International experience in the regulation of microfinance\textsuperscript{1}

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\textsuperscript{1} The contents of this paper relies very heavily on the articles listed under `References` at the end. The author makes no claim for originality but takes responsibility for any errors in interpretation of the texts mentioned.
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1. What is `regulation`?

When the term ‘regulation’ is used in the context of financial services, reference is usually being made to prudential financial regulation. This can be defined as “a set of general principles or legal rules that aim to contribute to the stable and efficient performance of financial institutions and markets”. Prudential financial regulation generally has three aims:

- to protect the stability of a country’s payments systems by ensuring the soundness of financial intermediaries
- to protect the interests of depositors
- to promote efficient performance through the operation of market competition

Under prudential financial regulation, the regulator vouches for the soundness of a particular financial institution. Its financial structure, accounting procedures, lending policies etc. are examined regularly and in detail for signs of risk or failure.

Some authors have drawn a distinction between prudential financial regulation and non-prudential regulation. Under non-prudential regulation, the regulator does not certify or take responsibility for the financial soundness of the institution. Non-prudential regulation, therefore, is more akin to simple legalisation or registration of financial institutions, with very light requirements in terms of examination and supervision.

Supervision concerns “the examination and monitoring mechanisms through which the authorities verify compliance with and enforce . . . . prudential financial regulation”.

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2 Principles of regulation and prudential supervision and their relevance for microentreprise finance organisations; Rodrigo A Chaves and Claudio Gonzalez-Vega
3 The rush to regulate: legal frameworks for microfinance; Robert Peck Christen and Richard Rosenberg; December 1999
4 Principles of regulation and prudential supervision and their relevance for microentreprise finance organisations; Rodrigo A Chaves and Claudio Gonzalez-Vega
2. Microfinance and the risks associated . . . .

When considering how ‘microfinance’ is regulated in different environments, it is important to share a common understanding of the term. Rather than seeking to coin a specific definition, it may be helpful to describe some of the features which distinguish microfinance from other forms of finance. In this way, it will also be possible to highlight some of the different types of risk which are inherent to microfinance and which need to be taken into account by regulators. It will also help to explain why financial authorities have sometimes seen the need to make special provision for the regulation of microfinance.

Small scale

With a few notable exceptions like the Grameen Bank, BRAC, BRI, BancoSol etc., microfinance organisations tend to be small-scale. They often operate within limited geographical areas and within specific economic sectors. For this reason, their loan portfolios tend to be less diversified than traditional banking institutions and therefore more liable to localised risk (e.g. floods severely effecting the agricultural sector in a particular rural area).

Local institutions

Microfinance organisations tend to be much more grassroots-based than traditional banking organisations. It is considered important for microfinance organisations to operate close to their customers, in order to provide a convenient service with low customer transaction costs. Lending decisions are usually decentralised to credit officers or group leaders on the ground. Without strong internal controls, this level of decentralisation can increase risk of fraud, staff incompetence etc.

Unsecured lending

Microfinance organisations tend not to use collateral to secure their loans. They rely on character reference, group guarantees, past repayment history etc. when assessing loan applications. They also tend to stress access to future, larger loans as an incentive for prompt loan repayment. Microfinance organisations emphasise strict borrower discipline enforced through their management structures, rather than physical collateral, as a means of safeguarding their portfolio. The level of documentation attached to each loan disbursement therefore tends to be low.

These alternative means of securing loans have proved historically effective in ensuring loan repayment. However, they may be more susceptible to economic shocks than traditional collateral-based
lending. An organisation’s liquidity problems, for example, can make borrowers start to believe that they will not be able to access future loans and this may effect their repayment behaviour. Economic shocks which effect large numbers of people in a local area (drought, disease etc.) may undermine the effectiveness of group guarantees where all members of a group are similarly effected by the problem. Microfinance organisations can be liable to experience sudden deterioration in borrower repayment if small slips in their management discipline start to occur. This may add special risk to a microfinance portfolio.

**High costs**

Microfinance organisations, which provide small loans to poor people, usually incur high operating costs and enjoy low returns per loan. For this reason, they tend to make short term loans with a high turnover and charge high rates of interest. If sudden repayment problems occur, as outlined above, this can have rapid and serious effects on an organisation’s profitability. The profitability of a microfinance organisation is therefore also more vulnerable than that of traditional financial institutions.

*Public* ownership

Microfinance institutions are seldom privately owned. They tend to be owned by NGO’s, social organisations, government donors etc. This results in special risks for the institution. With no personal financial stake in the performance of the organisation, owners are less likely to scrutinise and pressure management to operate the institution according to principles of safety and soundness. Owners may make decisions based on social motivation rather than financial prudence, which may threaten the financial viability of the institution. Owners are unlikely to be able to raise additional capital promptly in case the regulator makes a call on capital.

**A new industry**

Compared with traditional banking activities, microfinance is a very new sector - having developed only in the 1980’s and 1990’s. This means that microfinance managers are often inexperienced. It means that products and markets are often new and untested. Microfinance organisations often face little competition from other organisations and can therefore expand very quickly, before gaining sufficient experience to deal with the expansion. All these features mean added risk for microfinance organisations.
3. Which microfinance organisations should be regulated?

There is a wide range of risks associated with the operations of microfinance organisations, some of which are peculiar to this market sector. However, in what circumstances is it the role of the state to interfere in the operations of these organisations and to institute prudential regulation of their financial activities?

‘Credit-only’ institutions

There is a wide consensus amongst both commentators and financial regulators that organisations which do not mobilise voluntary savings should not be subject to prudential financial regulation. The failure of ‘credit-only’ microfinance organisations, which lend out funds provided by donors or governments, would not constitute a threat to the payments system of a country and would not jeopardise the interests of public depositors. A compelling interest does not therefore exist on the part of the state to ensure the financial soundness of such organisations. In general, the examples of state financial prudential regulation of microfinance referred to below only cover deposit-taking microfinance institutions.

Organisations which mobilise ‘savings’ as a compulsory condition for borrowing also do not need to be subject to prudential financial regulation. Customers of these organisations are all net-borrowers and, if the organisation failed, would be net debtors. It is therefore unnecessary for the state to interfere to protect their interests. In Bangladesh, unregulated microfinance institutions are allowed to mobilise deposits - but only from borrowers.

Deposit-taking institutions tend to constitute a very low proportion of microfinance providers. Limiting prudential financial regulation to these providers also enables the regulatory authorities to concentrate their scarce resources only on organisations which really require supervision.

Some authors recommend a much simpler and less burdensome form of non-prudential regulation for credit-only microfinance institutions. Such a system does not add a great extra burden to the regulatory authorities but can help to legalise the activities of microfinance organisations in countries where the legitimacy of their

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5 The rush to regulate: legal frameworks for microfinance; Robert Peck Christen and Richard Rosenberg; December 1999
activities is questionable. Moreover, non-prudential regulation can also help to provide basic forms of consumer protection for borrowers. The requirements of non-prudential regulation by the state might include:

- registration or legal chartering of the organisation
- disclosure of ownership
- reporting of financial statements according to set accounting norms
- transparent disclosure of interest rates
- external audits
- sharing of borrower names and their loan status with central credit information bureaux

**Small deposit taking institutions**

Many, very small informal institutions mobilise savings from their members - e.g. ROSCA’s, village banks etc. However, it is generally considered impractical and inappropriate for a state regulator to provide prudential financial regulation for entities like these. In South Africa, a large number of community based ‘stokvel’ or credit cooperatives exist but are specifically exempted from regulation by the financial authorities. The 1995 banking law states that member owned organisations with a common bond and assets of less than $1,500,000 are exempt from full prudential financial regulation. However, such organisations are subject to certain requirements which could be categorised as non-prudential regulation, including an annual audit.
4. Legal frameworks for prudential financial regulation of microfinance

In general, a number of different approaches have been taken by financial regulators and by microfinance institutions themselves to the issue of legal frameworks for prudential financial regulation. The following main approaches can be identified:

- use of existing legal frameworks to regulate microfinance organisations
- establishment of a new category of financial institutions that provide microfinance services and new rules for the regulation of these institutions
- self-regulation of microfinance institutions

4.1. Use of existing legal frameworks

4.1.1. Transformation of NGO microfinance institutions into banks or finance companies

A number of large microfinance institutions have taken the step of registering as formal banking institutions under existing banking law. The most well-known of these are:

- BancoSol in Bolivia - a commercial bank spawned from an NGO called PRODEM
- K-Rep in Kenya - an NGO which transformed itself into a commercial bank
- Finansol in Colombia - a finance company established by the NGO Corposol
- BRAC in Bangladesh - NGO which has set up a commercial bank

Registration of microfinance organisations under existing legislation may have implications in a number of areas where legal requirements mismatch with the features of microfinance providers:

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6 Others include: BASICS (India); Kafo Jiginew (Mali); FinAmerica (Colombia); Compartamos (Mexico); FINSOL (Honduras); CARD bank (Philippines); Financiera Calpia (El Salvador); ACEP (Senegal); Genesis (Guatemala); Banco ADEMI and Banco de la Pequena Empresa (Dominican Republic); Banco Solidario (Ecuador)
Minimum capital requirements

Microfinance organisations have to raise significant funds to meet the minimum capital requirements of commercial banks under existing laws. In Colombia, Corposol chose to set up a finance company rather than a commercial bank primarily because of the lower minimum capital requirements (1.38 million US$ rather than 3 million US$). For some NGO’s, this has not been a major problem - K-Rep Bank Ltd. decided to raise capital investment of 5.9 million US$, much higher than the 1.3 million US$ minimum capital requirement under Kenyan law, in an attempt to generate confidence in its financial position. In general, however, minimum capital requirements to establish commercial banks under existing law would be extremely difficult for the vast majority of microfinance institutions to meet.

Minimum capital requirements (US$) 1996

<table>
<thead>
<tr>
<th>Country</th>
<th>Commercial bank</th>
<th>Finance company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>3.25 million</td>
<td>not applicable</td>
</tr>
<tr>
<td>Bolivia</td>
<td>3.2 million</td>
<td>not applicable</td>
</tr>
<tr>
<td>Colombia</td>
<td>22.8 million</td>
<td>4 million</td>
</tr>
<tr>
<td>Kenya</td>
<td>1.3 million</td>
<td>670,000</td>
</tr>
<tr>
<td>Peru</td>
<td>5.5 million</td>
<td>2.8 million</td>
</tr>
<tr>
<td>Philippines’</td>
<td>80-180 million</td>
<td>4 million</td>
</tr>
<tr>
<td>South Africa</td>
<td>11.1 million</td>
<td>none</td>
</tr>
</tbody>
</table>

Non-secured lending restrictions

Banking laws in many countries stipulate restrictions on un-secured lending. Compliance with these regulations can be particularly difficult for microfinance institutions. In Bolivia, the banking law states that the unsecured portion of the portfolio cannot exceed double the institution’s equity. With net equity of 7 million US$, BancoSol is legally allowed to lend only 14 million US$ unsecured. In practice, its unsecured portfolio exceeds 24 million US$. BancoSol is thus dependent on flexible interpretation of this stipulation by bank regulators.

Ownership restrictions

Under the Bolivian banking law, the influence of a single shareholder in a commercial bank is limited to 20% of total votes. The NGO PRODEM, which established BancoSol, therefore restricted itself initially to 35% ownership, with shares also purchased by the International American Investment Corporation, Calmeadow, ACCION International and others.

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7 The range depends on location – inside or outside Metro Manila. The Philippines also has a category of rural bank, for which the minimum capital requirement is 80,000 US$ - 800,000 US$. 

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Other issues

Microfinance institutions which have registered under existing legislation have also met with problems in the field of:

- complying with regulators' reporting requirements
- loan documentation requirements
- requirements to approve the establishment of new branches
- high operational - cost ratios compared with other formal financial service providers

These mismatches can be dealt with in a variety of ways. Existing legislation can be applied flexibly by regulatory authorities in the case of registered microfinance institutions. Alternatively, the regulatory authority could institute exemptions from certain parts of existing legislation and replace these with other requirements that have similar effect. For example, microfinance organisations could be exempted from non-secured lending restrictions but subject to higher capital adequacy requirements instead, to cover the extra risks associated with reliance on non-secured lending.

In general, the option of registration under existing legislation will only prove practical for countries with the very strongest microfinance sectors. In addition, the regulatory authorities would have to be highly aware of the different risk profile of microfinance organisations and sympathetic towards their inclusion within the existing legal framework.

4.1.2. Existing formal institutions branching out into microfinance

In addition to NGO's and other microfinance organisations seeking to legalise their activities by registering under existing banking legislation, there are also cases of legally registered banking organisations branching out into microfinance activities. The most obvious example is Bank Rakyat Indonesia (BRI). Though BRI's microfinance branch - the Unit Desa system - has only been providing microfinance services since the mid 1980's, Bank Rakyat Indonesia is a state owned commercial bank which has been operating for over a century.

Private commercial banks in Chile, Panama and South Africa have also established microfinance subsidiaries. In Chile, the government has specifically encouraged the entry of large, existing commercial banks into the field of microfinance by auctioning off a lump sum subsidy to the bank that can provide the largest number of microloans with the smallest subsidy. Four banks now dominate the

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8 Banco del Estado, Banco Santander, Banco Sudamericano, Banco del Desarrollo.
microfinance market, reaching 80,000 microenterprises with a loan portfolio of 100 million US$. The microfinance activities of these banks are much larger than the combined efforts of NGO's in Chile and the financial authorities have decided that there is no need to establish new regulatory frameworks for microfinance.

4.1.3. NGO microfinance institutions forming alliances with already licensed institutions

Some NGO microfinance organisations have managed to avoid the issue of regulation when mobilising deposits by forming an alliance with banks or credit unions that are already licensed and regulated under national law. The NGO Freedom from Hunger, for example, has implemented its programmes through financial co-operatives and rural banks in Burkino Faso, Ghana, Mali, Madagascar and the Philippines. Plenty of other microfinance organisations have mobilised savings but then deposited the savings with licensed banking organisations rather than relending or intermediating the funds themselves.

4.2. New categories of financial institution

In a number of countries, financial authorities have sought to deal with the growing microfinance industry by creating a new legal category with specific prudential requirements for organisations to meet. In addition, these laws have tended to restrict the activities in which microfinance organisations can engage.

The countries where this approach has been attempted include:

- Peru - where special sets of regulations have been developed for municipal banks, rural banks and ‘Entities for the Development of Small and Micro Enterprises’ (EDPYME)
- Bolivia - where regulations have been established for the regulation of ‘Private Financial Funds’ (PFF)
- French West Africa - where the Mutualist Law is aimed at the regulation of microfinance organisations

4.2.1. Peru

A network of municipal banks has been developed in Peru on a German model. The banks have been established in provincial towns, with the provincial council as the principal owner. Technical assistance was provided by GTZ for drafting the legislation and establishment of the banks. A federation of municipal banks, founded in 1987, plays an important role in supervision of these institutions. The banks’ operations develop gradually - starting with savings and pawnshop services. Microenterprise loans are only introduced after 3 years, when certain performance standards have already been met. In 1992, a similar framework was established for the establishment of rural banks.
The ‘Entities for the development of small and micro enterprises’ (EDPYME) category was established in an attempt to cover a wider range of microfinance organisations. Its establishment was promoted particularly by COFIDE, the national development finance company, which discounts government and international credit lines through local financial institutions. COFIDE has to lend through registered entities so was keen to promote diversification of the formal sector. The EDPYME legislation was adopted in December 1995. EDPYME’s can only mobilise public deposits after they have received special permission from the regulatory authorities.

The legislation does contain provisions which cater for the special characteristics of microfinance institutions:

- no loan documentation is required for loans less than 10,000 US$.
- total liability no more than 10 times net equity
- loan loss provisioning percentages determined by the microfinance institutions themselves
- lower minimum capital requirements (265,000 US$) than commercial banks

By February 1999, about 6 NGO’s had transformed themselves into EDPYME’s and another 20 have applications pending.

4.2.2. Bolivia

The experience of regulating BancoSol convinced Bolivian regulators that it would be possible to create a whole new category of regulated financial institutions providing microfinance services. The Private Financial Fund category was established in April 1995. Minimum capital requirements stand at 1 million US$ - one third of the level required to establish a commercial bank. The legislation helps microfinance institutions avoid rules on unsecured lending by recognising group guarantees and movable property (jewelry, furnishings etc.) as collateral. In return, the range of activities in which PFF’s may engage is more restricted than for commercial banks. By February 1999, around 7 NGO’s had become Private Financial Funds.

4.2.3 French West Africa

In 1992-3, the Central Bank of the West African States sought assistance from the Canadian Societe de Developpement International Desjardins to draft legislation for the regulation of informal financial institutions. The legislation was adopted by all member states of the West Africa Economic and Monetary Union (except Benin). The legislation is based strongly on credit union structures and institutions that register under the law are encouraged
to turn themselves into credit unions within two years. The provisions of the law are very detailed and it is unclear whether the law will really allow for the legal development of microfinance institutions which decide not to follow the credit union structure.

### 4.2.4. Special cases

The Bangladeshi Parliament granted the Grameen Bank a special banking charter in 1983. The bank was originally 60% owned by the government (though this proportion has since varied over time) and has received special treatment by the regulatory authorities. However, the Bangladeshi government has not established a new category of financial institutions which specialise in microfinance services.

Again it is clear that special categories of financial institution providing microfinance services have only been established by regulatory authorities in environments where the microfinance industry has developed very strongly. Though entry qualifications are much reduced compared with commercial banks, the opportunity for registration has only been opened to a small number of relatively large microfinance institutions.
4.3. Self-regulation

In some countries where microfinance remains unregulated by the financial authorities, attempts have been made by microfinance institutions themselves, often in collaboration with government partners, to establish codes of best practice for microfinance. These codes of best practice constitute a voluntary effort to promote the safety and soundness of microfinance institutions.

South Africa

In South Africa, microfinance organisations established the Alliance of Microenterprise Practitioners. This alliance worked with two government owned wholesale development finance institutions (National Housing Finance Corporation and Khula Enterprise Finance Ltd.) to draft what are referred to as Statements of Sound Practice. The South African Reserve Bank also sits on a committee set up to approve the draft statements. It is worth noting that very few South African microfinance institutions are mobilising voluntary deposits, so the financial authorities are not interested in regulating their activities directly.

Philippines

A similar initiative has been launched by a coalition of microfinance NGO’s in conjunction with the Central Bank, the People’s Credit and Finance Corporation (a wholesale development finance intermediary), two commercial banks involved in microfinance, donors etc. The project is being funded by USAID and is known as the Philippine Coalition for Microfinance Standards.

5. Methods of supervising microfinance

Instituting legislation for the regulation of microfinance is a relatively simple process. More important is the ability of the regulatory authorities to implement this legislation. Practical problems associated with physically supervising a large number of small, diffuse financial institutions remains the principal barrier to prudential regulation of microfinance institutions worldwide.

Some innovative approaches to dealing with this issue have been adopted in Indonesia and Peru. Though responsibility for regulation remains with the central banks, supervision activities have been delegated to third parties:
Indonesia

Bank Indonesia, the central bank, has delegated responsibility for supervising 5000 village banks (BKD) to the Bank Rakyat Indonesia (BRI), a state-owned commercial bank with a wide branch network. Supervisors from BRI’s Small Business and Co-operative Division make regular monthly visits to the village banks to review portfolio quality, liquidity, balance sheets, profit and loss statements etc. The village banks have to pay a small fee to BRI for this service.

Peru

The municipal banks in Peru are supervised by the bank superintendency but also receive assistance and support from FEPCMAC, the federation of municipal banks.
6. Conclusions - some lessons for Vietnam

Perhaps the most important lesson from this survey is a lesson of caution. In most countries, it has proved neither possible nor necessary for the financial authorities to institute prudential financial regulation for the vast majority of microfinance institutions. Prudential financial regulation should only be considered for those organisations that seek to mobilise voluntary deposits. For credit-only organisations, or for those who mobilise compulsory savings against loans, the more important issue is legalisation and possibly some form of consumer protection in the form of non-prudential regulation.

In Vietnam, as yet, there are very few microfinance organisations which are mobilising voluntary deposits. It is positive that these organisations have started to think about drafting a voluntary code of conduct\(^9\) which is aimed at improving the safety and soundness of their financial operations. This should be promoted and shared more widely with the formal sector.

For the future prudential regulation of microfinance organisations by the state, it is unclear whether use of existing legislation or the establishment of a new legal category will be the best route forward for Vietnam. However, whatever the legal framework, it is clear that, due to the special characteristics and risks attached to microfinance, conventional approaches to regulation will need to be modified in a number of ways.

Regulators will need to de-emphasise the following requirements:

- minimum capital - most microfinance organisations are much smaller than commercial banks
- limits on unsecured lending - microfinance organisations are dependent on use of alternatives to traditional forms of collateral
- detailed loan documentation - microfinance organisations cannot require the same levels of loan documentation from customers as commercial banks
- interest rate ceilings - microfinance organisations need to charge interest rates that cover their higher operating costs

Instead, regulators should concentrate on:

- monitoring microfinance organisations’ past loan delinquency record and current arrears situation

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\(^9\) Prudential standards for community financial institutions in Vietnam; ActionAid Vietnam, MRDP and World Council of Credit Unions; April 1999
• verifying systems for reporting loan repayment delinquency
• higher loan loss provisioning requirements than for commercial banks
• higher capital to asset ratios than for commercial banks
• requiring strong internal audit facilities
• monitoring application of clear and consistent operational policies
• watching out for over-rapid growth by microfinance organisations
• require full testing of new products and services
• etc.

It is possible that attempts by microfinance organisations to develop their own standards and best practice could be taken up by the financial authorities as a basis for prudential regulation in the future.