Principles and Practices for Regulating and Supervising Microfinance

Inter-American Development Bank

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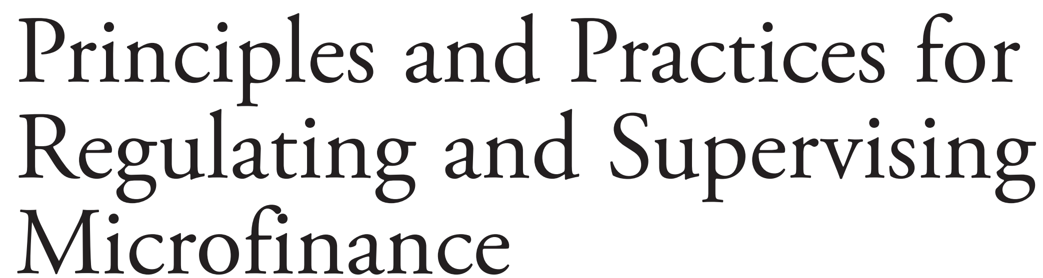

Principles and Practices for Regulating and Supervising Microfinance

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Foreword

This publication is aimed at bank supervisory authorities interested in or charged with developing a regulatory and supervisory framework for microfinance. It is intended to meet a growing demand for clearly identifiable principles and guidelines on how microfinance can be appropriately regulated and supervised. The growing awareness of the potential of microfinance, coupled with the emergence of several highly successful and fast-growing institutions, has effectively put the issue on the political agenda in most developing countries.

Bank supervisors in several Latin American countries have now begun taking active measures to address the issue of microfinance. The challenge they face, which is sometimes complicated by a multitude of legal initiatives in this area, is how to accommodate, or reasonably encourage, microfinance within a framework of generally accepted norms and prudential standards for the financial services industry. A framework that does not adequately address the particular features and risks of microfinance will not serve these institutions or, consequently, the people who depend upon them. For instance, a very inflexible and conservative approach may unduly restrict the supply and expansion of microfinance by not allowing financial institutions to adopt appropriate lending technologies. On the other hand, and much more common, well-intended efforts to promote microfinance may result in an overly lenient framework that enables and permits weak institutions to operate, which in turn may lead to bankruptcies, shake confidence in a budding industry and cause poor people to lose their savings.

The issue of savings is central to the regulation and supervision of microfinance. Supervisory authorities are supposed to make sure people do not lose their savings in failing institutions. Conversely, if an institution does not capture savings, the reason for bank supervisors to be involved is usually much weaker. They have limited budgets and must focus on those institutions and situations where they are really needed. Savings are also crucial for another reason: microfinance institutions want them. Historically, microcredit has been provided primarily by nonprofit organizations, which are typically not permitted to mobilize savings. As these institutions have grown, so has their demand for funding. Some have played by the rules and sought a bank or finance company license as a way to access funding in the form of savings. Others have pursued a different tactic—changing the rules to fit their particular situation.

During the past few years, nonprofit foundations in several Latin American countries have introduced legal initiatives to create new types of financial institutions specifically suited to their needs and ambitions. In some cases, where the bank supervisor has been part of the process, it has resulted in innovative and useful frameworks that can enable a rapid and balanced growth of the industry. In other countries, where the bank supervisor has not participated in the process, it has resulted in frameworks that are inconsistent with generally accepted banking practices.

That is where this publication comes in. It is meant to give supervisory authorities the tool they need to actively and constructively participate in the development of regulatory and supervisory frameworks for microfinance. In essence, it provides a checklist of the aspects that such a framework should include, based on the particular features and risks of this activity. Its level of detail is sufficient to guide the drafting of a law, as well as its primary regulations, on the matter.

One of the main challenges for developing an appropriate regulatory and supervisory framework

for microfinance lies in the great diversity of institutions that offer these services. No longer is the supply of microcredit dominated by nonprofit organizations; today, many banks and finance companies have developed significant portfolios in this market. In some cases, these institutions have been created through the "transformation" of nonprofit organizations and are dedicated exclusively to microfinance. In other cases, traditional banks and finance companies are building profitable microenterprise segments in their corporate or consumer portfolios. Meanwhile, a very significant share of microfinance services is provided by credit unions; there are about 5,800 such cooperatives in the region and 20% to 40% of their lending is typically directed to microenterprises. This institutional landscape is further complicated by the fact that several countries have created or are about to create new and distinct institutional forms specialized in microfinance.

As the publication points out, a coherent and comprehensive framework will to a significant extent be based on microlending as an activity, which would make it applicable to all supervised institutions that offer this service, regardless of whether they are licensed as a bank, finance company, credit union, or some new institutional form created specifically for microfinance. The implementation of these regulations—which among other issues include standards for portfolio classification, loan loss provisioning and write-offs—is relatively straightforward once microcredit has been defined.

More complex, however, is the design and implementation of regulations that are tied to an institution as such, for example capital adequacy or permitted operations. Any recommendations or limitations in these areas are hard to apply across the board to all banks, finance companies or credit unions since many of them operate only minimally or not at all in microlending. It just would not make sense, even if the unlikely opportunity presented itself, to change the basic framework for all banks just to accommodate or correctly regulate the few of them that operate in microfinance. Rather, supervisory authorities would have to negotiate any unique standards and requirements on a case-by-case basis at the time the institutions in question are licensed.

Finally, while perhaps overly ambitious, it may be useful to condense the recommendations of the publication into a few core principles. Of course, these principles, which are explained and justified in more detail in the remainder of this publication, are just a first attempt at distilling the general lessons learned in this field:

1. Supervise only those microfinance institutions that mobilize deposits from the public. If the institution does not mobilize deposits, there is no compelling reason for the supervisory authorities to be involved.

2. Allow only incorporated, shareholder-based microfinance institutions and cooperatives (not nonprofit organizations) to mobilize deposits from the public. Nonprofit organizations have no owners with money at stake (in fact, they have no owners at all) and therefore present important weaknesses in terms of governance and institutional stability.

3. Do not create new and distinct institutional forms for microfinance unless: (a) there are several mature and well-managed nonprofit organizations ready to transform into such financial intermediaries, and (b) the existing institutional forms—such as bank or finance company—are for all practical purposes unusable (due to high minimum capital requirements, for instance) or carry important operational restrictions (such as the inability to mobilize deposits).

4. Encourage the participation of private strategic investors in deposit-taking microfinance institutions that are formed through the transformation of nonprofit foundations. These institutions are typically dominated by the original nonprofit organization and therefore need profit-minded investors as a counterweight.

5. Define microcredit as a new form of lending, distinct from consumer, commercial and mortgage lending. This, in turn, will make it possible to simplify prudential rules and requirements for providing and managing microenterprise loans.

6. Create distinct standards for risk classification, client loan documentation, loan loss provisions and write-offs for operations defined as microloans. In some areas, the standards need to be stricter than current practice, in others more flexible; however, they should always be simple.

7. Implement risk-based supervision that, in the

case of microfinance institutions, focuses on: (a) governance and ownership, (b) lending methodology, and (c) internal control mechanisms and procedures. This will require bank supervisors to provide specialized training to its personnel and, in some cases, to form a specialized group or unit to handle the supervision of microfinance institutions.

8. Encourage the development and use of credit bureaus so that microfinance institutions can more easily assess the creditworthiness of potential clients and so that microenterprise clients can more easily use their credit histories to shop around among financial institutions.

While these core principles are based on the Latin American experience, we believe their general applicability extends to other regions as well. Clearly, specific regulations will have to be adapted to the conditions and context of each country, but we think the core principles should be as applicable in Asia, Africa, and Eastern Europe as they are in Latin America and the Caribbean.

We trust that the recommendations set forth in this publication, which by necessity are general, can be adapted to national circumstances to foster the growth of microfinance, which is so crucial for poverty reduction, economic growth, and the development of our countries.

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Preface

Background

This publication is the product of a two-year research project that brought together some of the most renowned experts on microfinance in Latin America. During 2000 and 2001, the project financed research in four countries—Bolivia, Colombia, Paraguay, and Peru—which were chosen based on the characteristics of their microfinance markets and the sophistication (or lack thereof) of their regulatory frameworks in relation to microfinance.

Bolivia and Peru are similar in that their microfinance markets and regulatory frameworks are relatively mature and have been firmly in place for the last eight or nine years. They have a significant number of financial institutions specialized in microcredit that are supervised by the agency in charge of supervising banks and other financial institutions. They can be distinguished in that Peru's framework is more open and plays more of a promotional role than Bolivia's. As a result, Peru has more than 30 regulated institutions specialized in providing microcredit, whereas Bolivia has five. In both countries, these regulated microfinance entities, which grew out of nonprofit foundations, dominate the supply of microcredit in their countries.

Colombia and Paraguay also have large microfinance markets, but their markets differ from one another and from those in Bolivia and Peru. In Colombia, the microfinance market is dominated by nonprofit organizations, and there are only two supervised financial institutions specialized in microcredit. In Paraguay, the market is dominated by supervised financial institutions that have entered the sector after having experienced a decline or increased competition in their tradtional markets (consumer and/or commercial loans for small and medium clients). In both cases, the regulatory framework for microfinance is incipient and not yet well-defined.

In order to examine the topic of microfinance regulation and supervision more broadly, this publication includes an analysis of credit unions, which are important providers of financial services (including microcredit) for middle- and low-income populations in the region. The supervisory context for credit unions varies among the four countries. In Bolivia, credit unions are supervised by the banking supervisor. In Colombia, the bank supervisor is in charge of large credit unions, while another specialized government agency handles the rest. In Peru, the bank supervisor has delegated the daily supervisory tasks to the credit union federation. Finally, in Paraguay, credit unions are unsupervised, although the central bank recently approved a resolution for the bank superintendency to supervise the largest ones.

In addition to the in-depth case studies of regulation and supervision of microfinance in these four countries, the project sponsored a region-wide survey to broaden the information base for this publication. The results of this survey are interspersed throughout the publication and provide a regional perspective on various regulatory and supervisory topics.

A total of eight consultants were hired to support the IDB in this project, several of whom had previous experience as bank supervisors. Throughout the period, the IDB and the consultants had the full cooperation of the supervisory authorities in the case study countries, which contributed significantly to the endeavor in the form of time and effort of their personnel. The publication builds upon the accumulated knowledge and experience of this group of professionals, many of whom are today considered among the foremost experts in the regulation and supervision of microfinance.

In addition to the research, the project financed two high level seminars that brought together virtually all of the region's bank superintendents to discuss the issue of microfinance. The first was held in Washington in June of 2000, and the second in Lima, Peru, in June of 2001. These seminars, and the subsequent support by the Association of Bank Supervisors of the Americas (ASBA), have been instrumental in building awareness of and interest in microfinance among the region's supervisory authorities.

Acknowledgments

The authors would like to thank the numerous professionals involved, at one point or another, in the research project. The complete list of these persons appears under the cataloging information.

The draft report of the research project was submitted for an extensive peer review by various experts. In all, more than 50 people participated in this review in one form or another, including specialized consultants, development organizations, and a large number of bank supervisors. Apart from the people mentioned in the cataloguing information, the authors would like to specifically acknowledge the support and observations of Carlos Cuevas, Richard Rosenberg, Robert Vogel and Jacques Trigo.

Authors' Note

The principles and recommendations outlined in the publication generally represent a broad consensus among experts and officials in the field of regulation and supervision of microfinance. However, there is open debate regarding the appropriate policy response in a few areas, particularly in relation to capital adequacy of specialized microfinance institutions and whether small credit unions not supervised by the country's bank superintendency should be permitted to mobilize deposits.

In these specific cases, the opinion of the two IDB authors is that fully specialized microfinance institutions should be subject to somewhat higher capital adequacy requirements than commercial banks and that small, unsupervised credit unions should be permitted to mobilize deposits. The justification for and thinking behind these positions are outlined in the publication.

Nonetheless, in the interest of full disclosure, the IDB authors would like to acknowledge that the principal consultant does not agree with these two positions, but maintains instead that capital adequacy standards should be uniform across institutions and that no unsupervised credit union, regardless of its size, should be allowed to mobilize deposits (only shares). These positions were expressed in the original draft submitted to the IDB, but were subsequently modified by the IDB authors.

The authors

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I Why bank supervisiors should care about microfinance

There are at least three reasons why bank supervisors should care about microfinance:

(a) **The Importance of the Microenterprise Sector**. Microcredit is crucial for millions of low-income people who depend on it to finance their business activities. Together, microenterprises constitute more than 90% of all businesses in Latin American, employ over half of the labor force and produce approximately 20% of the region's GDP. Given the importance of the sector, in terms of both output and employment, any increase in financial flows to the sector will likely have a noticeable impact on poverty levels and the national economy as a whole.

(b) **Trends in the Microfinance Industry**. Supervisors are caught between two trends—the increasing number of commercial banks adding microcredit to their lending activities, and the growing number of nonprofit microfinance organizations striving to acquire licenses as supervised financial intermediaries. There is also increased political and civil society interest in this topic. As a result, there is really not much of a choice; sooner or later bank supervisors will have to deal with the issue of microfinance.

(c) **The Distinctive Features of Microcredit**. Microcredit is not like commercial and consumer credit. The characteristics of the clients are distinct, the credit methodology is different and, in many cases, the ownership structure of the institutions is not the same as that typically found in conventional financial institutions. These factors give rise to a unique risk profile that needs to be addressed through adaptations in the regulatory framework and supervisory practices.

In view of the foregoing, it is important for supervisory authorities to be familiar with the risks of the industry and to establish a simple and rational regulatory and supervisory framework aimed at facilitating its balanced growth. Such a framework should promote transparency, control risks faced by institutions engaged in microfinance, and eliminate any barriers and unnecessary requirements they face. Without an appropriate regulatory and supervisory framework, it is hard to see how these institutions can reasonably expect to continue their rapid growth while providing the safety and stability expected by depositors and the general public.

The Importance of Microenterprises in Latin America

Microenterprises play a significant role in terms of job creation and gross domestic product in all coun-

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tries of Latin America and the Caribbean, but they appear to be especially important in countries such as Peru, Paraguay, Brazil, Mexico, and Bolivia. Their increased importance in recent years coincides with the fact that economic growth has not been accompanied by improvements in employment. As a result, many prospective workers have had to devote themselves to entrepreneurial activities because they have not found employment in the formal sector.

While the socioeconomic characteristics and official definitions of microenterprise vary from one country to the next, the similarities are greater than the differences. In general, microentrepreneurs work alone or with a few employees, and they oftentimes rely on unpaid workers, apprentices and family members. Most individuals linked to microenterprises have below-average incomes, and, in some cases, are among the poorest members of society. Generally, they work informally, without a business license or formal records of their activities or earnings.[1]

Microentrepreneurs are often held back by a lack of credit, technical knowledge, raw materials and access to water or electricity. Like any other economic undertaking, microenterprises require an enabling economic environment and access to different kinds of infrastructure and means of production, including financial resources on reasonable conditions in terms of amounts, cost and timeliness. In many cases, access to finance is given as the business's primary constraint.

The Importance of Financial Services for Microenterprises

The lack of access to credit services is a significant obstacle to the development and sustainability of microenterprises in Latin America and the Caribbean. Several studies indicate that the smallest firms seeking bank loans face considerable credit constraints, and that they receive credit much less

Table 1.1 Microenterprise in Latin America

Country	Labor Force (millions)	As % of the Labor Force			Millions of Jobs in Microenterprise
		Self-employed Micro-entrepreneurs	Employees of Microenterprises	Total Employment in Microenterprises	
Argentina	14.3	27.0	18.1	45.1	6.5
Bolivia	2.5	37.1	19.0	56.1	1.4
Brazil	59.4	23.4	24.5	47.9	28.5
Chile	5.2	23.7	20.6	44.3	2.3
Colombia	11.7	26.4	30.9	57.3	6.7
Costa Rica	1.2	17.8	23.1	40.9	0.5
Ecuador	3.3	31.5	15.0	46.5	1.6
Honduras	1.7	31.5	15.1	46.6	0.8
Mexico	33.6	30.7	20.9	51.6	17.4
Panama	0.9	19.5	12.9	32.4	0.3
Paraguay	1.1	22.3	34.9	57.2	0.6
Peru	2.9	35.2	16.2	51.4	1.5
Venezuela	7.5	27.3	14.5	41.8	3.1
Total	**145.6**	**27.2**	**20.4**	**47.6**	**71.2**

Source: Berger (2001). Data are from the mid 1990s.

[1] Microenterprises operate in commerce, agriculture, construction, manufacturing, transportation, and services, that is, in practically the entire economy. They are found in nearly all trades and occupations, including hairdressers, beauticians, moneychangers, cigarette makers, calash drivers, plumbers, mechanics, garbage collectors, vegetable vendors, kiosk operators, sellers of second-hand clothing, tailors, textile workers, woodcarvers, watchmakers, furniture-makers, coal and charcoal vendors, domestic workers and workers in cleaning services.

frequently than larger ones.[2] It is also known that many entrepreneurs would like to start up their own businesses, but refrain from doing so due to the lack of credit to finance their initial or subsequent operations. The fact that entrepreneurs and small firms face credit constraints bolsters the argument that national output and employment would increase if such constraints diminished.

While microentrepreneurs demand a diverse array of financial services, such as checking and savings accounts, drafts, transfers, and even international payments and remittances, their most pressing need has to do with access to short- and medium-term loans to finance their productive and commercial activities. Nonetheless, the coverage of the demand for this simple type of credit by the microenterprise sector is far from satisfactory in most of the countries of the region: only Bolivia and Nicaragua have coverage greater than 20%.

Naturally, not all microenterprises are commercially viable even if afforded access to additional financial resources. Bankable microenterprises may account for 25% to 50% of all microenterprises at any given time in any particular country. This suggests that only in countries such as Bolivia and Nicaragua is the market being reasonably covered, at least in the urban areas.

When creditworthy microentrepreneurs receive access to credit, the result can be dramatic. Although it is always difficult to separate the vari-

Table 1.2 Percentage of Microenterprises in Latin America with Access to Credit from Microfinance Institutions

Country and Date	Number of One-Person Enterprises	Enterprises with 1–5 Employees	Total Number of Microenterprises	Microenterprises with Access to Credit from MFIs	Percentage with Credit from MFIs
Bolivia, 1999	1,300,313	62,008	1,362,321	379,117	27.8%
Nicaragua, 1998	377,148	40,422	417,570	84,285	20.2%
El Salvador, 1998	606,569	60,617	667,186	93,808	14.1%
Honduras, 1999	832,941	58,239	891,180	107,054	12.0%
Chile, 1998	1,069,139	138,045	1,207,184	82,825	6.9%
Colombia, 1998	1,328,476	93,238	1,421,714	71,187	5.0%
Costa Rica, 1998	232,328	78,891	311,219	12,794	4.1%
Ecuador, 1998	1,396,139	298,524	1,694,663	65,719	3.9%
Dominican Rep., 1998	1,315,016	77,172	1392,188	49,437	3.6%
Colombia, 1999	5,726,653	775,152	6,501,805	219,240	3.4%
Paraguay, 1998	319,113	668,213	987,326	30,203	3.1%
Peru, 1997	4,102,561	2,763,632	6,866,193	185,431	2.7%
Panama, 1999	267,854	21,150	289,004	6,390	2.2%
Mexico, 1998	8,503,552	1,770,393	10,273,945	67,249	0.7%
Uruguay, 1998	314,891	27,018	341,909	1,600	0.5%
Brazil, 1999	16,567,943	2,421,810	18,989,753	62,485	0.3%
Argentina, 1998	1,807,615	103,555	1,911,170	4,940	0.3%
Venezuela, 1999	2,906,975	340,296	3,247,271	2,364	0.1%
Total	**48,975,225**	**9,798,375**	**58,773,600**	**1,526,128**	
Weighted Average					**2.6%**
Simple Average					**6.2%**

Source: Westley (2001).

Note: In some of the more developed countries, micro and small enterprises are likely to have access to financing from traditional banks and finance companies.

[2] See Diagne, Zeller and Sharma (2000) for a discussion of this topic.

ous factors that determine household welfare, access to credit does appear to lead to significant increases in income.[3] Such an improvement typically also has a positive effect on other aspects of household welfare, including nutrition and education. It also drastically improves the household's capacity to save. Given such improvements, it is not unreasonable to assume that microloans allow microenterprises to undertake projects with high rates of return that previously were not feasible.[4] Indeed, one sign that the smallest enterprises have many projects with high rates of return that are ready to go, but that are thwarted by the lack of financing, is the high interest that these firms are willing to pay on microenterprise loans, often from 30% to 80% annually in real terms.

Loans to microenterprises and relatively poor households have a positive effect when tailored to the needs and circumstances of the clients. Otherwise, access to credit may result in an ever-greater debt burden, eventually leading to the loss of assets that the microentrepreneur has accumulated over many years, and which he may have mortgaged or pledged as collateral. This problem can become especially serious in countries in which microentrepreneurs are often indebted to several institutions at once, as in Bolivia, Nicaragua, and Peru, where microfinance institutions compete with one another and operate with different objectives, policies, limits, and controls.[5]

Table 1.3 Impact of Access to Credit for Microentrepreneurs in Peru

Concept	With Access to Credit	Without Access to Credit
Total income	US$9,300	Less than US$6,000
Per capita income	US$1,800	US$1,316
Below the poverty line	28%	41%
Sources of income	3.3	2.8
Spending on education	US$227	US$191
Spending on food	41% of income	56% of income
Accumulation of fixed assets	2x	1x
Jobs created	2.3	1.9

Source: Dunn (1999).

Note: Study carried out with the support of Acción Comunitaria of Peru (now Mibanco), a leading institution with over 70,000 loan clients.

The risk of overindebtedness points to the need for credit markets to offer access to basic information on actual and potential borrowers. In addition, it suggests the need for institutions that make loans to microentrepreneurs to have adequately trained loan officers, as well as specialized internal control mechanisms. The risk of overindebtedness also highlights the importance of having a differentiated regulatory and supervisory framework that effectively addresses the particular risks of microfinance.

In the end, the only way to stimulate a sufficient flow of financing to the sector is to consider microfinance as a financial activity in its own right, and not as an isolated, passing or philanthropic activity. The stability and sustainability that accompanies a more commercial approach within an appropriate regulatory and supervisory framework is necessary for generating confidence among depositors, creditors and investors, who are the ones that in the long run will provide the funds to sustain the growth of the microfinance industry.

Trends in the Microfinance Industry

The need for bank supervisors to care about microfinance is also rooted in industry trends. The pressure to accommodate microfinance is increasing in the region and indeed in the rest of the world as well. In some countries, this dynamic has resulted from the work, over many years, of nonprofit organizations which, with the support of grant-making institutions and international organizations, have

[3] For a more extensive discussion of the impact of microcredit, see articles by Shreider and Sharma (1999) and Sebstad and Chen (1996).

[4] Often, microentrepreneurs' incomes increase even when they employ loan funds to resolve personal problems or address temporary economic difficulties, both of which can have major impacts on the incomes of poor households since these households typically have few assets with which to address such problems or difficulties in the first place.

[5] As pointed out by MicroRate, a specialized microfinance assessment firm, there are 285 organizations offering microcredit in Nicaragua, many of which operate with high administrative costs, high lending rates, and considerable dependence on grant monies.

made efforts to develop technologies for microenterprise financing and have later participated in creating financial institutions specialized in microfinance. In other countries, the dynamic reflects the commercial initiatives of traditional intermediaries who, pushed by competition in established markets and attracted by the profitability and growth possible in microfinance, are attempting to enter the microenterprise market.

These two trends—of rapidly growing nonprofit organizations and greater involvement in the sector by traditional financial intermediaries—mean that bank supervisors will sooner or later have to deal with the issue of microfinance. On the one hand, mature and profitable nonprofit organizations are increasingly seeking licenses to operate as supervised intermediaries, as a way to offer a broader range of services to their clients and to raise funds from financial markets and depositors. On the other hand, established financial intermediaries often encounter regulatory difficulties and inconveniences as they try to serve this segment of the market.

The pressure for regulatory reform often manifests itself in the political arena. In particular, nonprofit microcredit organizations have taken an increasingly active role in promoting legal reforms to facilitate microfinance. For instance, the desire and pressure to accommodate microfinance have led some countries to create new types of financial institutions, precisely for the purpose of enabling nonprofit microcredit organizations to convert into financial institutions that can raise funds in the financial markets and capture deposits from the public.

Table 1.4 Financial Institutions Created to Provide Microcredit

Year	Country	Name	Legal Form	Owners
1980	Peru	Caja Municipal de Ahorro y Crédito—CMAC	Municipal enterprise	Municipal governments
1992	Peru	Caja Rural de Ahorro y Crédito—CRAC	Shareholder company	Individuals and institutions
1994	Peru	Entidad de Desarrollo a la Pequeña y Microempresa—EDPYME	Shareholder company	Individuals and institutions
1995	Bolivia	Fondo Financiero Privado—FFP	Shareholder company	Individuals and institutions
2000	Brazil	Sociedad de Crédito para el Microempresario—SCM	Shareholder company	Individuals and institutions
2000	El Salvador	Sociedad de Ahorro y Crédito—SAC	Shareholder company	Individuals and institutions
2001	Venezuela	Banco de Desarrollo Especializado en Microcrédito—BEM	Shareholder company	Individuals, institutions, federal and municipal governments, and banks
2001	Honduras	Organización Privada de Desarrollo Financiero—OPDF	Private nonprofit entity	There are no owners, only founders
2001	Mexico	Sociedad Financiera Popular—SOFIPO	Shareholder company	Individuals and institutions
2001	Mexico	Sociedad Cooperativa de Ahorro y Préstamo—SOCAP	Cooperative	Individuals
2001	Panama	Banco de Microfinanzas—BMF[a]	Shareholder company	All those who can be shareholders of a bank

Source: Prepared by authors based on case reports and the project survey.

Note: (a) At least 75% of the portfolio of these banks must be made up of loans each of which is less than 3% of the BMF's net worth. The remaining 25% may be graned in loans subject to the credit limits of commercial banks (each loan smaller than 50% of the BMF's net worth).

Unfortunately, this can sometimes be a high profile response to a problem that could be better solved by a more modest regulatory approach.

So far, a total of 11 different types of financial institutions have been created in Latin America wholly or partly for the purpose of facilitating microfinance—in Bolivia, Brazil, El Salvador, Honduras, Mexico, Panama, Peru, and Venezuela. Except for the cases of Bolivia and Peru, which are both recognized to have the most advanced regulatory frameworks for microfinance in the region, the creation of these institutional forms is too recent to generate any firm track record or experience. As far as these two countries are concerned, the regulatory framework of Bolivia is generally considered somewhat more successful than that of Peru.

The majority of the eleven institutional forms are structured as shareholder-based corporations, consistent with the general practice of permitting only credit unions and shareholder-based institutions to operate as deposit-taking intermediaries. Nevertheless, some exceptions exist. In Peru, for instance, the *Cajas Municipales de Ahorro y Crédito* are fully owned by municipalities, although many of them are currently exploring privatization. The case of Honduras offers another interesting exception to the rule. There, a 2001 law enables nonprofit organizations to acquire licenses and operate as financial intermediaries while retaining their original legal structure. This highly unusual, and questionable, arrangement is unique in the countries of Latin America and the Caribbean.

There are two situations in which it may be appropriate to create a new type of financial institution to facilitate the transformation of nonprofit organizations into licensed and supervised intermediaries. First, if the minimum capital requirements for existing institutional forms (typically, banks and finance companies) are very high, such requirements could prevent, or at least delay, mature and well-managed nonprofit organizations from constituting themselves as financial intermediaries and entering the formal financial system. Second, if the existing institutional form that has the lowest minimum capital requirement (typically, a finance company) is severely limited in the type of operations it can carry out—particularly in the area of savings mobilization—then it may simply be an unattractive institutional form for those nonprofit organizations that want to become financial intermediaries.[6] In such cases, one would have to amend these limits or create a new type of institution that makes it possible for nonprofit organizations to form specialized financial intermediaries. On the other hand, if there are no large and mature nonprofit organizations ready and willing to become financial intermediaries, it is evidently premature to create a new type of institution for this purpose.

Consequently, if the minimum capital requirement for finance companies is reasonable (i.e., less than US$3 million) and if they are permitted to mobilize not only time deposits but also savings deposits, then there is really not much reason to create a new type of institution for microfinance. And if finance companies cannot mobilize savings, then the first alternative should be to see if it is possible to change that restriction—either on a case-by-case basis or as wholesale change to the institutional form—rather than creating a completely new type of institution. There is no value in an unnecessary proliferation of institutional forms; it only makes the job of supervisors that much harder.[7]

Some of these eleven institutional forms have not only been useful in encouraging microfinance, but even necessary. In other cases, however, the creation of a new type of financial institution appears to have been premature or less than perfectly designed. In these latter cases, the effort of policymakers is likely to have a more muted impact on the financing available to microentrepreneurs.

Of the eleven institutional forms that have been created in the region to facilitate microfinance, the ones in Bolivia and El Salvador appear to be the most justified and balanced because: (a) they fill the role of both finance company and microfinance institution, thus avoiding a proliferation of institu-

[6] In some Latin American countries, the permitted operations for finance companies are so limited that it is impossible to offer microfinance services through them. In Guatemala, for example, finance companies cannot mobilize savings deposits and can only lend over the medium to long term. Since the ability to capture savings is one of the primary motivations in the transformation of NGOs, and microloans usually have a term of 3 to 12 months, the Guatemalan finance company is completely unattractive for entities that wish to provide microfinance services.

[7] The bad reputation of finance companies in some Latin American countries has at times been mentioned as a reason for creating a new institutional form for nonprofit organizations that want to transform into formal financial intermediaries. However, if the reputation of finance companies is badly damaged, it might be better to propose replacing that type of institution and creating an institutional form that is flexible enough to accommodate the traditional activities of finance companies as well as microfinance (such as was done in Bolivia).

Table 1.5 Financial Institutions Specialized in Microcredit

Country	Institution	Deposits	Minimum Capital (US$)	Capital Adequacy Requirement	Minimum Capital for Banks/Finance Companies (US$)
Bolivia	FFP	Savings, Time	820,000	10%, same as banks	Banks: 7,500,000 Finance cos.: none exist
Brazil	SCM	No	53,000	16.6%, more than banks and finance companies (11%)	Banks: 6,500,000 Finance cos.: 2,600,000
El Salvador	SAC	Savings, Time	2,850,000 1,140,000[(a)]	12%, same as banks	Banks: 11,400,000 Finance cos.: none exist
Honduras	OPDF	Savings, Time	60,000	16.6%, more than banks and finance companies (10%)	Banks: 6,000,000 Finance cos.: 1,200,000
Mexico	SOFIPO SOCAP	Savings, Time[(b)]	45,000	8–11%, more than banks (8%)	Banks: 19,000,000
Panama	BMF	Demand, Savings,Time	3,000,000	8%, same as banks	Banks: 10,000,000 Finance cos.: none regulated[(c)]
Peru	CMAC CRAC EDPYME	Savings, Time Savings, Time No[(d)]	270,000	9%, same as banks	Banks: 5,200,000 Finance cos.: 2,600,000
Venezuela	BEM	Demand, Savings, Time	2,370,000	12%, same as banks	Banks: 19,800,000 Development banks: 5,700,000

Source: Prepared by authors based on case reports and the project survey.

Notes: (a) This lesser requirement is applied if the institution lends only to micro and small enterprises and mobilizes savings only from its borrowers. A microenterprise is defined as a business with less than 10 employees or less than US$5,700 in monthly sales. A small enterprise is defined as a business with 10 to 50 employees or monthly sales ranging from US$5,700 to US$57,000.
(b) SOFIPO and SOCAP are subject to a tiered regulatory regime based on their capital. Institutions with more than US$7,500,000 in capital operate in a manner similar to banks.
(c) There are finance companies in Panama; however, they are not supervised by the bank superintendency and they are not allowed to mobilize savings.
(d) All specialized institutions are subject to a tiered regulatory regime based on their minimum capital. The EDPYMEs may mobilize savings and time deposits when they are classified as module 1, which, among other conditions, requires capital of about US$1 million.

tional forms (as has occurred in Peru); (b) they are allowed to mobilize deposits from the public; (c) they have minimum capital requirements that demand a certain level of financial strength yet are low enough to enable nonprofit organizations to transform into the new structure; and (d) they are created as incorporated, shareholder-based companies which, while far from perfect, still offer the institutional form that provides the best set of checks and balances in terms of governance.

The designs of and rationales for the other nine institutional forms are less convincing. In some cases, the minimum capital requirements seem too low to ensure that the institutions can mount a sustainable operation; in other cases, the institutions are not permitted to mobilize savings, which begs the question of why they are supervised in the first place.

For instance, the minimum capital requirements for the institutional forms created in Mexico, Honduras, Brazil, and Peru are quite low, and in the cases of the EDPYMES of Peru and SCMs of Brazil, they are not permitted to capture deposits. The case of Honduras stands out for a different

reason: it is the only example where nonprofit organizations are permitted to operate as financial intermediaries (capturing savings) while retaining their legal status as foundations or associations. In Venezuela, the high capital requirements for conventional banks, coupled with the lack of an institutional form with a lower level of capital (such as a finance company), means that the new institutional form, *Banco de Desarrollo Especializado en Microcrédito,* fills a significant void. However, there are few, if any, nonprofit organizations in Venezuela that are mature or successful enough to actually transform into this new type of institution. In Panama, the creation of a new institutional form, *Banco de Microfinanzas,* was brought on and justified by the high capital requirements demanded of commercial banks; however, another option might have been to enable the existing finance companies (which are presently unsupervised and cannot mobilize deposits) to seek licenses to become supervised, deposit-mobilizing financial institutions.

In Mexico, the creation of two new institutions, *Sociedad Financiera Popular* and *Sociedad Cooperativa de Ahorro y Préstamo,* is part of an effort to consolidate the large number of institutional forms that currently exist in the financial system. It is a unique initiative in that it also explicitly deals with microfinance through the lens of credit unions, attempting to establish a fair and competitive framework that treats these institutions on a par with other financial intermediaries in the area of prudential regulation.

Credit unions play a leading role in providing microcredit in Latin America, considering that from 20% to 40% of their portfolios, or US$830 million to US$1.65 billion, is lent to microentrepreneurs. However, while credit unions in some cases have microlending volumes greater than those of banks and finance companies, they are usually subject only to the legislation and supervision applicable to cooperatives generally, along with thousands of productive, commercial, transport, education and health cooperatives. In other words, the regulatory and supervisory practices of most countries in the region place most credit unions in a virtual regulatory vacuum.

This lack of attention by supervisory authorities is becoming hard to justify. The large size of many credit unions means that the original bond among credit union members is becoming diluted, or dis-

Box 1.1 Why NGOs Shouldn't Mobilize Deposits from the Public

Most non-governmental organizations that provide microcredit in Latin America are organized as nonprofit foundations or associations established in keeping with the provisions of the civil codes.

Unlike commercial organizations, associations and foundations are governed by their own charters, drafted with broad legal discretion. In particular:

- Foundations and associations do not have owners in the strict sense of the word; instead they have founders, who may or may not have contributed economic resources to start up the organization.
- They are commonly governed by a board of directors and run by a manager or executive director. The board of directors is appointed by the board of trustees and may also include some trustees. The number of members of the board and the frequency of their meetings vary; the legislation leaves it up to each organization.
- Their operating framework allows them to engage in a wide range of operations that may easily create a distraction from handling deposits, such as: (a) implementing, promoting, and supporting the education and development of those in marginal economic sectors; (b) developing promotional services and technical education; (c) providing advisory services to groups working in community development activities; and (d) providing reimbursable and non-reimbursable financing to depressed social sectors.

As for means of dissolution, the civil codes provide only for voluntary liquidation of these entities for the causes set forth in their charters, or forced liquidation when they engage in illegal acts.

This breadth of form and objectives in the conduct of their business makes the association or foundation a suitable vehicle for managing resources earmarked for cultural, social, educational, and charitable purposes in poor or marginalized sectors. Nonetheless, these same characteristics also render them completely inadequate when it comes to mobilizing deposits from the public, including deposits from poor and/or marginalized communities.

appearing altogether. This, in turn, means that they tend to lose the ability to effectively supervise themselves, and should therefore be treated in all significant respects like any other deposit-taking financial institutions.[8] In other words, they should be regulated and supervised by the same authority that supervises banks and finance companies.

Nevertheless, given their large numbers and unusual governance structure, regulating and supervising credit unions is an enormous challenge to supervisory authorities. Considering, moreover, that credit unions are not usually thought to pose systemic risk to the financial system, most bank supervisors prefer to have them supervised by other government or industry organizations. However, delegated supervision of credit unions has not worked well in Latin America. Furthermore, supervisors need to understand that in many cases there is, in fact, systemic risk in credit unions. The sheer number of depositors and borrowers that belong to credit unions means that the failure of even a single one of these institutions can affect tens of thousands of people, most of whom have very limited means of coping with the loss of their savings or source of credit. The risks may not be systemic in the traditional sense, but they are certainly systemic in their possible political ramifications.

For the reasons mentioned, supervisors need to take a closer look at how to address the issue of credit unions. Supervisors in some countries have already begun developing frameworks for regulating and supervising credit unions, including Bolivia, Chile, Colombia, El Salvador, Jamaica, Mexico and Paraguay. While this is likely the beginning of a larger trend in the region, the implementation of these frameworks is still very much a work in progress. Finding models for how to effectively regulate and, in particular, supervise credit unions constitutes a major challenge for the region's supervisory authorities.

Table 1.6 Elements of Self-regulation of Nonprofit Microcredit Organizations

Areas	Key Objectives	Vehicle
Administrative Disciplines	Appointment of directors Powers and responsibilities of directors Bonds to be posted by managers and loan officers	Bylaws
Operational and Financial Disciplines	Limits on spending for non-financial services Specialization in loans Determination and preservation of net worth Maximum amounts of operating risks	Bylaws
	Prudent and transparent accounting rules Proper accounting treatment of subsidies received through submarket interest rates and through grants in cash and in kind	Accounting Rules
	Timely recognition of credit risk	Adoption of Financial System Regulations
Internal Controls	Internal auditing Monitoring handling of credit	Bylaws and Organization and Functions Manual
External Controls	External auditing Public dissemination of financial information	Adoption of Financial System Regulations

Source: Prepared by the authors.

[8] The lack of any meaningful bond among members, or a sense of ownership of the institution, is manifested in poorly attended membership meetings and assemblies. In many cases, a person can become a member merely by showing an ID. Additionally, the fact that share capital rarely offers a positive real return further decreases the incentive to participate in key decisions such as the election of board members and the approval of profit and loss statements, much less in the control of the credit union. In other words, in practice, the vast majority of "members" in credit unions, particularly in the larger ones, are little more than clients.

Finally, nonprofit organizations that only provide credit should not be subject to government supervision, since they are financed by grants and loans, not deposits from the public. For these institutions, it is preferable to encourage self-regulation geared to strengthening governance mechanisms,[9] specializing operations around lending activities, and fostering external oversight by creditors and donors. These schemes should promote reliable and comparable financial information, based on accounting principles applicable to financial institutions, and the participation of independent and experienced external auditors. Incorporating these elements into the everyday life of nonprofit organizations could be done by modifying their bylaws, accounting rules, and organizational and operational manuals.

The Distinctive Features of Microfinance

It is not only the importance and growth of microfinance throughout the region that justify the attention bank supervisors should give to it. This attention is also justified by the fact that microfinance has a unique risk profile derived from several distinctive characteristics, which can be grouped into four main areas: (a) ownership structure and composition, (b) client characteristics, (c) product characteristics and (d) lending methodology. The distinctive features of microfinance, and the unique risk profile derived from them, mean that bank supervisors need to adapt the regulatory framework and their supervisory practices in order to effectively supervise the institutions that undertake this activity.

The distinctive ownership feature arises from the fact that an institution specialized in microfinance is typically dominated by the nonprofit organization that created it. In many cases international aid agencies are also significant shareholders, while profit-driven investors are normally in a minority, if there are any at all. This situation gives rise to some potential institutional weaknesses since: (a) there may be little intrinsic interest among shareholders to push for efficiency and profitability in the institution and (b) shareholders may not have the same capacity as commercial investors to promptly respond to a capital call. Supervisory authorities need to be aware of these potential weaknesses and devise regulations and practices that mitigate them, including the application of thorough screening mechanisms when licensing institutions specialized in microcredit.

On the other hand, the past ten years have shown that international aid agencies and nonprofit organizations can be stable and responsible shareholders. Their commitment to microfinance institutions goes beyond their narrow interest as shareholders and often results in support and assistance that wouldn't be available from conventional, commercially-oriented shareholders. Therefore, these unconventional shareholders should not be dismissed out of hand.

The distinctive client, product and lending methodology features are all interrelated. More specifically, the product and the lending methodology are fundamentally a result of the characteristics of the clients. As explained earlier, microcredit clients normally do not have the stable income of a wage earner, registrable collateral or formal financial statements. This underlies the notable differences between microcredit and corporate credit, where in the latter the loan is evaluated in light of formal financial information and registrable collateral. It also underlies the notable differences between microcredit and consumer credit for wage earners, where in the latter the evaluation is based primarily on an applicant's regular flow of income.

Microlenders replace the traditional methodologies of commercial and consumer banking and adapt to the particular characteristics and needs of the group they serve. As a result, the microcredit methodology is based fundamentally on a field evaluation of the client's character and ability to pay, with the latter obtained by analyzing the cash flow of the client's socioeconomic unit (the enterprise and household, taken together). Also, instead of relying on collateral, the microcredit methodology employs alternative incentive systems that encourage the borrower to repay.

[9] In foundations, the typical governance problems include the following: (a) the excessive concentration of powers in the board of directors, including administrative powers and control over day-to-day operations; (b) the lack of an adequate framework for delimiting the functions of the other institutional organs; (c) the lack of formal mechanisms of corporate control; (d) the lack of a regime of responsibilities applicable to the board of directors and the executive organs; (e) the lack of accountability mechanisms; and (f) the lack of prudential standards and failure to manage risk.

The characteristics of the clients and the lending methodology shape the product: small, typically short-term loans that carry high interest rates. The loans are small and short-term because this is what the clients demand and because it allows microfinance institutions to effectively structure repayment incentives around the promise of larger and longer-term loans in the future. The high interest rates are necessary to cover the considerable costs of the lending methodology. It is simply very costly to conduct on-site visits to clients and manage thousands of small loans that are frequently turned over.

The distinctive features of the clients, the lending methodology and the products result in a unique risk profile for microfinance institutions.[10] The risk profile is not entirely unlike that of conventional financial institutions, but the emphasis among different areas is different.

First, as a result of their decentralized structure and the close relationship between clients and loan officers, microfinance institutions have pronounced operational risk. The quality of the portfolio and the institutions' overall performance depend crucially on the capacity and professionalism of its loan officers, as well as on appropriate incentive systems and internal controls.

Second, while microenterprise loan portfolios are atomized, which decreases risk, they also tend to be geographically concentrated, which increases risk. In addition, the fact that loans are typically uncollateralized becomes a significant worry once loan arrears start to rise.

Third, the risk profile of microfinance institutions is defined by the cost structure of microlending, which basically consists of high up-front costs (due to the on-site evaluation of potential clients) covered by high interest rates. This means that once loans go bad, the impact on the institutions' bottom line will be much quicker and much more drastic than for banks and other financial institutions that serve consumer and commercial clients with conventional credit methodologies.

Fourth, the high cost of providing microcredit means that microfinance institutions are highly sensitive to limits imposed by the government on the interest rates that they can charge. The imposition of such limits, which may not pose a significant obstacle for banks serving large corporate clients, may easily and significantly disrupt the

Table 1.7 Distinctive Features of Microfinance

Category	Traditional Banking	Microcredit
Ownership and Governance	• Profit-maximizing institutional and individual shareholders • Centralized decision-making	• Mainly nonprofit institutional shareholders • Decentralized decision-making
Client Characteristics	• Diverse formal businesses and salaried individuals • Geographically dispersed clients	• Low-income entrepreneurs with rudimentary family businesses and limited formal documentation • Located in a specific geographic area
Lending Methodology	• Collateral and formal documentation • Salary incentives are a minor part of loan officer compensation	• Character and cash flow analysis through on-site inspections • Salary incentives are a major part of loan officer compensation
Product Characteristics	• Larger amount • Longer term • Lower interest rate • Monthly repayment	• Smaller amount • Shorter term • Higher interest rate • Weekly and bi-weekly repayments, some monthly

Source: Jansson (2001).

[10] For a discussion of the risk profile of microfinance institutions, see Staschen (1999).

operations of microfinance institutions that have higher operational costs as a result of serving smaller or harder-to-reach clients.

Fifth, the implicit or explicit promises of future loans as an incentive for timely repayment means that microfinance institutions are exposed to a certain liquidity risk, since any inability to renew loans could influence repayment by current clients. All financial institutions face this risk to some extent, but it is more pronounced in microfinance institutions.

Finally, as mentioned earlier, there are important ownership and governance issues that influence the risk profile of microfinance institutions and further complicate their effective supervision.

The unique risk profile of microfinance institutions means that supervisors need to make an extra effort to understand, identify and counteract the potential weaknesses of microfinance institutions. They need to establish clear regulatory standards and supervisory practices that allow them to identify and address problems in microfinance institutions at an early stage, long before a crisis is reached. A first and basic step in this effort is to understand the microlending methodology.

The Microlending Methodology

To effectively and appropriately regulate and supervise financial institutions engaged in microlending, supervisors need to understand the specifics of the lending methodology. Any regulatory modifications or changes in supervisory practices must be on the characteristics of the microlending methodology, which, in essence, revolves around four basic themes: (a) client analysis, (b) the use of collateral, (c) progressive lending, and (d) monitoring arrears.

Client Analysis

In the first step of the microcredit client analysis, the loan officer typically assists the applicant in preparing the financial statements of his or her business in order to determine available and expected cash flow. However, since microenterprises are often intertwined with the economy of the applicant's household, the loan officer has to analyze the applicant's socioeconomic unit (household-business) as a whole. Unlike in the case of traditional credit evaluation methodologies, the microcredit loan officer compiles the necessary information through visits to the applicant's business and home. This information is then used to estimate the applicant's payment capacity, and, later on, to set the loan amount and adapt the payment plan to his or her cash flow.

The second step of the microcredit client analysis is an evaluation of the borrower's character and willingness to repay the loan. To this end, the loan officer compiles information about the borrower's social and economic characteristics in order to assess his or her reliability in following through on commitments. The most important sources of information for this analysis are neighbors, suppliers, and clients, in addition to leaders of trade or business associations, whose opinions offer a basis for gauging the applicant's character. The loan officer processes this information and consults the credit bureau (if there is any) for additional information on the applicant's credit history.

The loan amount is often calculated as a proportion of the difference between assets and liabilities (net worth) declared by the applicant, while the amortization schedule is determined based on cash flow. Once this analysis has been done, the loan officer presents the proposal to the loan committee, which meets at the respective branch or, in the case of larger loans, at the headquarters of the institution. This tiered decentralization ensures more expeditious processing of loan applications and makes it possible to reduce somewhat the high administrative costs of microlending.

These techniques address the lack of formal documentation of the applicant's business, and are also a first step in addressing the difficulties that arise from the lack of collateral. However, these methods place a lot of faith in the performance of the loan officers, who assume a greater variety of functions than their counterparts in conventional financial institutions.

In this context, a well-calibrated, performance-based remuneration system for loan officers is key in ensuring the quality and timelines of credit decisions. Accordingly, loan officers in microfinance

institutions typically receive relatively low fixed salaries, to which is added a monthly bonus based on the performance of their loan portfolio. The bonuses are based not only on the number and volume of loans made and outstanding, but also on the delinquency rate of each loan officer's portfolio. If correctly designed, these incentive schemes not only serve to keep arrears low, but also help prevent manipulation and fraud in the credit review and approval process.[11] This is important, because the wide range of functions carried out by loan officers, coupled with their close relationship to clients, can potentially give rise to deceptive or fraudulent practices.

Use of Collateral

The fact that microentrepreneurs often lack the collateral required by traditional banks does not mean that a methodology adapted to these circumstances will totally ignore collateral. Microfinance institutions often require that clients put up some sort of collateral, though the purpose is not primarily to recover losses in case loans become uncollectible, but rather to induce repayment in the first place. The collateral pledged by microentrepreneurs is typically of too little value to allow for a cost-effective repossession by the lender. Instead, collateral is used by the institution to underscore the seriousness of the commitment expected of the borrower.

In line with this approach, collateral usually takes the form of goods that have been identified by the loan officer in visits to the client's home or workplace and whose loss would occasion significant losses or replacement costs for the borrower. For larger loans, microfinance institutions tend to require movable property and real estate collateral that can be registered in the public property registries, consistent with the practices of conventional financial intermediaries.[12]

As described, the microlending methodology is designed to largely circumvent the traditional use of collateral. Nonetheless, one should bear in mind that the methodology would not work were it not supplemented by progressive lending and strict control of arrears.

Progressive Lending

The use of progressive lending is based on the fact that microentrepreneurs are typically interested in and dependent upon ongoing access to credit, while at the same time having limited access to alternative sources of financing. This enables microfinance institutions to implement effective incentive systems to reward good borrowers with preferential access to future loans. The preferential treatment normally includes the ability to obtain a new loan more quickly (and without having to undergo another loan analysis), a gradual increase in the loan amount, as well as more favorable loan repayment terms in the form of lower interest rates and longer amortization periods.

While progressive lending has proven very effective as an incentive for loan repayment, microfinance institutions, as well as bank supervisors, should be mindful of the risks inherent in increasing borrower indebtedness. This is particularly important in countries where microentrepreneurs tend to be clients of more than one financial institution at the same time. In these cases it may be difficult to determine the overall indebtedness of a borrower, which in turn could lead to inappropriate increases in loan amounts by individual microfinance institutions.

Monitoring Arrears

The microlending methodology requires strict control of arrears due the short-term nature of the loans, the lack of collateral and the high frequency with which installments are paid (in many instances, weekly or bi-weekly). In microlending, monitoring delinquent loans is not entrusted to a special department, but remains in the hands of the loan officers, as their familiarity with clients' personal circumstances and business relationships allows them to apply timely and significant pressure on delinquent borrowers.

The loan officer usually contacts the delinquent borrower the day after failure to receive a scheduled payment, and advises him of the risk he runs if the payment is not made immediately. If the client still

[11] However, some countries have labor laws that prohibit performance-based differentials in remuneration.

[12] This underscores the importance of formalizing microenterprises and their main assets and of improving the public property registries, in order to increase the opportunities for pledging collateral and reducing transactions costs.

does not make the payment, the intensity of collection measures is gradually increased, including contacts with family, neighbors and business associates. Ultimately, it can lead to the seizure of collateral and the permanent exclusion of the client from any further access to credit from the institution. The rigorous application of these measures is essential for the overall success of the microlending methodology.

On this point, it is important to recognize the central roles played by: (a) a functioning credit bureau, which provides an additional tool for screening clients, and (b) an efficient judicial system, which allows institutions to reasonably resolve claims and disputes with their clients. The availability of these external resources creates additional incentives to lend as well as to repay.

Variations in the Microlending Methodology

While there are certain core characteristics that define microlending, there are also significant variations in how it can be provided. For instance, some microfinance institutions use lending methodologies based on groups of borrowers who guarantee each other's loans. This methodology enables microfinance institutions to delegate some lending functions to the borrowers, which potentially reduces operating costs and affords very poor clients access to credit. These group-based technologies (called "solidarity groups" and "village banking") have some elements in common with the individual lending methodology, including strict monitoring of arrears, progressive lending and performance-based remuneration for loan officers.[13]

Credit unions usually employ a lending methodology in which potential borrowers must first become members, pay into the credit union an initial amount of share capital and, in some cases, also deposit savings. In this way, the potential borrower first displays the capacity to save and exercise financial discipline. After a certain time, the member is eligible to receive a loan based on the total amount of his or her share capital, and on meeting the other requirements typical of a traditional loan. However, in some instances, the quality of credit screening can suffer as a consequence of the semiautomatic nature of the credit approval process used by some credit unions, in which loans are granted more or less automatically as a multiple of member share capital. This is particularly serious in the case of microenterprise lending, where the estimate of repayment capacity should hinge on the probability of success of a business venture and the profits it is likely to generate.

The variations in microlending methodology mean that supervisors need to make an extra effort to understand the credit processes of the institutions engaged in microfinance. It also means that supervisors should not try to dictate or standardize the details of the internal credit processes used by these institutions, as this could prevent them from developing innovative practices that are appropriate for the populations they serve. Instead, supervisors should work to ensure that microfinance institutions and credit unions have the internal controls in place to effectively minimize operational and credit risk.

[13] BancoSol of Bolivia, the pioneer institution providing finance to microenterprises in Latin America, based its growth initially on solidarity group lending. This bank dominated the market in Bolivia until the mid-1990s, when other microcredit NGOs began to transform into regulated Private Financial Funds (described above). These institutions entered the microfinance market using individual lending methodologies, and presented increasingly tough competition for BancoSol. The trends in Bolivia in recent years have tilted the balance in favor of the individual lending methodology and away from the use of solidarity groups, which mirrors the situation in other countries of the region. Nonetheless, solidarity group loans are still an important option, in particular to reach poorer clients, and to attract new clients to the financial institution.

II Principles and practices for regulating microenterprise lending

Recently, several countries in Latin America have created new types of financial institutions in an effort to facilitate microfinance by making it easier to transform nonprofit microfinance organizations into financial intermediaries. While these efforts are commendable for their intentions, such an approach may not always be the most productive or effective. The first, and possibly the most important, step in creating a regulatory framework for microfinance is to design appropriate regulations for microenterprise lending as an activity and microcredit as a product.

Such regulations, which would guide, among other things, loan portfolio classification, loan loss provisions, write-offs, and loan rescheduling, should take account of the special characteristics and risk profile of microfinance. With regulations tailored to the distinctive features of microenterprise lending as an activity and microcredit as a product, the regulatory framework can be applied to all supervised institutions involved in microlending operations, regardless of whether they have been chartered as banks, finance companies, credit unions or some other type of supervised entity.

Such tailored regulations have numerous benefits: the regulatory costs associated with microenterprise lending will be lowered; financial entities will operate on a level playing field vis-à-vis one another; and supervisors will be able to rely on a framework that promotes a strict recognition of revenues, expenses and risks among the institutions active in the microfinance field. These considerations are not only important to institutions specializing in microenterprise credit but also for conventional banks and finance companies interested in adding microenterprise lending to their existing operations.

As a rule, a regulatory framework for microfinance should be based on simple rules and principles that allow for easy verification and do not restrict the initiative and creativity of the institutions providing this type of service. These guiding concepts for regulating microenterprise lending—flexibility and simplicity—are necessary to foster a continued and balanced growth of microfinance among supervised entities. Microenterprise credit requires regulatory

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flexibility in terms of interest rates, collateral and internal lending processes. It requires simplicity in terms of client documentation, portfolio classification, loan loss provisioning and loan write-offs. Together, these guiding principles allow room for innovation, reduce the regulatory costs of compliance, and permit easy verification by the supervisor.

The implementation of a rational regulatory framework is facilitated by a clear definition of microenterprise credit, as this allows supervisory authorities to apply tailored regulations to such operations. As explained in further detail in this chapter, it is important that this definition is formulated in a way that allows the bank supervisor to easily verify that loans classified as microenterprise loans by an institution are, in fact, microenterprise loans. If that is not the case, and it is hard for the supervisor to verify which loans are microenterprise loans, the introduction of tailored regulations for microenterprise credit can easily become difficult to implement and costly to supervise.

Failure to provide a differentiated regulatory treatment for microenterprise lending can produce a variety of consequences, depending on the regulations in place in the country. If microenterprise loans are classified as commercial loans, this might entail documentation requirements that are excessive for microenterprise borrowers. This would not only be a disincentive to lending, but also to reporting. Moreover, classifying microenterprise loans as conventional commercial loans might result in them automatically being assigned to a higher risk category since they are typically not backed by registered collateral or supported by for-

Box 2.1 Sound Credit Practices

1. The pricing and purpose of credit operations are the exclusive realm and responsibility of financial institutions and their directors.

2. Prior to granting a loan, financial institutions should make reasonably sure that the loan applicant has the capacity to comply with his or her obligations in accordance with the conditions of the contract.

3. Financial institutions should grant loans only in the amounts and for the terms required to carry out the operations that they are being used to finance.

4. Funds loaned should be disbursed to the borrower in a manner that is consistent with the purpose of the loan.

5. The purpose of the loan should be established in the loan contract, which should in addition state that, in the event that the financial institution determines that the funds were used for purposes other than those agreed upon, and that this was done without the prior consent of the financial institution, the latter may call the loan.

6. The loan repayment period should be consistent with the nature of the loan operation and the repayment capacity of the borrower.

7. If the loan interest rate is stipulated in the contract, it may not be unilaterally modified by the financial institution.

8. Loans granted by financial institutions should be appropriately secured using personal property, cosigners, or other types of collateral permitted by the regulatory regime. These types of collateral should be expressly referenced by the financial institution's policies, manuals and procedures.

9. In the event it is found that the borrower has provided false information, the financial institution may call the loan and seek satisfaction of the obligation through legal channels.

10. Financial institutions should be certain that their lending operations are appropriately funded in order to avoid asset-liability mismatches stemming from the maturities, interest rates and currencies used in their loans.

Source: Prepared by the authors.

mal financial statements of the borrower's business. This can potentially lead to inappropriately high loan loss provisions for performing microenterprise loans, which in turn impacts the income statement of the financial institution.

On the other hand, if microenterprise loans are classified as consumer loans, other problems arise. For example, required loan loss provisions for consumer loans are often too low for microenterprise lending, thus sending a mistaken signal to microfinance institutions by encouraging a lack of discipline in borrower screening, evaluation and monitoring.

As with other credit operations, microenterprise lending should be carried out within the general framework of sound lending practices (see Box 2.1). Adherence to these practices will encourage a basic quality in credit operations, including the assumption of reasonable amounts of risk and a fair treatment of clients. Microfinance regulations should treat these general principles as a point of departure, and then add or adapt specific issues that reflect the distinctive features inherent in microenterprise lending.

Definition of Microenterprise Credit

Recommendation

The definition of microenterprise credit should be based on the following parameters: (a) it is granted by a financial institution to an individual or firm, or to a group of such borrowers, whose principal source of income derives from business activities involving the production or sale of goods or the provision of services; (b) it is not necessarily accompanied by formal records or documentation detailing the income or repayment capacity of the applicant, nor by registered collateral; and (c) it is typically granted on the basis of the applicant's character (willingness to repay) and the combined cash flow of the borrower's business and household.

To make the definition more operational it is useful to specify an absolute loan amount that serves as a primary determinant in the classification of the loan. The inclusion of an absolute amount in the definition makes it easier for financial institutions and supervisors alike to identify which loans should be classified as microenterprise loans. The amount used in the definition should roughly correspond to the range where financial institutions start abandoning the microenterprise lending methodology in favor of a more conventional, collateral-based, lending approach. In the context of Latin American countries, this reasoning implies that an amount of around US$10,000 would be appropriate in most cases.

Based on the above considerations, an appropriate definition of a microenterprise loan might be as follows: "a financial operation no greater than US$10,000 provided to a borrower—either an individual or firm—or to a group of borrowers to finance production, marketing or service provision activities whose principal source of repayment is the revenue generated by the business."[14]

The definition of microenterprise credit serves as the basis for establishing regulations and guidelines pertaining to loan documentation, portfolio classification, loan loss provisions, loan rescheduling and write-offs. Consequently, a good definition of microenterprise credit is crucial to bank supervisors in their efforts to establish regulations to compel financial institutions to appropriately recognize the risks, revenues and expenses related to their microenterprise lending activities.

Rationale

The recommended definition is proposed from a technical banking standpoint where the primary concerns are the willingness of borrowers to repay and the source of repayment, in this case the income generated by the borrower's microenterprise activities. The definition also encourages financial intermediaries to implement lending procedures that are consistent with the distinctive characteristics of the clients and the product.

The recommended definition distinguishes microenterprise credit from consumer and commercial credit, and also distinguishes it from any definitions of microenterprise or microenterprise

[14] Another alternative involves creating a special category of small commercial loans, which could accommodate most microenterprise loans. However, this category would still require a different set of rules in the same areas discussed in this chapter.

lending that may be adopted in tax-related or social legislation. This legislation typically defines microenterprises in terms of their socioeconomic characteristics, such as assets, sales, or number of employees. While such definitions may be appropriate for some purposes, they are not appropriate in the case of prudential regulation.

A definition of microenterprise credit that is tied to the socioeconomic characteristics of a microenterprise is difficult to apply in practice. Imagine that the supervisor had to try to verify whether a microenterprise client had current sales of $2,000 per month, rather than $3,000 or 5 employees, instead of 6. Verification would become complicated and expensive.

In addition, use of the definition suggested above creates an important element of legal stability since it is not subject to possible changes that, for political or other reasons, might be introduced every so often into the definition of a microenterprise or microentrepreneur. Moreover, the definition suggested above is both broad and inclusive, as it includes sole proprietorships and family businesses operating in a variety of activities, with or without employees and inside or outside the bounds of the formal sector.

Examples

In Bolivia, Peru and Colombia, significant progress has been made with regard to the definition of microcredit and the distinction between microcredit and consumer and commercial loans. However, further improvements could still be made. The definition in Bolivia is formulated in a very reasonable and inclusive manner, but lacks a monetary loan amount to define the transaction. In the cases of Peru and Colombia, the definitions include socioeconomic characteristics of the business (assets, employees, etc.), which serve to define the clients, but make cost-effective verification by the bank supervisor virtually impossible.

Bolivia

The Superintendency of Banks and Financial Institutions (*Superintendencia de Bancos y Entidades Financieras,* or SBEF) defines a microenterprise loan as a loan granted to a borrower—either an individual or firm—or to a group of borrowers (in this last case secured by a joint guarantee) to be used to finance small-scale production, commerce or service provision activities, for which the primary source of repayment is the sales or revenues generated by these activities. It is a requirement that approval of such loans must be "supported by a verification and analysis of the financial situation of the borrower(s); this analysis should demonstrate the repayment capacity of the borrower(s), taking into consideration the potential for honoring any joint guarantee in the event of loan repayment delinquency or the death of one or more of the co-borrowers. The analysis should include consultation with the SBEF's credit bureau and other sources of credit information."[15]

As a comparison, the SBEF manual defines a consumer loan as a loan granted to an individual to be used to finance the procurement of consumer goods or the payment of services, repayable in consecutive payments and whose primary source of repayment is the salary of the borrower. This definition also covers credit cards issued to salaried individuals.

Peru

The Superintendency of Banking and Insurance (*Superintendencia de Banca y Seguros*) stipulates that microenterprise loans are direct and indirect loans to be used for production, trade and service activities by individuals or firms whose assets, excluding fixed assets, are valued at no more than US$20,000 and whose total indebtedness within the system is likewise no greater than US$20,000.[16] Microenterprise loans include those granted through the use of credit cards, leasing arrangements and other forms of financing.

In the case of individual borrowers, the primary source of income should be the business activity, and no one whose principal source of income is salaried employment can be included in this category. According to the regulations, consumer loans are defined as loans granted to individuals to pay for goods and services not related to a business activity.

The Banking Superintendency (*Superintendencia Bancaria*) defines microcredit as a loan granted to a microenterprise whose outstanding indebtedness

[15] Manual de Recopilación de Normas de la Superintendencia de Bancos y Entidades Financieras, Title V, Chapters II and III.

[16] Reglamento para la Evaluación y Clasificación del Deudor y la Exigencia de Provisiones de la Superintendencia de Banca y Seguros, Chapter 1, Section 1.2.

to the financial institution is not in excess of twenty-five (25) times the current monthly minimum wage (approximately US$2,980). A microenterprise is understood to be any unit of economic activity—be it an individual or a firm—engaged in entrepreneurial, agricultural, industrial, commercial or service activities, whether rural or urban, having no more than 10 workers and whose total assets are less than 501 times the current monthly minimum wage.[17]

Internal Lending Process

Recommendation

The regulatory framework should state that financial institutions providing microenterprise loans have in place written manuals and policies that explicitly identify the controls instituted at the various levels of the organization with regard to the screening, approval, monitoring and collection of these loans. Such controls should leave a paper or electronic trail that shows evidence of their implementation, both in the credit files as well as in the other records identified in the credit manual. Although controls need to be precise, the regulatory framework should not attempt to predefine the internal credit process.

Rationale

In view of the special characteristics of the microlending methodology, as well as the need to continuously adapt it to the clients' needs, it is important for microfinance institutions to have flexibility in designing appropriate internal credit processes. The control mechanisms should consider the distinctive features of the microenterprise clients, the loan products and the lending methodology itself.

Successful microfinance institutions have in place management and internal control mechanisms that are unique to microfinance, ranging from the way in which loan files are kept and client follow-up is conducted to the way in which loan officers and middle management are compensated as a function of the performance of their respective credit portfolios. The regulatory framework should respect and accommodate these practices if they have been proven to work.

Examples

Supervisory authorities in Bolivia and Peru have taken deliberate steps to enable financial institutions to develop and implement appropriate credit processes for serving the microenterprise sector.

Bolivia

In accordance with the regulatory framework established by the Superintendency of Banks and Financial Entities, files for loans below Bs. 500,000 (approximately US$80,000) have simplified documentation requirements. This rule applies to all types of loans, including commercial loans, mortgage loans for housing, consumer loans and microenterprise loans.

The Superintendency further stipulates that institutions providing microenterprise loans and other loans up to the above-mentioned amount, are required to keep on file "the information established by their own credit methodology,"[18] which should include, as a minimum, the following:

Loan files, either physical or on magnetic media, for each borrower or group of borrowers, containing the information stipulated in the institution's own credit manuals.

Credit manuals that explain and detail the credit methodology, including the following:

- A description of the organizational structure of the credit department and of the department responsible for internal controls over credit operations.
- A description of the client information to be collected and analyzed by the loan officers.
- A detailed listing of the documentation required for loan approval and follow-up, as well as the documentation required to demonstrate the application of appropriate internal control mechanisms.
- A detailed listing of the information that must be generated in order to provide evidence of

[17] Banking Superintendency External Circular 050, dated October 2001.

[18] Recopilación de Normas para Bancos y Entidades Financieras de la Superintendencia, Title V, Chapter I, Section 9.

collection efforts, both administrative and judicial, for each loan type or modality.

- A description of policies for establishing provisions for non-performing loans and for writing off uncollectible loans.

Peru

With a view toward facilitating microfinance, the Peruvian Superintendency of Banking and Insurance allows financial institutions wide latitude in developing their own policies and procedures for screening, approving and monitoring microenterprise loans.[19] In exchange for this flexibility, the Superintendency requires that financial institutions provide fairly detailed reports on their policies and procedures for these types of loans. The Superintendency must also be notified of any modifications to the policies and procedures of the institutions, and may request changes to them or the incorporation of additional elements.

Interest Rates

Recommendation

Financial institutions should be authorized to freely set interest rates applicable to their microenterprise loans; however, they should not be able to unilaterally modify interest rates.[20]

Rationale

Governments typically give two reasons for enforcing interest rate caps: to reactivate the economy (by bringing down the cost of capital) and to protect small and vulnerable borrowers. However, interest rate caps usually do not achieve either of these goals. Rather, the main effect of interest rate caps is to exclude borrowers that are costly to serve or considered particularly risky. In the view of many bankers, microenterprises fall into both categories.

Any interest rate caps set by usury laws or bank regulations are therefore inappropriate and counterproductive in the case of microfinance. The characteristics of microenterprise loans, and the lending methodology used to provide them, mean that financial institutions must be able to charge relatively high interest rates in order to recover their costs. While governments undoubtedly will need to deal with fraudulent and unscrupulous lending practices, caps on interest rates are not the answer. Instead of protecting small and vulnerable borrowers, caps typically exclude them from credit altogether.

However, in order to avoid abuse, loan contracts should clearly spell out the methodology used in calculating the interest rate and, in addition, provide simple means by which the borrower can understand the amounts to be repaid to the financial institution. This is particularly important in the case of microenterprise loans since the clients tend to have limited levels of schooling and little experience with borrowing from financial institutions.

Example

Colombia

In recent years, microfinance institutions in Colombia have been subject to constant pressure from restrictive caps on interest rates. This has hampered their efforts to reach smaller clients and, in some cases, has threatened the very survival of the institutions themselves. Although the regulations that establish the interest rate caps have been in existence for many years, it was only as recently as 1999 that they became a limiting factor in the financial market, following a modification in the way the reference rate was calculated.

These interest rate restrictions have their origins in criminal, civil and commercial codes, which define the crime of usury as charging interest equal to 1.5 times the average interest rate charged by banks (with some variation among codes).[21] Law 45 of 1990 stipulated that the concept of interest also includes commissions, honoraria and fees paid for services related directly to the loan. The only

[19] Central Bank of Paraguay Resolution No. 8, dated December 30, 1996.

[20] If a country insists on enforcing interest rate caps, the top permissible rate for microenterprise loans should be phrased as a multiple of the average rate charged on microenterprise loans in the system (excluding consumer or large commercial loans). This would allow for higher caps on microenterprise loans and permit financial institutions to cover the relatively high costs of providing these types of loans. The generation of the necessary statistics would, of course, require a prior definition (and classification by institutions in the financial system) of microenterprise loans, which again speaks to the importance of developing such a definition.

[21] According to the Criminal Code, charging usury interest rates is grounds for a sentence of six months imprisonment and payment of a fine.

exception to this rule is credit card fees, based on a decision by the Monetary Board.

Problems arose in March 1999 when the Colombian government, in view of persistently high interest rates, decided to attempt to lower rates by applying usury limits. Toward this end, the authorities decided to include prime loans, which carry the lowest interest rates, in the calculation of the benchmark rate. At the same time, credit cards, which carry the highest rates, were excluded from the calculation. The net effect of this change was a dramatic decrease in the maximum permitted rate, which immediately dropped between 12 and 14 percentage points.

The decrease in the reference rate made it virtually impossible for microfinance institutions to continue operating. After considerable lobbying and extensive consultations with the legislative branch, a degree of relief was achieved with the approval in 2000 of Law 590, whose purpose was to promote the development of micro, small and medium-sized enterprises and which stated that financial institutions could charge commissions and fees up to the equivalent of 7.5% per annum on loans of less than 25 minimum monthly salaries (approximately US$2,980). That same year, the superintendency also introduced a number of modifications to the formula for calculating the reference rate, which provided further relief. Even with these changes, however, financial institutions working in the Colombian microfinance sector continue to operate under considerable pressure on their margins.

Contractual Transparency

Recommendation

The regulatory framework should set high standards of contractual transparency and fairness for microenterprise loans. Regulations must reinforce the notion that microenterprise borrowers need to be informed in a straightforward manner of the various elements of the loan contract, including how the interest rate is calculated and any other aspects that would reasonably enter in to the decision-making process of the client. Loan contracts should therefore be accompanied by explanatory notes that specify, in simple terms, the rights and obligations of the parties.

Box 2.2 Limits on Interest Rates

Within the framework of financial systems liberalization, most countries of the region eliminated interest rate controls during the 1990s, allowing market forces to set the appropriate levels. However, in some countries in the region, these limitations have returned for formal financial institutions (see Table 2.1). In addition, in many countries, civil and commercial codes limit the interest rate that all other institutions (including nonprofit organizations and individuals) can charge.

Table 2.1 Examples of Countries with Interest Rate Caps for Formal Financial Institutions

Country	Basis for Calculation	Current Level	Does It Include Commissions and Other Costs of Credit?
Colombia	1.5 times the average rate charged by banks for ordinary, freely-assigned loans	38%[(a)]	Yes
Ecuador	Fixed, nominal level (of 18%)	18%	No
Paraguay	50% above the average rate charged by commercial banks on consumer loans	76% nominal (60% real)	Yes
Uruguay	75% above the average market rate		Yes

Source: Prepared by the authors based on project survey.

Note: (a) For very small loans, as much as 7.5% in additional commissions per year may be charged.

When compensating balances or other deposits are required (or the purchase of member shares in the case of credit unions), such elements should be included when calculating the effective cost of the loan and also should be communicated to the client.

In the case of variable rate loans, the benchmark rate should be independent of the interest rates charged by the individual financial institution making the variable rate loan.

Rationale

The clients of microfinance institutions are among the most exposed and most vulnerable in all of Latin American society. They frequently have low levels of formal schooling and limited experience with the formal financial system. As a result, guidelines that increase contract transparency and fairness are especially important for these borrowers.

Inadequate guidelines could also expose financial institutions to legal action by disgruntled customers. Although this type of problem does not immediately threaten the solvency of financial institutions, it does threaten their image and the trust placed in them by their clients.

In some countries, serious problems have arisen as a consequence of insufficient contract quality and transparency in microlending activities. The most egregious violations have been noted among aggressive consumer lending companies (that have recently entered the microenterprise market), but microfinance institutions have not always been innocent of, or immune to, the accusations leveled by distressed microenterprise borrowers.

In some cases, loan contracts have not specified the obligations and rights of the parties to the contract; in other instances, loan contracts have included inequitable language and conditions, exorbitant and randomly applied fees and/or unilateral decision-making powers in favor of the lending institution. Lenders have failed to provide borrowers with appropriate information and explanations concerning the legal scope of the contract and the consequences arising from it. Even if microfinance institutions are not the primary culprits in these cases, these types of violations have a profound impact on microenterprise clients and may affect their repayment behavior vis-à-vis microfinance institutions.

Example

Abuse of microenterprise clients has been observed in a number of countries (including Bolivia and Colombia) and has resulted not only in the reluctance of borrowers to meet their obligations to financial institutions but, in some cases, has also encouraged borrowers to organize "borrower syndicates." These groups have aggressively criticized various lending practices and to some extent encouraged a culture of nonpayment.

Bolivia

In Bolivia, the high interest rates charged by consumer finance companies have touched off a crisis that has resulted in the creation of a number of borrower syndicates. These syndicates have demanded extensions of due dates, rescheduling of loans, waiving of late interest fees, relaxation of collection agency practices, and even total forgiveness of outstanding loan balances.[22] The syndicates, originally formed by clients of consumer finance companies, have been joined by individuals unable to pay their debts to all kinds of institutions, including banks, savings and loan associations, credit unions, and microfinance institutions.

The charges most frequently filed by small borrowers include: (a) the charging of exorbitant interest rates and fees in exchange for a deferral of payments, (b) improper seizure of goods, (c) failure to give borrowers a copy of the loan contract, (d) defamatory slurs against borrowers posted on signs or painted onto the walls of borrowers' homes and (e) intimidation of family members.

The discontent reached such dimensions that large masses of people converged on the city of La Paz for more than 40 days in 2001. Borrowers from all over the country took to the streets, broke into banks and even took the Bank Superintendency by force, holding its staff hostage for 10 hours and threatening to dynamite the building.

Ironically, some small borrowers have suffered abusive practices by their own borrower syndicates. Official agencies (including the Superintendency of Banks and others) have received allegations of deception and fraud committed against members of these

[22] These syndicates include the National Association of Small Borrowers, the Association of Small Solidarity Borrowers in Arrears, the General Organization of Borrowers and the Borrower Advocacy Group.

syndicates. As it turned out, some syndicate leaders were promising desperate borrowers debt forgiveness in exchange for a fee, though such an outcome could obviously not be promised in advance.

Collateral

Recommendation

The regulatory framework should not predefine what type of collateral financial institutions should use in their microenterprise loan transactions, either implicitly (by passively applying regulations designed for consumer or commercial lending) or explicitly. Given the special characteristics of microenterprise borrowers, microfinance institutions need flexibility in the type of collateral they employ to support their loan contracts.

Notwithstanding the need for flexibility, the bank supervisor should be able to expect microenterprise loans to be backed by the business and/or household assets declared by the borrower, or by individual guarantors who have been properly evaluated in terms of their assets and cash flow. In the case of loans granted against unregistered collateral, loan contracts should describe the characteristics of the goods, their location and their estimated value.

Rationale

As a rule, microenterprise loans are collateralized using unregistered goods or are secured with pledges of loan comakers (third-party personal guarantees). Only rarely are microenterprise loans secured with a registered mortgage or with a formal lien against other assets. In most instances, it is simply not cost effective to place formal liens on collateral in the public registries (which in many Latin American countries are not effective or efficient in perfecting security interests) given the small amounts involved in microenterprise lending. Moreover, the cost of formally seizing and selling microenterprise loan collateral is typically prohibitive in relation to the value of the pledged asset. As a consequence, the region's successful microfinance institutions typically require registered collateral (using assets such as equipment or real estate) only for loans greater than US$5,000-10,000 in value.

Although it may not make sense to base microenterprise lending on registered collateral, many microfinance institutions do nevertheless accept or even demand some sort of collateral from their clients, including refrigerators, television sets, other household goods, tools, and equipment. While such assets do not always permit the lender to recover the full value of the loan, they nevertheless put significant pressure on borrowers to honor their contracts.

The lack of effective collateral tends to limit the supply and raise the interest rates of microenterprise loans. Consequently, improvements in property registries that expand the range and use of acceptable and cost-effective loan collateral would positively impact the supply and pricing of microenterprise credit.

Example

Peru

In recent years, the modernization of property registries and the process of administrative simplification in Peru have led to a significant reduction in the cost and time required to formally secure loan collateral. Not surprisingly, this has significantly facilitated the expansion of the microfinance industry, as the example of Huancayo, in the central region of the Peruvian Andes, shows.

In Huancayo, a mortgage can now be registered within three days as a floating guarantee that provides security up to a specific amount for all loans granted by a microfinance institution to a borrower. For a mortgage valued at US$5,000, a fee of US$30 (6 per 1000 of the amount of the mortgage) must be paid to the Public Registry, together with a fee of US$0.68 (2 soles) to the notary for authentication of each signature. The lien is automatically constituted through the registration of the loan contract, with no need for issuance of a notarized public document.

Additional costs include a fee of US$50 to US$75 payable to an appraiser registered with the Registry of Expert Appraisers for issuance of an appraisal report with accompanying photographs. In addition, a fee of US$14.40 is charged by the registries for the authenticated copy of the title of ownership and the certificate of registration of the mortgage. In general, the legal problems involved in constituting the mortgage are resolved in a single day by the microfinance institution's attorney. At most, the entire processing of a loan secured by a mort-

gage takes one week for typical cases and up to two weeks when procedural difficulties arise.

Despite the modernization process, the use of the mortgage guarantee in Huancayo is limited, since only 30% of micro and small enterprises have clear title to their property. Because of this, chattel mortgages on vehicles are a commonly-used alternative due to widespread vehicle ownership by many micro and small entrepreneurs, and to the ease with which such collateral can be seized and sold. The modernization of the vehicle registry, the high degree of formalization of ownership, the ease of attaching vehicles, and the broad and dynamic market for used vehicles facilitate the seizure and sale of vehicles pledged as loan collateral.

To register a chattel mortgage on a vehicle, the interested party must provide a certificate of freedom from liens (at a cost of US$7.20), pay the cost for appraising the vehicle (US$14.40) and record the loan contract in the appropriate registry of the Ministry of Transportation and Communication (between US$7.20 and US$28.40, depending on the value of the vehicle). In all, these procedures take only three days. The significant reduction in the cost and time to establish this type of guarantee has made it an economically feasible support for microenterprise lending.

Loan Contract Currency

Recommendation

Prudent lending practice is that the loans should be denominated in local currency for clients producing nontraded outputs and in foreign currency for clients producing traded outputs.

In addition, microfinance institutions should match the currency composition of their funding sources to the currency composition of their loan portfolio, or else take steps to ensure appropriate exchange coverage through currency swaps or other operations. All contracts in a currency other than the local currency should be consistent with the general financial system rules governing exchange positions and the handling of foreign exchange.

Rationale

Financial institutions should be aware that their risk increases when they fail to take into account the nature of the markets in which their clients sell their outputs (whether these outputs be goods or services). Clients may sell either traded outputs or nontraded outputs. The former are goods and services that are either exported or else compete directly with imported goods and services. The latter are neither exported nor do they compete directly with imported goods and services.

Many agricultural, mining, and manufacturing products are traded goods, while most commercial sector activities and services are normally nontraded. Since microfinance institution clients are mostly in the commerce and services sector, most produce nontraded outputs. Even those microfinance institution clients who are in the manufacturing and agricultural sectors sometimes produce goods that are rustic or otherwise only consumed locally, and are not close substitutes for goods traded internationally. These clients also produce nontraded outputs.

The importance of this distinction is that if there is a devaluation of, for example, 2:1, the prices of traded goods typically rise by 2:1 also, in proportion to the devaluation. The prices of nontraded goods typically rise by much less than 2:1 because the production of these goods requires labor and other nontraded inputs whose cost is not directly and immediately affected by the devaluation. This means that if the microfinance institution gives a dollar loan to a client who produces nontraded outputs, that client could easily be ruined by a sharp devaluation since the price of what the client produces (in the local currency the client earns) will not keep up with the client's loan service payments (also expressed in local currency). For example, with a 2:1 devaluation, the loan service payments will double in local currency terms, while the value of what the client sells will typically rise by much less.

Table 2.2 Contract Currency and the Cost of Microloans

Country	In Local Currency	In U.S. Dollars
Bolivia	Rare	28%–36%
Colombia	40%–60%	Not used
Paraguay	75%–79%	Rare
Peru	56%–138%	26%–36%

Source: Prepared by the authors based on case studies.

During the Asian financial crisis of the late 1990s, many financial institutions learned this lesson the hard way when their clients who had dollar loans and nontraded outputs could not repay and the financial institutions were faced with huge defaults in their credit portfolios. Therefore, to avoid foreign currency risk, microfinance institutions should lend in local currency to clients producing nontraded outputs and lend in foreign currency to clients producing traded outputs. In addition, microfinance institutions should match the currency composition of their funding sources to the currency composition of their loan portfolio, or else take steps to ensure appropriate exchange coverage through currency swaps or other operations.

Examples

In Bolivia and Peru, financial institutions have been granted significant freedom in defining the currency of their loan contracts. In Colombia, however, financial institutions operate under relatively severe restrictions.

Bolivia

The Superintendency of Banks and Financial Institutions in Bolivia has authorized financial institutions to conduct operations in a range of currencies, stating simply that "banking and financial institutions are authorized to conduct deposit, loan and contingency operations, as well as provide financial services, in both foreign and local currency." In the particular case of Bolivia, this freedom to contract in any currency has led to a nearly complete dollarization of the banking system: approximately 95% of the loan portfolio and 92% of all liabilities are currently denominated in U.S. dollars.

While financial institutions of course follow the Superintendency's guidelines for matching assets and liabilities, this does not mean that they have eliminated their exchange rate risk. While almost all financial transactions are denominated in U.S. dollars, only a modest percentage of borrowers actually produce traded outputs. As a result, the system is highly sensitive to external shocks. A sudden strengthening of the U.S. dollar relative to the local currency, the boliviano, could render many borrowers unable to repay their loans since the value of their debt and debt payments would increase far more quickly than their income stream.

Colombia

In Colombia, loans can be made in either local or foreign currency, depending on whether the institution is authorized as an exchange market intermediary. However, the exchange rules applicable to financial intermediaries state that resources obtained from foreign currency financings can be used only for expressly authorized foreign currency loan operations.[23] In view of the fact that many microfinance institutions take on debt in dollars from donors or specialized investors in the U.S. or Europe, the above-described rule can become a significant constraining factor in their effort to obtain an appropriate match between their assets and liabilities and between the currency of their loans and the tradability of their clients' outputs.

Peru

In Peru, the financial system legal framework allows financial institutions to grant loans in either local or foreign currency, stipulating only that there must be an appropriate match between the currencies of their assets and liabilities. The framework also permits financial institutions to make loans in local currency adjusted in relation to the consumer price index, provided that they include the phrase "constant purchasing power" after the loan amount in the loan contract.[24]

Client Documentation

Recommendation

The formal documentation required for microenterprise loans should be minimal and focus on information that attests to the client's identity and place of residence. Naturally, this information should be accompanied by the data collected and analyzed by the loan officer, including verification of the client's payment history in the credit bureau, if available.

[23] External Resolution 8 of 2000, issued by the board of directors of the Central Bank (Banco de la República).

[24] Articles 178 and 240 of the General Law Governing the Financial and Insurance Systems and the Organic Law of the SBS (Law No. 26702).

Given the informal or semi-formal nature of many microenterprises, financial institutions should not be required to verify compliance with tax obligations or other government regulations. In fact, in light of the high operating costs of providing microcredit, government authorities should make a proactive effort to reduce or eliminate overly formal requirements that further raise the cost of microcredit, such as the compulsory notarization of signatures on loan contracts.

Rationale

One characteristic of microenterprise loans is that the prospective borrower generally lacks formal financial statements for his or her business. Most microentrepreneurs use nothing more than a notebook to record their business transactions, and many do not do even this. Furthermore, little distinction is usually made between the accounts of the business and the household.

Consequently, most microenterprise borrowers are only able to provide minimal formal documentation to the loan officer. Instead, loan documentation is generated largely by the loan officer, based on visits to the borrower's business and home.[25] The documentation essentially records interviews, references and the cash flow analysis made by the loan officer.

Considering the lack of formal documentation available from microenterprise borrowers, the regulatory framework needs to offer some flexibility for this type of client. Financial statements, tax records and other similar documents should not be required. Such flexibility allows financial institutions to develop appropriate documentation standards that fit with their credit methodology and clientele.

Examples

The bank superintendencies of Bolivia and Peru have both left it largely up to the financial institutions themselves to determine the appropriate documentation requirements for microenterprise loans. However, they subsequently verify that the requirements make sense in the context of the institutions' lending methodology.

Bolivia

Perhaps there is no better indication of reasonable documentation requirements than those utilized by one of the premier microfinance institutions. In the case of Caja Los Andes in Bolivia, the microenterprise loan application must include the following information, of which some is obtained from the client and the rest is generated by the loan officer:

1. Data on the socioeconomic unit
   - Personal data on the applicant
   - Data on the spouse or cosigner
   - Household assets and length of time at current address
   - Household data, including dependents, household expenses and non-business income

2. General data on the microenterprise
   - Activity, location, length of time in business, number of employees and other information
   - Characteristics of the production process (or commerce or service activities)
   - Terms of sale
   - Production levels
   - Conditions applicable to purchases
   - Personnel costs

3. Financial situation
   - Balance sheet and estimate of household net worth
   - Estimate of the household's monthly income and expenses, and therefore its savings (the difference between income and expenses)

4. Results of consultation with the credit bureau at the Superintendency of Banks and Financial Institutions

Peru

Circular B-1931-92 of the Superintendency of Banking and Insurance (SBS) lists the minimum client information required for loan approval and borrower classification. However, because these requirements were created for large loans made by commercial banks to formal enterprises, they are not appropriate for microenterprise loans. To facilitate microenterprise lending, the SBS has indicated that financial institutions may simplify documentation requirements as long as the remaining documentation is sufficient to allow the SBS to examine the analysis and the decision made by the institution.

This accommodation of documentation requirements for microenterprise lending is part of a larger approach to the sector, in which the SBS allows

[25] This is unlike consumer loans, where only the household is subject to analysis, and commercial loans, where only the business is analyzed.

significant leeway for financial institutions to devise and calibrate their own credit methodologies.[26] In return, the institutions must submit a detailed description of their policies, processes and procedures (including documentation requirements) to the SBS. The SBS may request the inclusion of additional information and must be informed of any modifications to these policies, processes and procedures made by the financial institutions.

Peruvian financial intermediaries are not required to verify whether their microenterprise clients have been issued a taxpayer number, nor whether they are up to date in their tax obligations.[27] While microfinance institutions may include tax verification as one factor in assessing a client's repayment capacity and general record of compliance with debts, most microfinance institutions prefer to analyze the client's payment capacity through on-site visits and verify his or her payment history with a credit bureau. Tax records are simply too unreliable for this purpose.

Also significant is the fact that Peruvian loan contracts do not require signature authentication by a notary public; this is required only for recording liens on collateral in public registries. On average, a notary charges between US$0.85 and US$1.42 to authenticate a signature. Were it mandatory, it would raise lending costs by half a percentage point on a typical microenterprise loan. While this is not a prohibitively-high cost for microenterprise clients to bear, it would nevertheless be an unwelcome and unnecessary charge for people who have little to spare.

Through the above provisions, the Peruvian regulatory framework adjusts for the differences between commercial and microenterprise loans. Documentation requirements are significantly streamlined for the latter type of loans and, as a result, operating costs are reduced for the financial institutions that offer them.

Colombia

Although the Banking Superintendency (SB) in Colombia has not taken specific steps to simplify documentation requirements for microloans, the regulatory framework does contain a few provisions that facilitate microenterprise lending.

In general, financial institutions must request that their clients provide a copy of their identification document, bank references, financial statements, income tax returns and a credit bureau report, plus whatever information the financial institution deems necessary to determine the repayment capacity of potential borrowers.

However, in an attempt to facilitate small business lending, the SB does not require nonsalaried individuals to provide income tax returns to lenders. The superintendency also does not require financial institutions to obtain audited financial statements from individuals doing business as merchants (except in certain circumstances), where "merchants" are defined in article 10 of the Commercial Code. Many microenterprises are covered by this exemption.

Non-Performing Loans

Recommendation

A loan should be considered to be non-performing (or delinquent) on the day following noncompliance with part or all of a required payment. When a loan is non-performing, the financial institution should be required to: (a) record the entire balance of the loan as past due, not just the amount of the missed payment(s); (b) suspend the further accrual of interest income until interest is actually received; (c) establish provisions to cover the expected losses of loan principal; and (d) within a period of 90 days or less, reverse out all interest income that has been accrued but not received or else establish provisions to cover the expected losses of this accrued interest. The regulations should also cover delinquent loan rescheduling and write-offs, topics, like provisioning, that are covered in subsequent sections.

Rationale

The regulatory framework should compel financial institutions to quickly and accurately recognize the risk posed by past due microenterprise loans. The first step in this process is a clear definition of non-performance, as suggested above.

[26] Circular SBS B-2000-98 and Resolution No. 572-97, Chapter I, Section 2.1.

[27] It is important to clearly distinguish between the functions of credit evaluation and monitoring of tax compliance. The latter function should be carried out by the appropriate government agency, using its own supervisory tools, and not be delegated to financial institutions.

Microenterprise loan portfolios contain too many loans to permit bank supervisors to conduct individual inspections of most of them and their clients. Consequently, to retain effective monitoring capabilities over these portfolios, the supervisor must rely on simple, clear and objective standards for how non-performance is defined and measured. Such guidelines make it possible for the bank supervisor to effectively monitor and compare the performance of individual microfinance institution loan portfolios.

In addition to the benefits for the supervisor, strict guidelines in this area encourage financial institutions to quickly take steps to collect past due loans.

Examples

Three examples of how non-performance can be defined and measured are given below. The Bolivian guidelines are an example of best practices in this area, while those of Paraguay require strengthening; the case of Peru falls in between.

Bolivia

The superintendency's accounting guidelines for banks and financial institutions states that on the day following noncompliance with part or all of a required loan payment, the entire balance must be recorded as past due (*atrasado*) and accrual of interest income must be suspended. After 30 days of non-payment, the loan is recorded as expired (*vencido*) and, after 90 days, all interest earned but not collected is transferred to an off balance sheet account for suspended assets, with a corresponding charge to expenses.

In addition, the superintendency has established that "in the case of loans payable in installments, non-performance commences as of the due date of the earliest unpaid installment, based on the original schedule of payments; in these cases, the total balance outstanding should be recorded as non-performing until such time as both principal and interest have been brought completely up to date. Loans with no maturity date will be considered to be non-performing as of the day on which they were granted. Loans that are used to pay off other loans without a new analysis of the borrower's repayment capacity shall be considered to be past due as of the date on which the original loan—or the loan arising out of the most recent, correctly-performed rescheduling—became delinquent."[28]

Paraguay

In Paraguay, the superintendency has ruled that in the case of bullet loans (which are repaid with a single payment of principal and interest at the end of the loan term), the accrual of interest income is to be suspended on the day following loan maturity in the event of non-payment. In the case of loans payable in installments, suspension occurs when any installment becomes more than 60 days past due.[29]

Unfortunately, this system allows the accrual of interest income on delinquent installment loans, which also introduces a distortion into credit negotiations between financial institutions and their clients.

Peru

The definition of arrears and the treatment of interest on delinquent loans is spelled out in Resolution SBS 357-2000 issued by the Superintendency of Banking and Insurance (SBS). This resolution states that interest on commercial loans that are past due by more than 15 days is not to be recorded as income, but rather as suspended interest. In the case of microenterprise, consumer and mortgage loans, interest is to be suspended starting at 30 days past due. Provisions must be established for interest on delinquent microenterprise loans once they become eight days past due.

Risk Classification of Loans

Recommendation

Microenterprise loans should be risk classified based on the number of days of non-performance and on how many times they have been rescheduled. As a rule, microenterprise loans should be classified in the highest risk category once they become 90-120 days past due, or upon the third rescheduling.

In order to classify microenterprise loans in the manner described, financial institutions need to

[28] Recopilación de Normas para Bancos y Entidades Financieras de la Superintendencia, Title V, Chapter I, Section 1, Article 3.

[29] Central Bank of Paraguay Resolution No. 8, dated December 30, 1996.

have information systems that allow them to easily classify all loans in their microenterprise portfolio.

Rationale

As with other types of loans, microenterprise loans should be classified in categories of lesser to greater risk of uncollectibility. However, in contrast to larger commercial loans—where each loan is analyzed individually—the classification of microenterprise loans has to be done in a simple, transparent and cost-effective manner.

Since there are thousands of loans in a typical microenterprise loan portfolio, each insignificant from the standpoint of individual risk, it would be uneconomical to classify them in the same manner that commercial loans are classified, that is, by analyzing the borrower's present and future cash flows, his or her total indebtedness to the financial system, and any other factors that could affect repayment capacity. A better option is, therefore, to use a simple but rigid procedure in which microenterprise loans are rapidly and automatically reclassified from one category to another as the number of days of non-performance increases.

Since microenterprise loan operations generally have a relatively short repayment period and often involve more frequent payments (sometimes even weekly), the time period for reclassifying these loans should be relatively short. The maximum range of 90-120 days recommended above is a parameter used by leading microfinance institutions. In addition, in view of the high risk involved in rescheduled loans, such loans need to be classified in a higher risk category than other loans that are the same number of days past due.

Even if all of these measures are used, the risk of a microenterprise loan portfolio is still not always easy to measure. If the lending institution's credit methodology is deficient, loans that are classified as normal may have latent problems that will surface in the future. Also, in some cases, clients are indebted to multiple institutions at once. Unless there is a well functioning credit bureau, this can be hard to detect and, therefore, can pose significant risks to lending institutions. These risks cannot be fully recognized through the use specific loan loss provisions, so supervisory authorities also need to use generic provisions to compel financial institutions to recognize the overall risk of their loan portfolios (as is discussed further in the section on loan loss provisions, below).

Example

The most appropriate classification guidelines for microenterprise loans have been established by the bank superintendencies of Bolivia and Peru. The bank superintendencies in Paraguay and Colombia are currently working on developing guidelines that concord better with the realities of microlending, but so far no new regulations have been issued.

Rescheduling or Restructuring of Loans

Recommendation

The regulatory framework should compel financial institutions to promptly and fully recognize rescheduled (also called restructured) microenterprise loans. Such loans should not be treated as current, either for accounting purposes or for purposes of establishing loan loss provisions.

Table 2.3 Classification of a US$1,000 Loan (by the number of days past due)

Category	Bolivia[a]	Peru	Colombia	Paraguay
1	Up to 5 days	Up to 8 days	Up to 30 days	Up to 60 days
2	6 –30 days	9–30 days	31–60 days	61–120 days
3	31–60 days	31–60 days	61–90 days	121–180 days
4	61–90 days	61–120 days	91–180 days	181–360 days
5	More than 90 days	More than 120 days	More than 180 days	More than 360 days

Source: Prepared by the authors based on case studies.

Note: (a) Categories 3, 4 and 5 are also used to classify loans that have undergone 1, 2 and 3 reschedulings, respectively.

Additional collateral offered by the client should not change a loan's classification in view of the high cost of executing microenterprise collateral relative to its value. On the other hand, clients who are current in their payments, demonstrate increased loan repayment capacity, and, because of this, obtain a new loan or an increase in the size of an existing loan should retain their classification as current.

The regulatory framework should require that financial institutions have in place the necessary information systems to identify and monitor all microenterprise loan reschedulings, particularly since these loans are often approved, either formally or *de facto,* on a decentralized basis in branch offices. In addition, rescheduled loans should be reported to the superintendency's credit bureau.

Rationale

Since non-performing loans represent a major threat to any financial institution, rescheduled loans should be considered higher-risk operations, particularly in the case of microfinance where collateral is either nonexistent or else uneconomical to seize and sell (execute). The fact that financial institutions can use rescheduling as a means to avoid making loan loss provisions and, therefore, recognizing losses from uncollectible loans, provides additional justification for strictly regulating and monitoring rescheduling practices.

Examples

Generally speaking, regulations governing rescheduling practices are not particularly strict in the countries of Latin America, as shown, for example, in the cases of Colombia, Paraguay and Peru. A stricter treatment of rescheduling is recommended, including for the rescheduling of microenterprise loans.

Colombia

The Banking Superintendency defines a rescheduled loan as a loan in which the conditions originally agreed to have been modified to the benefit of the borrower.[30] The rescheduling of a loan may take place either before or after the loan's original maturity date. In principle, rescheduling implies that the loan must be reclassified to a higher risk category. However, this need not occur if: (a) collateral is improved, (b) an analysis of the borrower shows that the rescheduling is appropriate and (c) the borrower's income flows are sufficient to service the rescheduled loan.

As a rule, rescheduled loans can be improved one step (to a less risky loan classification) when the borrower is current in servicing the debt and has paid at least two installments of the rescheduled loan. If the rescheduled loan subsequently becomes delinquent, its classification must revert immediately to the risk category it had prior to the rescheduling if this prior classification is a riskier one. The institution then must also establish the appropriate loan loss provisions and suspend accrual of interest.

Paraguay

The Superintendency of Banks has defined a "renewed loan" as the simple extension of the term of a loan, a "refinanced loan" as a modification resulting from the prior payment of some of the debt, and a "rescheduled loan" as a modification that provides financial relief for the borrower by means of a reduction in the interest rate, extension of the due date, or other change that reduces the amount of the installment.[31]

In addition, the Central Bank of Paraguay has indicated that refinancing and rescheduling may improve a loan's classification when (a) the client has paid all past due interest and at least 10% of the principal without the aid of any new financing; (b) the refinancing or rescheduling occurs as a result of a new credit assessment that examines the borrower's business and repayment capacity; (c) the present value of future scheduled payments, given the rate of interest on the loan, is equal to or greater than the present value of the original loan; and (d) the restructuring of the loan effectively ensures the borrower's ability to repay it.[32]

Peru

The Superintendency of Banking and Insurance considers as restructured a loan of any type in which changes in the term or loan amount have

[30] External Circular SB 100 of 1995.

[31] Circular SB No. 108/99, dated March 30, 1999.

[32] Central Bank of Paraguay Resolution No. 8, dated December 30, 1996.

been made as a result of a borrower's difficulties in repaying the original loan. Such changes may have been made either before or after the original maturity date of the loan. Any restructuring must be supported by a duly documented analysis of the client's payment capacity. Interest, commissions and all other income derived from the restructured loan should be recorded in the financial institution's accounts on a cash basis only (no accruals permitted).

Loan Loss Provisions

Recommendation

The regulatory framework should require financial institutions to establish specific and generic loan loss provisions to cover the portfolio at risk. Specific loan loss provisions should be calculated as a percentage of the unpaid balance of each microenterprise loan, without taking into account the value of any collateral (in view of the high cost of seizing and selling microenterprise collateral relative to its value).

Bank supervisors can use the same schedule of provisioning percentages for microenterprise loans as for other types of loans (most Latin American countries use five risk categories, each with a successively higher provisioning percentage). However, microenterprise loans should be moved more rapidly from lower to higher risk categories. This is achieved by lowering the number of days of non-performance associated with each risk category in the case of microenterprise loans.

It is advisable that the category corresponding to the lowest risk require a provision of 1% (to reflect the fact that any loan has a risk of uncollectibility) and that the category for the highest risk have a provision of 100%. The bank supervisor should be authorized to order additional generic provisions (above and beyond the 1%) when it determines that an institution has a weak or deficient microenterprise lending methodology, or its clients are highly indebted to other lenders.

Finally, if the accounting standards governing the accrual of interest on non-performing loans are not up to standard, financial institutions should be required to establish provisions for this accrued interest (see previous section on Non-Performing Loans).

Rationale

The expected losses associated with the microenterprise loan portfolio must be recognized though the timely establishment of specific, and possibly generic, loan loss provisions.

As for specific provisions, it is important to determine both the percentage of the specific provisions and the basis against which these percentages will be applied. Generally, specific provisions should be established against one of the following two bases:

- The accounting balance of the loan, that is, the balance of principal plus interest due or
- The principal balance only, which implies that interest due but not paid should be subject to provisioning or reversal.

The importance of generic loan loss provisions typically increases as competition among microfinance institutions intensifies. Increased competition, while generally desirable, can lead to a relaxation of lending policies and controls, and to the overindebtedness of microenterprise clients. Generic provisions serve to recognize and guard against this type of risk.

It is not advisable to require larger generic or specific provisions for loans with higher interest rates (which could be viewed as a proxy for credit risk). This would strongly discriminate against microenterprise loans since their high interest rates are often simply a reflection of high administrative costs, rather than of some extraordinary risk.

Examples

Bolivia, Peru, Colombia and Paraguay utilize very similar percentages for their specific loan loss provisions (Table 2.4). However, as noted earlier (Table 2.3), higher risk classes and provisioning percentages are encountered with many fewer days of loan delinquency in Bolivia and Peru than in Colombia and Paraguay. In addition, Bolivia's provisioning regulations provide a much more prudent treatment of collateral than those of the other three countries. In Bolivia, the value of collateral is not deducted prior to establishing provisions, while in Peru, Colombia and Paraguay such deductions are allowed. In the case of Peru, the problem

stems from the definition of microenterprise credit. Because this definition includes loans of up to US$20,000, it also covers small commercial loans, in which it is more reasonable to subtract the value of collateral when establishing loan loss provisions.

Bolivia

Bolivian financial institutions are required to establish specific provisions for microenterprise loans based on the number of days of delinquency and whether the loans have been rescheduled.

The Superintendency of Banks and Financial Institutions may also require that an institution establish generic provisions if its lending methodology exhibits "risk factors related to collectibility." In determining appropriate generic provisions, the Superintendency has established the following parameters.

1. When the lending methodology is inadequate in its design or implementation, information systems are insufficient for purposes of management or internal control, or loan rescheduling policies are inappropriate, the financial institution is required to establish a generic provision equal to the greater of the following amounts:[33]

   3% of the outstanding balance of the loan portfolio

   1% for each 10% of irregularities detected in a random sample of loans reviewed during the regular inspection of the Superintendency.

2. In the case of "contamination risk," generic provisions may be established for those loan clients who also have loans with another financial institution. A financial institution is required to establish a generic provision equal to "the amount that would result from reclassifying those microenterprise borrowers that owe a greater amount to another financial institution *and* are classified by the latter in a higher risk category, to that higher risk category." However, if the Superintendency finds that these irregularities exceed 20% of the sample, the institution is required to establish a generic provision equal to the amount that would result from having *all* clients reclassified to the highest-risk category to

Table 2.4 Specific Loan Loss Provisions on Microenterprise Loans (percentages)

Category	Bolivia (a)	Peru (b)	Colombia (c)	Paraguay (d)
1	1	1	0	0
2	5	5	1	1
3	20	25	20	20
4	50	60	50	50
5	100	100	100	100

Source: Prepared by the authors based on case studies.

Notes: (a) Bolivia: Percentages are applied to the outstanding principal balance, since uncollected interest must be reversed following 90 days of failure to pay an installment. The value of collateral is not taken into account.
(b) Peru: Percentages are applied to the outstanding balance of principal plus interest. For loans backed by preferred guarantees (mortgages and registered liens on movable property) these percentages are reduced by half (except for categories 1 and 5 where no change is made). For loans backed by easily convertible preferred guarantees, such as bank accounts and securities, these percentages are reduced to 25% (except for category 1, which is reduced by half and category 5 which remains at 100%).
(c) Colombia: Regulations provide for a general provision of 1% of the total gross amount of the portfolio. Percentages are applied, for all types of loans, to the outstanding principal balance, except for consumer loans, where the percentage is applied to principal plus interest, and for commercial and housing loans classified in category 2. Percentages are applied to the difference between the amount of the loan and up to 70% of the value of the collateral.
(d) Paraguay: Percentages are applied to the principal plus interest of microenterprise and consumer loans, with the option of deducting the execution value of real and bank collateral.

[33] Examples of inadequate lending methodology include noncompliance with the institution's own established credit policies and procedures and/or sound practices of loan approval and administration, such as failure to: i) verify residence and employment and keep the client data card up to date, ii) verify source of income and make a reasonable estimate of payment capacity, iii) verify payment history on debts with other creditors, iv) verify payment history of the guarantor and check the guarantor's basic documentation and source of income, and v) verify the existence of any registered collateral, its proper valuation, and the steps taken to ensure its protection.

which they have been assigned by any other financial institution in the financial system.[34]

Loan Write-Offs

Recommendation

Financial institutions should deduct from their assets, on a monthly basis, all microenterprise loans that have been 100% provisioned for a period of 360 days. For cost reasons, there is no need to carry out the analyses and procedures applicable to commercial loans prior to loan write-off.

Loan write-off regulations should also include rules on: how credit bureaus are to be notified, how borrowers with loans that have been written off can rehabilitate themselves, and on the obligation to classify any loans made to unrehabilitated borrowers as lost (category 5).

Rationale

Given the nature of microenterprise loans, a period of 360 days in which the loan is fully provisioned is considered to be sufficient time for the borrower to bring his or her payments up to date, either by paying in cash or by surrendering goods in lieu of cash.

The requirement to write off uncollectible loans on a monthly basis avoids sudden reductions in the size of the loan portfolio and prevents the discretionary use of write-offs to manipulate portfolio-at-risk measures. A consistent and comprehensive write-off policy ensures not only comparability among financial institutions, but also facilitates the operation of credit bureaus.

Regulations governing write-offs should also ensure that clients who have had loans written off are identifiable, at least until such clients rehabilitate themselves.[35] Although financial institutions cannot be prohibited from granting loans to unrehabilitated clients, these loans should be classified in the highest risk category and, consequently, be provisioned 100%. This puts pressure on noncompliant borrowers and promotes discipline in the credit market.

Example

Bolivia

Bolivia's Superintendency of Banks and Financial Institutions (SBEF) has taken care to stipulate that write-offs neither extinguish a borrower's obligations nor affect the rights of financial institutions to take legal action to recover amounts owed to them. This stipulation by the SBEF stems from the fact that, in the past, unscrupulous borrowers have argued to judicial authorities that their loan obligations were extinguished as a result of having been written off. SBEF's regulations also state that writing off loans with balances of 1% or more of the financial institution's net worth requires the prior authorization of the financial institution's board of directors and must also be reported to the general assembly of shareholders.

Delinquent loans for which a provision of 100% has been in place for more than one year must be written off against those provisions and transferred to an off balance sheet account. Delinquent loans that have been provisioned 100% can also be written off more quickly than one year. In both cases, the financial institutions must submit the following documentation:

1. Report by the financial institution's attorney on the status of judicial collection efforts, accompanied by affidavits, edicts, judgments, resolutions, sentences and any other relevant documents that show that no assets were able to be seized or were insufficient to cover the full amount of the loan.

2. Report by the risk management unit on the status of the borrower, including outstanding amounts of principal and interest, specific reserves established, collateral, and opinion as to the degree of collectibility.

3. Sworn statement by the statutory auditor that the loans to be written off are not in any way linked to the owners, directors or management of the financial institution.

4. Minutes from the board meeting showing that the loan write-offs were brought to the attention of the board and authorized as necessary.

[34] Clearly, these requirements presuppose a well-functioning credit bureau. Without such a source of information, financial institutions would not be able to reclassify their borrowers as mandated by the Superintendency.

[35] In fact, data reported to a credit bureau regarding payment of loans should clearly identify the disposition of the loan: paid by the client him/herself, paid by the cosigner or other third party, paid by the sale of collateral, or unpaid and written off.

Table 2.5 Accounting and Legal Requirements for Writing Off a Microenterprise Loan

	Board Approval	Verification of Uncollectibility	Delinquency of More Than … Days	The Loan is 100% Provisioned
Bolivia				✓
Colombia (SIB)[a]	✓			✓
Colombia (SES)[b]	✓			
Costa Rica				✓
Dominican Republic (SIB)[a]		✓	720 without real collateral 1,080 with real collateral	✓
Dominican Republic (AIRAC)[b]	✓		360	
Ecuador	✓	✓	1,080	✓
El Salvador			4,380 without collateral 8,760 with collateral	
Guatemala		✓	31	
Honduras	✓	✓		✓
Jamaica	✓		365	✓
Mexico		✓		
Nicaragua	✓	✓		✓
Panama	✓	✓		
Paraguay		✓	360 (loans up to US$950) 720 without real collateral 1,080 with real collateral[c]	✓
Peru (SIB)[a]	✓			✓
Peru (FENACREP)[b]	✓	✓		✓
Uruguay			720	
Venezuela	✓	✓		

Source: Prepared by the authors based on project survey.

Notes: (a) Agency charged with supervising banks.
(b) Agency charged with supervising credit unions.
(c) In Paraguay, it is also possible to write off uncollectible loans prior to these time periods in the event of: (i) a general prohibition against financial institutions placing liens against and selling registered collateral and (ii) the declared bankruptcy of a borrower.

Legal Recovery

Recommendation

Banking regulations in some countries require the initiation of legal action to recover delinquent loan balances after they have been overdue for a significant period of time. Such regulations should be avoided in the case of microenterprise loans. It is also recommended that alternative dispute resolution methods, such as arbitration, be promoted.

Rationale

The costs associated with legal loan recovery in Latin American countries often make this option uneconomical in the context of small loans. The time and expense of navigating the judicial system are simply too high in relation to the loan amount.

The problems associated with legal recovery are not easy to solve, and the bank supervisory agency is often very limited in what it can do since the problems originate in the legal provisions and institutional weaknesses of the judicial system.

Example

Bolivia

The regulations of the Superintendency of Banks and Financial Institutions state that financial institutions must initiate judicial action no later than 91 days following the date on which a borrower becomes delinquent, unless an extension (of no more than 90 days) is granted by an authority within the financial institution higher than that which initially approved the loan. Such authorization must be reported to the institution's board of directors, or equivalent authority, and be documented in the borrower's loan file. This documentation must include: (a) the amount of the loan, (b) the number of days past due, (c) the reason for and length of the postponement of legal action, (d) the level of authorization for the postponement, with names and signatures, and (e) the date of the meeting of the board of directors.[36]

Nevertheless, in the case of small loans, including microenterprise loans, the financial institution may instead opt to pursue extrajudicial means of collection, instead of going through the court system. Based on a cost-benefit study, the financial institution would utilize extrajudicial collection for all loans whose outstanding balance is less than or equal to a set amount, as approved by the board of directors or equivalent authority of the institution.

There are two procedural modalities available to financial institutions: the executive process and the coercive process. The cost of the two processes has been estimated by Superintendency to be quite similar. Both cost at least US$700, even in those cases where borrowers do not contest the process or file any appeals. Consequently, almost all financial institutions providing microenterprise loans have established a policy of not resorting to legal recovery for loan balances smaller than US$1,000. The time required for the judicial recovery process is very unpredictable, as it depends on the degree of urgency of the creditor and the additional costs that the creditor is willing to incur.

According to Bolivia's Superintendency, the high costs of legal recovery are associated with the extensive—and excessive—list of steps and requirements mandated in such processes:

1) Purchase of judicial tax stamps for filing the suit; 2) purchase of forms and papers for issuance of a writ of notification; 3) form for the seizure of collateral, which must be filled out; 4) personal summons with writ of notification; 5) request for service with summons; 6) writ authorizing service with summons; 7) service by summons with writ of notification; 8) request for notification by edict; 9) writ authorizing notification by edict; 10) publication of notifications (3); 11) record on the presentation of notifications; 12) carrying out of the seizure; 13) minutes of the settlement; 14) response to pleas; 15) request for sentence; 16) stamped paper for sentence; 17) notification of sentence; 18) request for service with summons; 19) writ authorizing service with summons; 20) service of summons with writ of notification; 21) request for notification by edict; 22) writ authorizing notification by edict; 23) publication of notifications (3); 24) record on the presentation of notifications; 25) request for writ of execution; 26) execution; 27) request for pre-auction measures; 28) writ and official letter authorizing pre-auction measures; 29) certification of payment of federal taxes; 30) cadastral certificate; 31) certification of payment of taxes; 32) appraisal; 33) record of filing and request for auction; 34) writ authorizing auction; 35) official letters for publication; 36) publication of notifications; 37) payment of notary fees; 38) request for second auction; 39) writ authorizing second auction; 40) official letters for publication; 41) publication of notifications; 42) record of adjudication; 43) affidavit of adjudication; 44) payment of transaction taxes; 45) recording of taxes.

Risk Weighting

Recommendation

Microenterprise loans should have a risk weighting of 100%.

Microenterprise loans should not be pre-defined as high-risk loans, and thereby penalized with a high-

[36] Recopilación de Normas para Bancos y Entidades Financieras de la Superintendencia, Title V, Chapter I, Section 5, Article 1.

er risk weighting, solely because they are provided by means of an unconventional lending methodology or because they bear interest rates higher than the average for commercial banking loans.[37]

Rationale

There is no empirical evidence to suggest that microenterprise loans are inherently more risky than other types of loans since detailed comparisons of loan delinquency patterns are not available. In fact, one could make the opposite argument, at least on theoretical grounds, that microenterprise loans are less risky than larger sized commercial loans. Since most microenterprise clients have few alternatives for accessing credit and other financial services, their relationship to the microfinance institution takes on great importance to them. If they are refused credit due to a bad payment history, they often have nowhere else to go. Consequently, it might be reasonable to argue that, all else equal, microenterprise clients would put forth a greater effort to honor their loan commitments.

Naturally, all things are not exactly equal. Microenterprise clients tend to be poor and have few resources set aside to deal with a crisis in the family or other unexpected emergencies. This tends to increase the risk associated with microenterprise lending and may counteract the impact of greater payment effort described in the preceding paragraph.

Nor is it clear whether general economic downturns affect microenterprises more severely than larger enterprises. If the source of the problem is volatile capital flows, large companies will in fact be more affected than smaller ones since the former tend to finance themselves at least partly abroad or in a foreign currency. Larger companies are also more directly exposed to changes in the country's terms of trade since they tend to import and export goods to a larger extent. While economic woes will ultimately affect microenterprises as well, it would seem that they are somewhat more sheltered from these problems, particularly when they arise from difficulties in international markets.

The fact that microenterprise loans in many cases are not backed by conventional collateral—or, when they are, the collateral cannot be economically executed—does not justify a higher risk weight. This problem is addressed through stricter provisioning standards.

[37] For example, the Argentine bank superintendency considers the interest rate as a proxy for risk, which leads to high risk weights being assigned to microenterprise loans.

III Principles for regulating microfinance institutions and credit unions

Beyond creating an appropriate regulatory framework for microenterprise lending, bank supervisors may also need to make modifications in the types of licenses that are available to organizations wishing to operate as supervised microfinance intermediaries. Nevertheless, the creation of new types of institutions for microfinance should be approached with caution because the proliferation of institutional forms tends to complicate supervision. Sometimes the matter is out of the hands of bank supervisors, however, because initiatives to create new types of institutions for microfinance often come from private groups and civil society associations. In some cases, bank supervisors find out about the initiative only when it is circulated as a new legislative proposal in congress.

Clearly, it is preferable for bank supervisors to be informed of and involved in any initiative to create new types of financial institutions. By the same token, bank supervisors must be able to say something other than an inflexible "no" when informed of this kind of initiative. Sometimes it does not make sense to create a new type of institution, and thus a negative stance by the supervisor is justified, but other times the creation of such a license may be the only way to reasonably facilitate a continued and sustainable expansion of microfinance in the country.

The purpose of creating a new type of financial institution to do microfinance is normally related to the desire to convert nonprofit organizations engaged in microfinance into formal financial intermediaries. The creation of a new type of financial institution, however, requires consideration of a whole new set of regulatory issues, including the need for guidelines on such topics as con-

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trol by owners, minimum capital, permitted operations and noncommercial indebtedness. The required regulations must be tailored to each different type of institution and, accordingly, are different from the regulations discussed in the last chapter, which pertained to microfinance as an activity/product. The need for a set of regulations tailored to each different type of institution engaged in microfinance can be justified by the fact that their different organizational, operational and ownership structures create risks and weaknesses that are unique to each type of financial entity.

The application of a differentiated regulatory framework, however, is complicated by the variety of financial institutions engaged in microfinance activities to a greater or lesser extent, such as:

(a) commercial banks with a portion of their portfolios dedicated to microenterprise loans

(b) finance companies with a portion of their portfolios dedicated to microenterprise loans

(c) commercial banks specializing exclusively in microfinance, which have typically come into existence as a result of the transformation of nonprofit organizations

(d) finance companies specializing exclusively in microfinance, which have typically come into existence as a result of the transformation of nonprofit organizations

(e) credit unions with a portion of their portfolios dedicated to microenterprise loans

(f) new types of financial institutions created specifically to enable nonprofit microfinance organizations to more easily operate as regulated financial entities (as described in Chapter 1).

In view of the considerable diversity of financial institutions engaged in microfinance, supervisory authorities cannot apply a standard approach to all of them. The different types of institutions differ significantly in terms of their ownership, organizational structure, operations and overall risk profiles. For example, a finance company growing out of a nonprofit organization and specializing exclusively in microfinance is quite different from a commercial bank that allocates only a portion of its portfolio to such activities. The differences are even greater in the case of credit unions, which possess a number of truly unique ownership and governance characteristics.

The recommendations made in this chapter are most easily applied to new types of financial institutions that are created to permit the transformation of nonprofit microfinance organizations into regulated financial entities. In such cases, the recommendations are not only entirely appropriate but can also be easily implemented through the law and regulations that create and define the new type of institution.

Most of the recommendations proposed in this chapter are also applicable in their entirety to existing finance companies and banks engaged exclusively in microfinance activities. In these cases, however, their implementation might be somewhat more problematic. It makes little sense to overhaul the regulatory framework for all banks or finance companies simply because a few of them specialize in microfinance. Rather, in view of the fact that most of the finance companies and banks engaged exclusively in microfinance have been created through the transformation of nonprofit organizations, the appropriate solution is for the supervisory authority, at the time a new institution is licensed, to require that its articles of incorporation include the limitations and recommendations suggested in this chapter.

In the case of conventional banks and finance companies engaged only partly in microfinance, implementation of the suggested regulations not only constitutes a practical challenge but also requires a theoretical justification. Clearly, it would be inappropriate alter regulations in such areas as capital adequacy, credit concentration and permitted operations if the institution channels only a small portion of its resources into microfinance. Only if the institution has a substantial involvement in microfinance do the regulations suggested here begin to be applicable. Accordingly, any implementation among mainstream banks and finance companies would have to be partial, gradual and individualized. The supervisory authority should negotiate with each institution, on a case-by-case basis, any modifications that it deems to be justified.

Finally, credit unions pose special challenges for

supervisors. Not only are they very different from banks and finance companies in terms of their purpose, governance and operations, but in some countries, there are more credit unions than the supervisor can possibly hope to supervise effectively in the forseeable future.[38] As a result, supervisors in some Latin American countries have preferred not to make any effort to effectively supervise these intermediaries.

With 100 or more credit unions present in many Latin American countries, any mention of regulating credit unions invariably leads to the question of which credit unions should be regulated. In some cases, it is not realistic to regulate all of them. However, there are several reasons why at least large credit unions should be subject to government-backed prudential regulation and supervision: (a) they have a large number of depositors needing protection, (b) the bond among members is often weak, eroding elements of self-supervision, and (c) some large credit unions could fairly be classified as posing systemic risk in the conventional sense of the phrase.

Smaller credit unions present a more difficult challenge to supervisory authorities, inasmuch as they are often very numerous but typically account for only a very small percentage of the total deposits of the financial system. At first blush, it may seem unrealistic for the bank supervisor to supervise smaller credit unions since the costs of doing so could be very high. This problem could be overcome if the superintendencies were able to charge cost-covering or nearly cost-covering supervision fees for their services. They would then have the resources to properly supervise credit unions without having to call on commercial banks and other supervised financial institutions to cross-subsidize credit unions.

Such a system might be seen as fairer by the credit unions if supervision fees were broken into two parts. The first part would be an inspection fee, levied according to the number of man-days of supervisory time spent on the on-site inspection of the credit union (much as is done in the German system of credit union supervision, where the credit unions are presented with a bill for the cost of services rendered at the end of the inspection). The second part would be a traditional supervision fee, calculated as a percentage of the credit union's assets, for example, 0.2% of total assets. This fee would cover all of the other costs of supervision, such as those associated with off-site data collection and analysis, the work of the superintendency's legal department, the updating of regulations, and the intervention and closure of credit unions.

By levying the fee in two parts, a traditional, one-part fee of 0.5–1% of assets, which might be needed in some cases to cover all of the costs of credit union supervision, would be avoided. Such a fee might seem exorbitant to credit unions, whereas a two-part fee, in which the high costs of making a field visit are made plain and levied separately, might seem more justified.

This is not to say that any financial institution, including credit unions, will like to pay for supervision. However, we believe that it would be in the credit union's long-run interest to pay even the full cost for good quality supervision, given the benefits conferred by such oversight. Credit unions might have to raise their loan rates somewhat to cover these added costs, but this should not be a major problem. Credit union loan rates are often below what banks charge even for much larger loans, and are also below what the credit unions themselves could charge for the small loans they make. In addition, many credit unions are located in rural areas, where they have captive markets and even greater discretion to increase loan rates. In any case, good supervision may result in the credit unions making substantial efficiency gains, which may obviate the need for any loan rate increases at all. In addition, good supervision benefits the credit union by providing the external controls that help it to become

[38] The unique governance features of credit unions are linked in part to the fact that members can be depositors, borrowers and owners of the institution all at the same time. This readily leads to conflicts of interest in how the credit union should be run. Members who are net depositors are more concerned about the financial sustainability of the institution, and members who are net borrowers are more concerned about having continued access to inexpensive loans. Since all members have one vote, it is not obvious that the members with money at risk in the credit union (the depositors) will be able to dominate its management. In fact, it is often the other way around, which, in the case of many Latin American credit unions, has led to weak performance and a precarious existence on the verge of insolvency.

Credit unions exhibit a number of other distinctive characteristics that add to their governance challenges. For example, they typically operate in a much more restricted geographical area than banks, so they enjoy a much lower degree of diversification in both their loan portfolio and their funding sources (local deposits). For a more in-depth discussion of the characteristics of credit unions and the implications for their regulation and supervision, interested readers may consult Westley and Branch (2000a), Richardson (2000b) and Poyo (2000).

a more stable and financially sustainable institution. This enhanced stability and safety bolsters public confidence in credit unions and helps these intermediaries to attract deposits, thus providing resources for growth, service expansion, and further cost reductions through scale economies.

A second alternative for dealing with the issue of the high cost supervising the smaller credit unions might be to outright prohibit smaller unregulated credit unions from taking deposits, permitting them only to take shares (which, unlike deposits, are not remunerated at a pre-established interest rate, but only with dividend distributions out of any profits earned during the year). However, this would effectively leave many rural communities without important financial services.

Lastly, the supervisory authority could delegate the supervision of smaller credit unions to some other institution (typically another government agency or a federation of credit unions), though this generally results in supervision of a lower quality due to lack of trained personnel and/or conflicts of interest in the delegated supervisor. Nor does delegation ensure that the bank supervisory authority can avoid, in the final analysis, assuming responsibility for any problems that occur in the sector.

To these challenges must be added the fact that credit unions have a tendency to resist regulation by supervisory authorities. They do this mainly for two main reasons. First, they fear that proposed regulations will not be sufficiently well adapted to the particular characteristics and circumstances of credit unions and that they might therefore impose unreasonable and unrealistic requirements. Second, some credit unions object to the fact that they would have to limit themselves only to financial services (which is necessary in order to allow for effective supervision) and no longer provide health, education or other services as part of their on-going operations. The tradition of providing such nonfinancial services is deeply rooted in the cooperative movement in many countries.[39]

Considering the distinctive features and special issues associated with credit unions, they probably constitute the most complicated and challenging area of regulation and supervision within the general field of microfinance. Although this publication suggests solutions for a number of technical aspects related to credit union regulation and supervision, it does not deal with the fact that many important and difficult decisions must be made at the political level, in view of the organizational capacity of credit unions and the need to adapt laws and regulations to the special characteristics of these financial institutions.

In view of the considerable differences that exist between credit unions and incorporated financial institutions, this and the following chapter provide separate recommendations for these two types of institutions. This allows the recommendations that are made to not only be fairer but also more precise.

Legal Form and Purpose

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should require regulated microfinance institutions to be chartered either as corporations or credit unions. Nonprofit organizations should not be allowed to operate as regulated and supervised entities. Institutions operating as regulated and supervised entities should be not be permitted to engage in ongoing business activities other than financial intermediation, such as the provision of technical assistance, training or social services.

Microfinance Institutions. The regulatory framework should provide mechanisms that enable financially sustainable and well-capitalized associations or foundations to participate in the creation of financial corporations. However, the creation of new financial institutions by a nonprofit organization should also include the participation of for-profit investors, who often impose a greater degree of discipline and control over the institution and are often better able to respond to capital calls by the supervisor in case the institution's solvency is threatened.

Credit Unions. Credit unions wishing to offer social or other nonfinancial services should only be

[39] As is further explained in this chapter, credit unions would not be completely barred from providing nonfinancial services; they just would not be able to do it as a line of business. In other words, they would have to pay for these types of activities from the retained earnings of previous years.

permitted to do so using profits accumulated from prior years. They should not be permitted to offer these services as ongoing business activities. This separation of financial and nonfinancial activities, which in some cases might result in the break-up of a cooperative, is necessary to ensure adequate prudential management and supervision of these entities.[40]

Rationale

Microfinance Institutions. While many microfinance institutions have traditionally operated as nonprofit organizations in accordance with their national civil codes, the stock corporation is nevertheless the most appropriate legal form for conducting financial intermediation activities. Stock corporations make it possible to distribute risk, improve oversight, and introduce stronger performance incentives. In addition, stock corporations can be sold to or recapitalized by third parties in the event of a crisis, with no need for amendments to their charter or changes in their legal status.

Credit Unions. The great advantage of credit unions is the fact that, by giving one vote to each owner/member of the cooperative, a mechanism is put into place that helps to ensure that the services provided are consistent with the wishes of a majority of the credit union members. In contrast, a corporation might possibly respond solely to the wishes of a few wealthy shareholders.[41]

However, the insertion of nonfinancial services into the daily operations of credit unions, a practice common in many countries, tends to impede the professional management of the financial activities. Staff and systems are not specialized enough. Lack of separate cost and revenue accounting (between financial and nonfinancial activities) makes it more difficult to discern, analyze and remedy any problems in the financial operations of the institution. Accordingly, credit unions are best served by a regulatory framework that focuses their activities on financial services, encourages operational efficiency and strengthens internal and member controls.

Examples

Bolivia

Credit Unions. In Bolivia, a country with one of the most diverse cooperative sectors in Latin America, credit unions are chartered in accordance with the provisions of the General Law Governing Cooperative Institutions (*Ley General de Sociedades Cooperativas,* or LGSC), enacted on September 13, 1958. As provided in article 24 of the LGSC, which was subsequently nullified in 1993, credit unions were defined as cooperatives organized for the purpose of providing loans to their members at an interest rate that would never exceed the highest rate legally permitted to banks. The same article stated that credit unions would be required to develop lending programs to facilitate the granting of housing loans to the working classes.

Article 24 of the LGSC was nullified by the new Law Governing Banks and Financial Institutions (*Ley de Bancos y Entidades Financieras,* or LBEF) of 1993. Unlike the previous General Banking Law, which was in effect since 1928, the LBEF regulates the services offered by several types of financial institutions:

- banks
- financial service companies: leasing and factoring companies and bonded warehouses
- mutual savings and loan institutions (which specialize in housing loans) and credit unions
- other nonbank financial institutions

In December 1996, Supreme Decree No. 24439 was issued in order to provide regulations for both laws (the LGSC and LBEF). It also created two types of credit unions:

Open credit unions, which take deposits from their own members, the general public and other financial institutions (either domestic or foreign). These credit unions are chartered—in accordance with the provisions of the LGSC—as specialized, single-purpose institutions. They are subject to the "limited liability" framework and require an operating license issued by the Superintendency of Banks and Financial Institutions, which regulates them. Their activities are subject to the provisions of the LBEF

[40] If, for any reason, credit unions supervised by the banking superintendency are allowed to engage in multiple activities, they should be required to keep separate accounting books for their financial and nonfinancial activities. In addtion, all financial activities should be backed by separate and clearly distinguished capital, rather than having the credit union's entire capital available to cover the risks involved in both financial and nonfinancial activities. Under the latter system, nonfinancial activity losses could wipe out the capital that protects a credit union's deposits.

[41] For example, in corporate entities, shareholders might decide to reorient services toward a wealthier clientele in hopes of increasing profits.

and other legislation affecting the financial system.

Open credit unions are, in turn, subdivided into four categories, based on the amount of capital they must have at the time they apply for an operating license. Credit unions with higher levels of required capital are allowed to engage in a broader range of operations.

Closed credit unions, which fund themselves exclusively from share capital provided by their own members. They are governed by the provisions of the LGSC and the regulations issued by the National Cooperative Institute (INCOOP). These credit unions are not authorized to accept deposits, only shares. Until recently, members could withdraw their shares only when they left the credit union. However, by virtue of recent regulations issued by the Superintendency, closed credit unions can now permit members to withdraw shares that are not needed by the credit union to meet its capital adequacy requirements.

Decree No. 25703, dated March 11, 2001, amends the regulatory framework governing closed credit unions, dividing them into *comunales* (community-based) and *laborales* (employer-based), depending on whether or not there exists a common employment link among the members and, by extension, a source for repayment of loans that is at once well-defined and relatively secure through the use of payroll deductions.

The operations Bolivian credit unions are permitted to engage in span a wide range, with four categories of open credit unions (varying by size) and two additional categories of closed credit unions. The largest open credit unions are permitted to offer the widest range of services, nearly the same as those offered by commercial banks. At the other extreme are the closed credit unions, both the *laborales* and *comunales,* that operate with an extremely restricted scope, not only in terms of the types of operations they are authorized to carry out but also in terms of their own ownership structure, type of clientele and volume of operations.

Peru

Microfinance Institutions and Credit Unions. Article 282 of the General Law Governing the Financial System (*Ley General del Sistema Financiero*) states that in addition to banks and finance companies, a series of specialized microfinance institutions—including *Cajas Rurales de Ahorro y Crédito* (CRACs), *Cajas Municipales de Ahorro y Crédito* (CMACs) and Micro and Small Enterprise Development Institutions (EDPYMEs) —and credit unions are authorized to engage in financial intermediation activities. With the exception of credit unions, these institutions are organized as stock corporations, with a minimum initial capital of approximately US$270,000. The CRACs and CMACs are permitted to accept both savings and time deposits.

The Peruvian legislation provides a tiered regulatory system to enable all three types of specialized microfinance institutions to gradually expand the scope of their operations. Among other things, this enables them to: (a) issue credit and debit cards, provided they have capital of US$1.3 million and meet other requirements; (b) provide checking accounts without overdrafts and issue bonds, provided they have capital of US$2.6 million and meet other requirements; and (c) provide checking accounts with overdrafts provided they have capital of US$5.2 million and meet other requirements.

Ownership

Recommendation

Microfinance Institutions. The founding shareholders of microfinance institutions should be subjected to the same ethical and financial standards as the founding shareholders of other financial institutions. The bank supervisor should be required to evaluate and, as needed, reject requests for operating licenses where the capital structure does not ensure balanced control by owners and a sound business orientation.

The regulatory framework should require in the medium-term the presence of private investors with an equity participation sufficient to enable them to exercise veto power in significant corporate decisions. The regulatory framework should also state that the bylaws of nonprofit institutions that have an equity participation in a microfinance institution include authorization to acquire such shares in profit-oriented businesses. The contracts that these nonprofit institutions have with donors and other major funders must also permit such acquisitions.

Credit Unions. Regulatory authorities should ensure that the membership of a credit union consists of *individuals* (not organizations) who join together for the purpose of overcoming a lack of adequate financial services. Other cooperatives may also be allowed to participate in the ownership of a credit union provided that there exist regulations to prevent the potential conflicts of interest that can arise in such structures.

Rationale

Microfinance Institutions. The nature of financial intermediation—a highly leveraged business in which the law must protect the savings of thousands of individual depositors—requires that financial institutions have a stable equity base and that their shareholders possess high moral standards, financial capacity and a clearly defined objective of doing business over the long term. For this reason, it is important to carefully analyze the quality and nature of the founders of all financial institutions, including microfinance institutions.

Although private investors do indeed participate as shareholders in microfinance institutions, the most important shareholders to date have generally been federal and municipal governments, local and foreign nonprofit organizations, international organizations and bilateral aid agencies. Equity participation by such entities in a financial institution is not always consistent with a clear business orientation, firm control of the institution by the owners and optimal protection of deposits. On the other hand, the supervisory authority should beware that in certain circumstances private investors might engage in excessive risk taking.

The nature and quality of shareholders become critically important when an institution requires increased equity resources, either because it is successful and its growth requires increased capital, or because it is losing money and requires recapitalization. A supervisory authority that has not taken into account the nature and motivations of institutional investors could find itself confronting any of the following problems:

- Inability to require federal, state or local governments to increase their equity participation in a financial institution. Local governments may, even when willing, find themselves lacking the resources demanded by the supervisory authority.
- Failure of institutional investors to devote sufficient time and effort to fulfilling their role as owners, especially if the amount of their investment is considered small by the investor or if the investment has already been classified as an expenditure by the investor's tax authority.
- Inability of nonprofit associations, networks of associations and international/bilateral donors to increase their equity participation and improve their controls over the financial institution in the short term.

In addition, the bylaws of many nonprofit organizations, as well as their contracts with key donors and other funders, often prevent the nonprofit organization from being a shareholder in profit-oriented businesses. Accordingly, in processing the microfinance institutions's request for an operating license, the supervisory authority should require any such modification of bylaws and contracts as is deemed necessary.

Credit Unions. The recommendation that members of credit unions be individuals (as opposed to organizations) derives from the fact that the indiscriminate participation by any type of entity in the cooperative structure tends to dampen the cooperative spirit and weaken the institution. The participation of other credit unions, while not always not ill-advised, can nevertheless create problems in the form of conflicts of interest in cases where the credit unions offer, or may potentially offer, services to the same group of clients. This problem can occur in countries with second-tier credit unions, which are supposed to provide services to member credit unions, but sometimes compete with them as well in providing financial services to individuals. To avoid a possible conflict of interest with such member credit unions, the regulatory framework should state that second-tier credit unions cannot provide services to individuals, but, rather, only to their own member credit unions.

Examples

Bolivia

Microfinance Institutions. In 1995, Supreme Decree No. 24000 was issued to promote the creation of nonbank financial institutions focused on serving micro and small enterprise clients. The decree authorizes the organization of Private Financial Funds (known by their Spanish acronym, FFP) as corporations with a minimum capital of

630,000 Special Drawing Rights, equivalent at the time to approximately US$1 million. These institutions are governed by the same ownership rules applicable to banks and are authorized to conduct a wide range of operations, including the mobilization of savings and time deposits. However, they are subject to stricter risk diversification standards than those applied to banks.

The chartering of FFPs is regulated by Resolution SB No. 71/96, issued on August 20, 1996, which states that the initial step in the chartering process is a meeting with the Superintendency of Banks and Financial Institutions (SBEF). That meeting marks the date from which the applicant and SBEF are held to a rigid timetable for completing each step in the process. In addition to a tightly controlled schedule for the chartering process, the regulation is also strict in the sense that the charter application is automatically rejected in its entirety if the SBEF objects to any of the founding shareholders, with no possibility for other founders to replace the objectionable shareholder. The purpose of this is to encourage the applicant to make a very careful analysis of its founding shareholders so that from the outset the FFP is owned by persons with sufficient financial capacity and impeccable reputations.

Six FFPs are currently in operation. Of these, three were created by nonprofit organizations specializing in microfinance. In all cases, the legal minimum capital has been deposited in cash in Bolivia's central bank. Subsequently, the nonprofit organizations have made additional equity contributions in cash using the funds obtained from the repayment of loans by the nonprofit organization's clients, to whom the FFP grants new loans. This arrangement increases the capital of the FFP while simultaneously ensuring that only creditworthy clients are transferred to its loan portfolio.

Two of the three microfinance FFPs have received strong support—in the form of personnel, clients, systems, credit technology and equipment—from their founding organizations, which subsequently ceased microfinance operations. This support explains not only the substantial success they have achieved to date, but also the national and international recognition accorded to these entities. The shareholders of these FFPs include—in addition to the founding nonprofit organizations—international and bilateral organizations and private sector investors with minority interests. In the case of the third microfinance FFP, there are four nonprofit founding organizations that jointly exercise majority control. Unlike the cases of the other two microfinance FFPs just described, the nonprofit founding organizations of the third FFP continue to operate and, to some extent, compete with the FFP they have created. Interestingly, this FFP has experienced serious difficulties in achieving the levels of efficiency, portfolio quality and profitability necessary for long-term sustainability.

Colombia

Credit Unions. According to law 79 of 1989 and law 454 of 1998, a credit union must have a minimum of 20 members who have met the laws' conditions for suitability and who have participated in a training course on the cooperative movement. Any individual or organization can be a member of any type of cooperative, including municipalities, federal government agencies, and nonprofit organizations. For the reasons given previously, such indiscriminate participation creates serious weaknesses in the control and management of Colombian credit unions.

Control by Owners

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework for microfinance institutions should require that the individual charged with carrying out internal oversight on behalf of the shareholders have experience with microfinance activities.[42] This individual should verify the use of appropriate credit policies and methodologies, and inform the shareholders of these findings. Since many microfinance institutions began as nonprofit organizations, it becomes critically important for the regulatory framework to clearly define the responsibilities of the board of directors (which represent the interests of the shareholders) and of management.

Credit Unions. The regulatory framework should

[42] If the regulations already require "fitness and experience" to occupy this position, no additional regulation is required since this phrase includes experience with microfinance activites if the institution offers them.

set forth the standards of moral fitness, education and training that are required to be a member of the supervision committee. The regulatory framework should also grant the supervision committee the authority to convene a meeting of the general assembly of members in cases involving serious violations by the board of directors or management of laws, regulations, the credit union's bylaws or the resolutions of the general assembly. The reports issued by the supervision committee should be made available to the supervisory authority, which may then take corrective or punitive actions, including the removal of the responsible parties.

Rationale

Microfinance Institutions. Corporate law requires the existence of a unit or individual responsible for reviewing the corporation's decisions, activities, accounts and profitability, and for keeping the shareholders duly informed. This mandate takes on special importance in the case of financial institutions, which not only manage shareholder capital but also significant volumes of third-party resources, such as deposits. Given the special characteristics of microfinance and microfinance institutions, it is important for those providing internal oversight to have experience in this area in order to effectively discharge their duties.

Credit Unions. The supervision committee provides oversight of a credit union on behalf of the members. Credit union regulations should require a minimum level of moral fitness and professional training for the members of the supervision committee. The regulations should also reinforce the controls exercised by the supervision committee by permitting this committee to convene general meetings of the credit union membership in cases of serious irregularities.

It is essential that the supervision commitee of a credit union keep the supervisory authority abreast of any irregularities by issuing periodic reports. In this way, the supervisory authority is able to take appropriate corrective or punitive actions on a timely basis, including, in extreme cases, the removal of the responsible individuals. The supervision committee also provides additional volunteer opportunities for members to become involved in the issues and problems facing their credit union.

Examples

Paraguay

Credit Unions. Paraguay's General Cooperative Law (No. 438/94) deals with the issue of oversight; however, it is incomplete and needs additional regulations. The Law stipulates that the following individuals may not be members of the supervision committee:

- Individuals who are related to members of either the board of directors or the supervision committee itself in the second degree by blood or first degree by marriage.
- Those absolutely or relatively incompetent to act.
- Those involved in competing organizations, or organizations with opposing interests.
- Those who have been bankrupted as a result of negligence or fraud, those prevented by judicial mandate from occupying public positions, and those convicted of crimes.

Given the importance of the supervision committee's control functions, it would be wise to apply a stricter standard by also prohibiting the following people from serving on this committee:

- Those occupying positions as directors, managers, auditors, or employees of other financial institutions regulated by the Superintendency of Banks.
- Those holding positions in any of the various branches of government, with the exception of those engaged as technical consultants or who are teachers.
- Those who have delinquent loans.
- Directors and employees of the Central Bank or Superintendency of Banks.

The regulatory framework also does not require members of the supervision committee to have financial sector experience. In contrast, banks and finance companies require their controllers and directors to have a minimum of three years of financial sector experience. On the other hand, since the operations of many credit unions are much less complex than those of banks and finance companies, it is recommended that smaller credit unions be accorded special treatment.

In light of these considerations, the regulatory

framework could include the requirement that all supervision committee members have a minimum of three years of financial sector experience. However, in the case of credit unions whose capital is less than the minimum capital required for finance companies, professional or business experience in sectors other than the financial sector could be counted toward the three year minimum.

Finally, in view of the desirability of periodically renewing the makeup of the credit union's primary control apparatus, and, inasmuch as cooperative legislation does not establish a maximum period of time for members of the supervision committee to serve, it would be advisable to establish a limit of four or five years for such positions in credit unions.

Colombia

Credit Unions. The regulations governing the operation of credit union supervision committees (as set forth in articles 38, 39 and 40 of law 79 and articles 59 and 60 of law 454) require that their members be elected by the general assembly and that these members may not at the same time be employees or advisors of the credit union or members of the credit union's board of directors.

Likewise, law 79 stipulates that all credit unions must have an auditor who works with the supervision committee on matters of institutional control and reports directly to the members. The reports issued by the auditor support the objectives of the supervision committee, management, and the members. The auditor must include in his or her reports issues required by the credit union regulations.

Board of Directors and Management

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should require that, in addition to moral fitness, the board members and management of microfinance institutions and credit unions demonstrate knowledge of financial institution management, microfinance and the regulatory framework. The supervisory authority should have the power to veto or demand the replacement of any directors who lack the necessary experience or whose stay in the country is only for a limited period of time.[43]

The regulations should clearly separate the roles and responsibilities of directors from those of management and should also delineate the interrelationships of the directors and management with the general assembly and, in the case of credit unions, with the supervision committee.

Rationale

Microfinance Institutions and Credit Unions. Strict compliance with high standards of moral fitness and technical capacity are especially important in the case of microfinance institutions and credit unions since these institutions often have an unconventional ownership structure, with most shares held by nonprofit organizations, international agencies or a very fragmented shareholder base.

Moreover, providing small loans effectively and efficiently requires an organizational structure that allows most credit decisions to be taken at the level of the individual loan officer. Accordingly, the board of directors and management of microfinance institutions participate in only a small percentage of the loan-granting decisions, and must instead assume monitoring responsibilities not commonly seen at their levels in other financial entities. This requires a fairly specialized knowledge of credit policies and procedures, human resource management (incentive pay schemes and internal control systems), information technology and other areas.

For these reasons, the supervisory authority should require each institution's bylaws to clearly spell out the functions and responsibilities of the board of directors and management, and should ensure that these are appropriate in the context of microfinance. For example, the board could meet monthly and the general manager could perform certain of the risk monitoring functions normally carried out by the internal auditor, thereby freeing up the latter to monitor borrowers more closely.

[43] This type of problem has been observed among those representing international or nonprofit organizations on the boards of directors of some microfinance institutions.

Credit Unions. In credit union legislation and in the bylaws of many credit unions, there is often a glaring failure to clearly distinguish the roles and responsibilities of the board of directors from those of management. For example, it is not uncommon to observe the board of directors participating and even interfering, either directly or through committees, in the loan approval process which, given the small amounts involved and the collateral provided, clearly should be handled by the general manager or his or her subordinates.

The supervisory authority should also ensure that credit committees consisting of volunteers drawn from the credit union membership play an appropriate role. In small credit unions (those with approximately 200-300 members or less), volunteer credit committees frequently perform well and make good loan-granting decisions since members often know the loan applicants better than a salaried loan officer would. However, when credit unions reach a certain size, it becomes impossible for volunteer credit committees to have a personal knowledge of all loan applicants. Moreover, it becomes highly impractical for the credit committee to approve all loans, given the substantial volume of operations involved. Furthermore, volunteer credit committee members do not usually have the skills or knowledge to conduct a thorough credit analysis of an applicant, which is necessary when detailed personal knowledge of the applicant is no longer available. Accordingly, as credit unions grow in size, volunteer credit committees should be disbanded or take on the function of determining from a sample whether loans are being made in compliance with the credit union's policies and procedures. In lieu of the volunteer credit committee, professional loan officers and managers should make the loan-granting decisions.

Examples

Peru

Microfinance Institutions. Article 79 of the General Law Governing the Financial System (*Ley General del Sistema Financiero*) states that the board of directors of a financial institution must consist of at least five members that meet all moral fitness and technical capacity requirements and have been elected by the general assembly of shareholders. Not eligible to act as directors are those who have committed fraud, who have been directors or managers of financial institutions that have been intervened by the Superintendency, and those held responsible for acts that were officially sanctioned by the Superintendency (articles 81 and 92 of the General Law). In addition, a board position may not be held by any individual who is bankrupt, by residents who do not have a taxpayer registry card, by those with loans more than 120 days in arrears or in the process of judicial collection, or by those with substantial shareholdings in firms with loans that are likewise more than 120 days in arrears or in the process of judicial collection.

The law also states that directors and managers are liable for infractions committed by their financial institutions when they have: approved operations and agreements that are contrary to the law; failed to take steps to correct irregularities; failed to supply information, or have submitted false information, to the Superintendency; failed to comply with the Superintendency's legal resolutions; or have failed to take steps to ensure that internal and external audits are performed in a timely manner.

Bolivia

Credit Unions. The General Law Governing Cooperative Institutions (*Ley General de Sociedades Cooperativas*), which took effect on September 13, l958, states in article 93 that the board of directors is charged with executing the plans and guidelines approved by the general assembly "in accordance with the provisions of the regulations." However, the relevant regulations were never issued. This regulatory vacuum was ultimately filled by means of a ministerial decree (No. 24439). This decree states that the Superintendency of Banks and Financial Institutions (SBEF) will issue regulations pertaining to the oversight functions exercised within a credit union by the board of directors, supervision committee and internal auditor. In addition, the decree states that these regulations must be incorporated into all credit union bylaws.

The SBEF has established, in its Compilation of Regulations (*Recopilación de Normas*), a number of detailed provisions regarding the makeup, powers and responsibilities of the boards of directors of credit unions:

Compilation of Regulations, sbef
(extract)

> *Article 6*
> "The bylaws will establish the number of members of

the Board of Directors, to elected by the General Assembly in accordance with all relevant laws and statutes. There will be an odd number of regular Board members, totaling not less than three (3) nor more than seven (7), plus two (2) alternate members. The General Assembly will elect the Credit Union's first Board of Directors, and any subsequent Board of Directors in the event the Board is fully replaced, by selecting one Board member for a period of one year, half of the remaining Board members for a period of two years, and the other half for a period of three years, based on the number of votes obtained. Subsequently, the period of service for members of the Board of Directors to be replaced will be three years. No member of the Board of Directors may be elected for more than two consecutive terms. If, after serving two terms, a member wishes to be a candidate for a third or subsequent term, he or she must wait for a period of no less than three years, and will not be permitted to occupy the position of Board member during this period. Any vacancy on the Board of Directors will be filled by the alternate member receiving the greatest number of votes. The Board of Directors will elect from among its members a President, a Vice-President and a Secretary. As appropriate, all other members will serve as regular members."

Article 8
"The functions and powers of the Board of Directors include the following, without detriment to such others as it might have in accordance with the law:

(a) To obey and enforce the laws and their implementing regulations, the Credit Union's Bylaws and other internal regulations, the resolutions of the General Assembly, and the Board's own rulings and resolutions.

(b) To approve such regulations as may be necessary to carry out the provisions of the Bylaws and the policies approved by the General Assembly, as well as those needed to exercise the powers and fulfill the duties of the Board of Directors itself.

(c) To establish policies and approve annual budgets and administrative and operating plans and programs, in accordance with the General Law Governing Cooperative Institutions, its implementing regulations and the institution's own Bylaws.

(d) To delegate specific powers to managers for the implementation of financial intermediation activities, the opening and operation of bank accounts and other administrative actions.

(e) To grant initial approval to the financial statements and the annual report prepared by management, which must include the external audit report, for submission to the General Assembly.

(f) To provide initial approval of any amendments to the Bylaws and submit such amendments to the General Assembly.

(g) To convene the General Assembly, including preparation of the agenda and a call for elections, as required.

(h) To appoint and remove the manager and/or managers.

(i) To create and dissolve specific committees and commissions, as may be appropriate, to improve the management of the Credit Union.

(j) To approve participation by the Credit Union in federated cooperative institutions and other similar organizations.

(k) To approve loan and deposit rates of interest.

(l) To assess, on a monthly basis, the execution of the budget and the financial status of the Credit Union based on the financial performance parameters defined in the Credit Union's strategic plan. Any resolutions deriving from such assessments must be duly recorded in the minutes.

(m) To approve regulations that govern membership, including acceptance, sanction and exclusion of members based on pertinent laws, their implementing regulations and the Credit Union's own Bylaws.

(n) All other powers and functions that, in accordance with the General Law Governing Cooperative Institutions and the Credit Union's own Bylaws, do not fall to the General Assembly or to Management."

The SBEF has also developed Model Bylaws specifically for credit unions that, among other things, lists the powers and responsibilities of the general manager:

Model Bylaws
(extract)

Article 57
"The General Manager is the highest ranking executive officer of the Credit Union, and is responsible to the Board of Directors for the overall operations of the Credit Union. The powers of the General Manager include the following:

(a) To exercise the administrative and legal representation of the Credit Union, with such powers as may have been conferred to him or her by the Board of Directors within the existing legal framework.

(b) To represent the Credit Union in any other proceedings, except those expressly identified by the General Law or these Bylaws as those reserved exclusively for the Chairman of the Board of Directors.

(c) To implement programs in accordance with the plans and budgets approved by the Board of Directors.

(d) To appoint, promote and dismiss employees and other officers, in accordance with the law.

(e) To counsel the General Assembly, the Board of Directors and the Supervision Committee, with authority to participate and speak in their sessions, but with no right to vote.

(f) To plan, organize and direct the management of the Credit Union, in accordance with the regulations and policies established by the Board of Directors and existing legal provisions.

(g) To sign, in conjunction with the Accountant, the financial statements of the Credit Union in accordance with the formats, due dates, reporting frequency, and regulations set forth in the Superintendency's Manual of Accounts for Banks and Financial Institutions."

Article 58
"The General Manager of a Credit Union, by virtue of the general powers listed in the preceding article, is endowed with the following specific powers, provided he or she is in compliance with the Board of Directors' regulations regarding authorized signatures and with the registration of signatures:

(a) To open, transfer and close checking accounts in banks.

(b) To draw and cash checks.

(c) To endorse checks for deposit in the Credit Union's checking account.

(d) To accept, draw, renew, endorse, discount, collect and protest bills of exchange, vouchers, notes, drafts, certificates, policies, warrants, shipping documents, and any other commercial or civil document.

(e) To guarantee, lend, take out insurance and endorse insurance policies.

(f) Others …"

Internal Control

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should clearly define the responsibility of the board of directors of the microfinance institution or credit union to establish appropriate internal control and internal auditing policies and procedures. These internal control mechanisms should be clearly described in the organization and operating manuals and should include the audit trails needed to ensure adequate ex post control. Control mechanisms related to treasury functions and deposit mobilization should be similar to those used by banks, while those related to microenterprise loan administration need to be highly specialized given the substantial degree of decentralization inherent in such lending.

Internal auditing policies and procedures should include, in addition to standard mechanisms for auditing banking operations, examination routines designed to detect fraud in the management of large numbers of microenterprise loans. These routines should give priority to visiting borrowers, which, among other things, will help the institution detect weaknesses in the design and implementation of its own internal control processes.

Credit Unions. The regulatory framework should ensure that the internal control mechanisms approved by the board of directors, supervision committee and internal auditor are appropriate for the types of financial services credit unions provide.

Rationale

Microfinance Institutions and Credit Unions. Microenterprise lending is a highly decentralized business. In many cases, the loan officer is the institution's only employee who is personally acquainted with the borrower. In this context, the only things that the loan officer typically does *not* do, for reasons for internal control, is to approve the loan, disburse the loan and receive payments.

The internal control procedures should specify the role to be played by each managerial level and committee with respect to the loan officers' activities, in order to avoid excessive familiarity between

clients and loan officers and between loan officers and their supervisors. According to the available literature on fraud in microlending, cases of fraud occur primarily at the level of the loan officer, through the creation of phantom borrowers or the misappropriation of payments.

Example

Peru

Microfinance Institutions. Although there is no special set of regulations governing the internal control procedures of Peruvian microfinance institutions in particular, the Superintendency of Banking and Insurance (SBS) has issued a general set of regulations, which pertain to all regulated financial institutions. These are oriented to ensuring an appropriate management structure, the reliability of information systems, adequate functioning of risk management systems, and compliance with legal provisions. To this end, the Regulations Governing the Internal Control System (SBS Resolution 1040-99) state that internal controls must, at a minimum, include an organization and functions manual, a risk control system and an information system for monitoring the institution's operations. The information system must have security and contingency mechanisms in place. The regulations also state that internal auditors must assess the internal control system on an ongoing basis, while external auditors are required to perform this task annually, based on the provisions set forth by the SBS and on international auditing standards.

Minimum Capital

Recommendation

Microfinance Institutions. The supervisory authority should establish a minimum capital level sufficient to support the startup of operations of a regulated financial institution over a reasonable period of time, such as three years. This means that there should be sufficient capital to finance all of the fixed assets necessary for the institution to operate during that time, including premises, computers and other equipment, software systems, safe, furniture, etc. The capital, to be contributed by shareholders from their own net worth, should also cover any expected losses incurred by the institution during its initial years' of operations. Given these considerations, the appropriate minimum capital requirement in most Latin American countries will likely be in the range US$1-3 million.

The minimum capital level should be specified in such a way that its purchasing power is not significantly eroded by inflation. For example, minimum capital could be specified in United States dollars, as a given number of minimum wages or as an amount in local currency that is periodically increased in accordance with the movement of a local price index (for example, the consumer price index).

Credit Unions. The issue of minimum capital is more complicated in the case of credit unions since they already operate (usually in large numbers) as deposit-taking institutions by the time they become subjected to formal regulation and supervision. Accordingly, the level of minimum capital should not only be based on the viability of operations but also, in view of the limited resources available to the supervisory authority, on the number of credit unions that could be reasonably supervised. Furthermore, since credit unions often operate under lax accounting standards, in which it may be difficult to accurately determine institutional capital, the supervisory authority should consider using the amount of savings deposits (instead of capital), or some other easily measurable indicator, to determine which credit unions are to be supervised.

Rationale

Microfinance Institutions and Credit Unions. The first and most important task of the supervisory authority is to protect the depositors and the integrity of the financial and payments systems. Accordingly, minimum capital requirements must be sufficient to cover the cost of fixed assets plus any operating losses projected for the first few years of operations as a regulated financial institution, in order to ensure that the institution will not be forced to suspend operations.

In view of the large number of credit unions and the growing number of microfinance institutions

in almost every Latin American country, the supervisory authority should carefully assess the number of institutions that it has the capacity to supervise directly and set minimum capital requirements accordingly. The supervisor may subsequently modify the minimum capital levels it has set in order to adjust the number of credit unions and microfinance institutions it supervises.

In the case of microfinance institutions, the supervisory authority may wish to increase minimum capital requirements for another reason, namely, to mitigate problems of moral hazard. The idea is that shareholders who have risked considerable amounts of their own resources will be less likely to encourage or accept obviously risky loans or make other risky financial transactions. Accordingly, the supervisory authority may wish to establish minimum capital requirements sufficiently high so that the potential loss of such an amount of capital would prevent the institution's shareholders from engaging in undesirable conduct. This consideration is not relevant to credit unions since their ownership is typically distributed among a large number of small shareholders.

Capital Adequacy

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should require a somewhat higher capital adequacy ratio (ratio of capital to risk-weighted assets) for microfinance institutions and credit unions than for commercial banks. The appropriate capital adequacy ratio might reasonably fall in the range of 10% to 15%.

Moreover, considering the somewhat lower level of financial sophistication of microfinance institutions and credit unions (compared to commercial banks), regulatory authorities should consider using a simple leverage measure (capital/total unweighted assets) in place of the relatively more complex capital adequacy indicator.

Credit Unions. The regulatory framework should recognize only institutional capital in the capital

Table 3.1 Minimum Capital Requirements for Microlending Institutions

Country	Institution	Minimum Capital (US$)	Can Accept Deposits?
Bolivia	Private Financial Fund	820,000	Savings, time
Brazil	Microenterprise Credit Institution	53,000	No
El Salvador	Savings and Loan Institution	2,850,000 1,140,000[(a)]	Savings, time
Honduras	Private Organization for Financial Development	60,000	Savings, time
Mexico	Popular Finance Company Savings and Loan Cooperative Institution	45,000	Time
Panama	Microfinance Bank	3,000,000	Demand, savings, time
Peru	Municipal Savings and Loan Institution Rural Savings and Loan Institution Micro and Small Enterprise Development Institution	270,000	Savings, time Savings, time No
Venezuela	Specialized Microcredit Development Bank	2,370,000	Demand, savings, time

Source: Prepared by the authors based on the results of the project survey

Note: (a) This lower requirement is applicable if the institution lends only to micro and small enterprises and accepts savings only from its borrowers. A microenterprise is defined as a business with fewer than 10 employees or less than US$5,700 in monthly sales. A small enterprise is defined as a business with 10 to 50 employees or with US$5,700 to US$57,000 in monthly sales.

adequacy ratio of credit unions. As a second best option, member shares could be considered to be a part of capital if they are "stabilized." Stabilization means that whenever the capital adequacy ratio of credit unions approaches the minimum level allowed, members are no longer permitted to redeem their shares—either by directly cashing them in with the credit union, or indirectly, by taking out an automatic loan.[44]

Rationale

Microfinance Institutions and Credit Unions. There are at least three reasons why microfinance institutions and credit unions should be required to maintain higher capital adequacy ratios than banks.[45] These reasons relate to governance, diversification and the volatility of earnings.

Governance. Most microfinance institutions are, to a large extent, owned by nongovernmental organizations, donors and governments. For-profit private investors contribute little or nothing to the capital base of most microfinance institutions. In credit unions, each member has one vote, regardless of the number of shares he or she holds. Accordingly, compared to banks, both microfinance institutions and credit unions are relatively lacking in profit-driven investors serving on their boards of directors who: (a) are willing and able to respond promptly to calls for capital in order to replace capital losses and prevent bankruptcy; and (b) scrutinize management carefully to ensure that

Table 3.2 Solvency Ratios for Microlending Institutions

Country	Institution	Minimum Capital (US$)	Solvency Ratio
Bolivia	Private Financial Fund	820,000	10%, same as banks
Brazil	Microenterprise Credit Institution	53,000	16.6%, greater than banks and finance companies (11%)
El Salvador	Savings and Loan Institution	2,850,000 1,140,000[(a)]	12%, same as banks
Honduras	Private Organization for Financial Development	60,000	16.6%, greater than banks and finance companies (10%)
Mexico	Popular Finance Company Savings and Loan Cooperative Institution	45,000	8-11% (lower % with higher minimum capital), greater than banks (8%
Panama	Microfinance Bank	3,000,000	8%, same as banks
Peru	Municipal Savings and Loan Institution Rural Savings and Loan Institution Micro and Small Enterprise Development Institution	270,000	9%, same as banks
Venezuela	Specialized Microcredit Development Bank	2,370,000	12%, same as banks

Source: Prepared by the authors based on the results of the project survey.

Note: (a) This lower requirement is applicable if the institution lends only to micro and small enterprises and accepts savings only from its borrowers. A microenterprise is defined as a business with fewer than 10 employees or less than US$5,700 in monthly sales. A small enterprise is defined as a business with 10 to 50 employees or with US$5,700 to US$57,000 in monthly sales.

[44] Most credit unions in Latin America allow their members to take out automatic loans for up to 90% of the value of their shares, with funds available immediately and no need for prior credit or other analyses. In practice, members consider this an easy way to redeem their shares and one that allows them to avoid the 60-day or other mandatory waiting periods that many credit unions have put in place for share redemptions.

[45] Though we believe these arguments to be valid, it should be noted that there are not yet sufficient empirical data to firmly conclude that microfinance institutions are, as a general rule, more risky than commercial banks.

it operates in the most efficient manner possible and keeps within acceptable levels of risk.

Diversification. Compared to banks, most microfinance institutions and credit unions have a relatively small number of branch offices operating within a much more restricted geographic area. Accordingly, their loan portfolios and, in the case of credit unions and an increasing number of microfinance institutions, their sources of financing (which to a large extent consist of local deposits) reflect lower levels of geographic diversification. In the event of an adverse economic shock at the local level, these less geographically diversified credit unions and microfinance institutions can suffer serious financial harm. Banks, on the other hand, much more frequently operate with a regional or national scope and, consequently, are more able to withstand local shocks.

Volatility of earnings. This consideration is particularly pertinent to microfinance institutions because they use lending technologies that result in high administrative costs (usually 15-20% of loan amounts or more). Credit unions, for their part, tend to employ a collateral-based credit technology much more similar to that of commercial banks, which typically results in much lower administrative cost burdens. The problem for microfinance institutions arises from the fact that a considerable portion of the high administrative expenses is incurred during the initial phase of the loan cycle, particularly that related to client identification and analysis. Microfinance institutions recover these costs by charging relatively high interest rates. However, if a significant portion of the loan portfolio becomes delinquent, these already-incurred expenses cannot be recovered and earnings will be severely reduced. Most microfinance institutions cannot offset these losses by executing what collateral they may have taken on the loan because of the high costs of seizing and selling this collateral in relation to its value. In contrast, commercial banks are not as vulnerable to sudden drops in portfolio quality. They have much smaller costs associated with their lending, typically under 5% of the amount lent, and often find it worthwhile to execute pledged collateral.

Based on the logic of these three arguments, it can be concluded that the minimum capital adequacy ratio for microfinance institutions and credit unions should be somewhat higher than that for banks, at least until a history of stability and proper management can be documented. Regulations in which the same ratio is applied to all types of financial institutions—in effect in some Latin American countries—can be seen as well-intentioned attempts to avoid penalizing microfinance institutions or credit unions by requiring higher levels of capital. In reality, however, these regulations are flawed and dangerous because microfinance institutions and credit unions need the additional capital to appropriately protect themselves from a greater likelihood of insolvency.[46]

It is also possible to err in the opposite direction and require an excessively high capital adequacy ratio for microfinance institutions and credit unions, thus unnecessarily limiting their intermediation activities. The regulatory authorities in Argentina, for example, have a capital adequacy requirement that is particularly biased against microfinance activities, not only by specialized institutions, but also by banks dedicating themselves in part to microfinance.

Credit Unions. There is a general consensus that, in order to satisfy the capital adequacy ratio, capital should at least include the credit union's institutional capital, that is, its accumulated earnings plus all reserves that are not earmarked for specific expenditures such as educational or social programs. Defined in this way, institutional capital consists of long-term resources readily available to protect member deposits or meet emergencies and, accordingly, clearly qualifies as capital as generally understood in stock corporations.

There is less consensus on whether member shares in credit unions should be treated as capital. The problem is that credit unions are, as a rule, under obligation to reimburse the total amount of such shares to all members who opt to leave the credit union. If member shares are counted as capital, a sudden exodus of members—perhaps when an adverse shock weakens the credit union's

[46] It is not enough, as some have argued, simply to require that microfinance institutions and credit unions strongly provision against loan losses. If there is a large negative shock and many borrowers are forced into delinquency and then into default, the resulting provisions (and subsequent losses) may render the microfinance institution or credit union insolvent. What is needed is a thicker cushion of capital before the onset of the shock, so that the microfinance institution or credit union can absorb the resulting losses without becoming bankrupted and thus defaulting on depositors and other creditors.

finances—could produce a rapid decapitalization of the institution. The credit union would not have its capital reserve at precisely the time when it is most needed. In contrast, stock corporations, such as banks or microfinance institutions, do not face this problem because they have made no promise to redeem the shares held by their owners. Rather, those owners wishing to sell their shares in the company must look to other interested parties, leaving the company's capital reserve intact and available to meet emergencies.

In order for the regulatory authorities to even consider including member shares as capital, credit union members must be prevented from withdrawing their shares (whether directly or through the mechanism of automatic loans) any time the required capital adequacy ratio is in danger of being breached. However, the practical effects of such a restriction can be severe for credit union members. Members wishing to withdraw their shares for whatever reason (business opportunities, family emergencies, etc.) could find themselves unable to access their money. To avoid this type of restriction, the best solution is to count only institutional capital in calculating the capital adequacy ratio, as is done, for example, in the United States. In this way, institutional capital protects both shares and deposits, and members are able to withdraw their shares at any time.

Table 3.3 Components of Capital in Credit Unions[(a)]

Country	Reserves Set by Law	Reserves Set by Bylaws	Accumulated Earnings	Member Shares	Legal Restrictions on Withdrawal of Contributions
Bolivia	✔	✔	✔	✔	Limitations in times of institutional crisis
Colombia (financial cooperatives)	✔	✔	✔	✔	Limited only when capital adequacy or minimum capital limitations are reached
Colombia (credit unions)	✔	✔	✔	✔	Limitations in times of institutional crisis
Costa Rica	✔	✔	✔	✔	On nominal value, only on withdrawal of the member
Dominican Republic	✔	✔	✔	✔	At the time the member leaves the credit union or after 10 years
Ecuador	✔	✔	✔	✔	None
El Salvador	✔	✔	✔	✔	No withdrawals in excess of 5% of paid-in shares
Jamaica	✔	✔		(b)	On nominal value, only on withdrawal of the member
Paraguay	✔	✔	✔	✔[(c)]	On nominal value, only on withdrawal of the member
Peru	✔		✔	✔	Withdrawal only when the member leaves the credit union, and limited in times of crisis
Uruguay	✔	✔	✔	✔	On nominal value, only on withdrawal of the member

Source: Prepared by the authors based on the results of the project survey.

Notes: (a) Chile, Guatemala, Honduras, Mexico, Nicaragua, Panama and Venezuela did not respond to the credit union survey and, accordingly, are not included in this table.
(b) In Jamaica, shares are normally not counted as capital. However, there is a nonwithdrawable portion of shares that is included in capital.
(c) In the new regulations being considered by the central bank, any shares pledged as loan collateral are not included as capital.

Credit Concentration

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should not restrict the loan operations of regulated credit unions and microfinance institutions to specific geographical regions or specific sectors of economic activity. However, these financial institutions should be subjected to a limit on the size of their loans, preferably in the range of 3% to 5% of net worth. Within this limit, credit unions and microfinance institutions should be required to secure, with executable collateral, loans that are greater than 1% to 2% of the financial institution's net worth.

Credit Unions. As mentioned earlier, regulated credit unions should be compelled to specialize in financial services and give up the provision of non-financial services (such as technical assistance, training, and productive activities) as an ongoing business activity. Such services may be provided as a charitable activity paid for out of prior years' retained earnings.

Rationale

Microfinance Institutions and Credit Unions. The imposition of a strict size limit on loans results in diversification of credit risk and also encourages an ongoing focus on financing small-scale activities. Since the limits are expressed as a percentage of net worth, they enable institutions to increase the size of their loans *pari passu* with their growth. The limits suggested stand in stark contrast to the credit concentration limits typically set for commercial banks in Latin America, which, in many cases, are allowed to provide loans of 20%-50% of net worth. Such a large limit can easily result in serious credit risk unless the institution effectively employs advanced risk measurement and monitoring systems.

The above notwithstanding, the proposed credit concentration limits should be applied with a degree of caution. For example, for microfinance institutions with net worth of US$1 million, a limit of 1% would restrict microenterprise loans to US$10,000, which, in most cases, is quite acceptable. However, if the minimum capital of the institution is lower, the limits may need to be more flexible. For example, the minimum capital of Peru's EDPYMEs is only US$270,000, while the minimum capital of credit unions in Bolivia and Ecuador is approximately US$200,000. The application of a 1% limit to these institutions could severely restrict their ability to provide financing to successful microentrepreneurs who demand slightly larger amounts of credit.

In short, it is important to carefully consider the costs and benefits in setting credit concentration limits. Restrictive limits increase diversification and reduce risk but at the same time may prevent the institutions from effectively serving their most successful clients.

Examples

Bolivia

Microfinance Institutions and Credit Unions. In Bolivia, the credit concentration limit for private financial funds (FFPs) and regulated credit unions is 1% of the institution's net worth, in the absence of legally acceptable and executable collateral. When such collateral is available, the limit increases to 3%. For banks, these limits range between 5% and 20%. The minimum capital of FFPs is approximately US$1 million, while the minimum capital of credit unions varies between $200,000 and $5 million, depending on what type of operations the institution is permitted to conduct.

In the loan portfolio evaluation process that the superintendency conducts of all financial institutions, all delinquent personal loans that are less than 500,000 bolivianos (approximately US$75,000) and are not supported by the minimum documentation required for commercial or consumer loans are subject to the loan loss provisioning schedule established for microenterprise loans.

Paraguay

Microfinance Institutions and Credit Unions. In Paraguay, there is no specialized financial institution dedicated to microfinance; rather, most microcredit is provided by finance companies and credit unions. Finance companies operate with the same credit concentration limit as banks, namely, 20% of net worth, which can be increased to 30% with the approval of the Superintendency of Banks. Credit unions are not currently subject to control by the Superintendency; however, there exists a proposal to do so, in which they would

operate with a credit concentration limit of 2% of net worth.

Peru

Microfinance Institutions. In Peru, the credit concentration limit for all financial institutions ranges between 10% and 30% of net worth, depending on the existence and type of collateral securing the loan. There is no separate limit for institutions specializing in microfinance, that is, for the *Cajas Municipales de Ahorro y Crédito, Cajas Rurales de Ahorro y Crédito,* and the EDPYMES. While a credit concentration limit of 30% clearly seems inappropriate for institutions specialized in microfinance, the low level of minimum capital required of such organizations (US$270,000) makes it difficult to impose a limit much below 5-10%.

Permitted Operations

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should allow microfinance institutions and credit unions to offer a range of financial services to their clients. However, the types of permitted operations should be tied to the size of the institution and its level of management expertise, in order to prohibit unsophisticated institutions from engaging in excessively complex or risky operations.

Microfinance institutions should generally be allowed to provide financial services such as savings accounts, credit and debit cards, financial leasing, currency exchange, loans against invoices (factoring) and the issuance of third party guarantees. In addition, microfinance institutions should be authorized to enter into correspondent bank arrangements with other financial institutions and offer money transfer and billpaying services.

As a general rule, microfinance institutions should not be authorized to offer checking accounts or engage in foreign trade financing. Moreover, the regulatory framework should prohibit these institutions from making loans on behalf of third parties, whether through the creation of trust funds or other similar fiduciary arrangements.

Rationale

Microfinance Institutions and Credit Unions. Because of their low levels of capital and relative inexperience in managing financial instruments, it is often inappropriate for microfinance institutions and credit unions to offer checking accounts and foreign trade financing. These types of services are typically too complex and risky for relatively unsophisticated financial institutions.

As for trust funds and other fiduciary arrangements in which loans are made on behalf of other institutions, these arrangements can introduce a dangerous duality into the institution's credit processes. Funding for these programs is often provided by donors or governments which specify a distinct and less stringent set of loan underwriting conditions than those applicable to the institution's normal lending program. As a result, these types of arrangements can lead to poor borrower selection, borrower dissatisfaction (especially in the case of borrowers who pay higher interest rates in the institution's normal loan program), and poor repayment rates among all borrowers. If the problems become serious, they can threaten the financial viability of the institution.

Example

Bolivia

Credit Unions. In Bolivia, two types of credit unions specializing in financial intermediation were created under Supreme Decree No. 24439, which was subsequently ratified by Law No. 2297 ("Law to Strengthen Financial Regulations and Supervision"), enacted on December 20, 2001:

Open credit unions, that is, those that mobilize savings from their members, the general public and from local or foreign financial institutions. These organizations require an operating license issued by the Superintendency of Banks and Financial Institutions, and their operations and activities are governed by the Law Governing Banks and Financial Institutions. Open credit unions are divided into four categories, based on the minimum capital they are required to have. Credit unions with higher levels of required capital may offer a wider range of loan and deposit services (see Table 3.4). These differences in permitted operations among the four credit union categories used to be very significant but have been reduced

Table 3.4 Permitted Operations of Open and Closed Credit Unions in Bolivia[a]

Asset Operations	Open Credit Unions 1 and 2	3	4	Closed Credit Unions
Grant loans	Yes	Yes	Yes	Yes
Operate with credit cards and traveler's checks	No	No	No	No
Discount and/or negotiate securities	Yes	Yes	Yes	No
Issue guarantees of various types	Yes	Yes	Yes	No
Open, advise, confirm and negotiate letters of credit	No	No	No	No
Receive bills of exchange or other items for collection	Yes	Yes	Yes	Community
Issue drafts or payment orders payable within the country	Yes	Yes	Yes	Community
Conduct exchange operations including the purchase and sale of currency	Yes	Yes	Yes	Community
Purchase, hold and sell precious metals	No	No	Yes	No
Purchase, hold and sell securities registered with the Superintendency of Pensions, Securities and Insurance	Government securities only	Fixed income only	Yes	Community
Purchase, hold and sell obligations traded on the stock market	Yes	Yes	Yes	Community
Purchase and sell commercial paper	Yes	Yes	Yes	No
Serve as intermediary for the subscription, placement and sale of securities	Yes	Yes	Yes	No
Rent safety deposit boxes	Yes	Yes	Yes	No
Carry out trust commission and operations	Yes	Yes	Yes	No
Procure and sell real estate to be used for their own business activities	Yes	Yes	Yes	Community
Enter into financial leasing contracts	No	No	No	Yes[b]
Serve as financial agent for resources originating abroad	No	No	Yes	No
Liability Operations				
Offer savings and time deposit accounts	Yes	Yes	Yes	No
Offer checking accounts	No	No	Yes[c]	No
Receive member shares	Yes	Yes	Yes	Yes
Issue and place mortgage bonds	Yes	Yes	Yes	No
Take out subordinated loans	Yes	Yes	Yes	No

Source: Prepared by the authors based on case studies, Article 39 of the LBEF and Law No. 2297.

Notes: (a) Law No. 2297 of 2001 virtually eliminated the differences among the four types of credit unions, which previously were much more significant.
(b) In financial leasing, the financial institution advances funds to the client to buy an asset. The financial institution also retains ownership of the asset purchased until these funds are repaid in full, together with all agreed-upon interest.
(c) With authorization from the Superintendency of Banks and Financial Institutions.

through a series of recent amendments to the original law.

Closed credit unions, that is, those that mobilize savings exclusively from their members. These organizations are governed by the provisions of the General Law Governing Cooperative Institutions and by the regulations issued by the National Cooperative Institute. Closed credit unions are divided into "community" and "employer-based" institutions, based on whether members all work for a common employer, and implicitly, whether there is relatively secure source of loan repayment through payroll deduction.

Peru

Peru's General Law Governing the Financial System (No. 26702) states that, in addition to banks and finance companies, a series of specialized institutions may also conduct financial intermediation activities:

Cajas Rurales de Ahorro y Crédito (CRACs), which accept deposits from the general public and pro-

Table 3.5 Principal Operations Permitted for Microfinance Institutions in Peru

Type of Operation	CMACs	CRACs	EDPYMEs
Deposit-taking	Savings and time	Savings and time	Not permitted
Contracting lines of credit	Permitted, from domestic and external sources	Permitted, from domestic and external sources	Permitted, from domestic and external sources
Credit provision (types of loans permitted)	Commercial, microenterprise (ME), consumer, pawn	Commercial, microenterprise (ME), consumer	Commercial, microenterprise (ME), consumer
Other Services	Appraisal of items pledged as security, trust funds	Acceptance of drafts, loan guarantees, trust funds	Discount of drafts, loan guarantees, trust funds

Source: General Law, articles 285, 286 and 288

Table 3.6 Modular Operating Scheme

Type of Operation	Module 1	Module 2	Module 3
Deposit-taking	Savings, time, custodial	Module 1 + checking accounts without overdrafts or central bank clearing	Module 2 + checking accounts with overdrafts and central bank clearing
Credit provision	Commercial, microenterprise, consumer	Module 1 + mortgage loans and leasing	Same as Module 2
Other	Debit and credit cards, discounting of drafts, factoring, letters of credit, foreign trade, payment orders	Module 1 + bond issuance, warrants, cashier's checks, underwriting, establishment of subsidiaries to operate as stock market agents	Module 2 + negotiation of public debt
Minimum required capital[(a)]	US$1,305,000	US$2,610,000	US$5,190,000
Other requirements	Rating of A or B for the preceding year; appropriate internal controls and organization	Rating of A or B for the preceding year; appropriate internal controls and organization	Rating of A or B for the preceding year; appropriate internal controls and organization

Source: General Law, article 290.

Note: (a) Circular SBS G-066-2000. Exchange rate used: US$1 = 3.49 soles.

vide loans to micro and small enterprises, preferably those that operate in rural areas.

Cajas Municipales de Ahorro y Crédito (CMACs), which accept deposits from the general public and provide loans to micro and small enterprises.

Micro and Small Enterprise Development Institutions (*Empresas de Desarrollo de la Pequeña y Microempresa,* or EDPYMEs), which provide loans to the micro and small enterprise sector.

Credit unions authorized to accept deposits from the general public.

Thus, Peruvian legislation has established a subsystem of nonbank financial intermediaries that focus on making resources available to the micro and small enterprise sector. The General Law has also established a tiered regulatory system to allow for the gradual expansion of the type of services that these entities can provide, commensurate with an increasing level of capital, internal controls, and management expertise. The tiered system thus creates the potential for small and relatively unsophisticated microfinance institutions to grow and expand into full-fledged financial intermediaries.

In practice, however, the SBS has been very cautious in letting the CRACs, CMACs and EDPYMEs advance to Module 1, even when the institution in question clearly qualifies for this module.[47] Consequently, the Peruvian Superintendency of Banks and Insurance is under pressure to clarify its time frames and criteria for approving the graduation by institutions to each module.

Distribution of Dividends

Recommendation

Microfinance Institutions. The determination and distribution of profits in microfinance institutions should be governed by the rules applied to the financial and tax systems in general. The mandatory capitalization of profits during the initial years of operation is a sound prudential mechanism that should be included in the regulatory scheme or granted as a power to the supervisory authority for use when issuing a license.

Credit Unions. The regulatory framework for credit unions should include the following requirements: (a) to capitalize all or most of their profits until institutional capital requirements have been satisfied; (b) to clearly designate the beneficiaries of the credit union's reserves in the event of dissolution or liquidation of the credit union; and (c) to clearly communicate to the credit union members the rate of return they have earned on their shares.

Supervisory authorities should explore ways in which profitable credit unions can be encouraged to pay dividends sufficient that the rate of return on member shares is at least equal to the inflation rate, thus helping to encourage members to remain in the credit union.

Rationale

Microfinance Institutions. Microfinance institutions do not require artificial advantages to achieve or increase their profitability, so any financial or tax regulations related to their profits and dividends should be neutral compared to those in effect for other financial institutions.

The recommendation to capitalize initial profits is particularly important in the case of microfinance institutions that have not been created from already-existing nonprofit organizations. It takes time to build up a portfolio of stable clients, and it is appropriate to treat any profits earned during that initial period as fragile and possibly temporary.

Credit Unions. Historically, most credit unions have neglected the accumulation of institutional capital. Such capital is necessary, however, to provide a solid base of resources for protecting deposits and member shares. Accordingly, credit unions should be encouraged to generate and capitalize earnings, while those credit unions that have created a solid base of institutional capital should not be prevented from distributing a significant portion of their earnings in the form of dividends.

One important and unique issue to be addressed in

[47] Since the minimum capital requirements are the same for all three types of institutions, it is not particularly consistent for the EDPYMEs to be denied permission to accept deposits, especially in view of the fact that the principal operations the EDPYMEs are permitted to engage in on the asset side are quite similar to those permitted to the CMACs and CRACs. Likewise, it would be preferable for the CMACs to be permitted to make loan guarantees, as is permitted to the CRACs and EDPYMEs.

credit unions is the question of who owns the credit union's reserves in the event the institution is liquidated. Not only does this determine to whom these remaining funds will be provided, but it can also have important tax implications during the life of the credit union. If a credit union designates that these reserves will be distributed among its members, this may result—depending on the country's legislation—in the credit union being considered a for-profit institution and subjected to income and other taxes.

Examples

Peru

Microfinance Institutions. In Peru, an innovative provision of Resolution SBS 600-98 establishes that all financial institutions must capitalize profits during the first three years of operations, in order to strengthen the institution's capital base. This provision is meant not only to encourage increased capitalization but also to demonstrate to shareholders that investments in the financial system must focus on the medium and long term.

In addition, the General Law Governing the Financial System (article 65) states that any earnings must be used to establish adequate loan loss provisions before any dividends can be distributed. The order of priority in the use of earnings is the following: reestablishment of minimum capital, creation of legal reserves, creation of specifically-prescribed reserves, and distribution of dividends. Furthermore, dividends can only be authorized once the financial statements for the period have been approved by the shareholders.

Colombia

Credit Unions. According to Article 10 of Law 79 (Cooperative Law), a credit union's earnings are characterized as operating, nonoperating, inflationary and third-party. Once profits have been assigned to these categories, the following rules apply:

- Operating profits go to the credit union's educational fund (20%), its solidarity fund (10%) and its reserves for the protection of shares (20%). The remaining 50% can be used as determined by the General Assembly.
- Nonoperating profits go to reserves.
- Inflationary profits go to a monetary correction reserve.
- Third party profits go to a special fund.

In the event that a credit union is liquidated, any remaining reserves must go to a different credit union, which must be identified in the liquidated credit union's bylaws.

As can be seen from these rules, the Colombian regulations tend to give priority to the social mandate of credit unions. While this social mandate is important, credit unions need an underlying financial sustainability. Given that so much of profits must be set aside in predetermined accounts, the Colombian regulations tend to discourage credit unions from distributing dividends to their members. By holding down the rate of remuneration of shares, these regulations discourage new membership and deaden the dynamism of many credit unions. These regulations also result in members demanding compensation in less transparent ways, such as through low interest rates on loans.

Geographic Scope and Hours of Operation

Recommendation

Microfinance Institutions and Credit Unions. Microfinance institutions and credit unions that are supervised by the bank supervisory authority should be authorized to operate without restrictions on their geographic scope or hours of operation. The regulations and administrative procedures governing the opening and operation of branches and other installations (mobile offices, limited-service windows in supermarkets, etc.) should be flexible and allow financial institutions to respond to the needs of their clients. Microfinance institutions and credit unions in compliance with prudential regulations should not require the approval of the bank supervisor to open new offices (although the bank supervisor should be informed).

Credit Unions. Credit unions should limit their activities to a geographic area that can be reasonably controlled by its members (who are also its owners).

Rationale

Microfinance Institutions and Credit Unions. Many microenterprise clients work long hours, have few employees to help them, and live in areas with limited access to transportation. Consequently, financial institutions serving these populations need to adapt the nature and location of their branches and other points of service, as well as their operating hours, to best meet the needs of this clientele. In addition, the volumes of cash handled in many offices do not justify extravagant facilities or large investments in infrastructure or security. The supervisory authority should therefore allow financially and operationally sound microfinance institutions and credit unions considerable flexibility in determining how they can best serve their clients. Institutions that show financial and/or operational weaknesses should be supervised more closely and require the approval of the supervisor before opening up new offices.

Like all other financial intermediaries, regulated microfinance institutions and credit unions should have the freedom to establish offices wherever they detect a bankable and serviceable demand for financial services. The regulatory framework should be free not only from geographic restrictions on their operations, but also from any mechanism designed to provide exclusive markets and limit competition.

Credit Unions. While regulated and supervised credit unions should be free to operate nationally, it is important to keep in mind that regional ties are extremely important in explaining the stability of credit unions. Credit unions arose primarily as a response by groups of residents with "something in common," who felt that they had no access to appropriate financial services and wished to obtain them by creating a cooperative. The common element that joins credit union members together is often the region where they live.

The operation of a credit union is often improved if it remains within the area where it was originally created. The cohesiveness of members helps ensure a reasonable level of good governance and self-supervision. If the geographic link is not maintained, the credit union should have in place strong administrative and governance controls that can compensate for the lack of geographic cohesion.

Examples

Colombia

Credit Unions. Colombian regulations include no restrictions on the geographic scope of operations for credit unions, which are authorized to operate freely in cities or rural areas, with or without ties to a common employer, and at either the regional or national level. Nor are there any restrictions on how credit unions can provide services to their clients, whether it be through branches, limited-service windows or mobile units.

However, this freedom has come with some risks. The crisis that affected the sector between 1998 and 2000 showed that it was those credit unions that had expanded their operations geographically and started to include nonmembers that suffered the biggest problems. In the end, many were liquidated.

This geographic expansion by some credit unions was not accompanied by an improvement in information systems that would have enabled the credit unions to better manage their operations and risk. In addition, the acceptance of new clients that had little in common with the original members made for poor repayment ethics in times of crisis. In contrast, those credit unions that continued to work within their original geographic region, maintaining both their geographic identity and their social and economic affinity, fared much better.

Peru

Microfinance Institutions. In Circular B-1996-97, the Superintendency of Banking and Insurance (SBS) spells out the requirements for opening, moving and closing offices. Based on these requirements, financial institutions with a risk rating of A or B need only notify the SBS when they open or close an office.[48] All other financial institutions (those with a risk rating of C or D) require prior SBS authorization to open or close an office, with the additional requirement that any request to open an office must be accompanied by an economic feasibility study. The SBS regulations also permit financial institutions to share premises,

[48] Peru has its own risk rating system. An A or B in this system does not necessarily correspond to an A or B from international ratings firms such as Moody's or Standard & Poor's.

which includes the possibility of entering into contracts for window services and the leasing of space.

The regulatory framework is therefore reasonably flexible in how it handles the opening and closing of branch offices, while incorporating a certain degree of control by the SBS over less stable institutions. This element of control is quite reasonable since an aggressive expansion can easily generate high costs and considerable risk.

On the other hand, the General Law (article 139) states that financial institutions must remain open and provide service to the public in all of their offices for a minimum of six hours per day on all workdays. Service on non-workdays is optional. This regulation appears excessively restrictive in the case of microfinance institutions, which sometimes have or would like to have offices in locations where only very limited operating hours are economically justified.

Related Party Lending

Recommendation

Microfinance Institutions. The regulatory framework should prohibit microfinance institutions, as well as all other banking institutions, from providing loans to any of their directors, major shareholders, members of management or the businesses or relatives of these three groups. If the definition of "related party" is more inclusive (for example, if it includes employees or small shareholders), then it may be necessary to permit a very limited amount of related party lending, totaling no more than a small percentage of the financial institution's net worth, such as 5%.

Credit Unions. The regulatory framework should strictly limit or prohibit credit unions from providing loans to any of their directors, supervision committee members, members of management or the businesses or relatives of these three groups. In cases where some related party lending is allowed, its total amount should be limited to a small percentage of the credit union's net worth, such as 5%.

Microfinance Institutions and Credit Unions. The regulatory framework should stipulate that loans to related parties should not be granted on terms more generous than those received by other borrowers.

In addition, loan delinquency should be grounds for immediate suspension of the duties of anyone working in the management, direction or oversight of a microfinance institution or credit union. In such cases, the person should not be allowed to resume his or her duties, nor access additional loans, until he or she brings all payments up to date.

Rationale

Microfinance Institutions. Allowing loans to related parties is a recipe for disaster in financial institutions. Loans to related parties not only create conflicts of interest but, in the case of loans to major shareholders, effectively reduce shareholder capital, which is meant to protect depositors and other creditors of the institution. Consequently, strict limits need to be imposed for all financial institutions, and microfinance institutions are no exception.

Credit Unions. In spite of the dangers of related party lending, credit unions may need some flexibility in this area. In particular, it may be necessary to have a more flexible limit for credit unions operating in areas that are not served by other financial institutions. In cases where no other alternatives for borrowing exist, it may be important to allow a very limited amount of related party lending. In such credit unions, which typically are small, there tends to be a greater degree of mutual acquaintance among members. This contributes to increased control over the conflicts of interest that arise with this type of lending.

Since all credit union members normally purchase shares and thus are shareholders in the institution, the definition of related party lending does not include those who are only shareholders (unless they are also a director, manager, or a member of the supervision committee). With each credit union member having a single vote, this omission should not normally create problems since a loan to a shareholder does not necessarily imply a loan to a person with strong ties to the power structure of the institution.

Examples

To date, no country has created special related party lending limits for microfinance institutions. In many cases, the limits that are applied generally to financial institutions are too generous, which

leads to problems of moral hazard and conflicts of interest.

Paraguay

Microfinance Institutions. The General Law Governing Banks, Finance Companies and Other Credit Institutions (No. 861/69) states that the following restrictions on related party lending must be observed:

- Loans or guarantees granted to directors, managers, controllers and employees. Each such loan or guarantee may not exceed 0.5% of the net worth of the financial institution and, when taken in the aggregate, may not exceed 10%. These limits may be increased to 1% and 20%, respectively, if collateral acceptable to the Superintendency of Banks is provided.
- Loans or guarantees granted to major shareholders (each holding more than 10% of total shares). The total amount of such loans or guarantees may not exceed 20% of the net worth of the financial institution.

In all cases of related party lending, loan conditions should not be more advantageous than those existing in the market.

Credit Unions. Regulations recently drafted by the central bank would limit total related party lending to 5% of the net worth of the credit union, with related parties defined as being any member of the board of directors, supervision committee, election committee, management, as well as any employee or the internal auditor, or the spouses or dependent children of any of the aforementioned groups.

Table 3.7 Limits on Related Party Lending (% of Net Worth)

	Limits Applicable to One Individual or Company	Overall Limit
Bolivia	0%	0%
Chile	5%	100%
Colombia (SIB)[(a)]	10%	20%
Colombia (SES)[(b)]	10%	N/A
Costa Rica	20%	40%
Dominican Republic (SIB)[(a)]	15-30%	100%
Dominican Republic (AIRAC)[(b)]	N/A	N/A
Ecuador	2%	10%
El Salvador	5%	5%
Guatemala	20%	40-50%
Honduras	20%	120%
Jamaica	None exist	None exist
Mexico	None exist	None exist
Nicaragua	15%	60%
Panama	5% of total assets	5% of total assets
Paraguay	20%	40%
Peru	0.35%	37%
Uruguay	25%	25%
Venezuela	10%	20%

Source: Prepared by the authors based on the results of the project survey.

Notes: (a) Agency charged with supervising banks.
(b) Agency charged with supervising credit unions.

Peru

Microfinance Institutions and Credit Unions. The General Law establishes the following limits on related party lending:

Loans granted to directors and employees of the financial institution cannot, in the aggregate, exceed 7% of the financial institution's paid-in capital plus reserves. No individual director or employee may receive financing exceeding 5% of this overall limit (article 201).

Loans granted to other related parties (owners and managers) cannot, in the aggregate, total more than 30% of the net worth of the financial institution (article 202).

In addition, the General Law states that the conditions attached to all related party lending may not be more advantageous than the most favorable conditions available to the institution's clientele as regards loan term, interest rate and collateral.

Bolivia

Microfinance Institutions and Credit Unions. Article 32 of Bolivia's Central Bank Law states that financial institutions may not grant related party loans, and defines a related party borrower or borrower group as one that meets one or more of the following conditions:

- Holds more than 10% of the shares of the financial institution, either directly or indirectly through individual or company third parties.
- Performs, in the financial institution, managerial, directorial or internal control functions, or provides ongoing advisory services to the institution's upper management. Also classified as related party borrowers are all business entities that participate in the institution on a for-profit basis.
- In the case of a company based in Bolivia or abroad, does not have up-to-date information on and identification of the owners. Exempt from this requirement are companies whose shares, or whose owners' shares, are traded regularly on the stock market.
- Does not exhibit a commercial or productive objective sufficient to justify the financing received, nor a net worth or net flow of funds sufficient to support the financing.

Indebtedness

Recommendation

Microfinance Institutions and Credit Unions. Microfinance institutions and credit unions should have the authority to borrow from both commercial sources (for example, financial institutions) as well as from noncommercial sources (for example, public agencies or donor organizations), located either within the country or abroad. Existing regulations applicable to all other financial entities on diversification of funding sources should also be observed by microfinance institutions and credit unions. In the case of short-term financing (one year or less), the level of indebtedness of a microfinance institution or credit union with any single creditor (either commercial or noncommercial) should be limited to a relatively moderate percentage of net worth, such as 50% or less.

The aggregate amount of noncommercial financing should also be subjected to additional limits, as is discussed in the next section.

Table 3.8 Indebtedness with a Single Creditor

Country	Criterion
Bolivia	100% of net worth
Chile	10% of short-term assets net of provisions
El Salvador	25% of net worth
Nicaragua	Borrowed funds with terms of less than 12 months provided by foreign institutions ≤ 100% of net worth or 10% of deposits, whichever is lower
Panama	25% of net worth

Source: Prepared by the authors based on the results of the project survey.

Note: The countries surveyed but not shown in this table have not implemented regulations governing indebtedness with a single creditor.

Rationale

Microfinance Institutions and Credit Unions. Just as it is not wise to have an excessive concentration of credit, it is likewise not wise to depend excessively on a single source of financing, particularly in the case of short-term funds. The reason for this is that the withdrawal of, or failure to renew, such financing may lead to serious liquidity problems. Such problems, in turn, can disrupt loan operations, destabilize the institution and, if the situation is not resolved, threaten its solvency. Accordingly, there should be limits on short-term indebtedness, based on the institution's net worth, as opposed to the net worth of its creditors.

Example

Bolivia

Microfinance Institutions and Credit Unions. Even in Bolivia, a country that is considered to be one of the most advanced in the area of microfinance regulation, the topic of diversification of liabilities has not received the degree of attention it merits. As reflected in Table 3.8, Bolivia has set a relatively high limit on indebtedness with a single creditor. It is not surprising, therefore, that several

of the microfinance institutions operating in Bolivia, which are generally considered to be among the best in the region, depend excessively on lines of credit provided by second-tier government banks.

Noncommercial Credit

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework for microfinance institutions and credit unions should restrict their dependence on government and donor resources ("noncommercial credit"). The limit established for such resources should be in the range of 10% to 50% of the net worth of the financial institution, with a stricter limit for credit unions than for incorporated microfinance institutions. In the event that such resources are provided at below-market interest rates, the subsidy should be appropriately recorded in the institution's financial statements.

Rationale

Microfinance Institutions and Credit Unions. Dependence on noncommercial resources needs to be limited in order to avoid situations in which microfinance institutions and credit unions are used as conduits for targeted credit programs. Dependence on noncommercial sources of funding produces a variety of harmful effects, particularly in the case of credit unions.

In the first place, noncommercial credit tends to displace deposit mobilization, an important financial service in its own right. Secondly, it creates an unhealthy dependence on donor or government programs that one day may be scaled back or eliminated altogether, possibly jeopardizing the financial institution. Thirdly, dependence on noncommercial credit also builds a culture and expertise within microfinance institutions and credit unions of courting donors rather than providing good service to depositors, undermining efficient, customer-oriented management. Lastly, in the case of credit unions, noncommercial loans upset the natural equilibrium between net depositors and net borrowers, which often results in credit unions being dominated by borrowers. These credit unions are often weak in collecting loans and maintaining prudential controls, as was the case in so many credit unions in Latin America that received funds from donors and governments in the 1970s and 1980s. Such funding led to weakened and, in many cases, insolvent credit unions. On the other hand, strengthening deposit services creates a clientele (i.e., depositors) interested in maintaining sound management of the institution, an objective that is consistent with that of the supervisory authority.

When government or donor loans are provided at below-market interest rates, the amount of this implicit subsidy (i.e., the grant element) should be recorded in the financial institution's profit-and-loss statement as an expense, in order to avoid overstating profitability. In the financial institution's balance sheet, the amount of this implicit grant should be credited to the institution's capital account.

Table 3.9 Noncommercial Liabilities of Bolivia's Microfinance Institutions

Institution	Net Worth of the Institution (Millions of US$)	NAFIBO Financing			FUNDAPRO Financing		
		Millions of US$	% of Borrower's Net Worth	% of Creditor's Net Worth	Millions of US$	% of Borrower's Net Worth	% of Creditor's Net Worth
BancoSol	14.3	7.5	52	21	1.5	10	9
Caja Los Andes	5.2	11.0	212	31	3.4	66	21
FIE	4.1	2.5	61	7	1.7	42	11
Eco-Futuro	2.8	–	–	–	0.5	18	3
Prodem	4.6	2.0	44	6	3.4	74	21

Source: Prepared by the authors based on case studies. All data refer to December 31, 2000.

Example

PERU

Microfinance Institutions. The large volume of public sector loans directed to the Peruvian *Cajas Rurales de Ahorro y Crédito* (CRACs) since they were created by the government in the early 1990s (totaling more than half of their overall liabilities) has been identified as an important cause of the governance and management problems of these financial intermediaries. During 1997–99, the Superintendency of Banking and Insurance liquidated eight microfinance institutions, of which seven were CRACs (out of a total of 20 CRACs existing then in Peru) and one was an EDPYME (out of a total of 14 EDPYMEs).

The liquidations of the CRACs were attributable to a number of factors, but fundamentally reflected a pathology characterized by the following conditions:

- The presence of serious problems resulting from related party loans to directors, shareholders and employees.
- A high incidence of acts of fraud, as reflected in: the proliferation of serious legal, management, accounting and financial irregularities; the falsification of share capital contributions; the granting of phantom loans; and the improper use of the institution's resources.

Much of this pathology is explained by how the CRACs funded themselves, in particular, their fragmented ownership structures and the voluminous loan resources they received from the Peruvian government. In addition to being excessive in amount, these government loans were not accompanied by appropriate conditionality or by a suitable selection of shareholders and staff for these new institutions. These factors have distorted the incentives of the owners and managers of the CRACs and increased moral hazard.

Investments in Fixed Assets and Other Companies

Recommendation

Microfinance Institutions and Credit Unions. The regulatory framework should hold microfinance institutions and credit unions to the same requirements as other financial institutions with regard to their holdings of fixed assets and shares of stock in other companies.

Investments by microfinance institutions and credit unions in other companies should be allowed only in very special cases closely linked to the established sphere of activity of the microfinance institution or credit union, such as a minority participation in a credit bureau, an armored car company or a firm providing electronic banking services. In cases where regulation in this area is lax, the supervisory authority should apply strict criteria in valuing such investments.

Rationale

Microfinance Institutions and Credit Unions. Banking regulations often limit the holding of fixed assets (land, buildings, vehicles, computers and other equipment for the financial institution's own use), to a greater or lesser degree, in order to prevent the immobilization of resources. It is not prudentially necessary to establish limits for microfinance institutions and credit unions that are different from those established for banks.

Credit unions and microfinance institutions (like all other financial intermediaries) should generally limit themselves to the provision of financial services and thus should not invest resources in—or distract the attention of management or the board of directors through—the provision of nonfinancial services. This implies that multipurpose credit unions should spin off their non-intermediation-related activities once they become regulated financial institutions, in much the same way as is required of microfinance institutions that provide training or marketing services.

Credit Unions. Many credit union crises have stemmed from the investment of large sums of money in real property for the institution's own use or for the provision of nonfinancial services to members (such as grocery stores or schools). In some cases, credit union directors or managers have spent lavishly on unproductive, showy fixed assets in order to serve their social goals or desire for self-aggrandizement.

Example

BOLIVIA

Microfinance Institutions and Credit Unions. Article 52 of the Banks and Financial Institutions Law states that the total amount of investments made by a regulated financial institution in fixed assets and in holdings of stock shares of financial service and insurance companies may not exceed its net worth.

This requirement seeks to limit the immobilization of resources in these types of assets since such immobilization may reduce the capacity of a financial institution to make loans and/or may increase the cost of loans to borrowers. Table 3.10 shows the value of the fixed assets held by a number of individual microfinance institutions and by all banks in Bolivia. BancoSol and Prodem are notable for the significant immobilization of 44% and 52%, respectively, of their net worth in fixed assets, which, in both cases, also represents approximately 10% of their loan portfolios.

Table 3.10 Fixed Assets Held by Bolivia's Microfinance Institutions and Banks

	Institutions Specializing in Microfinance						
Fixed Assets	BancoSol	Caja Los Andes	FIE	Eco-Futuro	Prodem	Total	Banks
In Millions of US$	6.3	1.1	0.8	0.8	2.4	11.5	144.7
As a % of Net Loan Portfolio	9	3	4	8	11	7	4
As a % of Net Worth	44	20	19	30	52	36	29

Source: Superintendency of Banks and Financial Institutions. All data refer to December 31, 2000.

IV Practices for supervising microfinance institutions and credit unions

The previous two chapters outlined the main building blocks for a coherent regulatory framework designed to address the major risks faced by microfinance institutions and credit unions. Such a framework helps ensure that microfinance institutions and credit unions operate within prudent limits and do not jeopardize the funds entrusted to them by depositors. It also promotes the presence of stable financial services for microentrepreneurs, as well as the flow of funding from investors. Finally, a clear and well conceived framework also greatly facilitates the work of the supervisory authority.

Nevertheless, a sound regulatory framework does not eliminate the need for specialized supervisory personnel and tailored practices and procedures. Proper oversight of microfinance institutions and credit unions requires specialized supervision to identify and address the distinctive risks faced by these institutions. The development of such supervision requires a sustained investment in human resources on the part of the supervisory authorities.

Unfortunately, many bank supervisory agencies have extremely limited budgets, which constrain them in supervising microfinance institutions and credit unions. A major challenge therefore lies in finding supervisory structures and processes that are not overly costly for the supervisory authority, but are effective in identifying and addressing the risks associated with microfinance institutions and credit unions. In this context, it is important to note that the creation of new types of financial entities devoted specifically to microfinance may easily increase the complexity and cost of supervision. This added cost may or may not be justified, but it is important for lawmakers and supervisory authorities to be aware of it.

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While the supervision of microfinance institutions is likely to add costs for the supervisory authorities, the issue of microfinance cannot remain unaddressed given its importance for hundreds of thousands or millions of people in most Latin American countries. The growing trend of commercial banks downscaling into microfinance, coupled with the established practice of microfinance nonprofit organizations upgrading, or transforming into licensed financial intermediaries, effectively puts the issue at the doorstep of the supervisory authorities.

The challenges inherent in the supervision of microfinance institutions and credit unions do not relieve the supervisory authorities of their fundamental responsibility: in granting a license to a financial institution, the government assumes a fiduciary duty to that financial institution's depositors. To discharge this duty, the supervisory agency must acquire the tools and capabilities that allow it to effectively supervise the institutions it licenses.

The supervisory agency's licensing authority allows it to limit the number of microfinance institutions created from the process of nonprofit organizations transforming into licensed financial institutions. In the case of credit unions, however, the supervisory authority is up against a sector in which there are already financial institutions in operation and accepting deposits. These are semiformal, community-based institutions that have grown to the point that, in some cases, they are as large as commercial banks. Accordingly, the question is not whether the supervisory agency should or should not authorize credit unions to accept savings (they already do this) but, rather, how to set up a system of supervision which, on one hand, respects the origins and aims of the credit unions and, on the other, protects the individual depositors of these institutions.

The issue of how to organize a supervisory system for credit unions is pivotal. Ideally, this responsibility should be taken on by the bank supervisory authority, given its technical capabilities and the structures it already has in place. However, since there are oftentimes more than 100 credit unions in any given country, in many cases the bank supervisory authority considers it impossible to oversee all of these institutions. Moreover, since credit unions are already accustomed to operating without any government oversight, they are typically opposed to this type of supervision, which they feel, in many respects, is unsuited to the intrinsic nature of a cooperative.

For these reasons, bank supervisory agencies generally find themselves forced to limit their role in the supervision of credit unions, either by keeping the number of regulated credit unions low or by delegating some or all of the supervisory responsibility to a third party. In the first case, depositors in unsupervised credit unions do not enjoy the same protections as depositors in banks, which *are* supervised. In the second case, the quality of supervision may suffer, as the delegated supervisor may not have the same level of skills and expertise as the bank supervisor. Nevertheless, the pressure to delegate supervisory responsibility is strong, particularly in cases where the bank supervisor is operating on a budget that does not permit it to collect supervision fees from the institutions it supervises. In such cases, the licensing and supervision of a greater number of institutions creates additional costs but no additional revenue for the supervisor.

In some countries, credit unions have tasked their own federation with providing a form of self-supervision. On occasion, supervisory agencies have used a variant of this structure to set up a delegated supervision system, in which routine data collection and other tasks are performed by the federation and key decisions (such as licensing, intervention and liquidation) are made by the supervisory agency. However, delegated supervision of credit unions has not proven very successful, due in part to a conflict of interest within the federation. Federations are owned by the credit unions that comprise them, and also are charged with promoting and supporting member credit unions. Understandably, federations find it hard to discipline and shut down the very credit unions that own them, particularly the large and powerful ones.[49] While some European and North American countries have functioning delegated credit union supervision systems, in developing countries the number of failures has clearly out-

[49] For further discussion of this issue, see Westley and Branch (2000a), Poyo (2000), and Pabst (2000).

stripped the number of successes. Consequently, supervisory authorities should approach this option with extreme caution.

Despite its problems, a delegated supervision system may be the only realistic alternative in situations in which the supervisory authority decides to or is tasked with overseeing a large number of credit unions, but is limited by a fixed budget (in which it has no ability to collect fees from the supervised institutions). In such cases, the only way to defray the cost of supervision may be through delegated supervision. However, for delegated supervision to work, the following conditions must be met: (a) the duties and responsibilities of the bank supervisory agency and the delegated supervisor must be clearly defined; (b) the delegated supervisor must have the requisite technical capacity and resources; and (c) the delegated supervisor must be reasonably independent of the institutions it supervises. Even assuming these conditions are met, it would still be advisable for the bank supervisory authority to directly supervise the large credit unions, which could present systemic risk to the overall credit union system and, in some cases, to the financial system as a whole.

There is little question that most credit unions would prefer to be entirely unregulated or else regulated by their own federation, without any involvement from the bank supervisory authority. In some cases, self-regulation by the federation is suggested as an alternative to direct or delegated supervision. However, self-regulation has proven to be even less effective than delegated supervision. This is because while both schemes suffer from the same conflict-of-interest problem, self-regulation does not even have the benefit of the banking authority overseeing the supervision process. Hence, while self-regulation may seem attractive to the supervisory authorities on budget grounds (it costs them nothing) and to the credit unions because it gives them more control over their own supervision, the probability of self-regulation ending in failure is overwhelming given its conflicts of interest. Moreover, the government cannot simply ignore its responsibility to depositors, who expect deposit-taking institutions to be safe and properly supervised (and deposits to be insured, explicitly or implicitly).

Delegated supervision is less of an issue in the case of microfinance institutions, which do not normally have a federation or association with a supervisory mandate. However, some Latin American countries (for example, Mexico and Honduras) are witnessing the emergence of delegated supervision systems for microfinance institutions. In the case of Mexico, the idea is to work through federations whose establishment is being promoted under a new law to govern microfinance institutions and credit unions.[50] In the case of Honduras, the idea is for the bank supervisory agency to use delegated supervision through private auditing firms.[51]

These types of delegated supervision systems should be approached with caution. Federations of microfinance institutions, just like the federations of credit unions discussed above, have an inherent conflict of interest in disciplining their owners. Supervision systems based on the use of audit firms pose a different type of problem. If it is difficult for bank supervisory authorities to effectively supervise microfinance institutions, it is an even greater challenge for audit firms. To begin with, the purpose of an audit is to verify information, not to assess risks. Accordingly, the auditor's task is different from that of a supervisor in several important respects. In addition, audits rarely include the tests necessary to confirm the true quality of an institution's loan portfolio, particularly in the case of microfinance institutions whose portfolios are highly atomized. The only way to turn audits into effective supervisory tools is to incorporate specific protocols, a measure that would increase their cost.

In conclusion, the first and foremost decisions to be made by the officials in charge of implementing a supervisory structure for credit unions and microfinance institutions is to decide which agency will do the supervision and how the supervision will be done (direct, delegated or self supervision). Once the supervisory agency and type of supervision have been decided upon, attention can be turned to a

[50] The People's Savings and Loan Act (Ley de Ahorro y Crédito Popular) of June 4, 2001 establishes two new types of financial institution: the Sociedad Financiera Popular and the Sociedad Cooperativa de Ahorro y Crédito Popular, the former in the form of a stock company and the latter in the form of a cooperative.

[51] Decree No. 229-2000 of February 3, 2001 establishes "private organizations for financial development" (OPDFs) specializing in microfinance

number of other important issues, such as supervisory processes and tools, accounting standards, disclosure requirements and credit bureaus. In all of these areas, the supervisor must make adaptations to ensure the efficient and effective supervision of credit unions and microfinance institutions.

Organization of the Supervisory Agency

Recommendation

Microfinance Institutions and Credit Unions. The supervisory agency must ensure that its organizational structure allows for on-going, close supervision of credit unions and microfinance institutions. To this end, it should at a minimum assign full-time, specialized staff to this task because if staff are not specifically assigned, there is a tendency for them to be drawn into the supervision of larger institutions and thereby neglect the smaller credit unions and microfinance institutions. If there are a significant number of credit unions and microfinance institutions to be supervised, a specialized line unit should be formed in which expertise can be built and experience accumulated over time.

If there are not enough credit unions and microfinance institutions to justify the formation of a specialized unit within the supervisory agency, it is preferable that supervision be done by the bank supervision department, rather than the department in charge of supervising non-deposit-taking institutions (such as bonded warehouses, currency exchange houses and state funds). This is because the risks of credit unions and microfinance institutions are more like the risks of commercial banks than they are like the risks of non-deposit-taking institutions. In this case, microfinance and credit union specialists should at least participate in the on-site evaluations of the lending methodologies used by microfinance institutions and credit unions. Moreover, in the case of credit unions, specialists also should bring specific knowledge to bear in other key areas that often cause difficulties in credit unions, including the issues of borrower domination, low salaries and lack of professionalization, the proper role of volunteer credit committees, and under-or over-expenditure on fixed assets (resulting, for example, in overly shabby or overly luxurious premises).

As argued earlier, delegated supervision of credit unions and microfinance institutions is generally not recommended, particularly not in the case of the largest and most powerful credit unions. Nevertheless, cost considerations may compel the

Table 4.1 Sources of Financing for Supervisory Authorities

Supervisor Financed 100% by the Supervised Institutions	Supervisor Financed by Supervised Institutions and Public Funds	Supervisor Financed 100% by Public Funds
SBIF Chile	SBEF Bolivia (central bank)	SIB Paraguay
SIB Dominican Republic	SIB Colombia (national budget)	SIB Uruguay
AIRAC Dominican Republic [(a)]	SES Colombia (50% national budget) [(a)]	
JCCUL Jamaica [(a)(b)]	SGEF Costa Rica (80% central bank)	
SIB Panama	SSF El Salvador (50% central bank)	
SBS Peru	SIB Guatemala (central bank)	
FENACREP Peru [(a)(c)]	CNBS Honduras (50% central bank)	
	CNBV Mexico (finance ministry)	
	SBOEF Nicaragua (25% central bank)	
	SBOIF Venezuela (56% national budget)	

Source: Prepared by the authors based on the results of the project survey.

Notes: (a) Supervisory agency for credit unions.
(b) The Jamaican Cooperative Credit Union League also has investment income.
(c) 92% of the FENACREP budget is obtained from fees paid by supervised credit unions and the remaining 8% is from undisclosed sources.

supervisory agency to delegate the supervision of smaller credit unions.

Rationale

Microfinance Institutions and Credit Unions. Whether or not a specialized line unit is established, one of the pivotal issues in the supervision of microfinance institutions and credit unions (especially the latter, due to their large numbers) is how this effort should be financed. In this regard, there are two main trends in Latin America: in some countries, the cost is covered entirely by the government and in others it is paid for at least partly by the supervised financial institutions.

Obviously, a supervisory agency whose budget is at least partly financed by the institutions it supervises has more financial flexibility since the licensing of new institutions brings it additional budgetary resources. In those cases in which the supervisory agency does not obtain any additional resources to help pay for the added costs of supervising credit unions and microfinance institutions, it has two alternatives: it can simply choose not to supervise these types of institutions or it can delegate the responsibility for supervising them to another public or private entity. Both of these alternatives are far from ideal. Large credit unions and dynamic microfinance institutions require good regulation and serious supervision to attain their long-term potential and to protect their depositors.

Examples

The Bolivian and Peruvian superintendencies were the first Latin American bank supervisory agencies to explicitly recognize microfinance in their organizational structures.

Bolivia

Microfinance Institutions and Credit Unions. The organizational structure of Bolivia's Superintendency of Banks and Financial Institutions (SBEF) consists of a superintendent, an intendent general and four line units referred to as intendencies,[52] along with administrative and support units. One of the four intendencies, the Intendency of Nonbank Financial Institutions, is in charge of three types of entities: (a) private financial funds, some of which are important microfinance institutions (six licensed), (b) credit unions (24 already licensed and six with licenses pending), and (c) mutual savings and loan associations (13 licensed). It also oversees BancoSol, a commercial bank specializing in microfinance, two government funds, a second tier bank and more than 40 currency exchange houses.

The Intendency of Nonbank Financial Institutions is further broken down into two divisions, each headed by a division chief. One division supervises credit unions and the other supervises all other nonbank financial institutions. The reasons for having a special division devoted exclusively to credit unions are because credit unions have distinctive features and risk profiles and because the SBEF uses a specialized supervisory tool for the supervision of credit unions, the PEARLS model, developed by the World Council of Credit Unions.[53] For the supervision of other types of financial institutions, the SBEF uses the CAMEL model.

The Intendency of Nonbank Financial Institutions has twenty technical staff, ten in each division. Over the past several years, the Intendency has provided all staff with comprehensive training in off- and on-site supervision techniques for credit unions and microfinance institutions. It is also endeavoring to consolidate its various supervisory tools into a single instrument applicable to all nonbank financial institutions.

Peru

Microfinance Institutions. The head of the Superintendency of Banking and Insurance (SBS) is the Superintendent, and reporting to the Superintendent are four Deputy Superintendents—for Banking, Insurance, Administration and Legal Affairs—as well as two Managers—for Economic Studies and Internal Auditing. The Office of the Deputy Superintendent for Banking is, in turn, subdivided into Intendencies A, B, C, D, E and F, where E and F handle different types of microfinance institutions. Intendency E is in charge of supervising the 12 CRACs (rural savings and loan institutions), 13 EDPYMEs, Mibanco (a commer-

[52] These four intendencies are: Bank Supervision, Supervision of Nonbank Financial Institutions, Studies and Standards and Legal Affairs.

[53] For a description of the PEARLS model, see Richardson (1994; 2000; and 2000a).

cial bank specializing in microfinance) and FOGAPI (a government guarantee fund for small loans). Intendency F is in charge of supervising 13 CMACs (municipal savings and loan institutions) and institutions in the process of liquidation. Both intendencies conduct off-site analyses and on-site inspections.[54]

The SBS budget is derived entirely from a system of supervision fees paid quarterly by all supervised institutions. The current fee is one seventeenth of one percent (0.059%) of the average assets plus contingent credits of each supervised institution. Under this scheme, microfinance institutions paid US$148,000 to the SBS in 1999 and US$195,000 in 2000. However, the costs incurred by the Superintendency in supervising these institutions was US$3,246,000 in 1999 and US$3,022,000 in 2000, resulting in a US$3,098,000 deficit in 1999 and a US$2,827,000 deficit in 2000.[55] Thus, the supervision fees paid by microfinance institutions covered only 4.6% of their supervision costs in 1999 and 6.5% in 2000.[56] Fees paid by larger intermediaries, mainly banks, closed the gap. The overall budget of SBS stood at US$25.2 million in 1999 and US$25.1 million in 2000.

Role of Microfinance and Credit Union Specialists

Recommendation

Microfinance Institutions and Credit Unions. The supervisory agency should make an extra effort to provide training, competitive salaries and professional development opportunities to staff specialized in microfinance.

Rationale

Microfinance Institutions and Credit Unions. The supervisory agency's performance of its basic responsibilities—licensing, monitoring, inspection, sanctioning and liquidation of financial institutions—requires a staff of specialists familiar with the different types of institutions under the agency's supervision. Given the limited availability of supervisors with knowledge of microfinance or

Table 4.2 Use of Microfinance Specialists for Supervision

	Operational Staff	Microfinance Specialists	Credit Union Specialists
Bolivia	111	27	9
Chile	116	0	0
Colombia (SIB)	372	0	0
Colombia (SES)[(a)]	85	0	25
Costa Rica	142	0	24
Dom. Rep. (SIB)	282	1	2
Dom. Rep. (AIRAC)[(a)]	7	4	3
Ecuador	N/A	N/A	20
El Salvador	N/A	3	3
Guatemala	175	0	0
Honduras	110	0	0
Jamaica (JCCUL)[(a)]	50	1	49
Mexico	N/A	N/A	N/A
Nicaragua	N/A	N/A	N/A
Panama	87	0	0
Paraguay	159	0	0
Peru (SIB)	350	30	2
Peru (FENACREP)[(a)]	N/A	N/A	N/A
Uruguay	51	5	5
Venezuela	209	0	0

Source: Prepared by the authors based on the results of the project survey.

Note: (a) Supervisory agency for credit unions.

[54] The SBS does not supervise credit unions directly, but, rather, delegates supervision to the credit union federation, FENACREP.

[55] "Presupuesto de Supervisión de Instituciones Microfinancieras," SBS Report 040-99-GEE and SBS estimates for the year 2000.

[56] These percentages are probably unduly low for at least two reasons. First, in making the estimates, the costs associated with support units (legal department, economic studies, etc.) are allocated in proportion to each intendency's direct costs, whereas in practice, the support units focus disproportionately on meeting the needs of the most important intendencies. Secondly, these estimates ignore the fact that, oftentimes, the intendencies overseeing microfinance institutions lend out personnel to other intendencies during emergencies, such as bank interventions.

credit unions, such expertise needs to be built in-house through training and professional development. Therefore, staff in these areas needs to be trained and retained through professional development opportunities and competitive salaries.

The training of superintendency personnel should focus on the most important risks facing microfinance institutions and credit unions and the supervisory standards, methods and tools that can be used to identify and mitigate these risks. The training of specialists in the supervision of microfinance institutions and credit unions should include several elements:

(a) Theoretical and practical training by external experts, plus visits to other supervisory agencies that have greater experience in this area, and visits to successful microfinance institutions inside the country and abroad.

(b) Off-site monitoring and on-site inspection, using tools and procedures that are specifically designed to assess the loan portfolio and risk of credit unions and microfinance institutions. Specialists must also come to understand the day-to-day workings of these intermediaries.

(c) Staff rotation policies that allow microfinance and credit union specialists to periodically supervise commercial banks and other types of financial institutions.

(d) A professional development and incentives policy geared to motivate and retain personnel specialized in microfinance and credit unions.

Licensing of Microfinance Institutions and Credit Unions

Recommendation

Microfinance Institutions and Credit Unions. In licensing a microfinance institution or credit union, the supervisory agency must evaluate its business plan, its system of governance, the experience of its management, its credit technologies and its information systems. If the institution already exists (as an unregulated nonprofit foundation or credit union), the licensing evaluation should also include an on-site inspection and an evaluation of its portfolio quality.

The entry of existing commercial banks into microfinance should not require any authorization from the supervisory authority. However, the supervisory agency should consider the points made in this chapter in monitoring and inspecting microcredit portfolios within commercial banks.

Rationale

Microfinance Institutions and Credit Unions. As with any other financial institution, the licensing of a credit union or microfinance institution requires evaluations of: the institution's business plan, the integrity and financial capacity of its founders and the integrity and experience of its managers.

If the licensing involves a pre-existing nonprofit organization or credit union, the supervisory agency needs to pay particular attention to the following elements:

(a) The system of governance, ensuring an appropriate division of responsibilities between management and the board of directors.

(b) The level of integration of systems, staff and credit technologies, in order to prevent inefficient or high-risk operating procedures, delinquent loans or inadequate information systems (hardware and software) from being passed on to the new institution.

(c) The capacity of the institution to manage the various risks to which a financial intermediary is exposed.

(d) The advisability of placing operating restrictions on the institution (as is done in some countries) to ensure that they don't assume risks that they are not prepared to manage but, at the same time, are not constrained from offering efficient and valuable services to their clients.

If the institution applying for a license is entirely new, with no ties to any existing nonprofit organization or credit union, then supervisors should focus on the following elements:

(a) The adequacy of the capital contributions, both in cash and total.

Table 4.3 Powers of the Supervisory Authorities

	Issue Regulations	Issue Charters	Issue Operating Licenses	Authorize Mergers and Reorganizations	Supervision	Sanctions	Liquidation	Revoke Licenses
Bolivia	✓	✓	✓	✓	✓	✓	✓	✓
Chile	✓	✓	✓	✓	✓	✓	✓	✓
Colombia (SIB)	✓	✓	✓	✓	✓	✓		✓
Colombia (SES)[c]	✓	✓	✓	✓	✓	✓	✓	✓
Costa Rica	✓	(a)	(a)	(a)	✓			(a)
Dom. Rep. (SIB)	✓				✓	✓		
Dom. Rep. (AIRAC)[c]								
Ecuador	✓	✓	✓	✓	✓	✓	✓	✓
El Salvador	✓	✓	✓	✓	✓	✓		✓
Guatemala			✓		✓	✓		
Honduras	✓	(b)	(b)	(b)	✓	✓	✓	(b)
Jamaica (JCCUL)[c]	(a)		(a)	N/A	(a)			
Mexico	✓		✓		✓	✓		
Nicaragua	✓	✓	✓	✓	✓	✓	✓	✓
Panama	✓	✓	✓	✓	✓	✓	✓	✓
Paraguay	✓	✓	✓	✓	✓	✓	✓	✓
Peru (SIB)	✓	✓	✓	✓	✓	✓	✓	✓
Peru (FENACREP)[c]		(a)			✓			
Uruguay	✓	(a)	(a)	(a)	✓	✓	✓	(a)
Venezuela	✓	(a)	(a)	(a)	✓	✓		(a)

Source: Prepared by the authors based on the results of the project survey.

Notes: (a) Supervisors have this authority, but only in conjunction with other government bodies such as the National Financial Supervision Board in Costa Rica, the Office of the Registrar of Cooperatives in Jamaica, the Executive Department in Uruguay, the Financial Regulation Board in Venezuela and the Public Records Office in the case of FENACREP/Peru.
(b) The Honduran National Banking and Insurance Commission merely issues a favorable or unfavorable opinion as the basis for action by the Honduran Central Bank, which is in charge of licensing and liquidating financial institutions.
(c) The supervisory agency for credit unions.

(b) The financial capacity, experience and reputations of the proposed owners and directors.

(c) The experience of the proposed managers in running microfinance institutions or credit unions, as measured by their professional record in managing leading microfinance institutions or credit unions in the country or abroad.

(d) The quality of the proposed credit technologies, as measured against those used in successful microfinance institutions or credit unions in the country or abroad.

Table 4.4 Recommended Components of a Business Plan

Components	Microfinance Institutions	Credit Unions
Knowledge of the Market		
• Macroeconomic outlook	Yes	Yes
• Demand for credit by urban and rural microenterprises	Yes	Yes
• Microcredit supply and market competition	Yes	Yes
Institutional Structure		
• Legal status and objectives	Yes	No
• Shareholders	Yes	No
• Governance structure	Yes	No
• Management team and organization chart	Yes	Yes
Financial Projections		
• Loan officers, credit technology and incentives policy	Yes	Yes
• Credit terms	Yes	Yes
• Staff productivity	Yes	Yes
• Seed capital	Yes	Yes
• Sources of finance	Yes	Yes
• Delinquency and provisions	Yes	Yes
• Cost coverage and profitability	Yes	Yes
Risk Management Policies		
• Credit, liquidity, interest rate, foreign exchange and operational risks	Yes	Yes
• Operating procedures and internal controls	Yes	Yes
• Internal auditing	Yes	Yes
• External auditing	Yes	Yes
Founding NGOs		
• Transfer of personnel	Yes	No
• Transfer of clients	Yes	No
• Transfer or replacement of information systems and other infrastructure	Yes	No
• Proposed activities for the remaining NGO	Yes	No

Source: Developed by the authors.

Example

Bolivia

Credit Unions. Executive Order 24439 of 1996 states that all credit unions mobilizing savings or time deposits are required to obtain a license from and be supervised by the Superintendency of Banks and Financial Institutions (SBEF). It allows the credit unions three years to obtain this license. Credit unions that do not obtain this license are not permitted to mobilize deposits.

As part of this program of bringing prudential supervision to credit unions, the SBEF also did the following: (a) issued credit union regulations and a set of model credit union bylaws; (b) established a credit union supervision unit within the

Intendency for the Supervision of Nonbank Financial Institutions, including a unit chief and six staff members; and (c) evaluated each credit union that applied for an SBEF operating license on a case-by-case basis.

Of over 200 credit unions, a total of 63 applied to the SBEF for an operating license. The evaluation process consisted of the phases outlined below, designed and implemented by personnel with experience in regulation and in credit union management.

Phase 1: Assessment of Compliance with Institutional Requirements. The first phase of the evaluation process verified the completeness and accuracy of the documentation presented by each credit union concerning its legal standing, division of powers within the institution, management structure and the suitability of its board members and managers. These suitability checks included verification of tax compliance and professional credentials and an examination of police records and credit history. This initial phase of the evaluation process ended with the issuance of a preliminary opinion on the quality of the board of directors and managers of the credit union.

Phase 2: Economic-Financial Appraisal. The second phase of the evaluation process consisted of an economic-financial assessment of the credit union, covering the time period from 1996 up through the time the credit union applied for the license. Because only the largest credit unions had been submitting data to the SBEF prior to these evaluations, it was necessary to ask the remaining credit unions to submit their financial statements and data on portfolio quality, membership turnover, and other aspects of their operations. This phase of the evaluation process screened out credit unions whose financial viability appeared questionable. Those in a reasonably secure financial position moved on to the next phase, the on-site assessment.[57]

Phase 3: On-site Assessment. The third phase was designed to verify the capacity and entrepreneurial vision of each credit union's directors and managers, the institution's ability to provide reasonably high quality services and its ability to generate timely, reliable financial data for the SBEF and its credit bureau. During these on-site visits, SBEF staff also examined the credit union's lending policies, methodologies and procedures; its organization and staffing levels; and its internal control processes in such areas as deposits, loans and expenditures. During the visits, the credit union's books were also reviewed to see if there were overvalued assets or omitted liabilities.

As of August 2001, this process had resulted in the granting of 24 operating licenses by the SBEF. A number of credit unions are still being evaluated while others have been denied licenses. These latter credit unions have begun to dismantle their deposit-taking operations, converting deposits to shares payable from any annual profits generated by the credit union.

Off-site Supervision

Recommendation

Microfinance Institutions and Credit Unions. The supervisory agency should require essentially the same data from credit unions and microfinance institutions as it does from commercial banks.[58] However, it is important for the supervisor to periodically review and simplify data reporting requirements for all financial institutions to avoid burdening them with unnecessary requirements, particularly in the case of smaller financial institutions. As in the case of banks, off-site supervision of credit unions and microfinance institutions

[57] As part of the process of assessing the viability of the credit unions, the SBEF also considered their age, as some of them had been in business for over 30 years and had long-established local and regional markets. Also considered by the SBEF was the number of borrowers that each credit union shared with other financial institutions, a sign of potential overindebtedness among clients. This review showed that 64% of the credit unions' borrowers had loans from only one credit union, indicating a fairly high degree of client loyalty.

[58] However, an adjustment in the reporting interval could be made in certain cases. For example, small credit unions and microfinance institutions and those operating in rural areas could be given longer reporting intervals for some data. Thus, instead of generating weekly or monthly reports, such institutions would produce them on a monthly or quarterly basis, respectively (see the section on Disclosure and Reporting of Financial Information, below, for additional discussion). In general, the data from such institutions are of relatively minor importance in the preparation of aggregate monetary and financial statistics, and so a lower reporting frequency does little harm to the execution of monetary and exchange rate policy.

should provide data and analyses to support the planning and execution of future on-site inspections. It should also follow up on the findings and instructions of previous inspections.

The supervisory agency should also require all financial institutions to report to the credit bureau, if there is one. The credit bureau allows the supervisor to easily identify overindebted borrowers and compare the loan classifications given to borrowers who have loans with more than one financial institution. This greatly enhances the supervisory agency's ability to monitor the overall risk in the financial system and identify vulnerable institutions (see the section on Credit Bureaus, below).

Rationale

Microfinance Institutions and Credit Unions. The reason for requiring standardized data is that the design and administration of the supervisory authority's data bases can be impaired if each type of supervised institution submits different types of data or is allowed to present the same data in different formats.

The unique aspects of analyzing microfinance institutions and credit unions are mainly related to understanding their special characteristics and risks (as discussed earlier in this manual). It is important for the supervisor to receive data for key indicators of the financial health of microfinance institutions and credit unions and compare them to benchmark levels for acceptable and excellent performance. In general, these data are available from the standard reports presented to most supervisory authorities.

Example

Peru

Microfinance Institutions. Off-site supervision by the Superintendency of Banking and Insurance (SBS) is performed by teams of analysts verifying the compliance of supervised institutions with established regulations. These teams make prospective evaluations of institutions, examining how they manage risks and identifying trends pointing to potential problems. The SBS also uses the reports of internal and external auditors to support its off-site monitoring.

The basic tool for off-site supervision is the monthly report SBS prepares on the condition and performance of each supervised institution and its peer group. This report, which presents and analyzes numerous financial and other indicators, is prepared from the financial statements and other information submitted by the supervised institutions. A typical report contains a background section on the intermediary and sections analyzing its assets, credit risks, profitability, solvency and liquidity. The intermediary is then assigned an internal rating based on this evaluation and the report ends with a series of recommendations for future supervision and monitoring.

The SBS does not have an established set of early warning indicators for microfinance institutions, but monitoring efforts focus on portfolio quality and leverage. To improve the quality of the monitoring, staff providing off-site analyses also participate in on-site inspections.

On-site Supervision

Recommendation

Microfinance Institutions and Credit Unions. On-site inspections of credit unions and microfinance institutions should focus on examining their credit methodology, information systems, internal controls and the quality of their human resources. Portfolio evaluations should be conducted using stratified samples since the large number of small borrowers served by these institutions makes the evaluation of a set of loans covering a high percentage of the overall loan portfolio value far too costly.

The supervisory agency should periodically conduct simultaneous on-site inspections of financial institutions that share the same delinquent borrowers. Based on a sample of such borrowers, inspectors should assess how different institutions have evaluated each borrower's ability to pay and structured his or her repayment schedule. The final results of this analysis should be shared with all financial institutions participating in the exercise.

Rationale

Microfinance Institutions and Credit Unions. Since a direct evaluation of the loans comprising a

high percentage of the overall value of a microenterprise loan portfolio is virtually impossible given the large numbers of small loans involved, the main goal of an on-site inspection should be to identify the strengths and weaknesses of the financial institution's management, processes and systems. As part of this, a portfolio analysis should be done, but it should pay serious attention to the strengths and weaknesses of the processes and procedures that generate the portfolio. These processes and procedures include: credit policies; loan origination practices; loan approval, monitoring and collection procedures; staff salary incentives; and the quality of back-office systems. Also, given the highly decentralized nature of loan approvals in microfinance institutions, internal controls should be evaluated in detail.

Example

BOLIVIA

Microfinance Institutions and Credit Unions. While the Bolivian Superintendency of Banks and Financial Institutions (SBEF) has developed a formal inspection manual, many important inspection procedures are, in fact, established in inspection memorandums and other planning documents. The main SBEF on-site inspection procedures are as follows:

First step. The drafting of a planning memorandum outlining: (a) the objectives, strategy and approach of the inspection, (b) the random and induced portfolio samples to be used, (c) other areas subject to inspection, and the methods to be used, and (d) the inspection period. The inspection period and size of the inspection team depend on the size and complexity of the financial institution. The team can consist of anywhere from three to six inspectors (including systems inspectors) and the inspection period can run from three to five weeks in length.

Second Step. On-site inspection, with a chief inspector heading up the inspection team and coordinating with the managers and other personnel of the institution being visited.

Third Step. Wrap-up with the management and/or directors of the institution, in which the relevant intendent and division chief from SBEF participate, along with the inspection team. In this session, the main conclusions derived from the inspection are discussed, and a first reaction from the financial institution is obtained. The final report is sent to the financial institution within a week.

Sanctions

Recommendation

Microfinance Institutions. The supervisory authority should apply the same type of sanctions to microfinance institutions as it does to commercial banks and finance companies.

Credit Unions. Sanctions for credit unions should be based on penalties levied on those individuals who have committed infractions, in addition to fines and provisions that reduce the net worth of the credit union.

Rationale

Microfinance Institutions and Credit Unions. There is no reason for microfinance institutions—which are incorporated, shareholder-based organizations—to be subject to a different type of disciplinary regime than commercial banks or finance companies. Credit unions, which are owned by a large number of small shareholders each with one vote, should be subject to a disciplinary regime that places greater emphasis on the personal responsibility of directors, managers and other personnel.

Accounting Standards

Recommendation

Microfinance Institutions and Credit Unions. The supervisory agency—not the accounting profession—should set the standards for the proper recording of transactions by microfinance institutions and credit unions. Of course, the specific standards proposed by the supervisory agency must fit within the context of the overall accounting standards adopted by the country, but there is significant flexibility within these overall standards. Specifically, the standards imposed by the supervisory agency should require the timely recognition of past due loans, the recording of

restructured loans, the creation of adequate reserves for bad debts and the recording of subsidies received in the form of funding at below-market interest rates. The quality of microfinance institution and credit union loan portfolios should be based primarily on payment arrears. Accordingly, it is important to have accurate accounting data on delinquent, restructured and written-off loans.

Rationale

Microfinance Institutions and Credit Unions. Financial market stability is founded on prudent and transparent accounting principles and practices. Not only do these allow the supervisory agency to effectively discharge its duties, but they also help ensure that other interested parties (depositors and investors) have reliable and timely information on financial institutions. Accounting standards should be designed to ensure that the financial information provided by supervised institutions is detailed and specific enough to evaluate large commercial banks as well as microfinance institutions and credit unions.

Transparent accounting standards are essential in enabling any commercial entity's creditors to evaluate its financial condition and performance. This is especially important in the case of financial institutions, which sometimes carry debt loads of more than ten times the value of their equity. In such cases, even fairly minor changes in the value of their assets can completely decimate their equity. Because of this, virtually all banking legislation in Latin America entrusts the supervisory agency—not the accounting profession—with establishing accounting standards for financial institutions. These standards are typically based on generally accepted accounting practices in the United States (USGAAP) or the International Accounting Standards (IAS).

Disclosure and Reporting of Financial Information

Recommendation

Microfinance Institutions and Credit Unions. In principle, the supervisory agency should hold credit unions and microfinance institutions to the same standards as other financial institutions with respect to the preparation, presentation and disclosure of financial information. This applies to information for the public (including depositors), the financial markets (creditors and investors) and the supervisory agency itself. However, small credit unions and microfinance institutions and those operating in rural areas could be allowed to have less frequent reporting of information on their liabilities (for example, reserve requirements and deposits stratified by size). Disclosure and reporting on the asset side of the balance sheet (including portfolio quality) should be done with the same level of detail and at the same intervals as for other financial institutions.

Rationale

Microfinance Institutions and Credit Unions. The content and reporting intervals for disclosing financial information should be based on cost-benefit considerations. Small microfinance institutions and credit unions and those located in rural areas are often not staffed or equipped to readily report the same data at the same intervals as large banks and other financial institutions. To do so would generate large costs that, ultimately, would have to be passed on to clients in the form of higher loan rates or lower deposit rates. In such cases, the supervisory agency must make an effort to establish reporting requirements and procedures that are reasonable given the characteristics of the institutions involved.

Reporting requirements for microfinance institutions and credit unions should also take into account their unique elements, including the added importance of portfolio quality, operating costs and interest rates. Accordingly, it is crucial for both the supervisory authority and the market to be provided with the following types of information:[59]

(a) Information on portfolio quality, based on a more detailed aging structure than that used for other types of financial institutions (1 to 30 days, 31 to 60 days, 61 to 90 days and over 90 days). This information should also indicate any restructured and written-off loans.

(b) Information on operating costs, broken down

[59] For a fuller discussion of appropriate transparency standards for microfinance institutions, see CGAP (2001).

Table 4.5 Data to be Regularly Reported by Financial Institutions

	Financial Statements	Asset Weighting and Capital Adequacy	Data for the Credit Bureau	Liquidity Position/ Reserve Requirements	Loans Stratified by Amount	Deposits Stratified by Amount	Changes in Bylaws, Ownership or Management
Bolivia	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly
Chile	Monthly	Monthly	Monthly	Daily			When made
Costa Rica	Monthly	Quarterly	Monthly	Monthly	Monthly	Monthly	When made
Dominican Rep. (SIB)	Monthly	Every 6 months	Quarterly	Weekly			When made
Dominican Rep. (AIRAC)[(a)(b)]	Monthly				Monthly		Monthly
Ecuador	Daily	Quarterly	Monthly	Weekly	Monthly	Monthly	When made
El Salvador	Monthly	Monthly	Monthly	Daily	Monthly		When made[(c)]
Guatemala	Monthly	Monthly		Daily	Monthly	Monthly	When made
Honduras	Monthly	Monthly	Monthly	Biweekly			When made
Jamaica (JCCUL)[(b)]	Monthly			Monthly			
Mexico	Monthly						When made
Nicaragua	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	When made
Panama	Monthly	Quarterly		Weekly	Quarterly	Quarterly	When made
Paraguay	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	When made[(d)]
Peru (SIB)	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	When made
Peru (FENACREP)[(b)]	Quarterly	Quarterly	Quarterly				When made
Uruguay	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly	When made
Venezuela	Monthly	Monthly	Monthly	Weekly	Quarterly	Monthly	When made[(e)]

Source: Prepared by the authors based on the results of the project survey.

Notes: (a) Credit unions in the Dominican Republic are required to submit monthly delinquency reports to AIRAC.
(b) Supervisory agency for credit unions.
(c) In El Salvador, changes in ownership and control must be reported on a monthly basis.
(d) In Paraguay, changes in the bylaws of financial institutions require prior authorization from the Bank Superintendency.
(e) Financial institutions in Venezuela are required to report any changes in management every six months.

by organizational level (main office, branches and agencies) and by occupational type (directors, upper and middle management, loan officers and all other personnel).

(c) Information on effective interest rates, including any commissions and fees charged and any compensating balances required.

(d) Indicators of the institution's financial health, covering such areas as loan delinquency, operating efficiency, capital adequacy and returns on assets and equity. The supervisory agency should also request information on asset-liability mismatches, such as maturity gaps, interest rate repricing gaps and foreign exchange exposures.

Example

No Latin American countries have explicitly established different reporting requirements for small or rural credit unions or microfinance institutions.

External Auditing and Risk Rating

Recommendation

Microfinance Institutions and Credit Unions. In general, the supervisory agency should define the scope of work of the external auditors to ensure that their reports are consistent and provide reliable and useful information for the supervisor as well as for investors. In the specific case of microfinance institutions and credit unions, external audits should place additional emphasis on verifying that their credit technologies and internal control procedures are working properly.

The supervisory agency should require that all deposit-taking financial institutions undergo at least one rating per year. This is becoming an increasingly accepted approach in Latin America, given the value of the extra layer of information and opinion provided by rating firms. An exception to this requirement would be made for very small institutions (if such institutions are supervised in the first place) since their asset base might not be able to support the additional cost.

The supervisory authority should not delegate its supervisory responsibility to audit firms or rating agencies. Such an arrangement is not likely to be effective given that these firms are not set up to perform a supervisory function. The work of audit firms and rating agencies is complementary to the task of supervision, not a replacement for it. While the supervisory responsibility should not be delegated in this way, the supervisory agency should nevertheless encourage external auditors and rating agencies to develop appropriate evaluation methods for credit unions and microfinance institutions in their own lines of work, taking the distinctive risk profiles of these institutions into account.

Rationale

Microfinance Institutions and Credit Unions. External audits and ratings are an excellent complement to the work performed by bank supervisors. Accordingly, in defining the scope of the work to be performed by external auditors and rating agencies, the supervisory agency should consider the scope of its own work and the work carried out by the internal auditors of the financial institutions themselves in order to avoid duplications of effort and unnecessary costs. The work performed by external auditors and rating agencies should not be construed as taking the place of the work of the supervisory agency, as the nature and purpose of the work performed by each group are different.[60]

As for ratings, some microfinance institutions and credit unions believe that rating agencies are biased against them. The bias generally stems from an incomplete understanding among rating agencies of the distinctive risk profile of microfinance institutions and credit unions. Though progress has been made in this regard over the past few years, it is important that all such bias be eliminated. Otherwise, ratings would simply represent an unnecessary and counterproductive expense for these institutions since the ratings would send incorrect signals to the market. Such negative bias unfairly complicates the efforts of microfinance institutions and credit unions to access financial markets.

Since the methodology used by rating agencies cannot be dictated by outsiders, the only way to address rating agency bias is for donors and supervisory agencies to support them in learning more about the distinctive risk profiles of microfinance institutions and credit unions. Though this may not have an immediate impact, it will ultimately lead to more accurate ratings.

Credit Unions. External auditors play an especially important role in the case of credit unions, particularly in those institutions that are not supervised directly by the bank supervisor. In all cases, in defining the scope of work to be performed by external auditors in credit unions, it is important for the supervisory agency to consider the duties of the supervision committee in these institutions, in order to prevent duplications of effort and unnecessary costs.

Example

Bolivia

Microfinance Institutions. The Bolivian Superintendency of Banks and Financial Institutions requires all deposit-taking financial institutions to be rated (except credit unions as of now) and all

[60] For a description of auditing standards for microfinance institutions, see CGAP (1998).

ratings to be publicly disseminated. It appears that the ratings have so far resulted in a bias against microfinance institutions. The only microfinance institution rated "A" or better is BancoSol (Solidario). All other microfinance institutions, including leaders such as Caja Los Andes, are rated BBB+ or lower and thus are classified in the same risk category as the lowest-rated banks. This bias also appears to go hand in hand with a relative ignorance of microfinance, since all private financial funds (FFPs) specializing in microfinance are classified in the same or very similar category, as illustrated in the table below.

Credit Bureaus

Recommendation

Microfinance Institutions and Credit Unions. The supervisory agency should push for the establishment of a credit bureau that provides up-to-date, reliable data on the indebtedness and payment record of individuals and companies. The credit bureau not only improves the supervisor's ability to monitor the credit risks facing financial institutions, but also allows financial institutions to better screen their clients and enhances the access of

Table 4.6 Ratings of Bolivian Microfinance Institutions

Fitch Ibca Duff & Phelps, as of March 31, 2001 (long-term bond issuer ratings)

"A" Rating or Better		"BBB" or "BBB+" Rating			"BB" Rating or Lower		
Citibank	AAA	Banks	Unión	BBB	Consumer	Acceso	BB
Santa Cruz	AAA		Ganadero	BBB	Loan FFPs	Fassil	B
BISA	AA	Microcredit FFPs	Los Andes	BBB+		Comunidad	B
Do Brasil	AA–		FIE	BBB+			
NAFIBO	AA–		Prodem	BBB+			
Económico	A+		Eco-Futuro	BBB			
Solidario	A+						
N. Argentina	A						

Source: Superintendency of Banks and Financial Institutions

Thompson Bankwatch, as of December 31, 2000 (short-term ratings)

"A" Rating or Better		"BBB" or "BBB+" Rating			"BB" Rating or Lower		
Santa Cruz	AAA	Banks	Unión	BBB	Consumer	Acceso	BB
BISA	AA				Loan FFPs	Fassil	B
Citibank	AA	Microcredit	Los Andes	BBB		Comunidad	B
Do Brasil	AA	FFPs	FIE	BBB			
Económico	A		Prodem	BBB			
Solidario	A		Eco-Futuro	BBB			
N. Argentina	A						
Mercantil	A						
Nacional	A–						

Source: Superintendency of Banks and Financial Institutions

low-income populations to the financial system (since a good payment record can partially or wholly supplant the need for physical collateral).

Accordingly, the supervisory agency should be vested with the power to administer a credit bureau, which will record the loans made by all financial institutions. In order to make sure that low-income clients, who usually borrow smaller amounts, are also registered in the system, the credit bureau should not have any minimum cut-off size for the loans that are recorded; rather, all loans should be recorded. The supervisory agency should also be authorized to share its credit bureau information with privately-operated credit bureaus, which could enhance the supervisor's information by supplementing it with credit and payment data from nonfinancial sources.

Rationale

Microfinance Institutions and Credit Unions. One of the principal elements of the lending process is the evaluation of the credit history of applicants—how well they have met their obligations in the past. In this regard, a credit bureau plays a useful role in at least three ways. First, it allows financial institutions to access information that prospective borrowers would normally have an incentive to hide (namely, a poor repayment history), and thereby raises the quality of credit decisions. Second, it supports the supervisory agency in analyzing financial institutions. Third, a credit bureau breaks down the information monopoly that many lenders have on the repayment history of their borrowers. This means that good borrowers can more easily shop around among various financial institutions, which promotes healthy competition and tends to reduce interest rates.

A functioning credit bureau is particularly important in the case of lending to microentrepreneurs. Many microentrepreneurs do not have physical collateral to secure a loan and, even if they did, it is often not cost effective for a microfinance institution or credit union to execute this collateral (since the value of the collateral is low compared to the legal and administrative costs involved). Consequently, for many microentrepreneurs, a good repayment history is the closest thing they have to collateral. And for microfinance institutions and credit unions, the information provided by a credit bureau significantly lowers the administrative costs associated with evaluating prospective microenterprise clients.

In many Latin American countries, there is a concern that credit bureaus may violate personal privacy or bank secrecy laws and foster abuse by financial institutions or the government. Clearly, the privacy of individual citizens and, in some cases, the secrecy of their banking and financial transactions must be accorded due consideration. For this reason, and for the public interest in general, it is important that credit bureau operators meet certain minimum technical, professional and ethical standards and that all data processed by credit bureaus are collected, safeguarded and used in an manner consistent with reasonable privacy considerations. The framework governing credit bureaus should also ensure that individuals have the ability to verify their personal information in the credit bureau and, if necessary, request corrections to their record.

However, these legitimate concerns should not prevent the establishment of credit bureaus, given their importance in expanding access to credit and supporting the stability of the financial system. The government should provide an appropriate regulatory framework for credit bureaus or, alternatively, foster self-regulation and the adoption of a code of ethics by the credit bureaus themselves.

Example

Nearly all countries in the region have in place credit bureaus administered by bank supervisory agencies. However, not all countries have information on all borrowers in the financial system and very few include client repayment information from sources other than financial institutions (such as department stores and public utility companies). Moreover, some countries do not keep records of small loans, as in the case of Colombia and Uruguay, whose credit bureaus record only transactions over a specific amount (US$12,500 in the case of Colombia and US$18,000 in the case of Uruguay). These types of thresholds effectively exclude all loans provided to microenterprises and, as result, make it harder for low-income borrowers to establish a credit history and obtain loans from other financial institutions.

Peru

Microfinance Institutions and Credit Unions. Articles 158 through 160 of the General Law

Governing the Financial System regulate the functioning of credit bureaus and vest the Superintendency of Banking and Insurance (SBS) with the authority to develop a credit bureau covering financial, credit, commercial and insurance risks that can be accessed by the general public for a fee. To this end, the SBS requires all intermediaries to regularly report data on their clients.

At first, the SBS required only information on borrowers with loan amounts over US$5,000, which it needed for financial system risk assessment purposes. However, since November 1997, the scope of its credit bureau services has been expanded to include all loans, recording the name of each borrower, his or her identity document number, the loan balance, any overdue payments, the amounts of any approved credit lines and any third-party guarantees.[61] As a result, by 2001, the SBS credit bureau had approximately 1.5 million registered clients and was processing somewhere between 350,000 and 400,000 inquiries per month.

Box 4.1 Improving Credit Bureaus

The experiences of Bolivia and Peru show that there are certain basic considerations that should be taken into account in establishing private credit bureaus.

1. *Minimum requirements with respect to the professional qualifications and integrity of parties seeking to set up and operate private credit bureau services.* Such requirements should not operate as entry barriers but, rather, should ensure that the parties administering such services have the requisite personal integrity (no record of administrative sanctions or criminal acts) and professional and technical training.

2. *Mandatory security standards for data collection, storage, protection and access.* There should be recognized guidelines on the use of firewalls and similar devices, as well as bonding requirements and fidelity policies to guard against exploitation or abuse by persons with access to this private information.

3. *The right of any individual to access his or her credit information at least once a year in order to make any necessary corrections and updates.* There should be procedures in place by which any individual can review his or her data, ideally, on-line. This service should be provided free of charge or else its cost limited to the cost of providing the service.

4. *A streamlined error correction system.* Individuals requesting that their credit bureau data be corrected or updated should not be required to deal with several different agencies or to wait a long time for these changes to be made.

5. *The designation of a government body to monitor compliance with regulations governing private credit bureaus.* This does not diminish the importance of establishing mechanisms and incentives promoting self-regulation and the adoption of a code of ethics by the private credit bureaus themselves.

Moreover, the regulatory framework for credit bureaus should address the following issues:

6. The obligation of financial institutions and businesses to inform applicants who have been denied a loan whether this denial is based on negative credit information furnished by a credit bureau.

7. Appropriate mechanisms and timeframes (e.g., 5 to 7 years) for removing negative information from an individual's payment history.

Source: Prepared by the authors based on case studies.

[61] Measure approved in Official Circulars 7099-97 and 7206-97.

The expanded coverage of the SBS credit bureau has been instrumental in promoting the development of microenterprise and consumer credit in Peru by enabling financial institutions to better verify the credit history of prospective borrowers and to monitor their level of overall indebtedness within the financial system. Moreover, there are two private credit bureaus that combine SBS's financial system data with information from other sources, including public utility bill payments, tax compliance and records of protested bills from chambers of commerce. These credit bureaus enhance the completeness of the information compiled by SBS, and they also provide convenient access to individuals who want to check their own credit histories.

The SBS credit bureau sends all financial institutions a report on shared borrowers. From this report, each institution can determine how many of its clients are overindebted because they have loans from several institutions. This report is highly valued by financial institutions because it allows them to compare their penetration of the microfinance market and the riskiness of their portfolio with that of other institutions.

While Peru's credit bureau can be considered a model, it could be improved. There is a significant lag (of two to three months) between a borrower's failure to make a payment and the appearance of this information in the SBS credit bureau. Part of the lag is attributable to the financial institutions and part is attributable to the SBS itself. The establishment of streamlined procedures would significantly improve the quality of the data supplied by the credit bureau.

V Reflections and perspectives on the future

Microfinance has been around since the mid seventies, much longer if credit unions are included, but it is only in the past decade that the topic has really come to the fore of the development debate. It has done so because it combines several attractive features. It empowers poor people, directly supports entrepreneurial activity and, as has been shown in the past 10 years, can be provided in a financially sustainable manner. In essence, it is the fusion of development purpose with business practice. The prospect of complete financial sustainability is unusual in development activities that directly target the poor, and this probably explains the great attraction of microfinance.

It has taken a long time to achieve financial sustainability, but the model has now been proven. It works. Microfinance institutions can simultaneously serve the poor and generate enough revenues to sustain all aspects of their operations, including a profit margin. In fact, in many cases they are more profitable than the banks in their respective countries. However, many of them are becoming so large and growing so fast that they will soon outpace the donor community's ability to provide the financing needed to sustain growth. Moreover, the justification for direct donor involvement is gradually decreasing as these institutions continue to demonstrate financial sustainability.

The search for resources has lead many nonprofit microfinance institutions to consider transformation from nonprofit foundations to regulated and supervised (for-profit) financial entities. In a sense, this leap is the ultimate test of sustainability and professionalism. It implies a fundamental change in governance structure and an irrevocable commitment to financial discipline.

Microfinance institutions have shown that they are willing to make this leap and undergo the necessary adjustments to operate within a regulatory framework. But the regulatory framework must be adjusted to their needs as well. This is not about blanket promotion of microfinance. The primary responsibility of bank supervisors is unquestionably to protect depositors and the financial system as a whole. This is now an accepted fact in the microfinance community and there is really no serious debate about it. Supervisors should not have to compromise their responsibility to depositors, not even in the case of microfinance.

The message of this publication is that no such compromise is necessary. Supervisors can maintain the integrity of the regulatory framework *and* accommodate microfinance at the same time. Appropriate standards are not the same thing as low standards. In fact, in some areas, appropriate standards for microfinance have to be tougher than the existing ones for banks and finance companies. In general though, the key word is simplicity. Microfinance cannot afford unnecessary, overly complex or ineffective regulations.

It is not so difficult to design an appropriate regulatory and supervisory framework for microfinance. While there are some strategic decisions to be made, the technical aspects are reasonably straightforward. Supervisors should therefore not be apprehensive about addressing this issue. In fact, supervisors cannot afford to be complacent or passive, because there are many other actors

involved in this topic that do not have the same appreciation for the priorities and limitations of supervisory agencies. Perhaps this can be seen as a political risk of microfinance.

Microfinance may be prone to some political risk, but in the overall scheme of things it is a manageable issue if supervisors are proactive. A more difficult question for supervisors is what to do about credit unions, which stands out as a topic that will continue to challenge supervisory structures and resources for the foreseeable future.

In the case of microfinance institutions, bank supervisors have control over how many they authorize to operate as regulated and supervised intermediaries. In the case of credit unions, however, bank supervisors face a pre-existing sector with scores or even hundreds of entities operating with little or no prudential oversight. This fact, together with the particular institutional characteristics of credit unions, makes it extremely challenging to design and implement a regulatory and supervisory framework for these entities. As a result, some supervisors have simply chosen to look away and not deal with the issue. Nevertheless, given the great number of depositors in credit unions and their significant share of total deposits in some countries, benign neglect is not a solution.

It is now fairly well understood what type of regulations are needed to control the risk of credit unions, including the importance that needs to be placed on the issues of governance and institutional capital. Supervisors in a few countries, for example Bolivia, have adopted regulatory frameworks that provide strict rules as well as incentives to promote good governance in credit unions. However, these initiatives are all relatively new and there is not yet any conclusive evidence on how effective these frameworks have been in neutralizing the inherent weaknesses in the governance of credit unions.

Even in the case of microfinance, where the situation is more manageable for bank supervisors, more information is still needed to design and implement fully effective regulations. To the alert reader, this publication has revealed at least three areas where further research is needed.

First, the appropriate risk weighting for microfinance loans is still unknown. As argued in the publication, it is presently not possible to conclude whether microenterprise loans should be assigned the same risk weight as commercial and consumer loans. In the Basel I capital accord, microenterprise loans are given a risk weight of unity (1), that is, the same as most commercial and consumer loans. This may or may not be appropriate; there is simply no research to indicate whether microenterprise loans have the same, more or less risk than other types of loans.

Second, the provisioning schedules for microenterprise loans proposed in this publication are based on educated assessments by experts and supervisory authorities, not statistical analyses. Ideally, the provisioning schedule for microenterprise loans should correspond to the expected loan losses at different stages of delinquency. Expected loan losses may depend on many factors and vary among institutions, and no studies have yet been undertaken to establish a reasonable minimum standard that could be used for regulatory purposes.

Third, existing research does not allow bank supervisors to determine whether financial institutions specialized in microfinance should be subject to a different capital adequacy ratio than other financial institutions, such as multipurpose banks and finance companies. On theoretical grounds, it appears that microfinance institutions may be at least somewhat more risky than other financial institutions and therefore should be subjected to somewhat stricter standards. However, there is no empirical research that would allow bank supervisors to confirm whether this is true or not.

Though these are central elements in a regulatory framework for microfinance institutions, the lack of empirical evidence should not prevent bank supervisors from proactively addressing the issue of microfinance. There is enough information and past experience to establish frameworks that, while perhaps not perfect, are good enough to allow the continued and balanced growth of this activity. Given the importance of the regulatory framework for the capacity of microfinance institutions to continue to grow, bank supervisors have a pivotal role to play in the development of the industry. This publication hopefully supports them in assuming this responsibility.

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