INTERNATIONAL MONETARY FUND

Microfinance: A View from the Fund[1]

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I. Introduction

1. **Broad access to financial services is a key characteristic of a deep and efficient financial system.** In many developing countries, access to financial services is highly limited due to a number of institutional weaknesses and other reasons, which prevent individuals from realizing their economic potential, and constrain economic growth. Insufficient access to financial services has also raised equality concerns, since it affects disproportionately the poor, and people living in rural areas.

2. **Microfinance institutions (MFIs) offer a promising alternative for broadening the reach of financial services to the poor, especially in developing countries.** MFIs seek to provide small-scale loans and other financial services to low income individuals and informal businesses. The size and scope of the microfinance industry has been expanding quickly, and is expected to grow further as the demand for financial services by the poor remains largely unmet. Some estimates indicate that the potential market for microfinance services worldwide may range between 400 to 500 million people, with less than one-tenth of them served by MFIs at end-2002.[2] The microfinance industry has generated increasing support among various types of donors, including bilateral and multilateral development organizations.

3. **The development of a healthy and sustainable microfinance industry is broadly consistent with the Monterrey Consensus and the achievement of the Millennium Development Goals.** Recognizing the potential of MFIs in addressing certain market failures, and the challenges ahead, the United Nations declared 2005 as the International Year of Microcredit. The initiative is aimed at promoting more inclusive financial sectors in developing countries, as part of the Monterrey Consensus on financing for development.

4. **In recent years, the Fund has been devoting more attention to microfinance, particularly in its interactions with low-income members.** While microfinance more closely concerns the mandate of the World Bank, it also intersects with the Fund's objectives of promoting sound macroeconomic policies and structural reforms, and to ultimately achieve higher standards of living in low-income countries. Structural reforms embodied in Fund programs financed under the Poverty Reduction and Growth Facility (PRGF) may incorporate, as appropriate, aspects related to the proper development of microfinance services.

5. **The Fund's mandate to promote orderly financial conditions in member countries also relates to the prudential aspects of microfinance.** Failures of MFIs may adversely impact depositors and, under certain circumstances, result in contagion effects on other financial institutions. These effects are likely to be felt most by users of their services, generally the low-income segments of population. Yet the appropriate nature and degree of prudential oversight remains a challenge, since it comes at the risk of diverting scarce

[2] Figures reported by the United Nations Capital Development Fund.

supervisory resources from other more systemically important institutions. At the same time, improper regulation can inhibit the development of the microfinance industry, or create undesired opportunities for regulatory arbitrage. These considerations are beginning to be addressed in the Fund's operational work, including its various programs, technical assistance on financial sector issues, and financial sector surveillance of members, especially in the context of the joint IMF-World Bank Financial Sector Assessment Program (FSAP).

6. **This paper is part of the Fund's contributions to the United Nations initiative and provides an overview of the potential role of the Fund in the area of microfinance.** It approaches the topic from a public policy perspective, focusing on the likely effects of microfinance activities on economic efficiency, equality, and macroeconomic and financial stability. Given the wide range of issues involved, the discussion is rather general, and more work is needed to develop the Fund's view on specific aspects, such as the integration of microfinance with more traditional financial institutions, as well as consideration of the regulatory and supervisory approaches to microfinance.

7. **The paper is divided into four sections.** The first presents a brief description of microfinance in terms of objectives, target markets, sources of financing, and lending strategies. The second briefly discusses efficiency and distributional considerations and related public policy issues, including financial support and regulation.[3] It also discusses complementary public policies that may help increase the reach of financial markets to the poor. The third section focuses on the potential role of the Fund in supporting microfinance activities and the final section summarizes the main conclusions.

II. Definitions, Scope and Key Issues

8. **MFIs seek to provide small-scale credit and other financial services to low-income households and very small informal businesses.** They provide a mechanism for the poor to smooth the effects of income shocks on consumption, find safe and affordable repositories for their savings, take advantage of profitable investment opportunities, and insure risk. In some countries, such as Bolivia, MFIs have become important players in the financial sector. Microfinance programs have also been introduced in developed countries to serve people living in disadvantaged areas such as inner cities.

9. **Typical MFIs are non-profit organizations, although a few have evolved into, or were established as, commercial enterprises.** Many MFIs are owned and operated by nongovernmental organizations (NGOs), with most of the funding coming from multilateral development agencies and, to a smaller extent, private charities and host governments.[4]

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[3] This paper refers to "public policy" in a broad sense that includes policies aimed at improving income redistribution, alleviating market failures, or improving economic stability. Similarly, "public sector" refers to the organizations pursuing any of these objectives, and therefore covers governments, development organizations, and the like.

[4] See Hardy, Holden, and Prokopenko (2002).

There are examples of MFIs owned by their members (as in the case of rural cooperatives), by the government, by socially inclined shareholders, or by shareholders motivated by profits. In some developing countries, commercial banks have started their own MFIs as a strategy for business expansion. A recent trend is for MFIs to raise capital through dedicated funds in developed countries, although the sums involved are still small.

10. **MFIs have developed a variety of innovative techniques to overcome obstacles in the provision of financial services to the poor**. The extension of financial services to low-income groups, particularly in developing countries, is hindered by many difficulties. These include weak legal creditor protection, ineffective enforcement of laws, lack of usable collateral, poor communication infrastructure, and weak prudential oversight over saving institutions. To get around these obstacles, MFIs have developed a series of novel techniques that are frequently adapted to specific circumstances. For instance, in microcredit, several widespread mechanisms are available to ameliorate the reliance on collateral. *Repeated lending* breaks down loans into small installments with a frequent repayment schedule to help establish the trustworthiness of the borrower. *Progressive lending*, increases loan disbursements gradually over time, so failure to repay an early loan causes borrowers to lose a larger loan in the future, strengthening their incentives to repay. A much studied mechanism is *joint liability*, whereby members of a lending group take turns at receiving loans, and are jointly responsible if a group member fails to repay. Joint liability gives group members strong incentives to monitor the borrower, with social sanctions among group members replacing weak legal sanctions. However, the application of these techniques has not always been effective, especially over long periods, as group solidarity over time weakens, and drop-out rates increase.

11. **Besides the provision of microcredit, some MFIs also collect savings and offer various financial products, such as insurance or payment services.** The range of financial services provided by MFIs has grown beyond microcredit, and now covers a relatively large menu which includes, but is not restricted to, savings, transfer services, and insurance. In recent years, the collection of savings has become more widespread, due to its high demand among the poor and its role as a natural source of funding for MFIs. Microinsurance, on the other hand, is still in its infancy, with life insurance being the most developed line of business. Microcredit is sometimes provided together with non-financial services, such as business development assistance, training, or even health services. Taking advantage of existing operations to offer other services, helps spread operational costs and enhance the performance of MFIs.

The size and scope of microfinance institutions

12. **MFIs have grown enormously and are now a varied and complex set of institutions.** The best known early MFI is the Grameen Bank of Bangladesh, founded in the mid-1970s. The Grameen model has been replicated in various countries, at times with mixed results, and new MFIs have emerged, sometimes quite different from that archetype (Box 1).

Box 1. Types and Scope of MFIs

MFIs differ widely in terms of sizes, scope, and sources of financing. In large parts of the world, MFIs follow the model of financial cooperatives, funding their lending from members' deposits and capital contributions. Other MFIs do not take deposits but specialize in microcredit, channeling grants, and sometimes loans, from various types of donors (including governments, bilateral and multilateral development agencies, charitable organizations, and similar institutions), while others borrow from commercial sources such as banks or international investment funds that target social-purpose investments. These business models have evolved over time, with some successful cases growing from the grant-dependent, credit-only model, into self-sustaining, full-fledged deposit taking institutions. At the same time, some MFIs are developing closer ties with commercial banks, as these decide to explore the microfinance niche.

In **Bolivia**, the microfinance sector covers a wide range of institutional structures and lending technologies, with several MFIs seeking to formalize their operations. The most successful, *BancoSol*, was incorporated as a commercial bank in 1992, after several years of operation as an NGO with a strong record of group lending to urban borrowers. In recent years, other MFIs have also formalized their operations and obtained permission to issue deposits. *Caja Los Andes*, a quasi-private nonbank financial intermediary that focuses on individual microcredit in urban areas, was created after the formalization and upgrading of an NGO with a successful record in microcredit. Other NGOs are seeking to formalize their operations and become regulated nonbank intermediaries. For example, *FIE*, an NGO with a successful track on individual client lending technology in urban areas, has expanded its products into lending for trading and leasing services, and is trying to incorporate as a nonbank financial intermediary to mobilize deposits. Similarly, *Fundación Sartawi*, an NGO with religious affiliation, operates entirely in rural areas, offering group loans to people in distant communities. It has been actively seeking to improve its cost efficiency, strengthen its organizational structure, and merge with another MFI to seek a charter as a regulated non-bank financial intermediary.

In **Benin**, the financing mix of MFIs is changing toward greater reliance on deposits and debt, helping improve their accountability and budgetary constraints. Currently, microfinance activities are carried out by two types of institutions: saving and loan cooperatives (SLCs), and associations established for specific purposes. The SLCs constitute the largest category of microfinance institutions in terms of credit and membership, and are the only institutions that collect deposits from members. In turn, the associations comprise two credit-only institutions that target small enterprises and receive funding from donors, including the World Bank. The financing mix of the associations is changing, after a project launched in 1999 with the objective of improving their financial sustainability. They are now being funded through a combination of credits to on-lend to clients, plus grants to finance technical assistance, training and operating costs. The financial performance of both institutions has so far met the expectations, with high loan repayment rates.

In **Guinea**, the MFIs and the commercial banks have cooperated increasingly to strengthen their linkages. Commercial banks service the deposit accounts of MFIs and provide them with cash management services, including extended credit facilities and emergency credit lines to cover cash shortfalls. In turn, banks have used the branch network of MFIs to extend credit to large rural clients and cooperate in loan collection. This cooperation has also helped growing businesses to graduate from micro-credit to conventional loans from the banks.

In **the Philippines**, the microfinance industry is highly heterogeneous. Major providers of microfinance include a large proportion of credit unions and cooperatives, credit-granting NGOs, and some rural banks. The latter started to venture into microfinance after seeing the potential profitability of the sector, and now constitute the dominant provider of commercial micro- and small-scale financial services for a large proportion of rural entrepreneurs. The number of MFIs is highest around urban centers and highly populated rural areas, and group lending remains largely the norm, following closely the Grameen methodology adopted by many early NGOs. Despite the very large number of providers, total outreach in the Philippines has remained quite limited.

13. **However, no systematic and comprehensive data on MFIs is collected and there are no authoritative figures on key characteristics of the microfinance industry**, such as the number and size of MFIs, their financial situation, or the population served. The generation of systematic data on the microfinance industry has been complicated by several factors, including the informality and dispersion of MFIs, lack of consensus on the data needed, and lack of universally accepted and clear-cut definitions of the products that qualify as microfinance or the boundaries of the industry. There are, nonetheless, independent datasets of varying quality and coverage that have been collected by different agencies over the years.[5] The compelling need for hard data on the microfinance industry, has triggered a recent initiative by the IFIs to assess the existing datasets, determine the current and anticipated data needs, and formulate the best strategy to close the gaps.[6]

14. **Aside from data limitations, a broad characterization of the microfinance industry can be extracted from various studies mostly at the country and regional levels.** Existing studies indicate that, despite a sizable number of MFIs in developing countries—tens of thousands according to some estimates—the evolution of the industry has not been uniform, with most of the activity concentrated in just a few countries. Further, the size distribution of the microfinance industry is highly skewed, with a few large MFIs covering most of the population served, while outreach remains very limited—below 1 percent of population in most countries. For example, a study based on data from 1,500 MFIs operating in 85 countries in Asia, Africa, and Latin America found that 3 percent of the largest MFIs served more than 80 percent of the total members.[7] The size of the industry was small, both in terms of the number of members (54 million, or 1.5 percent of the population), and in terms of the amounts involved (US$18 billion in total outstanding credit and US$12 billion in savings accumulated by members). A significant part of microfinance transactions (more than 95 percent of the total volume) were channeled through regulated institutions. On the other hand, 60 percent of MFIs were still unregulated but represented only a very small

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[5] Perhaps one of the most complete databases currently available is Daley-Harris (2003). It covers 55 developing countries and focuses on access to credit from specialized MFIs, but has the disadvantage of leaving aside many large development banks, postal banks, and other non-traditional financial institutions that may offer microfinance products. A larger database—which in fact subsumes the previous one—was compiled by Christen *et al*. (2004) at the Consultative Group to Assist the Poor (CGAP). It covers a wider range of financial institutions targeting markets below the level of commercial banks, including MFIs and other non-traditional financial institutions that do not necessarily specialize in microcredit, but reach a large number of small clients. The information content, however, is rather limited. A richer database in terms of financial and operating information, but covering a small number of MFIs (124 in June 2004) is provided by the Microfinance Information Exchange (MicroBanking Bulletin).

[6] For a discussion on data availability see Honohan (2004a). A description of the project can be found at http://www1.worldbank.org/finance/html/dataaccess.html.

[7] Lapenu and Zeller (2001).

proportion of loans and savings volumes (less than 2 percent). Similar findings have been reported in more recent studies.[8]

Can MFIs become commercially viable?

15. **While there are many important exceptions, a majority of MFIs remain dependent on donor subsidies because of high operational expenses.** Whether the microfinance industry can evolve into a self-sustained sector remains an open question and one of its main challenges ahead. Apart from a few remarkable success cases, available data indicates that only 1 percent of existing MFIs worldwide are financially stable. Perhaps the most striking aspect of the Grameen experience has been its excellent repayment record, in sharp contrast with the experience of most government development finance institutions.[9] Like Grameen, MFIs in general have been quite successful at keeping loan losses small. In most cases, however, low rates of borrower default combined with high lending rates have not translated into profitability or even the ability to cover costs. The small scale of the loans and the cost of reaching out to clients increase operational expenses, which absorb most of the interest margins. Even among the most efficient MFIs, operational expenses are of the order of 15-20 percent of loans, compared to less than 5 percent for banks operating in developing countries.[10]

16. **MFIs that have become financially self-sustainable tend to be larger and relatively more efficient.** The experience suggests that, by becoming larger, some MFIs have been able to lower their operating expenses relative to the size of their loan portfolios. For instance, in a sample of 124 MFIs striving for financial self-sufficiency in 2003, those achieving the objective (roughly half of the sample) were more than two times larger than the average, but operated a similar number of offices (Table 1).[11] Arguably, the increase in size facilitates a reduction in operating and personnel expenses per dollar lent, which increases profitability. In addition, self-sustainable MFIs tend to reach a larger number of borrowers and rely more heavily on deposits and other commercial sources of funding. In other aspects, financially self-sustainable MFIs are similar to the industry average, including with respect to loan quality, average yields on gross loans, and capitalization ratios.

17. **But MFIs striving to become commercially viable do not target the very poor.** MFIs aiming at commercial viability tend to lend to individuals around the poverty line or slightly above it, thus they do not reach the very poor. Targeting a relatively more affluent clientele leads to increases in loan sizes, and improved efficiency indicators. In contrast, most MFIs focusing on the poorest of the poor remain dependent on donor funds. An open and contentious issue is whether MFIs should focus more heavily on expanding their loan size in

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[8] See, for example, Honohan (2004b).

[9] Murdoch (1999), however, claims that Grameen exaggerated actual repayment rates.

[10] See The Consultative Group to Assists the Poorest, CGAP, (2000).

[11] See MicroBanking Bulletin (June 2004) at http://ww.mixmbb.org.

order to lessen operational costs and attain financial independence, or remain focused on targeting poor households and dependent on external subsidies.

Table 1. Selected Indicators for a Sample of Microfinance Institutions, July 2003 1/
(In percent, unless otherwise indicated)

	All MFIs	Financial Self-Sustainable MFIs
Institutional Characteristics		
Age (years)	8	10
Average Assets (million US$)	7.9	14.5*
Institutions (number)	124	66
Offices (number)	19	17
Financing Structure		
Capital/Asset Ratio	42.7	40.4
Commercial Funding Liabilities Ratio 2/	44.1	76.0*
Deposits to Total Assets	12.3	16.4
Gross Loan Portfolio/Total Assets	70.9	73.1
Outreach Indicators		
Active Borrowers (number)	15,553	22,841
Percent of Women Borrowers	62.9	61.9
Average Loan Balance per Borrower (US$)	532	621
Average Loan Balance per Borrower/GNP per Capita	54.3	66.4
Voluntary Savers (number)	3,345	6,019
Average Savings Balance per Saver (US$)	269	258
Financial Indicators		
Return on Assets	0.1	5.7*
Return on Equity	2.3	14.6*
Profit Margin 3/	0.3	19.4*
Operating Expense/Loan Portfolio	29.4	22.2*
NPLs (Overdue >30 days) to Gross Loans	2.8	2.5
NPLs (Overdue>90 days) to Gross Loans	1.5	1.5

1/ The sample of MFIs comes from the MicroBanking Bulletin. It is obtained by voluntary participation of MFIs worldwide, and therefore vulnerable to self-selection bias. Participating MFIs are benchmarked, and the information may be used by investors, donors and other service providers. A more detailed description can be found at http://ww.mixmbb.org.
2/ All liabilities with "market" prices in percent of average gross loans.
3/ Net operating income/financial revenue.

Notes
* The value of financially self-sustainable differs from the total sample at the 1 percent significant level.

Source: MicroBanking Bulleting, July 2003.

18. **The experience also suggests that MFIs may become more profitable by increasing their autonomy in financial management.** Excessive political interference in the microfinance industry appears to be one of the main threats to financial sustainability. The experience indicates that profitability of MFIs can be improved by increasing their autonomy, including setting interest rates on deposit and lending operations. At the same time, the dissemination of appropriate lending techniques such as group lending, and progressive lending, can also contribute to improve asset quality (Box 2).

Box 2. Are MFIs Commercially Viable?

One of the main challenges facing the microfinance industry is to become financially self-sustaining . While there are a many well-known success cases of MFIs growing from subsidized entities into formal and profitable financial institutions, the majority of them remain dependent on external funding. The experience shows that profitability can be improved by shielding MFIs from excessive political interference and increasing their autonomy in financial management, including freedom to choose their interest rates. Training and technical assistance can also help improve the financial position of MFIs.

In **Bolivia**, there are examples where increases in the outreach of MFIs have been accompanied with the implementation of cost-effective financial intermediation techniques. The most notable example is *BancoSol*, a commercial bank that focuses on microcredit in urban areas which has been able to keep very low levels of arrears and achieve full independence from subsidies. It now has the largest outreach among MFIs in Latin America, with roughly 60,000 clients (half of the microfinance market in Bolivia), and continues growing by internal revenue generation. *BancoSol* was created in 1992, receiving the business from *PRODEM*, an NGO with a successful record of microcredit in urban areas, which is currently seeking to adapt its lending methodology to a rural clientele in order to achieve financial sustainability.

In **Ghana**, weaknesses in financial performance among S&Ls (savings and loans) and credit unions engaged in microfinance were accompanied by a welfare focus and policies of low interest rates. In recent years, the combination of a more commercial approach, sector restructuring through re-capitalization and capacity-building, and better regulation, have contributed to reducing the proportion of distressed institutions. From 1996 to 2001, the proportion of "unsatisfactory" credit unions declined from 70 percent to 60 percent and that of those in the worst categories from 42 percent to 15 percent. The improvement in performance indicators has been driven by the development of innovative microfinance practices, stronger linkages between various actors of the sector, and a flexible regulatory and supervisory system.

In **Benin**, the microfinance industry has gone through cycles of bankruptcy and rehabilitation. The network of saving and loan cooperatives and mutuals (SLC) was first developed in the 1970s under the initiative of the Caisse Nationale de Credit Agricole (CNCA), a state-owned agricultural development bank. Following severe financial problems that lead to the liquidation of CNCA in 1987, the government, with the support of donors, launched a program to rehabilitate the SLCs granting them autonomy over their management decisions, including the liberalization of their deposits and lending rates. Under the new framework, SLCs deposits and membership increased, and more than half of the SLCs reached break even point by 1993. An umbrella organization was launched in 1993 to help coordinate the activities of the SLCs, provide refinancing and placement windows for excess liquidity, and channel subsidies. After 1998, while the number of SLCs continued to grow, their financial situation started to deteriorate again due to weak loan repayments. A new rehabilitation program supported by a donor was launched in 1999, with the objectives of reducing the non-performing loans, temporary blocking new credit extension, and improving internal controls and procedures. Under the program, total deposits and credit have been expanding rapidly, progress has been made in recovering nonperforming loans, and positive net profits were recorded in 2002.

In **The Philippines**, substantial progress in commercialization trends in the microfinance industry appears to be underway. After the formal recognition of microfinance by the government in 1997, ongoing initiatives and donor-supported programs have encouraged the expansion of microfinance outreach to the poor. Substantial progress has been attained, with the largest MFIs considered now to be on a sound and commercially viable footing. Largely due to training and technical assistance provided by donors, rural banks are increasingly adapting their services to tap the microfinance market. In parallel, several NGOs have been recently transformed into microfinance-oriented rural banks and into commercially regulated financial institutions, further attracting new market entrants. Still, there are significant threats to the viability of microfinance as a market niche, including weaknesses in physical infrastructure (equipment, telecommunications, transport, and the like), weak ownership and governance structures in NGOs, absence of an effective geographical network among rural banks, inadequate access to commercial sources of funds, and unclear regulation and supervision of microfinance operations.

III. Policy Issues Concerning Microfinance: An Overview

19. **From the public policy perspective, microfinance involves three different aspects.** First, it may help improve economic efficiency by ameliorating information related problems in financial markets. Second, microfinance services can have distributional effects and contribute to poverty alleviation by enhancing access to financial services to the poor. Third, to the extent that MFIs rely on deposit issuance, or pose any risks to financial stability, the public sector may also have a role to play in their prudential regulation and supervision.[12] This section presents a brief discussion of these three policy aspects of microfinance, as well as some complementary public policies that can help enhance the depth and reach of financial markets.

Microfinance and economic efficiency

20. **On efficiency grounds, microfinance may provide an alternative to alleviate frictions in financial markets.** It is widely recognized that financial markets are especially vulnerable to failures resulting from information asymmetries between the parties involved in financial contracts. As a result, financial markets may fall short of the socially-optimal outcome, failing to exploit otherwise efficient transactions. Such problems are exacerbated in developing countries, and disproportionately affect the poor since their lack of collateral worsens the effects of information asymmetries. By developing new lending and saving technologies, MFIs may help alleviate these market failures and increase the reach of financial services to the poor.

21. **Efficiency arguments imply that the private sector has an incentive to develop commercially-viable microfinance activities, but this has proven to be a challenge.** To the extent that microfinance activities provide a way to circumvent imperfections in financial markets, they have the potential to become self-sustainable. At the same time, if MFIs have a technological or informational advantage over traditional financial institutions, they should have been able to obtain access to private funding, perhaps including through various forms of cooperation or vertical integration within the financial system. In fact, enhanced cooperation between existing financial institutions and MFIs could contribute to foster the development of local financial markets. For example, commercial banks may help MFIs expand their portfolio of financial services by providing savings services, varied loan products, and insurance, whereas MFIs may facilitate the development of commercial banks' customer base. However, most of the external funding to the microfinance industry comes from donor sources, and the integration of MFIs with traditional financial institutions is not widespread.

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[12] Regulation and supervision are "prudential" when their main objective is to protect small depositors and the systemic integrity of the financial system.

Microfinance and equality

22. **MFIs may have a favorable effect on poverty reduction and are being used as a channel for donor funding.** By offering access to both credit and saving facilities, MFIs offer a promising option to help poor people engage in productive activities and cross the poverty line, which explains the increasing popularity of MFIs among donors. This, however, entails the risk of funds being diverted from other primary areas such as investment in education, health care, or water and sanitation projects.

23. **One of the key issues is whether MFIs are a cost-effective tool for redistributing scarce resources, and how they compare with alternative mechanisms.** There is a presumption that MFIs could have some advantages over traditional redistributive mechanisms.[13] For example, access to financial services by the very poor may have an empowering effect on households, helping avoid aid-dependency, and resources channeled through MFIs could contribute to gender equalization by facilitating women participation in economic activities. In addition, microfinance could be more self-sustaining than traditional redistributive mechanisms if the resources are invested in productive activities and at least partially repaid by borrowers. Microfinance could also improve resource allocation and help coordinate the production or distribution of a particular good or service, since MFIs evaluate *ex-ante* the use of resources and deal with many small borrowers. Despite these possible arguments in favor of microfinance, an evaluation of MFIs and other redistributive mechanisms on the basis of cost-effectiveness has been elusive.

24. **The assessment of the performance of microfinance institutions has been limited by insufficient data.** The generation of systematic datasets with financial information and operations of microfinance institutions has lagged well behind their development. The scarcity of data on microfinance activities hinders the evaluation of their cost-effectiveness as a poverty reducing mechanism, and their comparison with other alternatives. The lack of systematic follow-up also prevents the evaluation of financial sustainability and the comparison between alternative microfinance products and business strategies. In recent years, several public and private sector initiatives have started to fill the data gap, but reaching the smallest microfinance institutions has remained difficult, partly due to the associated costs on the institutions.

25. **Despite the growth and popularity of MFIs, questions remain about the effect of microfinance on poverty alleviation and about best practices.** Empirical studies on the effects of microfinance on poverty reduction have yielded mixed results, some finding a positive impact and others negligible effects. These studies, though, face key methodological difficulties, since the clients of MFIs are not selected at random from the population. For instance, MFI clients may have higher consumption than other individuals because they are more capable and entrepreneurial, not because they have access to credit (self-selection bias).

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[13] See for example, Hardy, Holden, and Propolenko (2002).

Conversely, areas served by MFIs may not do better than other areas because MFIs choose to locate in especially difficult environments (program placement bias). The evaluation of microfinance programs are further complicated by measurement problems. For example, differences in consumption between users and non-users of microfinance may not measure impact accurately, because money can be used to other ends.[14] While research efforts continue, MFIs and their sponsors have not been very supportive of rigorous evaluation of existing programs. Also, while a lot of experimentation occurs in the field, for instance using different techniques for enforcing loan repayment, systematic learning from experimentation and evaluation of different program remains limited.[15]

26. **A number of practitioners believe MFIs should aim at achieving profitability after an initial phase of subsidization to help cover start-up costs, but others disagree.** The case for early subsidization of microfinance is akin to infant industry arguments, and suggests the importance of setting up a clear and credible roadmap for the phasing-out of external support. Otherwise, the relaxation of budgetary constraints on MFIs may hinder their performance and create unwarranted dependence on external funding, especially if MFIs lack adequate transparency and accountability. Proponents of commercialization consider profitability as proof that microfinance is fulfilling its goals, and see self-sufficiency as necessary for the industry to grow in the future. They are also concerned that, as nonprofit organizations, MFIs may not have appropriate ownership structure, staff, operational systems, and incentives to improve the efficiency of their operations. Others, in contrast, see microfinance as a poverty alleviation tool, and stress the benefits of keeping lending rates low and reaching the most destitute members of society. They point out that the merits of subsidization should be decided on the basis of a cost-benefit analysis and comparisons with other anti-poverty programs.[16]

27. **There are some counter arguments regarding the subsidization of MFIs for poverty alleviation.** The subsidization of MFIs for income redistribution may also have some other pitfalls. For example, the provision of financial services to the very poor is a costly activity relative to the volume of resources channeled. Thus, a disproportionate part of the resources could be dissipated in administrative and operative expenses. Equally important, subsidization of MFIs could create a distortion, resulting in unfair competition with traditional financial institutions, and curtailing the development of a more sophisticated and commercially oriented financial sector. In other words, financial sector deepening may be actually hindered by improper subsidization of microfinance activities, that is, in areas that can be potentially covered by commercially-oriented institutions. A question that remains open is whether MFIs have an intrinsic advantage over traditional financial

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[14] On microfinance program evaluation, see Murdoch (1999).

[15] On the issue of appropriate evaluation of development programs, see Duflo and Kremer (2003).

[16] On these issues, see Armedáriz de Aghion and Murdoch (2003b).

institutions in the implementation of microfinance technologies, and whether subsidies, if required, should be routed through MFIs or through the more traditional banking sector.

Regulation and supervision of microfinance

28. **In most countries, MFIs are inadequately regulated and supervised.** So far, the growth of microfinance has occurred by and large outside a regulatory framework.[17] This, however, is beginning to change, as governments are considering whether and how to regulate MFIs. The area is still in its initial stages and there are different views on regulatory alternatives, but the general guiding principles are broadly shared among experts.[18] From a prudential perspective, the case for regulating MFIs depends on whether they are large enough to pose a threat to financial stability (either directly or through contagion effects to other financial institutions), and whether they engage in financial intermediation (i.e., they accept deposits to fund their lending operations). In the first case, prudential regulation and supervision is aimed at protecting the integrity of the financial system as a whole. In the second, it is aimed at protecting small depositors who are not well prepared to assess the soundness of a financial institution. If these two conditions are absent, an alternative, nonprudential regulatory approach may be more appropriate for both MFIs and supervisory agencies.

29. **A key issue, therefore, is to determine whether prudential regulation and supervision should be applied to MFIs**, or if nonprudential regulation is sufficient to limit the potential risks posed by MFIs. Typically, prudential supervision is more complex and expensive than nonprudential regulation, since it requires the regular monitoring of the supervised institutions by a specialized financial authority. Adding MFIs to the group of supervised entities comes at the risk of creating a supervisory responsibility than cannot be properly fulfilled, or of diverting supervisors' attention from other, more systemically important, institutions. This is especially true in developing countries, where supervisory authorities have limited resources to perform their duties. At the same time, compliance with prudential rules is also costly to the supervised entities and may be especially burdensome to MFIs, adding to their already high operational expenses.

30. **Under current circumstances, the costs of bringing MFIs into prudential supervision would probably exceed the associated benefits in the majority of countries.** As mentioned before, despite the large number of clients served by MFIs, the overall sector remains small in terms of size and does not pose major risks to financial stability or to the integrity of the payment systems in most countries. At the same time, a large part of MFIs obtain funding from grants and loans from various sources, including donors, bilateral and multilateral agencies and the private sector, and are therefore not good candidates for

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[17] In a number of countries, this has allowed MFIs to sidestep regulatory ceilings on lending interest rates applicable to formal credit institutions.

[18] A detailed discussion is provided in the Consultative Group to Assist the Poorest (2000).

prudential supervision. In other cases, deposit-issuing MFIs are small enough so that the costs of prudential supervision most probably exceed its benefits, even after taking into account the existence of implicit—or explicit—deposit guarantees on MFIs. In fact, the resulting balance between the benefits and costs would not necessarily imply the need for supervision in many cases, while in others the size and level of development of MFIs may only justify a tailored supervisory approach.

31. **As an alternative to prudential supervision, countries could implement a nonprudential approach** that relies on the enforcement of a set of registration requirements, laws, and regulations that are self-executed by the MFIs or by umbrella organizations. In any case, the decision on how to regulate MFIs will vary on a country-by-country basis and should be revisited over time and adapted to the changing characteristics of the microfinance industry (Box 3).

32. **The regulatory framework can, in some cases, encourage the formation of MFIs or widen the scope of existing ones.** Support for MFIs may come from regulations, as governments try to introduce new legislation to promote microfinance activities or to allow existing NGOs to evolve into deposit-taking status. In these cases, the critical issue is to assess whether the interaction between the new regulations and the overall regulatory framework creates opportunities for regulatory arbitrage, impedes the integration of microfinance activities into the broader financial sector, or inhibits innovation by MFIs. One alternative to minimize some of these potential pitfalls is to focus microfinance regulation on the activities themselves, regardless of the type of institution that carries them out. For example, regulations on microcredit could apply equally to MFIs or to commercial banks that decide to enter into this segment.

33. **As a complement of the regulatory framework, efforts could be made to disseminate basic principles guiding specific aspects of microfinance activities.** Properly designed standards and guidelines may also provide a set of basic principles facilitating good practices, but attention has to be paid to avoid the risk of limiting product innovation, which is a key characteristic of the microfinance industry. Guidelines may be also considered on complementary aspects of microfinance, such as audit protocols and accounting rules.

Box 3. The Regulatory Environment of MFIs

Regulation of MFIs is still at an early stage. In most cases, governments are following a practical approach, adopting flexible rules for licensing, regulating, and supervising MFIs, to reflect their reliance on deposit-taking and potential systemic impact. In addition, regulatory frameworks of MFIs are sometimes adapted to promote microfinance activities, seeking to balance the benefits of an increased supervision with the associated costs.

In **Bolivia**, a nonbank special charter was introduced recently to encourage the formalization of MFIs as nonbank financial intermediates, and to place them under the supervision of the Superintendency of Banks. Under the new charter, MFIs are allowed to operate with lower minimum capital requirements than commercial banks and to mobilize deposits, with the exception of checking. In recent years, several MFIs have been able to formalize their operations improving their outreach and cost-effectiveness with the technical and financial support from international networks and donors. These include *Caja Los Andes* and *FIE*, two MFIs recently incorporated as nonbank financial intermediaries, and *BancoSol* which was allowed to incorporate as a commercial bank.

In **Benin**, prudential regulations on MFIs are less comprehensive and stringent than for commercial banks. Current prudential regulations for deposit taking MFIs include six ratios relating to liquidity and stability of resources, risk concentration, and limits on activities other than saving and credit. MFIs are not subject to capital adequacy requirements, but liquidity requirements, and the coverage of medium- and long-term liabilities are broadly similar to those that apply for commercial banks. On the other hand, limits on concentration risks on a single member are substantially less stringent than for commercial banks. At the institutional level, the supervision and monitoring of MFIs is conducted by the Microfinance Unit (MFU) of the Ministry of Economy and Finance, with cooperation from the regional central bank. Besides monitoring the annual financial tables received from the microfinance institutions, the MFU conducts an increasing number of on-site inspection visits each year, although the resources to conduct a sound supervision of MFIs are insufficient.

In **Ghana**, the rural microfinance sector (RMF) has evolved into a three-tiered structure—formal, semi-formal, and informal—with a strong savings orientation and a much greater role of licensed institutions, relative to nongovernmental organizations (NGOs), than in many countries. Banking institutions, in particular the Rural and Community Banks (RCBs), and formal Savings and Loans Companies, account for most microfinance activities. The regulatory approach has been gradually adapted to the diverse structure of the RMF sector in Ghana. Currently, the regulatory framework provides a strong licensing system for the formal sector, formal registration for the semi-formal sector, and a relative laisser-faire stance for informal institutions. Given the high costs of supervising a large number of RMFs and the limited supervision capacity of the Bank of Ghana, the authorities have decided to rely on regulatory requirements to offset their supervisory limitations, including high reserve requirement for RCBs, minimum capital requirements for S&Ls, and relying on self-regulation of semi-formal deposit-taker MFIs through an apex body.

In **The Philippines**, the government has been working to create an enabling legal and regulatory framework for the growth of sustainable MFIs. The General Banking Law enacted in 2000 led to legal and regulatory changes to microfinance. Modification of regulations tried to accommodate cash flow-based lending, allow the entry of new microfinance-oriented rural banks, facilitate branching, and open a special rediscount window to provide liquidity assistance for banks under certain eligibility requirements.

In **Sri Lanka**, the regulatory and legal environment remains fairly weak. In particular, there are limited institutional options for the transformation of semiformal MFIs into commercially viable banks. Many prudential guidelines (capital requirements, loan documentation requirements, branching restrictions, supervision methods) remain incompatible with the successful operations of MFIs, based on nontraditional modes of lending and operational methods. The Cooperative Development Department very loosely supervises the Cooperative Networks, but it lacks proper equipment for prudent regulatory oversight. In addition, the existence of an inadequate framework for securing transactions hinders the willingness of MFIs to lend and scale-up their operations.

Complementary public policies

34. **The deepening of financial markets can also be supported by sound macroeconomic and financial sector policies.** Macroeconomic stability, grounded on a sound fiscal stance and an adequate combination of exchange and monetary policies can lower country risk, support the development of long-term credit markets, deepen financial markets, and enhance access to financial services. At the sector level, sound prudential regulation and supervision of traditional financial institutions can facilitate the exit of nonviable financial intermediaries, reduce the excessive number of institutions that characterizes many emerging and developing countries, and improve competition, which also translates into deeper financial markets.

35. **Improvements in the legal and institutional frameworks can also promote access to finance.** The entitlement of property rights and the upgrading of property registries in developing countries can broaden the collateral basis of low-income segments of the population and facilitate their incorporation into formal markets. Improvements in the legal and judicial systems, including the protection of creditors and an adequate bankruptcy framework, may also contribute to deepen the reach of traditional financial institutions.

36. **The public sector has an important role in the alleviation of informational problems in financial markets.** Credit bureaus and other credit reference services are powerful tools to enhance access to finance. By conveying information on credit history, they help alleviate information deficiencies, and strengthen borrowers' incentives to repay. In developed countries, well-functioning credit bureaus have induced a more aggressive lending behavior by financial institutions, lowering collateral constraints and enhancing the availability of credit to lower-income groups. The public sector may provide this service directly, or rely on its provision by private companies, enacting regulations on the information content of credit databases and rules on its uses to protect fairness and privacy.

IV. THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS IN MICROFINANCE

37. **The development of an efficient and healthy microfinance industry is consistent with the Millennium Development Goals (MDGs).** While this falls primarily within the scope of the World Bank's activities, it is also consistent with the Fund's objective of encouraging progress toward the MDGs in the context of the Monterrey Consensus. This section briefly describes the activities of the World Bank Group (WBG) and other institutions in support of microfinance, and discusses the potential role of the Fund.

Activities of the WBG and other institutions in promoting microfinance

38. **As noted earlier, despite some success stories, MFIs often face a range of constraints**, including: limited diversification of risks as clients, such as small-scale agricultural processors in rural areas that tend to be engaged in similar activities; limited capacity coupled with high operating and administrative costs; low deposit mobilization; and limited links to the formal banking system in the context of a weak supervisory framework.

The activities of the WBG and other institutions aim to address a number of constraints on MFIs development by making efforts on several fronts. These include the following:

- encouraging a more diverse range of MFIs and other financial entities to serve the variety of financial needs of the poor;
- attracting greater commercial investment and ensuring competition so as to provide affordable and efficient service in the provision of microfinance;
- supplying appropriate training to both MFI and government/central bank officials; and
- providing a suitable regulatory environment, while avoiding interference in the commercial operation of MFIs.

39. **The WBG activities recognize that the broader policy environment in which MFIs operate is also a critical consideration.** In particular, it is seen as important that country authorities shift emphasis from regulating business operations to building institutions that facilitate business by supporting an efficient and fair functioning of markets. The strengthening of property rights and of institutions that establish and enforce the rule of law through legal and judicial reform and reduction of bureaucratic harassment, is identified as a key area of reform.

40. **The WBG also recognizes the importance of integrating microfinance into formal financial systems, to ensure permanent access to financial services for significant numbers of poor people.** The WBG, perhaps the leading agency in this area, pursues a strategy to increase access to financial services by low-income households, by focusing on three principal areas:

- The policy, legal and regulatory frameworks required to facilitate the development of innovative financial institutions and instruments;
- Exposure to, and training in best practices that banks and microfinance institutions need to expand their outreach and develop sustainable operations; and
- Leasing, lending and other products that the WBG can use to increase access to financial services.

41. **The WBG pursues these objectives through a number of activities and instruments.** The World Bank has taken the lead in covering microfinance issues in FSAPs, including legal and regulatory frameworks for MFIs, and capacity building. In addition, the World Bank conducts Economic & Sector Work (ESW) on operationally relevant topics in microfinance. The findings of ESWs are instrumental in designing the work of the WBG in microfinance, including: (i) lending and investing (through the International Finance Corporation) in projects that enable MFIs to build their portfolios and extend outreach to the poor; (ii) disseminating best practices and providing training through, for example, the World

Bank Institute; and (iii) pressing for improved business climate in countries through policy advice and project conditionality. The WBG is also a major financial supporter of the Consultative Group to Assist the Poorest (CGAP), a multi-donor microfinance that acts as a service center for MFIs and other practitioners and member donors.[19] In parallel, the World Bank contributes to donor coordination in the area, by serving as the secretariat for the Donor Committee for Small and Medium Enterprises (SME) Development, a group of multilateral and bilateral donors and NGOs that fund SME development projects.

Box 4. Cooperation between DFID, CIDA, SIDA and RNE in Funding Microfinance in Tanzania

The coordination between donors in Tanzania is helping avoid duplication of tasks and improve resource allocation. Recent cooperative efforts between donors include the following:

- Support for government policy through the joint Tanzania Pro-poor Financial Sector Deepening Program which supports the government's National Microfinance Policy.
- Joint principles for pro-poor financial system development: the donors agreed on joint principles for action. For example, they agreed on a business approach to building the market, including an exit plan and allowing instruments to evolve as markets develop (e.g., from start-up grants to commercially-priced loans for more mature institutions).
- Harmonization of donor procedures such as accounting and reporting requirements and procurement policies.
- Establishment of a joint, professionally managed, trust fund that supports a range of initiatives, such as building retail capacity in credit unions and banks, establishing a credit rating system, and preparing policy guidelines and regulations.

42. **Many donors are active in the area, with some of the larger organizations having their own microfinance programs.** Microfinance has attracted many donors, some with large microfinance programs, such as UNDP, USAID, GTZ (Germany), AFD (France), CIDA (Canada), DFID (Great Britain). Also, many regional development banks (IADB, AsDB, AfDB), along with several central banks provide support to microfinance. Unfortunately, coordination between these organizations has been insufficient. There is room for the harmonization of their efforts and resources with the objectives, policies and activities defined by national, and sometimes regional, governments. In recent years, some donors (particularly small agencies with grant funding and thin technical capacity) have been increasingly leveraging their resources through joint programs (Box 4). Pooled funding can allow the consistent application of shared principles, increase the range of funding

[19] The CGAP provides on-site technical advice and assistance to MFIs, as well as training and capacity-building, through regional training hubs. It also develops technical tools for microfinance practitioners; helps disseminate best practices and develops performance standards; contributes to improving donor practices through training and coordination; and provides grants to a small number of promising MFIs on a performance-contract basis.

instruments, improve the leverage of specialist resources, and reduce the costs of program administration.

The scope for Fund activities on microfinance issues

43. **The Fund's involvement in microfinance should be consistent with its mandate and tailored according to the expertise of its staff.** The Fund's interest in microfinance mainly derives from its potential consequences for macroeconomic performance and financial stability. Given the small size of the microfinance industry, the Fund's involvement in this area is likely to remain limited, unless the industry becomes of systemic importance in specific countries. Activities that require expertise in the design of microfinance schemes are better suited to other institutions more active in this area, such as the World Bank.

44. **The Fund could contribute to the efforts to improve data generation on the microfinance industry.** It could collaborate with ongoing World Bank initiatives in this area, supporting the design of a basic set of indicators and encouraging their compilation in member countries, as appropriate. In the context of the UN Year of Microfinance, the Fund—in collaboration with the UNDP and the World Bank—sponsored a workshop to assess data needs and potential sources.[20] Following up on this initiative, the Fund is considering the possibility of undertaking a pilot project, based on a survey of central banks and regulators, to help determine data availability in a small sample of countries from all major geographical areas.

45. **A number of aspects of the Fund's operational work are indirectly relevant to microfinance.** By helping developing countries achieve macroeconomic stability, the Fund contributes to establishing a basis for sustainable growth in which MFIs can function effectively. Also, by promoting structural reforms in the financial sector and related legal reforms, the Fund contributes to the enhancement of the policy and institutional environment under which MFIs operate. The Fund can also assess the role of microfinance in specific countries, considering the direct and indirect fiscal costs associated with subsidization of microfinance. While the World Bank has an advantage on donor coordination, the Fund could cooperate on an as needed basis in this area. The Fund could also encourage donors to support data generation and the evaluation of microfinance programs. Working along these dimensions, the Fund can play a constructive but limited role, in advising governments on policy development.

46. **The Fund can make these contributions through a number of channels** in its work in developing countries:

- Through its surveillance work, the Fund develops an overall evaluation of the macroeconomic situation and the soundness of the financial system, making policy recommendations to help reduce existing weaknesses. In countries with a significant

[20] The seminar was held in October 2004.

microfinance industry, and to the extent appropriate information is available, the analysis of the financial system could include aspects of microfinance that are deemed relevant to macroeconomic and financial stability.

- Under Fund-supported programs, the Fund, in collaboration with other International Financial Institutions, may call for policies, or structural conditionality, to improve the financial sector environment and the legal framework, and thus indirectly affect the microfinance industry. This is particularly true for Poverty Reduction and Growth Facility programs, which are based on country-driven participatory PRSPs which normally cover microfinance.

- Policies related to microfinance have already begun to be addressed by the Fund staff in their coverage of development issues in the joint Bank-Fund Financial Sector Assessment Program (FSAP) in low-income countries. Tanzania was the first case of an FSAP with emphasis on development finance issues (Box 5). The topics covered in FSAPs could include, for example, institutional and regulatory aspects of microfinance, or policies to foster financial deepening.

- Through technical assistance, including the Africa Regional Technical Assistance Centers (AFRITACs), the Fund contributes to strengthening key policy aspects related to the financial sector, such as the regulatory and supervisory frameworks of traditional financial institutions. The Fund is well positioned to play a role in this area, and is extending its expertise to improve the regulation and supervision of MFIs. Similarly, technical assistance related with bank resolution mechanisms could be extended to cover the insolvency framework of MFIs, if a different or modified framework is deemed necessary.

Box 5. Microfinance in the Context of the FSAP: The Case of Tanzania 1/

The microfinance sector is frequently reviewed in the context of the Financial Sector Assessment Program (FSAP) in developing countries. While the exercises are adapted to reflect individual country characteristics, they typically include an assessment of the microfinance sector's performance, and its regulatory and institutional framework. The final report provides a list of policy recommendations to help improve the performance of the microfinance industry. These policy recommendations provide guidance for subsequent technical assistance in specific policy areas, and sometimes are used as part of structural conditionality under Fund-supported programs. The main findings of the Tanzania FSAP, concluded in 2003, were as follows:

- Microcredit accounted for almost 5 percent of all bank credit. The main providers were Savings and Credit Cooperatives (SACCOs), microfinance NGOs, and a few commercial banks. Despite some improvements in the access to formal credit, outreach remained very limited. Overall, the outstanding microcredit portfolio represented less than 0.4 percent of GDP (around US$35.3 Million), and 3.6 percent of total money. Credit from the SACCOs and the NGOs only amounted to 0.25 percent of GDP. MFIs served no more than 2.5 percent of the number of households. Extensive bureaucratic and nontransparent procedures and corruption hindered further access to finance.
- Microfinance NGOs were found to be heavily reliant on donor funding, whereas SACCOS were financed by share capital, loans and grants. Financial institutions were usually reluctant to lend to donor-dependent NGOs. The main commercial banks involved in microfinance were deposit-takers, with a total deposit mobilization of about US$336 million, equivalent to 15 percent of the system's total assets. In strong contrast, their total microlending did not exceed US$12.5 million or about 0.6 percent of the system's total assets.
- SACCOs failed to play a significant role in financial intermediation, mainly due to inconsistent government policies, flawed internal control mechanisms, weak governance structures, and inadequate regulatory framework.
- In 2003, legislative and regulatory changes concerning microfinance institutions were enacted to ensure prudential regulation. The FSAP assessed the new regulatory framework and called for a menu of regulatory options tailored to the scale of operations and range of services of MFIs. It emphasized the risk of imposing impractical heavy reporting and auditing burden on small cooperatives. On the other hand, it welcomed thorough supervision for larger deposit-taking institutions.
- The legislation also called for the regulation and supervision of all savings and credit societies with deposits above the proposed minimum core capital of licensed Microfinance Companies (MFCs). The FSAP cautioned against the effects of minimum capital requirements on entry into prudentially supervised status, and recommended a grace period of almost five years to enable graduating institutions to comply with the new MFCs requirements.
- In addition, the FSAP encouraged the development and strengthening of umbrella organizations, greater reliance on local banks rather than on external donor funding, and rigorous capacity building to help realize the development potential of microfinance institutions.

1/ See Tanzania FSSA: IMF Country Report 03/241, August, 2003.

V. CONCLUSION

47. **Microfinance activity has grown in recent years and MFIs can now be found in many countries at different stages of development.** Its size and scope is expected to grow

further in view of the largely unmet demand for financial services by the poor. Although experience does not provide clear-cut lessons on how best to maximize the benefits of microfinance, it is evident that financial services tailored to the unserved population broadens the reach of financial markets. Microfinance activities have so far tended to depend heavily on financial support from external sources, including bilateral and multilateral development organizations, that are attracted by their potential for poverty reduction and economic growth.

48. **Microfinance activities pose public policy choices that deserve careful consideration.** Frictions in financial markets may prevent efficient transactions from taking place which may affect the poor disproportionately. Such market failures are likely to be more prevalent in developing countries due to various institutional weaknesses. By implementing novel means for lending and saving, MFIs may be able to develop missing markets, and thereby provide broader access to financial services and contribute to economic efficiency. An open question, however, is whether MFIs offer an intrinsic advantage over more traditional financial institutions. Moreover, whether MFIs can become financially self-sustaining and eventually integrate with the formal financial sector remains the main challenge ahead.

49. **Microfinance can also serve as a vehicle for poverty reduction, but prolonged subsidization of MFIs can be detrimental.** Access to financial services may provide the poor with the wherewithal to cross the poverty line. The resulting empowerment could minimize the dependency on other more traditional redistributive mechanisms, while repaid resources can be recycled to other users and further leverage donors' money and help make the operation self sustaining. On the other hand, MFIs tend to have larger operational costs per unit lent and thus use up more resources in administrative expenses. The effectiveness of MFIs as a poverty reduction device needs to be assessed in relation to other alternatives on a cost-effectiveness basis, although the lack of systematic data on the industry renders this difficult. Channeling donor funding into microfinance without a proper assessment of the associated benefits and costs entails the risk of diverting scarce resources from other primary areas, such as health and education. Subsidization of MFIs may also relax their budgetary constraints and create unfair competition with traditional financial institutions, preventing them from entering the microfinance niche.

50. **Regulation and supervision of MFIs is still at an early stage and appears to be lax in the majority of countries.** The degree of prudential regulation of MFIs depends on the extent to which they intermediate deposits and pose a threat to financial stability. Despite the large number of customers being served by MFIs, the industry size is still rather small and does not entail systemic risks in most countries. On the other hand, to the extent that MFIs are moving into traditional financial intermediation, regulatory and supervisory approaches need to be considered. The optimal regulatory approach will need to take into account the specific circumstances of individual countries. In this context, the risk of diverting scarce supervisory resources from other, systemically important, financial institutions should be avoided. Overburdening MFIs with information and compliance requirements is also inadvisable. A lighter regulatory approach may be warranted, but this

should minimize discrimination against traditional financial institutions and guard against establishing legal loopholes and opportunities for regulatory arbitrage.

51. **The current overlap between the Fund's mandate and microfinance activities appears to be limited.** While MFIs reach a large number of clients, their size remains too small to pose any significant risk to financial stability. The Fund can contribute to the deepening of financial markets in developing countries by helping improve the policy and institutional frameworks of the financial sector and continuing to promote macroeconomic stability.

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