to an inventory of MFIs produced by the Consultative Group to Assist the Poorest (CGAP) (Christen 2000, 46), 77 of 205 MFIs in over 23 Latin American countries in 1999 were regulated MFIs that in total had a loan portfolio of 808 thousand active clients worth US$649 million. The 128 unregulated MFIs had a total loan portfolio of 712 thousand active clients worth US$229 million. In Asia, the situation is diverse. In Indonesia, for example, a range of regulated financial institutions including a state-owned commercial bank, rural banks, and other smaller financial institutions target poor households, outweighing unregulated MFIs. On the other hand, in Bangladesh, where microfinance has far greater outreach than in other countries in the region, there is virtually no specific regulation for microfinance except in the case of Grameen Bank; therefore, other large MFI programmes are operating without explicit regulatory framework together with a large number of small NGOs.[1]

2.3 Forms of Transformation

16. We have so far discussed MFI development by assuming a more or less *linear* institutional evolution starting from a green field project. However, the institutional arrangements to involve microfinance are not only in such a form, but also in the form of extended operations of existing financial institutions, such as commercial banks, specialised banks, credit cooperatives, and saving and credit unions. From various forms of transformation to an MFI, we may sort out three major patterns: (i) NGOs transforming to banks; (ii) banks intervening in the microfinance market; and (iii) cooperatives or credit unions (or other self-help groups) incorporating microfinance technology.

2.3.1 NGOs transforming to banks

17. The world's first private commercial bank to specialise in microfinance, Banco Solidario, S.A.(BancoSol), Bolivia, appears to have provided a prototype of the transformation of this type. The establishment of BancoSol in 1992 was an evolution of a successful microfinance NGO, Fundacion para la Promocion y Desarrollo de la Microempressa (PRODEM), a joint venture created in 1986 between the local business community and a U.S.-based international NGO who was already operating throughout Latin America (see box 1 for the evolution of PRODEM). Similar transformations have thrived in many countries in Latin America since the late 1980s. It is obvious that the transformation into a bank ensures business expansion,

[1] Rahman (2000, 52) reports that more than 1,000 NGOs are currently involved in microfinance activities in Bangladesh.

including greater savings mobilisation and easier access to commercial funds, since the increase of outreach fulfills the dual missions of MFIs: to be more effective in serving the poor and to be financially sustainable as an institution.

Box 1 **BOLIVIA**
Transformation from an NGO to a bank
BancoSol

Fudación para la Promoción y Desarrollo de lar Microempresa (PRODEM) was established in 1986 as an NGO to provide small-scale activities with access to credit. PRODEM was already achieving rapid growth by the beginning of the 1990s; however, the rate became constrained by limitations in its status and in 1992 Banco Solidario S.A (Bancosol) was established as a specialised bank solely engaged in microfinance operations. Seventy-five percent of the bank is owned by NGOs and donors, including PRODEM.

Vega et al.(1996, 28) states that "rapid growth at Bancosol has been based upon some unusual initial conditions, represented by the stock of tangible and intangible assets accumulated during the PRODEM stage." Upon the bank's establishment, PRODEM had transferred a loan portfolio of about 14,300 active clients worth US$3,960,000 (ibid.). At the same time, it had transferred intangible assets which had contributed to PRODEM's growth over the years, such as lending technology, information capital, human capital, and commitment to the mission (ibid., 5).

Transformation into a formal financial entity enabled easier access to commercial funds that could be substituted for donor funds. As of 2001, the bank has more than a thirty percent market share of microfinance operations and is the largest bank in the country in terms of number of clients. It has thirty-five percent of all borrowers of the banking system. Also the bank has been ranked among the top three banks in terms of solvency, liquidity and capital adequacy.

Source: Claudio Gonzalez-Vega, Mark Schreiner, Richard L. Meyer et al (1996) BANCOSOL *The Challenge of Growth for Microfinance Organizations*, The Ohio State University Bancosol http://www.bancosol.com.bo

18. The transformation into a bank appears to ensure the following changes in MFIs:
    - They acquire a more stable institutional form and a long-term institutional base.
    - They secure more appropriate and sustainable funding sources (from the financial markets) and financial independence.
    - They commercialise and integrate microfinance into the mainstream financial markets and establish microfinance in legitimate financial institutions.
    - They improve governance, management and transparency, through ownership and capitalisation.

19. Obviously, much is required if NGOs are to upscale and be formalised. According to Alip

(2002, 6), the following elements are crucial to the successful transformation of MFIs into a formal financial sector:

- Adherence to best methodological practices
- Appropriate interest rate setting—not subsidised but rather set at the market rate
- Installation of a strong MIS
- Systematic and rigorous human resource development
- Incentive package to reward staff productivity in saving and lending
- Financial and operational sustainability
- Broad based ownership structure
- Good governance
- Continuous loans and savings product development according to the demand
- Product diversification

Alip (2002, 6)

20. However, the ultimate motivation to become a bank quite depends on individual institutions and their countries' particular environments. Excluding the case of NGOs with philosophies that would not seek the transformation into a bank (for example, a prevailing social mission to be remaining as a non-profit entity), there are many factors which determine whether the transformation into a bank is advantageous or not. The most influential is the regulatory environment in a country: the entry requirement, the prudential regulations and other obligations in line with the monetary authorities or supervising ministry, the financial services that banks are permitted to offer, etc. If the regulatory framework is relatively comfortable for NGOs to be remaining as a NGO—according to its stage of institutional development, for example—, transformation into a bank may not be the desired option.

21. In Cambodia, where licensed NGOs are well categorised in the formal financial system as MFIs, together with clear rules on licensing and permitted services, such decision may be a rational choice (see EMT's case in Cambodia[box 2] and the Cambodian financial institutions in section IV). Another example with entirely different implications is Bangladesh. Except for a special law stipulating the Grameen Bank, there is no specific legal framework for MFIs; at present NGOs are not permitted to take deposits from the public or even to on-lend the savings of loan clients. However, since this is not enforced in reality, a large number of NGO programmes, including quite big MFIs such as BRAC, ASA, and Proshika, are operating under a somewhat unclear legal position.

Box 2

CAMBODIA
Choices—to be or not to be licensed as a bank
Ennatien Moulethan Tchonnebat

Ennatien Moulethan Tchonnebat (EMT) is one of the two licensed MFI NGOs in Cambodia. It was initially established as a rural credit project in 1991 by a French NGO, Group de Recherche et d' Echanges Technologiques (GRET), in cooperation with the Ministry of Agriculture, with a mission and vision to provide financial services to rural areas. Ten years after its foundation, EMT has now a loan portfolio of more than 74,000 clients worth approximately US$3.3 million. There are seven branches throughout nine provinces.

History of EMT:

- -1994 MFI became independent from GRET.
- -1997 EMT transformed from a project into an MFI, followed by its managerial transfer to local staff in 1998.
- -2000 EMT became a private company registered with the Ministry of Commerce.
- -2001 EMT was licensed by the National Bank of Cambodia.

Continuous development of human resources is one of the key elements in EMT's achievement. EMT seems to have carefully arranged its staff training and capacity building. Even after its independence from GRET, technical assistance was continued by GRET (from 1991–1997). EMT plans to continue training through on-the-job training, study tours in other countries and so on. The current budget for the training is subsidised by USAID until 2003.

The transformation of an NGO into a licensed microfinance bank implies expansion of services and operational capacity. Yet it is important to note that not all MFIs opted to be licensed as banks. In Cambodia, where MFIs are categorically organised and the areas of capacity for each legal status is clearly defined, MFIs may fully utilise their legal status even without registering to be a bank.

For example, EMT wishes to remain a licensed NGO for at least another five more years. During that period, EMT plans to achieve expansion to other provinces and increase the number of its financial products. Village assessment for geographical expansion will be carried out in terms of security, credit need, and business activities of clients in the targeted regions. EMT believes these can be better achieved under its current status as a licensed NGO rather than rushing into a specialised bank.

The examples of EMT suggest a more moral and philosophical manner of microfinance operation. In the case of EMT, horizontal expansion is valued rather than vertical expansion. The tiers of clients served do not seem to have changed as the operation scale has expanded, whereas ACLEDA has changed its target client over time from rural very poor to small and micro entrepreneurs. In other words, for EMT provision of good services to a large number of poor clients is more attractive than targeting large-loan clients, regardless of financial viability.

Authors' interview notes as of 13 March 2002

22. Nonetheless, the transformation into a bank is a mainstream process that MFIs aim at, and the number of microfinance banks worldwide has been increasing since the 1990s in accordance with the emergence of more supportive and elaborated legal and regulatory frameworks that take into consideration the microfinance specificities. For example, the Kenya Rural Enterprise Programme (K-Rep) evolved into K-REP Bank in 1994 after a long process after its establishment as an intermediary NGO in 1984 (see box 3). CARD Bank was established in 1997 as the first microfinance bank in the Philippines, with a status of rural bank (see chapter II). The Association of Cambodian Local Economic Development Agencies (ACLEDA) achieved rapid transformation into a specialised bank (ACLEDA Bank, established in 1998) after only six years of operations as a donor-supported NGO (see box 4). One important aspect that is common in these examples is that the attempt for transformation into a bank was not feasible if the monetary authorities had not created an enabling environment for MFIs. This aspect will be discussed in section IV.

Box 3 **KENYA**

The elements for successful transformation of MFIs

The Kenya Rural Enterprise Programme

The Kenya Rural Enterprise Programme Bank (K-REP Bank) is the first microfinance commercial bank in Kenya. It was established in 1984 as a five-year project to be an intermediary NGO that provides on-lending, training, and technical assistance to local NGOs, with assistance from US based NGO-World Education Inc. In 1987, another five-year project was followed by the United States Agency for International Development (USAID). During those periods, K-Rep experienced substantial growth in its development.In 1994, K-Rep decided to transform its microfinance operation into a commercial bank with the following purposes:

+ To achieve institutional and financial sustainability through improved governance and increased profitability
+ To balance management time between profitable microfinance and complimentary services that usually require some degree of subsidisation
+ To gain access to additional sources of funds

(Rozengard et al. 2000, 1)

In 1997, K-Rep found a partner, and in 1999 the Central Bank of Kenya licensed it as the first commercial bank for microfinance in Kenya.

As of 31 December 2001, the bank has total assets of K Sh 1.17 billion[1]. It has five branches, and twenty-one sub-branches.

[1] K Sh 1.17 billion is about US$15 million.

Box 4

CAMBODIA

How a project transforms into a commercial bank

ACLEDA Bank

Cambodia is a country where eighty-five percent of the population are living in rural areas.[1] According to an ADB report in 2000, about forty percent of the population are living in poverty, of which more than ninety percent are in rural areas. The credit demand in rural areas is substantial, yet the financial services have been very limited due to the lack of infrastructure and appropriate financial systems. Consequently, about forty percent of the rural population do not have access to commercial bank branches (ADB 2000, 3).

The Association of Cambodian Local Economic Development Agencies Bank Limited (ACLEDA Bank Limited) is one of the two licensed privately owned specialised banks in Cambodia. It was initially established by the UNDP and ILO as a "small/micro-enterprise development" project in 1992. Consequently a small project to provide credit at an interest rate of 10% per year began, through a national NGO for small/micro-enterprise development.

Since then, ACLEDA has experienced rapid growth with assistance from international donors, which has assured international donors that its operations are viable and that it has the potential to be a commercial bank. Via policy changes beginning in 1995, ACLEDA fully transformed into ACLEDA Bank Limited in 1998, and was licensed as a specialised bank by the National Bank of Cambodia. In the same year, the bank achieved financial sustainability.

As of the end of January 2002, ACLEDA had more than 80,000 clients with a total loan disbursement of more than $140 million. There are sixty-seven branches in the fifty-three districts. It has now more than 600 staff nationwide. ACLEDA has experienced a massive expansion in less than ten years, with substantial support by donors. Now ACLEDA has a mission to be formally registered as a commercial bank, together with its mission to expand services in the future.

In the case of Cambodia, there are virtually no formal financial institutions, either private or public, in the rural areas; commercial banks focus only on urban and suburban areas. This is a main reason why ACLEDA Bank achieved a surprisingly rapid expansion. Furthermore, donor technical assistance and financial support were keys to the rapid business expansion, particularly in the area of IT and the establishment of chartered accounts. As transforming an NGO into a bank does not just imply the institutional changes but also organisational culture changes, training for staff was also important.

1 ADB, *Report and recommendation of the president to the board of directors on a proposed loan to the Kingdom of Cambodia for the Rural Credit and Savings Project*, 2000.

2 ADB estimates that "the total demand for rural credit is about US$80–130 million, with the unmet demand of $50–100 million" (ADB 2000, 4).

3 Authors' interview notes with Mr. In Channy, General Manager as of 12 March 2002.

2.3.2 Existing banks intervening in the microfinance market

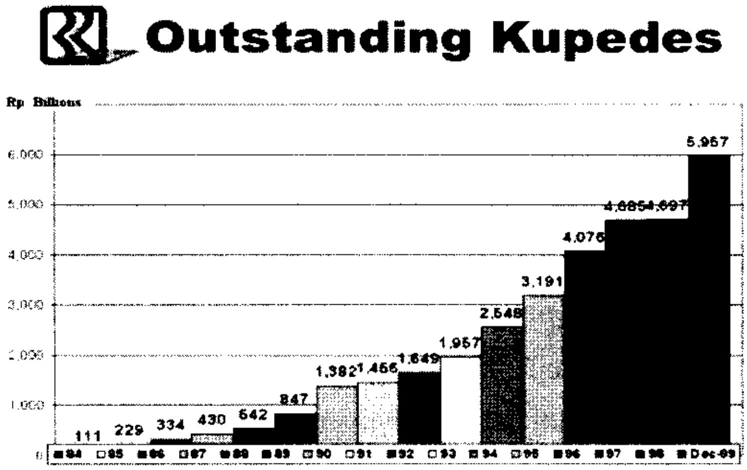
1) Case of state-owned banks

23. Traditionally, agricultural development banks have been established to increase farm household income by providing subsidised loans to rural households, and thus the fight against poverty has been an important part of their mandates. However, highly subsidised loans or direct credit schemes by state-owned banks failed in many developing countries due to various factors such as political interference, inefficient lending mechanisms, and lack of transparency in operations. Their operations often resulted in a high dependency on external funds, high delinquency rate, and, to the extreme, bankruptcy. But a number of governments are positive about restructuring those intermediaries, and one of the options then is to increase their engagement in microfinance operations.

24. Agricultural development banking and microfinance activities differ critically in terms of target clients, as well as institutional mandates and lending methodologies. The former focus exclusively on farmers and farming activities and the latter target poor households, including non-farmers; the former target an increase in production of agricultural products, often for a specific list of crops, and the latter aim at providing poor households easier access financial services. However, given the dominance of the agriculture sector in the national economy of developing countries on one hand and the large overlap of rural poor and the population engaged in farming activities on the other hand, the motivations for agricultural development banks to incorporate microfinance activities are legitimate.

25. Therefore, it is not surprising that one of the most successful and extensive microfinance networks in the world is that of an Indonesian state-owned bank, Bank Rakyat Indonesia (BRI). The BRI Unit Desa was established in the 1970s to meet the financial demand for an Indonesian rice intensification programme (BIMAS), a subsidised credit scheme. It was operated successfully to the 1980s but started to stagnate in the 1980s. Yet as the demand for its services was high and the number of it trained officers was large (Otero 1994, 209), a transformation to efficient operation of BRI without abolishing the department was desirable. As a result, microfinance operations were introduced and BIMAS was abolished. Its operation was decentralised, aimed at cost effective operations and a sound mechanism as a lean unit In Indonesia, a new regulatory framework was established accordingly, and the BRI moderately started to show favourable profitability. For example, its credit instrument

'*Kupedes*', has shown rapid growth since its outset. Otero concludes that the transformation of Unit Desa represents 'a significant policy shift within the government toward the financial sector' (1994, 209).



In Indonesia, a new regulatory framework was established accordingly, and the BRI moderately started to show favourable profitability.
For example, its credit instrument 'Kupedes', has show rapid growth since its outset. Otero conclude that the transformation of Unit Desa represents 'a significant policy shift within the government toward the financial sector' (1994, 209).

26. Generally, there seem to be two broad strategies for agricultural bank engagement in microfinance operations. One is to introduce new organisational and functional structures that are appropriate for microfinance—possibly accompanied by the closing of non-profitable business lines and/or the creation of a microfinance special unit. The other option is to be fully transformed into a wholesaler to individual MFIs. Rhyne and Christen (1999, 16) argue that these can be carried out "with or without the financial restructuring (i.e. new capital infusion) or privatisation." In either way, there are some key aspects that those institutions might face during the transformation period. Rhyne and Christian (ibid.) pointed out the following possible benefits of microfinance via state-owned commercial bank operations:
   - Possible utilisation of existing network for immediate channels for market penetration
   - Wide operational service areas (savings and loans)
   - Access to resources needed during the transformation period

27. First, utilisation of an existing network would be a critical advantage for the start of microfinance operations and is the most convincing rationale for state-owned banks to intervene in new markets by exploiting physical assets already invested in rural areas. With their extensive branching all over the country and the geographical knowledge of their staff members, banks have a wide outreach that forms a base for effective operations in microfinance. Second, the existing organisational framework will allow those banks to operate

both savings and loans, as the new operations can be also categorised as a part of the formal banking sector. This will not only enable banks to respond to the demand, but will also them to be innovative in creating new services according to their clients' needs. And third, state-owned banks have easier access to resources from the government and donors than do private banks or smaller players in microfinance. Although the ultimate objective for those institutions is sustainability, both financially and operationally, it has been widely experienced that "The best known examples of commercialisation … depended on donor funding and specialised technical assistance in their early stages of development and were ultimately driven by altruistic motivations" (Rhyne and Christen 1999, 2). In this sense, state-owned banks, which are accustomed to external finance, have easier access to other sources for new operations, as far as their accountability is sufficient for financiers.

28. Even though the use of an already existing entity has various advantages over the creation of a new institution, there still are some challenges that have to be overcome in the transformation process.
    - Organisational changes
    - Low productivity
    - Lack of incentives and accountability
    - Political interference
    - Lack of understanding of basis for lending to informal sector borrowers

    (Rhyne and Christen 1999, 17)

29. It is important to note that introducing a microfinance operation into an institution implies a drastic shift in its organisational culture. The management and staff have to learn the new lending methodology as well as the nature of the new target clients. The organisation in the new environment should be much more profit-oriented and thus the development of more client-oriented lending methodology will be required along with the transparent restructuring of the organisation.

30. Also, in many developing countries state-owned banks have been exposed to political interference. The benefits of microfinance are often cultivated as a political agenda, which consequently leads to high corruption and, thus, lack of confidence by the potential clients. In new institutional forms, the client segments for microfinance operations will be smaller; thus, transparency and accountability will be increasingly crucial to the entity's outreach. Overcoming political interference will largely depend on to what extent the institution or

the department can enjoy its own autonomy. The politicised ownership structure and governance often limits the potential growth of banks. Operations are particularly influenced by the restructuring policy for the entire banking system,[2] even when the department has maintained sound microfinance operations. Therefore, as Rhyne and Christen (1999, 17) suggest "it remains to be seen whether these operations can be given a new, secure institutional home."

31. In this regard, a challenge faced by Thailand's Bank for Agriculture and Agricultural Cooperatives (BAAC) is very relevant to whether or not a state-owned bank's transformation is eventually effective (see box 5). BAAC, another giant state-owned bank in Asia, with a tremendous number of outlets in rural areas, is said to be one of the most successful agriculture banks in the world. After as long as thirty-six years of operation, BAAC has now more than five million households as clients through its 15,000-branch network. The BAAC's penetration in villages is reported to be more than ninety percent of the country. In line with extension of financial activities not only to farming but also to farming-related economic activities, it has stepped forward to provide microfinance services to non-farming activities—though this is yet at the experimental stage.[3] It appears that BAAC has been searching for a way to transform into a rural development bank that offers more comprehensive financial services to the population.

32. Likewise, combining the outreach and viability is a challenge to sizable banks that have extended networks in rural areas—in fact, more so than to anybody else. It seems that a key to success is to maintain the advantages of state-owned banks; therefore, the evolution in mandates and organisational structure should not undermine them. As Seibel points out (1999), "a favourable financial sector climate, an effective demand for rural financial services, and a real commitment to profitability and sustainability of operations are essential (as preconditions for successful reform of agricultural development banks)."

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[2] Rhyne and Christen introduced the example of Jamaica's Worker's Savings and Loan Bank, profitable microfinance operations through post offices. The operational future became uncertain when the regulatory authority intervened into its core banking department (1999, 17).

[3] BAAC is not permitted to provide financial services to non-farmers. However, the rural households in Thailand have been so diversified that non-farming activities in farmers' households constitute a large part and their demand for consumption and investment in non-farming call attention of BAAC, given that commercial banks are not likely to address this market.

Box 5 THAILAND

Transformation of the Agricultural Bank to the Rural Development Bank

Bank for Agriculture and Agricultural Cooperatives

The Bank for Agriculture and Agricultural Cooperatives (BAAC), well known as one of the successful models of agricultural finance in the region, was established in 1966 as an agricultural development bank in Thailand. It has provided funds to more than 5 million farmers with its better than ninety percent penetration rate in the rural areas, and has contributed greatly to agricultural development in the country. Since the 1990s, however, there has been some shift in its demand for loans—from those for agricultural production to those for agricultural related activities. Furthermore, recently the bank has introduced a microfinance scheme for non-agricultural activities. In other words, the Bank is shifting its operation—from that of an agricultural development bank to that of a rural development bank.

During this transformation period, the bank has put great emphasis on its potential microfinance operations. Two major initiatives have been taken so far: (1) the Social Support Project, financed by the EU and (2) various programmes by Deutsche Gesellschaft Fuer Technische Zusammenarbeit (GTZ). Yet there is a challenge ahead as microfinance operation is a new concept in the bank.

To enhance the organisational capacity of BAAC, there have been a number of initiatives taken. For example, a new training scheme called *Service Culture* has been introduced with collaboration between GTZ and BAAC. The scheme aims to introduce the service mechanism into the bank, where traditionally the client's orientation was not highly valued. Under this scheme, training for trainers was organised: sixty personnel were trained in three years to become facilitators for the subsequent training of 10,000 staff members through BAAC's own financing initiatives. Clearly, this training has been effective in the new competitive environment surrounding the bank: as of 2002, the bank's clients were indicating satisfaction rates of more than ninety percent with BAAC's services.

Similarly, GTZ has introduced its Competency Plus scheme to increase the product knowledge of staff members. The scheme provides lesson plans designed on cash flow matching and repayment structuring, client information, and cross selling. Every staff member is required to know about all the products offered by BAAC. Also, as ninety percent of farmers now have income from non-agricultural activities, field officers should grasp each client's entire income flow in order to understand the overall financial picture. With this scheme, staff will be able to fully utilise the bank's product and provide effective service to a wide range of clients.

The bank is continuing its innovative approaches to its services. It has now tested non-farming lending as a new market segment of the bank (by introducing microlending in selected branches as part of its main operations in the transformation process). Success in these initiatives is yet to be seen, as institutional change cannot be achieved over night.

[1] Microfinance Linkage Project: Thailand 1994–2004 GTZ.
Authors' notes from an interview with Ms. Marie Luise Haberberger, GTZ.

2) Case of private commercial banks operating microfinace[4]

33. Historically, in many developing countries, financial institutions had been repressed with tight interest rate controls and reserve requirements, often resulting in credit rationing and fairly low interest rates. With the financial liberalisation in the 1980s, however, private banking operations expanded rapidly, providing free entry to potential new banks (Baydas and Graham 1997, 2). At this time, even though the regulatory environment became more favourable to overall banking operation, banks opted to concentrate on large business groups rather than small business entities. As the liberalisation went on and the emergence of new banks increased competition in the market, however, banks had to find ways to survive in the industry, and struggling banks were forced to look at new markets, "including the microfinance market" (Baydas and Graham 1997, 2).

34. Yet, in most cases, as seen from worldwide experience, the engagement of commercial banks in the field of microfinance has been limited to specialised financial institutions, *mostly transformed from a NGO into a microfinance specialised bank*. There has not yet been a sizable flow of already existing banks entering the microfinance market. Baydas and Graham (1997, 2) pointed out that this is due to the banks' perception of microfinance as being "too risky" and "too expensive" business and as having "socio-economic and cultural barriers" to those marginalised in the society, often impeding them from active initiatives in the market. Overall, microfinance operation is still considered non-profitable and thus should be left in the care of charity or the public sector domain. Therefore, commercial banks have not been main entrants into microfinance. Yet, "with a more widespread diffusion of innovations in financial methodologies, reducing the risks and costs of microlending, more banks will begin to incorporate microentrepreneurs into their portfolios (Baydas and Graham 1997, 2)."

35. The following several advantages make private commercial banks good candidates in the area of microfinance:

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[4] *As regards the interaction between commercial banks and microfinance, there is another important* aspect of financial linkages between private banks and MFIs—a separate issue from direct intervention by banking institutions into the microfinance markets. This aspect is touched upon as an issue of governance in section III in this chapter. Otherwise, see Garber (1997), for example. It would be better to deal with this issue from the viewpoint of overall financial leverage of private funds (including, but not exclusively, those of private banks), through equity participation, investment, and loan provision to MFIs.

- Being formal financial institutions
- Having physical structures
- Having well-established internal control and ownership structure
- Having independent sources of funds

Along with the positive aspects, however, are the following significant weaknesses:

- Lack of experiences in financing the poor
- Lack of commitment
- Required changes in financial methodology
- Need to be cost effective
- Need to develop human resources
- Need to adapt to new regulation and supervision

36. Nevertheless, the attention of commercial banks to microfinance markets has clearly emerged. In Latin America, traditional banks and finance companies constitute a significant segment as players in the microfinance markets. According to the CGAP inventory (ibid.) on MFIs in Latin America, this group served 337 thousand clients in 1999, as large as twenty-two percent of all clients of MFIs surveyed. Examples include Banco del Estado in Chile, Banco do Nordeste in Brazil, and Banco del Pacifico in Ecuador. This illustrates the highly competitive character of traditional financial entities in the Latin American microfinance markets, according to Christen (Christen 2000, 46).

37. Christen states that it is possible to distinguish two different sub-groups: commercial banks that see the microfinance market as a new niche market (as part of their overall operations) and consumer finance companies. It is reported that the former is the prevailing type in Chile, where the government even directly subsidises the entry of commercial banks into the microfinance market (government auctions off a relatively small lump-sum subsidy for each loan a bank makes, with the bank assuming all credit funding and risk). As a consequence, three large banks now offer microcredit to about 700 thousand microenterpreneurs.

38. We also find an example of a commercial bank intervening in the microcredit markets in Sri Lanka: Hatton National Bank (HNB, see box 6). HNB is "a rare example of a microfinance programme undertaken and carried out by a private commercial bank without reliance on government funding or incentives" (Gallardo et al. 1997).

Box 6 — SRI LANKA

Microfinance operations in private commercial banks

Hatton National Bank

Hatton National Bank (HNB) is one of the largest private banks in Sri Lanka. It was established in 1970 and has a large portion of population in the country with various services such as personal banking, corporate banking, commercial credit, corporate finance services, and international bank.

Historically, HNB has targeted plantation industry and its related activities. Also, according to Gallardo et al., the bank participated in World Bank–sponsored small- and medium-scale industry (SMI) loan programmes from the late 1980s to the early 1990s, which "provided additional experience and insight into micro/small-enterprise industries." Therefore, when HNB became involved in microfinance for the first time back in 1989, it had been already exposed to rural finance activities and the services provided to small-scale farmers (Gallardo et al. 1999, 1).

Along with its principal banking services, the *Gami Pubuduwa* (GP), or "village reawakening" programme (Gallardo et al. 1999, 1), was introduced in 1998, with a purpose "to provide financial assistance for self employment and small-scale business ventures" (HNB 2002) *Gami Pubuduwa* provides loans, each up to SLRs 250,000, at an average interest rate of 21.8%. In 1995, a group-lending scheme was introduced. The initiative was successful; as of the end of 1998, around SLRs 876 million ($12.5 million) had been disbursed to 17,500 activities[1] of which the amount outstanding was SLRs 277 million ($3.8 million) for 10,900 projects. The bank maintains that the repayment rate is 97.2%. According to Conroy, despite the fact that the rural financial market accounts for less than five percent of Sri Lanka's formal baking sector, the bank has realised its potential growth in the sector (2000, 285). Thus the bank's rural branches have been very active in savings mobilisation, resulting in substantial growth in savings of more than two hundred percent from 1994 to 1997.

Gallardo et al. Considers the HNB's experience to be "a rare example of a microfinance programme undertaken and carried out by a private commercial bank without reliance on government funding or incentives"(p. 24).

The major factors in HNB's operations could be categorised as follows:

1. the bank's familiarity in rural finance and small-scale banking service
2. perception of GP as part of formal financial services
3. stemming from (2), a bank culture that has less prejudice toward rural poor clients
4. careful selection of staff and the introduction of appropriate training for staff members
5. use of same intermediary channels for multiple purposes

Overall, according to Gallardo, HNB has taken horizontal approaches in its GP development, enabling the unit to utilise the abundant knowledge from its principal banking services, in addition to its physical facilities and infrastructure which had been already established through its long history of operation.

[1] Conroy, in *The Role of Central Banks in Microfinance in Asia and the Pacific*, Volume 2, Country Studies, ADB, 2000.

39. Consumer finance companies, the second category of Christen, see the microcredit market as starting to cross over into consumer lending, and this type is reportedly showing dynamic growth potential in some Latin American countries, such as Chile, Argentina, Brazil, Colombia, and Mexico. In Chile, one major bank manages its microenterprise lending operations through its consumer finance division and an international organisation like Inter-American Development Bank "provides some technical assistance and direct support for setup costs" (ibid.).

2.3.3 Credit unions and cooperatives

40. Credit unions or savings and credit cooperatives are user-owned institutions that offer savings and credit services to their members. "Membership in a credit union (we hereinafter call 'credit union' all similar institutions with different names, such as credit societies, credit cooperatives, savings and credit societies, etc.) is based on a common bond, a linkage shared by savers and borrowers that can be on a community, organisational, religious or employee affiliation." (WOCCU 2001, 2). With far longer history than microfinance institutions, credit unions have, since the middle of the 19th century, been helping "lower income groups increase their assets via establishing a credit relationship, establishing an enterprise, accessing working capital, increasing income through business expansion, meeting housing credit needs, and increasing wealth through savings" (Branch and Evans 1999, 3). Generally speaking, credit union provision of financial services proceeds as follows: "As new members join the credit union, they are able to access credit in small amounts, increasing with successful payment. Members establish a good credit history, usually by taking out small personal loans, and then enter into a period where they can expand their loan activity" (ibid., 3).

41. According to the World Council of Credit Unions (WOCCU), "credit unions are operating in 67 developing countries, provide microfinance services to low income members in Africa, Asia, the Caribbean, Central and Eastern Europe, and Latin America" (ibid., 1). As to the characteristics of clients and lending methodologies of credit unions, "Credit union lending portfolios generally are broadly diversified. Service to the poor is blended with service to a broader spectrum of the local population. Credit unions serving the poor achieve sustainability by spreading their costs across loans of larger and medium sizes as well. In this manner, credit unions can reach a large absolute number of the poor on a sustainable basis" (ibid., 1). Thus, targets and institutional arrangements of credit unions potentially overlap those of microfinance specialised institutions. Indeed, credit unions across many developing countries

have been significantly influenced by financial technologies exercised in microfinance NGOs and banks; solidarity group methods, progressive lending, and financial management are examples.

42. Even though little literature is available on the organisational evolution or transformation of credit unions over the years, including the influences of the emerging microfinance industry, the following are observed: (a) in many countries, sizable operations of credit unions tend to be organised into association or federation structures; (b) this tendency is apparent in former command economy countries, most typically in former socialistic countries, probably reflecting top–down approaches in their economic principles; and (c) it appears that one of the key organisational issues in credit unions is a balance between (1) highly decentralised operations at first-tier credit unions and (2) the required structure to ensure a good governance as a financial entity when the institution grows.

43. Branch and Evans (1999) mention four areas of challenge that must be addressed in order for credit unions to achieve financial self-sufficiency and outreach: (a) governance; (b) loan repayment delinquency; (c) business orientation and innovation; and (d) lack of external supervision and authorising legislation. Since credit union directors are elected on a one person–one vote basis, there will be many challenges as the institution develops. Issues on governance are revisited in this section later.

44. "Open bond credit unions in many countries have higher delinquency rates than other microfinance institutions operating in the same national environments" (ibid., 8). It seems natural that a mixture of credit union clients with different levels of income brings difficult tasks in management even if they were high professionalism. In the industry standards that WOCCU has established for credit unions, delinquency of 5% or lower is recommended, somewhat higher than microfinance institution best practices.

45. Credit unions should strengthen their business orientation, just as in any other corporation should, but their social orientation sometimes becomes an impediment to incorporating business principles. It is reported that many credit unions are lacking in business innovation—for example, they are staying with traditional loan products.

46. Due to their membership structure, credit unions in many countries have not been subject to sound external supervision, even those that are under supervising ministries. The limited

capacities of regulators are also serious constraints to the establishing of effective supervision systems. But an example of an organisation that is addressing this issue is WOCCU, which (1) provides technical assistance to national associations, credit unions, and regulators to enforce prudential disciplines and (2) has established a monitoring system known as PEARLS. In the case of the Philippines, a national movement to establish standard charters for credit cooperatives was activated a few years ago (see chapter 2).

47. Even credit unions pose many challenges, it is important to note their salient feature: credit union are saving-first institutions. Unlike microfinance institutions that start from a project or NGO undertaking, credit unions will not face a significant financial resource constraint; their principles are different from those of *microcredit* or any other non-bank financial entities. The prevalence of savings mobilisation in credit unions gives them a number of advantages: they can be free from over-dependency on public funds of government or donors; the growth pace of assets is safe in proportion to the issues of liabilities; and they tend to be free from credit delivery culture', thereby minimising the danger of too much client debt.

Box 7 BENIN

Restructuring of credit unions and national federations

Fédération des caisses d'épargne et de crédit agricole mutuel

Fédération des Caisses d'Epargne et de Crédit Agricole Mutuel (FECECAM)'s history traces back to the establishment of the Caisse Nationale de Crédit Agricole (CNCA) in 1970 as the first public development bank in the country, followed by caisses locales de crédit agricole mutuel (CLCAMs) and caisses régionales de crédit agricole mutuel (CRCAMs), the local and regional credit unions. Its aim was to provide loans and mobilise savings among its members. The operation was controlled by CNCA with a top-down approach: decisions were made at CNCA and delivered to individual local and regional unions. This ignored the demand and capacity of regional and local unions and led to insufficient management. Together with some other factors, such as corruption of the banking sector and constraints of an interest rate ceiling, caused deterioration in CNCA's operations and led to its liquidation in 1987.

With support from donors, government, and members of the network, a rehabilitation programme was carried out between 1989 and 1993 to support and strengthen the local and regional CLCAMS and CRCAMs. The adjustments and changes (closing down non-profit-making CRCAMS, cutting staff numbers, and introducing external annual audits and inspectors) were for both overall improvement in operations and the regaining of members' confidence. With the collaborative efforts of all stakeholders, by 1993 more than half of the CLCAMs had achieved break points where they made profits (Fruman 1998, 120). In 1994 the rehabilitation programme entered its second phase, the change from project status to autonomous network. The process has CLCAMs achieving further restructuring of the network and transferring of responsibility of elected directors through the creation of a national federation (ibid.).

According to Fruman (ibid.), phase 2 implementation has been successful as well: membership quadrupled in the four up to 1996. As of 1996, there were 165,000 members, which accounts for fourteen percent of the rural population, and the financial achievements were also substantial (total assets of US$52.3 million and loan outstanding of US$18.1 million). According to Westercamp (1999, 2) as of September 1997, FECECAM is the second largest lending institution, accounting for sixteen percent of the banking sector.

Lessons learned are that appropriate governance is a key to the development of CLCAMS in Benin, decentralised operation is essential, if directed in an appropriate manner, and technical and financial autonomy of the institutions play major roles in the establishment of sound management.

Sources: Fruman Cécile *FECECAM*, 1998, Sasakawa Africa Association

Westercamp, C *Federation of the agricultural savings and credit unions, Benin*, 1999, CGAP

[1] Caisse nationale de crédit agricole, later became national federation

[2] Caisses locales de crédit agricole mutuel and Caisses régionales de crédit agricole mutuel

3. Governance of Microfinance Institutions

48. "Governance is a process by which a board of directors, through management, guides an institution in the fulfillment of its corporate mission and protects its assets" (Rock 1998, 7). Effective governance is crucial to the sustainability of MFIs. Among the various elements necessary for development of effective governance, the most fundamental are an appropriate form of ownership, proper guidance by the board of directors, and the notion of the "fiduciary responsibility of microfinance institutions" (ibid., 5).

3.1 Ownership

49. Private banks are often owned by private depositors and inventors, whose large amount of finances is in the bank, being at risks occasionally (Christen 2000, 3). They have strong incentives to rigorously seek profit and monitor the sustainability of banks. Yet most MFIs today do not have private owners in their operations (ibid.). Their equity is funded mostly through governments, donors, and NGOs and they do not necessarily have profit-maximising motives , but rather "altruistic reasons" (ibid.).

50. In fact, there are various forms of ownership for MFIs and each of them has benefits and limitations. For effective operation of governance, therefore, it is important to understand those variances and the issues associated with them. Rock (1998, 9) categorises the ownership structure as follows:
    - Public ownership / government corporate structure
    - Ownership for non-profit NGOs
    - For-profit corporate structure
    - Private ownership
    - Credit union corporate structure

51. The public ownership/ government corporate structure refers to ownership by governments, donors, or multilateral agencies. Non-profit NGO corporate structure denotes the cases of local and international NGOs who operate microfinance activities as part of their more comprehensive programmes, or are specialised in financial services but have not yet fully established a managerial and financial base, such as capitalisation as a financial entity. For-profit corporate structure is one whereby a core NGO obtains ownership of an affiliated NGO MFI. Private ownership is established purely through private capital. The credit union

corporate structure implies the case where ownership and governance are managed by the credit unions themselves.

3.1.1 Public ownership/government corporate structure

52. The majority of MFIs started from projects in which funds are provided by domestic governments and multilateral agencies. According to Rock, those agencies are often involved in the ownership of MFIs "largely in response to their own policies and to 'political issues,' with the term *political* used in the broadest sense of the word" (ibid., 25). Motives of public entities often concern the social and economic development of the region or country, not necessarily profits.

53. *Empirical evidence shows the challenges associated with public ownership in microfinance.* In fact, worldwide a number of subsidised direct credit services to the poor have failed. They are often ineffective and fail to gain the confidence of their clients. As Rock states, programmes are normally well-intended, yet "misguided, development policy have severely distorted the market by directing credit to delinquency and severe undermining of public confidence in government development initiatives" (ibid., 20). There is often political interference, which leads to a lack of confidence by clients. Accordingly, the willingness to repay is undermined and the delinquency rate becomes significant, deteriorating the institution's portfolio.

54. Yet these experiences are not to deny the potential of public ownership. Among its various forms, such as wholesale institution, government-owned banks (see the case of state-owned banks, in section II of this chapter), and public-private partnership, there are examples where public ownership is introduced successfully and contributes to the development of the MFI sector. Therefore, one should not underestimate the particular aspects of public financial institutions, but rather form a mechanism which is efficient, transparent and best suited to its market demand. Public owned financial institutions often have "the extensive branch infrastructure of many government-owned banks, and the significant financial resources" (ibid., 20). They are loaded with information and have close relations with local government. Efficient utilisation of those resources, together with proper management of credit policies and political intervention, could provide a suitable environment for public ownership and its sound undertaking.

3.1.2 Ownership of non-profit NGOs

55. Local NGOs engaged in microfinance are often funded by representatives of the private sector or socially motivated individuals among local communities. They are also often supported by multilateral agencies or international NGOs through grants or finance at concessional rates. International NGOs often directly intervene in microfinance operations that are consistent with their arms in developing countries. Thus, the capital in such NGO-led projects most often still belong to sponsors or individuals, unless they are institutionalised as a corporate entity or a financial institution in a country. Board directors come from various professions, yet none of them are shareholders. Often their interests are purely social, not profit-seeking. Rock argues that "the NGO ownership structure of no real owners presents a structural weakness in the NGO model" (ibid., 22).

56. Empirical evidence suggests that operation of NGO-led microfinance is often successfully managed under strong leadership of boards of directors (ibid.). They are non-profit boards of directors, and are required to have strong vision, commitment as well as leadership and ability to direct their institutions to their targeted objectives. Effective governance is a prerequisite in MFI development; therefore it is important that the appropriate board of directors are set in place.

3.1.3 Ownership for MFIs owned by NGOs

57. When a core NGO obtains ownership of (makes an affiliate of) an MFI, it becomes difficult to draw a line between the NGO's operations and the MFI's operations. In other words, there tends to be no clear separation between owners and management (Omar, in Hannig 2000, 85).

58. Worldwide there are examples of efforts to establish mechanisms to build institutional accountability through "requiring diversified ownership involving private investors and stipulating the transparent arms-length relationship between the founding NGO and the microfinance institution" (Omar, in Hannig 2000, 87). Yet Omar asserts that it is still not clear "whether these measures are sufficient to ensure the necessary separation between owners and managers and to apportion legal accountability when the principal owner is NGO."

59. Board directors' lack of experience in management, in general, and expertise in financial services, in particular, is also problematic. Greuning has stated, "since most MFIs started out originally as NGOs, their ownership and organisational structure may be unclear and not geared for board supervision of management" (1998, 15).

60. In attempting to overcome the ownership and structural weakness of NGO-owned MFIs, the creation of private financial funds has been encouraged. However, the results have not been positive, as can be seen in the structure of Bancosol, where the shareholdings of the institution are 50–70 percent by NGOs, and the rest by international donors (Gomez 2000, 23). The composition of the shareholders in most cases indicates high participation by donors and international agencies and low participation by private depositors.

3.1.4 Private ownership

61. Private ownership of MFIs involves various forms of social capital. The current trend suggests a new emergence of ownership by purely private capital, such as "private individuals, corporations, investment funds, and financial institutions that are solely interested in making a return on their investment" (Rock 1998, 23). Their rationale is purely commercial. In reality, however, the majority of public ownership is still largely by donors, NGOs, and government, and the capital is often subsidised at concessional rates.

62. Donor-owned private ownership has some negative impacts. Rock argues that "while multilateral agencies have vast resources at their disposal, they cannot respond quickly to a capital call from an MFI because of their internal processes for decision making" (1998, 25). Also, their requirement of reports often burdens MFIs' daily operations. Some also argue that the inequality in accessing funds will distort the competitive market in industry.[5] When only some of a country's MFIs are capitalised using subsidised funds, those that are not find it difficult to compete, consequently discouraging the emergence of new MFIs.

63. Therefore, ideally, commercial banks and finance companies are privately owned. In fact, they are increasingly interested in microfinance operations, and their involvement is welcome. For example, thirty-seven percent of the capitalisation of ACLEDA Bank Limited, one of the first specialised banks in Cambodia, is by foreign investors.[6]

[5] CGAP Capital versus Capacity discussion 'From Blue Orchard Finance-Switzerland'

[6] 12.25% each by DEG (Germany), FMO (Netherlands) and Tridos Bank (Netherlands).

64. The involvement of private financial institutions is crucial to the sustainability of MFI operations (Gomez 2000, 25). This is in contrast to operations by NGOs and donors, because these entities often lack motivation for profit. Private ownership will bring operational benefits such as the following:

- strong internal control
- sound (efficient) risk management
- good governance through private capital's weighing of risks and through the covenants of commercial law
- free from political interference

3.1.5 Credit union corporate structure

65. As stated previously, governance is one big challenging issue that credit unions almost unanimously face in the course of institutional development. "The democratic one-person-one-vote governance process of credit unions has evolved and been maintained over the years to respond to a need to make the credit unions responsive to all of their owners. When Directors become unresponsive, members elect new Directors at the Annual General Meeting of membership" (Branch and Evans 1999, 7). As such, user-owned credit unions may bring about specific problems as follows.

66. Since most credit unions begin at a small community or closed group level, they often depend upon volunteers to undertake operations as well as governance and representation of membership. This structure may work well by maintaining low operating costs at the early stage of development; however, "a board dominated by volunteer non-professionals can be very responsive to local community social issues but fail to have the financial and business expertise required for a financial institution" (ibid.). Thus, volunteer credit committee operations may become less effective as credit unions become larger, because they have to adopt more sophisticated business practices. Therefore, "once the credit union achieves a scale which allows it to hire professional staff, it needs to separate decision-making and decision-control functions" (ibid.).

67. Branch and Evans advocate the establishment of clear rules in bylaws in credit unions and supervisory regulations in order to control this problem. "Appropriate bylaws and regulations establish criteria for who is qualified to assume a position as a director, define the decision oversight role of the Directors, identify the operational responsibilities of management, set

analysis criteria and establish controls on insider loans and ethical codes of behaviour to avoid conflicts of interest" (ibid.). Another key seems to be based on the functions of second- or third-tier associations or federations that many countries conceive. Since the institutional arrangements for good governance and capacity building of boards of directors are obviously beyond the capacity of individual credit unions, a set of criteria should be developed at the federation level.

3.2 The Role of Boards of Directors

68. A board is established "to provide oversight and give direction to the managers of an institution" (Rock 1998, 1). Depending on the organisation's legal structure, board members are selected from various actors: donors, government, individual clients, staff of the organisation, and shareholders. Rock and Otero have categorised the major roles of directors as *Management Accountability* and *Strategic Planning and Policy Setting* (Rock 1998, 11), as follows:

Function of a Board

Major Areas of Responsibility	Board Tasks
Management Accountability	Identify competent managers Set clear and measurable goals Monitor performance Confront weakness
Strategic Planning and Policy Setting	Provide input in charting a strategic course Provide guidance in setting policy Provide guidance in developing and mobilising solutions
Self-regulation	Maintain continuity Renew leadership Self-evaluate

(Rock 1998, 8)

3.2.1 Management accountability

69. Management includes both internal and external vision. Whereas external management involves the reflection of voices by stakeholders outside of the organisation, such as shareholders and donors, and the subsistence of solvency for those stakeholders, the internal function involves provision of appropriate direction to the operational management of the organisation. This is carried out through the selection of the executive board and the

establishment of organisational mandates for the short-term and long-term perspectives. Also the board will monitor the financial performance of the organisation as well as identify the problems in the organisation. For the latter, it is crucial that the board has "ability and willingness to make the hard decisions and confront weakness in the executive, and therefore the institution" (ibid., 11).

3.2.2 Strategic planning and policy setting

70. The strategic planning and policy setting role is a foundation for management accountability. First it is to direct the organisation to well planned, "long-term goals" (Rock 1998, 12). Although it is quite difficult for organisations to pursue consistent long-term institutional plans when there are changes in management and operational environment, it is crucial for them to establish long-term strategic goals for sustaining their institutions. A board of directors will "raise strategic issues that may not be addressed and, thus, significantly contribute to identifying and setting long-terms goals for the institution" (ibid., 12).

71. The role of directors does not vary greatly in the case of MFIs. Yet it does certainly have different functions in respect to specific features of MFIs. For example, the setting of direction will mainly focus on the extent to which "MFIs seek to maintain the dual focus of profitability and client coverage" (ibid., 18). In MFI operations, it has been widely recognised that there is a trade off between outreach and profit of the organisation. Yet Rock has challenged the notion that there is no trade off between the social goals of MFIs and the financial profitability of organisations, as there is a dual mission to sustain the MFIs, both from the social and from the economic perspectives (ibid., 18). Therefore, MFIs' boards of directors will have to balance the two missions. Consequently, it is advisable that the board consist of an equal distribution of professionals from the two sides-commercial and the development (ibid., 19).

'Fiduciary responsibility of microfinance institutions' (Rock,1998, P28)

72. MFIs' boards of directors have serious fiduciary responsibilities regarding their clients, who, not having alternative financial sources, are more susceptible to insolvency than are wealthier clients. Also, as the organisations grow, the performance of MFIs will have larger impact on the society.[7]

73. Overall, a board of directors in microfinance is required to commit fully to the organisational development. In addition to the types of functions it has in common with ordinary financial institutions' boards, it is also required to perform value-added functions, such as those of policymaker, operator, and conductor. As microfinance operations have special features which are different from those of conventional financial institutions (in its management and targets), the challenges that rise in the process of development are also different. MFIs are often referred to as a poverty alleviation strategy—thus as a usable political manifesto—and their target clients are those marginalised in the society, board members can be drawn to flawed businesses. This is why it is crucial for an MFI to select directors who have "loyalty and commitment to the institutional mission above any political aspirations" (Rock 1998, 35) and provide strong leadership in the organisational management.

[7] Rock (1998,P29) states 'large-scale MFIs such as BRI in Indonesia, the Grameen Bank in Bangladesh, and BancoSol in Bolivia, insolvency would affect both the domestic and the international microfinance sector', as the large number of affected population will harm the microenterprise sector.

4. Policy Issues

4.1 Legal and Regulatory Framework

74. MFI activity and range of activities have substantially increased in developing countries. As the scale of their operation has expanded, their areas of responsibility and their impacts on the society have also increased. The idea that all stakeholders and beneficiaries benefit from the establishment of legal and regulatory framework is a given, but it is important to note that the individual actors involved benefit for differing reasons, which often create conflicts of interest. What are the interests of those who regulate MFIs? How do the MFIs themselves benefit from being regulated? There are rationales from both internal and external perspectives. The external rationale concerns macro issues such as impact of the microfinance industry on the national economy, on the establishment of a sustainable financial sector, and on the social responsibility of MFIs as institutions which provide financial services, whereas the internal rationale often comprises operational and organisational matters of MFIs.

4.1.1 Rationale for regulation

1) Regulator's viewpoint

75. Otero (1994, 57) and Wiese (1999, 5) listed the following three major motives for government intervention in regulating financial institutions:
    - *Protection of investors and depositors:* to provide consumer protection against the various risks
    - *Assurance of systemic stability:* to ensure solvency and financial soundness for all intermediaries
    - *Enhancement of efficiency:* securing the rapid growth of the sector and the overall contribution of MFIs to the economy as a whole

76. First, according to Omar, the protection of depositors is a vital rationale for regulating MFIs (Hannig 2000, 76). The asymmetry of information causes a problem: because financial institutions provide little information on themselves, depositors have difficulty grasping the financial conditions of the financial institutions to which they place deposits. Thus, depositors are vulnerable to unscrupulous bank officials looking for high returns through high-risk investment. Therefore, a regulatory framework is essential—to protect depositors by requiring

that banks practice sound risk management.

77. Second, the regulation will prevent systemic instability, maintaining depositor confidence in overall financial system. The failure of one institution may, as Otero (1994, 59) states, the failure of one institution may "cause a panic or run on the deposits of other intermediaries that otherwise have healthy financial systems." MFIs seem more vulnerable to this risk, as their capital bases are very small and the group lending scheme will often, if not always, generate more anxiety among depositors.

78. Government's third major motivation for regulation is to secure the growth of MFIs and their contributions to the national economy. *Regulation* here means a set of preventive measures to secure macroeconomic stability. In developing countries, where per capita income is low, not much capital can be raised through stocks, bonds, mortgages, and other financial market sources; thus, cash and deposits are vital. As the amount of deposits grows, so too does the number of MFIs, along with a corresponding increase in the danger that one flawed MFI could cause a chain reaction. Regulation, therefore, is meant to prevent, or at least minimise, the risks of negative impacts from MFI failures. MFIs operate in various forms and occasionally collect deposits regardless of their lack of operational capacity. Thus, any complementary scheme helps intermediaries such as apex, wholesale institutions to establish sound benchmarks and systems for supervision, and provides the ability to differentiate eligible MFIs from others. Yet it is important to note that subsidisation and complementary schemes provided by donors or government often create dependency and political interference among those institutions, which consequently lead to moral hazard. Therefore, the establishment of regulation is considered to be a means of maintaining the operational competence of MFIs, particularly when guarantee schemes are provided.

79. Apart from the three major motives above, the following are some other rationales from the government and donor's perspectives:
   - to maximise the efficiency and maintain the profitability of the institution
   - to enable MFIs to provide financial services legally so that the loan collecting MFIs cannot be prosecuted
   - to meet the demand of political agenda for poverty alleviation and sustainable microfinance

   (Christen 2000, 2)

2) MFIs' viewpoint

80. MFIs, which are regulated in various ways, depending on the institution type and country, are being considered by a number of NGOs operating microfinance as means to be incorporated into the formal financial sector in the future. Those MFIs that desire regulation, feel that way because they expect it to provide the following benefits:
    - *Expansion of financial activities*, particularly for mobilisation of savings
    - *Increase in access to commercial funds*
    - *Credibility to donors*[8]

4.1.2 Frameworks and methodologies

81. Certainly it is particularly important to ensure the establishment of a sound environment—well-balanced between institutional growth of microfinance and the growth of the microfinance market at large—to sustain further development of the sector.

82. In fact, regulation could have negative impacts on MFI operations if the framework is inappropriately imposed or is implemented at the wrong time. Greuning addresses this danger "The principle drawback to blanket regulation of all MFIs is the potential repression of the innovation and flexibility possible with informality" (Greuning 1998, 10). Therefore, regulation needs careful consideration, and the framework for microfinance should reflect distinct features of microfinance.

    The following highlights the worldwide experiences on possible benefits and risks of regulatory framework. What seems clear is that most of the negative impacts arise due to the failure of regulatory frameworks to capture the special features of MFI operations and to insufficient capacities of regulators in understanding those features. In many cases we have found that the law and regulations limit microfinance capacity unnecessarily through excessively high criteria.

1) How to regulate

83. Just as the types and environments of MFIs vary, so too do the approaches taken by different

[8] As can be seen in Bolivia, much donor support comes through intermediaries or microfinance coalitions (Gomez 2000, 30), and donor funds are often placed in experienced well-managed MFIs. Regulation will accord credibility to MFIs, subsequently providing them easier access to donor support.

countries. Staschen (1999, 16), says that a universally pleasing category of MFI operation is not feasible and oversimplification and idealisation are to be avoided. MFIs are regulated and supervised in various ways according to the economic, political, and social conditions in each country. Nevertheless, there are common patterns for the establishment of frameworks for regulating MFIs: regulation within the existing legal framework, the creation of new MFI-specific laws, or the creation of second-tier institutions as a means of self-regulation. It seems important to note that the degree of application of those approaches varies depending on the country; there is not one that is applicable to all countries' conditions. In many cases, a country introduces a combination of various approaches.

84. The following are our tentative categories of regulatory frameworks:
    - *Regulation through existing framework (banking law, finance company law, cooperative law)*
    - Creation of *MFI-specific law (or framework)*
    - *Self-regulation*
    - *Hybrid approach—partly self-regulated, partly supervised by a third party*

    (Wright 2000, 3)
    - *Regulatory framework for cooperatives operating microfinance-type business*

2) Regulation based on existing framework

85. MFIs can be regulated within an existing legal framework; they are categorised just like banks under the general banking law as it is or the law is extended to place them within the framework. In most developing countries, MFIs are not allowed to mobilise savings from the public unless they are regulated or licensed as formal financial institutions. Therefore, the only ways for MFIs is to continue to expand their financial services are either to provide credit or to meet the banking requirement (Staschen 2000, 17).

86. According to Christen (2000, 16), Latin America has a long history of regulating MFIs, and the most common way has been via existing windows in banking regulations. This tendency is apparent from his assertion that about 95 percent of microcredit is provided by licensed institutions but only sixteen percent comes from institutions licensed through microfinance-oriented windows (ibid.).

87. MFI regulation via existing law can be of the following types:
    - MFIs are involved in bank-type business such as mobilising private savings and granting loans (Staschen 2000, 28)
    - MFIs are merged with existing financial institutions, thus automatically come under the existing legal framework
    - MFIs are subjected to a formal regulatory framework, with exemption from some ordinances
    - Alliances are formed with already-licensed institutions— a teaming up of MFIs/NGOs with existing banks (Christen 2000, 18)

88. This approach enables government to draw on larger financial resources (Staschen 1999, 17). Even though the financial impact of microfinance is still small in most countries,[9] its social impact by reaching out to a large segment of the population becomes significant. Therefore, the establishment of a legal and regulatory framework enables government to intervene—regulating MFI operations in order to protect their clients. Also some believe that supervision is easier since the legal framework is already established.[10]

89. Employing the existing framework can also have negative impacts—impediments to the development of the microfinance sector. Among those, the most common are conflicts between the existing regulation and the characteristics of MFIs in terms of loan provision, reporting and disclosure requirement, and collection of non-performing loans, all of which can lead to over-regulation and repression of MFIs. If regulation presents an excessively high barrier, then the potential for MFIs to enter the market will be limited, if not excluded.

90. Banking acts are aimed at regulation of conventional banks; it is not logical to assume they can be simply applied to microfinance operations. Various empirical studies have shown that doing so often has negative outcomes, arising from the gap in nature between formal (commercial) banks and the MFIs. In cases where a severe burden on MFI operations has been identified, they are often exempted from some of the formal banking regulatory requirements. It seems reasonable for this approach to be used as a tentative transitional process until the number of exemptions become sizable and further modification is necessary,

[9] Even in the Philippines, where more than eight hundred NGOs generate a total of more than 1.6 trillion pesos in investment per year, the MFI sector accounts for less than one percent of the entire financial system of the country.

[10] It is important to note that the capacity of supervisors to properly monitor and supervise MFIs is always questioned.

at least until the monetary authorities can solve interest rate dilemmas in microfinance (see Interest Rate in this section).

91. As a countermeasure to such impediments, Bolivia in 1998 amended some parts of its regulation to reflect the unique characteristics of MFIs. Those changes were in categories such as loan provision, debt collection, and requirement for branch openings (Staschen1999, 30), and they have proved to have provided a better operational environment for the MFIs. The example clearly suggests that traditional instruments of bank supervision (e.g. prudential ratios) fail to adequately monitor and control the specific risks of MFIs (Hannig 2000, 47).

3) New institutional form

92. *Governments can also establish a new category as a complement to the existing legal* framework, which many Latin American countries have done. MFIs that are subject to this new category can be supervised through an identical supervising organisation or a microfinance unit within the existing government agencies such as central bank or delegated supervisory institutions. With this approach, the institutions will be able to enter the formal financial market with minimum requirements. Legal arrangements for defining a new category for MFIs appear to be diverse across countries, including amendment of the existing law and enacting of a new law.

Creation of New Institutional Forms for Microfinance

	Bolivia	Peru	El Salvador	Brazil
Name:	Private Financial Fund (FFP):	EDPYME	Savings and Credit Company	Microenterprise Credit Company
Year Created:	1995	1995	2000	1999
Minimum Capital:	USD 828,000	USD 245,000	USD 2.86 million	USD 60,000
Number of Inst:	6	9	0	5 + pending
Capital Adequacy:	10%	9.09%	12% (same as banks)	5 x liquid assets
Checking:	No	No	No	No
Savings Deposits:	Yes	Yes, if $1 million in capital + rating	Yes	No
Max. Loan Size: (% of capital, or US$)	3% secured ($30,000) 1% unsecured ($10,000)	5% ($12,225)	2.5%indiv. ($71,500) 10% inst. ($286,000)	$6,000
Restricted Operations:	Trusts, foreign trade, equities, mutual funds underwriting	Depends on capital and maturity	Foreign investment, majority stakes in other companies	Non-microenterprises
Supervision:	Bank superintendency	Bank superintendency	Bank superintendency	Central Bank
Complementary Regulations:	Simplified loan analysis and provision reqs.	Simplified loan analysis and provision reqs.	N/a	Simplified requirements and flexible collateral

Sources: Interviews with central banks and bank superintendencies (Jansson 2001).

93. In Cambodia, for example, a new law on banking and financial institutions was introduced in 1999 along with two related regulations.[11] The central bank's scope in the newly created regulations not only is broadened in terms of monitoring and supervision, but also extends to all financial transactions by NGOs. According to ADB, this new regulation will enhance the public confidence in the financial sector and encourage the expansion of its development.

4) Regulation through MFI-specific law

94. MFI-specific law/regulation can be assumed to genuinely capture the special features of MFIs. Therefore, it should be carefully organised in a way that promotes further development of the sector. Not many countries have established a specific framework for MFIs, and fewer still have established specialised laws or regulations on MFIs.

95. In cases where MFIs operating as NGOs are already regulated under NGO-specific law, such as the Organisational Law or the Welfare Act, additional legislation can be enacted to enable them to acquire limited complementary capacities in some banking operations (including deposit-taking in some cases).

96. A new organisational form can be defined by MFI-specific law to promote and regulate the MFI sector. For example, Proclamation No. 40/1996, the Licensing and Supervision of Micro-financing Institutions Proclamation,[12] was issued as a specific regulatory framework for MFIs in Ethiopia. Ethiopia's law prescribes a single form and it excludes NGOs.[13] According to Shiferaw and Amha (2001, 32), the proclamation empowers the central bank to "license, supervise and regulate the delivery of financial services to the rural and urban poor through microfinance institutions." Although MFIs in Ethiopia had long been operated by NGOs and oriented much more toward welfare aspects of development rather than business orientation, this proclamation has become a landmark in establishing a proper legislative and regulatory framework for the microfinance industry in the country and has encouraged the development of industry.

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11 PRAKAS (regulation) No.B700-05 on licensing of rural credit specialised banks and PRAKAS No.B700-06 on licensing of microfinancing institutions.

12 Full title: Proclamation No. 40/1996: A Proclamation to Provide for the Licensing and Supervision of the Business of Microfinancing Institutions

13 Authors appreciate Mr. William Steel, World Bank, for his valuable comments and information on the Ethiopian case.

97. The law requires the registration of all the institutions as a shareholding company involved in microfinancing operation, with saving mobilisation of more than Birr 1 million mark. This company must be wholly Ethiopian-owned, by nationals or organisations (ibid., 68). Since a directive order in 1998, Ethiopia has not enforced an interest rate ceiling on MFIs. Although the benefits of this MFI-specific law have been realised, there have been some drawbacks to the development of industry. In some areas, the Ethiopian government's objective have already been realised, and in others assessment might be needed for further improvements. In most cases where there are deficiencies, it is due to the lack of understanding the specific nature of MFI business orientation.

98. For example, according to Shiferaw and Amha (ibid., 34), the law stated that microfinance activities should be carried out in a manner in which the "group guarantee will substitute for property collateral. Group guarantee plays an important role in microfinance operations." Yet the law should not exclude other possibilities, as group lending is not the only way to provide credit to the poor. Also the law created ownership problems among MFIs. As the law prohibits ownership by non-Ethiopian nationals, the donors and NGOs have continued their operations by sponsoring Ethiopians to be shareholders. This has led to weak internal control, conflict of interest and has severely compromised the minimum capital requirements needed for solvency of the company and mobilisation of savings from the public" (ibid., 65).

99. MFI-specific regulation will enable MFIs to expand their operations as well as increase competition among eligible legalised MFIs. The specially arranged domain is supposed to provide pure market competition among MFIs. Also, the establishment of new law provides benchmarks for NGOs who wish to become legal entities in the future. This approach will also encourage the development and expansion of microfinance industry and provide flexibility in MFI operations. By establishing a new mechanism, they are formulated in its best form to sustain and reflect the specific features of MFIs.

100. Yet success in its implementation largely depends on how well the microfinance specificity is captured and incorporated into the framework, with an appropriate balance between strengthening and relaxing the criteria. For example, overly loose requirements will increase the likelihood that MFIs get themselves in financial trouble from over-indebtedness of borrowers, causing problems in terms of repayment. Also, an imbalance occurs between regulation and risks of sustainability of businesses if requirements are too low. The

institutional capacities of regulators are also questioned, as they are required to be familiar with microfinance specificity. The lessons from past experiences suggest that regardless of how well new framework are established, the MFIs require guidance and enforcement by well-trained supervisors in order to fully maximise the benefits. The capacity building of regulators seems to be the most important precondition for successful formulation of MFI-specific law.

Box 8 **NEPAL**
Financial Intermediary Societies Act

Countries can be regulated with a combination of the existing framework and a complementing MFI-specific framework. In Nepal, the 1998 Financial Intermediary Societies Act (FISA) requires all NGOs registered under the Registration of Association Act (1977) with the objective of working as financial intermediaries to be registered with Nepal Rastra Bank (NRB). Under FISA, all the statutory rights belong to NRB but MFIs are allowed to set their own interest rates, with NRB's approval. There is no minimum capital requirement for those NGOs. The law does not provide any provisions for savings mobilisation by those intermediaries.[1] The law seems to be quite flexible at a glance, yet in reality the consent of NRB is required in many aspects.

Even though FISA is innovative in regulating microfinance activities nationwide, there have been a number of criticisms for its incompleteness. Sinha (in Mcguire 2000, 175) points out that the law has been established "in a glaringly deficient form and its implementation will be counter-productive." It has been pointed out that sustainable MFI development in Nepal will only be accomplished through amendment of FISA, particularly in the areas of savings mobilisation, annual registration, and the establishment of a threshold for the financial services to be regulated (ibid.). Nepal's case appears to be an example of existing framework complemented by MFI-specific regulatory framework.

[1] From poverty alleviation perspectives, savings mobilisation has been tolerated by NRB even the NRB Act legally prohibits it. Many NGOs mobilise savings whether or not they are registered.

5) Self-regulation

101.The self-regulatory approach to regulation largely varies among organisations, thus it is difficult to generalise and analyse how these systems are organised in relation to those of government regulation (Staschen1999, 39). Mcguire (1999, 274) states that the feasibility of various forms of self-regulation "depends on a range of factors, including the extent to which there is a network that can represent MFIs as a whole, the quantum of resources available for monitoring and supervision, and the availability of incentives and/or sanctions to enforce compliance." In this self-regulatory approach, the initiatives are taken by MFIs themselves so that government "cannot impose repressive regulation with unstable statutory right" (Staschen 1999, 18). Nevertheless, these types of operations rarely involve deposit takings from the public.[14]

102. Also the term *self-regulation* can be interpreted in various ways, which creates some confusion among the actors involved. So as to avoid unnecessary confusion, Christen has defined the term *self-regulation* as "to refer *exclusively* to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organisation to be supervised" (2000, 20). This type of operation can be often found in the forms of savings and credit cooperatives an MFI federations.

103. Self-regulatory systems can assume either of the following policy environments:
- The industry has maximum autonomy, i.e., there is no government intervention
- A transitional process in which industry is not matured enough to be incorporated into one framework

104. In self-regulation, external bodies or rating agencies[15] can be introduced in the self-regulatory mechanism. External auditors simply verify the information stated in the MFIs financial statements. Those regulatory agencies do not have authority to suspend any flawed MFI business, except in cases where the government has assigned that authority, yet they do provide some criteria for an industry standard and can work effectively as proof of quality of business performance.

105. Whereas self-regulatory systems provide opportunities for MFIs to be innovative, it will require strong discipline as well as technical expertise to monitor and supervise the organisation. The self-supervising organisations also have to bear the high cost of preparing required documents such as banking statements and balance sheets. In other words, it seems reasonable to state that an inappropriate approach could impose limits on MFI operations, in both technical and financial terms. Organisations also have to avoid conflicts of interest within themselves in order for their operations to be justified. Overall, according to Christen (2000, 20), self-supervision often fails in developing countries, because "having a watchdog that is controlled by the parties being watched presents an obvious conflict on interest."

[14] In rare cases where they are permitted to do such operation, it is often when the government holds exclusive right to supervise the operation either directly or through a regulatory agency (Staschen 1999, 19).

[15] There are several rating agencies such as Micro-Credit Ratings and Guarantees India Ltd. (M-CRIL), Micro Rate, PlaNet Rating and World Council of Credit Unions (WOCCU). Each has established its own rating methodology.

106.Nevertheless, for self-regulation to be effectively implemented, Staschen (1999, 18) has suggested an adoption of a "code of conduct, possibly specifying binding standards for the industry." By adopting such standards, self-regulating agencies could carry out sound operations, by measuring their performance according to the benchmarks. Staschen cited Akerlof's "lemon model" (1970), saying that this type of initiative intends "to narrow the information rift between MFIs and their source of capital so that it can distinguish between 'good risks' and 'bad risks,'" and concludes that it is also important that the standard is effective in practice and be respected by all related stakeholders in the industry. To summarise, the self-regulatory approach obliges the industry with quite a few requirements (institutional, financial, and even ethical), which are usually difficult to meet in countries where the overall institutional capacities of the microfinance industry are yet limited.

107.However, the second interpretation of this approach, the self-regulation, or more appropriately, the self-supervisory approach within the microfinance industry, can be effective as one of the measures to cope with transitional problems in regulatory capacity building. Acquiring regulatory capacities involves a lengthy process, and regulation without sufficient capacities only does harm to the industry. Therefore, prior to the emergence of a genuine regulatory framework and institutional capacities in monetary authorities, a weak form of self-supervisory systems within the microfinance industry may play a significant role in avoiding deterioration of microfinance programmes and maintaining the public's confidence in the MFIs. This appears to be possible if MFIs create a forum for the sharing of financial and managerial information.

108.Thus, this self-supervisory approach should be drawn into the collective efforts of MFIs to establish industry benchmarks through running such a voluntary forum. For example, a registry of MFIs could be expanded to track and make available their financial records, which would tremendously contribute to establishment of an appropriate framework in the subsequent stage (see *National Strategy on Microfinance Development* in this section).

6) Hybrid approach

109.Some have advocated a hybrid approach whereby supervisory bodies maintain the legal authority over the MFIs, and third parties carry out the monitoring (Christen 2000, 20). In other words, MFIs are regulated under a microfinance-specific legal framework and are monitored by different agencies. Although there have not been many examples by which to measure the effectiveness of this approach, Christen has identified some key elements for the successful implementation of its supervision and monitoring.

110. First, equipping the supervisors with definite authority over MFI operations is crucial (ibid.). This is for efficient and effective monitoring and supervision. Second, the monitoring agency needs to "be better at monitoring MFIs condition and risk than the typical external audit firm" (ibid.), since MFIs' internal auditing is often not reliable.

111. Third, it is also important to note a potential impediment to supervision under this approach. Christen (2000, 21) warns that although the supervisory agency may conduct monitoring, there are some cases where the law restricts its operational capacity. In those cases, there will be a gap between the mandate of the supervisory bodies and the policy conditions available to the institutions they supervise, making intervention difficult, even when the MFIs are facing problems.

7) Regulatory framework for cooperatives and credit unions operating MFI-type business

112. Any of the above approaches can be applied as the regulatory framework for cooperatives and credit unions, but complications in regulating such entities make it worthwhile to address their particular issues separately.

113. According to Mcguire (1998, 45), a number of cooperatives in developing countries are operating microfinance services. Their sizes and scales of business largely differ between countries, yet the their organisational structure and operational functions are somewhat similar. Christen (2000, 14) states that the "differences between the credit unions and the microfinance institutions are quickly breaking down" and "some credit unions have taken up the lending methodologies espoused by the microfinance community." Thus, there is no clear distinction between credit unions and microfinance institutions.

114. Typically, cooperatives and credit unions are regulated under particular laws by particular ministries. For example, in Indonesia, neither the Ministry of Finance nor the central bank has authority over the credit activities of those institutions, the Ministry of Cooperatives holds such responsibility. In the Philippines, cooperatives and credit unions are registered under the cooperative code of 1989, which for the fist time brought the two under one law.

115.The diversity of credit union activity makes it difficult to decide whether or not to put them under the same legal framework as that for ordinary formal financial institutions. The threshold of regulation depends on the scope of activities, and as far as microfinance is concerned, the extent to which the institutions are involved in banking services is the first key determinant for the framework. For example, in Nepal, cooperatives are required to meet conditions set forth by the Cooperative Society Act (1992). There is no specific law on microfinance operating cooperatives; therefore, they are licensed through Nepal Rastra Bank (the central bank) and their operation is regulated by the NRB Law and its provisions. As of 2000, twenty-eight cooperatives had been licensed (Sinha 2000, 157). Although the license is for savings and loan activities for members only, it provides social credibility to those institutions that obtain it (Okamoto 2002, 12).

116.Complications arise largely due to both physical and moral limitations of government and the cooperatives/credit unions. Jurisdiction is a key regulatory issue, and government's lack of financial and technical expertise dampens its enthusiasm for regulating (Vogel1994, 207). Even when a government department specialises in credit unions, it often faces difficulties such as shortage of expertise in financial management and lack of resources.

117.In attempting to regulate the increasing number of MFI credit unions and overcome impediments, some governments have modified their banking laws to include such entities. In Bolivia, for example, where credit unions had been regulated under the General Law of Cooperative Societies for more than thirty years after 1958, the new Banking Law has been enforced since 1993. Under the new law, credit unions, specifically those that mobilise public deposits, "must operate the rules applied to non-banking financial entities, incorporating credit unions into a formal financial system" (Gomez 2000, 8).

118.Also a unified standard and uniform accounting systems will smoothen the regulatory processes to ensure the financial soundness of cooperatives whether or not they are self-regulated. The standard could be formulated internally without the intervention of authorities. In the Philippines, for example, the Cooperative Development Authority (CDA) was created in 1990 for regulation and supervision of cooperatives. On the same day, Republic Act 6938 (Cooperative Code of the Philippines) was enacted into law, designed to "promote the viability and growth of cooperatives as instruments of equity, social justice and economic development."[16] Recently CDA has been working to establish a Standard Chart of Accounts which will be applied to all credit cooperatives. The Standard Chart of Accounts will not only ensure the uniformity of accounts, but also accredit transparency and discipline in management of cooperatives.[17]

119. The scope of regulation for cooperatives all seems to depend on the range of activities that they engage in and the capacity of the policy environment to support and sustain cooperative/ credit unions development. Although the importance of standard is emphasised, the establishment of these frameworks should not hinder the development of cooperatives—that is to say, regulation should be formulated not in a restrictive manner, but to ensure the healthiness of industry development. Therefore, the regulation should reflect the specific characteristics of cooperatives, yet have some flexibility in its operational framework.

4.1.3 Capacities for monitoring and supervision

120. A sound mechanism for monitoring and supervision is crucial for assurance of effective operation of the legal and regulatory framework. As methods of regulation are varied, the forms of monitoring and supervision are also different from country to country.

121. The legal and regulatory framework alone does not have the means; the regulation only functions effectively when both regulators and MFIs maintain the appropriate capacity. The basic principle for monitoring and supervision should be built upon risk-based management of banking operations. It is crucial for regulators and regulated institutions to have such a capacity to maintain an appropriate mechanism for risk-based management. However, one key is whether regulators truly understand this issue, so that the framework for monitoring and supervision would be based on the risk management of MFIs. Greuning (1998, 19) has pointed out that the regulators should focus more on the processes of managing risks rather than on the prudential ratio. Most important is the understanding and incorporation of specific risk profiles of microfinance operations into the monitoring and supervision systems.

122. Because monitoring and supervision are concerned, capacity building for both MFIs and regulators is key to the sustainable regulatory system for MFIs. In fact, in many cases, capacity building for regulators is directed by donor agencies. In the case of China, for example, the

[16] http://www.cda.gov.ph/profile.htm Authors are grateful to Mrs. Ludivina Albances, bank officer of Bangko Sentral ng Pilipinas, for valuable information. Information provided in a meeting memo prepared by Mr. Edzel Ramos, CARD Bank, Philippines.

[17] From notes of Mr. Edzel Ramos.

United Nations Development Programme has convened an advisory board on poverty alleviation in Beijing, where numerous issues regarding microfinance are discussed and various types of training have been provided (Conroy, in Mcguire 2000, 49). Conroy also mentions that the board considers issues such as "interest rates, and the respective roles of regulated financial institutions and civil society organisations in microfinance." The members are related ministries, the central bank, UN organisations, the World Bank, ADB, and international NGOs. Local NGOs and the key ministry, the Ministry of Civil Affairs, which registers and regulates community organisations, had not been included at the time of this writing. Yet Conroy believes that central bank participation in a forum is a positive sign for the future expansion of the activity.

123.Indeed as Greuning (1998, 33) states, donors can be very instrumental in providing policy guidelines. Yet those types of initiatives should not increase the dependency of recipient countries on external assistance. It is important that donor agencies not impose a ready-made package for capacity building, but scrutinise the characteristics of an individual country's financial system and reflect them in the coordination of various activities.

4.1.4 Areas to be regulated or not to be regulated

124.The effort of the government is crucial in regulating microfinance institutions, as it has to reflect the specific features of microfinance institutions. Yet at the same time, the government has obligations of public concern. For this, central banks are often required to form guiding principles which are "flexible, yet not lenient" (Rozengard 2000, 22).

125.Whether the savings mobilisation is small or large, complex or simple,...as long as it takes from public and mobilise its savings, the central bank has to regulate and supervise banking activities. Therefore, as Rozengard points out, the question does not concern whether central banks should regulate and supervise microfinance banks the question concerns "what special characteristics of microfinance banks might justify adjustments in the way the central bank carries out its regulatory and supervisory responsibilities" (ibid.).

126.There are some areas in which microfinance operations need particular care. The items described in the following are often questioned in terms of how readily adaptable they are to microfinance operations. Financial viability has been recognised as a core to microfinance development; therefore, principles promoting it are essential to the legal framework.

Box 9 **KENYA**

Central Bank Of Kenya

While microfinance institutions are encountering various legal constraints to entering the formal banking sector, central banks are facing challenges in adapting the environment for those newcomers to the market.

The Central Bank of Kenya provided its first banking license to a microfinance institution in 1999. In the budget speech that year, the minister of finance conveyed that the CBK's strategy for promoting microfinance institutions was by "establishing a division within its Banking Department to monitor operations of microfinance institutions and to assist them in their development" (Rozengard et al. 2000, 22).

The following results of a study carried out by a team from Harvard, introduce some of the innovative attempts by the Central Bank of Kenya, and areas to be improved otherwise.

Capital Adequacy: The study team found that the capital adequacy rate, 7.5% of risk weighted assets, the same rate applied to commercial banks, is too low for microfinance operations. Central bank personnel are not very familiar with microfinance operations, which are often more volatile and vulnerable to various risks , thus making early identification of problems difficult. Therefore, the study recommended that the central bank should, as Rozengard et al. (2000, 25) advocated, "consider making these requirements even more stringent for microfinance banks."

Interest rate: Microfinance banks are allowed to freely set their own interest rates, aiming at levels sufficient to ensure financial viability and long-term sustainability. This is to ensure that they can cover all the cost necessary for long-term sustainable operations. Yet the study points out that if the interest is set in that way, there should be some consistency in its measurement. For example, a standard of profitability, such as returns on assets or returns on equity, should be consistent with interest rate settings.

Liquidity: Microfinance is often exposed to a high level of seasonal liquidity risk. As has often been pointed out, the losses of savings by the poor have devastating effects. The study recommends, therefore, that, as Rozengard et al. (2000, 27) advocated, "the CBK might also consider making these requirements even more stringent for microfinance banks."

Management Quality: The study has recommended that the central bank establish minimum requirements in terms of organisational structure and reporting systems. The complicated system of organisational structure often creates inefficiency in its operations. Also, inappropriate reporting requirements often unnecessarily strain the capacities of microfinance institutions. It is often desirable, therefore, to establish a simple mechanism specifically for microfinance operations.

The example of the Central Bank of Kenya suggests it has recognised the differences between ordinary commercial banking and microfinance operations. Also it suggests that although in some areas the requirements need to be strengthened, in others there should be greater flexibility, reflecting the special features of microfinance operations. Flexibility does not imply that the requirements become lenient, rather it relates to the lifting of unnecessary hurdles to those interested in microfinance banking—a core responsibility of a central bank is to establish a simple, yet secure, system for microfinance operations.

1) Entry requirement

Minimum capital requirement

127.The rationale for minimum capital requirements is to create a strong financial sector via a few sound banks (Schmidt, 112) and for local supervisory bodies to maintain institutional sustainability by limiting the number of banks to take care of. The introduction of microfinance into the regulatory framework has been a new initiative in most countries, and "minimum equity requirements are now being applied to bank-like microfinance institutions in the same way as they are applied to normal commercial banks" (ibid., 115).

128.Yet this implies the high hurdles for small-capital MFIs to enter the formal market, event those with sustainable operations. "In banking, prudence is good and regulation is necessary.... However, there is no logical reason to make such institutions meet the same minimum equity requirements that are applied to commercial banks" (ibid., 118). Schmidt has suggested that microfinance institutions should be "subject to lower absolute equity requirements than commercial banks, and higher relative capital requirements than are applied to 'normal' banks" (ibid., 119).

Cambodia: Minimum Capital Requirement

Banks	Specialised Banks	Licensed MFIs
KHR 50 billion (USD 12.8 million)	KHR 10 billion (USD 2.6 million)	KHR 250 million (USD 64 thousand)

(National Bank of Cambodia)

Capital adequacy ratio

129.The purpose of a required capital adequacy ratio is to set limits on "the extent to which a financial institution may leverage itself" (Jansson 1998, 22). The Basle Accord has recommended that internationally active banks maintain capital of four percent tier-one capital and eight percent total (tier-one plus tier-two) capital in relation to risk-weighted assets, and many countries are also applying the Accord to domestic banks (Basel Committee on Bank Supervision 1997, 24). Hence the maximum risk-weighted asset-to-equity ratio of 12.5 to 1 has been applied in many countries.

130. Yet, questions arise about the applicability of this ratio to MFIs. Reasons could be considered from various perspective—mainly from external conditions and internal operational perspectives. First, one has to consider that the ratio was structured initially for financial institutions incorporated in OECD countries, in other words, for financial institutions in sustainable macroeconomic conditions. Therefore, small-scale MFI operations in very diversified, sometimes more volatile, environments might not be sustainable at this ratio (Jansson 1998, 22). As has been discussed, MFI operations have a number of specific features; thus, regulations for commercial banks cannot be simply applied to MFIs.

131. Second, the recommendation of eight percent "presumes adequate provisioning practices for delinquent loans," which might not be well managed in countries where MFIs operate. As for internal issues, Mcguire (1998, 79) has questioned the incentives for shareholders to pursue commercial profit in cases where the microfinance institution originally started as an NGO. Furthermore, often an MFI's portfolio risk is less diversified as operation has been concentrated in particular geographical regions, populations and sectors, thus making microfinance more vulnerable. Lastly, as MFI operations are costly and higher interest is charged on loans, a given percentage of a non-performing loans will decapitalise them faster than it will commercial banks.

132. Therefore, in order to maintain sustainable operations, the capital adequacy ratio must be stricter for MFIs than for commercial banks (Jansson, 22; Mcguire, 79; and Lapenu, 30). The recommended ratio varies depending on the vulnerability of the MFI sector and the stability of the macro economy. It should reflect the appropriate underlying risks of MFIs and not be excessively high, which would create disincentives for investment in the sector as such standards would lower the expected returns to equity (Jansson 1998, 24).

Philippines: Capital Adequacy Ratio

Banks	Thrift Banks	Rural Banks / Cooperatives
10%	10%	10%

(Llanto, in Mcguire 2000, 276)

2) Operational requirement

Interest rate

133.Usury law is established to protect borrowers from unscrupulous lenders. Yet for MFIs, it could often lead to negative impacts on operational and institutional sustainability. In fact the nature of the law not only prevents MFIs from charging the market rate of interest, but also "screens out clients with the highest credit risks" (Jansson 1998, 36). It prevents MFIs from earning enough to cover the high costs of their operations. Because of the high cost of their activities, MFIs should set their interest rates higher than commercial banks do.

134.First, this argument is supported by the fact that MFI transaction costs are higher than those of formal financial institutions. For example, in Bolivia where development of microfinance is well established, the interest rates of MFIs are normally twice as high as those of traditionally oriented financial institutions (Jansson 1998, 37). Because microfinance operations typically involve small loans over wide geographical areas, per-unit cost is very high. Thus to cover those costs, MFIs need to charge higher interest rates. Also, as Gulli has pointed out (1998, 64), in high inflation countries where the financial and economic climate is harsh, high interest rates are fundamental to securing and sustaining sound MFI operations.

135.Even though there are some counter arguments that high interest rates will exclude poor clients, narrowing the client outreach, there is no evidence to suggest that lower interest rates contribute to broader outreach to the poor (Gulli 1998, 64). The rationale for the poor to borrow from MFIs is not necessarily the low interest rates, but often simply comes from the availability of the loans (Okamoto 1995, 5) . It is now widely recognised that the poor are willing to use the service even if the interest is higher than the market rate. The poor often have limited access to formal financial services, and thus they often value the microfinance services and will utilise them in all capacities. Therefore, there is no clear evidence to show there is a correlation between the interest rate and outreach.

Box 10 — West Africa

The Impact of the PARMEC Law

The Project d' Appui à la Reglementation sur les Mutuelles d'Epargne et de Credit (PARMEC) was drawn up by the Union Economique et Monetaire de l'Ouest de l' Afrique (UEMOA) in December 1993. Law No. 94-040 (PARMEC law) was later (August 15, 1994) approved by the Council of Ministers as specific regulation for microfinance, aimed at developing the informal financial sector in UEMOA nations.[1]

With these regulations, microfinance institutions then had a legal basis for carrying out activities hitherto performed exclusively by banks and traditional financial institutions (CGAP 2002).

The law provides merits to those regulated institutions such as protection of institution, exemption from taxes, and most importantly legalisation of the institutional operations (UNDP 1997). Although one recognised benefit of the law is that it establishes a common standard and common regulations, it seems to fail to respect small, "less sophisticated" institutions (ibid.).

Usury law is one of the critical and controversial issues for the development of the microfinance industry. The original law prohibited the charging of interest that was more than two times the discount rate of the central bank, consequently preventing many organisations from covering their operational and financial costs. The situation has since been modified (Boucar 2000) such that by law the usury rate of commercial banks is 18% and that of MFIs is 27%, yet it is still considered to lack flexibility.

Boucar (2000, 5) has also pointed out an implication of the regulation on the loan-to-deposit ratio. Article 50 of the decree stipulates that;

"the risk assets of the entire institution covered by resources made available and covered by donors, cannot exceed twice the deposits of the entire membership."

This implies the loan-to-deposit ratio is based upon the amount of savings; therefore, MFIs that mobilise little or no savings are penalised.

Also some question the capacity of ministries to monitor and supervise those MFIs (Christen et al. 2000). Under the PARMEC law, MFIs are supervised by the finance ministries in each country. Considering the workloads, the requirements in human resources, and the insufficiency in training, those ministries will soon be overwhelmed. According to Christen (2000, 8), seven out of eight countries covered by this law have established a special unit for monitoring and supervising those institutions, supported by their central banks and international donors.

Sources: *UNDP, Microfinance Assessment Report for Benin (1997).*
Ibrahim Boucar, *An Assessment of the Legal, Regulatory, and Institutional Environment of the Microfinance Sector in Mali* (2000).
Christen, Robert Peck and Richard Rosenberg, *The rush to regulate*, CGAP Occasional Paper No.4

[1] Benin, Burkina, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.

136.Second, from microfinance perspectives, inadequately low interest rates will create high MFI dependency on external funds, delaying institutional development. Once an MFI's operations are in place, its financial performance is closely monitored. A measurement of operational self-sufficiency[18] shows that low interest rates make the dependency ratios of MFIs high.

137.Overall, the introduction of an interest rate ceiling contradicts the nature of microfinance. In reality, most of the targeted clients for MFIs are those with high credit risk, who are mostly landless farmers or marginalised women in the society. Also, for effective sustainability of operations, MFIs require more inputs than commercial banks do; The repayment of MFI loans is made in small, frequent installments, and training is required for field officers as well as for clients—all of which makes MFI operations costly.

138.MFIs have a mission to balance economic development, as well as its social impacts on borrowers, with the specific nature of MFIs, which largely differs from that of ordinary banks. On one hand, institutions have to set a reasonably high interest rate to sustain and cover their operational costs; on the other, they have to leave some scope for borrowers to fully utilise lending in a sustainable manner. It is important to note that there is no single consensus on the direction the MFI industry should take, yet it is crucial to establish interest rates that are conducive to the development of MFIs.

Methodology: How to set an adequate interest rate

139.In order to establish an environment for sustainable MF operation, after the challenge to overcome usury laws, the issue will be how to maintain an appropriate interest rate. This paper does not intend to get into details, as its focus is on policy issues rather than the technical interpretations of them, yet will introduce one method by CGAP as a standard to show how all the necessary elements are incorporated into a formula. It is important to be aware that various conditions that have no impact on formal banking operations will affect microfinance operations a great deal.

140.The commercial rate, or market rate, of interest is often referred to as a figure comparable to

[18] Ledgerwood (1999, 217) defines the ratio as (operating income) divided by (operating expenses+financing costs+provision for loan losses). The measurement is to see whether the MFI is generating enough revenue to cover all the operating expenses, financing costs and loan loss provisions.

the interest rate. Yet in microfinance industry, where often no clear market segment exists, the word *commercial* is rather ambiguous, as it does not capture the real picture. In reality, the commercial rate should refer to a reference rate— in this case, the money lenders' rate of interest, which is often unreasonably high.[19] Therefore, because the commercial rate is not an appropriate indicator, comparative measures of interest rates do not mean much for the desirable rate of interest for microfinance institutions. Rather the interest rate should be calculated in the way that the MFI's cost recovery rate is measured

141.Also for interest rate to be defined accordingly and implemented to maximise the profit and welfare of MFIs, Ledgerwood (1999, 143) has suggested that the "effective rate of interest refers to the inclusion of all direct financial costs of a loan in one interest rate."

142.CGAP (1996, 1) has suggested that the annualised effective interest rate R is calculated as follows.[20]

$$R=\frac{AE+LL+CF+K-II}{1-LL}$$

Where (AE) Administrative expenses

(LL) Loan loss

(CF) The cost of funds

(K) The desired capitalisation fund

(II) Investment income

(These five elements are shown as a percentage of the average portfolio outstanding.)

143.Administrative expenses (AE) includes all annual recurrent costs except the cost of funds and loan losses-e.g., salaries, benefits, rent, and utilities' as well as all donated services such as technical assistance and training, which in the future MFIs will have to bear themselves. For many MFIs, AE normally accounts for 10–20 percent of the average loan portfolio. According to CGAP, most MFIs tend to reach their economy of scale by the time they reach about 5,000-10,000 clients.

[19] Even though the actual interest rate range varies depending on the loan type, country and region, a comparative study in Robinson (2001, 196) finds that in Asian and Latin American countries it is quite common for money lenders to charge an interest rate of around 20% per week.

[20] For how the five elements are calculated, and details, see Rosenberg, CGAP Occasional Paper No.1 (August 1996).

144.Loan loss (LL) is the annual loss due to uncollectible loans. This is the ratio of delinquent loans that has to be written off. CGAP suggests that a rate above 5% tends to be considered as a sign of non-viability of institutions, whereas sound microfinance operations normally maintain the ratio at 1-2% (CGAP 1996, 2).

145.Cost of funds (CF): CGAP explains this ratio as a "future market cost of funds as the MFI grows past dependence on subsidised donor finance, drawing ever-increasing portions of its funding from commercial sources."

Usury Laws and Interest Rates in Latin America

Country	Usury Law & Interest Rate Restrictions
Argentina	No restrictions
Barbados	No restrictions
Belize	No restrictions
Bolivia	3% per month (nominal), applicable to persons and institutions
Brazil	12% per year in real terms
Chile	150% of the average rate of commercial banks
Colombia	Financial institutions: 150% of the average rate of commercial banks
Dominican Republic	No restrictions
Ecuador	There are some usury restrictions, but they do not apply to financial institutions
El Salvador	No restrictions
Guatemala	No restrictions
Guyana	No restrictions
Honduras	Average rate of commercial banks + 6% (nominal)
Mexico	No restrictions if there is a contract/agreement; 6% (nominal) if no contract/agreement exists
Nicaragua	Financial institutions: No restrictions Individuals and unregulated entities: 150% of the highest rate in the system
Panama	2% per month (real/nominal not defined)
Paraguay	Financial institutions: 150% of the average rate of commercial banks
Peru	No restrictions
Trinidad and Tobago	Financial institutions: No restrictions
Uruguay	175% of the central bank's average discount rate
Venezuela	Financial institutions: 4% per month (nominal) Individuals and unregulated entities: No restrictions

Source: MIC Survey 1997 in Jansson (1998, 36)

146.The capitalisation (K) represents the net real profit that the MFI decides to target. This comes from the idea that with MFI's limited access to external funds, increases in equity should ideally come from internally generated profit. CGAP suggests that long-term growth normally requires "a capitalisation rate of at least 5-10% of the average outstanding loan portfolio" (Rosenberg 1996, 4).

147.Investment income (II) is the income expected from the MFI's financial assets other than the loan portfolio. As each asset, such as cash, checks, deposits, etc., earns income at different levels, this income is expressed as a decimal fraction of loan portfolio (ibid.).

Loan loss provision

148.Financial institutions are required to measure potential risks in their loan portfolios and secure allowances for future losses. Loan loss provision is both general and specific : general being for the possible risks to current sound loans, and specific being for non-payment risk of individual loans (determined through data such as past repayment history, and days past due) (Jansson 1998, 26).

149.For many, microfinance is still considered risky business as it involves unconventional banking operations. Only a small number of MFIs are financially self-sufficient and many do not take collateral. According to Mcguire (1998, 79), portfolios of MFIs often show lower delinquency than those of commercial banks, but the delinquency tends to be more volatile.

150.Therefore it is now widely recognised that loan loss provision should be higher for MFIs than for commercial banks. With consideration for the nature of MFI operations and its specificity, the CGAP has recommended the following criteria for the loan loss provisions of MFIs.

Loan Loss Provision

Time in arrears	*Loan loss provision*
1-30 days	10% of full remaining unpaid balance
31-90 days	25% of full remaining unpaid balance
91-180 days	50% of full remaining unpaid balance
More than 180 days	100% of full remaining unpaid balance

(Christen 1999, 26)

151.There are other methods such as those introduced by CAMEL (ACCION) and by the Inter-American Development Bank. And the choice of provisioning method can have a substantial impact on certain financial ratios (Christen 1999, 26); thus, they should be carefully arranged accordingly.

Reserve requirement

152.According to Mcguire (1998, 78), reserve requirements are often introduced to limit monetary expansion in banking systems. The higher the reserve requirement, the less the deposit base available for on-lending and the less likely are banks to engage in microfinance. Worldwide experiences suggest that the reserve requirements should be lower for banks—so they will be able to utilise their funds efficiently.

153.For example, in Cambodia, the reserve requirement is set at 10% for commercial banks, but at 5% for both specialised banks and licensed microfinance NGOs. The National Bank of Cambodia considers that because specialised banks do not take deposits other than from their members and their capital bases are very small, any excessive reserve requirement would burden the MFIs and hinder their effective utilisation of funds.[21]

154.The reserve requirement used to be high in most developing countries; however, it has been reduced recently as part of the deregulation of banking systems, particularly for microfinance operations.

Reserve Requirement

Cambodia	Banks	Specialised Banks	Microfinance Institutions
	10%	5%	5%
Philippines	Banks	Thrift Banks	Rural Banks / Cooperatives
	Peso deposits: 10% statutory 4% liquidity	Peso deposits: 11% statutory 3% liquidity	Peso deposits: 5%

(National Bank of Cambodia)

(Llanto, in Mcguire 2000, 276)

4.1.5 Timing for regulation

155.Most MFIs grows outside the regulatory framework, which provides favourable conditions for newly established MFIs for 'innovation and in new products and methodologies and

[21] Based on a comment by Ms. Neav Chanthana, Bank Supervison Department, National Bank of Cambodia.

fine-turning successful methods of service delivery to target market' (Hannig, 2000, P76). In this respect, the proposed agenda for a regulatory framework should be established in a way that does not hinder the progressive aspects of MFIs; rather it should provide an environment that encourages the development of the microfinance industry.

156.It is now widely recognised that a gradual approach should be taken in pursuing these processes. For the microfinance industry, it is sensible to wait to be regulated until a sizable mass of viable regulation institutions develops in deciding when to design a regulatory framework (ibid.) rather than creating an instant framework which does not respect the evolutional processes and characteristics of microfinance development. As Omar (in Hannig 2000) has stated, "specialised microfinance regulation that comes too early is likely to have the counterproductive effect of hampering innovation, impeding the learning processes of microfinance practitioners and stunning the industry through excessive and inexperienced model building."

157.Also the timing for the establishment of a legal and regulatory framework should be decided with consideration not only for quantitative terms (the scale of microfinance operations), but also for qualitative measures such as the loan portfolio quality of the MFIs. As Christen (1999, 16) states, simply opening a sophisticated regulatory window does not make microfinance more profitable, because "scale increases will seldom make an unprofitable MFI profitable." Thus, before a country concerns itself with establishing a new framework, it first must ensure the healthiness of individual MFIs and estimate how various frameworks would impact those institutions.

5. National Strategy on Microfinance Development: *A Methodology for Public-Private Partnership*

158. As stated when referring above to capacities for monitoring and supervision, one central need in order to effectuate appropriate regulations is acquisition of capacities (both by regulators and by MFIs) in microfinance regulatory systems, including monitoring and supervision modalities. However, unless the industry develops to some extent, the knowledge and experiences to get familiar with particular risk profiles of microfinance will not be accumulated in a country. Development of the sector would have had to have been accompanied by effective regulatory systems. So this is a sort of chicken-and-egg problem.

159. The timing for regulation presents similar problems. NGOs or other forms of MFIs, including unlicensed ones, need flexibility for business expansion, but also seek a solid national framework in which a secure environment is promised. Regulators have to cope with potentially conflicting tasks; on one hand they have to make the environment secure (e.g. protect depositors, avoid systemic risk in the industry), but on the other hand they have to *foster* this emerging industry, particularly because it is new to the conventional practices. A country could seriously hamper microfinance development if there is poor timing in the introduction of regulations.

160. What are the answers to these problems? How can MFIs and regulators get rid of incapable regulatory capacities while the industry is emerging? How can the country avoid over-regulation or premature regulations while meeting the needs for stabilising the industry?

161. Perhaps there is no single answer; however, a key appears to be a process of *learning* microfinance particularities in depth—learning by both regulators (public sector) and MFIs (private sector). Learning is a gradual process, even more so here because it involves reciprocation between the public and private sectors. Regulators and policymakers should have established a sound environment as well as effective regulations by the time MFIs become really sizable, but the learning process can happen only gradually and this learning is possible only by grasping actual needs and problems of MFIs at each stage of development. MFIs are obliged to comply with the national legal framework at every stage of their development and to report their performance to the monetary authorities and supervising ministries since their responsibility is important to the entire society given the nature of the financial sector.

162. To make such a gradual and reciprocal process of learning between the public and private sectors work, a vision (where to go) and tools (how to go) need to be shared by both. In other words, *a national strategy* for microfinance development is effective, so *a vehicle* to create such a consensus while gradually learning together is needed. In the following, we attempt to resolve, though partially, what a national strategy should involve and how to create such a consensus.

5.1 National Strategy:
A Vision and Action Plans to be Shared by the Public and Private Sectors

163. Note that the word *national* here denotes shared by the public and private sectors, not state-driven. As we have so far studied in this chapter that there is indeed diversification both in forms of microfinance institutions and in their transformational processes and that the policy environment is so different across countries, there is no single model or even a mere few models for a country to follow in creating an enabling environment. Understanding the spectrum of diverse experiences across the world is indispensable for policymakers, and it is important to recognise that such diversity is not only because of the various countries' differences in stages of development or in transitional processes, but also because of the differences in *directions* by which microfinance stakeholders in each country converge. 'Direction' here does not denote any orientation predetermined by any of the parties; rather it means a more naturally consented vision among stakeholders through the learning process.

164. Obviously, such a vision reflects the endowments and initial conditions of existing political regimes and economic systems, the roles and functions of existing players in the financial sector, the degree of capacities of microfinance stakeholders, and the will and decision-making systems of the regulators and other policymakers, to name a few. For example, as to forms of MFIs, each country has different potentials in local NGOs, international NGOs, private banks, credit unions or cooperatives, and government owned financial institutions. As to the regulatory framework, each country may have a different image as to what extent MFIs should be finally integrated into the formal systems. If this vision is not shared to some extent in a country, then. public sector and private sector action plans cannot be agreed or do not make much sense even if they are.

165. At the same time, as we stated in this chapter, several conditions are crucial to the sustainability of microfinance.

- Step-by-step formalisation of MFIs through the process beginning from legalisation and licensing to introduction of explicit regulations is the most appropriate
- The sustainability of microfinance depends on the degree of understanding of microfinance specificities (risk profiles, etc.), which are overall characterised as a highly market-oriented approach to provide financial access to the poor
- Capacity building for regulation is the more serious issue than selection of particular forms of regulation and timing for introducing regulations is very influential.
- As mid- or long-term perspective, the integration of MFIs into the formal financial system appears to be the most effective way to materialise the dual mission of microfinance: outreach and financial sustainability.

5.2 Establishment of an Industry Standard: *Self-Supervisory Approach*

166. Considering the above-mentioned sharing of national strategy, it is important to note that efforts to establish industry standards are essential at every stage of development. Most important is the effectiveness of society's trust in MFIs, thereby contributing to developing the industry as well as achieving stability. As stated, self-regulation is effective in coping with transitional problems until the capacities of regulators fully develop.

167. To draw some examples, Mcguire (1999, 723) pointed out that in many cases existing criteria are often inadequate or not upgraded in a relevant manner. As evidence, he cited a World Bank case study in Bangladesh, where "the accounting, management information systems and external audit policies and the standards adopted by the large MFIs are good and comprehensive" (WB, 1996) but lack of being upgraded. For those environments, where sufficient supervision and monitoring are not available, the establishment of some sort of benchmark is a pressing need as a first step to the formal regulatory framework.

168. Greuning et al. (1998, 18) suggests two major issues to be addressed by the standard: "the definition of performance and operating standards" and "the appropriate procedures to be observed for situations that merit mandatory suspension of operations or termination of existence of a MFI."

169. Steel (n.d.) points out that setting benchmarks is necessary as a "complement or alternative to regulation" particularly when

- Large numbers of MFIs do not qualify for licensing

- Formal supervision capacity is inadequate
- MFI industry is trying to monitor/improve performance

Steel also categorises the roles of benchmarking as

- Collection of information, analysis in consistent format
- Establishment of benchmarks by which MFIs can compare performance
- Establishment of a code of conduct
- Establishment of minimum standards for membership

5.3 Establishment of a Microfinance Forum

170. The establishment of a forum (or coalition or the like) on microfinance involving all stakeholders is an indispensable vehicle to sort out a national strategy, and it plays an important role in capacity building through "information exchange, training, research, policy dialogue with government and donor agencies, and establishing standards for self-regulation" (Mcguire 1998, 278). Thus, all actors can share information and exchange views and concerns about their daily operations. A forum can provide information on training for financial management skills in areas such as savings and credit (ibid., 278) as well as provide an opportunity for policy dialogue between government and MFIs regarding regulatory issues and the future direction and policy environment for future development.

171. There are a number of examples of such forums. In Sri Lanka, for example, an informal forum was established in 1995 with initiatives from the UNDP. The 55-member forum was initially held once a month, and included local and international NGOs with microfinance operation, donor agencies, and government agencies such as the central bank, the Bank of Ceylon. The forum has been successfully implemented and still is held every two months, providing various opportunities for key stakeholders to exchange views for further development of the sector. In the Philippines, as seen in chapter II, a microfinance forum played an important role in bringing about monetary authority support, and similar movements have been exploited in NGO circles and cooperative circles.

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