of the private sector in the financial markets, and to help lower interest rates.

Poverty in the Ghanaian Context

29. From a level of 51% of the population in 1991-1992, poverty in Ghana has decreased to about 43% of the population living below Ghana ¢900,000 in 1998. Still, the average consumption level of the poor in Ghana is about 30% below the upper poverty line of Ghana ¢900,000. The reductions in poverty levels have tended to be concentrated in the Accra area and in the Rural Forest localities. Poverty is higher in rural areas (51.6 %) than in urban areas (22.8%): more than one-half of the population living in the Rural Savannah regions continue to be extremely poor. Poverty is highest among the self-employed households cultivating agricultural crops and has decreased only slightly, compared to the self-employed households engaged in export-crop agriculture and the wage employees in the public and private sectors.

Structure of the Microfinance Sector

30. Ghana has a tiered range of formal, semi-formal and informal institutions providing microfinance services to the urban and rural poor and underserved sectors of the economy. Financial intermediation and credit activities are under the regulatory jurisdiction of the Bank of Ghana (BOG). The regulatory framework under the Banking Law (1989) and the Non-Bank Financial Institutions (NBFI) Law (1993) accommodate a tiered structure of licensed financial intermediaries and of financial regulation. A snapshot summary of the range of institutions providing microfinance services (mostly microcredit and savings facilities) and the legal and regulatory environment under which they operate is shown in Table 3 below.

31. The formal sector institutions providing microfinance services consist of Rural Banks, Savings and Loan (S&L) companies and Credit Unions. Rural Banks are public companies owned by communities (with capitalization assistance from the BOG), registered and licensed as unit banks (no branching privileges) under the provisions of the Banking Law. The operations of Rural Banks are limited to a clearly-defined geographical (rural) area, and are permitted to offer banking services limited to loans and to checking, savings and time deposits. Moreover, the ownership and voting control structures of Rural Banks resemble credit unions because of their one share-one vote structure.

32. In contrast, private individual parties own the S&L Companies, which are registered and licensed under the NBFI Law and are permitted to offer banking services limited to loans and to savings and time deposits. Unlike the Rural Banks, ownership and control structures of S&L companies (which, like commercial banks, have branching privileges) follow cumulative shareholding positions. The minimum capitalization requirements at entry for both Rural Banks (US$20,000) and S&L companies (US$50,000) are significantly lower than the levels set for commercial and development banks.

33. The Credit Unions which are mutually-owned cooperative associations of individual members are registered under the Law on Cooperatives and subject to regulation by the Credit Union Supervisory Board, a government agency. They are also required, under the NBFI Law, to be registered and licensed by the BOG.

34. A number of NGOs, organized by private parties as trust entities or charitable institutions under the provisions of the Law on Trusts and Charitable Institutions, provide both microloans and nonfinancial services to their client-base, without being subject to regulation or supervision by external government agencies. The majority of microcredit NGOs belong to an umbrella organization – Ghana Micro Finance Network (GHAMFIN) – which provides staff training and organizational capacity-building assistance and disseminates best practice guidelines and standards for governance, operations and performance efficiency.

35. There is a large number of *susu collectors* in the informal sector, who provide collection and safekeeping services for the savings of mostly women market-vendors and operators of microenterprises. Technically, *susu collectors* are not involved in intermediating the aggregate savings which they collect and manage into loans. However, the women market vendors and microenterprise operators have been able to access "loans" from their own *susu collectors* in the form of "advance draw-downs" against the total amount of savings they have contracted to deposit weekly for a set period. In most cases, these advances have been made possible by commercial and development banks, rural banks, and S&L companies with which the *susu collectors* deposit the savings funds they collect and manage. There were indications that the "advance draw-down" feature had been introduced as a response to increasing competition among *susu collectors* for the savings of the market vendors and microenterprise operators.

36. A variation on the *susu* collection system is the *susu club*, wherein the members – the women market vendors and microenterprise operators go to a designated place on a scheduled day of the week to make their savings deposits with the *susu collector* who runs the *susu club*. The set-up allows a *susu collector* to service the savings deposit safekeeping needs of a much larger number of clients.

TABLE 3: GHANA – MICROFINANCE INSTITUTIONS AND REGULATORY FRAMEWORK

Type of MFI	Ownership	Legal Basis	Organized as	Fund Source	Authorized Activities	Agency Jurisdiction	Agency Supervision	Target Market
Comm'l Banks in Microfinance	Private / State	Companies Act; Banking Law	Limited Liability Company	Equity capital, comm'l loans, deposits	Full-service bank	Bank of Ghana	Bank of Ghana	Individuals, Comm'l enterprises
Agriculture Development Bank	State-owned	Companies Act; Banking Law	Limited Liability Company	Equity capital, comm'l loans, deposits	Full-service bank	Bank of Ghana	Bank of Ghana; RFID	Individuals, Comm'l enterprises
ARB Apex Bank	Rural Banks; Bank of Ghana	Companies Act; Banking Law	Limited Liability Company	Gov't & Int'l grants & loans	Apex bank functions under NBFI License	Bank of Ghana	Bank of Ghana; RFID	Rural Banks
Rural Banks	Community owned; [BOG has preferred shares]	Companies Act; Banking Law	Limited Liability Company; Unit Bank	Gov't loans, deposits	Savings deposits and micro-loans	Bank of Ghana	Bank of Ghana; RFID	Individuals & businesses in service area
Ghamfin	Individuals and organizations	Law on Trusts and Charitable Institutions	Company limited by Guarantee (Not-for-profit)	Grants & donations	Umbrella body of informal and formal MFIs; Training resources	None	None	NGOs, MFIs, S&Ls, Cus, Gov't Agencies
Savings & Loan Compnaies	Private parties	Companies Act; NBFI Law	Limited Liability Company	Equity capital; grants; loans, deposits	Savings deposits and micro-loans; hire-purchase financing	NBFI / BOG	NBFI / BOG	Individuals; small business, Susu collectors
Ghana Credit Union Association	Primary-level credit unions	Law on Cooperatives (Credit Unions); NBFI Law	Cooperative Society	Member Unions' capital contributions; loans; grants; deposits	Wholesale loans / deposits; CFF; CU PEARLS, training, monitoring, assessment	Registrar; NBFI/BOG	Registrar; NBFI/BOG	Credit Unions
Credit Unions	Individuals and organizations	Law on Cooperatives (Credit Unions); NBFI Law	Cooperative Society	Members' share capital & deposits	Members only savings deposits and micro-loans	Registrar; CU Supervision Board; CUA; NBFI/BOG	Ghana CUA; NBFI/BOG	Individual members
NGOs	Private parties	Law on Trusts and Charitable Institutions	Company limited by Guarantee (Not-for-profit)	Grants & donations	Micro-loans; Nonfinancial services	Ghamfin	None	Individuals; Groups
National Assn. of Susu Collectors	Individual Susu Colectors	Law on Cooperatives	Cooperative Society	Members' share capital contributions	Taking deposits; making loans to member susu collectors	None	None	Susu Collectors
Individual Susu Collectors	Individual Susu Colectors	None	None	Clients' fees	Collecting & safe-keeping of clients' savings	None	None	Market vendors; Self-employed

37. Individual *susu collectors* and *susu clubs* are neither registered nor licensed by any government agency, although there is a rapidly growing number of individual *susu collectors* who belong to cooperative associations of collectors (e.g., the National Association of Susu Collectors or the Greater Accra Association of Susu Collectors), which have taken steps to establish accreditation and identification procedures for their members as well as a form of deposit protection for the clients of their collector-members who would surely suffer losses in the event of nonperformance due to death or defalcation by a *susu collector. Susu collectors* would have an average of 150-200 women market vendors and microenterprise operators as clients, while *susu clubs* may have as many as 400-500 women market vendors and microenterprise operators as clients.

38. Traders, input-suppliers, money-lenders, rotating savings and credit associations (ROSCAs), and accumulating savings and credit associations (ASCAs) constitute the informal segment of the market for microfinance in Ghana.

Legal and Regulatory Framework for Microfinance

39. **Highlights of the Legal Structure and Judicial System.** Except for *susu collectors, susu clubs,* ROSCAs and ASCAs, MFIs in Ghana are required to establish legal entity. Banks and NBFIs (which include rural banks and S&L companies) are required to be incorporated entities under the Companies Act. Credit unions have legal status and identity through registration under the Cooperative Societies Act as well as the requirements of the NBFI Law. NGOs, including those with microcredit orientation, have legal status through establishment under the provisions of the Law on Trusts and Charitable Institutions and the required registration with the Ministry of Employment and Social Welfare.

40. Ghana's legal structure and judicial system needs to be further modernized and upgraded (i) to facilitate creation/registration/execution of lender's security interests on pledged collateral, (ii) eliminate duplicate/multiple pledging of collateral, and (iii) facilitate introduction of securitized financial instruments that can benefit microfinance development through better connection and linkages to formal sector institutions and financial markets. These modernizing improvements will be beneficial not just to the development of sustainable microfinance, but for the formal financial sector as well. As the experience of other countries (e.g., Romania) has demonstrated, reforming the legal and regulatory frameworks for financial transactions secured with movable assets has a substantial favorable impact on expanding access to markets for rural credit and microfinance.[10] For Ghana, such reforms would need to be accompanied by a significant reduction in government programs that can crowd out sustainable microfinance by private sector institutions.

41. **Highlights of the Regulatory Framework.** In Ghana, a tiered structure of institutions and graduated regulation for microfinance existed even before the Government gave formal recognition to microfinance in 1999 and through new BOG regulations pertaining specifically to microfinance. [11] The newly-adopted formal policies on microfinance and the adoption of a regulatory framework specific to microfinance activities had parallel co-existence with an existing credit-quota system for agricultural credit and SME finance. The regulatory (and tax) preferences enjoyed by rural banks and credit unions in combination with the operation of a graduated/tiered system have made it possible for NGO MFIs to transform into licensed institutions. This has been an indispensable element for

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[10] *See World Bank, "An Alternative Approach to Improving Rural Financial Markets in Romania", Rural Finance Briefing Note No. 1, January 2000.*

[11] *The Non-Bank Financial Institutions Business (BOG) Rules issued by the Bank of Ghana clearly defines micro-finance as "... lending to borrowers with the capacity to support loans of less than one million cedis, and in case of group lending – with joint and several guarantees of members of the group – for an amount not exceeding five million cedis."*

substantially expanding the ability of MFIs to mobilize financial resources beyond traditional grants and donations.

42. However, the remaining traditions of the former credit quota system can be detrimental to microfinance, and further policy clarification on this aspect is indispensable. The BOG continues to coordinate closely with GHAMFIN and with the Ghana Credit Union Association (CUA) to develop regulatory standards that can help promote institutional growth of the microfinance industry, and is seriously considering ways to simplify prudential standards/guidelines. A further development that bears watching is the establishment of a Government-sponsored and supported apex institution for rural banks. The experience elsewhere has shown that government-promoted apex organizations pose a significant risk of distorting the allocation of scarce financial resources and competing unfairly against private MFIs because of access to subsidized resources, thereby retarding the development of truly sustainable microfinance.

43. The Rural Banks, S&L companies, Credit Unions which are registered with and licensed by the BOG are not directly included in the central clearing and payments system. They participate in the central systems for clearing and payments through the larger commercial banks. BOG cancelled check-clearing services for all rural banks in 1992, which has made it extremely difficult for even the better rural banks to effectively compete in the marketplace, retain their clientele, and lower their operating costs. Neither do Rural Banks have access to BOG's discount window and all of them are subject to identical loan-to-deposit ratio requirements.

44. Credit unions are currently regulated under a self-regulatory mode, in the interim that a separate set of prudential norms and guidelines specific to credit unions is being put together by the NBFI/BOG. In addition, credit unions approved for licensing by BOG have to comply with and meet the prudential standards set by the CUA, whose vetting is pre-requisite to BOG licensing. The prudential norms followed by the CUA, which is supported by the Canadian Cooperative Association (CCA), are similar to operating and financial standards promoted by the World Council of Credit Union (WOCCU).

45. **Prudential standards.** The risk management criteria considered by BOG as important for MFIs and the adjustments made to recognize characteristics of microfinance operations are discussed below.

    - **Capital adequacy.** The minimum capitalization requirements for licensed MFIs – S&L companies and Rural Banks – are significantly lower than those for commercial banks and long-term development banks. S&L companies are required to have a paid-up capital of US$50,000 while Rural Banks are required to have US$20,000 in paid-up capital. The solvency standard established by BOG for these licensed financial institutions is unimpaired capital equivalent to at least 6% of risk assets for Rural Banks, and 10% of risk assets for S&L companies. There are indications that a significant number of Rural Banks, and S&L companies have capital adequacy deficiencies – largely because of unfavorable operating guidelines (e.g., on secondary reserves) that had to be adhered to, rapid growth in loan portfolios even as this growth was being accompanied by increases in non-performing loans and inadequate provisioning. Nonetheless, it seems clear that capital adequacy levels need to be reviewed periodically for appropriate adjustments.

    - **Mandatory liquidity reserves.** BOG prescribes the primary and secondary reserve assets that licensed deposit-taking institutions are required to hold, relative to an institution's total deposit liabilities. Currently, BOG requires all Rural Banks to maintain a prohibitively high secondary reserve of 52% of deposit liabilities[12] (but S&L companies are required to maintain a

[12] *For rural banks, the mandatory ratio of primary reserves (cash plus balances with other banks) to total deposit liabilities is 10%, although the actual ratio of primary reserves maintained by rural banks has been much higher -- 27% in 1998 (Source: Bank of Ghana Annual Report, 1998).*

comparatively lower secondary reserve of 15% of deposit liabilities) to be held in government debt instruments, Treasury Bills. While the high secondary reserve requirement might have been intended to strengthen these smaller financial institutions, the regulations do not distinguish between stronger vis-à-vis weaker MFIs and thereby penalizes the more efficient and stronger institutions. BOG classifies Rural Banks into a number of categories – e.g., satisfactory, mediocre and distressed – which could easily form a basis for a more fair and effective system of rewards and penalties for acceptable financial performance. The high level of mandatory secondary reserves significantly increases the funding costs for microfinance loans.

- **Security for loans.** Current prudential guidelines require licensed banks to obtain physical assets to secure loans. While formal sector banks and financial institutions have begun to accept treasury bills and deposit balances as acceptable collateral, these options are clearly beyond the reach of poor households in the rural and urban areas. Close coordination between the Ministry of Finance, BOG and GHAMFIN have led to a better understanding of the characteristics of microfinance loans and, possibly, formalizing the status of group guarantees as acceptable collateral in microfinance loans.

- **Recognition and classification of delinquent loans.** All licensed financial institutions are required to monitor and review their portfolio of credit and risk assets at least once every quarter on a regular basis. Assets are classified into four grades of risk: (i) standard; (ii) sub-standard; (iii) doubtful; and (iv) loss. Assets in risk grades (ii) to (iv) are considered non-performing and therefore no income may be accrued on them. BOG has specified prudential norms for microenterprise and small business finance which take into account the characteristics of the enterprises and businesses in these two categories. Microfinance and small business loans are required to be reviewed once monthly and are to be classified into (i) current, or (ii) delinquent. A delinquent loan is one on which payment of interest or scheduled payment of principal has not been received as of due date. BOG does not permit interest income to be accrued on delinquent loans accounts.

- **Provisioning for portfolio at risk.** Provisioning for delinquent microfinance and small business loans is made on a "basket" basis, rather than on an individual loan basis. Basket-based provisioning involves making a blanket provision for the aggregate outstanding balances of loans grouped in each arrearage basket, without regard to any security available for individual loans. The prescribed rate of provisioning for microfinance and small business loans is shown below:

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

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

- **Guidelines and standards for writing-off of non-performing loans.** The general practice among licensed MFIs is to write off non-performing or delinquent loans at the time that the loan loss is confirmed. It does not appear that BOG has specified a procedure covering the mandatory writing off of non-performing loans. A standard procedure and timing that triggers off mandatory write-off would obviously be impacted by the ability (or lack thereof) of MFIs to comply with capital adequacy and loan loss reserve requirements.

VI ASSESSMENT OF GHANA'S REGULATORY FRAMEWORK FOR MICROFINANCE

46. Ghana accords high-level recognition of the importance and relevance of microfinance – through the establishment of the Office of Microfinance Policy Coordination in the Ministry of Finance. The regulatory framework is so structured as to provide room for NGO MFIs to establish viable links with formal financial sector and to become properly licensed financial institutions at several entry and progression levels (S&L companies, and Rural Banks). A primary question to address is, what are appropriate levels of institutional capitalization for licensed MFIs.

47. Reforms in the legal system and judicial processes need to be made in order to catch up and keep in step with growth of the microfinance industry. There are significant obstacles and problems related to recognizing and protecting security interest in pledged collateral, and access for MFIs to capital markets through financial securities (capital market instruments).

48. Serious attention needs to be given to the technical capacity of BOG (and other government agencies) for adequate supervision of licensed MFIs (monitoring and technical guidance). Moreover, there is an urgent need to squarely address and clarify the ambivalent policy and regulatory framework on Rural Banks. The ownership structure of Rural Banks resembles that of cooperative financial institutions; the level of owners' commitment to support the financial institution is severely limited given the insignificant value required for each share held (Ghana ¢50), and therefore there are resulting serious problems in internal governance. Ghana's makers of financial policy need to address the following issues: (i) is privatization with greater monetary commitments from fewer shareholders the answer? (ii) how should insolvent, capital-deficient or unsound Rural Banks be dealt with, particularly their depositors? (iii) what should be the proper role of the new apex institution for Rural Banks?

49. A major achievement of the stakeholders in Ghana's microfinance community is the degree of coordination between BOG/NBFI vis-à-vis CUA in vetting (through a certificate of good standing) of credit unions seeking to comply with registration and licensing requirements and in disseminating and enforcing standards and guidelines for effective governance and voluntary (internal regulation).

50. Overall, Ghana's financial institutions continue to service a narrow range of clients and few have direct linkages with each other – leaving large portions of the bankable public, particularly microenterprises and small businesses, with limited or no access to convenient credit and secure savings options. For instance, Ghana Commercial Bank, with 96 of its 134 branches in rural areas, has nothing other than a check-clearing relationship with neighboring rural banks. Without the needed linkages, sustainable rural finance operations will continue to be constrained by inadequate client information, low business volumes, poor governance, and inadequate supervision.

VII BACKGROUND ON MICROFINANCE IN THE PHILIPPINES

Macroeconomic and Policy Environment

51. The Philippines has a population of about 73.4 million, which has been growing at about 2.3% per year, compared to population growth of 1.2% annually for countries in the East Asia and Pacific region. Recent statistics (1999-2000) indicate that 44% of the population live in rural areas and 56% in urban areas. Gross Domestic Product (GDP) stood at US$82.2 billion (with GNP of US$1,200), with an annual growth rate of 4.5%. Inflation has not been a problem in recent years as annual change in the CPI has averaged 5.0%, while the level of interest rates has remained stable at a level between 6.5% and 8% p.a. Agriculture now accounts for only 17.5% of GDP, while Industry accounts for 31% and the Services sector 52%. The financial structure has modest depth: the degree of monetization of the economy (as measured by the M2/GDP ratio) stands at 47.5%, with the

population-to-bank office ratio standing at 10,200 persons per bank office. In spite of this macroeconomic setting, the Philippines has had a focus on poverty reduction as the core of its development strategy for some time.

52. The overall policy framework for microfinance is informed by the overall framework and strategy for poverty alleviation, safety nets and rural development, which seek to balance growth and macroeconomic stability with human development and empowerment in such a way as to positively impact the reduction of the country's poverty levels in the medium term. The strategic framework identifies the main sources of poverty, and aims to explicitly measure all sectoral strategies and programs in terms of the extent to which they contribute to reducing poverty.

Poverty in the Philippine Context

53. Some 37.5% of the population, or 27.3 million people live below the poverty line. Within this circle of poverty that afflicts 32.1% of all families with poverty, 18.5% of all urban families are poor, and 44.4% of rural families live in poverty. Poverty trends have been declining during the past decade, but poverty has been persistent in certain urban areas (primarily the National Capital Region, which continues to be a magnet for migration from the poorer provincial areas) and a number of rural regions -- especially the Bicol provinces and most of the Mindanao region.

Structure of the Microfinance Sector

54. Compared to Ghana, the Philippines has a comparatively wider range of formal, semi-formal and informal institutions providing microfinance services to the urban and rural poor and underserved sectors of the economy. Financial intermediation and credit activities are under the regulatory jurisdiction of the Bangko Sentral ng Pilipinas (BSP). The regulatory framework under the General Banking Law of 2000 (which repealed the General Banking Act of 1949) and a number of parallel Laws governing specialized banks and NBFI have made room for a tiered structure of licensed financial intermediaries and of financial regulation. The General Banking Law of 2000 provides adequate room for banks and quasi-banks to have foreign equity content: foreign individuals and non-bank corporations are permitted to own or control up to 40% of the voting stock of a licensed bank or quasi-bank. The percentage of foreign-owned voting stock is determined by the citizenship of individual shareholders, and the citizenship of a corporation follows the citizenship of its controlling shareholders, regardless of its place of incorporation. A snapshot summary of the range of institutions providing microfinance services (mostly microcredit and savings facilities) is shown in Table 4 below.

55. The formal sector institutions directly and indirectly providing microfinance services consist of Commercial Banks, Thrift Banks (Savings and Mortgage Banks, Private Development Banks, Stock Savings and Loan Associations), Non-Stock Savings and Loan Associations, Rural Banks, Cooperative Banks, Finance Companies, Private Lending Investors and Pawnshops. Credit Unions and Savings and Credit Cooperatives (including savings and credit units of multipurpose cooperatives) are included in the formal sector, even though these types of institutions are outside the coverage of the General Banking Law and the jurisdiction of the BSP. Commercial Banks, Thrift Banks, Non-Stock Savings and Loan Associations, Rural Banks, Finance Companies, Private Lending Investors and Pawnshops are owned by private individual investors, and are registered and licensed by the BSP under the provisions of the General Banking Law or other institution-specific laws.

Table 4: PHILIPPINES – MICROFINANCE INSTITUTIONS AND REGULATORY FRAMEWORK

Type of MFI	Ownership	Legal Basis	Organized as	Fund Source	Authorized Activities	Agency Jurisdiction	Agency Supervision	Target Market
Comm'l Banks in Microfinance	Private or Gov't. shareholders	Gen. Banking Law; Law on Corporations	Limited Liability Company	Equity Capital, Comm'l Funds, Deposits	Full-service bank;	Central Bank; Deposit Insurance Co.	Central Bank; Deposit Insurance Co.	Bank/Non-Bank MFIs (RBs, CBs, NBFCs)
People's Credit & Finance Corp.	Land Bank Philippines	Finance Co. Act	Limited Liability Company	Capital / loan funds from Gov't & Int'l Agencies	Apex Organization	Central Bank; Land Bank	None	Coop Banks, NGO MFIs
Thrift Banks	Private Investors	Thrift Banks Act; Law on Corporations	Limited Liability Company	Equity capital, comm'l funds, deposits	Savings deposits and loans	Central Bank; Deposit Insurance Co.	Central Bank; Deposit Insurance Co.	Microenterprises/ small business; general public
Rural Banks	Private Investors	Rural Banks Act; Law on Corporations	Limited Liability Company	Equity capital, comm'l funds, deposits	Savings deposits and loans	Central Bank; Deposit Insurance Co.	Central Bank; Deposit Insurance Co.	Microenterprises/ small business; general public
Cooperative Banks	Cooperative Societies	Rural Banks Act; Cooperat-ives Code	Limited Liability Company	Equity capital, comm'l funds, deposits	Savings deposits and micro-loans	Central Bank; Deposit Insurance Co.	Central Bank; Deposit Insurance Co.	Microenterprises/ small business / cooperatives
NonBank Finance Company	Private Investors	Gen. Banking Law; Law on Corporations	Limited Liability Company	Equity capital, comm'l funds	Wholesale deposits and microloans	Central Bank	Central Bank	Microenterprises/ small business
Pawnshops	Private Investors	Gen. Banking Law	Ltd Liab Co; Sole Prop, Partnership	Equity capital, comm'l funds	Pawn loans	Central Bank; SEC	None	Individuals
2nd/3rd - Tier Federation of Credit Unions or Savings & Credit Cooperatives	Primary-level cooperative societies	Cooperatives Code	Cooperative Association	Members' equity capital, comm'l funds, deposits	Mgmnt/finance services + liquidity facility to member coops	Cooperatives Development Authority	None	Savings & Credit Cooperatives; Credit Unions
Credit Unions and Savings & Credit Cooperative Assn.	Individual members (natural persons)	Cooperatives Code	Cooperative Association	Capital + deposits from members	Savings deposits from members and micro-loans to members	Cooperatives Development Authority	None	Individual members
N G O - MFIs	Private Trustees	Law on Trusts and Non-Profit Foundations	Non-profit Foundation / Private Lending Investor	Grants, donations, comm'l loans	Microfinance loans to individuals and groups	Annual Reports to SEC and Central Bank	None	Individuals and groups
N G O s	Private parties	Law on Trusts and Non-Profit Foundations	Non-profit Foundation	Grants, donations, comm'l loans	Microfinance loans to individuals and groups	Annual Reports to SEC and BIR	None	Individuals and groups

56. The minimum capitalization requirements at entry for Private Development Banks, Rural Banks, Cooperative Banks, Finance Companies, Private Lending Investors and Pawnshops are significantly lower than the levels set for Commercial Banks. The operations of Rural Banks and Cooperative Banks are limited to a clearly-defined geographical area, e.g., municipality, province or administrative region, and are permitted to offer banking services limited to savings and time deposits and loans. Unlike the Rural Banks of Ghana, the ownership and voting control structures of Philippine Rural Banks and Cooperative Banks are based on cumulative ownership of share capital, rather than the one share-one vote structure of their Ghanaian counterparts.

57. Individual members are the mutual owners of Non-Stock Savings and Loan Associations and of the Credit Unions, Savings and Credit Cooperatives and Multipurpose Cooperatives which are registered under the Cooperative Code and subject to regulatory jurisdiction of the Cooperative Development Authority (CDA). Unlike Ghana, these cooperative financial institutions (CFIs) are outside the regulatory and supervisory jurisdiction of the BSP, as well as of the deposit insurance system. There is a significant number of large CFIs whose membership/client base, institutional capital funds, deposit resources and asset size are even larger than those of licensed thrift and rural banks.

58. Many NGOs, organized by private parties as trust entities or charitable institutions under the Law on Trusts and Charitable Institutions, provide both microloans and nonfinancial services. Their credit activities are not regulated or supervised by external government agencies. A significant number of NGOs and MFIs belong to an umbrella organization -- the Microfinance Council of the Philippines, which disseminate best practice guidelines and standards for governance, operations and performance efficiency.

59. As there is a lack of clarity about the legitimacy of credit operations of NGOs, a number of them have sought to obtain legitimacy by registering themselves with the SEC under the authorization category of Private Lending Investor. Private Lending Investors and Pawnshops are formally organized entities, in the sense that they are entities registered with the SEC, which is the central registry agency. Pawnshops are required to be authorized and licensed by the BSP.

60. Traders, input-suppliers, money-lenders, ROSCAs and ASCAs constitute the informal segment of the market for microfinance in the Philippines.

Legal and Regulatory Framework for Microfinance

61. **Weaknesses in Legal System and Judicial Processes.**[13] The Philippine legal system is a hybrid, reflecting the country's cultural and colonial history. The system combines elements of Roman law from Spain, Anglo-American common law introduced by the U.S., as well as customary legal traditions practiced by the minorities (e.g., Islamic law). The influence of Spanish law is evident in aspects of civil law, including family relations, property matters and contracts. US law has influenced constitutional and corporate law – especially taxation, commerce, labor relations, currency and banking, as well as rules of evidence and government operations. In the Muslim areas of the south, Islamic law is utilized.

62. The Judicial Reorganization Act of 1981 provides for four main levels of courts – (i) metropolitan, municipal and municipal circuit trial courts at the local level which deal with the majority of criminal and civil cases; (ii) regional trial courts which deal with more serious criminal and civil cases; (iii) the Intermediate Appellate Court which deals with appeals from local and regional courts, and major commercial cases; and (iv) the Supreme Court which hears appeals from the Intermediate Appellate Court in criminal cases. The Supreme Court has jurisdiction over cases affecting government ministers, petitions for injunctions and habeas corpus writs, as well as appellate jurisdiction over the constitutionality of any treaty, law, presidential decree, proclamation, order or regulation. The

[13] *"Philippines: Legal System (A)", Oxford Analytica Brief, July 7, 2000.*

Supreme Court also regulates the practice of law, promulgates rules on admission to the Bar, and disciplines lawyers.

63. Successful and sustainable business investment relies on legal systems that uphold the rule of law and an independent judiciary, which underlie important commercial settings such as intellectual property rights protection, contract enforcement and private property rights. Legal processes have been characterized by inefficiency, long delays and undue political influence – especially after judicial independence was seriously compromised by the Marcos dictatorship. Legal system needs to be further modernized and automated in order to facilitate creation/registration/execution of security interest on pledged collateral, eliminate duplicate/multiple pledging of collateral, and facilitate introduction of securitized financial instruments that can benefit microfinance development through better connection to and linkages with formal sector institutions.

64. **Highlights of the Regulatory Framework.** A tiered structure of institutions and graduated regulation existed even before the government gave formal recognition to microfinance in 1997 and through the new BSP regulations pertaining specifically to microfinance. BSP Circular No. 272, series of 2001 defines microfinance loans as "... small loans granted to the basic sectors, as defined in the Social Reform and Poverty Alleviation Act of 1997 (Republic Act 8425), and other loans granted to the poor and low-income households for their microenterprises and small businesses so as to enable them to raise their income levels and improve their living standards. These loans are granted on the basis of the borrowers' cash flows and are typically unsecured. The maximum principal amount of microfinance loans shall not exceed ₱150,000 ... [which] is equivalent to the maximum capitalization of microenterprise under R.A.8425. The schedule of loan amortizations shall take into consideration the projected cash flow of the borrowers, which is adopted into the terms and conditions formulated. Hence microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow conditions of the borrowers."

65. The newly-adopted formal policies on microfinance and the adoption of a regulatory framework specific to microfinance activities co-exist on a parallel basis with a credit-quota system for agricultural credit and SME finance. However, under the provisions of BSP Circular No. 272, series of 2001, microfinance loans shall be considered in compliance with required loans to small and medium enterprises required under R.A.6977.

66. The regulatory (and tax) preferences enjoyed by thrift banks, rural banks, and credit unions in combination with the operation of a graduated/tiered system have made it easier for NGO MFIs to transform into licensed institutions. This has been an indispensable element for substantially expanding the ability of MFIs to mobilize financial resources beyond traditional grants and donations.

67. However, the continued coexistence of a targeted credit quota system is detrimental to microfinance, and further policy clarification on this matter is indispensable. The BSP continues to coordinate closely with the microfinance community in developing regulatory standards that can help promote institutional growth of the microfinance industry, and is seriously considering ways to simplify prudential standards/guidelines including a manual for examination of the microfinance business of licensed banks. A significant development in 1997 was the adoption of the National Strategy for Microfinance in which the private sector is to play a major role while government's role is to be limited to establishing the enabling environment for efficient functioning of markets. One of the guiding principles of this strategy is the withdrawal of government line agencies in implementing credit and guarantee programs, and the clear distinction between access to credit on commercial terms versus welfare-oriented policies and programs.

68. Most of the rural finance and MFIs which are registered with and licensed by the BSP – some categories of thrift banks, rural banks and cooperative banks and CFIs which are beyond BSP jurisdiction – are not directly included in the central clearing and payments system. They participate in the central systems for clearing and payments through the larger commercial banks.

69. A significant number of CFIs are supposed to be regulated by a government agency -- the CDA, as well as by their voluntary second-tier and third-tier federations. The technical and resource capacity of the CDA to effectively monitor and regulate CFIs are severely restricted. Insofar as the second–tier and third-tier federations are concerned, there are CFIs which do not belong to any of the several regional and national federations. In addition, the operational structure of CFIs generally has greater affinity to banking institutions, and competition in the same local communities among banks and CFIs has increased.

70. A number of CFIs have taken advantage of the liberal provisions in Philippine cooperative laws to change their organizational structure into "community-development" credit unions, which legitimizes their reaching out to entire municipalities to expand their membership or client base. CFIs are larger in number, and in terms of client base and asset size bigger than NGO MFIs and cooperative banks, but are beyond BSP jurisdiction. This increases the vulnerability of large numbers of the lower income population to systemic risks since their savings and time deposits with their CFIs are in turn kept by the latter with formal banking system, and there is no mandatory inclusion in the formal deposit protection system.

71. All licensed banks are participants in the Philippine Deposit Insurance System which constitutes the formal deposit protection framework for depositors in licensed banks – up to a maximum amount of Php 100,000 (US$2,000) in deposits. Banks are assessed a fee at the rate of 0.5% of their average deposit liabilities and the fee is collected quarterly. Under the provisions of the Deposit Insurance Law, the Philippine Deposit Insurance Corporation (PDIC) exercises auxiliary and supplementary prudential supervision authority over licensed banks, with the authority and power to exclude imprudent banks from the deposit protection system.

72. **Prudential standards.** The risk management criteria considered by BSP as important for MFIs and the adjustments made to recognize characteristics of microfinance operations are discussed below.

    - **Capital adequacy.** The minimum capitalization requirements for licensed institutions with a specialized microfinance focus – Private Development Banks, Rural Banks and Cooperative Banks – are significantly lower than those for commercial banks and savings banks. The rural finance/MFIs, whose banking services are limited to savings and time deposits and loans for a market and client base limited to defined geographical areas (province- or region-wide only) are required to have a paid-up capital based on the market area covered. The paid-up capital for rural banks and cooperative banks ranges from US$50,000 to US$260,000 depending on the class of municipality or metropolitan area the bank is located in. Thrift banks operating outside the Metropolitan Manila area are required to have US$1.0 million in paid-up capital, and US$6.5 million if the head-office is in Metropolitan Manila area. By way of comparison, the paid-up capital requirement for universal banks is US$100 million, and US$48 million for regular commercial banks.

    - **Solvency standards.** The solvency standard established by BSP for these licensed financial institutions is unimpaired capital base equivalent to at least 10% of risk assets. The new Risk-Based Capital Adequacy guidelines established by the Monetary Board of the BSP follows the Basle risk-based capital adequacy framework. The latter recommends a minimum level of 8% incorporating both credit risks and market risks. Supplemental guidelines on classification of assets based on market risk have not yet been issued.

    - **Mandatory liquidity reserves.** BSP prescribes the primary and secondary reserve assets that licensed deposit-taking institutions are required to hold, relative to an institution's total deposit liabilities. Under present BSP regulations on mandatory liquidity reserves, thrift banks and rural banks continue to enjoy preferential reserve requirement levels, relative to universal banks and regular commercial banks.

- **Security for loans.** Current prudential guidelines require licensed banks to properly document their loans and to have such loans secured with collateral. The risk-based classification of loan assets takes into account the type and realizable value of supporting collateral. BSP has, in recent years, recognized that collateral-based loans are generally beyond the reach of poor households in the rural and urban areas. Close coordination between the BSP, the National Credit Council and the Coalition for Microfinance Standards has led to a better understanding of the cash-flow orientation of the operations of microenterprises and small businesses, characteristics of microfinance loans, and best practices in microfinance lending (e.g., group guarantees as acceptable collateral in microfinance loans). To implement the provisions of the General Banking Law of 2000 concerning microfinance, the BSP recently approved BSP Circulars No. 272 and 273, series 2001. Circular 273 partially lifts the general moratorium on establishment and licensing of new thrift and rural banks focused on microfinance, while Circular 272 provides clear prudential guidelines for relief from the standard regulatory approach to loan administration and collateral requirements.

- **Recognition and classification of delinquent loans.** All licensed financial institutions are required to monitor and review their portfolio of credit and risk assets at least once every quarter on a regular basis. Assets are classified into four grades of risk: (i) standard; (ii) sub-standard; (iii) doubtful; and (iv) loss. Assets in risk grades (ii) to (iv) are considered non-performing and therefore no income may be accrued on them. BSP is presently drawing up specific prudential norms for microenterprise and small business finance which take into account the characteristics of the enterprises and businesses in these two categories.

- **Provisioning for portfolio at risk.** Provisioning for delinquent loans is made on an individual loan basis (rather than the "basket-based" approach permissible in Ghana for licensed MFIs). BSP's prescribed rate of provisioning for loans, including microfinance and small business loans is shown.

Classification of loan	Rate of provisioning
Loans especially mentioned	5%
Substandard loans:	
With collateral	6% - 25%
Without collateral	25%
Doubtful	50%
Probable loss	100%

In addition to the specific loss provisions to be made for delinquent or non-performing loans, BSP requires licensed banks to maintain a general loss provision equivalent to 2% of the gross loan portfolio, net of inter-bank loans and loans considered non-risk under current regulations (e.g., loans fully secured by hold-out on deposits). Financial institutions are also required to separately disclose, in their financial accounts and reports, the specific and general loss provisions made for non-performing delinquent loans and standard/current loan assets.

- **Guidelines and standards for writing-off of non-performing loans.** The general practice among licensed banks is to write off non-performing or delinquent loans at the time that the loan loss is confirmed. It does not appear that BSP has specified a procedure covering the mandatory writing off of non-performing loans. A standard procedure and timing that triggers off mandatory write-off would obviously be impacted by the ability (or lack thereof) of MFIs to comply with capital adequacy and loan loss reserve requirements.

VIII ASSESSMENT OF PHILIPPINE REGULATORY FRAMEWORK FOR MICROFINANCE

73. In recent years, the Philippine Government has given high-level recognition to the importance and

relevance of microfinance – adoption of National Policy on Microfinance in 1997, recent specific inclusion of microfinance policy and activity in the amended General Banking Law (2000), promulgation of microfinance-friendly BSP circulars on microfinance transactions by licensed banks and NBFIs.

74. The regulatory framework is so structured as to provide room for NGO MFIs to establish viable links with the formal financial sector and to become properly licensed financial institutions at several entry and progression levels -- Cooperative Banks, Rural Banks, Thrift Banks and "quasi-banks". Capitalization levels at entry are periodically reviewed by BSP to determine if the levels are either too high or too low. The approach, which has thus far worked, is based on considerations of the market in which an applicant bank intends to operate – category of the municipality, based on municipal revenue as a proxy variable the community's aggregate income level; as well as the projected business volumes for the applicant bank (which tracks the relationship between planned/expected asset size vis-à-vis capital adequacy levels).

75. Reforms in the legal system and judicial processes need to be made in order to catch up and keep in step with growth of the microfinance industry. There are still significant obstacles and problems related to recognizing and protecting security interest in pledged collateral, which could facilitate MFIs' access to capital markets through financial securities (capital market instruments). This is considered important because the Philippines has a capital market that is rapidly developing.

76. MFIs licensed by BSP as banking institutions are included in the formal deposit insurance system and, in principle, are subject to examination by PDIC for compliance with/observation of prudent operating standards. NBFIs in microfinance are subject to regulations of BSP [if performing quasi-banking] and/or SEC [if not engaged in quasi-banking].[14]

77. Most of the rural finance and MFIs which are registered with and licensed by the BSP – some categories of thrift banks, rural banks and cooperative banks and CFIs which are beyond BSP jurisdiction anyway – are not directly included in the central clearing and payments system. They participate in the central systems for clearing and payments through the larger commercial banks.

78. The operational structure of CFIs – particularly the open-bond associations -- has greater affinity to banking institutions and competition in the same local communities among banks and CFIs has increased. A number of CFIs have taken advantage of the liberal provisions in Philippine cooperative laws to change their organizational structure into "community-development" credit unions, which legitimizes their reaching out to entire municipalities to expand their membership or client base. The liberal provisions make it fairly easy for a closed-bond CFI to change into an open-bond CFI.

79. CFIs are larger in number, and in terms of client base and asset size bigger than NGO MFIs and cooperative banks, but are beyond BSP jurisdiction. This increases the vulnerability and exposure of large numbers of the lower income population to systemic risks, because (i) their deposits with their CFIs are kept by the latter with institutions in the formal banking system, and (ii) deposit protection is not a universal nor mandatory practice among CFIs and their federations. An urgent priority is to squarely address the need for an adequate and appropriate framework for prudential regulation of CFIs, in such a way that overall regulation of financial institutions is unified rather than fragmented.

IX Lessons Learned from Experiences of Ghana and the Philippines in Microfinance Regulation

80. The tiered regulatory approach has promoted the development of sustainable microfinance in the

[14] *NBFIs are required to comply with the "19-LenderRule", which mandates that NBFIs may not borrow from 20 or more lenders for the purpose of re-lending or purchase of receivables or other obligations.*

Philippines and Ghana, by clearly identifying pathways for NGOs and semi-formal MFIs to become legitimate institutions under the regulatory framework with greater ability to access financial resources from commercial markets. The foremost examples for Ghana and the Philippines are:

a. CARD Rural Bank in the Philippines which was formed by the Center for Agricultural and Rural Development, an NGO working with women in rural villages under a group-based microfinance model.

b. Opportunity Microfinance Bank, which was established recently as a joint effort between the APPEND network of Philippine NGO microcredit institutions and Opportunity International.

c. Sinapi Aba Trust in Ghana, a successful and sustainable NGO MFI operating in the Kumasi region, which is trying to transform into a licensed community bank with assistance from Opportunity International, but is facing new obstacles of higher minimum capital requirements.

d. Similar to the Philippines, Indonesia's regulatory framework (see Annex) has allowed for the establishment of smaller but licensed unit banks – BPRs, or rural credit banks. Larger microfinance NGOs such as Bina Swadaya and Catholic Relief Services have established, through equity investments and credit lines, their own networks of BPR units providing microfinance services to the poor in urban and rural areas.

81. Among the risks that a graduated and tiered regulatory framework may present is that of regulatory arbitrage. Investors and stakeholders in a financial institution seeking to be authorized and licensed might choose to be established and constituted under an institutional format which is subject to least possible external regulation and supervision, as well as the lowest possible amount of capitalization at entry. This does not appear to have been experienced by the Philippines nor Ghana, with respect to the MFIs obtaining status as licensed specialized banks.

82. Ghana and the Philippines have a comparatively wide range of informal, semi-formal and formal institutions with the provision of microfinance services as their principal line of business. Indonesia has an even varied range of MFIs. The legal and regulatory environment in these three countries have, for many years, permitted the establishment of specialized institutions with limited financial intermediation activities in geographical areas with defined limits. More recently, the government authorities in Ghana and the Philippines have moved forward to articulate a vision and strategy for microfinance and its role in poverty alleviation programs, making adjustments in their banking and financial laws and regulations. The principal characteristics of the framework for regulating microfinance activities in Ghana and the Philippines are highlighted in Table 5 below.

83. In contrast to the Philippines and Ghana, a primary challenge for the Indonesian government is to craft a coherent vision and strategy for microfinance development as an integral part of the urgent need to reform and restructure the financial sector. In the aftermath of the economic and financial crisis that the country encountered in recent years, it is remarkable that Indonesia's main rural/MFIs have weathered the crisis with relatively non-severe repercussions on their client base and operations – in spite of a fragmented regulatory structure and some degree of ambiguity in the policy framework for rural/microfinance.

84. While Ghana, the Philippines and Indonesia all have licensed rural banks their relative financial performance and sustainability profiles have differed significantly – largely because of differences in effective governance by owners/stakeholders and the base of unimpaired capital and ability of owners to step forward with additional capital.

Table 5. Microfinance Regulatory Framework: Ghana and the Philippines

	Ghana	*Philippines*
Continuum of MFIs	Wide range of unregulated and regulated MFIs REGULATED / LICENSED MFIS ▪ Finance Companies ▪ Community/Rural Banks ▪ S & L Companies ▪ CFIs (Credit Unions) UNREGULATED / UNLICENSED MFIS ▪ NGOs ▪ Susu Clubs & Collectors ▪ ROSCAs and ASCAs	Wide range of unregulated and regulated MFIs REGULATED / LICENSED MFIS ▪ Thrift Banks ▪ Rural Banks ▪ Cooperative Banks ▪ Private Lending Investors ▪ Pawnshops UNREGULATED / UNLICENSED MFIS ▪ NGOs ▪ Credit Unions / Savings and Credit units of Cooperatives ▪ Village "banks" (Solidarity Groups) ▪ ROSCAs and ASCAs
Strategy for Developing Sustainable Microfinance	▪ Adopted National Strategic Framework for the Microfinance Sector (1999-2000) ▪ Established Central Policy Coordination Office at Ministry of Finance ▪ Introducing amendments to banking laws and regulations responsive to microfinance (minimum capitalization & adequacy requirements; liquidity management standards; loan collateral, classification and loss provisioning guidelines) ▪ Simplifying (1) reporting standards, chart of accounts; (2) external audit requirements; (3) microfinance manual for Central Bank examiners and inspectors	▪ Adopted National Policy on Microfinance (1997-98) ▪ Established Central Policy Coordination Office at Department of Finance and at Bangko Sentral ▪ Introducing amendments to banking laws and regulations responsive to microfinance (minimum capitalization and adequacy requirements; liquidity management standards; loan collateral, classification and loss provisioning guidelines) ▪ Simplifying (1) reporting standards, chart of accounts; (2) external audit requirements; (3) microfinance manual for Central Bank examiners and inspectors
Missing Links and Regulatory Weaknesses	▪ Community ownership of rural banks obstructs internal prudential governance and management controls ▪ Need to integrate unregulated/unlicensed MFIs into payments infrastructure ▪ Accelerate capacity building for staffs of Regulatory Authority and MFIs	▪ Fragmented regulatory framework: Cooperative Financial Institutions are outside (1) Central Bank jurisdiction, (2) formal deposit insurance system ▪ Need to integrate unregulated/unlicensed MFIs into payments infrastructure ▪ Accelerate capacity building for staffs of Regulatory Authority and MFIs

a. In Ghana's rural banking system, the rural banks are owned by all the members of a community. The rural banks are therefore quasi-cooperative organizations, where each shareholder/resident has one vote. Because the value of the single share held by a shareholder/resident is so low at Ghana ¢50 (roughly about US$ 0.007 equivalent), there is correspondingly little financial commitment, management interest and ownership control from the "owners-at-large". The format for ownership of rural banks in Ghana is deficient, unwieldy and not conducive to institutional sustainability, and some other format which permits identifiable, qualified investor/stakeholders to own, control and manage these community-based financial institutions may have a better chance of developing into viable financial institutions.

b. Individual shareholders own the rural banks in the Philippines (although cooperative banks are owned not by natural persons but by cooperative entities), who have a proportionate degree of control and ownership interest in the management, operations and results of the rural bank based on their equity ownership position.

c. For Indonesia, the more successful rural banks (BPRs) appear to be mostly those that have been organized, funded and managed by identifiable individuals as shareholders – while most of the less successful and weaker BPRs are generally the village-based institutions that were decreed by government to be licensed banks.

d. The procedures enforced by the central bank regulatory authorities in Ghana, the Philippines and Indonesia include assessment and evaluation of directors and officers of banking institutions subject to licensing – the "fit and proper" test.

85. Indonesia imposes ***nationality requirements*** on the ownership and control of rural banks, which create a significant barrier to entry. Ownership of shares of stock in rural banks is reserved exclusively for Indonesian citizens or legal entities owned and controlled by Indonesian citizens. For sustainable rural/MFIs with the potential to transform into licensed rural banks, this requirement effectively eliminates the possibility of attracting international NGOs and similar organizations which, in other countries, constitute a major source of additional capital funds to support sustainable growth and expanded outreach for a MFI.

86. The adjustments to risk management criteria made by BOG and BSP recognize the special characteristics of microfinance operations and provide useful lessons for regulatory authorities in other countries.

- **Required minimum capital and capital adequacy levels.** Minimum capitalization levels at entry, and required levels of unimpaired paid-in capital were set at levels lower than those for regular commercial or development banks, even though the mandatory capital adequacy ratio was uniform for all licensed banking and nonbank financial institutions. Especially in the case of the Philippines and Indonesia, and less so for Ghana, required levels of capitalization at entry and of unimpaired capital after entry have been subjected to review, and adjusted from time to time to recognize changing economic and market conditions.

  a. There are clear indications from the Philippine experience that the required minimum levels set for entry took into account the size of the market and the volume of intermediation business that different types of MFIs would be generating, because most MFIs – when they are formed – will operate only within determined geographical areas, rather than on a nationwide basis.

  b. With respect to capital adequacy standards, the prudential levels set for licensed MFIs by the banking authorities in the Philippines, Indonesia and Ghana do not differ much from the levels set for the larger commercial and thrift banking institutions in those countries.

Shareholders of licensed MFIs may have greater difficulty in putting together additional resources in the event of a call for additional capital mandated by the banking authority. Thus, it would be justifiable to support the case for a more conservative approach that sets a higher capital adequacy level for MFIs, in spite of the argument that higher levels result in less efficient use of capital.

c. Global best practice experience of MFIs reporting their operating and financial performance data to the MicroBanking Bulletin provide clear empirical evidence to support more prudent capital adequacy standards for MFIs. As shown in Table 6 below, data from the MicroBanking Bulletin indicate that the ratio of unimpaired capital to average total assets ranges from a low of 20% to as much as 60% for MFIs in different regions, with different operational and organizational formats. The data also shows that the asset-to-capital leveraging of reporting MFIs, which would be much lower than the 10% to 15% capital adequacy level generally maintained by commercial banks, has enabled the MFIs to access borrowed funds at commercial rates as additional resources to fund their loan portfolios.

Table 6. Financial Profile of Selected MFIs (In %)

Region	*Capital/assets*	*Operating self-sufficiency*	*External funds/ loans Φ*
Africa	51.6%	88.8 %	51.7 %
Asia	48.5	109.8	40.7
Latin America	44.2	113.8	44.4
Eastern Europe	54.2	107.4	146.5
Organizational formats			
Bank	20.3	107.6	106.0
Non-Bank FI	46.5	96.4	52.2
Credit Union	34.7	109.3	67.7
NGO	59.5	106.4	41.6

Φ External Funds / Loans = Borrowed Funds @ commercial rates / Average Loan Portfolio

Source: The MicroBanking Bulletin, Issue no. 6 (April 2001), Tables A and B

- The mandatory procedures for **recognition and classification of delinquent loans** are being reviewed for the possibility of taking into account the nature and cycles of microenterprises and small businesses; the characteristics of microfinance loans – especially in terms of acceptable collateral and repayment patterns; and the short-term maturity profile of microfinance loans
- **Provisioning for portfolio at risk** in the case of Ghana took into account the comparatively more numerous, smaller principal amount, and shorter maturity cycles of microfinance loans. "Basket-based" provisioning, instead of individual loan provisioning, was adopted as the acceptable approach. This basket-based loan classification and provisioning approach is more practical and less complicated and costly, compared to the prevailing practice of identifying, classifying and provisioning on an individual loan basis. In addition, the general reserve for microfinance loan losses, in the case of Ghana, is set at a level higher than that for regular commercial loans.

87. In working with a tiered structure of financial institutions and a tiered regulatory structure, the regulatory experiences of Ghana and the Philippine provide important lessons as regards the threshold levels of microfinance intermediation activities which trigger the need for external regulation.

- **Informal entities.** External regulation has not been required for informal sector entities such as Self Help Groups (SHGs), ROSCAs, ASCAs, susu clubs and susu collectors, and informally organized groups such as village banks which do not access funds beyond members' savings kept within the group.
- **Registration as basic regulation.** The most basic form of regulation is standard registration, covering documents of establishment and governance structure. This applies to all MFIs which access funds from donors, government agencies, commercial banks -- in the same manner that other business and social organizations are required to establish status as legal entities.
- **Monitoring through standard periodic reports** constitutes a higher tier in the regulatory structure, and often applies to institutions engaged in financial intermediation which does not include retail deposit-taking activities. Banking laws govern the mobilization of retail deposits from the public, but apply only to *voluntary* deposits and do not cover forced savings or mandatory deposit schemes specifically tied to loan contracts.
- **Limited-license bank and non-bank MFIs** may be organized as a non-bank intermediary, financing company, or specialized or limited bank with a limited license which permits deposit-taking activities from the general public. Generally, this is limited to a multiple of its total qualifying capital and generally excludes the ability to create demand deposits, with operations limited to a defined area. Such an MFI may need to comply with higher capital adequacy guidelines and resulting lower leverage multiples, with limits on services and operations. The more restrictive limits on capital adequacy are consistent with restrictions on deposit-taking and, by reducing the comparative return on equity, serve as a preventive measure against opportunistic behavior by investors seeking gains through *regulatory arbitrage.*
- **Full offsite and onsite supervision** is appropriate for licensed banks, which are permitted to mobilize retail deposits from the general public. They are subject to licensing requirements and full prudential supervision by the regulatory authorities, particularly their compliance with and observance of capital adequacy, risk-asset classification and leverage, loan classification and provisioning standards, concentration of loans and deposits and deposit insurance enrollment.

OTHER REGULATORY FRAMEWORK ISSUES

Regulating Cooperative Financial Institutions

88. CFIs comprise membership-based institutions based on closed-bond or open-bond relationships: "closed-bond" CFIs limit membership to a clearly defined group of persons and generally have a limited scale of operation in terms of geography and size of client/membership base. "Open-bond" CFIs draw their membership not from a specifically defined group and tend to be larger in scope of operations and deposit volume.[15]

89. The prudential supervision of CFIs is an important responsibility that is often not addressed properly nor adequately. Very often CFIs, like other cooperative associations, are perceived as social welfare organizations, and their financial supervision is not given a high priority, because their small size and sometimes remote location makes supervision costly. A common argument is that CFIs are

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[15] *William R. Emmons and Franck A. Schmid provide a rigorous examination of the on-going debate (in the U.S.) concerning fields of membership, i.e., common bonds, based on theoretical models of credit union formation and consolidation and the empirical evidence on the relationships between potential credit union membership vis-à-vis credit union participation rates. See their paper, "Credit Unions and the Common Bond", in the Federal Reserve Bank of St. Louis Review, September/October 1999.*

cooperatives, owned and operated by members transacting only among themselves, and therefore should be regulated by agencies responsible for other types of cooperatives.

90. In reality, however, CFIs are more like banking institutions than other types of cooperatives (e.g., agricultural production, marketing, or service cooperatives). CFIs are diversified financial intermediaries providing financial services to virtually all sectors – commerce, agriculture, industry and services – of a local economy. Their operations may be concentrated in the micro and small enterprise segments of the market but in most cases, they fund their operations from community savings and thus must compete for deposits with other types of financial intermediaries in the locality – especially licensed banking institutions. Consequently, CFIs confront the same types of risks similar to other shareholder-owned financial institutions.[16]

91. CFIs, for their institutional benefit as well as for their member-owners, would be far better regulated by those trained to supervise banks and other financial institutions – a task that requires specialized technical skills in order to properly safeguard the savings of members. Thus, banking authorities in a number of countries are carefully assessing whether to place CFIs (especially those where the number of members, level of assets and loans, and volume of deposits have begun to approach or even exceed those for small licensed banks) under the jurisdiction of a central regulatory authority for banks.[17]

92. Good practice prudential supervision for MFIs calls for modifications in the methods customarily used by regulatory authorities for commercial bank supervision in a number of key areas – particularly those closely related to the nature and characteristics of the business activities serviced by MFIs. With respect to CFIs, the areas in which effective CFI supervision will diverge significantly from best practice commercial bank supervision center on the impact of CFI characteristics: borrower domination, external funding sources, non-professional/volunteer credit committees, fixed asset levels, and quality of staff due to low-salaried or volunteer staff. The main approaches to regulation and prudential supervision of CFIs (which is also applicable to MFIs in general),[18] and the strengths and deficiencies of each approach are summarized below:

    a. Direct prudential supervision by the public sector supervisory authority. This approach is the most desirable because the protection of the small but numerous depositors is fundamentally a function appropriate for the public sector. Moreover, the approach avoids the conflict-of-interest problem which arises from prudential supervision delegated to a CFI federation or MFI umbrella organization. The approach is likewise the only one that achieves unification of supervisory jurisdiction over financial intermediation activities across the widest range of financial intermediary institutions. The principal drawback to direct prudential supervision by the public sector regulatory authority is often the scarcity of trained supervisory staff and resources of most central supervisory authorities.

    b. Auxiliary prudential supervision as in the German system of credit union supervision, where the supervision is carried out by two or more regional credit union auditing federations – so

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[16] *Jeffrey Poyo, "Regulation and Supervision of Credit Unions", in Glenn D. Westley and Brian Branch (eds.),* *Safe Money: Building Effective Credit Unions in Latin America. Johns Hopkins University Press (for Inter-American Development Bank and World Council of Credit Unions): Washington, DC, 2000.*

[17] *The experience of Peru, Bolivia, Mexico, Albania, Ghana and the Philippines illustrates this new thinking.*

[18] *See: Matthias Arzbach and Álvaro Durán, Regulación y Supervisión de Cooperativas de Ahorro y Credito en América Latina. DGRV: San José, Costa Rica, Junio 2000, pp. 8 –10; and Helmut Pabst, "Mejores Prácticas en la Supervisión de las Cooperativas de Ahorro y Crédito", exposición en la 1ra. Convención de Cooperativas Ahorro y Crédito del Perú, Lima, Perú, 17-19 octubre del 2001. Confederación Alemana de Cooperativas (DGRV): Lima, Perú, octubre 2001.*

that a credit union is never supervised by the very same federation it belongs to but rather by the other federation. The German experience highlights the results of many long years of success with the system: the governing boards of the federations are highly professionalized, with many years of specialized professional service. The federations do not carry out promotional or lobbying functions, which are undertaken by separate organizations (DGRV and BVR).

c. Delegated prudential supervision, in which the government regulatory authority delegates the prudential supervision function to a private/non-public sector supervisory entity. The ideal arrangement is one where the delegated supervisory entity is independent of the credit unions – even though this result is most likely difficult to achieve. In situations where the delegated private sector entity is the CFI federation or MFI umbrella organization, the most significant drawback is the conflict-of-interest problem because the member CFIs or MFIs select the leadership and governing board of their federations or umbrella organizations.

d. For a system of self-regulation and autonomous supervision to work it is indispensable that there is a set of well-founded prudential standards, guidelines and practices which are understood clearly and conscientiously observed by the member entities of the CFI federation or umbrella organization. One of the major weaknesses is the absence of an organization and mechanism for imposing sanctions and penalties for non-compliance with prudential standards, fraud, or for carrying out intermediation activities and management practices that may be harmful to members and clients as well as to other CFIs or MFIs.

93. Ghana and the Philippines have different approaches to regulation and prudential supervision of CFIs. Ghana's regulatory framework classifies credit unions' financial intermediation activities under the NBFI category subject to the jurisdiction of the Bank of Ghana and prudential supervision by its Non-Bank Financial Institutions Department. In contrast, credit unions and savings and credit cooperatives in the Philippines are subject to regulation only by the CDA - an agency under the Office of the President. Since they are outside the jurisdiction of BSP as the principal regulatory authority for banks and financial institutions, credit unions and savings and credit cooperatives are excluded from participation in the Philippine formal deposit insurance system, and participate in the central check-clearing and payments system through licensed banks.

94. Both Ghana and the Philippines could benefit from the experience of other countries which have begun to address the establishment of a prudential regulatory framework appropriate for CFIs – although it must be pointed out that the regulation and supervision of MFIs and CFIs is a relatively recent development, even in Latin America. One such country is Peru, even though the experience in regulating and supervising credit unions is perhaps still too new and too limited.[19] Peru has adopted a *hybrid delegated approach* to the regulation and prudential supervision of credit unions, whereby they (i) are subject to the Law on Cooperatives, and (ii) like banks and other financial intermediaries, are subject to the provisions of the laws governing banks, finance companies, insurance companies, and the Superintendency for Banks and Insurance Companies (SBS). The off-site and on-site

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[19] *Peru's regulatory framework for CFIs consists of the Law on Cooperatives (1990); the General Law on Banking, Finance and Insurance Companies (Decree No. 770); and the General Law on the Financial System, the Insurance System, and the Superintendency of Banks and Insurance Companies (Law No. 26702). CFIs are considered to be financial intermediaries and, like banks, finance companies and insurance companies, are under the regulatory and prudential jurisdiction of the Superintendency for Banks and Insurance Companies. See: Eduardo Casavilca, "Impacto de la Regulación en las Cooperativas de Ahorro y Crédito en el Perú", exposición en la 1ra. Convención de Cooperativas Ahorro y Crédito del Perú, Lima, Perú, 17-19 octubre del 2001. Superintendencia de Banca y Seguros: Lima, Perú, octubre 2001.*

supervision of open-bond credit unions are carried out directly by the staff of the SBS. On the other hand, the prudential supervision of closed-bond credit unions is undertaken by a designated third-party entity, the National Federation of Savings and Credit Cooperatives of Peru (FENACREP), for and in behalf of the SBS under well-defined structures and mechanisms for responsibility and accountability. Any sanctions arising from non-compliance with the prudential standards and guidelines issued by the Superintendency, based on the delegated on-site examination and supervision work carried out by FENACREP, are implemented by the SBS itself.[20]

Ownership and Control of Microfinance Institutions

95. Regulations on permitted forms of ownership and control of MFIs constitute significant barriers to entry by interested promoters and organizers of microfinance entities into legitimate operations. The banking laws of most countries require that entities subject to licensing must have an organizational format as a stock corporation or limited liability company -- for banking and other financial institutions, or as mutually-owned cooperative associations – for credit unions, savings and credit cooperatives or non-stock savings and loan associations. Generally, the shareholders in a stock corporation or limited liability company, or in credit unions and savings and credit cooperatives may be natural persons or legal entities. This is the case, for instance, in Ghana and the Philippines.

96. The restrictive barrier to entry is created when the establishment rules and banking regulations specify that ownership and control in authorized and licensed MFIs (including banks) may be held only by natural persons (as in the case of Honduras, El Salvador and Indonesia). An even more restrictive barrier to entry is constituted by establishment rules and banking regulations which specify that ownership and control of authorized and licensed MFIs (including banks) may be held exclusively by natural persons who are citizens (El Salvador) and/or legal entities which are 100% - owned by citizens (Indonesia). A related restrictive barrier consists of regulations which prohibit the employment of non-citizens are directors or managers of authorized and licensed MFIs. These restrictive regulations on ownership and control effectively preclude the entry and participation of specialized, experienced and financial resource-endowed international organizations in the development of sustainable microfinance.

Self-Regulatory Organizations

97. Self-regulation refers to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations to be supervised – usually a member-controlled federation of MFIs. Christen and Rosenberg[21] point out that experience from the field appears to justify a categorical conclusion: in poor countries, self-supervision of financial intermediaries has been tried dozens of times and has repeatedly proven to be ineffective, even in the many cases where donors provided heavy technical assistance. One reason for the failure of the model is the obvious conflict of interest that arises. The immediate benefit to the participating institutions is not great enough to induce them to hold a rigorous line when problems arise. Most of the experience with self-supervision has been in federations of financial cooperatives, but it is hard to see any reason to expect better results from federations of MFIs.

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[20] *Pabst, Helmut. "Mejores Prácticas en la Supervisión de las Cooperativas de Ahorro y Crédito", exposición en la 1ra. Convención de Cooperativas Ahorro y Crédito del Perú, Lima, Perú, 17-19 octubre del 2001. Confederación Alemana de Cooperativas (DGRV): Lima, Perú, octubre 2001.*

[21] *Robert P. Christen and Richard Rosenberg. The Rush to Regulate: Legal Frameworks for Microfinance, Consultative Group to Assist the Poorest (CGAP) Occasional Paper. CGAP: Washington, DC, April 2000.*

98. One means by which governments, international financial institutions and donors (and, in a few cases, private organizations) are trying to accelerate the expansion of microfinance services, is the establishment of wholesale financial institutions, organized and known variously as apexes, second-tier banks, national funds, etc.) to channel financial resources and, in varying degrees, technical assistance and overhead support to microfinance retailers.[22] Some countries may have an apex institution (usually a national fund) wholesaling loans to local MFIs—typically credit-only MFIs. As a principal lender/investor, such an apex becomes a "virtual" supervisory agency: it must evaluate and monitor the soundness of the MFIs it lends to if it expects to have its loans repaid. For MFIs that fail to meet its standards, the sanction is denial of loans.

99. Suggestions have been made from time to time that apex institutions supervise deposit-taking MFIs, usually under a delegated supervision arrangement with the central bank authority. Such an arrangement might involve potential conflicts of interest: for instance, would an apex institution move expeditiously to close down an MFI that owed it money? The justification for these apex institutions often includes an expectation that they will catalyze significant quality improvements in the MFIs they fund, but few have been notably successful at this task.

Legal and Judicial Systems for Loan Contracts and Security Interest

100. For both Ghana and the Philippines, there are still major limitations in the legal definition, registration and repossession of collateral which stand in the way of providing not only greater access to financial services for poor owners of microenterprises, but also for legitimate MFIs to gain much needed access to commercial sources of funds in the formal banking and finance sector. Indonesia shares many of these limitations as well: one example of an obstacle to microfinance lending is Bank Indonesia's administrative regulation that borrowers must present to the lending bank a properly issued Business License (NPWP) for loans of Rp.25 million or more.

101. In Ghana and the Philippines -- as in many developing countries -- the secured transactions framework, viz., (i) creation (legal definition), (ii) perfection (registration), and (iii) execution (repossession) – has emerged as a substantial constraint to rural credit access. In the World Bank's experience in a number of countries confronted with these obstacles in the legal and judicial systems, Economic and Sector Work has been followed by technical assistance and lending for help in (a) drafting a comprehensive legal framework and (b) modernizing registry systems. Addressing these issues can be expected to increase access to credit by facilitating and legitimizing direct lending by banks and NBFIs for loans secured by moveable property, and by increased linkage transactions through the wholesale and retail system secured by inventory and accounts receivables.

102. Closely related to strengthening the legal and regulatory framework is improving the information base for formal commercial as well as rural MFIs lenders. To reduce risks and transaction costs, the design of rural microfinance projects should support steps to provide accurate and timely information regarding collateral, including aspects such as: (i) expansion, modernization and unification of public registries, particularly for land; (ii) improvement and modernization of titling and registration procedures; and (iii) promotion of credit bureaus and rating services particularly to provide better information about potential institutional borrowers such as SHGs and NGOs.

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[22] *Fred Levy, "Apex Institutions in Microfinance", The World Bank: Washington, DC, June 12, 2000 (Draft).*

ANNEX: OVERALL REGULATORY FRAMEWORK FOR RURAL/MICROFINANCE INSTITUTIONS – INDONESIA

Type of MFI	*Ownership*	*Form of Organization*	*Established under Law No.*	*Authorized Activities*	*Government Agency with Jurisdiction*	*Regulated by*	*Supervised by*
Commercial Banks in Microfinance	Private / State	Limited Liability Co.	Law No. 10 / 1998	Full-service bank; KPKM and KBLI	Bank Indonesia	Bank Indonesia	Bank Indonesia
Bank Rakyat Indonesia	State-owned commercial bank	State-owned bank	Law No. 10 / 1998	Full-service bank	Bank Indonesia	Bank Indonesia	Bank Indonesia
BRI Retail	Retail banking division of BRI	Operating division		Full banking services	Bank Indonesia	Bank Indonesia	Bank Indonesia
BRI Unit Desa	Micro banking division of BRI	Operating division		Savings deposits and micro-loans	Micro Banking Division - BRI	Bank Indonesia (for BRI as a whole)	Bank Indonesia (for BRI as a whole)
Bank Pembangunan Daerah (BPD) Regional Development Banks	Provincial government	Government enterprise	Law No. 10 / 1998	Full-service bank; Loans and TA to LDKPs	Bank Indonesia; Provincial Government; Ministry of Home Affairs	BI; Provincial Government	Bank Indonesia
Bank Perkreditan Rakyat (BPR/NonBKD) Rural Banks	Private parties; Local governments.	Limited Liability Co. or Cooperative or Government Enterprise	Law No. 10 / 1998	Savings and time deposits; microfinance loans	Bank Indonesia	Bank Indonesia	Bank Indonesia
Badan Kredit Desa (BPR BKD) - Village Banks and Paddy Banks	Village-owned and village-managed	Staatsblad	Staatsblad 1929 Village Credit Institutions Act	Microcredits only	Finance Ministry; BRI; Bank Indonesia	Finance Ministry; BRI; Bank Indonesia	BRI Branch on behalf of Bank Indonesia
Lembaga Dana Kredit Pedesaan (LDKP) – Village Rural Fund and Credit Institutions	Local and Provincial Government Administration	Government enterprise (NBFI)	Provincial Government Decrees; Ministry of Finance, 1984	Micro-loans only	Provincial government	Provincial BPD	Provincial BPD
BKK (Central Java)	Provincial government	Government enterprise (NBFI)	Provincial Decree No. 2 / 1970; Ministry of Finance, 1984	Savings deposits and micro-loans	Provincial government; Ministry of Finance	Sub-district government head; Provincial BPD	Provincial BPD
LPD (Bali)	Local villages (desa adat)	Government enterprise (NBFI)	Provincial Decree No. 2 / 1988	Savings deposits and micro-loans	Badan Pembina LPPD presided over by the Governor	Audited by Inspektorat Wilaya Daerah	BPD - Bali

Type of MFI	*Ownership*	*Form of Organization*	*Established under Law No.*	*Authorized Activities*	*Government Agency with Jurisdiction*	*Regulated by*	*Supervised by*
Unit Eknomi Desa – Simpan Pinjan (UED-SP)	Village government	Village enterprise	Ministry of Home Affairs Instructions No. 412/440/SJ 1998	Microcredits and savings	Ministry of Home Affairs; village head + LKMD	Sub-district and district PMDs, national PMD	Sub-district and district PMDs, national PMD
Credit Unions (KOPDIT)	Private sector individuals	Financial Cooperative	Government Ordinance No. 9 / 1995	Savings deposits and micro-loans (members only)	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
KOSIPA	Government-sponsored	Financial Cooperative	Law No. 25 / 1992	Savings deposits and micro-loans (members only)	Ministry of Coops, Small/ Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
KUD / USP	Government-sponsored	Credit dept. of multi-purpose cooperative	Law No. 25 / 1992	Savings deposits and micro-loans (members only)	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise	Ministry of Coops, Small/Medium Enterprise
Pawnshops	State-owned	Government enterprise		Pawn loans	Ministry of Finance	Ministry of Finance	
NGOs	Private sector	Non=profit foundation		Promote linkages; credit delivery and loan collection			

Revised and updated 2/22/2001 from Randhawa/Gallardo Back To Office Report; See also: "ProFI Microfinance Institutions Study", Report prepared for BI-GTZ ProFI Project, Denpasar,Bali March 2001

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