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A Framework for Regulating Microfinance Institutions

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Is there a need to regulate microfinance institutions? If so, what activities should be regulated? Who should regulate them? And what issues are fundamental to the sector's regulation?

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Summary findings

The continuum of institutions providing microfinance cannot develop fully without a regulatory environment conducive to their growth. Without such an environment, fragmentation and segmentation will continue to inhibit the institutional transformation of microfinance institutions.

Van Greuning, Gallardo, and Randhawa recommend a tiered approach to external regulation, one that takes into account the different types of microfinance institutions, the products they offer, and the markets they service. A tiered approach can be useful in designing regulatory standards that recognize the basic differences in structure of capital, funding, and risks faced by different kinds of microfinance institutions.

The model they develop for a regulatory framework identifies *thresholds* of financial intermediation activities, thresholds that trigger the requirement that an institution satisfy *external* or *mandatory* regulatory guidelines. It focuses on risk-taking activities that must be managed and regulated.

They illustrate the usefulness of the model by practically applying prudential considerations to various categories and values of financial risk for each of three broad categories of microfinance institution:

- Those that depend on other peoples' money (such as donor or public sector funding).
- Those that depend on members' money.
- Those that leverage the general public's money to fund microfinance loans.

For each category, the model highlights:

- The observed value ranges for selected indicators of financial risk.
- Recommended ranges of value suitable for consideration under internal governance.
- Suggested threshold values that indicate the need for external regulation.

A transparent, inclusive framework for regulation will preserve the market specialties of different types of microfinance institutions—and will promote their ultimate integration into the formal financial system. One example of the kind of regulation the authors recommend: Require standard registration documents and procedures—no different from those required of regular corporations—including the designation of a central government agency with which they should register as corporate entities.

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, or electronically on the Internet at www.worldbank.org/html/dec/Publications/workpapers/domfincapmkt.html. Please contact Ann Thornton, room MC9-765, telephone 202-458-0409, fax 202-522-3198, Internet address athornton2@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. The authors may be contacted at jvangreuning@worldbank.org, jgallardo@worldbank.org, or brandhawa@worldbank.org. February 1999. (41 pages)

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List of Acronyms

ADEMI	Asociacion para el Desarrollo de Microempresa, Inc. (Dominican Republic)
BancoSol	Banco Solidario, S.A. (Bolivia)
CAMEL	Capital, Asset quality, Management quality, Earnings and Liquidity methodology for financial risk analysis and management
CGAP	Consultative Group to Assist the Poorest
MFI	Microfinance Institutions
MSB	Microenterprises and Small Businesses
NGO	Non-Governmental Organizations
PEARLS	Protection, Earnings, Asset quality, Rates of return and cost, Liquidity and Signs of Growth methodology for financial risk analysis and management
PVO	People's Voluntary Organization
ROSCA	Rotating Savings and Credit Associations
WOCCU	World Council of Credit Unions
USAID	United States Agency for International Development

Executive Summary

1. This paper seeks to provide a framework for addressing regulatory issues which impact operations and institutional development of microfinance institutions (MFIs). Arguing against universal regulation or creating separate specialized regulations, the approach in this paper uses the analysis of MFIs' liabilities to highlight the distinguishing features of different types of MFIs and focuses on risk-taking activities that need to be managed and regulated. The *continuum* of MFIs can be classified into three broad categories: (i) MFIs which depend on *other peoples' money* (Category A), (ii) MFIs which depend on *members' money* (Category B), and (iii) MFIs which leverage *the public's money* (Category C) to fund microfinance loans. The *continuum* of institutions providing microfinance in a financial systems context cannot develop without a conducive regulatory environment. Instead, fragmentation and segmentation will continue to inhibit MFIs' institutional transformation. Hence, this paper recommends a *tiered* approach to external regulation which takes into account the different categories and types of MFIs.

2. Financial systems as a whole continue to evolve and find new ways to service demands for financial services in the emerging markets. The innovative and rapid development of many localized efforts to provide financial services to the poor outside of formal channels has generally overtaken policy formulation by governments. The reaction of some governments and multilateral agencies is unfavorable to microfinance – comprehensive regulation is being proposed for microfinance activities and institutions through mandated standards of performance and risk-ratios. These proposals are based on untested hypothesis about the institutional and market impact of moving from an unregulated environment to one that is as tightly regulated as formal banks and financial institutions.

3. The structure of liabilities highlights the primary sources of funding for MFIs: contributed equity capital, donor funds, concessional and commercial borrowings, members' savings, wholesale deposits from institutional investors and retail savings and sight deposits from the public. The important factors that differentiate MFIs from each other are therefore found mainly on the liabilities side rather than on the asset side of the balance sheet. From a regulator's point of view, it is the *source of funding* that differentiates a licensed bank MFI from a non-bank MFI.

4. A risk-based approach to financial regulation focuses on the same issues that good managers and boards of directors should be concerned with in managing an MFI. Aside from highlighting the central role of institutional capital, the approach helps in identifying the risks that prudential regulation should address. The approach can be useful in designing regulatory standards that recognize the fundamental differences in the structure of capital, funding and risks faced by MFIs. This paper's model of a regulatory framework uses the risk-based approach to regulation and addresses the following questions:

- Is there a need to regulate MFIs?
- If so, what activities should be regulated?
- Who should regulate MFI operations?
- What are the fundamental issues in the regulation of MFIs?

5. The paper points out the benefits from a transparent and inclusive regulatory framework within which MFIs can progressively evolve into formal financial institutions. The paper develops a regulatory framework model to identify *thresholds* of financial intermediation activities which *trigger* a requirement for an MFI to satisfy *external or mandatory* regulatory guidelines. As financial institutions, it is prudent for all of the different types of MFIs to observe *internal or voluntary* guidelines for risk management. The table below summarizes the regulatory framework model -- indicating the fund-generating activities

of different types of MFIs which trigger a need for mandatory external guidelines, and the proposed regulatory measures and agencies to carry them out.

Regulatory Thresholds of Activities by Type of Microfinance Institution

MFI Type	Activity that Determines Regulatory Status	Proposed Form of External Regulation, if Required	Regulatory Agency
CATEGORY A MFIs			
Type 1 Basic Nonprofit NGO	Making microfinance loans not in excess of grants and donated/ concessional funds (loan capital).	None -- Voluntary registration with Self-Regulatory Organization.	None, or Self-Regulatory Organization.
Type 2 Nonprofit NGO with limited deposit-taking	Taking minor deposits, e.g. forced savings or mandatory deposit schemes, from microfinance clients in community.	None -- Exemption or exclusion provision of banking law; compulsory registration with Self Regulatory Organization.	Self-Regulatory Organization.
Type 3 NGO transformed into Incorporated MFI	Issuing instruments to generate funds through wholesale deposit substitutes (commercial paper, large-value certificates of deposit, investment placement notes).	Registration as corporate legal entity; authorization from Bank Supervisory Authority or Securities & Exchange Agency, with limitations on size, term and tradability of commercial paper instruments.	Companies' Registry Agency; Bank Supervisory Authority or Securities & Exchange Agency.
CATEGORY B MFIs			
Type 4 Credit Union, Savings & Credit Cooperative Society	Operating as closed- or open-common bond credit union; deposit-taking from member-clients in the community, workplace or trade.	Notification to and registration with Cooperatives Authority or Bank Supervisory Authority; or certification and rating by a private independent credit rating agency.	Cooperatives Authority, or Bank Supervisory Agency or Credit Rating Entity.
CATEGORY C MFIs			
Type 5 Specialized Bank, Deposit-taking Institution, or Finance Company	Taking limited deposits (e.g. savings & fixed deposits) from general public beyond minor deposits exemption in banking law. Microfinance activities more extensive than NGOs but operations not on scale of licensed banks.	Registration and licensing by Bank Supervisory Authority, with a limitation provision (e.g., savings & fixed deposits, smaller deposits-to-capital multiple, higher liquidity reserves, limits on asset activities and uses).	Bank Supervisory Authority.
Type 6 Licensed Mutual-Ownership Bank Type 7 Licensed Equity Bank	Non-restricted deposit-taking activities, including generating funds through commercial paper and large-value deposit-substitutes, from the general public.	Registration and full licensing by Bank Supervisory Authority as a mutual-ownership or equity bank; compliance with capitalization / capital adequacy requirements, loan loss provisioning and full prudential regulations.	Bank Supervisory Authority.

6. The categories of risk which financial institutions including MFIs need to manage comprise balance sheet structure risk, profitability risk, solvency/capital adequacy risk, credit risk, treasury risks (consisting of liquidity risk, interest rate risk, market risk, and currency exposure) and operational risk. The nature of the microfinance business and the institutional structure of MFIs determine the priority ranking of risks that need to be managed. The processes of internal regulation through governance and mandatory external regulation are closely linked to each other. Several key players from the MFI sector, the regulatory agencies and the general public have a critical partnership and shared responsibility in the risk management process.

7. The approaches to external supervision of MFIs can range from nonexistent to full regulation, either through the existing prudential regulatory framework or by modifying the existing regulatory requirements to fit the organizational and operating characteristics of MFIs. A primary example of the adaptive approach is "tiered banking" and graduated regulation – a structure which takes into account the defining characteristics of the microfinance business and the varied range of MFIs involved in it.

8. A second example is the initiative by leading credit unions in Guatemala, with the assistance of World Council of Credit Unions (WOCCU) and the Consultative Group to Assist the Poorest (CGAP), to establish an independent credit rating and certification agency for credit unions. Similar to the operation of credit rating agencies in capital markets, the private rating agency that is being established has no statutory authority but can wield significant power if investors and lenders respect its independence and credibility.

9. The paper concludes by identifying measures to preserve the market specializations that MFIs have and to promote their linkage and integration with the formal financial system. Even when a supportive macroeconomic environment exists, MFIs may face obstacles from accounting specifications, tax and fiscal regulations that discriminate against microfinance. Developing packages of financial services suited to the microfinance market requires coordinated efforts among donors, governments, microfinance practitioners and institutions, and target clients of themicroenterprises and small businesses themselves. Coordination among the key participants can be enhanced by dialogue and dissemination of commonly understood measures that clarify regulatory aspects in the provision of financial services and establish an environment under which MFIs can follow an orderly progression to institutional development.

I. Introduction, Objectives and Structure of the Paper

Background

1. Banks in developing countries typically serve no more than 20% of the population leaving the rest with little, if any, access to financial services. The unserved majority which employs as much as 60% of the economically active population depends on informal and semi-formal sources of finance. Most of the entities providing microfinance services are non-formal and semi-formal institutions not subject to prudential regulations which apply to banks and other formal-sector institutions. The ability of most microfinance institutions (MFIs) to leverage capital and mobilize external resources is generally limited. To support outreach to low-income clients, donated resources are generally leveraged and augmented by borrowing from formal financial institutions or large institutional and individual investors, or accepting limited deposits from the public.

2. A broad range of institutional channels for microfinance target different segments of the microenterprise and small business (MSB) market. In some countries such as Bolivia, Indonesia, Philippines, Bangladesh and Sri Lanka¹, licensed specialized and regular commercial banks participate in providing financial services to the MSB sector. However, the global experience shows a rapid but uneven pattern of institutional, and inconsistent application of regulatory principles. The range of institutional channels for microfinance in most countries is limited to NGOs and credit cooperative societies.²

Objectives

3. The main objective of this paper is to provide a framework for addressing regulatory issues which impact MFI operations and institutional development. The paper notes the disadvantages of creating a separate set of regulations for specialized treatment, or of universal regulation of MFIs. The paper shows that existing regulatory principles can be adapted to address coverage appropriate for MFIs and those activities that may need to be regulated. The paper could be useful in developing guidelines to establish a regulatory environment which permits MFIs to progressively evolve into institutions capable of wider outreach and achieving critical mass in operations. A *continuum* of institutions providing microfinance in a financial systems context cannot develop without conducive regulatory environment. Instead, fragmentation and segmentation will continue to inhibit the institutional transformation of MFIs.

4. Earlier efforts have been made to establish and promote a common understanding of microfinance activities among regulatory authorities who have reacted to the rise of microfinance services by enacting legal measures – ranging from the marginalist and ad hoc to full intervention.³ In addition, there have

¹ The Indonesian experience in village banking is discussed in James Boomgard and Kenneth Angell, "Bank Rakyat Indonesia's Unit Desa System: Achievements and Replicability", in Otero and Rhyne, eds., The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor. West Hartford, CT. Kumarian Press, 1994. The microfinance experience of Panama's Multi Credit Bank is discussed by Rachel Rock, Carlos Castello and Vivienne Azarcon in "Other Microfinance Institution Experience with Regulation", in Rock and Otero, eds., From Margin to Mainstream: The Regulation and Supervision of Microfinance Institutions, Washington, DC: ACCION International, 1997. Sri Lanka's experience with commercial bank downscaling into microfinance is discussed in Joselito Gallardo, Bikki Randhawa and Orlando Sacay, A Commercial Bank's Microfinance Experience: The Case of Hatton National Bank in Sri Lanka", Discussion Paper No. 369, Washington, DC: The World Bank, 1997.

² "Financial Assistance and Other Programs to Support Low-Income Entrepreneurs: An Introductory Guide", Economic Development Institute (report prepared by Silvia Dorado-Banacloche), Washington, DC: The World Bank, August 1996 (Draft).

³ The countries which have recently taken legislation and regulation initiatives (with varying degrees of coverage) include South Africa, Zambia, Uganda, Malawi, Nepal, Bangladesh, Bosnia, Georgia, Moldova and Ukraine.

been initiatives to regulate the provision of microfinance services, as well as the establishment and operations of all MFIs.⁴ This paper's approach differs by (i) using the liabilities side of the balance sheet to underscore the distinguishing features of different MFIs in sourcing funds, and (ii) highlighting the asset side of the balance sheet to focus on the risk-taking activities in the uses of those funds that need to be managed and regulated. The usefulness of the risk-based approach to financial management and regulation is demonstrated through:

- Establishing a fundamental framework for determining which activities, types of MFIs and forms of regulation and supervision are appropriate;
- Highlighting the underlying regulatory guidelines for different types of MFIs which can preserve and enhance the flexibility possible with informal methods;
- Identifying measures to promote the linkage and integration of MFIs with the formal financial system in order to diminish the segmentation in financial markets.

Structure

5. Chapter II of the paper presents a summary of the operational and structural characteristics of MFIs at different stages of development, from specialized NGOs outside the banking system to licensed financial institutions subject to prudential regulation. This section highlights the factors which are important for good risk management and discusses the importance of financial statements in assessing the need for regulation and the impact of fragmented regulation on institutional development.

6. Chapter III presents the model of a regulatory framework to examine the rationale for regulating selected activities of certain types of MFIs. The discussion addresses the following basic questions:

- Is there a need to regulate MFIs?
- If so, what activities should be regulated, and
- Who should regulate MFI operations?
- What are the fundamental issues in the regulation of MFIs?

7. Chapter IV focuses on the basic principles of *risk management as a continuing, dynamic process*, as opposed to *static ratio management*. The risk management categories discussed are balance sheet structure, profitability, capital adequacy, credit risk (such as loan administration, portfolio management and loan loss provisioning practices), liquidity risk, interest rate risk, market risk, currency risk and operational risk. This paper uses the financial statements of different types of MFIs to illustrate the key values, ratios and relationships of items in the balance sheet and income statement as diagnostic tools which are relevant to risk management and regulatory issues.

8. Chapter V summarizes the regulatory issues discussed and the major conclusions and recommendations drawn from the analysis. The section includes a discussion of "tiered" banking structures and graduated regulation,⁵ as well as a brief summary of innovative approaches in self-

⁴ References are made to Rachel Rock and Maria Otero, *op. cit.*; Robert P. Christen, "Issues in the Regulation and Supervision of Microfinance", paper presented at ACCION International conference, Washington, DC, November 1995; The World Bank, Consultative Group to Assist the Poorest (CGAP), *Focus Note Series*, "Regulation and Supervision of Micro-Finance Institutions: Stabilizing a New Financial Market" (No. 4, August 1996); Craig Churchill and Shari Berenbach, *The Regulation and Supervision of Microfinance Institutions*, Washington, DC: MicroFinance Network, February 1997.

⁵ Banking laws provide for "tiered" banking structures and graduated regulation in Bolivia, El Salvador, Nicaragua, Peru, Indonesia, Philippines, Sri Lanka, Georgia and Uganda among others.

regulation through a market-based private rating and certification institution⁶ and through umbrella organizations. The discussion also brings out the need to better synchronize sponsors', donors' and regulators' requirements for reports and information which are indispensable to risk-management processes in MFIs, particularly in the use of performance indicators for MFIs within relevant peer groupings.

⁶ This is the initiative of leading credit unions in Guatemala, with the assistance of the World Council of Credit Unions (WOCCU) and the Consultative Group to Assist the Poorest (CGAP) to establish a private credit rating and certification agency.

II. Using Financial Statements to Determine the Need for Regulation

Characteristics and types of microfinance institutions (MFIs)

9. The organizational characteristics and business operations of microenterprises and small businesses (MSBs) influence the types and formats of financial services provided by MFIs. Although MSBs have differing demands depending on specific country situations, the features common to them are low-technology, labor-intensive activities, limited access to financing from the formal sector, lack of conventional forms of collateral and accounting records and concentration of business activities in poor urban and semi-urban areas. The financing required is mostly for short-term working capital, in relatively small amounts.

10. Traditional sources of finance for MSBs are family and friends and the informal markets -- rotating savings and credit associations (ROSCAs), various "club" systems pooling members' savings for loans,⁷ village banks, buyers' advances (in cash or in kind), and moneylenders. There may be some access to semi-formal microfinance institutions (legally organized financial intermediaries which are not regulated by the monetary authorities) such as non-profit NGOs, larger village banks, suppliers who provide trade credit, and pawnbrokers. Formal MFIs comprise savings and credit cooperatives, credit unions, incorporated NGOs, finance companies, and specialized and regular banks. The latter includes banks established by NGOs, or "windows" and departments created by commercial banks to handle MSB business. Chart 1 in the page following summarizes the organizational and market-niche characteristics of different types of MFIs.

11. MFI loans to informally-organized businesses are numerous but in small amounts for short-term periods, with the aggregate loan portfolio turning over several times during the year. The loans are generally unsecured, with simple repayment structures and documentation requirements, and at interest rates generally higher than those in the formal sector. In contrast, regular loans of commercial banks are fewer in number and for larger amounts. The majority of commercial bank loans are formally secured, with more complex structures and short- to medium- term maturities.

12. Commercial banks could be significant players in microfinance because of the advantages from branch office infrastructure and systems and the ability to mobilize resources from the public. However, they generally do not have the product lines, loan procedures, operating cost structures and staff skills to make a profit from numerous but smaller-sized microfinance loans. The lack of an information base on the MSB market as well as difficulties in enforcing loan contracts contribute to their limited participation in microfinance. Only a handful of commercial banks have been able to carry out a downscaling of regular banking operations to reach MSBs.⁸

13. Chart 1 on the next page shows the characteristics of semi-formal and formal MFIs, which may be classified into three broad categories⁹ based on their main sources of funding. Category A MFIs which

⁷ Some country examples are *stokvels* in South Africa, *tontines* and *susu* in West Africa, *iqqubs* in Ethiopia, *ke* in Korea, and *arisan* in Indonesia.

⁸ Notable among commercial banks downscaling regular banking operations into profitable microfinance programs are Hatton National Bank in Sri Lanka and Multi Credit Bank in Panama. See Gallardo, Randhawa and Sacay, *op. cit.* and Rock, Castello and Azarcon, *op. cit.*

⁹ William F. Steel has suggested that MFIs be classified into three broad categories, based on their use of (i) other peoples' money (grants and donations), (ii) members' money (share capital contributions and savings), and (iii) the general public's money (retail deposits). We have adopted the use of these categories in the regulatory framework model developed in this paper.

Chart 1. Distinguishing Characteristics of Types of MFIs in the Continuum

Type of MFI	Legal Form of Organization	Basis for Establishment	Ownership	Governance	Main Source of Funds for Operations & Loans	Market Niche
Category A: MFIs Using Other Peoples' Money						
Type 1 NonProfit NGO	NonProfit NGO	Social Services Law, Trustees' Ordinance	Foreign & Local Donors, through a Trust	Board of Trustees	Grants and Donations	Specifically-defined Urban or Rural Low-Income Area
Type 2 NonProfit NGO with limited deposit-taking	NonProfit NGO	Social Services Law, Trustees' Ordinance + Registration with Central NGO Body	Foreign & Local Donors, through a Trust	Board of Trustees	Grants and Donations, Limited Deposit-Taking	Specifically-defined Urban or Rural Low-Income Area
Type 3 NGO transformed into Incorporated MFI	NonProfit Limited Liability Stock or Non-Stock company	Companies' Registration Law	Individual persons and/or Institutions as members or stockholders	Board of Directors	Grants and Donations, Limited Deposit-Taking, Concessional and Commercial Borrowings	Specifically-defined Urban or Rural Low-Income Area
Category B: MFIs Using Members' Money						
Type 4-A Credit Union, Savings & Credit Cooperative Society	Closed Common Bond Association	Law on Cooperative Societies or Savings & Credit Associations	One-man one-vote membership limited to natural persons sharing strictly-defined interests (village or employment).	Board of Directors	Members' Share Capital Contributions and Savings Deposits	Specifically-defined Urban or Rural Community or Place of Employment
Type 4-B Credit Union, Savings & Credit Cooperative Society	Open Common Bond Association	Law on Cooperative Societies or Savings & Credit Associations	One-man one-vote membership limited to natural persons sharing broadly-defined interests (trade, craft or large geographical area).	Board of Directors	Members' Share Capital Contributions and Savings Deposits	Broadly-defined Urban or Rural Communities or Employment Sectors
Category C: MFIs Using the Public's Money						
Type 5 Specialized Bank, Deposit-taking Institution, or Finance Company	Limited Liability Stock Company	Companies' registration law; Limited license issued by Bank Regulatory Authority	Individual persons and/or Institutions as members or stockholders	Board of Directors	Savings deposits, Wholesale Funds and Commercial Borrowings	Regional or National Market Area
Type 6 Licensed Mutual-Ownership Bank Type 7 Licensed Equity Bank	Limited Liability Stock or Non-Stock Company	Companies' registration law; Full license issued by Bank Regulatory Authority	Individual persons and/or Institutions as members or stockholders	Board of Directors	Retail Deposits from the General Public, Wholesale Funds and Commercial Borrowings	Regional or National Market Area

use *other peoples' money* comprise (i) non-profit NGOs using grants and donations to provide micro-loans (Type 1), (ii) non-profit NGOs that augment grants and donations with members' savings and limited borrowings from commercial banks (Type 2), and (iii) non-profit NGOs that have changed their organizational format into incorporated entities and exercised some leverage by mobilizing some "wholesale" funds through wholesale deposits, commercial paper or bank credit lines (Type 3).

- Type 1 - a non-profit NGO, organized as a self-help organization (SHO), people's voluntary organization (PVO) or association, whose capital and funding for lending operations are sourced mainly from grant funds provided by donors.
- Type 2 - a non-profit NGO, organized as a SHO, PVO, association or foundation which augments donor funds by accepting limited or minor deposits from members (similar to the practice in village banks) and accessing limited borrowings from commercial banks.
- Type 3 - a non-profit NGO which has changed into an incorporated format and mobilizes wholesale funds through commercial paper issues or wholesale deposits to augment minor deposits, commercial bank loans, grants and concessional funds from government.

14. Category B formal MFIs which use *members' money* consist of membership-based credit unions and savings and credit cooperative associations whose services are limited exclusively or primarily to members (Type 4). The credit union or savings and credit cooperative society may be registered on the basis of an open- or closed-common bond membership. Generally, more than half of its total funding for financial services to members is generated from members' savings and share capital contributions.

15. The formal MFIs in Category C which use *the general public's money* consist of (i) corporate entities authorized to operate as specialized banks or finance companies (Type 5), (ii) licensed banks with mutual ownership of capital by members (Type 6) and (iii) licensed regular banks with equity capital owned by individual investors (Type 7).

- Type 5 - a registered business corporation licensed by a regulatory authority to operate either as a specialized bank, limited deposit-taking company or finance company permitted to accept limited deposits from the public (e.g., savings and fixed deposits), in addition to wholesale funds and commercial borrowings to support microfinance and other operations. The regulatory agency generally imposes a minimum capitalization level upon entry into the limited deposit-taking activity.
- Type 6 - a licensed regular bank whose share capital is mutually owned by members, and
- Type 7 - a licensed regular bank with individually-owned shares of capital which is authorized to mobilize retail deposits from the general public. Type 6 and Type 7 MFIs are subject to prudential guidelines on minimum capitalization and capital adequacy; qualification of directors and officers; mandatory reserve requirements and deposit insurance; portfolio aging, loan classification and loan loss provisioning; as well as periodic reporting requirements and disclosure standards.

The financial statement approach

16. The structure and composition of financial statements is useful for distinguishing the types of MFIs according to the differences in the risks that they need to manage. With respect to the balance sheet structure, the composition of assets indicates the uses of resources that have been generated and the underlying risks in those various uses. Net loans and short-term investments -- earning assets -- generally comprise the majority of total assets in an MFI's balance sheet. There may be cases, however, where non-earning assets (such as real property and equipment) make up a significant portion of total assets.

The liabilities side of an MFI's balance sheet indicates the sources of funding to support the assets generated in its microfinance operations as well as the extent to which the institution's capital has been leveraged to mobilize funds.

17. The structure of liabilities highlights the extent of an MFI's funding from public and private sources. The primary sources of funding for MFIs are contributed equity capital, donor funds, concessional and commercial borrowings, members' savings, wholesale deposits from institutional investors, and retail savings and sight deposits from the public. The important factors that differentiate MFIs from each other are found mainly on the liabilities side rather than on the asset side of the balance sheet. From a regulator's perspective it is primarily the *source of funding* that differentiates a licensed bank MFI from a non-bank MFI. Sample values of liabilities for different types of MFIs in the continuum are shown in Table 1 below to highlight the differences in the structure of liabilities. The values used do not refer to any particular currencies, but illustrate the relationship in the value of a particular liability item to total liabilities as the basis for identifying a threshold value that triggers a need for regulatory coverage. The liability-generating activities and their corresponding threshold values are explained in the Notes which accompany the Table.

Table 1. Sample Threshold Values of Liabilities for Continuum of MFIs

Types of MFIs	Basic Non-Profit NGO	Non-Profit NGO with Limited Deposit-Taking	NGO transformed into Incorporated MFI	Credit Union	Specialized Bank or Limited Deposit Taking Institution	Licensed Mutual Ownership Bank	Licensed Equity Bank
	1	2	3	4	5	6	7
LIABILITIES							
Retail funding from members / the public		20	30	260	400	460	600
Minor deposits (informal finance)		① 20	① 30	① 50			
Members' deposits				② 210		② 100	
Others' savings accounts					160	60	100
Retail/public deposits					③ 240	③ 300	③ 500
Wholesale funds (commercial paper, wholesale deposit instruments)			④ 100	④ 100	④ 100	④ 150	④ 200
Non-public funding	150	160	140	130	230	200	200
Donor loans (concessional rate)	40	50	30	20	20		
Government loans (concessional rate)	10	10	10	10	10		
Commercial bank loans (market-rate)	100	100	100	100	200	200	250
Total Funding Liabilities	150	180	270	490	730	840	1,000
Other liabilities (no financial cost)	10	10	10	10	10	10	10
TOTAL LIABILITIES	160	190	280	500	740	850	1060
CAPITAL							
Paid in capital / members' shares	10	20	25	60	⑤ 80	⑤ 120	⑤ 200
Donated capital	50	50	50	20	20	20	
Preferred capital / subordinated govt. funds	30	30	30	30	30	30	
Retained earnings / surplus / reserves	0	10	15	20	30	30	40
TOTAL CAPITAL	90	110	120	150	160	200	240
TOTAL LIABILITIES & CAPITAL	250	300	400	650	900	1,050	1,300

Accompanying Notes to Table 1:

The symbols marked on liability and capital items and values indicate microfinance activities that trigger a need for external regulation. The symbols and activities are briefly described below, and discussed in the chapter that follows.

- ① Taking minor deposits (e.g., through forced savings or mandatory deposit schemes) may be permitted under an exemption or exclusion provision in the general banking law but otherwise require no mandatory external regulation.
- ② Credit unions and savings and credit cooperatives are permitted to take savings and fixed deposits generally from members only, under an exemption or exclusion provision of the general banking law and as registered cooperative societies. There are some cases of credit unions or savings and credit cooperatives accepting deposits from non-members, but limiting loans to members only.
- ③ The license and authorization granted by a bank regulatory authority for taking deposits from the public may be limited as to instruments (savings and fixed deposits) and to market coverage (region or community base), or unlimited as to instruments (including demand deposits) and to market coverage (nationwide).
- ④ Issuing instruments to generate funds through wholesale deposit substitutes (commercial paper, investment placement notes, large-value certificates of deposit) requires registration as a corporate entity, authorization from a securities & exchange agency and/or bank regulatory authority.
- ⑤ A bank regulatory authority mandates compliance with minimum levels of capitalization and capital adequacy (among others) as necessary conditions for initial entry and continued operation as an authorized and licensed banking institution.

Importance of financial statements in determining the extent of regulation

18. The usefulness of a risk-based approach to financial regulation is that it focuses on the same issues that good managers and boards of directors should be concerned with in managing a MFI. Aside from highlighting the central role of institutional capital, this approach helps in identifying and clarifying those risks which should be addressed by prudential regulation. This approach could also assist in designing appropriate regulatory standards that recognize fundamental differences in the structure of capital and risks faced by MFIs, as discussed in Chapter III.

- The primary differentiator of Category A MFIs which depend on other peoples' money (Types 1-3) from other types is their qualifying capital which consists substantially of donated funds. In contrast, the qualifying capital of Category B MFIs which use mostly members' money (Type 4) consists mainly of members' share capital contributions and institutional reserves. The qualifying capital of Category C MFIs using the general public's money (Types 5-7) consists of equity contributions from individual shareholders. Nonetheless, most MFIs share a common difficulty in quickly responding to a capital call in the event that additional equity is required. Thus, the power to require additional capital assumes a major role as a regulatory instrument for supervisory authorities. However, this power can be exercised only over licensed financial institutions and not on unregulated nonbank MFIs.¹⁰
- The other important difference is that nonbank MFIs in Categories A and B are not legally permitted to mobilize deposits from the general public, a liability-raising activity which is allowed only to Category C MFIs. This restriction has a significant impact on how the operations and assets of NGO MFIs are financially supported by their funders.

¹⁰ This point was raised by Richard Rosenberg of CGAP in the first draft of this paper.

The impact of fragmented regulation on MFIs' institutional development and transformation

19. Banking laws in many countries compartmentalize and segment markets and institutions, constraining MFI innovations and making their institutional development difficult. While the global experience demonstrates the potential for operational growth of MFIs, the range of institutional channels is segmented by the current legal and regulatory environment in most countries. The regulatory environment needs to be changed in order to transform the fragmented spectrum into a cohesive continuum which would make it easier for MFIs to pursue a process of progressive institutional transformation. This paper, however, does not make any proposal for MFIs to pursue plans for institutional transformation, nor does it suggest any sequential steps for development. Any decision to transform, evolve, or maintain a status quo is dependent on an MFI's strategic plans for its future.

20. The percentage of non-profit NGO MFIs likely to reach critical mass in outreach and financial viability is small. In turn, only when critical mass in outreach and financial viability are attained can liabilities be safely raised from the public, through institutional transformation into licensed formal banking institutions subject to prudential regulation. In the few successful cases of transformation, the process has been characterized by the NGO MFI and its promoters becoming the founding shareholders for a subsidiary institution which then obtains a license for banking operations.¹¹

21. The environment for integrating MFIs into the formal financial system differs considerably across countries. It is emphasized that no sequencing or "stages of development" is implied in the identification and placement of different categories of MFIs in the continuum. 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. A properly structured regulatory framework could facilitate organizational development and, where it is appropriate, institutional transformation. Some MFIs may be better off remaining as low-leverage, slow-growth but effective service institutions meeting the needs of their existing clients.¹² The MSB sector is not monolithic, and experience has shown that the imposition of regulatory standards and procedures where none are called for can only serve to constrict access of MSBs to microfinance services from different types of MFIs.

¹¹ See "Introducing Savings in Microcredit Institutions: When and How", Focus Note No. 8, The World Bank, Consultative Group to Assist the Poorest (CGAP), April 1997 which is a synopsis of a paper by Marguerite Robinson, presented at the annual meeting of the Microfinance Network, Manila, Philippines, November 1995.

¹² 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.

III. Issues in Proposals for Regulation of MFIs

Is there a need to regulate MFIs ?

22. Banking laws generally define “banking business” to consist of receiving funds from the public (by accepting deposits or borrowing from the general public) *and* using such funds for loans and investments, at the risk of the institution conducting the business. Most countries permit deposit-taking from the general public to be carried out only by formally licensed financial institutions and restrict the use of the name “bank” only to entities legally organized or licensed as such. In a number of countries, the business of lending to the public (e.g., pawnbroking) is subject to prior registration with a supervisory authority.¹³ Nonbank MFIs with forced-deposits or mandatory savings schemes, however, do not provide bank-type savings services since the deposits are tied to borrowers’ loan contracts. Involuntary savings schemes do not permit a nonbank MFI to leverage its capital by accepting retail deposits from the community.

23. The power to regulate deposit-taking from the public through licensing provides the platform by which bank regulatory agencies can then supervise the other operations and activities of regulated institutions. It is important to consider whether or not the regulatory authorities have the institutional capacity and staff resources for MFI supervision. It is likewise important to consider the incremental costs to MFIs of having the required organizational, technical and staff resources to comply with the reporting requirements and supervisory procedures. However, there are practical difficulties in applying the guideline that the benefits of regulation should exceed its costs -- particularly in measuring the trade-offs. Beyond these questions of reporting requirements, regulatory standards and supervisory guidelines is the issue of which activities of MFIs should be regulated, by whom and in what form.

24. When governments establish broad regulations over both the formal banking and non-banking sectors, there is a risk of imposing regulatory structures inappropriate to operations of MFIs. The principal drawback to blanket regulation of all MFIs is the potential repression of the innovation and flexibility possible with informality. Moreover, regulation by a government agency does not necessarily correct market inefficiencies in discriminating between sustainable and non-viable providers of microfinance services. This kind of market-oriented distinction is best accomplished through the operations of market-based institutions such as licensed commercial banks doing business with MFIs, or through independent, credible credit-rating agencies.

What activities and types of MFIs should be regulated?

25. 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 qualifying capital in leveraging additional resources to fund operations. It should be noted that linking the wholesale funding, limited deposit-taking and unrestricted deposit-taking activities to the 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.

¹³ For instance, in most of the transition economies in Eastern Europe, the ability of NGOs to extend loans is subject to prior authorization from a government agency.

26. The differences in funding sources and the corresponding risks that have to be managed trigger the need for and type of external regulation. The assessment of MFIs' financial statements and the results of activities which these statements report on helps to identify thresholds at which different categories of risk are being taken and different degrees of regulation which may be warranted. Taking a longer term view, 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.

27. This paper emphasizes the fact that all parties concerned benefit from a regulatory framework that is transparent and clearly provides a continuum where MFIs can progressively evolve into formal financial institutions. In this context, the proposed model for a regulatory framework serves to identify *thresholds* of financial intermediation activities which would *trigger* a requirement to satisfy *external or mandatory* regulatory guidelines. 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 1 in the preceding section identified sample thresholds in liability-generating activities which triggered a need for graduated forms of regulation. Table 2 below accents the key features of the regulatory framework model. The table identifies the fund generating activities that trigger a need for mandatory external guidelines and summarizes the proposed regulatory measures and agencies to carry out them out.

Table 2. Regulatory Thresholds of Activities by Type of Microfinance Institution

MFI Type	Activity that Determines Regulatory Status	Proposed Form of External Regulation, if Required	Regulatory Agency
CATEGORY A MFIs			
Type 1 Basic Nonprofit NGO	Making microfinance loans not in excess of grants and donated/concessional funds.	None -- Voluntary registration with Self-Regulatory Organization.	None, or Self-Regulatory Organization.
Type 2 Nonprofit NGO with limited deposit-taking	Taking minor deposits, e.g. forced savings or mandatory deposit schemes, from microfinance clients in community.	None -- Exemption or exclusion provision of banking law; compulsory registration with Self-Regulatory Organization.	Self-Regulatory Organization.
Type 3 NGO transformed into Incorporated MFI	Issuing instruments to generate funds through wholesale deposit substitutes (commercial paper, large-value certificates of deposit, investment placement notes).	Registration as a corporate legal entity; authorization from securities & exchange agency, with limitations on size, term and tradability of commercial paper instruments.	Companies' registry agency; Securities & Exchange agency.
CATEGORY B MFIs			
Type 4 Credit Union, Savings & Credit Cooperative Society	Operating as closed- or open-common bond credit union or savings & credit cooperative society; deposit-taking from member-clients in the community, workplace or trade.	Notification to and registration with Cooperatives Authority or Bank Supervisory Authority; or certification and rating by a private independent credit rating agency.	Cooperatives Authority, or Bank Supervisory Agency or Credit Rating Entity.
CATEGORY C MFIs			
Type 5 Specialized Bank, Deposit-taking Institution, or Finance Company	Taking limited deposits (e.g. savings & fixed deposits) from general public beyond minor deposits exemption in banking law. Microfinance activities more extensive than NGOs but operations not on scale of licensed banks.	Registration and licensing by Bank Supervisory Authority, with a limitation provision (e.g., savings & fixed deposits, smaller deposits/capital multiple, higher liquidity reserves, limits on asset activities and uses).	Bank Supervisory Authority.
Type 6 Licensed Mutual-Ownership Bank Type 7 Licensed Equity Bank	Non-restricted deposit-taking activities, including generating funds through commercial paper and large-value deposit-substitutes, from the general public, investors and other banks.	Registration and full licensing by Bank Supervisory Authority as a mutual-ownership or equity bank; compliance with capitalization / capital adequacy requirements, loan loss provisioning and full prudential regulations.	Bank Supervisory Authority.

28. Basic considerations

- a) No external regulation should be required for Types 1 and 2 MFIs and those entities in the informal MFI sector such as rotating savings and credit associations (ROSCAs), club pools and village banks which are informally organized. Donors, government agencies and commercial banks from which their funds are sourced may be presumed to have the capability for due diligence and make informed decisions about them -- a form of regulation through market selection.
- b) A standard registration requirement which covers documents of establishment and governance structure should apply to MFIs in Types 3 through 7 in the same manner that other business and social organizations are required to register. It is not necessary to design and establish a separate structure of regulatory standards and procedures for MFIs because existing guidelines for prudential regulation can be adapted to accommodate MFIs.
- c) Banking laws govern the mobilization of deposits from the public, but can also address the mobilization of other types of resources to accommodate the financing and investing needs of other sectors, principally by means of non-deposit financial securities and instruments. The banking laws in a number of countries provide a definition of "public" as persons beyond a specified number who are not related to each other by law or association. Banking laws should apply only to *voluntary* deposits and should not cover forced savings or mandatory deposit schemes which are specifically tied to loan contracts.
- d) Banks and other regulated institutions in the formal sector mobilize non-deposit funds through capital market activities such as wholesale deposits, commercial paper issues and securitization. Subject to well-defined requirements and procedures under the banking and securities laws, it should be feasible to allow MFIs similar (but restricted) mobilization of non-deposit funds. In a number of countries where institutions can raise funds in the capital markets, an independent credit rating agency performs an indispensable market-based regulatory role. No special treatment or exemptions from eligibility or registration requirements should be accorded MFIs which plan to mobilize wholesale funds, and MFIs should satisfy the same standards required of other institutions that raise funds in the wholesale and capital markets.¹⁴

29. Regulatory thresholds

- a) NGO MFIs that begin to resort to fund mobilization through wholesale deposits or deposit-substitutes (as in Type 3) should satisfy securities registration requirements of the securities and exchange agency. Issuers of wholesale-type financial instruments such as commercial paper securities and investment participation certificates have to satisfy certain minimum requirements with respect to their financial standing and ability to service the placement or investment.

¹⁴ Timothy Lyman (Day, Berry & Howard LLP) points out that in countries without an effectively functioning securities regulatory system, MFIs that do not take deposits from the public can still place the general public at unregulated risk through debt securities. This is especially true in countries (e.g., the transition economies) where the legal and economic systems have not developed clear distinctions between debt and equity, or among different types of securities, or determined the most effective forms of regulating them.

- b) Limited deposit-taking in the form of forced savings or mandatory deposits which are tied to loan contracts by Types 2, 3 and 4 MFIs should simply be authorized under an *exemption or exclusion notice* under the general banking law (similar to the approach developed in South Africa, described in the Appendix) without need for a specific license. The approach allows for a universal application of banking law on deposit-taking activities and serves to *unify*, in the central monetary authority, regulatory jurisdiction over financial matters.
- c) Compared to closed-common bond societies, deposit-taking by open-common bond savings and credit cooperatives or credit unions (Type 4) could be riskier and deserves closer attention. The former limits 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. On the other hand, open-common bond credit unions draw their membership from a geographic area rather than a specifically defined group and tend to be larger in scope of operations and deposit volume. However, the closed- vis-à-vis open-common bond distinction is somewhat limited. For instance, the distinction needs to be modified to take into account the divergent and competing objectives of owner-borrowers and owner-savers, in any consideration of regulations over the deposit-taking activities of member-based organizations.¹⁵
- d) A Type 5 MFI operates as a non-bank intermediary, financing company, or specialized or limited bank. Its limited license may permit deposit-taking activities from the general public, generally to an amount limited to a multiple of its total qualifying capital and excluding the ability to create demand deposits, with operations limited to a defined area. What distinguishes it from MFIs in Types 6 and 7 is that it is subject to assets-side restrictions and the deposits it can accept may be limited to savings and fixed deposits. However, a Type 5 MFIs will still have to comply with capital adequacy guidelines, albeit at lower leverage multiples while limits on services and operations apply. Deposits mobilized should be covered by liquidity reserves in the form of pre-determined levels of deposits with the banking system or investments in government securities. While the liquidity reserve requirement might be steeper than those for Types 6 and 7 MFIs the authority to engage in limited deposit-taking activity allows the MFI to gain experience in managing liquidity risks and deposit mobilization programs.
- e) Types 6 and 7 MFIs, registered as mutual-ownership or equity-share banks are permitted to mobilize deposits from the general public and create demand deposits through checking accounts. They are subject to licensing requirements and full regulation and 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.

Who should regulate MFIs? - monitoring regulatory triggers

30. There are two approaches to regulation of MFI operations: (i) *internal regulation* through governance and (ii) *external regulation* by a supervisory agency. For regulated MFIs these two approaches are closely related since the effectiveness of the second approach is highly dependent on the first. However, observance of sound risk management guidelines through internal regulation is absolutely

¹⁵ See Rodrigo A. Chaves and Claudio Gonzalez-Vega, "Principles of Regulation and Supervision: Should They be Different for Microenterprise Finance Organizations?", Occasional Paper No. 1979, Rural Finance Program, Ohio State University, September 1992.

indispensable, whether or not a MFI is subject to external regulation. Boards of Directors, who represent the shareholders, members or donors, have the ultimate responsibility and accountability for internal oversight and governance over management in a MFI's operations.

31. The approaches to external supervision of MFIs can range from nonexistent to full regulation, either through the existing prudential regulatory framework or by modifying the existing regulatory requirements to fit the organizational and operating characteristics of MFIs. A primary example of the adaptive approach is "tiered banking" and graduated regulation – a structure which takes into account the defining characteristics of the microfinance business and the varied range of MFIs involved in it.¹⁶ In a "tiered banking" structure, a range of financial intermediaries is licensed by the regulatory banking authority to provide banking and financial services to the public. The licenses granted specify limits to the types of services that may be offered, as well as the prudential guidelines to be observed. Small, specialized or limited banks coexist with large universal or multiple banks in a "tiered banking" structure which remains under the jurisdiction of the regulatory bank authority.

31. A second major example is the adaptation, based on the experience in capital markets, which uses a credit rating agency for market-based regulation. While a credit-rating agency (e.g., Moody's or Standard and Poor) does not have statutory authority over rated institutions, it can exercise significant regulatory power if investors and lenders respect its independence and credibility. An interesting initiative is being taken in Guatemala by a group of leading Guatemalan credit unions, with the assistance of the World Council of Credit Unions (WOCCU) and the Consultative Group to Assist the Poorest (CGAP), to establish a privately-funded and autonomously-managed credit rating and certification agency for credit unions.¹⁷

33. A working partnership among "fit and proper" key players in financial risk management is fundamental to a functioning regulatory framework even though the responsibilities, accountabilities and interests of the key players are different. The approach proposed in this paper provides a framework for identifying and allocating tasks to seven key players who are accountable for different components of the risk management process. Table 3 below summarizes the partnership, whose priority task is to clearly define *accountability* and install information and surveillance systems to track compliance with established policies, procedures and programs.¹⁸

Internal regulation and governance

34. Governance can be viewed as a framework of checks and balances designed to ensure that no party or parties within an MFI impede the attainment of corporate objectives by diverting its resources for private gain. Effective governance depends on a carefully designed system which links shareholders/ members/ donors to the board of directors or trustees, to executive management, the staff and clients, and the

¹⁶ The regulatory approach through "tiered banking" and graduated regulation in Ghana, Uganda and Zambia is discussed in detail by William F. Steel in several World Bank internal memoranda. See also David Porteous, "Tears for the Unbanked / Tiers for the Unbanked", a paper presented at the South African Reserve Bank Seminar on Informal Financing, August 7, 1996.

¹⁷ World Council of Credit Unions (WOCCU), "Guatemala: Private Sector Credit Union Rating and Certification Program", a Proposal to CGAP by WOCCU, Madison, WI: WOCCU, December 15, 1997.

¹⁸ In *Bank Governance Contracts: Establishing Goals and Accountability in Bank Restructuring*, World Bank Discussion Paper No. 308, World Bank: Washington, DC, 1995 Richard Roulier presents an innovative model -- a governance contract -- for instituting bank governance and assuring that owners understand their responsibilities, delegate those responsibilities to properly constituted governing boards, and establish proper relationships with government regulatory agencies.

general public. The linkages among the key players become increasingly important because MFIs are an integral part of the total financial system.

35. Shareholders or members are responsible for appointing the board of directors or trustees, officers in executive management, the audit committee and external auditors, and ultimately determine the direction and business of an institution. MFIs are different from nonfinancial companies in that the loyalties of management and the board should be not only to shareholders and/or donors, but also to depositors and other sources of funds who provide the leverage to institutional capital. Depositors are different from normal trade creditors because the acceptance of funds from depositors carries a *fiduciary* responsibility which is different from the obligation under a commercial borrowing.

Table 3. Risk Management Partnership among Key Players

Key players	Accountability
1. Shareholders	Responsible for appointing good and competent directors
2. Board of directors	Set policy and appoint good and competent management
3. Management	Carry out the business in accordance with established policy
4. Audit committee / internal audit	Test compliance with policy
5. External auditors	Express opinion and evaluate risk management policies
6. Outside stakeholders: The Public	Understand responsibility and insist on proper disclosure
Donors and creditors	Assess financial standing, operating results, quality of
Investors / depositors / clients	Responsible for own decisions
Analysts	Analyze MFI and advise investors, creditors and donors
Credit rating agencies	Carry out fair and impartial rating and point out downside risks
Media	Inform the public
7. Regulators	Create regulatory framework to optimize risk management

36. Unlike a cooperative society or licensed specialized bank, Category A MFIs manage and dispose funds donated by persons, institutions and government agencies to benefit certain segments of the public for purposes that are usually adequately defined. On the other hand, a savings and credit cooperative society manages and invests funds contributed by members, while Category C MFIs -- licensed specialized banks, deposit-taking institutions or regular banks manage and invest funds solicited from the general public. In all cases the directors, officers and managers of the MFI carry a trustee's responsibility with respect to the funds they manage and invest. A key guideline for self-regulation through internal governance is that *key financial indicators for risk-management should be set at ranges of values more conservative than the limits permitted under prudential guidelines set by bank regulatory authorities.*

37. An organized entity generally adopts a code of conduct or ethical behavior that is expected to be observed by directors, officers and staff. The code covers their activities and behavior in the course of conducting the organization's business, representing it in transactions or functions and in carrying out the duties and responsibilities assigned to various individuals. This is particularly important for Category A and B MFIs because the adoption and enforcement of a clear code of conduct sends a strong signal to donors, clients, the government and the general public that the institution maintains high standards. In addition, the code of conduct can be an effective way of enhancing integrity and dedication among staff, which is indispensable for success in a self-help organization.

38. Since most MFIs start out originally as NGOs, their ownership and organizational structure may be unclear and not geared for board supervision of management. Moreover, the founding investors who provide the initial capital for such MFIs (e.g., NGOs, international and local donors, government agencies) may have neither the financial depth nor the operative willingness to respond quickly to calls for additional capital if and when the need for fresh funding arises.

39. The board oversees MFI operations and bears ultimate responsibility to shareholders, donors and depositors for its solvency. This requires that adequate risk management policies and procedures are in place. Governance exercised by the board enhances institutional survival and moves an institution beyond dependence on its founding visionary.¹⁹ On the other hand, the board can also push an MFI towards imprudent growth and financial crisis, as documented by the experience of FinanSol/CorpoSol in Colombia.²⁰ The recent experience of Bankin Raya Karara (BRK) in Niger illustrates the consequences of inadequate controls and oversight by the board of directors over executive management.

40. For the board of directors of any financial institution including MFIs, the fundamental responsibilities with respect to governance cover four areas:

- a) A *fiduciary responsibility* to ensure the financial integrity and soundness of the MFI and safeguard the interests of all of its stakeholders;
- b) A *strategic role* in designing corporate strategy by considering the principal risks faced by the institution, and reviewing and approving the business plans formulated by management in the context of the MFI's mission;
- c) A *supervisory function* in delegating to management appropriate operating authorities and approval limits, and supervising its execution of the business plan; and
- d) A *management development responsibility* for selection, evaluation and compensation of the senior management team, including succession planning for the MFI's chief executive and other key officers.

41. Thus, the risk management process through internal governance is a joint responsibility of executive management together with the board and its audit committee and internal auditors. External auditors can complement and strengthen the internal risk management processes through audit programs that are oriented to risk analysis and assessment, rather than limited to traditional balance sheet and income statement audit examinations. For MFIs that are subject to prudential supervision, external auditors can assist significantly in optimizing the external risk management process through proper coordination and liaison with supervision examiners and internal auditors.

External regulation and prudential supervision

42. Sectoral and industry associations are generally formed for advocacy purposes. However, they can also assist in and carry out many forms of self-regulation, in order to pre-empt or reduce government intervention. There are umbrella groups for NGO MFIs which have been formed within a country or region for the purpose of sharing good practice techniques, elevating the quality of internal self-regulation and board supervision, and disseminating standards and measures for improved management

¹⁹ Max Clarkson and Michael Deck, "Effective Governance for Microfinance Institutions", a paper for the 4th annual MicroFinance Network Conference, *Establishing a Microfinance Industry*, Niagara-on-the-Lake, Canada, November 1996.

²⁰ See Jean Steege, "The Rise and Fall of Corposol: Lessons Learned from the Challenges of Managing Growth", USAID, Microenterprise Best Practices Project, Washington DC, October 1998.

and operations.²¹ However, self-regulation through an umbrella organization can be effective only if the majority of the institutions are under its jurisdiction and if sanctions for non-compliance can be enforced. These two conditions are seldom met.

43. The vast majority of semi-formal and formal MFIs (excluding the informal MFIs such as ROSCAs, stokvels, village banks and savings clubs) are non-profit NGOs. Only a handful of microfinance NGOs have developed sufficiently to transform into licensed banks or financial institutions. The financial dynamics and risk characteristics of MFI operations differ from those of formal banking institutions in several ways:

- MFIs' loan delinquency rates can be much more volatile, even though some well-run MFIs have achieved loan delinquency rates comparable to or lower than those for regulated banks.
- MFIs operate with higher administrative and operating costs and financial spreads than commercial banks. Thus, a given level of loan delinquency is likely to impact an MFI's cash flows more adversely than a commercial bank's.
- Most MFIs have limited capacity than regular commercial banks to increase their capitalization levels quickly because most MFIs are capitalized by grants from governments, donors and international agencies, or by individuals and associations with limited wealth rather than by easily identifiable, clearly solvent individual private investors.
- Many of the business and operating risks that MFIs confront are rooted in several features unique to microfinance:

(i) access to financial services from organized MFIs is a relatively new and untested experience for microenterprises which avail of financing from informal moneylenders,

(ii) most MFIs are new institutions whose operations are often perceived as no different from those of charitable, welfare-oriented agencies,

(iii) few professionals and technicians with prior banking operations experience are familiar with MFI operations and methodologies, and

(iv) the growth in operations and high visibility of MFIs, especially those in Category A, is often dependent on the continued commitment and contribution of charismatic leadership.

44. These differences can be overcome by adopting a fundamental framework for prudential regulation currently applicable to regulated commercial banks and by making modifications appropriate to MFIs through "tiered banking" and graduated regulation. Regulatory parameters should be structured such that benefits from regulation exceed its costs, not only for the MFIs but also for the regulators and the public that is served. While the empirical measurement and determination of net benefits may be difficult, it is in this manner that the overall regulatory framework could be evolved so that the environment under which MFIs operate supports an orderly process of institutional development and transformation.

45. Bank supervisors, deposit insurance companies and securities regulators become involved in the external risk management process for regulated MFIs because of the compelling interest of the government in the soundness and stability of the banking and financial system for the sake of the rest of the economy. However, it needs to be clearly understood that (i) external supervisors and regulators

²¹ In Kenya, the NGO Act of 1990 created an NGO Council composed of the first 100 NGOs registered under the Law. The Council is tasked with developing codes of conduct to regulate activities of NGOs in various fields, which are subject to approval by the Non-Governmental Organizations Coordination Board. See The International Center for Not-for-Profit Law, Handbook on Good Practices for Laws relating to Non-Governmental Organizations, The World Bank: Washington, DC, May 1997 (Discussion draft).

cannot prevent regulated and licensed institutions from failing and (ii) as facilitators of the risk management process supervisors and regulators must evaluate and enhance the statutory framework under which risk management is carried out by regulated and supervised MFIs.

Sanctions

46. Requirements for proper reporting have to be backed up by appropriate sanctions and penalties for non-compliance. The non-submission of reports renders it difficult, if not impossible, for registration and supervisory agencies to determine whether or not an entity still exists and is in operation. Two principles to follow are (i) the punitive consequences should be commensurate to the degree of non-compliance and (ii) the basis for sanctions and penalties should be standard for institutions and non-discriminatory.

47. For example, the sanctions imposed by bank supervisors on licensed MFIs and financial institutions increases in the severity of penalties as non-compliance escalates or is repeated. Membership-based cooperative societies are obligated to observe the rules and guidelines promulgated by a commissioner of cooperatives. Incorporated NGO MFIs should observe the same requirements that apply to registered for-profit institutions, which are required to prepare and submit to a registration agency a set of externally-audited financial statements and annual report of operations. It should be noted, however, that the degree of compliance by registered entities with even this minimal set of requirements is generally uneven and it is unclear that the regulatory agencies have the resources and staff to process these required reports.

48. An important issue is the nature and format of guidelines that would be required and may be appropriate for suspending, canceling or revoking an MFI's basis for legitimate operation in those cases where it cannot perform up to acceptable standards. In a few cases, an MFI might voluntarily seek termination. Such acceptable standards constitute the basis on which an authorization or license for microfinance activities has been granted. The two major issues that need to be addressed are (i) the definition of performance and operating standards, and (ii) the appropriate procedures to be observed for situations that merit mandatory suspension of operations or termination of existence of an MFI.

IV. Basic Considerations in Risk Management

Fundamental considerations

Risk-management rather than ratio-management

49. There is a tendency for regulators and financial analysts to focus on observance of prudential ratios which leads to an emphasis on *ratio management*, rather than on the basic processes of managing risk. While ratios are useful tools for risk monitoring and management, undue emphasis on financial ratios could result in problems because non-routine and non-auditable risks comprise a bigger threat than routine risks which can be subjected to audit tests and procedures. Risk control systems will not prevent failure at the management level and may not properly address the causes of failures in the decision-making processes.

50. Contrary to the preoccupation with ratio-management, the proper approach to risk management should instead focus on the following areas:

- On routine risk which can be minimized and even eliminated through standardized policies and procedures and controlled through an internal audit and control system to identify infractions of limits of authority, approved procedure, etc.;
- On the top level of management itself, with respect to the composition of the management team and its members' personal risk profile in terms of knowledge, experience, skills, risk attitudes;
- On management's decision-making processes, especially the interaction among the members of the decision-making team and the factors that influence their decisions; and
- On risk management as a dynamic and continuing process of assessment, rather than one of generating and supplying the financial data and ratios reflected in the current balance sheet or income statement.

Risks that have to be managed by financial intermediaries including MFIs

51. The majority of MFIs are simple financial institutions which are not likely to be involved in sophisticated instruments and risks. Nonetheless, they are exposed to a number of the financial and operational risks faced by financial intermediaries. Some risks which can result in a defined loss are regarded as "pure" risks, namely: (i) operational risk, (ii) credit risk and (iii) liquidity risk. On the other hand, "speculative" risks which can result in either a profit or a loss include (i) interest rate risk, (ii) market (price/investment) risk and (iii) currency risk. Operational risks arising from (i) fraud, (ii) error, and (iii) systems problems are especially important in MFI operations because of their internal governance structure. The major categories of risk faced by financial intermediaries, including MFIs, are summarized in Table 4 below.

Table 4 - Major Categories of Risk

1. Balance sheet structure	▪ past and future risks resulting from intended or unintended changes in the size, structure and composition of the balance sheet.
2. Profitability structure	▪ risks resulting from changes in the composition of various sources of income and expense categories which affect the efficiency of the institution.
3. Capital adequacy / solvency	▪ the risk that the institution will have insufficient capital to continue operating, at its average risk-weighted asset profile, as well as the risk of non-compliance with internally set or externally prescribed minimum capital standards.
4. Credit risk	▪ the risk that a counterparty (including a sovereign counterparty) to a credit agreement will not be able or willing to service the interest or repay the principal.
5. Treasury risk:	
Liquidity risk	▪ the risk that the institution has insufficient funds on hand to meet its obligations. This risk includes concentration of large depositors/funders, reliance on volatile deposits/funds, and the currency structure of deposits/funds.
Interest rate risk	▪ the risk of an adverse flow of income and expenses and the ultimate diminution in the institution's net equity as the result of adverse changes in interest rates.
Market risk	▪ the risk of capital gain or loss resulting from investments in commodity, fixed interest, equity or currency markets.
Currency risk	▪ the risk of changes in exchange rates having a negative impact on foreign receivables and foreign payables, when the institution has foreign currency-denominated balance sheet items.
6. Operational risk	▪ the risk from non-financial areas such as accounting, electronic data processing (EDP), loss of market share, employee relations, or physical events causing a financial loss or stoppage in operations.

Allocation and sharing of risk management responsibilities

52. There is complementarity in the responsibilities for risk management -- voluntary regulation through internal governance vis-à-vis mandatory regulation through external supervision. Even though most types of MFIs are outside the scope of jurisdiction of regulatory authorities, the adoption and observance by non-regulated MFIs of risk management principles and practices upon which prudential regulations are based can lead to a better-performing microfinance market.

53. Regulators ensure prudent risk management by prescribing risk-based capital adequacy requirements for supervised intermediaries. By specifying the limits to the relationship between risk assets and the amount of qualifying capital adequate to safeguard solvency and liquidity, they determine the overall size of risk-oriented business and deposit-based funding that a regulated institution can carry out. In addition, regulators in many countries determine the extent of branch operations, limits of exposure to any single borrower or investment or industrial sector that the regulated institution is permitted. Prescribing how a regulated institution should conduct its business will serve to jeopardize its operational flexibility and innovation. Instead of such a misplaced focus, regulators should insist on documented evidence of application of acceptable risk management procedures.

Application of risk management principles

54. The financial risks to be managed internally through governance and regulated externally by supervisory authorities can be evaluated according to a number of analytical formats. The traditional CAMEL methodology (capital, asset quality, management quality, earnings and liquidity) for evaluating risk position of financial institutions was created as a supervisory tool, rather than as a management tool. A major focus of the CAMEL ratios is measurement of acceptable levels of solvency of an institution and the safety of deposits. On the other hand, the system of monitoring and evaluation indicators for credit unions known as PEARLS (protection, earnings, asset quality, rates of return and cost, liquidity and signs

of growth) was developed first as a management tool and later became an effective supervisory mechanism.²² PEARLS results in *objective measurements*, whereas the CAMEL approach involves some degree of *subjective judgment* by analysts or examiners particularly on management quality and capability. In addition, private commercial banks have developed their own financial monitoring and evaluation systems which isolate and measure different categories of risks.

55. The main thrust of this paper is to promote a standard application of risk management principles which would be useful to an institution's management and its governing board or trustees, shareholders or members, external auditors, the regulatory authorities, institutional creditors, donors and the general public.²³ This paper emphasizes that *the responsibility for risk management rests principally on voluntary regulation through internal governance, rather than on external supervision by regulatory authorities*. Risk-based financial regulation should identify and specify the following aspects:

- a) The particular risks that are most relevant to MFIs,
- b) For each relevant risk, the key indicators that are most important for risk management in MFI operations,
- c) The ranges of values and their trends over time which would be useful to directors and managers responsible for internal governance in monitoring the financial health of MFIs that they manage, and
- d) The ranges of values and their trends over time which would be invaluable in establishing regulatory guidelines to be used by external supervisors who have the mandate to regulate MFIs under their jurisdiction.

56. Table 5 (together with its accompanying Notes) in the pages that follow summarizes the categories of risk and range of values of financial risk indicators for the three broad classes of MFIs in this paper's regulatory framework model. Table 5 highlights (i) the observed value ranges of selected financial risk indicators, (ii) recommended value ranges suitable for consideration in internal governance and, where appropriate or warranted, (iii) suggested threshold values with respect to external regulation for each of the three categories of MFIs. The recommended and threshold values are neither absolute nor arbitrary, and it is emphasized that practical applications should take into account specific country conditions.

57. This paper has used values of certain indicators of financial and operating performance of MFIs which were readily available from published work, simply for the purpose of illustrating the application of risk management principles discussed in this paper to different types of MFIs. The basis for selecting the MFIs whose financial indicator values are being used for illustrative purposes was the closeness by which they *approximated the conceptual types of MFIs in the continuum* discussed in this paper. However, no claim is being made that the MFIs selected conform strictly to the characteristics of each type of MFI in the continuum, and neither is it the intention to "force" these MFIs into any classifications. For illustrative purposes, the values of key indicators derived from the 1993 USAID-sponsored survey of eleven successful microfinance programs, the database developed by the Microfinance Program of the

²² David C. Richardson, "PEARLS - Financial Stabilization Monitoring and Evaluation", World Council of Credit Unions Research Monograph Series, No. 4, August 1997 edition (processed).

²³ A detailed discussion of financial performance and risk management indicators for banking institutions can be seen in (i) Jan Hendrik Van Greuning, "The Implementation of a Risk-Based Approach to Bank Supervision as a Micro-Economic Component of Monetary Policy", unpublished doctoral dissertation, Pretoria, South Africa: University of Pretoria, 1993; (ii) Chris Baltrop and Diana McNaughton, Banking Institutions in Developing Markets: Interpreting Financial Statements, vol. 2, Washington, DC: The World Bank, 1992 (1996) and (iii) for MFIs in particular, the CGAP Appraisal Format, which is described in Chapter 5 of the CGAP/SBP Microfinance Practical Guide (1997).

Table 5. Key Risk Management Factors and Indicators

Risk Management Factors and Indicators	Category A MFIs Using Other Peoples' money: Non-Profit NGOs, NGOs and MFIs with Limited Deposit Taking			Category B MFIs Using Members' Money: Credit Unions; Savings & Credit Cooperatives			Category C MFIs Using the Public's Money: Specialized/Limited Equity Banks; Licensed Mutual-Ownership Banks Non-Bank Financial Institutions		
	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Self-Regulatory Body	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Regulation	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Regulation / Supervision
I. Balance Sheet Structure									
Earning assets:									
Loans as % of ave. assets	55-75%	65-70%	65-70%	60-70%	70-80%	70-80%	65-80%	70-80%	none required
Non-performing loans as % of total loan portfolio	2-10%	< 5%	5-10%	7-10%	< 5%	≤ 5%	1.5-6.5%	< 5%	5-10%
Non-earning assets:									
Fixed assets as % of capital	not available	≤ 5 %	none required	20-25%	≤ 5%	5-10%	not available	≤ 20%	≤ 25%
Funding liabilities as % of total capital:									
Wholesale deposits & borrowings	not available	≤ 100%	≤ 100 %	1-3%	0%	0%	not available	≤ 150%	150%
Retail public or members' deposits	not available	≤ 100%	≤ 100%	145-180%	≥ 250%	250 %	not available	≤ 300%	300%
II. Capital Adequacy									
Risk-weighted assets : capital	1.5-3 X	≤ 3 X	3 X	2.5-3.5 X	≤ 4 X	3-5 X	5-20 X	≤ 5-6.5 X	6-8 X
Total liabilities : capital	not available	not available	2 X	2-3 X	≤ 3.5 X	3.5 X	not available	≤ 8 X	< 8 X
% of current earnings retained	not available	build up capital	build up capital	not available	build up capital	build up Cap.	not available	build up Res.	build up Res.
Institutional capital / required minimum capital - %	not available	≥ 100%	> 100%	not available	not applicable	not applicable	not available	> 100%	≥ 100%
III. Liquidity Risk									
10 largest depositors / funders as % of total deposits/funds	not available	≤ 25%	none required	not applicable	not applicable	not applicable	not available	≤ 10%	none required
Volatile funds as % of total deposits/borrowings	not available	0	none required	0%	0%	0%	not available	≤ 10%	none required
Cash + deposits + short-term investments as % of deposits / borrowings	not available	25%	25%	10%	10-15%	20%	not available	25%	20%

Table 5. Key Risk Management Factors and Indicators (Continued)

Risk Management Factors and Indicators	Category A MFIs Using Other Peoples' money: Non-Profit NGOs, NGOs and MFIs with Limited Deposit Taking,			Category B MFIs Using Members' Money: Credit Unions; Savings & Credit Cooperatives			Category C MFIs Using the Public's Money: Specialized/Limited Equity Banks; Licensed Mutual-Ownership Banks Non-Bank Financial Institutions		
	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Self-Regulatory Body	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Regulation	Range of Observed Values	Suggested Thresholds for Internal Governance	Suggested Guidelines for External Regulation / Supervision
IV. Income Statement Structure									
Effective yield on loan portfolio	30-45%	≥ market	none required	19-25%	≥ market	none required	28-45%	≥ market	none required
Net interest margin as % of average assets	10-25%	≥ 18%	none required	10-15%	≥ 15%	none required	12-20%	≥ 12%	none required
Unadjusted return on ave. assets	3-5 %	≥ 3%	none required	2-4%	≥ 3%	none required	1-7%	≥ 2%	none required
Unadjusted return on ave. equity	9-18%	12-16%	none required	6-11%	≥ 12%	none required	4-32%	≥ 12%	none required
Operational self-sufficiency - %	110-140%	> 115%	≥ 115%	118-147%	≥ 115%	none required	107-148%	≥ 115%	none required
Financial self-sufficiency - %	95-125%	> 100%	≥ 100%	103-127%	≥ 115%	none required	103-137%	≥ 110%	none required
Administrative expense as % of average assets	15-20%	< 15%	none required	7-15%	< 12%	none required	4-15%	≤ 10%	none required
V. Credit Risk									
Delinquency as % of loans > 90 days overdue (P.A.R.)	2-6%	≤ 5%	5%	7-10%	< 5%	≤ 5%	1-6.5%	< 5%	5-10%
Loan loss reserve as % of total loan portfolio	0.5-2 %	≥ 2%	2-5 %	1 - 3 %	> 3%	≥ 3%	0.75-2.5%	≥ 5%	≥ 5%
Loan loss reserve as % of portfolio at risk	not available	100%	100%	100%	100%	100%	not available	100%	100%
Portfolio concentration:									
20 largest borrowers as % of loan portfolio	not available	minimize	none required	not available	minimize	None required	not available	minimize	≤ 25%
Loans to DOSRI as % of institutional capital	not available	< 5%	≤ 5%	not available	< 5%	≤ 5%	not available	≤ equity of borrower	≤ 5%
Sectoral and geographical concentration	not available	minimize	none required	not available	minimize	None required	not available	minimize	≤ 10%

Accompanying Notes to Table 5

A. Range of Observed Values of financial risk indicators:

For Category A MFIs the indicators used are those for Fundacion Integral Campesina (FINCA) in Costa Rica, La Asociacion Dominicana para el Desarrollo de la Mujer (ADOPEM) and Asociacion para el Desarrollo de Microempresa Inc. (ADEMI) in the Dominican Republic, Kenya Rural Enterprise Programme (K-REP) in Kenya, and Alexandra Business Association (ABA) in Egypt as reported in Christen *et al.* (1995), supplemented by data from Benjamin and Ledgerwood (1998, draft), and *The Microbanking Bulletin*, v. no. 1 (1997) and no. 2 (1998).

For Category B MFIs the indicators used are those for Union Popular Credit Union (Tiquisate), UPA Credit Union (Amatitlan) and 20 core credit union members in the National Credit Union Federation (FENACOAC) in Guatemala, as reported in Almeida and Branch (1997, draft).

For Category C MFIs the indicators used are those for the Lembaga Perkreditan Desa (LPD) community-owned village banks and the Bank Rakyat Unit Desas in Indonesia, and Banco Solidario S.A. (BancoSol) in Bolivia, as reported in Christen *et al.* (1995).

- B. Suggested values of financial risk indicator thresholds for internal governance and external supervision (Columns 6 and 7, Category B) for credit unions and savings and credit cooperative societies (Category B) are taken from Richardson (WOCCU, 1997).
- C. Suggested threshold values of financial risk indicators for external regulation (Column 4, Category A) apply only to NGO MFIs availing of an exemption provision for limited deposit-taking under the banking law and/or receiving authorization for mobilizing wholesale deposits through commercial paper issues, large-value certificates of deposit or investment certificates from the bank supervisory authority.
- D. Suggested threshold values of financial risk indicators for external regulation (Column 10, Category C) apply primarily to MFIs obtaining authorization and license from the bank regulatory authority to operate as specialized banks or financial institutions. The limitation may pertain to geographical limits on operations (county-wide or regional, but not nationwide), exclusion of trust and foreign exchange/foreign trade-related services, and/or exclusion from provision of demand deposit services.

While the Basle Agreement permits a gearing ratio value of 8:1 for risk-weighted assets to capital, this paper supports a lower limit equivalent to 80% of the Basle ratio for MFI banks because of the nature of risks in microfinance and access to capital of organizers, promoters and shareholders of licensed-bank MFIs. In lieu of a risk assets : capital ratio some countries use a ceiling on the ratio of liabilities to capital. Setting a limit on funding liabilities at 8-times capital results in a 6.5:1 approximate ratio of risk assets : capital, assuming that the value of loans outstanding does not exceed 80% of average total assets. The interrelationship among the variables in the balance sheet supports the position put forward in this paper that MFIs would be well served to observe more stringent and lower gearing ratios than those permitted in the Basle or national standards.

Economics Institute and CGAP, ²⁴ guidelines developed and disseminated by WOCCU for universal use by credit unions, and the case study analyses of performance and financial results of various types of MFIs undertaken by the Sustainable Banking with the Poor Project (SBP), all of which were readily available in published form. ²⁵

58. Because of the institutional structure of MFIs and the nature of the microfinance business, the categories of risk that are most relevant to MFIs are balance sheet structure, profitability, capital adequacy, credit risk, liquidity and operational risk. The aspects of these categories of risk as they apply to operations of different types of MFIs are discussed in the sections that follow. The discussions also identify the financial indicators that are considered to be important for internal governance and where warranted prudential external guidelines. It should be noted that the presentation of key indicators for categories of risks is not intended to provide across-the-board comparison among the different types of MFIs in the continuum. The proper comparison of MFIs should be limited to MFIs of the same type.

Risks in the balance sheet structure

59. The risks embodied in the balance sheet structure should be analyzed to assess the significance of discrete changes in the composition and quality of asset and liability items because their structure has a direct impact on profitability. The growth in the size of MFIs' balance sheets is usually higher than that for commercial banks and individual components of the balance sheet of a dynamic institution will be changing in response to market conditions. The important items for examination and measurement are those areas where the business and product mix of the institution change, resulting in important structural changes to its balance sheet and income statement and consequently how it should manage the diverse risks it faces.

60. The ability to source funds from the public results in less reliance on grants and donations, but it brings on the additional burden and responsibility of ensuring that revenue is sufficient to pay interest on wholesale deposits and that liquidity is maintained to service deposit withdrawals. A few MFIs are able to access wholesale funding from offshore markets, such as ADEMI in the Dominican Republic and BancoSol in Bolivia. When an MFI takes out foreign currency loans or wholesale deposits it must have access to adequate mechanisms to mitigate foreign exchange risk, ensure convertibility and provide reserves for its exposure to foreign exchange risk.

61. The key indicators of risk from the balance sheet structure are changes in the size and composition of earning and non-earning assets relative to total assets not only for a given year but over several time periods. The experience of a number of MFIs indicates generally rapid expansion rates of loans and high growth rates of total assets over time, particularly in the first 5 - 7 years of operations. Rapid portfolio expansion and asset growth, however, should be managed carefully and matched by maintenance in overall asset quality. Growth has to be balanced with commensurate growth and diversification in funding sources as well as in capital, which sets constraints on overall asset growth.

²⁴ The Microfinance Program of the Economics Institute has published information from its database in MicroBanking Bulletin, vol. 1 No. 1, 1997.

²⁵ Robert Peck Christen, Elisabeth Rhyne, Robert C. Vogel and Cressida McKean, Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs, USAID Program and Operations Assessment Report No. 10, Washington, DC, July 1995; Richardson, *op. cit.*, and McDonald P. Benjamin and Joanna Ledgerwood, "The Association for the Development of Microenterprises (ADEMI): Democratizing Credit in the Dominican Republic", The World Bank Project on Sustainable Banking with the Poor (Draft), January 1998.

62. The items to focus on with respect to the liabilities side will be changes in the size, composition, financial costs and relative importance of different sources of funds. Growth rates should be related to growth in total assets not just for a specific year but over several time periods. The relationships between wholesale funds and capital, and between retail deposits from the public vis-à-vis capital indicate the degree of leveraging, and should be closely monitored in internal governance processes to ensure compliance with authorized limits. The strategic differentiators for the types of MFIs are the sources of qualifying capital and reliance on donor and government funds for onlending, access to and costs of wholesale deposits, and the ability to mobilize retail deposits from the public.

63. Insofar as the balance sheet structure is concerned, prudential guidelines that may be set by external regulators for observance are triggered only by specific liabilities-generating activities of MFIs. The regulatory framework model highlighted earlier in Table 2 shows that limited deposit-taking by Type 2 - 4 MFIs should be under an exemption provision in the banking law; funding through wholesale deposit substitutes should be in accordance with securities law; and funding through limited and unlimited retail deposits should be with authorization from the supervisory authorities.

64. Reaching threshold levels in liabilities-generating activities trigger requirements to satisfy external regulatory requirements, particularly on capital adequacy levels, and compliance with additional prudential guidelines on balance sheet structure items. These additional asset-side guidelines may include limits on risk-weighted assets as a multiple of qualifying capital, procedures for classification of loan portfolio, loan loss provisioning measures, liquidity reserves, periodic reports, on-site surveillance, etc. These are discussed under the appropriate risk categories in subsequent sections.

Solvency and capital adequacy

65. An adequate capital base acts as a safety net for the risks to which an institution is exposed, absorbing possible losses and providing a basis for maintaining confidence among investors, lending institutions and depositors. Capital is the ultimate determinant of the institution's lending capacity because assets are funded by deposits, borrowings and capital. Assets cannot be expanded beyond the limit of risk-weighted capital-to-asset ratio mandated by external regulators, or set as an operating policy in internal governance. Consequently, the availability and cost of capital are determinants of the maximum level of assets.

66. The relationship of *equity or qualifying capital to total assets* measures the extent to which capital has been, and can continue to be leveraged to support the asset base. The relationship between *equity or qualifying capital and total liabilities* provides the measure of how much the MFI has borrowed, and can continue to borrow from others on the strength of its capital base. For both non-regulated and regulated MFIs, voluntary governance through self-regulation requires maintaining *levels of leverage that are more strict and conservative* than those permitted by prudential guidelines of regulatory authorities.

67. The relationship between *required minimum capital and current earnings retained and excluded from distribution as dividends* is an important determinant of future growth and commitment of management, directors and shareholders to the institution's financial health. Regulated MFIs should give special attention to this particular indicator because bank regulators can be reasonably expected to raise minimum capitalization levels from time to time, and maintaining a healthy surplus over the minimum helps to prepare an MFI for future increases.

68. The relationship between *total loans and equity* provides a measure of the multiple by which equity has been stretched to generate the principal income-earning asset. Furthermore, the relationship can also

provide a measure of the extent to which the quality of the loan portfolio can deteriorate into nonperforming or nonrecoverable status before equity or qualifying capital is adversely impacted.

69. Regulators must ensure that capital requirements focus on providing an adequate buffer against which losses on asset portfolios can be written off. This ensures that depositors (or institutionalized explicit deposit insurance schemes) will only absorb losses once shareholders' funds have been exhausted. It is practically impossible to accurately measure the minimum amount of capital necessary to avoid the risk of loss for depositors, and no amount of capital will ever be adequate in the hands of incompetent management. Even competent management will make errors of judgment in a business involving the management of a series of risks.

70. For MFIs that are permitted wholesale funding activities through commercial paper securities, or to operate as limited deposit-taking institutions (as in Hong Kong, Bolivia or Peru) external regulators should impose minimum levels of capitalization upon entry, maintenance of risk-weighted asset-to-qualifying capital levels more strict than those for licensed retail deposit-taking institutions, and liquidity reserve requirements.

Income statement structure

71. The measurement of efficiency in banking and financial institutions is difficult and elusive because there is no satisfactory definition of their "output" or product. Comparisons based on operating costs and margins must be used cautiously because of significant differences among institutions in capital structure and leverage, business mix, range and quality of services, inflation rates and accounting practices on valuation of assets.²⁶ Other factors which affect profitability and efficiency in intermediation of a financial institution, bank or MFI must also be considered:

- First, inflation has the effect of increasing operating costs faster than income in most cases.
- Second, financial institutions operate on traditional fixed margins, resulting in the limited ability of financial institutions, including MFIs to adjust their pricing of loans when the interest cost of borrowings and deposits have been increased.
- In turn, the above two factors directly impact the ability of an MFI to accumulate and build up institutional capital to maintain internally- and externally-set sustainability goals.

72. The need to generate profits implies the need to manage risk. Liquidity and interest rate management have become accepted approaches to profitability management. Since capital and profitability are intimately linked, the key objective is to ensure sustained profitability so that a MFI can increase institutional capital from operations. A choice cannot be made between the pursuit of adequate interest margins and the control of risk as they are interrelated, and interest margins are a direct consequence of the risks involved and the ability to manage such risks.

73. Many financial and organizational factors determine the long-term sustainability of an MFI and its operations.²⁷ On the financial side, an MFI must consistently maintain low levels of portfolio at risk and high on-time repayment and loan recovery rates, because continued and growing loan losses will

²⁶ Dimitri Vittas, Measuring Commercial Bank Efficiency, World Bank Policy Research Working Paper No. 806, Washington, DC: The World Bank, 1991

²⁷ Three technical guides available for the analysis of financial statements of MFIs are: Financial Ratio Analysis of Micro-Finance Institutions, The SEEP Network: New York, 1995; Technical Guide for the Analysis of Microenterprise Finance Institutions, Inter-American Development Bank: Washington, DC, 1994, and Joanna Ledgerwood, Financial Management Training for Micro-Finance Organizations: Finance Study Guide, CALMEADOW: Toronto, 1996.

erode its capital base. An MFI must earn a level of income from lending operations sufficient for the following requirements:

- a) cover the financial cost of funds used: a positive *net financial margin*,
- b) cover operating and administrative expenses: *operating self-sufficiency*, measured by the ratio of operating income to operating expenses,
- c) cover all financial and operating expenses, including the building up of reserves for loan losses and exchange risks, and mitigating the effects of inflation on its operations: *financial self-sufficiency*, measured by the ratio of operating income to total adjusted costs (including adjustments for subsidies), and
- d) contribute to the enlargement of its capital base, after generating a competitive return to its shareholders: *return on average equity*, measured by the ratio of net operating income to average net worth. *Return on average assets* provides a measure of how profitably resources are being employed in the asset base to generate profits. The two indicators are *adjusted* to smooth out the effects of price inflation and subsidies in order to provide accurate comparison of profitability levels from one time period to another.

74. Regulation should not depress the profitability of banks and regulated financial intermediaries. Excessive liquidity requirements through high levels of mandated reserves, together with quantitative quotas on loans for target sectors increase financial costs, damage profits and may encourage disintermediation. Supervisory authorities need to recognize the importance of profitability and actively encourage banks and regulated financial institutions to maximize it, because a sound banking and financial system is based on profitable and adequately capitalized institutions. As indicated in Table 5 no mandatory profitability indicators are proposed because it is not within the scope of regulators' authority to dictate how MFIs and financial institutions should operate their businesses.

Liquidity risks

75. A controversial issue in microfinance is the balance between benefits and risks of offering deposit services. For MFIs deposit-taking is a way to fund outreach expansion while reducing reliance on donor support and, for poor households, deposit facilities in MFIs can provide a convenient medium for savings which might otherwise not exist. Mobilizing deposits establishes an MFI program as a financial intermediary rooted in the community and not just a channel for delivering external funds.²⁸ It can also enhance loan repayment levels when borrowers see their own neighbors and relatives as the ultimate source of their loans.

76. However, mobilizing deposits is a heavy responsibility for MFIs because their depositors are at risk of losing their savings if an MFI without formal deposit-taking authorization fails due to poor management or vulnerability to adverse external events. When MFIs accept deposits, regulatory authorities may have no choice except to bail out depositors whether or not deposit insurance is formally in place. The conclusion is that *mobilizing voluntary deposits beyond certain thresholds* should be subject to prudential regulation as well as mandatory coverage under formal deposit insurance schemes.²⁹

²⁸ Consultative Group to Assist the Poorest (CGAP) Focus Note No. 8, *op. cit.*

²⁹ In some countries where savings and credit cooperatives are not part of the formal deposit insurance system, members' deposits are "self-insured" through deposit insurance schemes in district or regional federations.

77. In managing liquidity risk the important factors to focus on are the relationships between (i) readily liquifiable and marketable assets vis-a-vis deposits from the public and/or wholesale deposits and borrowings, and (ii) interest- and term-sensitive deposits and borrowed funds vis-a-vis total public deposits and wholesale funds. The extent of concentration in funding sources which is measured by the percentage of total deposits and/or borrowed funds consisting of funds from the 10 largest depositors or fund-placers is likewise important because it indicates the degree of dependence and vulnerability an MFI may have on particular types of funds sources.

Credit risk

78. Sound credit risk management entails the identification of existing and potential risks inherent in lending activities. This involves the implementation of clearly defined policies setting forth the MFI's credit risk philosophy and the parameters under which credit risk is to be controlled. Control involves limiting risk through procedures that ensure adequate portfolio diversification. Clearly defined levels of authority for credit approval also help ensure that credit decisions are prudent and within defined parameters. The maintenance of detailed, up-to-date information on borrowers is a pre-requisite for ongoing risk assessment by internal auditors and management. An effective reporting system must generate accurate and timely reports for management, the board of directors or trustees, external auditors and independent credit rating agencies concerning the extent of an MFI's credit risk exposure, as well as the status of its loan portfolio.

79. The loan portfolio of MFIs differs from that of other financial institutions in that the majority of microfinance loans are very short-term in duration and are unsecured. This fundamental characteristic of microfinance lending calls for close attention to key indicators of credit risk and tools for managing portfolio quality, which are described below. While the indicators can signal potential problems, it will be indispensable to maintain close contact with clients and their businesses in order to make informed assessments of their ability and willingness to repay loans.

- a) *Portfolio at risk*: the relationship of loans with past due payments ≥ 90 days, to total loan portfolio. For MFIs internal guidelines for strict measurement of all loans with overdue payments greater than 30 days is relevant because most MFI loans are short-term and unsecured. The longer the overdue period, the greater the probability of an uncollectible problem loan.
- b) Measures of *on-time repayment rate* and *loan recovery rate* are indispensable for controlling portfolio risk, as are *patterns of delinquency* according to sector or geographical market area;
- c) *Risk-weighted classification* of the loan portfolio is an important area of internal governance procedure that is worth standardizing for universal application by MFIs, simply because it makes good management practice.
- d) *Aging profile of the loan portfolio* identifies and classifies overdue loans by age and is indispensable for managing loan portfolio quality.
- e) *Adequacy of loan loss provisions* relative to total overdue loans provides a measure of whether or not reserves for loan losses are under-provided and capital adequacy or solvency is understated.
- f) *Other sources of credit risk* requiring attention are sectoral or geographical concentration and the board-approved internal limits and procedures for loan approval and loan classification.

80. With respect to external regulation, only the MFIs with banking or finance company licenses are subject to the portfolio quality and credit risk management procedures specified by a bank superintendent. Attempting to place mandatory prudential guidelines on credit risk management by non-regulated MFIs will only serve to stifle the innovation and flexibility possible in an unregulated operating environment.

Interest rate risk

81. The interest rate risk commonly faced by MFIs is directly linked to their ability to adjust interest rates on their microfinance loans vis-à-vis the interest expenses that are incurred for borrowed funds from commercial banks and similar institutions. An MFI that can legitimately access deposits faces risks on the interest expenses it incurs to mobilize such deposits. In periods of volatility of interest rates on deposits, MFIs can be significantly exposed to interest rate risk. In addition, MFIs will face adverse impacts on profitability and capital adequacy.

Market risk

82. Market risk arises from the capital gain or loss that may result from investments made by an institution in commodity, fixed interest-instruments, equity or currency markets. Among the financial risks that MFIs must confront and manage, this category of risks is of lesser significance because of the nature of their operations and the reduced availability of resources for such investments.

Currency risk

83. Experience indicates that some MFIs have currency risk exposure because of foreign-currency resources mobilized through borrowings from international banks and wholesale US Dollar certificates of deposit. The currency risk exposure arises because the liabilities are denominated in foreign currency, while assets are denominated in local currency. This is a classic case of currency mismatch in assets and liabilities. Another form of currency risk arises from the inability to convert from local to foreign currency in a timely manner. When a currency mismatch occurs in the balance sheet, the usual risk-management approach is to obtain forward foreign exchange cover which is normally available for short-term (i.e., one-year or less) periods. The other approach is to “self-insure” by establishing and accumulating a special reserve fund for adverse changes in the exchange rate.³⁰

Operational Risk

84. Microfinance programs that have been successful, cost-effective and transparent are characterized by comparatively high volumes and low margins, decentralized operations and on-field delivery of financial services directly to borrowing and depositing clients at the locations where they carry out their business. The application of these specialized technologies works only with skilled and trained staff at all levels of the organization, efficient telecommunications and transportation facilities, and an effective set of management information, reporting and internal control systems. These technologies make internal control and up-to-date management information systems indispensable. The lack of written operating policies, procedures, manuals and systems can signal exposure to substantial operational risk. The more important items consist of written policies on loan approval process, loan authority limits, loan portfolio classification and loan loss write-offs, MIS reporting system and formally-constituted audit procedures.

³⁰ This self-insurance system is the practice adopted by *Asociación para el Desarrollo de la Microempresa, Inc. (ADEMI)* in the Dominican Republic with respect to its long-term borrowings from the European Investment Bank.

V. Summary and Conclusions

Summary of issues addressed

85. The paper developed a working model of a regulatory framework for managing the different kinds of risks inherent in microfinance operations. The model which is illustrated in Table 2 emphasizes *risk management as a dynamic continuing process* (as opposed to static *ratio management*) and recommends a licensing requirement for some categories of MFIs in the continuum, based on a threshold of funding generated from the general public through retail deposits.

86. The discussion has emphasized that the fundamental responsibility for regulation of an MFI rests on the shareholders and the governing board they have appointed. Vigilant and competent internal regulation is a common necessity for the continuum of MFIs discussed in this paper. The analysis highlighted the point that *liability-generating activities beyond certain thresholds* trigger the need for external regulation. When an MFI becomes subject to regulation, regulators then impose prudential guidelines over portfolio quality, exposure to credit risk and liquidity levels, which are asset side activities.

87. The analysis also led to a delineation in the sharing of responsibilities and accountabilities for risk management among several key players. The financial risk management approach to good corporate governance is useful in analyzing the incidence of responsibility and the quality of performance of those key players. *Bank regulators cannot (and should not always) prevent bank failures.* Their primary role is to act as facilitators in an effective process of risk management and to evaluate and enhance the statutory framework and environment under which regulated banks and MFIs can pursue an orderly process of institutional development and transformation.

Major conclusions of the study and recommended action

88. The discussion generated some principal conclusions about regulating the organization and operations of various categories of MFIs. The conclusions arrived at are enumerated below:

- Require standard registration documents and procedures -- no different than those imposed on regular corporate entities -- including the designation of a central governmental agency for registration as corporate entities;
- Establish clearly understood thresholds for fund-mobilization from the general public as well as the non-public wholesale sectors which should require registration, reporting and monitoring, and compliance with registration and licensing procedures;
- Allow minor deposit-taking under an exclusion provision in the banking law, and authorize wholesale deposit-funding linked to registration and minimum capital requirements for certain types of MFIs not licensed as banks;
- Allow limited deposit-taking activities from the public under a limitation provision (linked to a risk assets-to-capital or liabilities-to-capital level lower than the limit for regular banks) together with requirements for maintaining liquidity reserves;
- Establish recommended limits on issuance of wholesale deposit substitute instruments, linked to registration and minimum capitalization requirements;
- Establish internal governance and self-regulation structures and processes. Ratios are useful only as complementary tools in the exercise of prudent management by the board and senior management.
- Authorize unrestricted deposit-taking for MFIs which can satisfy the same prudential guidelines on capital adequacy as licensed commercial banks, even though the required minimum

capitalization may be set at levels lower than those for regular commercial banks. It should be noted that many countries' banking laws do not allow for *tiered-banking*, under which licensed but specialized banks can be established at levels of minimum capital lower than those for "universal" banks.³¹

89. The experience in Bolivia, Peru and the Philippines with lower minimum capital requirements for specialized institutions licensed to carry out limited banking operations demonstrates the use of a minimum capitalization requirement as a *standard of entry* rather than a *barrier to entry*. In the recent reforms to its banking laws, Nicaragua will permit the establishment of nonbank financial entities with a non-profit charter, a specialized microfinance and SME focus and shareholder capital at a level lower than that for regular commercial (multiple) banks.³² The application of a liability-to-capital ceiling would complement the standard of entry aspect of minimum capitalization, becoming a positive inducement for striving to increase capital (and the resulting capacity to expand microlending) over time.

Considerations for governments, donors and MFIs

90. The worldwide inventory of microfinance institutions undertaken by the World Bank indicates that as of September 1995, some \$7 billion in loans to more than 13 million individuals and groups were outstanding in the 206 institutions that responded to the survey. These institutions had also mobilized over \$19 billion in 45 million active deposit accounts.³³ Supporting the survival and development of the economic activities of the poor has become one of the priorities of the policy agenda of the 1990s.

91. The financial system as a whole continues to evolve and find new ways to service demands for financial services in the emerging markets. The innovative and rapid development of many localized efforts to provide financial services to the poor outside of formal channels has generally overtaken policy formulation by governments. The reaction of some governments (e.g., Bosnia, Bangladesh and others) and multilateral agencies (e.g., Asian Development Bank)³⁴ is unfavorable to microfinance — comprehensive regulation is being proposed for microfinance activities and institutions through mandated standards of performance and risk-ratios. These proposals are based on untested hypothesis about the institutional and market impact of moving from an unregulated environment to one that is as tightly regulated as formal banks and financial institutions.

92. Institutions specializing in supporting and promoting the development of microenterprise development and microfinance services, such as the Consultative Group to Assist the Poorest (CGAP), US Agency for International Development, Microfinance Program at the Economics Institute in Boulder, Colorado, ACCION International, and Women's World Banking to name a few, have initiated and promoted efforts to bring about a supportive policy and institutional environment for microfinance. This is being done by promoting and intensifying dialogue among the key participants in microfinance -- government regulatory agencies, microfinance practitioners and donors. Aside from assistance through staff training and dissemination by seminars, workshops and publications to increase the awareness and

31 "Tiered-banking" exists in a few countries (e.g., the Philippines, Indonesia, Peru) where specialized banks may be established at capitalization levels much lower than for regular universal banks, but with operations limited to specifically-defined geographical areas and deposit-taking limited to savings and fixed deposits.

32 In El Salvador, the thrust is to reform the law on Federacion de las Cajas de Credito and Bancos de los Trabajadores, which will permit a new type of financial institution with lower capitalization requirements, taking deposits from the public and providing loans primarily to microenterprises and small businesses.

33 Julia Paxton and Carlos Cuevas, A Worldwide Inventory of Microfinance Institutions, Sustainable Banking with the Poor (SBP) Project. Washington, DC: The World Bank, 1997.

34 Philippines — National Summit of the Coalition for Microfinance Standards, August 20, 1998.

use of best practice methodologies in microfinance operations, donors can be very instrumental in providing policy guidance and technical assistance not only in conceptualizing but also in the actual setting up of tiered and graduated regulatory structures within which microfinance can reach the unserved and underserved economic sectors.

Information, disclosure and reporting requirements and standards

93. One of the foundations for a viable prudential regulatory framework is the collection, organization and provision of operating and financial information on a timely basis, under a well-organized and orderly reporting system. The comprehensive and integrated risk management partnership among the key players requires the provision and sharing of information among several of the key players. The information on operations and financial results of an organization is generated periodically for the use of management and the organization's supervisory board. The information to be shared with outside third parties will depend on the requirements of external auditors, donors, regulators and outside stakeholders such as depositors, clients and credit-rating agencies. However, few MFIs are legally required to disclose their financial condition with the rigor demanded of licensed banks, which makes meaningful comparisons of MFI financial statements rather difficult.

94. If they are operating prudently, NGO MFIs which are not subject to any form of regulation or supervision by government regulatory agencies will maintain information systems, records and reports for their own internal use. These will include the quality of the loan portfolio, the organization's status as regards operating and full financial self-sufficiency, the management of liquidity, liabilities and capital funds. To some extent, these important pieces of information are available and can be provided to donors and other stakeholders without any undue burdens on the MFI.

95. The question of what specific minimum standards of performance are relevant to or should be required of MFIs in different non-regulated and regulated categories -- whether by donors, government regulators, stakeholders or independent credit rating agencies -- is a more difficult issue. The difficulty arises from the need to recognize differences in country settings and accepted social and commercial practices and conventions, but also because of the variety of microfinance institutions and their client base. The global experience in capital markets development has demonstrated the ability of independent, private sector-organized credit rating agencies to establish credible market-based performance standards, and may provide insights into how standards for microfinance institutions might be developed.

96. The Microfinance Program of the Economics Institute in Boulder, Colorado and CGAP are involved in a project to develop a database on the financial performance of MFIs, to help MFI managers improve their understanding of the performance of their own individual institutions through comparison with data from similar MFIs in their peer group. This is similar to the use by managers of commercial banks and other businesses of peer group analysis as a valuable management tool. Confidential reports to participating MFIs on their individual financial performance in the context of an appropriate peer group are the main product of the project. The secondary output is a semi-annual *MicroBanking Bulletin* which provides a broader audience with statistical financial data on participating MFIs as a whole as well as on peer groups of such MFIs.

97. The World Bank can provide assistance through staff training and dissemination by seminars, workshops and publications, to increase the awareness and use of best practice methodologies in microfinance operations. Building strong institutional management and financial performance should be the focus of technical assistance and a prerequisite for obtaining access to World Bank loans. As a specific example, the World Bank has elaborated policies relevant for lending to financial intermediaries,

which supports countries to strengthen their financial sector policy framework, build institutional capacity to function competitively in markets (including rural, microfinance and SME sectors). The policies explicitly recognize *specialized institutions* such as MFIs, as acceptable channels, and support to these institutions is not considered as directed credit. The CGAP program coordinated by the World Bank has introduced a new institutional approach anchored on a business-like partnership in which the roles and responsibilities of the donor and MFI partner are clearly defined and delineated. The donor assumes the role of an investor, with institutional performance of the MFI substituting for dividends a its return on that investment.³⁵

Final observations

98. The usefulness of the model for a regulatory framework developed in this paper will depend on the collection and organization of operating and financial information on a timely basis, under a well-organized and orderly reporting system. The comprehensive and integrated risk management partnership among the key players requires the provision and sharing of information among the key players about their discharge of respective responsibilities. Since the organization and preparation of financial and operating information can become an additional burden to the staff and resources of MFIs there is need to continue the effort to simplify information requirements for government agencies and donors.

99. Building the institutional capacity of MFIs enables microfinance practitioners as a group to influence the design of policies and information reporting standards set by government agencies and by donors. For instance, the Regional Action Research model encourages the development and formation of microfinance networks and has been an important tool for enhancing the capability of MFIs to work closely together in their dialogue with donors and policy makers.³⁶ The build up of institutional capacity should enable the directors and managers of MFIs to develop efficient management information systems for identifying and managing risks and satisfy relevant data and information requirements of stakeholders. There is an urgent need for donors to synchronize their information requirements to avoid imposing undue additional costs and operating burdens on MFIs. In this regard, the collaborative work of CGAP and the Microfinance Program of the Economics Institute to establish a database through the MicroBanking Bulletin can be an indispensable foundation for synchronized standards of information.

100. For MFIs the principal challenge is to build up the institutional capacity to expand client outreach and secure the financial sustainability of their operations. Some microenterprise development programs provide both financial and non-financial services to their clients. Non-financial services vary widely according to the socio-economic environment and the perceived constraints -- lack of business skills, market connections, etc. -- faced by the target clientele. For these institutions, there is a distinct need to introduce and adopt sound commercial practices into their financial activities as well as to formalize the provision of operating information. These are best achieved through exposure to and application of best practice techniques for managing risk, reducing administrative costs, increasing revenue and collection and organization of information which is necessary for internal management and control systems.

³⁵ "Anatomy of a Micro-finance Deal: The New Approach to Investing in Micro-Finance Institutions", Consultative Group to Assist the Poorest, The World Bank, Focus Note No. 9, August 1997.

³⁶ "Regional Action Research on Sustainable Micro-Finance Institutions in Africa: Basic Guidelines", The World Bank, Washington, DC (1997). The five-year action-research program, which was initiated in 1994 to support innovative techniques and effective networking, currently covers six countries in the Africa region: Kenya, Ghana, Zambia, Ethiopia, Cameroon and Mozambique.

Appendix

Schedule 1. Summary of South African Exemption Notice

1. The South African Banks Act of 1990 establishes the statutory definition of the "business of a bank" and, subject to the approval of the Minister of Finance, designates limited financial intermediation activities that are *explicitly excluded* from the legal definition of banking business. The exclusion notice took effect January 1, 1995.

2. As provided for in the Banks Act, the exemption notice pertains to any financial intermediation activity carried out by a group, among whose members exists a *common bond*. The law provides very clear definitions and specifications of the following aspects of *common bond* groups, registration, reporting and excluded activities:

- What constitutes a *common bond*,
- Types of associations that satisfy this *common bond* requirement (e.g., employees' credit union or savings and credit cooperative, "stokvel", housing finance cooperative),
- Deposit-receiving and fund-disbursing or lending activities of the group and its members that are excluded from the definition of banking business,
- Compliance with requirements for registration with appropriate government authorities, submission thereto of audited financial accounts and operating reports and publication of financial reports, and
- Monetary ceilings (less than R1 million for Group I and between R1 million to R9.99 million for Group II) on the amount of members' subscriptions that may be held by the common bond association in order to continue to qualify for the exclusion notice.

3. In other countries (e.g., Colombia, Bolivia, Honduras, Sri Lanka, Philippines, Taiwan, Canada and the Netherlands) *common bond* associations and organizations are established and operate under the jurisdiction of a Cooperatives Law which specifies requirements for registration and reporting, permitted activities not subject to banking statutes and income and sales taxes and criteria for membership similar to the South African legal provision. The principal difference and *innovation* in the South African approach relevant for developing countries is that *the exclusion from the statutory definition of the "business of a bank" is contained in the Banking Law itself*, thereby unifying the supervisory and regulatory jurisdiction within the banking superintendency.

4. The key provisions of the South African exclusion notice are listed below.

DEFINITIONS

1. A '*common bond*' exists between

- (a) members of a specific group consisting of employees of the same employer who are members of the same savings and credit scheme that is operated and administered on behalf of such group of employees in accordance with set rules agreed upon between such group of employees and their employer; or
- (b) members of a specific group that may be described by the term or concept known as "Stokvel", which
 - (i) is a formal or informal rotating credit scheme with entertainment, social and economic functions;
 - (ii) fundamentally consists of members who have pledged mutual support to each other towards the attainment of specific objectives;
 - (iii) establishes a continuous pool of capital by raising funds by means of the subscriptions of members;
 - (iv) grants credit to and on behalf of members;
 - (v) provides for members to share in profits and to nominate management; and
 - (vi) relies on self-imposed regulation to protect the interest of its members; or
- (c) members of a specific group, governed in terms of rules agreed to and signed by the group's founders, exclusively established for the purpose of raising funds and applying or holding available such funds for housing advances to members, irrespective of whether or not such group is bound by its rules to terminate upon the expiration of a fixed period or upon the occurrence of an event specified in its rules; or

(d) members of a specific group that chooses to identify itself by use of the name Credit Union or Savings and Credit Cooperative-

- (i) which group consists of persons of similar occupation or profession or who are employed by a common employer or who are employed within the same business district; or
- (ii) which group has common membership in an association or organisation, including religious, social, co-operative, labour or educational groups; or
- (iii) which group resides within the same defined community, rural or urban district, and
- (iv) which group receives funds from members against the issue of stock or by means of the subscriptions of members;

"employee" means any person who is employed by or working for an employer and is receiving or entitled to receive any remuneration,

"employer" means any person whosoever employs or provides work for any person and remunerates or expressly or tacitly undertakes to remunerate him;

"group" means a number of natural persons;

"member", in relation to a group as mentioned in subparagraph (a), (b), (c) and (d), means a person who contributes towards the funding of the group in order to obtain any benefit in terms thereof.

DESIGNATED ACTIVITY

2. Subject to the conditions set out in paragraph 3, the acceptance of money by or on behalf of a *common bond* group from such members and the pooling and utilization thereof for one or more of the following objectives:

- (a) The relief or maintenance during minority, old age, widowhood, sickness or other infirmity, whether bodily or mental, of members or their husbands, wives, widows, widowers, children or other relatives or dependents;
- (b) the granting of annuities, whether immediate or deferred, to members or to nominees of members, or the endowment of members or nominees of members;
- (c) the provision of a sum of money to be paid or other benefit to be provided-
 - (i) on the birth of a member's child;
 - (ii) on the death of a member or any other person mentioned in paragraph (a) or in the form of an endowment insurance on the life of a member or such a person;
 - (iii) towards the expenses in connection with the death or funeral of any member or any such person; or
 - (iv) during a period of confined mourning by a member or such a person;
- (d) the acquisition of movable goods by a member;
- (e) the acquisition of any land by a member;
- (f) the erection, on any land, of buildings for residential or business purposes or the acquisition of any such buildings by a member;
- (g) the insurance against fire or other contingencies of the implements of the trade or calling of any member;
- (h) towards expenses in connection with any recreational or social event of a member;
- (i) the provision of a sum of money to a member on a member's leaving the services of his employer owing to dismissal, resignation or otherwise;
- (j) the relief or maintenance of members, or any group of members, when unemployed or in distressed circumstances;
- (k) the provision of money for the advancement of the education or training of members or their children;
- (l) the establishment of any business by a member;
- (m) the development of the community to which the members belong;
- (n) the provision of means for members to receive interest or a dividend on their contributions.

CONDITIONS

3. The conditions referred to in paragraph 2 which are applicable to a *common bond* are the following:
- (a) none of the activities of a group may fall within the objectives of a pension fund organisation as set out in the definition of "pension fund organization" in the Pension Funds Act, 1956;
 - (b) the rules of a group shall not entitle any member at any time, albeit subject to any such notice as may be prescribed in the rules of the group, to withdraw the full amount of his contributions;
 - (c) a group as mentioned in paragraph 1(b) shall either be a *member of or be affiliated to the National Stokvels Association of South Africa ("NASASA") or any such similar representative self-regulatory body approved in writing by the Registrar of Banks;*
 - (d) a group as mentioned paragraph 1(d) shall either be a *member of or be affiliated to the Savings and Credit Co-operative League of South Africa ("SACCOL") or any such similar representative self-regulatory body approved in writing by the Registrar of Banks;*
 - (e) the benefits of the members of the group shall not be provided exclusively by way of loans that, in terms of the rules of a group, must be repaid;
 - (f) a group shall keep, in one of the official languages of the Republic of South Africa, such accounting records as are necessary to fairly reflect the state of affairs and business of a group and to explain the transactions and financial position of such group;
 - (g) a group shall fix a date on which, in each year, its financial year will end, and such financial year shall be a group's annual accounting period;
 - (h) a group shall within 120 days after the end of each financial year cause annual financial statements, pertaining to its affairs and business in respect of that financial year, to be made out in one of the official languages of the Republic of South Africa;
 - (i) a group must fit into one of the following categories:
 - i. Category I: not holding from members subscriptions amounting to more than R1 million; or
 - ii. Category II: holding from members subscriptions amounting to more than R1 million but not more than R 9.99 million;
 - (j) the financial statements of a group that fits into Category II shall be presented to a person duly registered as an accountant and auditor, in terms of the Public Accountants' and Auditors' Act, 1991 for purposes of the drawing up and presentation of a report;
 - (k) in the event that the accountant and auditor is unable to make a report or to make it without qualification, his report shall state the facts or circumstances that prevent him from making his report or from making it without qualification;
 - (l) for a group in Category II, copies of such audit report shall be presented within 60 days after completion:
 - i. for a group as defined in paragraph 1(a), to the members of and to their employer, or
 - ii. for a group in the "Stokvel" category, to the members of such group and the National Stokvels Association of South Africa ("NASASA") or any such similar representative self-regulatory body approved in writing by the Registrar of Banks; or
 - iii. in the case of a group as defined in paragraph 1(c), to the members of such group; or
 - iv. in the case of a group as defined in 1(d), to the members of such group and to the SACCOL or any such similar representative self-regulatory body approved in writing by the Registrar of Banks.

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