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Policies, Regulations and Systems that Promote Sustainable Financial Services to the Poor and Poorest

Women's World Banking

Introduction

This paper is intended for policy makers, microfinance leaders, and other stakeholders that are working to build financial systems that work for the poor majority. It is intended to reflect experience and lessons from around the world on how policies, regulations and systems can be shaped to promote the development of a sound and responsive microfinance industry. It is based on work by WWB leaders and many others to build consensus among major actors that has resulted in important policy changes in many developing countries. Each section features concrete examples of good practice.

The paper highlights key developments in the microfinance industry. It summarizes research to understand what poor women want in microfinance services, since this should be the foundation for building pro-poor, pro-microfinance policies. It begins from the global consensus that microfinance should both work for the poor and be financially sustainable.

Microfinance needs to be treated as a vital part of the financial system, with the special needs and features of microfinance operations and institutions recognized in financial sector policies and regulations. We highlight the important role that a broad range of regulated and unregulated financial institutions can and do play in the provision of microfinance services, and the importance of building policies and support systems that encourages a range of institutional types to enter and expand microfinance services. The key roles that government policy makers can play in microfinance are outlined.

Recognizing that the majority of microlending institutions are likely to remain unregulated, the chapter emphasizes the importance of microfinance networks, wholesalers, rating agencies and others in building systems to monitor performance using common indicators and definitions. This is not a substitute for prudential regulation, which is vital for those institutions that mobilize savings from the public. Performance monitoring systems are important in building transparency and a common commitment to excellence among the range of microfinance retailers.

The paper highlights the key features of policy and regulatory change that will be needed to help ensure sound, responsive microfinance operations—whether these are by regulated microfinance institutions or form a small part of a commercial banks loan portfolio—as well as key features in the available legal structures for those microfinance institutions that seek to become for profit, regulated legal entities.

A. Evolution of the Microfinance Industry

Microfinance involves financial services to poor people, provided in an efficient, responsive and financially sustainable manner. While institutions need to build toward financial sustainability over time, experience now demonstrates that, in most settings, microloans can be provided to the poor and poorest, in ways that cover operating and financial costs, once institutions reach moderate numbers of microborrowers—20,000 clients in most settings. While the focus over the last ten to twenty years has been on expanding microloans to support the economic activities of the poor, it is clear that microfinance needs to encompass a range of financial services—lending, savings and insurance—that help poor people build their income and assets, lubricate their household economies, and mitigate the risks that poor families face.

Microfinance has a number of roots. For hundreds of years, poor people in Africa and Asia have formed savings and lending groups. Moneylenders and the informal curb market have provided quick services, at very high costs, to poor households who had no access to mainstream financial institutions. In the last century, cooperatives and credit unions in developing countries have focused on savings mobilization and lending with rural households, many of which are poor. Over the years, governments have created lending programs for poor entrepreneurs and producers; most of these programs have suffered from subsidized interest rates, political patronage, and low repayments.

In the last twenty years, the "microfinance industry" has emerged. During the 1980s and 1990s, particularly in Asia, Africa, and Latin America, thousands of microfinance NGOs were established to provide microloans, using individual and group lending methodologies. In the 1990s, while many of these NGOs failed to reach scale or financial sustainability, others led the way in demonstrating that:

- Poor people, particularly poor women, are excellent borrowers, when provided with efficient, responsive loan services at commercial rates.
- Microfinance institutions can provide microloans to poor people in an efficient and financially sustainable way, once the number of clients reaches reasonable scale—10,000 to 20,000 borrowers in most settings.
- Microfinance—lending, savings, and other financial services to poor people—is an effective way to help poor people help themselves build income and assets, manage risk, and work their way out of poverty.

Most of the growth in the microfinance industry over the last ten years has taken place in the absence of specific financial sector policies for microfinance. In Bangladesh, where about one third of the world's estimated 30 million active microborrowers reside, the growth has come from specialized microfinance NGOs and Grameen Bank. Grameen Bank has its own special legal structure, and does not fall under regulatory oversight of the central bank. In Bolivia, which has been a leader in building microfinance policies and regulations, most of the growth in outreach came before the regulations. Since the regulations have been put in place, growth has been more rapid among unregulated MFIs, with the rapid growth in portfolios of regulated MFIs coming mainly from growth in average loan size. In Indonesia, Bank Rakyat Indonesia, a state-owned commercial bank, succeeded in building the world's largest commercial microfinance savings and lending services for millions of poor people in an otherwise ineffective bank, using existing banking regulations.

Beginning in the mid-1990s, leading microfinance institutions have worked together to build performance indicators and standards for the microfinance industry. These initiatives have been motivated by recognition among practitioners that:

- Microfinance must demonstrate very high performance on portfolio quality, efficiency and financial sustainability if microfinance institutions are to be recognized as integral members of the financial system, able to mobilize commercial borrowings.
- Effective ways of looking at efficiency, risk and profitability need to differ for microfinance portfolios relative to traditional banking activities, with microfinance practitioners well placed to determine the appropriate performance indicators and standards for the industry.
- Microfinance institutions that do not mobilize savings from the public are not likely to warrant regulation by traditional bank supervisors; other means need to be found to build transparency, accountability, and pressure to perform for non-regulated MFIs.

Many global, regional and country level networks have adopted or are adopting similar performance indicator, standards and institutional evaluation methods which reflect key success factors in microfinance. These performance indicators, standards and approaches to evaluating MFIs have been adopted by international donors. However, implementation has been uneven. Similar evaluation methods and performance indicators have been adopted by the new set of "rating agencies" that have emerged in the microfinance industry.

Recent focus on NGO "transformation". During the 1990s, a phenomenon emerged in parts of the donor and microfinance community that focused on the felt need to "transform" or convert microfinance NGOs into regulated, for-profit structures, owned and governed by shareholders. The rationale in promoting this "commercialization" model was that:

- Microfinance institutions should rely on savings and commercial borrowings rather than donor grants.
- Institutions that mobilize savings from the public should be subject to prudential regulation.
- Regulated structures would provide more assurances to commercial lenders and investors.
- Microfinance NGOs have no owners, and NGO boards can be dominated by social objectives, resulting in structures that have limited accountability or focus on efficiency and profitability.

To date, this "transformation" model has had limited success and several unintended consequences:

- Only about twenty-five of the thousands of microfinance NGOs around the world have converted to for-profit, regulated structures.
- Most countries do not have the legal structures or regulatory regimes in place that would make such conversions feasible or desirable.
- The pool of domestic commercial investors in for-profit microfinance institutions in most developing countries is extremely limited. In fact, the ownership structure of all converted microfinance NGOs is dominated by various combinations of donors, donor funded funds, international NGOs, and the originating NGO (Annex 1). The benefits of converting from an NGO to a "private" structure with ownership and governance dominated by donors and NGOs is questionable, in terms of accountability, know-how, consistency in target group and performance focus.
- Few if any converted MFIs have developed broad-based savings mobilization from the public; most rely on a narrow set of institutional depositors, donor-funded equity and debt, and commercial borrowings as their sources of funds (Annex 2). With limited efforts to mobilize savings from the public, the underlying rationale for prudential regulation is not fulfilled.
- Many microfinance NGOs are not yet of the size, efficiency and/or profitability to make incurring the costs of legal conversion and regulation feasible or desirable.
- In countries where the performance thresholds for becoming a regulated MFI have been low, weak NGOs have become weak regulated MFIs, with little of the anticipated benefits in performance improvements or mobilization of commercial finance.

Over the last five years, a number of private mainstream commercial banks, finance companies, and insurance firms have entered microfinance, as retailers or wholesalers in microfinance. Many of these institutions see microfinance as a large potential market; most have top managers who are motivated by community concerns as well as profits. These traditional financial institutions have learned from microfinance institutions (MFIs) and pioneer banks how to reduce the high transaction costs in microlending. Some are combining labor-intensive lending methodologies and distribution systems with the use of technology. In addition to private financial institutions, a few government banks have established large, efficient and profitable microfinance operations—breaking from the tradition of low efficiency, low profitability, low repayment and subsidy approaches to lending to the poor. Most public and private mainstream financial institutions are not resource constrained; they have established broad-based savings mobilization, they are fully integrated into domestic financial markets, and major coverage in microfinance can be achieved with a small percentage of a bank's assets. While the long-term commitment to microfinance is questionable with some mainstream financial institutions, those that do commit can invest in building microfinance capabilities, products and MIS, while using a small portion of their financial resources, their branch infrastructure, and their internal systems to achieve significant outreach.

Major differences in regional and country patterns. The broad sweeps of the microfinance industry and movement over the last twenty years are described here. However, patterns differ

radically across regions and across countries. Microfinance is at very different stages of development. The present and potential importance of different legal structures, distribution systems and methodologies differ widely.

B. Building Financial Systems that Work for the Poor Majority

Listening to the needs of poor clients has provided the basis for developing financial services and delivery systems that work for the poor majority. Research by WWB and others to understand what poor women want in financial services yields common responses across continents. These responses lead us to design responsive financial products and systems, based on the needs of clients.

CREATING A PRO-POOR POLICY FRAMEWORK: LISTENING TO CLIENTS

The voices of microfinance clients provide a clear picture of what is required to build systems which work for the poor:

- Microfinance clients want more, faster and better financial services
- They value speed and convenience
- They want access to larger loans
- They want respect and recognition

Low income women and men define microfinance broadly:

- They want business loans
- They want to be able to deposit voluntary savings
- They want housing and education loans
- They want health and life insurance
- They are willing to pay what it costs for responsive, sustainable services.

Poor people prefer individual loans over group loans. As their experience grows, clients of group loans resent the time that group meetings take, and the need to guarantee repayment by other members of the group.

How do we create a policy environment that responds to these needs?

- Creating an environment which encourages microfinance institutions to operate efficiently and to innovate such that clients are served rapidly and close to their places of business.
- Removing interest rate ceilings and removing subsidy cultures that inhibit sustained access, competition and innovation.
- Encouraging competition in the industry so that costs go down for all clients and so that a range of products—including housing and education loans as well as voluntary savings and insurance--are provided that meet the needs of clients at different stages.
- Eliminating collateral requirements that most poor clients cannot meet and that effectively denies them access to the financial system.
- Ensuring prudential requirements that protect the savings of the poor.
- Facilitating ways in which clients can participate in the ownership of MFIs.

Microfinance needs to be recognized as a vital part of the financial system, dedicated to meeting the financial needs of poor clients in a responsive and profitable manner. This financial systems approach recognizes the important role that different organizational and legal structures can and do play in meeting the evolving financial service needs of poor households. It recognizes the important roles of both regulated and unregulated institutions in the microfinance

system: grassroots savings and credit groups and microfinance NGOs, along with universal commercial banks, finance companies, cooperative banks, regulated MFIs, insurance companies, and wholesale financing institutions. This financial systems approach looks to remove policy, regulatory and legal barriers to the provision of sound financial services to poor people by each class of institution. It also looks to building the institutional infrastructure to: facilitate access to finance by high performing institutions at different stages; build shared performance standards in the microfinance industry; and encourage capacity building and innovation.

The integration of microfinance into the financial sector does not mean that all microfinance institutions should be regulated. It means promoting strong regulated and unregulated institutions of all types that work to provide services on a sustainable basis, and creating enabling regulatory frameworks and legal structures for those MFIs that seek to mobilize and intermediate savings from the public.

Broad consensus now exists that microfinance needs to work for poor people and be financially sustainable. During the 1990s, polarizing debates seethed between advocates of the "commercial" approach and those that saw their mission as serving the "poorest of the poor". Consensus now exists among most major microfinance actors that microfinance must work for the poor and must be financially sustainable. It is also recognized that microfinance is not the answer for all of the world's poorest families; some will need support other than microfinance, if they are to move out of poverty. Experience demonstrates that the financial needs of poor people are best served by encouraging a broad range of institutional types to provide the efficient and responsive lending, savings, insurance and other financial services that poor people need to build their businesses, increase income and assets, and reduce risks. Poor people need sustained access to an evolving set of financial products and services. These can only be provided by financially sustainable institutions, dealing with diverse segments and products, each in the position to increase outreach and grow with their clients.

While donors and other sources of subsidized funds will continue to have important roles to play in supporting MFIs on the road to financial sustainability, microfinance in the twenty-first century will be dominated by those institutions that are or can get integrated into domestic financial markets, through wholesale financing arrangements, commercial borrowings and/or broad-based savings mobilization. Consensus statements by leading MFIs in Bangladesh and India, by microfinance leaders from the 13 African microfinance networks that comprise AFMIN, and by policy leaders convened by WWB from around the world demonstrate a convergence around core principles on financial systems that work for the poor majority (Annex 3).

Savings mobilization is key as a highly valued service to poor people, as a source of funds, and as a basis for real local accountability. In WWB surveys conducted in Latin America, Africa, and Asia, the service most desired by poor clients is the capacity to save small amounts with their microfinance institution; savings help poor people build assets and manage risks. Many grass roots, cooperative, and banking institutions in Africa and Asia have demonstrated the desire and capacity to save among rural and urban poor households. As demonstrated by SEWA

Bank in India, Bank Rakyat in Indonesia and other successful pioneers, when simple, responsive savings products are offered, broad-based savings can become the dominant source of funds for the microloan portfolio. In contrast, most microfinance NGOs that have converted to regulated MFIs have not used their new legal structures to mobilize broad based savings from the public. Most rely primarily on term deposits from a narrow set of institutional investors. It is clear that institutions that have focused on microloans need to develop a distinct set of capacities to successfully mobilize savings from the poor and non-poor. Experience demonstrates that MFIs need to make substantial investments upfront to build the capacity to mobilize savings from the public; however, if well-designed, this deposit base can become the major funding source and the basis for long term institutional sustainability. Prudential regulation is key in broad-based savings mobilization to protect depositors. For poor people, the loss of savings deposits can have a devastating impact on their ability to build and maintain a personal safety net. Specialized microfinance institutions that seek to mobilize savings from the public need to comply with prudential regulations, with these regulations adjusted to reflect prudent governance and management, operating systems and business practices, financial and operating ratios, and portfolio quality in microfinance.

THE IMPORTANCE OF SAVINGS TO CLIENTS AND TO MFIS

Poor people value the ability to save for a variety of reasons:

- To cope with emergencies such as death or the effects of natural disasters.
- To cope with unexpected investment opportunities such as purchasing items needed for their businesses when prices are low.
- To manage irregular income streams particularly those entrepreneurs engaged in seasonal work.
- For long-term investments such as purchasing land, financing children's education and business needs such as tools and machinery and vehicles.
- For social and religious obligations such as marriage, religious holidays and pilgrimages.
- For old age, sickness and disability.

Savings are important to MFIs for a variety of reasons:

- Mobilizing deposits serves as an additional source of funds for on-lending to clients thereby enabling growth of the portfolio.
- Mobilizing deposits can enable microfinance institutions to reduce their dependence on donors because they can be used to finance the MFIs loan portfolio.
- Mobilizing deposits imposes a strict financial discipline on MFIs that ultimately benefits the institution.

Source: Marguerite Robinson, The Microfinance Revolution, 2001, Chapter 7.

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Across countries and regions, policies, regulations, legal structures and industry infrastructure are needed that encourage a range of institutional types to enter and expand sound, efficient and financially sustainable microfinance operations—rather than pinning hopes on a single model. Most policy and regulation can be built for microfinance as an activity, applied across the range of regulated legal structures. While most growth in microfinance services is likely to continue to come from traditional financial institutions and microfinance NGOs, a subset of strong microfinance NGOs will seek to become regulated for profit financial institutions as a means to mobilize savings from the public and to facilitate the rapid expansion in commercial financing. Therefore, in addition to building policies and regulations tailored to the needs of microfinance as an activity, in many countries, new legal structures will be needed for deposit taking MFIs, or existing legal structures will need to be modified to fit the nature of microfinance. These policies, regulations and legal structures need

to balance promotion of the microfinance industry with the need to protect savers, investors and the industry itself.

Government needs to remove itself from direct lending to poor people. Government programs—normally based on a social welfare, subsidy approach—nearly always end in being used as vehicles for political patronage, extremely low repayments, market distortions and eventual truncation of services. Government banks can play important roles as retailers—if they are given autonomy in selecting clients, if they are required to charge unsubsidized lending rates, and if microfinance operations are either separated from inefficient, normal banking operations or are part of a commercially-oriented, efficient state bank.

Government has important roles to play in building a pro-poor, pro-microfinance policy, regulatory framework, and set of legal structures. Recognition by finance ministries, central banks and bank superintendencies of microfinance as an important, legitimate loan class, with its own characteristics within the financial system, is important. Government needs to help ensure that the mix of wholesale financing, performance monitoring, and capacity building mechanisms are in place to promote the sound growth of microfinance in institutions with different legal structures, at different stages of development. Government needs to recognize the important roles of different legal structures in microfinance—microfinance NGOs, credit unions and cooperatives, finance companies, commercial banks, regulated MFIs, grassroots groups, insurance companies. Government needs to create general regulations and norms to encourage sound and responsive microfinance operations across the range of regulated legal structures, and government needs to t remove the policy, regulatory and legal barriers in each of these structures that may undermine their use in providing efficient, responsive, sustainable financial services to the poor.

Policy makers and microfinance leaders have built a consensus on the key elements of policy frameworks for microfinance. Some of the best policy environments for microfinance have been created when leaders of finance ministries and central banks engaged deeply and directly with microfinance practitioners in identifying the key features. These mutual learning and consensus building processes can create deep understanding among policy makers of how rigorous microfinance is done, and can build appreciation among MFIs of banking norms and standards. In addition to building shared visions and principles for microfinance (Annex 3), these processes lead to clarity on the most effective role of different actors in promoting a sound microfinance industry that responds to the evolving needs of poor clients in efficient, financially-sustainable ways. Based upon consensus-building processes undertaken globally, and in several countries of Africa, Asia, Latin America, policy-makers, microfinance practitioners and international funds have built agreement on key features of a policy framework that supports the development of a robust and responsive microfinance industry include the following:

- A pro-poor economic policy stance, including the recognition of sustainable microfinance services as a key vehicle in tackling poverty. :
- Solid macroeconomic policies, avoiding high inflation.
- Liberalized interest rates for microfinance, using competition rather than interest rate ceilings to encourage efficiency and lower interest rates over time
- Elimination of market-distorting subsidies, notably in government programs.
- Modifications in financial sector policies, regulations and legal structures to promote the entry and expansion of sound microfinance services by a range of structures, to encourage the offering of multiple financial products, and the explicit recognition of the important roles that unregulated NGOs and grassroots structures have in the delivery of microfinance services.
- Promotion of performance indicators and standards, that encourage transparency and sound performance across the range of institutions engaged in microfinance.
- Permission to mobilize deposits from the public for those regulated institutions that meet prudential standards, with more liberal treatment of savings mobilization from MFI borrowers.
- Fair tax treatment, including temporary tax incentives for microfinance institutions undertaking the costs of converting to formal, regulated structures.
- Simple reporting requirements and supervision for microfinance activities and institutions, with a focus on performance.
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C. Building Transparency and Performance Standards in Microfinance

Shared performance standards, transparency and accountability are key to building solid and responsive financial services for poor households—for both regulated and unregulated microfinance institutions. Since prudential regulation will only cover a small number of those institutions involved in microlending, the role of microfinance networks, wholesale lenders, microfinance rating agencies, auditors and international funders will all be key in building transparency and performance in the microfinance industry.

The basics for strong performance by regulated and unregulated MFIs are sound governance and management, appropriate microfinance operating systems, strong MIS and internal controls. The ability of bank regulators to evaluate these capabilities and systems specific to microfinance is key. Regulators also will need to learn the key performance indicators and standards in microfinance, to be able to evaluate performance. Standards of efficiency, profitability, portfolio quality assessment, and capital adequacy need to be based on good practice in microfinance, not on conventional commercial banking norms. Since most microfinancing institutions are not likely to be regulated, it is important to establish industry norms and standards for unregulated

microfinancing institutions, and to develop appropriate means to reinforce these performance standards.

It is important to establish key performance indicators and norms for microfinancing institutions, across the spectrum of size, stage and legal structures. These indicators and norms can be used by regulators in monitoring the microfinance portfolios and organizational capabilities of regulated banks, finance companies, MFIs, and cooperative banks. For the broader set of unregulated MFIs, these performance indicators and standards can be used to build transparency in the microfinance industry, and to gear the entire industry to similar performance objectives.[1] The following table provides the key performance indicators in microfinance, used by a range of country, regional and global networks, international funders, and microrating agencies. While definitions still differ slightly across groups, there is a rapid convergence in definitions that will make it possible to compare performance of institutions around the world.[2]

[1] Performance indicators focus on key outreach, efficiency and sustainability measures. These are distinct from a) full institutional evaluations of an MFI and b) detailed analysis of the poverty of borrowers or of the impact of loans. Each of these instruments is important for different purposes.

[2] The recently released "Definitions of Selected Financial Terms, Ratios and Adjustments for Microfinance," available on the CGAP website, is the result of roundtable discussions between specialists from three Washington based development agencies (IDB, USAID and CGAP) and three rating agencies specializing in microfinance (Microrate, M-CRIL, PlaNet Rating). This document proposes standard definitions and suggests a standard method of calculating certain financial rations.

KEY PERFORMANCE INDICATORS IN MICROFINANCE

DIMENSION	INDICATOR[1]	WWB	AFMIN	MBB	MicroRate	ACCION	GIRAFE PlaNet Finance	WOCCU	Philippines Coalition	PKSF
Outreach	No of active borrowers	x	x	x	x[2]	x	x		x	x
	No of active savers	x	x				x	x		
	Loan Portfolio Outstanding	x	x	x	x	x	x	x		x
	Savings Portfolio	x	x			x	x	x		
	Ave Loan Size/Average Loan Balance	x	x	x		x	x			x
Efficiency and Productivity	Operating Expense Ratio	x	x	x	x	x	x	x	x	x
	Caseload	x		x	x	x	x			x
Portfolio Quality	Portfolio at Risk	x	x	x	x	x	x	x	x	
	Loan Loss Reserve Ratio	x			x	x		x		
	Write off Ratio	x			x		x			
	Loan Loss Provision Ratio	x		x	x	x		x		
Sustainability/ Profitability	Operational Self-Sufficiency	x	x	x		x	x	x	x	x
	Financial Self-Sufficiency	x	x	x		x	x	x	x	x
	Adjusted Return on Assets	x		x	x	x	x	x		
	Adjusted Return on Equity	x		x	x	x	x	x		
Capital Structure	Debt To Equity Ratio	x			x				x	x
	Capital to Asset Ratio			x		x		x		
	Leverage - Capital to Equity Ratio						x			
Liquidity	Current Ratio								x	x
	Liquidity Ratio				x	x		x		

Note: [1] Definitions may vary from one network or agency to another but the same terminology for the indicator is used
[2] Microrate has used number of loans but which is equivalent to number of active borrowers

Sources: WOCCU & ACCION: SEEP FSWG - Performance Monitoring Systems Report
MicroRate: Technical Guide; Actual Report
PlanetFinance: www.planetfinance.org; Appraisal and Rating Report

Key actors in implementing this system of performance monitoring at global and country levels include: wholesale financing institutions, microfinance networks and associations, rating agencies, and international funders.

- **Wholesale financing institutions** should use rigorous absolute and incremental performance standards in establishing eligibility criteria for microfinancing institutions accessing loan funds on commercial or semi-commercial terms. While some government wholesale or apex institutions have gotten caught in mandates to move large amounts to institutions that do not meet rigorous performance standards, the best private and wholesale institutions have been successful in using rigorous eligibility criteria in providing loan funds to induce transparency, consistency in reporting, and performance improvements in retail microfinance institutions.

PALI KARMA-SAHAYAK FOUNDATION (PKSF)

PKSF is a semi-autonomous, national-level wholesale financing institution in Bangladesh. It provides loans to about 150 retail-level MFIs in rural Bangladesh, at interest rates slightly below commercial borrowing rates, utilizing donor funds principally from the World Bank. It plays an important role on the areas of capacity building and advocacy.
PKSF has been successful in establishing eligibility criteria that reflect high performance standards and solid institutional evaluations. While most MFIs in Bangladesh use various group-lending methodologies, eligibility for funds is not based on the use of a particular group or individual lending method.

PKSF uses core financial and operating performance indicators and definitions that are similar to those used by leading microfinance networks and rating agencies (Box 3). Its institutional assessment tool focuses on:

- The adequacy of systems and methodologies used by the MFI to evaluate borrowers
- Viability of the microfinance institution, including operating methods and systems, human resource development programs, building of an institutional culture, financial management and internal controls.
- Financial and operating performance of the institutions, including measures of self-sufficiency, portfolio quality, productivity and financial ratios.

PKSF is playing a leading role in building a simple system of performance indicators and definitions, for use in building transparency and performance in the microfinance industry in Bangladesh. The managing director of PKSF chairs the technical committee which the central bank governor has asked to build these performance indicators for the microfinance industry as a whole; CDF, the microfinance network in Bangladesh, and leading microfinance practitioners participate in this committee.

- **Microfinance networks and associations** have major roles to play in building consensus on which performance indicators will be used, building capabilities in MFIs to establish and use performance data, collecting and verifying the performance data, and determining with network members when to make performance data available to other MFIs, funders and the general public, in the aggregate or for individual institutions.

SA-DHAN IN INDIA

Sa-Dhan, the Association of Community Development Finance Institutions, is the leading network of microfinance institutions in India. Established in 1998, during the policy change work led by Indian microfinance practitioners, whole institution FWWB and WWB, Sa-Dhan has played a leading role in getting the recommendations of the 1998 policy forum and 1999 task force implemented. Part of the consensus report for the policy forum was consensus on key performance standards in microfinance.

In the last two years, Sa-Dhan has led the work to build common performance indicators and standards among its members, with deep work by Sa-Dhan to develop consensus and understanding among MFI leaders on which performance indicators are the most important, and why the collection, verification and dissemination of performance standards by Sa-Dhan is key.

Sa-Dhan's work on developing performance indicators and standards has produced the following consensus among leading MFIs in India:

- All MFIs should commit to incremental performance improvements on all key dimensions, and should commit to eventually achieving high absolute performance levels.
- MFIs should receive support in building the capabilities to meet high performance standards, and to using performance indicators as internal management tools.
- A careful process was agreed to gather information, build capacity, create agreed indicators, establish good and best practice standards over time, and see meeting the standards as a step to meeting full regulatory standards where appropriate.

While in early days, Sa-Dhan saw its work on performance indicators as a precursor to building a body for "self-regulation" of the microfinance industry, Sa-Dhan and its members now see this work on performance indicators and standards as a key measure in itself in building transparency and commitment to performance improvements in the range of microfinance institutions in India. Sa-Dhan works closely with the Micro-credit Rating and Guarantees International Ltd, formerly M-Cril. This India-based rating agency for microfinance institutions has played a key role in building transparency and commitment to performance among the MFIs that it has rated.

- **Specialized microfinance rating agencies** play important roles as third party evaluators of microfinance institutions. Most of these agencies do not actually rate MFIs; rather they provide a systematic, external evaluation of operations and performance. For both regulated and unregulated institutions, these rating agencies can help provide reassurances to domestic and international investors on the relative and absolute institutional soundness and performance of microfinance institutions. Also, by using standardized evaluation approaches and performance definitions across MFIs, a rating agency encourages transparency, benchmarking and performance improvements in the institutions rated.

MICROFINANCE RATING AGENCIES

At present, three specialized rating agencies operate in the microfinance industry. Each has a different regional focus, and each uses its own standardized approach to evaluating MFIs.

	MicroRate[1]	**Micro-Credit Ratings and Guarantees International Limited (formerly M-CRIL)[2]**	**PlaNet Finance[3]**
Geographic Scope	Mostly Latin America	Asia	Sub-Saharan Africa, Middle East/North Africa, Latin America, Eastern Europe, Asia
Number of Institutions Rated	70 (since 1997)	97 (since 1998)	34 (since 1999)
Methodology	This methodology analyzes five core areas of MFI financial and operational performance: Management and Governance, Management Information Systems, Financial Conditions, Credit Operations, and Portfolio Analysis.	The rating instrument uses minimum financial and other performance conditions in addition to scoring on governance aspects (13%), management factors (38%) and financial performance (49%) to arrive at a risk grade.	The 26 indicators are grouped under six areas of risks (GIRAFE): Governance, Information, Risk Analysis, Funding, Efficiency and profitability. There are two stages to the rating process: evaluation and formal rating.
Rating Scale	Does not actually rate institutions, but offers opinions of creditworthiness by marking an evaluation with "Recommend", "Watch" or "Caution".	From **α+++** (highest safety, excellent systems—most highly recommended) to **γ** (highest risk, poor systems —not worth considering).	A global rating is given, from **G1** to **G5**, along with a composite rating, scoring the six areas of assessment from "**e**" to "**a**".
Approach Bias****	Strong on financial track record and benchmarking against peers.	Strong on capacity constraints based on specific issues.	Strong on management, governance, and best practices.

Source: 1 MicroRate website
2. Mcrilnews, M-Cril newsletter Volume 4 No 4, July 2002
3. PlaNet Finance website

While microfinance rating agencies provide an important information bridge between MFIs and some commercial investors, some commercial sources still are looking for ratings from traditional, internationally recognized rating agencies such as Standard and Poor's. Microfinance rating agencies have begun forging alliances with the traditional rating agencies, to build joint credit risk rating products. It would be an important step if mainstream rating agencies get involved in rating MFIs, based on a clear understanding of the special nature of microfinance.

- **Publications on performance** by the Microbanking Bulletin and others on performance of a growing number of largely successful microfinancing institutions, enabling benchmarking with institutions of similar sizes, from similar contexts. (*More on MBB)*
- **Donors** that use similar performance indicators and evaluation methods reinforce the performance standards and norms in the industry. A number of donors have done extensive work to develop a coherent set of performance indicators for microfinance. It is important that head office and field level staff of all donors are familiar with microfinance performance indicators and institutional evaluation methods, to avoid undermining the local microfinance industry.
- **Audit firms.** Most accounting firms are not yet skilled at understanding how to evaluate microfinance institutions or portfolios. Their use of similar performance indicators would increase the rigor, thoroughness and credibility of audits of MFIs.

These performance monitoring systems are NOT self-regulation. Much confusion has been created around the loose use of the term self-regulation. The authors believe that the use of the term regulation should be used only when the regulator has the power to disband the institution, withhold a license, or provide other censures. While these performance monitoring systems are important in building transparency and commitment to excellence in the microfinance industry, they should not be seen as a substitute for building the changes in prudential regulations and legal structures needed to encourage sound microfinance by regulated financial institutions and the increased reliance on savings and commercial borrowings by microfinance institutions. Performance monitoring systems are intended to:

- Build transparency in the microfinance industry, by introducing common performance indicators and definitions.
- Create shared commitment and healthy competition among MFIs to improve performance.
- Facilitate the flow of concessional, semi-commercial and commercial funding to high performing institutions at different stages of development.
- Help networks and other service providers tailor the mix of technical and financial services, to help MFIs improve performance, outreach and innovation.

D. Banking Regulation that Fits the Needs of Microfinance Portfolios

Until recently, most central banks and bank superintendencies have not seen the importance of understanding the nature of microfinance. This is changing. From Uganda to the Dominican Republic to the Philippines, top policy makers from finance ministries and central banks recognize the importance of microfinance, and are ensuring that those officials responsible for drafting laws and regulations, and for supervising MFIs understand the business and the special features of providing financial services to large numbers of poor people.

One key measure that central banks and bank supervisors have taken is to modify conventional regulatory requirements to fit the needs of microfinance operations—regardless of whether these operations are conducted by a specialized microfinance institution or form a small part of the

overall portfolio of a commercial bank (Annex 4 and 5). These special features of microfinance include:

- The limited size of the microfinance market relative to the assets of the financial sector, due to the need for very small loans by large numbers of poor people, reducing the risks of microfinance to the financial system.
- The practice among most successful microfinancing institutions of mitigating credit risk not by requiring conventional collateral, but rather by making very small, short term loans with gradual increases in loan sizes and maturities, using simple processes for evaluating business and credit risk, and executing strong systems to ensure excellent on-time repayment.
- The high transaction costs of making very small loans, necessitating high interest rates to cover operating and financial costs.
- The importance of providing rapid and convenient access to financial services to poor people spread across urban slums and dispersed rural areas, necessitating different approaches to branching and distribution systems, use of simple loan documentation systems, and recognition that in many settings cash transactions will need to take place outside branch premises.
- The fact that, in most countries, microfinance services to the poor has been built by non-bank, unregulated institutions, that, while performing well, may not have the scale or sophistication to deal with typical reporting requirements.

Key dimensions in policy, banking regulation and supervision adapted to the needs of microfinance include the following:

- **Interest rates ceilings need to be removed on microloans.** The single most effective way for the government to promote financial services for the poor is to liberalize interest rates. The single most damaging thing a government can do to destroy access to financial services by poor people is to impose interest rate caps. Microfinance institutions need to be able to cover the high transaction costs of making very small loans. Poor borrowers want sustained access to financial services, not subsidies. While some microfinance operations use high interest rates to cover inefficiencies, experience demonstrates that competition from a range of suppliers is the best way to introduce pressure to improve efficiency. Government policy makers and politicians have a key role to play in getting the general public to understand why interest rates for microloans must be higher than for corporate finance. Building this broad understanding of why relatively high interest rates are needed if financially sustainable financial services are to be built for millions of poor people is key--avoiding and countering attacks that MFIs and banks are charging the poor usurious interest rates.

- **Evaluating portfolio risk.** Most bank regulation bases risk assessment of the portfolio on the strength of the collateral on the loans. In most microfinance methodologies, traditional collateral is not used. In most individual lending methodologies, risk is reduced through: evaluations of the cash-flow of the microbusiness and the household, increasingly complemented by loan scoring; by the provision of very small loans with short maturities, with the amounts and maturities increased based on excellent on-time repayments; and the use of personal guarantees. In group lending, peer pressure and guarantees, mandatory savings amounts, and disciplined delivery and collection on small loans are used to reduce risk. The insistence by bank regulators that institutions use conventional collateral would

radically reduce the ability of institutions to serve poor clients with limited assets. In several countries—including the Philippines, Bolivia, the Dominican Republic and Pakistan—bank regulators no longer base their risk assessments of microfinance portfolios on the underlying collateral. Rather, the regulators now look at the maintenance of excellent aggregate portfolio quality, with rigorous standards on loan loss provisioning and reserves, and at the adequacy of systems to evaluate risk and maintain portfolio quality.

- **Reporting and underlying loan documentation.** It is important that reporting requirements are rigorous, but simple, to reflect the relative small size of many MFIs. While large scale financial institutions are accustomed to and able to deal with elaborate reporting, one incentive to encourage bank involvement in microfinance would be to keep reporting requirements on microfinance portfolios simple. Underlying loan documentation should be available at the institution, but the large numbers of small transactions make it too cumbersome and costly to include individual loan documents as part of the reporting system. Summary reports on clients and loans can be generated from the MFI's management information system.

- **Microfinance capabilities and systems**. Regulations and norms on microfinance activity need to include a review of the rigor and appropriateness of risk evaluating methodologies and manuals, the adequacy of loan documentation, well-integrated management information systems that generate the needed reports in a timely and reliable manner, and adequate internal controls. Performance indicators need to reflect good practice in microfinance. It is critically important that the central bank or bank superintendency invests in training its own staff to understand how to evaluate the key systems, capabilities, manuals, and performance of microfinance portfolios, operations and institutions. In a numbers of cases, special units in the central bank and bank superintendency have been created to provide the needed specialized know-how in microfinance.

- **Branch operations**. Microlending and microsavings operations can operate out of conventional bank branches; normally these need to be supplemented by smaller, simpler outlets, including collection points, temporary outlets in marketplaces, mobile banking or the use of village groups as distribution points for disbursements and collections. In many countries, the definition of a branch needs to be modified to accommodate these unconventional structures. Also, institutions engaged in microfinance need to be able to conduct cash transactions outside the branch premises. Finally, where the bank regulators have created limitations on the establishment of new branches, microfinance institutions need to be given exemptions, since they are targeting a set of clients not reached by conventional bank operations.

CREATING A SOUND COUNTRY REGULATORY AND POLICY FRAMEWORK: THE CASE OF THE PHILIPPINES

Over the last five years, microfinance leaders—operating as members of the Philippine Coalition on Standards in Microfinance, and as representatives on the Credit Council—have helped policy makers in the Central Bank, Monetary Board and key ministries gain a deep understanding of microfinance, and establish a set of pro-poor, pro-microfinance policies and regulations. WWB has supported the initiatives of country leaders at key junctures.

Beginning in 1991, the government took a decidedly pro-microfinance stance and enacted legislation that was favorable to the sector. The National Strategy for Microfinance was adopted in 1996, and had as its principles:

- Creating a greater role for private sector MFIs in providing financial services.
- Building an enabling policy environment.
- Enacting market-oriented financial and credit policies.
- Ensuring the non-participation of government in provision of credit.

Some of the key measures taken by the Central Bank and Government of the Philippines—issued as policy statements, legislative changes, and administrative circulars—are the following:

- Exemption from rules on interest rates for microfinance activities, with a statement that interest rates charged on microloans should not be lower than prevailing market rates, to reflect the higher costs of making small loans, and to ensure the financial sustainability of microfinance activity.
- Government has removed itself from direct involvement in making microloans, eliminating over 100 subsidy-based, failed government microcredit programs.
- The risk on a financial institution's microloan portfolio is no longer evaluated on the basis of collateral, but rather on the aggregate portfolio quality and track record, with no collateral required, but with rigorous portfolio quality, provisioning and loan loss reserve requirements.
- For rural, thrift, and commercial banks that desire to build microlending as part of their core business, requirements include: a vision statement expressing commitment to reach low income clients; managers and staff with experience in microfinance; at least 20% of the paid-up capital needs to be by persons or entities with experience in microfinance; and the operations manual needs to be consistent with the core principles of microfinance.
- Rural, development and commercial banks that have microfinance as their principal activity are exempted from the moratorium on the establishment of new banks, and the moratorium on establishing new branches; rural banks established for microfinance are exempt from gross receipts tax for five years from license date.

Source: Circulars 272,273,282 and Rural Banks Act 1992.

E. Legal Structures that Work for Regulated Microfinance Institutions

In addition to building policies and regulations that fit the nature of microfinance as an activity—legal structures need to be built or adapted to enable a subset of strong microfinance NGOs to convert to regulated financial institutions that can mobilize public savings and rapidly expand commercial funding. Specialized legal structures for deposit-taking MFIs may be established or the parameters of existing legal structures can be modified to fit the needs of microfinance.

Sooner rather than later, many of the larger microfinance institutions will need to rely on a combination of equity capital, commercial loans, mobilization of institutional and individual savings, and bond issues to finance their growth. Recent experience indicates the advantages that regulated financial institutions have over NGOs in offering borrowers deposit facilities, mobilizing institutional savings, issuing bonds, and providing assurances to commercial lenders.

Bank regulation is established to protect savers, investors and the banking industry. It is now agreed in most quarters that:

- MFIs engaged exclusively in microlending—be they NGOs, trusts, or companies—need not be subject to banking regulation.
- Microfinance institutions that mobilize mandatory savings as a collateral substitute for borrowers and do not intermediate this savings should not be subject to prudential banking regulation.
- Except for small cooperative and other community based institutions, entities that mobilize more than small aggregate amounts of savings from non-borrowers should be subject to regulation, either by the central bank or its designated authority.

> There is still debate as to whether unregulated microfinance institutions should be able to mobilize voluntary savings from borrowers. Until recently, the consensus was that most microfinance borrowers will be net borrowers, meaning that, if the MFI were to fail, the borrower will owe more to the institution than the institution owes to the borrower. However, while this may be true in the aggregate, it may well not be true for all borrowers. What seems clear is that unregulated MFIs that mobilize savings from borrowers should deposit this savings in a bank, should not be free to use this savings to finance its lending portfolio, and should, and attempt to ensure that borrowings exceed savings at the individual account level as well as in the aggregate.

For specialized MFIs that seek to become regulated financial institutions, features of the available legal structures are key. In the Philippines, for example, available legal structures—commercial banks, rural banks, thrift banks and cooperatives—have been adequate vehicles to enable solid microfinance NGOs to convert to regulated financial institutions, without requiring modifications in the legal structures. In contrast, in Colombia, the only private equity structures are commercial banks and commercial finance corporations (CFCs). While local leaders are working with policy makers to make needed changes in the CFC structure, the present CFC structure offers few advantages to a microfinance NGO: CFCs have not been allowed to borrow from the banking system, CFCs cannot mobilize savings from the public, and CFCs have high minimum capital and capital adequacy requirements. Thus, until the needed modifications are made, a microfinance NGO converting to a CFC in Colombia would need to incur the increased costs of compliance, reporting, and taxation, with an actual reduction in powers to mobilize capital or integrate itself into domestic financial markets.

In several countries, including Bolivia, the Philippines, Gambia, Ghana Uganda and Pakistan, measures have been taken to create microfinance-friendly legal structures, that enable regulated MFIs to mobilize equity, savings, and commercial borrowings, and which reflect the nature of microfinance. Key dimensions include:

- **Relatively low minimum capital requirements.** Experience demonstrates that minimum capital requirements should be set high enough to discourage a plethora of small, weak, undercapitalized institutions, but low enough to encourage solid MFIs that wish to mobilize deposits from the public to enter the regulated financial system. Depending on country

contexts, the minimum capital requirements should probably be set at US$500,000 to US$5 million.

- **Appropriate capital adequacy ratios.** Views differ on whether capital adequacy ratios should be set at the same levels as for commercial banks (normally 8%) or higher. Normally, strong MFIs experience less volatility in portfolio performance than do commercial banks, meaning that an 8% would be conservative and prudent. However, as the Bolivian experience demonstrates, if there is deterioration in portfolio quality of MFIs, contagion across institutions can occur. While microfinance institutions tend to have highly diversified portfolios by sector and low concentration of portfolios, grass roots or political moves can create a run on microfinance loans. Thus, while this situation has occurred only rarely, a slightly more conservative capital adequacy ratio, or 10% to 12% may be justified. Furthermore, conservative capital adequacy ratios can serve to boost investor confidence in this relatively young industry, as investors learn how to evaluate microfinance institutions.

- **Ownership structures.** Regulations regarding the equity structures and ownership mix in regulated microfinance institutions will be key to the future of the industry. Regulations should be flexible, enabling a balance in stakeholders, which can include : the originating NGO; board, staff and clients of the originating and converted structures; domestic and international commercial and social investors. One worrying trend is the dominance of international donors and donor-funded funds in the ownership of some MFIs. It is important that the originating NGO have a substantial stake in the converted MFI ownership structure, to help ensure that the focus on the poor and high performance are maintained. Choosing domestic or foreign partners with knowledge on and commitment to sustainable finance for the poor is key. Experience demonstrates the value of having the originating microfinance NGO retain major interests and accountability in achieving the mission and performance; avoiding major interests by those donors or donor funded funds which do not have the depth of knowledge or sustained commitment to microfinance, and the importance of cultivating local commercial and social investors to reinforce local accountability.

REGULATIONS ON OWNERSHIP OF REGULATED MFIS

In the Philippines, the central bank provides for 100% local ownership in rural banks, the structure that CARD Bank adopted, and that other microfinance NGOs that seek to convert are likely to adopt. This policy reflects the belief that for relatively small banks that focus on financial services to local communities, locally-owned structures provide the strongest accountability. CARD Bank's ownership is comprised of the NGO, board and staff, and clients. This option may have underestimated the value of international investors as sources of funding and expertise.

In contrast, the draft legislation in Uganda for Microfinance Deposit Taking Institutions (MDIs), allows a single entity to own no more than 20% shares. In the context of Africa, this runs the risk of having regulated MFIs be 80% owned by international donors and donor funded international NGOs, facilities and banks. This formula introduces the risk of local institutions losing control.

High performance standards. It is essential that licensing requirements include norms that help ensure that only high performing microfinance NGOs are allowed to become regulated financial institutions. These norms and pre-requisites need to fit what works in microfinance;

bank supervisors responsible for reviewing the systems and performance of MFIs applying to become regulated institution need to understand the nature of microfinance.

- MFIs should be fully financially self-sufficient, with positive returns on assets, prior to considering conversion, or being allowed to convert. Even in microfinance-friendly policy environments, the conversion, compliance, and tax costs will create an additional burden on MFIs.
- Only those MFIs that have excellent portfolio quality, efficient and well-documented lending procedures, strong internal controls, and a strong track record of operating at reasonable scale of operations should be allowed to convert.
- MFIs that are converting should have begun work to build their capacity to mobilize savings and manage deposits prudently, if they intend to mobilize savings from the public.

Appropriate Tax Treatment. In some countries, MFIs may face cascading tax burdens, including tax on grants, profits, value added, and/or interest; these cascading tax burdens should be removed (See Box on Russia). In many countries, microfinance NGOs are not subject to taxation. Conversion to a regulated structure normally involves high conversion costs in addition to permanent cost increases due to regulatory and reporting requirements. The immediate introduction of high tax burdens can make this transition extremely burdensome. To encourage converting MFIs to maintain their focus on financing the poor, temporary tax relief may be justified.

TAXATION IN MICROFINANCE: CASE STUDY ON RUSSIA

The lack of a legal basis and an inadequate tax structure for microfinance activities in Russia for non-banking institutions has been a major obstacle for expansion of their own operations and for the development of the sector in general. In early 1999, The Russia Women's Microfinance Network (RWMN) identified these constraints; subsequently, RWMN built strategies to address these obstacles, with technical and financial support from WWB. The following are results to date:

- **Profit Tax on Grants**. On May 6, 1999, President Yeltsin signed a new law on non-taxable grants, which extended this tax exemption to NGOs involved in "technical support". Microfinance programs fall under the definition of technical support activities and therefore are now free to receive grant funding without paying 35% profit tax on the grant amount. These important changes in the law were incorporated due to the intensive advocacy work of RWMN and other NGOs. RWMN also influenced other key changes in the law that reduced burdensome requirements for foreign institutions that provide grant support to Russian organizations. The law was signed in May 1999.

- **Microfinance as a Main Activity for Non-Banking Institutions.** Again, due to efforts by RWMN, official letters from President Putin and Speaker of the Duma, G. Selesnev, were received by RWMN formally communicating that non-banking institutions engaged in microlending do not require licensing.

- **Value-Added Tax (VAT)**. Changes proposed by RWMN to the Law on VAT made it possible for non-banking institutions registered as private funds to be engaged in microlending activities and to be exempt them from the value-added tax. The Law was signed by the President in January 2000 and became effective immediately.

- **Interest Expense Deduction.** Amendments to Part II (Profit Tax), Article 25 of the Tax Code made it possible for non-banking institutions to deduct interest expense on loans from their taxable income. The Law was signed by the President in August 2001 and became effective in January 2002. This measure reduces

costs of MFIs working with borrowed funds, and also helps MFI clients who can now deduct interest expenses on loans obtained from MFIs.

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Prudential regulation is only as good as the supervision behind it. Until recently, most central banks and bank superintendencies have not seen the importance of understanding the nature and nuances of microfinance. Often, legislation and regulatory measures for microfinance have been drafted, without due consideration to the actual burdens of supervising many small, unconventional microfinance institutions. As some wise regulators say, do not regulate what you cannot supervise. It is important both to the regulated MFIs as well as to the regulators that reporting requirements be rigorous but simple. It is also important to anticipate the number of institutions that are likely to be regulated over a period, and to build this capacity in the supervising entity.

Regulation and Supervision of MFIs: The Case of Uganda

The Micro-Deposit Taking Institutions Bill of 2001 (MDI Bill) provides an example of regulation and supervision that allows those institutions that are ready, willing and able to mobilize deposits in a prudent manner to do so. By adopting a tiered structure to the regulation of microfinance activities, the MDI Bill creates an enabling environment for the continued development of MFIs in the country. It acknowledges that microfinance NGOs are a legitimate and important part of Uganda's financial system, acknowledges their unique needs, and furthers the capacity building of these organizations.

The MDI Bill creates a tiered system: Tier 1 institutions are commercial banks; Tier 2 institutions are licensed credit institutions; Tier 3 Microfinance Deposit-Taking Institutions (MDIs) may take deposits from the public and on-lend them to the public; Tier 4 institutions may only accept compulsory savings from clients, and Tier 4 cooperatives may take voluntary savings from members and on-lend them only to members. As part of the MDI Bill, an MDI Deposit Protection Fund will be established by the Bank of Uganda to protect depositors.

Of the approximately 500 MFIs currently in operation in Uganda, it is expected that only a very few (3 to 5) will qualify for MDI status upon passage of the MDI Bill. This means that the vast majority of MFIs in Uganda will not be subject to Bank of Uganda regulation and supervision. As these Tier 4 institutions grow, they may qualify for a Tier 3 MDI license and be subject to the provisions of the MDI Bill. There is currently a variety of Tier 4 organizations, including: approximately 10 to 15 medium sized MFIs (with 5,000 to 25,000 clients); approximately 40 smaller MFIs (with 500 to 5,000 clients); and a large number of MFIs with fewer than 500 clients.

To assist with the expansion of these Tier 4 institutions, the Ugandan Microfinance Network (AMFIU), with support from the Bank of Uganda and the Ministry of Finance have begun to develop a set of performance indicators that can be used as benchmarks for the various categories of Tier 4 MFIs.

Source: Micro-Deposit Taking Institutions Bill of 2001

Conclusions

Listening to the needs of poor clients and the institutions that serve them needs to shape the policies and regulations for microfinance. Poor clients say that they want:

- Access to loans that are provided quickly and close to their place of business.
- Facilities to deposit their voluntary savings.
- A range of financial products, including business, housing and education loans, various saving vehicles, and insurance.
- Access to financial services, not subsidies.

A policy environment that responds to the financial services that poor people want

- Encourages institutions to operate efficiently.
- Enables institutions to build delivery systems that go to the clients.
- Removes interest rate ceilings and subsidy cultures, encouraging competition as the means to reduce costs to poor clients.
- Encourages sustainable microfinance services and institutions, that grow with their clients--eliminating subsidized, short-lived government programs.
- Eliminates traditional collateral requirements that most poor clients cannot meet.

- Ensures prudential regulations that protect the savings of the poor.
- Removes policy barriers to the profitable provision of microlending, savings, insurance and pension services to the poor, to help poor people build economic activities and assets, and mitigate risks.

Microfinance needs to be recognized as a vital part of the financial system, dedicated to meeting the financial needs of poor clients in a responsive and financially sustainable manner. This financial systems approach recognizes the important roles that a broad range of regulated and unregulated institutions can and do play in providing financial services to poor people.

Shared performance standards, transparency and accountability are key to building solid and responsive services for poor households—for both regulated and unregulated microfinance institutions. Since prudential regulations will only cover a small number of those institutions involved in microlending, the role of microfinance networks, wholesale lenders, microfinance rating agencies, auditors and international funders will all be key in building transparency and performance standards in the microfinance industry. A strong consensus is emerging on the key indicators and definitions to measure outreach, efficiency, portfolio, profitability, capital structure and liquidity. These performance monitoring systems are not self-regulation. Rather they are important in building transparency and commitment to excellence in the microfinance industry.

Emphasis needs to be given to introducing changes that reflect the needs of microfinance operations—regardless of whether these are conducted by a specialized microfinance institution or form a small part of the overall portfolio of a commercial bank or finance company. The policy and regulatory framework for microfinance is to encourage entry and expansion of microfinance services by a broad range of regulated financial institutions, Increasingly, policy makers and regulators are recognizing microloans as an important and legitimate loan class, with its own features. Key policy and regulatory measures are:

- Removal of interest rate ceilings on microloans.
- Evaluation of risk based not on collateral, but on a rigorous evaluation of the aggregate quality of the microloan portfolio and operational soundness, with strict provisioning policies and reserve requirements.
- Rigorous, but simple, reporting requirements on microlending operations.
- Flexibility in establishing branches and distribution systems, including allowance of cash transactions outside branch premises, particularly in rural areas.

Prudential regulation is needed for those specialized MFIs that seek to mobilize savings from the public. Banking regulation need not apply to MFIs engaged exclusively in microlending, those that mobilize mandatory savings from borrowers as a collateral substitute or small community based institution that mobilize small amounts of savings from non-borrowing members. Debate exists on whether unregulated microfinance institutions should be able to mobilize savings from borrowers. If done, these savings should be deposited in a bank and not used to finance the microloan portfolio, and MFIs should seek to ensure that borrowings exceed savings at the individual account level as well as in the aggregate.

For the small but important subset of specialized MFIs that seek to become regulated financial institutions, new legal structures may be needed, or existing legal structures adapted to incorporate the following key features:

- Relatively low minimum capital requirements, in most contexts between US$500,000 and US$5 million.
- Appropriate capital adequacy ratios, normally between 8% and 10%.
- Availability of a range of appropriate legal structures.
- Flexible ownership structures that encourage strong participation by the originating microfinance NGO, dominant local control, and a balance of stakeholders which can include, in addition to the originating NGO: board members, staff and clients; local and foreign commercial and social investors. Dominance by donors and donor-funded funds should be avoided.
- High performance standards for those MFIs seeking to become regulated entities.
- Appropriate tax treatment, including provisions for temporary tax relief for those MFIs that convert.
- Limitations in banking supervision capacity recognized and addressed.

Increasingly, financial sector policy makers are recognizing the importance of microfinance, understanding its special features, and working with local microfinance leaders to ensure that the needed changes are made in financial sector policies, regulations and support systems to encourage the growth of a sound, responsive financial system that works for the poor majority. While consensus exists on the key features of pro-poor financial systems, policies, regulations and support services need to be designed to respond to each country context.

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Ownership Composition by Investor Type
Selected MFIs
(Latest available data, 2000 - 2002)

Name	Country	Foreign			Local			
		ID	PFI	Total	LNGO	LCI	LGSI	Total
CARD	Philippines			0.00%	100.00%			100.00%
PRODEM	Bolivia			0.00%	83.64%	16.36%		100.00%
BancoADEMI	Dominican Rep	17.00%		17.00%	83.00%			83.00%
EcoFuturo	Bolivia	22.02%		22.02%	75.21%	2.77%		77.98%
CERUDEB	Uganda	24.00%		24.00%		4.60%	71.40% (1)	76.00%
FIE	Bolivia	24.11%	1.75%	25.86%	70.14%	4.00%		74.14%
Mibanco	Peru	29.47%		29.47%	61.43%	9.10%		70.53%
Compartamos	Mexico	32.50%		32.50%	62.80%	4.70%		67.50%
BancoSolidario	Ecuador	40.61%		40.61%	36.26%	23.14%		59.39%
FINAMERICA	Colombia	41.31%		41.31%		4.59%	54.10% (2)	58.69%
CALPIA	El Salvador	41.85%		41.85%	40.40%	0.21%	17.54%	58.15%
Caja los Andes	Bolivia	46.70%		46.70%	46.90%	6.40%		53.30%
ACLEDA	Cambodia	49.00%		49.00%	51.00%			51.00%
XacBank	Mongolia	58.59%		58.59%			41.41% (3)	41.41%
K-Rep	Kenya	61.20%		61.20%	38.80%			38.80%
BancoSol	Bolivia	73.45%		73.45%	23.64%	2.91%		26.55%

(1) Mainly religious foundations
(2) Mainly government development bank
(3) Local NGO investors

ID: International Donors and Donor-backed Investors
PFI: Private Foreign Investors
LNGO: Originating NGO, Board, Staff, Clients
LCI: Local Commercial Investors
LGSI: Local Government and Social Investors

Sources: Institutional annual reports, Virtual Microfinance Market website, Microfinance Network website, MicroRate rating report, Institutional websites

Most Regulated MFIs rely on Institutional Not Individual Deposits (US$ equivalents, end 2000)

Name of MFI	Gross Portfolio Outstanding	Active Deposits	AD/GPO	Active Deposits Institutional	Active Deposits Individual
Caja los Andes	52,633,750	25,278,962	48%	74%	26%
PRODEM	33,627,864	25,280,800	75%	84%	16%
BancoSolidario	72,221,000	44,590,000	62%	86%	14%
Fincomun	3,500,000	8,500,000	243%	89%	11%
BancoADEMI	64,875,950	25,265,700	39%	92%	8%
FIE	27,483,000	11,025,000	40%	98%	2%

Institutional deposits normally refer to time deposits mobilized from a narrow set of institutions, often being other financial intermediaries.

Statements of Core Principles in Building Financial Systems That Work for the Poor Majority

	India Consensus Report—1998	**AFMIN Consensus—2002**	**Country Scorecard—2000**
Microfinance is one of the effective means to reduce poverty.	X	X	X
Poor entrepreneurs want rapid and simple access to financial services, not subsidies.		X	X
Microfinance is about investing in people and institutions, rather than subsidizing clients or relying on permanent subsidies for microfinance institutions.		X	X
Institutions engaged in microfinance should be able to charge the interest rates needed to cover the high costs of making small loans, and to become sustainable.	X	X	X
Laws and regulations should encourage a range of legal structures to provide financial services to poor people, including credit and savings cooperatives, NGOs, regulated microfinance institutions, finance companies, and commercial banks with microfinance portfolios.	X	X	X
Regulation and supervision should fit the various stages and legal structures of organizations engaged in microfinance.	X	X	X
Performance standards, prudential norms and regulations, and reporting requirements should fit the characteristics of the microfinance sector, for example: reliance on overall portfolio performance rather than on traditional collateral on loans.	X	X	X
Microfinance institutions (MFIs) that meet appropriate safety and soundness standards should be given the regulatory structures that allow them to mobilize voluntary savings from borrowers and from the general public.	X	X	X
Appropriate legal structures are needed to enable institutions engaged in microfinance to be financially viable, to meet the needs of target clients and to mobilize domestic and international resources.	X	X	X
Favorable tax treatment can encourage the development of the needed infrastructure in microfinance institutions, and reflect the high costs of providing financial services to poor people.	X	X	X

Examples of Regulation under Banking Law and Special Microfinance Legislation

	Country	Nature of Legislation/Clauses
Under banking legislation	Bolivia	BancoSol became a commercial bank under banking legislation.
	Kenya	KREP Bank was established as commercial bank, with only one adjustment to banking law dealing with regulations on branching.
	Philippines	Prior legislation allowed small, medium and large banks to mobilize savings: commercial banks as well as rural banks, as well as thrift and cooperative banks. In 2001 and 2002, Central Bank Circulars made adjustments to reflect the needs of microfinance.
Special Legislation	Bolivia	Specialized structure—Private Financial Funds—enabled four microfinance NGOs to convert to for-profit, regulated equity structures. They are able to mobilize institutional and limited individual deposits.
	Colombia	Commercial Finance Company (CFC)—draft law would reduce minimum capital and capital adequacy requirements, and allow CFCs to borrow from financial institutions and mobilize savings from the public.
	Uganda	New legislation recognizes four sets of institutions for microfinance: commercial banks, cooperatives, deposit-taking MFIs, and microfinance NGOs. Only those specialized MFIs that mobilize and intermediate voluntary savings will be regulated. Four to six of the 500 microfinance NGOs are expected to convert into deposit-taking MFIs over the next three years.

Annex 5

REGULATORY COMPONENTS, CHALLENGES AND SOLUTIONS FOR MFIs

Components of Regulation	Hurdles for MFIs	MFIs' Needs	Solutions
Licensing requirements	Conditions may be too onerous.	Simple procedures and documentation; enough time between granting of license and establishment of new institution.	Simple, straightforward licensing requirements, reasonable time-frame.
Minimum capital requirements	Minimum capital requirements are often barriers to entry.	Entry capital requirements that are reasonable.	Low minimum capital requirements, commensurate with risk profile of MFI.
Capital adequacy	Higher capital adequacy ratios than for traditional banks (under the Basle Committee guidelines).	Fairness across institutions.	Fairness in how assets are held.
Liquidity / Reserves	Requirements may be onerous; costs of maintaining reserves.	Adequate protection in base of downturn.	Fairness in how assets can be held.
Restrictions in the amount of lending without collateral	Rule on secured lending.	Unsecured loans or use of non-traditional collateral, generally without conventional collateral on microloans.	Require outstanding aggregate portfolio performance—based on portfolio at risk, with adequate loan loss provisioning and reserves.
Provisioning	Rules may be too complex.	Adequate provisioning is important in order to protect a loan portfolio not backed by collateral.	Clear rules and reporting requirements; not too many risk categories.
Reporting requirements	Heavy reporting requirements. Ratios institutions are required to report on may have different meanings, loan documentation requirements too heavy.	Simple reporting requirements focusing on overall performance indicators, generally without requiring reporting on individual loans.	Rigorous, but simple reporting requirements with MIS of MFI producing key reports.

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Restrictions on operations	Branching limitations; too much interference into operations.	Decentralized branch /delivery structures, with flexibility on the location of new branches, and convenient hours of operation. Transparent and needs-based hiring and remuneration.	Freedom to operate; regulations based on assuring sound governance and professionalism, but not interventionist in terns of freedom to operate.
Ownership and equity	Limitations to ownership; Central Bank approvals.	NGO may be positioned to be principal shareholder; institution may want to have local ownership dominate with limited partnership of foreign investors.	Regulations which allow more concentration in ownership than for traditional banks; foreign investors may enter with relatively small share of capital.
Management	Requirements may not fit profile of those leading microfinance.	Need governance and management structure with strong skills in banking and microfinance.	Requirement based on what it takes to make an MFI work.
Systems and Procedures	Expenditures regarding MIS, internal audits may be too high for smaller MFIs.		
Performance Standards	Performance indicators and standards often geared to commercial banks.		