Chapter 7

Rural and Microfinance Institutions: Regulatory and Supervisory Issues

7.1 Overview

The providing of financial services to the poor and the very-poor, particularly in rural areas, is the purpose of microfinance institutions (MFIs), and the assessment of the regulatory framework for MFIs is part of broader assessment of adequacy of access. Access, however, is multidimensional, and assessing its adequacy requires a review of (a) the range of financial services provided—and target groups served—by several tiers of formal, semiformal, and informal financial institutions; (b) the demand for financial services from households, microenterprises, and small businesses at different levels of the income strata; and (c) the different combinations of financial service providers, the users of those services, and the range of services that prevail in different geographical segments of the market. The primary objectives of the assessment of the adequacy of access are (a) to identify the gaps that exist (and that need to be corrected) in the range of products that are available for different layers of households, microenterprises, and small businesses in various geographic markets; and (b) to assess whether the regulatory framework for financial transactions helps expand or restrict access to the needed financial services.

7.2 Rationale for Assessing the Regulatory Framework for Rural Finance and Microfinance Institutions

The core objectives for the regulatory framework are the same for microfinance activities and institutions as for other components and segments of the overall financial system. However, the key principles and standards for the design of a regulatory framework for

institutions providing financial services to the rural finance and microfinance sector are likely to be different from those for formal banking and finance institutions, because the design must consider the operational, market, and client characteristics of the rural finance and microfinance sector. This section focuses on the regulatory framework issues that have an important influence on access to financial services for low-income rural households.

The term *financial services* extends beyond the traditional credit products and savings deposits facilities provided to varying degrees by different types of rural finance and microfinance institutions. See section 7.3 and table 7.1 in that section for a listing and discussion of various types of MFIs, including those linked to nongovernmental organizations (NGOs) and various non-bank institutions). The term includes payments, money transfer and remittance services, and insurance and contractual savings products. It is important to focus on access to payments and savings products by different segments of the population and the supply of those products by different institutions. Payment and savings products are often the most important financial services for low-income households. Improved access to savings product can help households achieve higher returns on their savings and smoother cash flows, and can reduce vulnerability to external shocks.

The degree and quality of access to financial services available to low-income rural households and their small businesses is influenced by the quality of the legal and regulatory framework. This framework should be guided by the following core principles of good microfinance: (a) to provide a level playing field among participants in the provision of a range of financial services beyond credit and savings facilities; (b) to allow the institutional transformation of nontraditional and non-regulated MFIs (such as multipurpose and microcredit NGOs) into specialized, regulated, or licensed rural finance and microfinance intermediaries; (c) to promote and reward transparency in financial accounting and transaction reporting; and (d) to foster the exchange and sharing of credit histories of borrowing clients.

Available data and information show that deeper, more-efficient financial markets can contribute to accelerated agricultural growth and better food security. Scaling-up access in rural markets to a wider array of financial services through a varied range of financial intermediaries becomes critical to help low-income rural households smooth consumption and enhance labor productivity, which is the most important production factor controlled by the poor. Also, agriculture has strong forward and backward multiplier effects for the overall economy. Economic growth in agriculture is a key precondition for overall economic growth and poverty reduction, given that most of the world's poor still live in rural areas (Robinson 2001; Zeller 2003)

There are examples of agricultural development banks, MFIs, and credit unions developing strong rural portfolios, while commercial banks do not generally seem to fit this market niche as readily. Some MFIs have tried to transform from nongovernmental status to a regulated, supervised financial institution; however, with notable exceptions, this has not proven to be a reliable route to improved rural outreach of financial services. In general, commercial banks have not entered the rural and agricultural credit markets on a substantial scale in most developing countries, despite incentives designed to encourage downscaling and rural market penetration.

In a few countries, agricultural development banks have succeeded in transforming themselves into more-sustainable institutions by offering demand-driven financial ser-

vices, building credible lending contracts, and using full-cost recovery interest rates. The experiences of Thailand's Bank for Agriculture and Agricultural Cooperatives (BAAC, Bank Rakyat Indonesia's (BRI) village units in its microbanking system (Yaron and Charitonenko 1999; Zeller 2003), and the revival and restructuring for privatization of Mongolia's Agricultural Bank (Boomgard, Boyer, and Dyer 2003) and of Tanzania's National Microfinance Bank demonstrate that state-owned banks can be transformed into dynamic, profitable, and successful rural-oriented financial intermediaries with business-oriented management reforms. Of course, such transformation of state owned banks can be achieved only with firm political commitment, ownership of reforms, management autonomy, and incentives (Zeller 2003).

Group-based models have built impressive portfolios in rural markets; savings and loan cooperatives and credit unions have grown rapidly in diverse settings.[1] Emphasis on the importance of large-scale operations, internal systems, attractive products, and portfolio quality has contributed to improvements in performance. In addition, the village banking methodology[2] pioneered by FINCA International has shown, in many cases, that rural community-based and self-managed financial entities can become self-sustaining. This model was later adapted with changes by CARE, Catholic Relief Services, World Vision, and even a few commercial banks.

Several MFIs have shown that they can profitably serve large numbers of relatively poor households, microenterprises, and small businesses. Although the client base is typically in peri-urban markets or in off-farm business activities in rural markets, those experiences have renewed interest in the feasibility of reorienting rural finance and microfinance institutions. There is a growing list of MFIs that have moved beyond their initial urban client base to tailor their products to rural clients, including the Equity Building Society in Kenya, CrediAmigo, a bank-affiliated MFI in Brazil and the Development Bank of Brazil (BNDES), MiBanco in Peru, Financiera Calpia in El Salvador, and Basix India Ltd, a micro–credit institution serving the rural poor in India. The experiences of these MFIs point toward the possibilities of adaptation and replication by other MFIs operating in predominantly rural markets.

The rural finance and microfinance sector is small relative to the commercial financial sector, with limited effect on the overall stability of the financial system. In a large number of developing countries, the total loans outstanding in the rural finance and microfinance sector was about 1 percent of broad money supply (M2), with this sector reaching fewer than 1 percent of the population as clients. A handful of countries stand out from the rest with higher levels of microfinance outreach and penetration, especially in Indonesia (6.5 percent); Thailand (6.2 percent); Vietnam and Sri Lanka (4.5 percent); Bangladesh and Cambodia (3.0 percent); Malawi (2.5 percent); and Bolivia, El Salvador, Honduras, India, and Nicaragua (at 1.0 percent or slightly more) (Honohan 2004).[3]

7.3 Institutional Providers of Rural Finance and Microfinance Services

The distinction between microfinance and small and medium enterprise (SME) finance and the recognition of the different types of financial institutions catering to those

segments are important to the assessment of the adequacy of access and the effect of regulation. While different categories of borrowers often face similar constraints, lenders commonly distinguish between microfinance, which refers to credit provided to poor households and to informal (i.e., unregistered) microenterprises, and SME finance, which refers to credit given to enterprises registered as large microenterprises, small businesses, and medium-size enterprises.

There are several important differences between the two categories of borrowers. Microfinance is most often provided by non-bank institutions such as NGO MFIs that are often based on the group-lending approach (although numerous microfinance loans may consist of loans to individuals rather than to groups), as well as various membership-based financial cooperatives and mutual-assistance associations. SME finance is provided mainly by banks, building societies, and non-bank financial institutions (NBFIs) and does not use a group-lending approach. Another important difference is security: Microfinance is almost never formally secured, although informal security (i.e., not legally binding) in the form of collateral interest over household goods and tools is commonly used, while SME finance usually allows a firm's assets or personal guarantees to legally secure small business loans. Those differences create a natural separation between the institutions that specialize mainly in microfinance and the institutions that provide small business loans, although some institutions do provide both kinds of finance services.

Institutional providers of financial services to low-income rural households, microenterprises, and small businesses fall into several categories according to the scope of regulation, type of ownership, and type of services offered. The institutions can be differentiated on (a) whether they are required to obtain a license to carry out financial intermediation activities, to be registered with some central agency (but not required to obtain a license) that will provide nondeposit credit-only services, or to be registered as a legal entity; (b) what type of organizational format, including ownership and governance aspects, they have; and (c) what types of financial services are permitted and provided. The principal categories are

- government programs or agencies for rural finance, microfinance, or SME finance
- non-bank, nonprofit NGO MFIs
- membership-based cooperative financial institutions (CFIs)
- postal savings banks (PSBs) or institutions
- development finance institutions
- specialized banking institutions (usually licensed for limited operations, activities, or services to differentiate them from full-service commercial banks) such as rural banks, microfinance banks, and non-bank finance companies
- commercial banks

Key differences in the organization and operation of those different institutions are highlighted in table 7.1. The institutions differ in terms of what products and services they are allowed by law and regulation to offer; whether they are subject to rigorous prudential regulation, internal governance structure, and accountability; and how funds for administrative and business operations are sourced. The differences arise from the applicability of legal and regulatory requirements, and those differences have important

Table 7.1. Institutional Providers of Financial Services

Institutional provider	*Organizational format*	*Ownership*	*Regulatory status and how regulated*	*Financial services permitted to be offered*
Government rural or micro or SME finance programs or agencies	Trust fund or agency	Government	Not regulated by banking authority	Wholesale or onlending funds to participating institutions
Non-bank/nonprofit/ NGO MFIs	Nonprofit foundation, trust, or association	Private sector entities or organizations	Not regulated by banking authority	Microfinance loans only; no voluntary deposits
Membership-based cooperative financial institutions (CFIs)	Savings and credit cooperative organization (SACCO) or credit union	Members	Not regulated by banking authority, but may be regulated by department in cooperative	Savings and time deposits and loans to members only
Postal savings banks (PSBs)	State-chartered institution	Government	Not regulated by banking authority	Savings and time (fixed) deposits only and money transfers
Development finance institutions	State-chartered institution	Government	May or may not be regulated by banking authority	Wholesale certificates of deposit, loans, and credits
Specialized banking institutions				
Rural banks	Limited liability company	Private sector investors or shareholders	Licensed or supervised by banking authority	Savings and time deposits, loans, and money transfers
Microfinance banks	Limited liability company	Private sector investors or shareholders	Licensed or supervised by banking authority	Savings deposits, microfinance loans, and money transfers
Non-bank finance companies	Limited liability company	Private sector investors or shareholders	Licensed but not necessarily supervised by banking authority	Wholesale certificates of deposit, loans, and credits
Commercial banks	Limited liability company	Private sector investors or shareholders, or state-owned institution	Licensed or supervised by banking authority	Demand and savings and time deposits, loans, credits, money transfers, and foreign exchange; full banking services

implications for the outreach and sustainability of the institutions. For indicators of structure, outreach, and performance of MFIs, see box 7.1.

Not all institutional providers of financial services listed in table 7.1 may exist in a given country for a number of important reasons, including the stage of development of the rural finance and microfinance sector. In a number of countries, rural finance and microfinance services may be provided by several types of institutions.

7.3.1 Government Rural Finance, Microfinance, or SME Finance Programs or Agencies

The direct provision of rural finance, microfinance, and SME finance loans and credit facilities by government agencies or programs should be noted and examined in the assessment of adequacy of access. Those government programs usually have an unfair

Box 7.1 Benchmarks for Outreach and Financial Performance and Soundness of Rural Finance and Microfinance Institutions

Standards and indicators for the breadth and depth of outreach, the operating and financial performance, and the financial soundness of rural finance and microfinance institutions have been developed by an international network of donors and practitioners. Those standards and indicators have been adopted by prudential supervisory agencies and regulatory authorities in a number of countries. Among the more prominent examples are the standards and indicators developed and detailed in the monitoring systems developed by ACCION International (ACCION "CAMEL"), World Council of Credit Unions (WOCCU "PEARLS") and Microfinance Information eXchange (MIX). For purposes of comparison with and reference to best practices, the benchmarking standards published periodically by WOCCU, MIX (MicroBanking Bulletin), MicroRate, and Microfinance Centre for Central and Eastern Europe (CEE) and the Newly Independent States (NIS) are easily accessible. Those benchmarks can be useful in carrying out the assessment of adequacy of access for rural finance and microfinance institutions, and are summarized here.

- Breadth and depth of outreach
  - number of deposit accounts (because some institutions such as postal savings banks [PSBs] provide only deposit services)
  - number of active borrowers, and as a percentage of total population and of population at or below poverty line
  - average loan balance or amount per borrower, and as a percentage of (a) gross national product (GNP) per capita and (b) national poverty income level
- Financial structure
  - ratio of institutional capital to average total assets
  - ratio of equity to debt
  - ratio of average total loans outstanding to average total assets
  - commercial funding (market-price liabilities) as a percentage of gross loan portfolio
- Overall financial performance and soundness
  - adjusted Return on Assets (ROA)
  - adjusted Return on Equity (ROE)
  - operational self-sufficiency (revenue from loans, investments, and other financial services as a percentage of administrative and operating expenses)
  - financial self-sufficiency (revenue from loans, investments, and other financial services as a percentage of financial or interest expenses, loan-loss provisions, and administrative and operating expenses)
  - on-time loan repayment rate
  - portfolio at risk overdue greater than 30 days as a percentage of gross loan portfolio
  - loan–loss reserve as a percentage of portfolio at risk overdue greater than 30 days

competitive advantage over and tend to crowd out the private sector-based providers of similar financial services to households, microenterprises, and small businesses. In a number of countries, state-owned development finance institutions or specialized banks are the institutional vehicles used. The key issues to address in the assessment, aside from whether the institutional vehicles are reaching their target sector or client base and have, in fact, contributed to the development and expansion of the target sector, are (a) efficiency of loan collection, (b) incidence of loan defaults and adequacy of loan-loss provisions, (c) claims on budgetary or fiscal resources for loan guarantees and additional capital to cover operating losses, and (d) level of solvency or insolvency.

7.3.2 Non-bank, Non-profit NGO MFIs

Non-bank, non-profit NGO MFIs include (a) mixed-purpose NGOs that have credit provisions in their socially oriented activities and (b) specialized credit-only MFIs. Those MFIs are generally private sector-owned institutions and are typically organized as non-

profit foundations, trusts, or associations. In a number of cases, the MFIs are organized as formally incorporated entities under a country's Companies Act. Some MFIs are stand-alone local entities, while others may be affiliated with or sponsored by international NGOs such as FINCA, CARE, Catholic Relief Services, World Vision, ACCION International, and Women's World Banking. The geographical reach of their operations vary depending on their organizational and legal status and on the type of NGO sponsor, with some MFIs operating only at the district or county level others on a province-wide or region-wide basis, and a few on a nationwide scale.

7.3.3 Membership-Based CFIs

CFIs are (a) multipurpose cooperative associations (e.g., producers, services, marketing, and rural cooperatives) that include savings and credit functions; and (b) single-purpose, membership-based, financial cooperative organizations (e.g., credit unions and savings and credit cooperative organizations [SACCOs]). CFIs, which have been in existence in many countries much longer than non-bank, nonprofit NGO MFIs, are clearly distinguishable from the NGO MFIs in that their financial transactions (deposit taking and credit giving) are generally limited to registered members under a closed- or open-common bond, typically defined by geography (residence), occupation, or place of employment. The rights and privileges of ownership in CFIs are based on the one person–one vote principle, and management is exercised by members–owners. In general, CFIs will outnumber NGO MFIs in many countries, and their combined outreach will tend to be larger as well.

7.3.4 Postal Savings Banks

A PSB has the ability to reach a very large number of depositors for savings and time deposits in generally small amounts, and to provide payments and transfer or remittance services, particularly in the rural areas in a number of countries, including Azerbaijan, Kenya, Pakistan, and Tanzania. However, PSBs are limited to deposit-taking and payment services and do not extend credit. PSBs are intended primarily to provide a safe and secure facility for the small savings of poor and low-income households, especially in rural areas, even though the management and boards of PSBs may be tempted to expand into rural finance and microfinance lending services to improve earnings. In practice, the priority should be on improving efficiency, cost-effectiveness, and governance before broadening the asset portfolio beyond safe assets such as bank deposits and government issues.

7.3.5 Development Finance Institutions

In many countries, Development Finance Institutions (DFIs) have been established and funded by the Government to develop and promote certain strategic sectors of the economy (e.g., highly capital intensive investments, the agricultural sector) and to achieve social goals. DFIs are expected primarily to fill in the gaps in the supply of financial services that are not normally provided by the banking institutions. The DFIs also play a crucial role in the development of SMEs, the housing sector, and in some countries micro-

credit. The key issue to monitor is the extent to which DFIs are accorded special benefits in the form of funding at lower rates, implicit government guarantees to the institutions's debts, favourable tax treatment etc.

7.3.6 Specialized Banking Institutions

The regulatory framework for banking and finance in a number of countries also covers lower-tier licensed banks that have the legal capability for deposit-taking activities (generally limited to savings and fixed deposits) and for providing loans, but the capability excludes trust and investment services and foreign exchange or trading facilities. In some countries, banking activities may be limited to the geographical market area that is serviced (county or district, province, or region). The limited-service banking institutions, (e.g., rural banks and microfinance banks) are subject to prudential supervision by a country's central supervisory authority, and they are required to comply with reporting requirements and with applicable prudential standards. Non-bank finance companies involved in rural finance, microfinance, and SME finance—which do not take retail public deposits but are permitted to fund their operations and loan portfolios through commercial borrowings and wholesale, large-value, institutional deposits—are generally required to register and to obtain a license. However, those companies may not be prudentially supervised by a country's central supervisory authority.

7.3.7 Commercial Banks

Commercial banks may have direct participation in low-income markets as a result of their complying with directed or credit quota policies of government for targeted sectors. Sometimes, banks have indirect involvement in rural and microfinance as depositories of the operating funds of MFIs and CFIs, or they have involvement through commercially priced wholesale loans and credit facilities to MFIs and CFIs as bank clients. An important area to focus on is the existence of vertical and horizontal business relationships between commercial banks, on the one hand, and MFIs and CFIs, on the other. The importance of this point stems from the synergistic relationships that the smaller MFIs and CFIs can form with the larger commercial institutions from the formal sector, whereby the combination can reach a larger number of clients with resources than may be obtained from the latter large institution at commercial—not subsidized—rates and terms.

7.4 Conceptual Framework for the Regulation of Rural Finance and Microfinance Institutions

The aim of a supportive regulatory framework is to build strong regulated and unregulated institutions of all types (a) to provide services on a sustainable basis under uniform, common, shared performance standards and (b) to encourage the regulatory authority to develop appropriate prudential regulations and staff capacity that are tailored to the institutions' operational and risk profiles. This objective requires defining different tiers of financial institutions with different degrees of regulatory requirements. The requirements could vary from (a) simply registering as legal entities, to (b) preparing and publishing

periodic reports on operations and financial results, to (c) observing non-prudential rules of conduct in business operations, to (d) securing a proper license and being subject to prudential regulation by a regulatory authority, prudential supervision, or both by a central supervisory authority. Lower-tiers institutions serving the lower end of the market can enable non-bank microlenders to seek greater formalization without actual licensing.

As the rural finance and microfinance sector grows, adding a licensing tier that permits MFIs to legally mobilize savings and other commercial sources of funds can encourage capacity building and innovation that are aimed at self-sufficiency and greater outreach. Another approach that has been used is to open a special window for micro-lending as a product that enables commercial banks, as well as alternative specialized institutions, to benefit from different cost and regulatory structures. Licensing of rural and community banks can also facilitate the emergence of new types of MFIs that serve specific markets. However, the premature creation of special tiers with easy entry may result in weak institutions, may affect the development of the commercial financial system, and may risk overwhelming inadequate supervisory resources.[4]

Thus, the licensing of MFIs should be designed to balance promotional and prudential objectives. The main potential threats pertaining to deposit-taking MFIs are that (a) deposit-taking MFIs could collapse, thus adversely affecting the commercial system, and that (b) prudential regulation of deposit-taking MFIs could prove to be an administrative burden that distracts supervisors from adequately protecting the safety and soundness of the main financial system. The Consultative Group to Assist the Poorest (CGAP) *Microfinance Consensus Guidelines* (Christen, Lyman, and Rosenberg 2003) takes a balanced view, arguing that deposit taking on a small scale may essentially go unsupervised—especially where the deposits consist of only forced-savings components of the lending product, so that most depositors are net borrowers from the MFI at most times. This approach would leave the supervisory apparatus unencumbered from having to deal in-depth with a profusion of tiny MFIs.

A consensus on the framework for the regulation of rural finance and microfinance institutions has evolved on the basis of country experiences in recent years. This framework (summarized in table 7.2) identifies different categories and tiers of institutional providers of microfinance, and it specifies the thresholds of financial intermediation activities that trigger the need for progressively stronger types of regulation and supervision. The legal and regulatory framework for banking and finance in many countries may not include lower tiers for rural finance and microfinance banks. Some countries may be in the process of establishing the legal and regulatory framework specifically to create new tiers for rural finance or microfinance banks, which usually have a limited geographical coverage specified by law. Regulation of microfinance activities and institutions may take three main forms: (a) simple registration as a legal entity; (b) non-prudential regulations that provide standards of business operations and oversight, such as operating and financial reports to be submitted, to protect the interests of clients or members; and (c) full prudential supervision. Global experience illustrates that the benefits from regulating microfinance may be limited when commercial banking standards are applied to MFIs without adequate consideration of microfinance methodologies.

Non-bank finance companies and other types of registered institutions providing rural finance and microfinance services are not subject to statutory prudential regulation and

Table 7.2. Tiered Structures and Regulatory Triggers by Type of MFI

Type of microfinance institution (MFI)	*Activities that trigger regulation*	*Forms of external regulation*	*Recommended regulatory authority*
Informal savings and credit groups funded by members fees and savings	None	None required	None required
Category A: Nongovernmental organizations (NGOs) funded by donor funds			
Category A1: Funding only from grants	None, if total loans do not exceed donated funds, grants, and accumulated surplus	Registration as a nonprofit society, association, or trust	A registrar of societies or self-regulating body, if any
Category A2: Funding from donor grants and from commercial borrowings or securities issues	Generating liabilities through borrowings to fund microloan portfolio and operations	Registration as a legal corporate entity; authorization by a banking authority or securities commission	A registrar of companies, banking authority, or securities agency
Category B: Financial cooperatives and credit unions funded members' money and savings	Accepting deposits from and making loans to members	Registration as a financial cooperative	A registrar of cooperatives or banking authority
Category C: Special-licensed banks and MFIs funded by the public's money (deposits, investor capital, and commercial borrowings)	Accepting wholesale and retail public deposits for intermediation into loans and investments	Registration as a corporate legal entity; licensing as a finance company or bank (with full prudential requirements)	A registrar of cooperatives or banking authority

Note: This regulatory framework for the classification of MFIs was originally proposed by van Greuning, Gallardo, and Randhawa (1999) and modified by Randhawa (2003). Except for informal groups, MFIs are classified into four categories that are based on the structure of their liabilities (i.e., sources of funding). Cooperatives in category B have a long but inefficient history of regulation. If their deposit taking is small in scale and limited to their members, they should be given low regulatory priority. Category C should not include MFIs that require mandatory savings to secure loans as long as most customers are net borrowers most of the time. Formal banks with a microfinance department are not included in this regulatory framework because they are subject to prudential supervision, even if it is usually not adapted to the specific features of this segment of the financial system.

supervision by a central supervisory authority, because they do not mobilize retail deposits from the public and intermediate those deposits into loans and investments. Nevertheless, such institutions should observe and adhere to a set of rules and standards with respect to the conduct of their business operations to provide protection for their borrowing customers and for third-party providers of wholesale commercial funds, even though commercial fund providers and institutional investors are presumed to be well informed and to be capable of any required due diligence.[5] An overview of desirable standards for conduct of business is provided in box 7.2.

7.5 Assessment of the Regulatory Framework Issues for Rural Finance and Microfinance Institutions

The assessment of the regulatory framework for the rural finance and microfinance sector covers both the institutional aspects and the benchmarks used to evaluate the sector's performance and soundness. The considerations include (a) assessing the need for prudential supervision versus non-prudential regulation and for the technical capacity for supervi-

Box 7.2 Conduct of Business Regulations for MFIs

Listed below are basic standards and rules covering the conduct of business operations of "non-prudentially regulated" non-bank finance companies and other types of registered institutions providing rural and microfinance services. Generally, company registration laws and regulations require legally registered companies to prepare and submit audited annual reports and financial statements to the registry agency. Because there may not be any onsite examination or supervision by a regulatory body, the burden of observance and compliance falls substantially on an institution's internal governance structure and, without doubt, on the institutions that may be the sources for wholesale funds.

- adherence to and use of uniform accounting standards and procedures for internal and external reporting of operating and financial results
- annual reports on operating and financial results, which have been reviewed by acceptable external auditors and that include periodic reporting and publication of financial results
- written policies and procedures approved by the institution's board and management covering loan approval and documentation; loan account aging, classification, and provisioning for possible loan losses; loan delinquency control processes; loan loss write-offs; and internal audit and control systems
- observance of industry standards with respect to debt-to-equity ratio, equity-to-risk assets ratio, short-term assets-to-short-term liabilities ratio, portfolio at risk (loans overdue greater than 30 days as a percentage of total loan portfolio), and portfolio at risk coverage (provisions and reserves for loan losses as a percentage of portfolio at risk)

sion, as well as the costs of that supervision; (b) determining which agency should carry out the supervision or regulation, and whether delegated or auxiliary supervision may be warranted or justified; and (c) establishing benchmarks and standards for evaluating outreach and for financial performance and soundness. In addition, certain cross-cutting issues—taxes that may obstruct more effective outreach and costs, and credit information-sharing systems that can help MFIs manage loan delinquencies and reduce costs—need to be considered. Also, PSBs and CFIs—though significant components of the rural finance and microfinance sector—are often excluded from the scope of the regulatory framework. However, an analytical evaluation of their outreach, operating performance, and financial soundness—as well as the primary problems they face or may pose to the rest of the sector—may be an important aspect of the assessment of adequacy of access. A discussion of regulatory issues relating to PSBs and CFIs is contained in box 7.3.

Some key questions in assessing the regulatory framework of rural finance and microfinance institutions include the following:

- Is there a need to regulate (but not prudentially supervise) those other institutions? If so, what is the scope of the regulation? Very often the distinctions between broad regulatory oversight (sometimes called *non-prudential regulation*) and detailed prudential supervision are ignored in a number of countries. Inappropriate regulatory approach has led to the misallocation of scarce supervisory and staff resources in the attempt to impose prudential standards and requirements on rural finance and microfinance institutions that are not engaged in mobilizing and intermediating public deposits, a step that poses a systemic risk. Prudential supervision involves the regulatory authorities' verifying the compliance of institutions with mandatory

Box 7.3 PSBs and CFIs and the Scope of Their Regulation

Postal savings banks (PSBs) are generally not included in the prudential regulatory framework for banking and financial institutions, which can aggravate weaknesses that often exist in the PSBs' internal governance structure and accountability processes. Individual members' deposits in PSBs are not included in formal deposit insurance or in protection schemes (when those schemes exist), but they are implicitly guaranteed by the government. Thus, the risk exists for potential claims on the government treasury or budget in the event of losses from mismanagement or fraud. Furthermore, savings and time deposits collected by PSBs are not intermediated into rural finance or microfinance loans, but they are often used to help fund treasury or budget operations by the requirement that PSBs' investments be limited to government treasury bills and bonds.

Cooperative financial institutions (CFIs) offer important potential ways to decentralize the access to financial services, particularly in rural areas that banks and commercial microfinance institutions (MFIs) may find too costly to reach. In many countries, CFIs constitute an important and comparatively large segment of the rural finance and microfinance sector in terms of the number of institutions and their membership base. Governments, as well as the donor community, need to focus more attention on measures to treat CFIs as part of the financial services segment, rather than as part of the cooperative segment. There have been only a few cases of countries adopting specialized laws and regulations for CFIs.

Individual members' deposits in CFIs may be protected when a deposit insurance fund has been established privately by an upper-level regional or national cooperatives federation. While the deposits of a CFI with a commercial bank may be included in formal deposit insurance or protection schemes (when those schemes exist), the recognized legal depositor is the CFI, not the individual members who may own the deposits. There exists the risk of potential claims on the government treasury or budget in the event of losses from mismanagement or fraud, if the CFI segment of the rural finance and microfinance sector is fairly large.

As a closed-circuit financial system, deposits collected by CFIs from individual members are intermediated into rural finance or microfinance loans to members only, but there are instances where CFIs effectively offer deposit services to nonmembers and the general public, because the "common bond" for membership is loosely specified.

standards—such as minimum capital levels and adequacy, liquidity management ratios, and asset quality standards—as measures for financial soundness. Prudential supervision of deposit-taking category C institutions (see table 7.2) is aimed at protecting public savings that are being mobilized and lent out or intermediated, which puts public savings at risk of being lost if loans are not repaid. In contrast, for various categories of institutions—institutions in category A2 and similar institutions in category B—may require only non-prudential supervision or regulatory oversight, as outlined in table 7.2.

- Which agency should regulate the institutions? An important issue is the extent to which regulatory authority should be centralized, delegated, or decentralized (see box 7.4 for further discussion). Box 7.5 contains a further discussion of supervision standards, technical capacity and cost considerations that enter into the assessments.

Box 7.4 Critical Issues in Delegating Prudential Supervision

Delegated supervision covers arrangements where the central banking and financial institutions supervisor delegates direct supervision of an identified set of institutions to a body or agency outside the central supervisory authority, while monitoring and controlling that other body's or agency's supervisory work (see Christen, Lyman, and Rosenberg 2003). Limited examples of delegated supervision are being used for microfinance institutions (MFIs); thus, there is little experience to date on the effectiveness of this approach.

If the approach were to be applied even on an interim basis, it is critical to answer the following questions in advance (see Christen, Lyman, and Rosenberg 2003):

- Who bears the costs (which may be substantial) of the delegated or auxiliary supervisory agency and the additional costs of the central supervisory authority's oversight and monitoring of the agency?
- Should the delegated or auxiliary supervision arrangement prove to be unreliable or ineffective, and should the mandate to the delegated or auxiliary supervisory agency need to be withdrawn, does a realistic and practicable fallback or alternative option exist for the central supervisory authority?
- In the event that a supervised institution fails, which agency—the central supervisory authority or the delegated or auxiliary supervisory agency—will have the authority and capability to clean up and rectify the situation by suspension, intervention, or liquidation?
- Does a delegated or auxiliary supervisory agency bear any legal liabilities in the exercise of the delegated or auxiliary responsibilities?

7.6. Some Cross-Cutting Issues Affecting Rural Finance and Microfinance Institutions

Tax issues may present obstacles to rural finance and microfinance institutions from more effectively providing access to financial services. The legal and nonprofit status of non-bank NGO MFIs may sometimes be questioned by tax authorities on the grounds that the credit services they are providing to their clientele are priced at commercial rates, rather than at "charitable" levels, as in the case of NGO MFIs in India. In other instances, licensed specialized banks and non-bank finance institutions may not be permitted by tax accounting laws and regulations to expense provisions for possible loan losses, in spite of prudential regulations issued by the central supervisory authority, as in Tanzania, which creates an unnecessary real economic burden to such specialized banks and non-bank finance institutions. A related problem stems from the requirement by tax authorities that delinquent loans may be written off only when the sale and disposition of collateral securing such a defaulted loan results in recovering a monetary value that is less than the value of the collateral, as in the case of Kenya.

Credit registries allow borrowers to build up a credit history and can assist lenders in assessing risk, thereby reducing the cost of lending and improving access. Credit registries that give easy and reliable access to a client's credit history can dramatically reduce the time and costs of obtaining such information from individual sources and, therefore, can reduce the total costs of financial intermediation. Credit reporting makes borrower quality much more transparent, which benefits good borrowers and increases the cost of defaulting on obligations. It helps borrowers build up a credit history and eases access to

credit. Credit registries are especially important for SMEs, because their creditworthiness is more difficult to evaluate and because they have less visibility and transparency relative to large enterprises.

Often, current regulations may provide for the sharing of only negative information (i.e., information on nonperforming loans). It is preferable that regulations allow for sharing of both positive and negative information to improve reliability of credit risk evaluation and to increase competition.[6] Reporting positive information significantly increases the predictability of rating and scoring models used by lenders, thereby translating into lower loss rates, higher acceptance rates of credit applicants, or both (see Staten 2001). Sharing positive information will also allow borrowers to build their credit history, which can especially benefit small borrowers, because it will allow them to establish a good borrowing reputation and to improve their chances to increase borrowings as their business grows. Regulations governing information sharing should also allow for adequate consumer and data protection mechanisms. Allowing all finance providers to share both positive and negative information on their borrowers will allow small business to participate in

Box 7.5 Supervision Standards, Technical Capacity, and Cost Issues

In an assessment of the prudential regulatory and supervisory framework for microfinance, the following key questions need to be addressed:

- Are the prudential standards applied to specialized banks and financial institutions in the rural finance and microfinance sector consistent with and adapted to the nature and characteristics of the market clientele they service (e.g., microfinance loans are short term, repeating, and unsecured with group guarantees being widespread practice), or are the prudential standards used the same as those that apply to regular commercial banks?
- Does the central bank or supervisory authority have rural finance- or microfinance-dedicated staff members assigned to the supervision and examination of the specialized banks and financial institutions in the rural finance and microfinance sector? In a number of countries, including Kenya, Pakistan, the Philippines, and Tanzania, the supervisory authority has a separate specialized microfinance section that deals with policy issues (including appropriate standards), but actual examination and supervision of all licensed banks and financial institutions are carried out by technical staff members from the banking supervision department. In other countries, including Ghana, Indonesia, and the Philippines, rural and community banks are examined and supervised by staff members in the rural banking department of the supervisory authority.
- What is the comparative workload (number of licensed institutions, or number of days needed to complete onsite examination or supervision) of supervisory staff members assigned to commercial banks versus that of members assigned to specialized banks and financial institutions in the rural finance and microfinance sector?
- What is the judgmental assessment of the technical capability of staff members and the quality of their examination and supervision of specialized banks and financial institutions in the rural finance and microfinance sector in comparison with technical staff members responsible for commercial banks? Is this a fair comparison?
- Is it possible to estimate and compare the costs associated with the examination and supervision of specialized banks and financial institutions in the rural finance and microfinance sector in comparison with the costs for the examination and supervision of commercial banks? Is this a fair comparison?
- Does the central bank or monetary authority require the commercial banks and the specialized banks and financial institutions in the rural finance and microfinance sector to pay for or to defray the costs associated with examination and supervision? If so, what charges are imposed?

Box 7.6 Findings and Recommendations on Microfinance Regulatory Issues in Selected FSAPs

Case I: A Transition Economy

Key Issues

Access to financial services through microcredit programs is primarily through microfinance institutions (MFIs) and credit cooperative organizations (CCOs) registered with and licensed by the central bank. The microfinance sector is small in terms of total credit volume and number of households and enterprises reached. The most critical issues for development of the microfinance sector are (a) diversification of funding sources, as authorization for mobilizing deposits does not come automatically with licensing, even for CCO members' deposits; and (b) striking a balance between developing a safe and sustainable sector and imposing unreasonable burdens on both the regulated institutions and the regulatory authority.

Policy Recommendations

- MFIs and CCOs should be allowed to take deposits from their members or borrowers, provided they meet established prudential norms related to expected financial and operational risks.
- The legal and regulatory environment for MFIs or CCOs that do not take deposits should be reviewed and simplified commensurate to their risk profile.
- Improvement of the regulatory and supervisory framework through better prudential reporting standards and more-effective sanctions could make supervision more effective.

Case II: A Developing Country

Key Issues

The regulatory regime for microfinance is uneven and tilted toward overregulation. The policy direction is unclear as to whether the provision of microfinance and small-scale finance services will depend more on formally licensed banks and institutions reaching down, or will depend on developing the scaling-up of community- or nongovernmental organization (NGO)–based MFIs, including savings and credit cooperative organizations (SACCOs).

Policy Recommendations

- The move toward a more systematic and thorough regulatory regime for the few MFIs to be taking more than a specified amount of deposits is commendable, but smaller NGO MFIs and SACCOs able to reach remote rural areas should not be suppressed by excessive regulation.
- The development and strengthening of umbrella organizations and the greater reliance by MFIs on funding from local banks rather than external donors should be encouraged.
- A specialized agency for cooperative financial institutions should be considered for focusing on capacity building and financial infrastructure.

Sources: FSAP reports

the process of reputation building and generation of credit history. It would help facilitate the process of borrowers' graduating from microfinance to bank finance as their business develops. Information sharing among all finance providers could contribute significantly to reducing segmentation and increasing competition.

7.7 Ways to Address Rural Finance and Microfinance Regulatory Framework Issues

The core issues in the legal and regulatory framework for rural finance and microfinance will differ from one country to another because of country differences in the structure

and stage of development of the rural finance and microfinance sector and because of the regulatory approach used. This difference is illustrated by highlighting key issues and policy recommendations in selected Financial Sector Assessment Program (FSAP) reports, which are summarized in box 7.6.

7.8 Consensus Guidelines on Regulating and Supervising Microfinance

CGAP published consensus guidelines approved by 29 international donor agencies that support microfinance (Christen, Lyman, and Rosenberg 2003). Those guidelines were approved by CGAP members in September 2002. The consensus guidelines list 21 key policy recommendations on regulation and supervision of microfinance, which create a good checklist of issues to focus on in the assessment of regulatory aspects that pertain to access to financial services. The particular set of key policy recommendations in the checklist that may be applicable to a given situation will vary from one country to another depending, among other things, on the range and variety of institutional providers of rural finance and microfinance services, on the size and relative importance of each type of rural finance and microfinance institution category, and on the size of the rural finance and microfinance sector relative to the formal commercial finance sector. Several of the key policy recommendations are selected for emphasis and are highlighted next:[7]

- Problems that do not require the government to oversee and attest to the financial soundness of regulated institutions should not be dealt with through prudential regulation. Relevant forms of non-prudential regulation, including regulation under the commercial or criminal codes, tend to be easier to enforce and less costly than prudential regulation.
- Before regulators decide on the timing and design of prudential regulation, they should obtain a competent financial and institutional analysis of the leading MFIs, at least if the existing MFIs are the main candidates for a new licensing window being considered.
- Minimum capital needs to be set high enough so that the supervisory authority is not overwhelmed by more new institutions than it can supervise effectively.
- Where possible, regulatory reform should include adjusting any regulations that would preclude existing financial institutions (banks, finance companies, etc.) from offering microfinance services, or that would make it unreasonably difficult for such [regulated and licensed] institutions to lend to MFIs.
- Prudential regulation should not be imposed on “credit-only” MFIs that merely lend out their own capital, or whose only borrowing is from foreign commercial or non-commercial sources or from prudentially regulated local commercial banks.
- As a corollary to the above principle and] depending on practical costs and benefits, prudential regulation may not be necessary for MFIs taking cash collateral (compulsory savings) only, especially if the MFI is not lending out (i.e., not able to intermediate these funds).

- Design of microfinance regulation should not proceed very far without estimating supervision costs realistically and identifying a sustainable mechanism to pay for them. Donors who encourage governments to take on supervision of new types of (licensed) institution should be willing to help finance the start-up costs of such supervision.
- In developing countries, "self-supervision" by an entity under the control of those supervised is not likely to be effective in protecting the soundness of the supervised financial institutions.
- A microlending institution should not receive a license to take deposits until it has demonstrated that it can manage its lending profitably enough so that it can cover all its costs, including the additional financial and administrative costs of mobilizing the deposits it proposes to capture.
- Financial cooperatives (credit unions and savings and credit cooperatives)—at least large ones—should be prudentially supervised by a specialized financial authority, rather than by an agency that is responsible for all types of cooperatives (financial and non-financial).

The Bibliography includes a number of reference works and guidelines that are useful in addressing the above questions—particularly on relevant prudential standards, tools for supervision, and costs of supervision—as well as providing the benefit of lessons from the experience of a number of countries that have had to address similar questions and issues.

Notes

1. Example of rapid growth in cooperatives and credit unions include Burkina Faso, Ecuador, Guatemala, and the Philippines.
2. Village banking is a means of delivering financial services such as small loans and savings products to those people who could not otherwise obtain them. While many agencies and organizations provide small loans to low-income families, not all use the village banking method. Developed by FINCA (http://villagebanking.org/), the village banking method is unique in the responsibility and autonomy given to borrowers in running their banks and in the method's emphasis on community, as well as individual development. The village banking method has been shared widely with 40 voluntary agencies and development organizations that currently operate more than 80 programs worldwide. The village banking method is highly participatory in nature. It gives the beneficiaries a voice and involves them in the development process. Not only do members receive loans, but also they form cohesive groups that manage and collect repayments on those loans, that save diligently, and that decide on ways to invest those savings, and progress together, thus forming networks for mutual support.
3. Data cited as of 2003.
4. See Honohan (2004) for a discussion of this point.
5. In some countries, wholesale borrowings through commercial paper or money market instruments and through medium- to long-term large-value certificates of deposit may require prior authorization from a securities or capital market authority or, where

the institutional investor or lender is an insurance company, from the insurance commissioner.

6. Positive information includes repayment history with amounts and terms of the loans, while negative information includes delays in repayment and defaults.
7. See Christen, Lyman, and Rosenberg (2003). The selected set of key policy recommendations is presented and reproduced verbatim, except for those terms in brackets, which have been inserted for purposes of further clarification, and except for some changes in the order of presentation.

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