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Oversight is a Many-Splendored Thing:

Choice and Proportionality in Regulating and Supervising Microfinance Institutions

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I. Introduction

Just as there are many different types of microfinance institutions (MFIs), there are also many options for regulating and supervising MFIs. Oversight is a many-splendored thing, with a long menu of options from which to formulate an appropriate mixture of MFI regulatory and supervisory regimes – one size certainly does not fit all.

The objective of this essay is to highlight the many choices available for regulating and supervising MFIs, and to provide guidance in judicious application of the proportionality principle to make prudent selections among these choices.

To make the case for choice and proportionality in MFI regulation and supervision, this essay is organized around the following five key questions:

- Why regulate and supervise financial institutions?
- Why distinguish between regulation and supervision?
- What is so special about microfinance institutions?
- What are our main alternatives for MFI oversight?
- How can we balance conflicting objectives?

Each question will be addressed in sequence, so that by the end of the essay the reader might fully appreciate the complexity of MFI regulation and supervision, as well as the opportunities that MFI diversity offers to effectively meet oversight needs creatively.

II. Lest We Forget: Why Regulate and Supervise Financial Institutions?

The financial sector is among the most regulated and supervised part of a nation's economy around the world, regardless of a country's stage of economic development or the nature of its political system. This is not accidental or coincidental. The functions performed by financial institutions, particularly banks, are unique, and thus, the risks entailed in undertaking these functions are also unique.

The first principal group of financial institution functions revolve around the mobilization of savings and the allocation of credit, or financial intermediation; the second main set of functions are related to the provision of liquidity and payment services, or facilitation of financial transactions. The risks associated with these financial functions are twofold: macroeconomic market failures and microeconomic institutional collapses.

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There are four macroeconomic market failures related to financial institutions. First, not only do financial services have a high intrinsic value, but they are also perceived as *quasi-public goods*, essential components and basic needs of an efficient and equitable economy that should be available to all. Second, financial sector difficulties are therefore seen as imposing costs on society far in excess of the cost to any single financial institution or to the customers of that institution, commonly referred to as *negative externalities*. Third, today's global economic crisis is a vivid example of the tremendous havoc that these negative externalities can wreak by causing massive *macroeconomic disequilibrium*. Fourth, financial sector weaknesses are heightened by *asymmetries of information*, or unequal distribution of information – savers generally lack the capacity to assess the soundness of depository institutions, while lenders find it difficult to assess the willingness and capacity of borrowers to repay their loans.

These four macroeconomic vulnerabilities are further exacerbated by two unique risks associated with the microeconomic transmission mechanisms of financial institution failure: they start with bank runs for individual institutions, due to the *sequential servicing of customer claims* and resultant loss of customer confidence; they spread throughout the financial system and later the real economy via *the contagion effect*, like a viral disease, ultimately resulting in systemic collapse.

The purpose of financial institution regulation and supervision is thus to maintain confidence in the financial system and protect consumers of financial services, by mitigating these risks associated with both macroeconomic market failures and microeconomic institutional collapses. The primary objective is to avoid a banking crisis, where one or more bank failures can lead to systemic collapse, thereby threatening depositors with loss of their savings, depriving creditworthy businesses and households of access to loans, and compromising the viability of the entire payments system.

III. Terminology Check: Why Distinguish Between Regulation and Supervision?

Regulation entails setting standards and determining rules of the game; supervision is monitoring and enforcing compliance with these regulations. It is important to distinguish between the two because they are both distinct from each other and symbiotic. Understanding the differences between financial regulation and supervision, as well as their interactions with each other, should help countries to articulate highly focused and specific objectives, and thus apply the most appropriate tools to achieve these objectives.

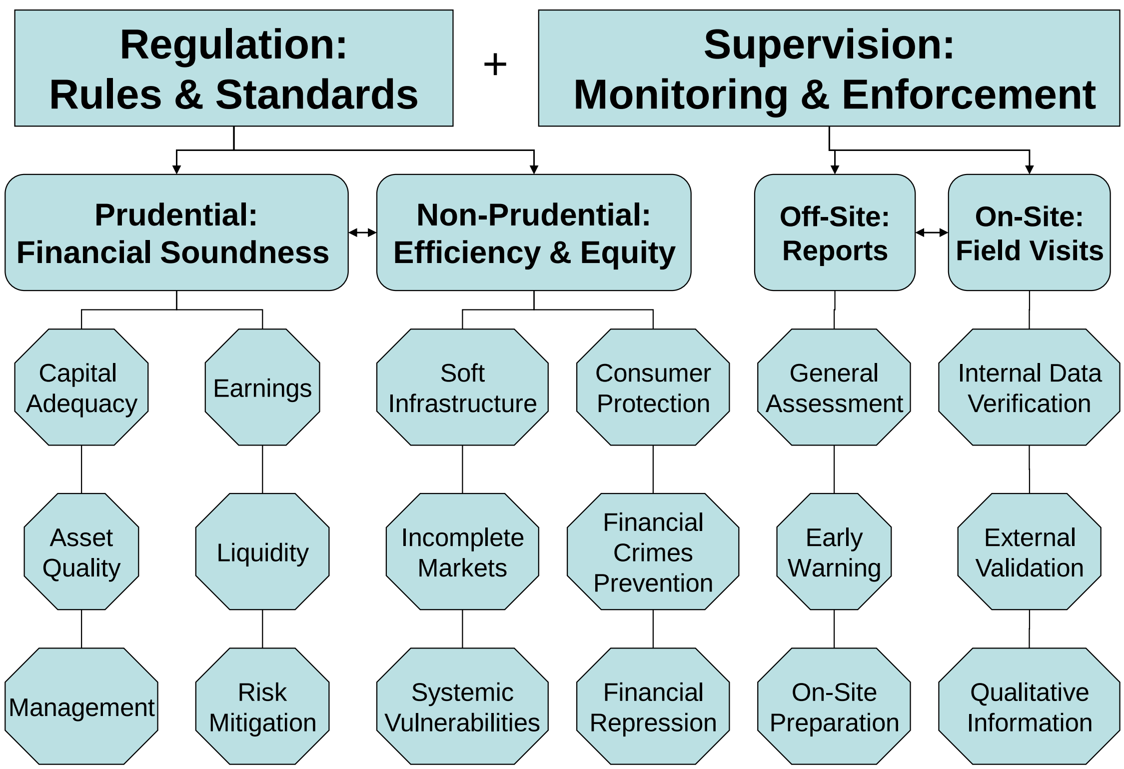
As indicated in Figure 1 below, there are two basic types of financial regulation: those related to financial soundness, or prudential regulation, and those related to market efficiency and market equity, or non-prudential regulation.

The purpose of prudential regulation is to determine the health of financial institutions, particularly to ensure that they are liquid and solvent, and are usually based on some variation of the CAMEL-Plus rating system: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **Risk** Mitigation. This is the main preventative measure to guard against financial institution failure.

The purpose of non-prudential regulation is to improve the quality of the markets in which financial institutions operate. The most extensive of these is sometimes referred to as "soft infrastructure" regulation, and is comprised of: legal and judicial protocols for secured transaction, contract enforcement, and bankruptcy procedures; tax and accounting treatment of financial institutions and products; authority to grant permission to undertake financial activities, as well as establish and transform financial institutions; and credit bureau operating parameters.

Other components of non-prudential regulation include: requirements to serve incomplete markets, such as the Community Reinvestment Act in the United States; measures to reduce system vulnerabilities, such as controls over hot capital; consumer protection laws to promote transparency and accountability, such as requiring common presentation of effective interest rates and full disclosure of the risks of financial instruments; financial crimes prevention, particularly money laundering and the funding of terrorist operations; and although often well-intentioned but usually counterproductive, financial repression measures, such interest rate ceilings and credit allocation quotas.

Figure 1: Oversight of Microfinance Institutions



Supervision of financial institutions is commonly divided into two components: off-site and on-site supervision. Off-site supervision is based on reports, and is designed to provide a general assessment of financial institution soundness, give supervisors an early warning of potential problems, and help field supervisors prepare for their on-site inspections. On-site supervision is based on field visits, and is conducted to provide internal data verification, external data validation, and qualitative information on management, customer, and market conditions.

Given the many elements of financial institution regulation and supervision, the fundamental challenge for governments is to determine the most cost-effective allocation of oversight responsibilities, especially in the context of MFIs. It is not self-evident that all responsibilities should lie with the central bank or national superintendency.

IV. The Informal Economy: What Is So Special About Microfinance Institutions?

Most of the preceding discussion has been focused on regulation and supervision of financial institutions in general. However, microfinance has special features that pose unique oversight challenges, the most important of these being:

- Client base – Microfinance clients are low-income households and informal family businesses, so while they still require the same financial services as higher income households and formal enterprises, the design and delivery of these products must be adapted to their specific household finances and business needs. For example, the priority for savings services might be safety and access rather than return, while the primary consideration for loans might be matching repayment schedules with the timing and amount of anticipated cash flows.

- Lending methodology – Most microenterprises do not keep formal financial records and their owners do not possess conventionally accepted collateral, so loan appraisal is often based on a qualitative assessment of character and a rough estimate of cash flow from a reconstructed income statement, while items such as movable assets or group guarantees are accepted as collateral.

- Transaction costs – Although the cost of loanable funds might not be much higher than the cost for other markets and microcredit risk might actually be lower, the transaction costs for microfinance are extremely high due to the small value of each transaction and the necessity of reducing client transaction costs by bringing microfinance services as close to clients as possible. This means that interest rates on loans must be at the high end of market rates to cover all lending costs.

- Portfolio composition – In contrast to small and medium enterprise lending and corporate lending, microcredit is comprised of very small, quite short-term loans, and one of the keys to MFI financial sustainability is to generate an extremely high volume of microloans as efficiently (low unit costs) and effectively (low number of non-performing loans) as possible.

- Structure and governance – Most MFIs have a relatively decentralized structure and weak governance practices, often making conventional institutional assessment inappropriate for determining financial soundness.

Failure to adapt standard financial oversight metrics to these special attributes of microfinance can result in problematic microfinance regulations, for example:

- *Application of standard prudential norms and ratios* that in many respects are not demanding enough for MFIs. The most common example of this practice is loan classification, provisioning, and write-off requirements – given the short-term nature of microloans, the aging and write-off of microcredit arrears should be faster than conventional loans. Likewise, given the remote location of many MFI branches, it might be more prudent to require higher liquidity ratios for MFIs than for mainstream commercial banks. On the other hand, unreasonably high minimum capital requirements often serve as barriers to entry for new MFIs without contributing significantly to MFI financial soundness.

- *Mandatory bank consolidation and rationalization programs* in the belief that larger financial institutions and conventional financial products are safer than community based financial institutions offering customized products for local markets. However, these programs often increase financial sector vulnerabilities through the concentration of credit risk by location, product, and market.

- *Rejection of non-conventional collateral for microloans* and treating the entire microcredit portfolio as unsecured, thus requiring capital at the highest risk weighting and adding considerably to the MFI's cost of making microloans. In addition, *imposition of formal collateral registration requirements* further increase the expense of microcredit by adding to borrower transaction costs.

- *Imposition of extensive formal loan documentation requirements* for microcredit borrowers when such financial records simply do not exist for microenterprise, as well as *imposition of nominative loan portfolio documentation requirements* for MFIs when aggregate portfolio documentation would be more practical and appropriate to monitor loan portfolio quality and assess MFI credit risk exposure.

- *Imposition of interest rate ceilings* too low for MFIs to cover all of their lending costs, forcing MFIs to either seek subsidies or resort to non-transparent means of increasing effective interest rates such as special fees and commissions.

- *Imposition of individual legal lending limits* rather than by portfolio composition, which would be a more effective way of mitigating risk of credit concentration.

- *Imposition of operational efficiency measures* that are often too lax for MFIs, such as number of loans per loan officer – this number is usually much higher for MFIs than mainstream commercial banks.

- *Imposition of organizational structure, staffing, and physical office requirements* more appropriate for large commercial banks than MFIs.

These regulations are usually promulgated with good intentions: to mitigate the most critical vulnerabilities in financial institutions. However, while MFIs, especially microfinance banks, do indeed have risks similar to other financial institutions, measurement of these risks must be adapted to the special characteristics of microfinance.

This does not entail leniency in standards. A bank, even a microfinance bank, is still a bank, and one that accepts savings from low-income families should be even more careful in protecting these savings than banks serving wealthier clients, as the poor often have nothing else to fall back on should their savings be wiped out.

Thus, as noted above, sometimes MFI regulations should be stricter than the norm. What is required, though, is flexibility in calibration: equally rigorous requirements for the same regulatory objective measured differently.

The special nature of microfinance also requires adaptation of MFI supervision.

For off-site supervision, reporting systems must be more frequent than conventional bank reports, given how quickly things can go bad with high-volume, small-scale, short-term lending – timing is critical in microfinance supervision. Microcredit reports must also be more consolidated than conventional loan reports to reflect portfolio condition and trends, as loan by loan reporting for microcredit can be overwhelming in volume while adding little of value for supervisory purposes. To be frequent, timely, and easily consolidated, MFI reports must also be relatively short and simple.

For on-site supervision, MFI field inspections must also be more frequent than for conventional banking, and should go beyond typical audit functions to include external data validation via customer interviews and technical support if required. This high intensity of MFI on-site supervision, coupled with the rapidly expanding number of MFIs in many countries and the need for a large cadre of specially designated and trained field supervisors dedicated exclusively to MFIs, usually creates overwhelming oversight demands for central banks or national superintendencies. Hence the need for allocation of MFI regulatory and supervisory responsibilities among a variety of institutional alternatives, as discussed in the next two sections of this essay.

V. Menu of Choices: What Are Our Main Alternatives for MFI Oversight?

The key to cost-effective allocation of MFI regulatory and supervisory responsibilities is matching the most appropriate MFI oversight model with each segment of the MFI market. This entails clear identification of MFI oversight alternatives, together with conceptually credible disaggregation of the microfinance sector by both MFI characteristics and the nature of microfinance services offered by each type of MFI.

As noted in Table 1, the subjects of MFI oversight can be grouped together into six general categories:

- conventional banks, which generally offer a full range of microfinance credit, savings, and payment services;
- branchless banking, which, in its most mature form, can also offer microfinance services comparable to conventional banks;
- special license banks, which can vary from full service banks to banks with selected restrictions on their services, the most common of these being geographic limitations, prohibition on foreign exchange transactions, and exclusion from national payment and clearing systems;
- finance companies, which can either provide credit to a variety of sectors or be specialized lenders (i.e., auto loans or home loans), but in either case must usually raise their funds from financial or capital markets – in most countries they are not allowed to accept deposits from the public;
- client-owned MFIs such as credit unions, cooperatives, and *mutuelles*, which typically can only collect savings from, and make loans to, their members; and
- other non-bank MFIs such as leasing, insurance, and wire transfer companies.

Table 1: Regulation and Supervision Alternatives for Microfinance Institutions

Alternative	Conventional Bank	Branchless Banking	Special License Bank	Finance Company	Client-Owned MFI	Other Non-Bank MFI
Central Bank/Bank Superintendency	Credit/Savings/Payments	Credit/Savings/Payments	Credit/Savings/Payments			
Delegated Regulation/Supervision			Credit/Savings/Payments			
Other Regulatory/Supervisory Agency				Credit	Credit/Member Savings	Credit, Leasing, Insurance, Payments
Self-Regulation/Supervision				Credit	Credit/Member Savings	Credit, Leasing, Insurance, Payments
Unregulated/Unsupervised				Credit	Credit/Member Savings	Credit, Leasing, Insurance, Payments

There are also five basic alternatives for MFI oversight, noted in Table 1 as well:

- direct regulation and supervision by a central bank or bank superintendency;
- central bank/bank superintendency delegated regulation and supervision, perhaps to a state-owned bank on behalf of the central bank/bank superintendency;
- a regulatory/supervisory agency other than a central bank/bank superintendency, such as a unit in the ministry of finance in charge of non-bank financial institutions, another ministry such as the ministry of cooperatives, or a semi-autonomous agency such as an insurance regulatory commission;
- MFI self-regulation and supervision, for example a cooperative or credit union association overseeing its member institutions; and
- essentially unregulated and unsupervised MFIs.

As indicated in Table 1, when MFI oversight alternatives are matched with types of MFIs, the results fall into two groups based on MFI product lines.

The determining factor that distinguishes these two groups from each other is whether or not the MFI accepts deposits from the public. If the answer is potentially yes, as in the first three types of MFIs, then a central bank or bank superintendency is usually responsible for MFI regulation and supervision, either directly or via a proxy such as a state-owned bank acting on its behalf. If the answer is absolutely not, as in the latter three types of MFIs, then alternative MFI regulatory and supervisory models are utilized.

The market segmentation presented in Table 1 is simplified and stylized to provide a comprehensive conceptual framework and accompanying general policy guidelines based on this framework. In practice, situations are often more complicated and ambiguous. For example, although client-owned MFIs such as such as credit unions, cooperatives, and *mutuelles* are usually formally restricted to receiving deposits from members only, the larger they become, the smaller their community of common interests and the more they begin to look like banks – sometimes the only thing members have in common is payment of a pro-forma membership fee. In addition to being *de facto* banks without the oversight that *de jure* banks have, giving them unfair competitive advantage, these client-owned MFIs might grow to become among the largest financial institutions in a country as well, and thus, also too big to ignore from a regulatory and supervisory perspective.

Thus, determination of the appropriate regime for regulating and supervising MFIs must go beyond simple application of the guidelines presented in Table 1. While a useful point of departure, they should be accompanied by a cost-benefit analysis, typically implicit rather than explicit, of proportionality in reconciling conflicting policy objectives in an environment of severe resource constraints, as described in the next section.

VI. The Proportionality Principle: How Can We Balance Conflicting Objectives?

A common dilemma faced by central banks and bank superintendencies around the world is that they simply do not have the resources to effectively regulate and supervise all financial institutions in their country. So what is the best allocation of their scarce resources, particularly in respect to MFIs, given their mandate to protect consumers of financial services and to maintain confidence in their financial system?

The principle of proportionality is a helpful way to prioritize and allocate regulatory and supervisory responsibilities for MFIs, in three distinct but inter-related dimensions.

The first of these is proportionality in the *probability* an MFI will fail versus the *potential impact* of that failure. For example, if there is a high probability of failure but the impact is local rather than systemic, it should be low public priority. In contrast, if there is relatively low probability of failure but this failure can potentially undermine a significant part of the financial system, it should be a high public priority.

The second is proportionality in the estimated *total and distributional cost* of preventing an MFI failure versus the likely *total and distributional benefit* of preventing the failure. For example, if regulatory and supervisory costs are high and borne by the state while significant benefits accrue to donor agencies sponsoring MFIs, it should be a low public priority – let the sponsors lose their investment or find another way of protecting it against failure of their MFI NGO. In contrast, if oversight costs are moderate and borne by the state while significant benefits accrue to low-income third-party savers, it should be a high public priority, perhaps delegated if direct oversight it too costly.

The third is proportionality in *risk mitigation* versus *stifling of financial sector innovation*. This dimension is more functional than institutional. For example, standard prudential norms greatly reduce risk without smothering initiative. In contrast, over-reactive re-regulation after a financial crisis, such as forcing consolidation or prohibiting customized microfinance products, tends to be counterproductive in two ways – it both increases risk and stifles innovation.

In determining the regulatory and supervisory priorities of a central bank or bank superintendency, policy makers should therefore ask themselves:

- If a microfinance institution fails, who are the winners and who are the losers?
- How much are they estimated to win or lose if the MFI collapses, and what is the likelihood of collapse?
- Is there an acceptable balance between MFI oversight costs and benefits?
- Are these costs and benefits fairly distributed?
- Will problems with an individual MFI spread throughout the microfinance industry, or even worse, the entire financial sector?
- Could too much risk aversion in the design of preventive measures kill incentives to innovate?

These questions do not imply that all MFIs not regulated or supervised by the central bank or bank superintendency should be left to the whims of market forces in fanatical adherence to laissez-faire ideology.

Rather, they suggest criteria for determining operational parameters in the selective utilization of scarce public resources – Table 1 provides institutional alternatives for the regulation and supervision of MFIs that fall outside the scope of MFI oversight that can be provided cost-effectively by central government banking authorities.

VII. Conclusion

Diversity in MFIs requires corresponding diversity in the regulation and supervision of these MFIs. The rapidly growing, quickly evolving MFIs around the world have a plethora of different institutional structures, products, and markets, and thus, have significantly different vulnerabilities that pose a wide variety of risks to their customers and their markets. At the same time, central banks and bank superintendencies do not have the capacity to cost-effectively regulate and supervise all of these MFIs. This essay summarizes the principal alternatives for oversight of MFIs, and applies the proportionality principle as a framework for making prudent selections among the main MFI regulatory and supervisory options.

VIII. Appendix: A Note on Key References

This essay focuses on fundamental policy questions in the regulation and supervision of MFIs from a strategic and tactical perspective.

Few specific examples are provided for two main reasons:

- the field is changing so quickly that many of the examples would probably be obsolete by the time this handbook is published; and

- others have already exhaustively documented current MFI regulatory and supervisory practices.

In July 2003, The Consultative Group to Assist the Poor (CGAP) published *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance,* which provides a glossary of many of the terms and concepts summarized or adapted in this paper, as well as a description of "best practices" for both prudential and non-prudential regulation and supervision of microfinance, based on the collective experience of CGAP's 29 donor member agencies.

In addition, CGAP, together with The Iris Center at the University of Maryland, jointly created the "Microfinance Regulation and Supervision Resource Center," which is accessible via the following URL: http://www.microfinanceregulationcenter.org.

The Resource Center provides a worldwide comparative data base on microfinance regulation and supervision. To quote from the web site:

> Use the Comparative Database to get a snapshot of the regulatory environment for microfinance in 52 different countries. From individual country profiles to comparisons across countries, institution types and topics, the Comparative Database quickly and easily provides a comprehensive overview of regulation and supervision around the world.

The Resource Center also provides a short guide to the basic issues and alternatives in microfinance regulation and supervision in a framework that is a somewhat simplified version of the framework presented in this essay.

Finally, branchless banking is mentioned briefly in this essay, but is a rapidly growing industry that has created unique challenges in microfinance regulation and supervision. CGAP, together with the United Kingdom's Department for International Development (DFID), published *Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance* (CGAP Focus No. 43) in January 2008; this provides extensive documentation of branchless banking trends to date, together with a detailed analysis of the implications for microfinance regulation and supervision.