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TKNREPORT

The Regulation and Supervision of Microfinance: Main issues and progress

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Abstract

This policy paper attempts to explore three main aspects of the current debate on the regulation and supervision of microfinance. Using the case study of microfinance industry development in Indonesia, this policy paper mainly argues that appropriate regulation and supervision of microfinance is critically important in bringing the poor and vulnerable communities the financial services they need. In order to reach its full potential and further grow as a credible development tool, the microfinance industry must eventually be able to enter the area of licensed, prudentially supervised financial intermediation. Having said this, microfinance regulation and supervision is necessarily complex and filled with challenges. It is also very contextual. Blindly extending domestic prudential rules and consumer protection laws will not work. Specific adjustments will be necessary to capture the specificities of microfinance activities, both in the field of prudential and non-prudential regulation. Regulators will also have to weigh the potential costs of regulation and supervision, including the potential unintended consequences of regulation, particularly in regard to innovation and competition. Regarding supervision, adequate oversight mechanisms are critical for the proper framing of microfinance activity, but, like regulation, these measures have costs, both for public authorities and microfinance institutions. Such costs must be realistically estimated and sustainably supervised.

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Abbreviations and acronyms

APR	Annual percentage rate
BI	Bank Indonesia
BKD	Badan kredit desa (village banks)
BPR	Bank perkreditan rakyat (rural banks)
BRAC	Building resources across communities
BRI	Bank Rakyat Indonesia (Indonesian people's bank)
KYC	Know your customers processes
LDKP	Lembaga dana dan kredit pedesaan (Rural Funding and Credit Institution)
LPJK	Lembaga Pengawas Jasa Keuangan (Financial Services Supervisory Agency)
MCR	Minimum capital requirement
MFIs	Microfinance institutions
NGOs	Non-governmental organizations
IT	Information technology
LTD	Limited company

Executive Summary

After more than 40 years of successful development and increasing recognition as a development tool, microfinance has been hard hit by a series of crises that has led many critics to severely question the so-called "microfinance promise," namely the win–win rhetoric of "poverty alleviation with profit." While some of these problems are inherent to any fast-growing sector, others, including the repayment crises observed in various Latin American countries and in Andra Pradesh in South India, clearly point to deeper dysfunctions in the microfinance industry. Although these developments are not uniform across the globe, the critical importance of microfinance to the poor requires a proper response by microfinance stakeholders and policy-makers. Furthermore, in line with its maturity process, the microfinance sector has gone through a number of important and inevitable structural changes which, per se, call for proper regulation and oversight. These developments include, in particular, the fast commercialization of the industry, the change from "credit only" activities to "deposit-taking microfinance institutions (MFIs)," and the entry of new actors and credit delivery mechanisms in the microfinance sector (e.g., mobile banking).

Today, there is a broad consensus within the microfinance community that the regulation and supervision of microfinance is critically important for its future development and its credibility as a development tool. However, how best to regulate and supervise microfinance remains a very challenging question. Indeed, the business of managing a microloan portfolio differs in important ways from that of managing conventional bank loans, and microfinance forms an extremely diverse sector of activity. A "one-size-fits-all" solution is therefore neither possible nor desirable. Likewise, it is not possible to blindly extend existing banking and consumer protection laws and standards to microfinance institutions and activities. Any new regulatory and supervisory framework for microfinance will have to balance the need for financial stability, resilience, integrity and consumer protection with the need to preserve financial inclusion, innovation and healthy competition.

This policy paper attempts to explore three main aspects of the current debate on the regulation and supervision of microfinance. Using the case study of microfinance industry development in Indonesia, the paper mainly argues that appropriate regulation and supervision of microfinance is critically important in bringing poor and vulnerable communities the financial services they need. In order to reach its full potential and further grow as a credible development tool, the microfinance industry must eventually be able to enter the area of licensed, prudentially supervised financial intermediation. Having said this, microfinance regulation and supervision is necessarily complex and filled with challenges. It is also very contextual. Blindly extending domestic prudential rules and consumer protection laws will not work. Specific adjustments will be necessary to capture the specificities of microfinance activities, both in the field of prudential and non-prudential regulation. Regulators will also have to weigh the potential costs of regulation and supervision, including the potential unintended consequences of regulation, particularly regarding innovation and competition. Regarding supervision, adequate oversight mechanisms are critical for the proper framing of microfinance activity, but, like regulation, these measures have a cost, both for public authorities and microfinance institutions. Such costs must be realistically estimated and sustainably supervised.

1.0 Introduction

After more than 40 years of successful development and increasing recognition as a development tool, microfinance has recently been hard hit by a series of crises that has led many critics to severely question the so-called "microfinance promise" (Morduch, 1999), namely the win–win rhetoric of "poverty alleviation with profit." While some of these problems are inherent to any fast-growing sector, others—such as the repayment crises observed in various Latin American countries and, more recently again, in the South Indian state of Andra Pradesh[1]—clearly point to deeper dysfunctions in the microfinance industry. Of course, these developments are not uniform across the globe. Nor are they the primary and sole cause of the economic and social disruptions observed. However, given their critical impact on poor communities, they are serious enough to require a proper response by microfinance stakeholders and policy-makers. Furthermore, it is increasingly clear that, in line with its maturity process, the microfinance sector has gone through a number of important and inevitable structural changes which, per se, call for proper regulation and oversight. These developments include in particular the fast commercialization of the industry, the change from "credit only" activities to "deposit-taking microfinance institutions (MFIs)", and the entry of new actors and credit delivery mechanisms in the microfinance sector (e.g., mobile banking).

Today, there is a broad consensus among the microfinance community that the regulation and supervision of microfinance is critically important for its future development and its credibility as a development tool. However, how best to regulate and supervise microfinance remains a very challenging question. Indeed, the business of managing a microloan portfolio differs in important ways from that of managing conventional bank loans, and microfinance forms an extremely diverse sector of activity. A "one-size-fits-all" solution is therefore not possible, nor is it desirable. Likewise, it is not possible to blindly extend existing banking and consumer protection laws and standards to microfinance institutions and activities. Any new regulatory and supervisory framework for microfinance will have to balance both the need for financial stability, resilience, integrity and consumer protection while, on the other hand, the need to preserve financial inclusion, innovation and healthy competition.

In this paper, we explore three main aspects of the current debate on the regulation and supervision of microfinance.[2] First, we review the key issues microfinance stakeholders and policy-makers are aiming to address through regulation. Second, we outline the main issues at stake in the regulation and supervision of microfinance and look into the latest initiatives in this field. Finally, we assess how the regulation and supervision of microfinance has progressed in Indonesia, a well-known frontrunner in this field. As we shall see, there are major lessons to be learned from this experience, both in terms of enabling policies and corrective measures.

[1] Andra Pradesh is one of the 28 states of India, situated on the country's southeastern coast. It is India's fourth largest state by area and fifth largest by population. Self-help groups and MFIs have a long and important history in Andra Pradesh and have deeper penetration than in any other state. In early October 2010, microlending in Andra Pradesh faced a major crisis. Thousands of clients of some of the India's biggest microfinance institutions (SKS Microfinance, Spandana, Share, and so on) committed suicide, mainly as a result of critical over-indebtedness situations. This has led Indian authorities to reform microlending practices in India and carry out an in-depth review of the regulatory framework ruling microfinance activities. For further details on microfinance initaitives in Andra Pradesh, see, for example Consultative Group to Assist the Poor (CGAP), (2010a).

[2] Considering the large spectrum of microfinance activities, this paper will focus essentially on deposit-taking microcredit activities.

2.0 Why Regulate and Supervise Microfinance?

While it is the absence (or near absence) of formal regulation that has long given microfinance the necessary flexibility to develop as a successful financial inclusion tool, this situation has changed gradually over the recent decades. Indeed, as the sector matures, the arguments in favour of proper regulation (hard and soft) and oversight of microfinance are becoming increasingly more substantial. The academic literature[3] provides a number of important justifications, including the following: (1) the protection of the country's financial system and small depositors; (2) addressing the consequences of rapid growth and fast commercialization of the microfinance sector; (3) consumer protection and the fight against abusive interest rates; (4) the entry of new providers and credit delivery mechanisms in the microfinance sector; (5) lessons from the recent financial crisis; and (6) fraud and financial crimes prevention.

2.1 Protecting the Country's Financial System and Small Depositors

In order to become financially sustainable and better meet the needs of millions of poor people, many non-profit microfinance institutions (MFIs) are seeking to transform themselves from credit-focused microfinance organizations to deposit-taking financial intermediaries. However, deposit-taking is not without risk. MFIs must be able to lend profitably enough to pay for and protect the deposits they want to mobilize. They must also be able to cope with temporary downturns when these arise. Failure to do so can quickly harm financial stability and deprive small depositors of their savings. This is particularly true in microfinance, where the use of cash as collateral remains limited and where default payments (though rare) tend to be rapidly contagious when they arise. For this reason, most countries in the world have subjected their banking sectors to prudential regulation based on the "Basel Committee standards" (today known as the "Basel 2 standards").[4] The main objective of these international norms is to prevent a systemic failure of the financial system and protect depositors' savings. While microfinance activities taken individually are not systemic as such, they can rapidly become so in saturated markets characterized by intense competition. The repayment crisis that hit the state of Andra Pradesh in October 2010 illustrates this well. As we shall see, prudential regulation is complex and covers many areas (minimum capital, capital adequacy, liquidity, large exposures, loan-loss provisions, risk-management, governance, reporting, and so on). While some rules may apply equally to conventional finance and microfinance, others will require important adaptations.

2.2 Addressing the Consequences of Rapid Growth and Fast Commercialization of the Microfinance Sector

The microfinance industry has grown exponentially since its conceptual rebirth in the late 1970s by Professor Muhammad Yunus. It has grown, on average, by 40 per cent per year over the period 2004–2008, accumulating total assets above US$60 billion and delivering unheard-of returns on assets ranging between 15 per cent and 30 per cent (Chen, Rasmussen, & Reille, 2010: p. 1). This impressive growth was made possible due to the fast commercialization of the industry, as more mature MFIs were looking for new sources of funding, greater outreach and "proper" returns for investors. While there is no doubt this massive penetration of private funding into MFIs has allowed microfinance to grow well beyond what would have been possible with just donor and government support—and helped some MFIs to become financially independent—it also came at a significant price. Indeed, MFIs that were dependent on external money suddenly started playing along market rules and committed themselves to

[3] See, for example, Peck Christen and Rosenberg (1999) and Chen, Rasmussen, and Reille, (2010).

[4] For further details on Basel Committee standards, see Bank for International Settlement (2006). As a consequence of the 2008 financial crisis, the Basel 2 framework has recently been reformed, giving birth to the so-called "Basel 3" norms. These revised norms are currently being transposed in all the jurisdictions that are member of the Basel Committee.

corporate investors rather than pro-poor outreach and poverty reduction. They also faced direct competition from other credit institutions (mainly commercial consumer lenders with aggressive growth strategies). This in turn has led a number of microfinance institutions to neglect their double-bottom line objectives with clear negative impacts on asset quality.

As a result of intense profit-seeking behaviour, poor governance, and overstretched systems and controls, many newly transformed MFIs have largely overlooked credit discipline, which then rapidly translated into severe loan delinquency problems. This was particularly true in markets where intense competition led many low-income borrowers to take multiple loans, the size of which was not fit to their needs, nor to their repayment capacity (Chen, Rasmussen, & Reille, 2010). In many countries, this situation was made even worse by the fact that new entrants to the market typically ignored the credit delivery technologies that were successfully implemented by microfinance institutions in the past (e.g., solidarity group lending, village banking, compulsory saving techniques, etc.) (Ramirez, 1999). As a result, many borrowers were lured into credit contracts that were clearly not adapted to their needs, which in turn contributed to major repayment crises. Such situations were encountered in several countries in Latin America over the period 1997–2000 (e.g., Bolivia, Guatemala, Nicaragua), but also in Morocco (2007–08) and, more recently again in South India (Andra Pradesh in 2010).

Thus, while competition is generally considered to be a healthy economic process, in the case of microfinance, it has clearly happened too fast and—for many countries—in the near absence of sound rules. Better regulation and oversight of microfinance is aimed at controlling some of these excesses.

2.3 Consumer Protection and the Fight Against Abusive Interest Rates

Despite its commitment to financial inclusion and poverty alleviation, the practice of microfinance has raised increasing concerns in terms of consumer protection. The rapid commercialization of the industry has largely contributed to this phenomenon (excessive focus on growth and returns instead of asset quality, misleading contractual information, excessive interest rates, etc.), but it is not the only reason. Group lending technologies, which form the basis of many microfinance programs, have also led to severe abuses as a result of their peer pressure mechanism. Examples include aggressive loan collection techniques (e.g., daily harassment, public humiliation, social exclusion, etc.) as well as individual privacy issues. In this context, two main consumer-protection issues are currently the focus of attention of microfinance professionals and regulators. The first concerns abusive lending and collection practices. The second concerns "truth in lending," i.e., the delivery of accurate, comparable, and transparent information about interest rates.

As we shall see in the second section of this paper, while measures in favour of consumer protection are fairly consensual and have already led to a number of very constructive initiatives in the microfinance sector (both regulatory and non-regulatory), measures to control interest rates remain controversial. Indeed, whereas some in the sector (mostly regulators) believe that capping interest rates is an appropriate way to avoid abusive rates and promote transparency, most microfinance professionals are against such practices. The biggest danger, in their view, is that policy-makers will not be able to set an interest rate cap high enough to permit the development of sustainable microcredit, which in turn would jeopardize financial inclusion services to the poor (Helms & Reille, 2004). We will get back to the details of this debate later in the second section of this paper, which discusses the regulatory challenges of microfinance.

2.4 Entry of New Providers and Credit Delivery Mechanisms in the Microfinance Sector

Over time, the microfinance sector has become increasingly more diverse. New actors have entered the market with new products (saving facilities, money transfer services, insurance) and credit/payment delivery mechanisms. This is generally considered to be a positive development for the poor (Kapoor, Morduch, &. Ravi, 2007), as new means are being introduced to better meet their needs in a safer and more flexible way and—it is hoped—at a lower cost. Nonetheless, these new products and services are not without risk, and efforts to control the potentially negative side effects of these innovations have so far been limited. One good example in this context is the emergence of mobile banking. Use of this new credit/payment delivery mechanism has grown impressively in many countries, significantly broadening the opportunities to "bank the unbanked." Initiatives such as M-PESA in Kenya, Wizzit in South Africa and Smart Money in the Philippines are all good illustrations of this successful development. However, as shown by Kumar, McKay, and Rotman (2010), mobile banking also bears important risks for customers, in particular where these lack both information technology (IT) skills and financial literacy, which is common in microfinance. These risks typically include: "addiction" to mobile banking services leading to potential problems of over-indebtedness, loss of social ties between the borrower and the credit agent, loss of group cohesion in group lending programs, data privacy issues, etc. Some form of regulation is therefore considered necessary to control for these negative side effects. While electronic money institutions and their services are just starting to be regulated in industrialized countries (e.g., the E-money directive in Europe),[5] progress has been slower in developing countries. Considering the rapid development of mobile banking in these regions, many policy-makers now see this as a priority for the future (e.g., Indonesia).[6] The challenge, though, is how to regulate this sector without jeopardizing innovation.

2.5 Lessons From the Recent Financial Crisis

According to various Consultative Group to Assist the Poor (CGAP) reports and the Microfinance Information Exchange (MIX),[7] MFIs have emerged relatively untouched from the financial crises of the past few decades when compared with commercial financial institutions. However, this situation is changing. Indeed, with the commercialization of the industry, microfinance institutions now have many more links to international financial markets than before (particularly those which have now become publicly traded institutions, such as Compartamos, SKS, and so on) and, as a result, are increasingly exposed to potential turbulences in global financial markets. As reported by CGAP, a number of MFIs in Latin American countries (e.g., in Nicaragua, Peru and Bolivia) and Eastern Europe were actually hard hit by the 2008 financial crisis, though in different ways.[8] Looking at this evidence, microfinance experts generally agree that more mature MFIs, which derive an important part of their funding from international markets, would benefit from more rigorous prudential control and oversight. Such regulation would help them face two main types of risks: institutional refinancing risk (liquidity) and foreign currency dislocations.

2.6 Preventing Fraud and Financial Crimes

Two types of concerns related to fraud and financial crimes predominate in connection with microfinance regulation: (a) concerns about securities and abusive investment arrangements such as pyramid/ponzi schemes, and (b) money laundering concerns. In addressing these, it is generally agreed that the same rules should apply to MFIs as to

[5] For further detail on the E-money directive in Europe, refer to the European Parliament and the Council of the European Union (2009).

[6] For further detail on the development of E-money regulation in Indonesia see, inter alia, CGAP (2010: p. 5).

[7] See, for example, Littlefield and Kneiding (2009), CGAP (2009), and Gonzalez (2011).

[8] The specific impact of the 2008 financial crisis on MFIs varied with the structure of the institution's liabilities, its financial state, and the economic health of its clients.

other economic sectors. In many countries, the existing anti-fraud and financial crime regulation will be adequate to address abuse in the base of MFIs. Often, the most pressing need is to improve enforcement of existing laws rather than to create new rules.

Overall, a number of important arguments plead in favour of an appropriate regulation and supervision of the microfinance industry. While some of these are common to those observed in conventional finance (protecting the financial system and depositors' savings), others are more specific to the microfinance industry and its overall development through time (excessive commercialization, abusive loan collection techniques, excessive and opaque interest rates, etc.). Today, few microfinance professionals would contest the need for regulation and oversight. However, the critical question is this: how best to achieve this, given the specific characteristics of microfinance and the potential unintended consequences of regulation, in particular with regard to innovation and competition? We will address these issues in the next section of this paper.

3.0 Regulating and Supervising Microfinance: Main issues at stake

The microfinance industry differs in many ways from the conventional banking industry. Its client base is made up of very low-income earners and microenterprises that are typically widely scattered across the country and often lack basic financial education. Furthermore, the average loan size delivered by MFIs is much smaller and shorter-term than in conventional banking, and lending is usually unsecured (e.g., no collateral is provided in exchange of a credit). Microfinance institutions also tend to come in many different sizes and legal formats (i.e., non-profit non-governmental organizations (NGOs), for-profit NGOs, self-help groups, credit unions, cooperatives, commercial entities (limited company (Ltds.), etc.) and have highly diverse lending practices (group lending, village banking, individual lending). The social missions of MFIs also tend to vary a lot across the microfinance sector. While some institutions are clearly committed to broader development goals (such as Freedom from Hunger,[9] Pro Mujer,[10] and Building Resources Across Communities (BRAC)),[11] others are more profit-driven though still committed to financial inclusion. In this context, how should MFIs be regulated and supervised?

In what follows, we will address some of the key challenges faced by policy-makers in their attempts to regulate and oversee the microfinance sector. As captured by the CGAP Guide to Regulation and Supervision of Microfinance,[12] these challenges are numerous and typically involve the following questions: Exactly which MFIs should be regulated? Should microfinance be subject to a specific regulatory framework or should it be integrated into standard domestic banking and consumer protection law? Which specific aspects of microfinance activities deserve more stringent (or more flexible) prudential and non-prudential measures compared to conventional finance? How to create a cost-effective supervisory framework for microfinance structures without losing sight of the most risky activities? How to preserve healthy competition and innovation in the sector?

[9] Established in 1946, shortly after the end of World War II, Freedom From Hunger is an international development organization that is recognized for fighting hunger with innovative self-help programs. Further information concerning the activities of Freedom From Hunger is available from its official website at http://www.freedomfromhunger.org/.

[10] Pro Mujer is a not-for-profit development organization dedicated to providing women in Latin America with vital financial, health, and human develoopment services that are typically out of reach, but are crucial to breaking the cycle of poverty. Further information concerning the activities of Pro Mujer is available from its official website at https://promujer.org/.

[11] Established in 1972 by Sir Fazle Hasan Abed, BRAC is the largest Bangladeshi-based NGO by number of staff (employing over 120,000 people), the majority of whom are women. BRAC is present in all 64 districts of Bangladesh, with over 7 million microfinance group members, 37,500 non-formal primary schools and more than 70,000 health volunteers. Further information concerning BRAC's activities is available from its official website at: http://www.brac.net/.

[12] See, for example, Peck Christen et al. (2011).

3.1 Who Should Be Regulated?

Regulators have come up with different answers in different countries. In general, however, it is considered that non-depository MFIs should not be subject to **prudential** regulation, unless the nature of their activities prescribes otherwise. Indeed, credit-only MFIs generally present less risk for the financial system and, considering the large amount of small MFIs, it would simply be impossible and too costly to oversee the whole industry. All MFIs should nonetheless be subject to basic **consumer protection** measures, although not necessarily in a regulatory way. Soft legislation may be more appropriate, especially for very small institutions.

3.2 Amending Existing Regulations or Creating a New Regulatory Framework for Microfinance?

This question has led many regulators and microfinance professionals to carefully assess the specific institutional, prudential, operational and market risks attached to microlending—compared to other standard banking activity. While these sometimes differ significantly from conventional banking, it is generally considered that incorporation of microfinance rules within the existing regulatory framework will increase the likelihood that the regulatory changes are properly harmonized with the existing regulatory landscape, including, where relevant, international standards. Moreover, as argued by Peck Christen, Lauer, Lyman, and Rosenberg (2011), adjusting existing rules or standards may be technically easier—and cheaper—and may limit the risk of regulatory gaps and/or arbitrage. Such a "risk- based" approach has also led many regulators to focus more on regulating microfinance as a set of activities rather than as a set of institutions. The underlying principle to this approach is well-known: "same activity, same risks, same rules."

3.3 Adjusting Prudential and Non-Prudential Regulation to the Specific Risks of Microfinance

This is perhaps the most challenging task facing policy-makers when regulating microfinance activities. In what follows, we assess some of the key areas where microfinance—in particular deposit-taking activities—typically requires more focused attention compared to conventional banking.

3.3.1 Prudential Regulation of Microfinance

As outlined in all major reports on the regulation and supervision of microfinance,[13] MFIs' activities typically raise the following major prudential issues:

The first is the **minimum capital requirement** (MCR). This represents the lowest amount of currency that investors can bring to the equity base of a financial institution seeking a banking license. Setting this ratio is particularly tricky for regulators. If, for example, the MCR is too high, many MFIs will be discouraged from entering the sector, and efforts to promote financial inclusion among poor communities will be severely constrained. If, on the contrary, it is too low, almost any deposit-taking institution would become eligible, challenging both the financial soundness of the system and its oversight capacity. It is important, therefore, that regulators opt for an MCR that will secure the resilience of the financial system while not discouraging micro-lending activity.

The second prudential issue concerns **capital adequacy**. This ratio refers to the minimum amount of capital a financial institution should hold to avoid solvency problems. The Basel 2 prudential standards require all licensed credit institutions to maintain their level of own funds to minimum 8 percent of their total risk weighted assets.[14]

[13] See, for example, CGAP (2003), Christen et al. (2011), and Lhériau (2009).

[14] The ratio captures three main types of risks: market risk, credit risk and operational risk.

Despite the usually excellent repayment performance of MFIs (delinquency rates are often lower in microfinance than in conventional banking), microfinance professionals and regulators generally agree that MFIs should be subject to tighter capital adequacy requirements than standard banks (Peck Christen et al., 2011). The main reasons for this include the following: (1) MFIs' portfolios tend to be more volatile than those of commercial banks, and, accordingly, can deteriorate with surprising speed. This is partly due to the fact that MFIs' portfolios are usually unsecured or secured by limited—and often illiquid—assets; (2) non-repayment events in MFIs, when they arise, tend to be more contagious than in a commercial bank. Indeed, when a micro-borrower sees that other clients are not paying back their loans, his/her own incentive continues to decline rapidly. Many MFIs in Latin America (e.g., in Bolivia, Guatemala and Nicaragua) experienced this situation during the 1997–2000 downturns; and (3) operational risks in microfinance tend to be particularly high in microfinance. Indeed, many new MFIs are growing very quickly, with limited (and often ill-trained) human resources and infrastructure capacities. This tends to put heavy strain on both staff and IT systems, and sometime put MFIs at serious risks of default. For all these reasons, therefore, specialized depository MFIs will typically require higher capital adequacy ratios than conventional banks.

A third prudential issue for MFIs concerns **unsecured lending limits and loan loss provisions**. Standard prudential regulation typically limits unsecured lending to some percentage (usually 100 per cent) of a bank's equity base. Likewise, bank regulation usually requires 100 per cent loan-loss provisions for all unsecured loans at the time they are made, even before they become delinquent. However, none of these rules are adapted to microcredit portfolios. Indeed, most micro-lending is unsecured, and it is not possible for MFIs to automatically provision large portions of microcredit loans as soon as they are made. Some regulatory adjustments are thus necessary to accommodate for these specificities. CGAP experts have recommended that only delinquent loans be provisioned more aggressively than secured bank loans. Where possible, they also advise treating group guarantees as collateral.

As the recent financial crisis has clearly revealed, **liquidity and foreign exchange risks** are two other areas where deposit-taking MFIs may require more conservative prudential requirements (depending, of course, on the degree of exposure of MFIs to domestic and foreign markets). Indeed, faced with liquidity problems, conventional banks can always reduce lending efforts for a while to replenish their cash reserves. In contrast, MFIs cannot stop lending without seriously disrupting the repayment of their outstanding loans. Furthermore, most MFIs do not have access to emergency liquidity from the central bank or to the market sources of liquidity upon which standard banks typically rely. As a general principle, therefore, depository MFIs will need higher liquidity requirements than conventional banks. Regarding currency risks, MFIs often operate in countries where there is no proper instrument or knowledge on how to hedge efficiently against foreign exchange swings. This in turn means that borrowers bear a large part of the risk. It is important, therefore, that supervisors carefully check MFIs' capacity to manage currency risk and impose clear limits if the MFI is not able to address these risks properly.

Turning to the **protection of depositors**, it is generally agreed that, if deposits in commercial banks are insured, deposits in other institutions prudentially licensed (including microfinance institutions) should also be insured. However, to the extent that the costs of such deposit guarantee schemes are very high and usually prohibitive for most MFIs, balanced funding solutions must be found to limit the negative impact of such protection schemes on microfinance institutions.

Two final critical considerations when exploring the prudential treatment of microfinance institutions concern **reporting requirements** and **governance** issues. Again, the Basel 2 prudential standards contain a number of very stringent provisions in these areas for conventional credit institutions (known as "pillar 2" and "pillar 3" provisions). However, these are not necessarily fit to MFIs activities. Given the size (and term) of microloans and the nature of the

borrowers, it seems indeed excessive or even impossible to require them to generate the same loan documentation and reporting requirements as commercial banks. As a general principle, therefore, unless the size and operations of an MFI justifies otherwise, loan documentation and reporting requirements be simpler for MFIs than for normal commercial bank loans (Peck Christen & Rosenberg, 2003).

Governance is typically an area where policy-makers need to devote special attention when it comes to overseeing microfinance activities. Indeed, the specific governance structure of an MFI can have a significant impact on its capacity to manage risk and enforce credit discipline. This is particularly true for NGO and cooperative entities, which are often characterized by either weak ownership and management structures (in the case of NGOs) or very decentralized management and decision systems (in the case of cooperatives). At the end of the day, whether or not an MFI is able to manage correctly its deposit and lending activity—and act responsibly towards its clients—will highly depend on the quality of its overall governance and management (e.g. commitment of the Board to both asset quality and the MFI's social mission, ability to manage internal conflicts of interest, and responsibility towards investors), its internal controls and auditing, its IT systems, and its human resources. As argued by Vogel, Gomez, and Fitzgerald, (2000), controlling for these factors is likely to contribute much more to the prudential health of an MFI than controlling for the portfolio quality of thousands of microcredits.

As reported by L. Lhériau (2009) in his guide on microfinance regulation, most developing countries today are adjusting their prudential regulatory framework to Basel 2 standards, and large deposit-taking MFIs are usually subject to these rules. Nonetheless, regulators still find it very challenging to apply prudential norms to MFIs, as many Basel 2 provisions remain ill-adapted to microfinance activities. Taking these concerns into consideration, the Basel Committee has recently issued a paper entitled "Microfinance activities & the Core Principles for the Effective Banking Supervision."[15] This document recognizes the distinct regulatory challenges and the broader policy goals faced by supervisors engaged in overseeing microfinance activities. It points out the areas where some degree of flexibility in applying the 25 Basel Core Principles to microfinance is appropriate. Positively, these include the critical points mentioned in this section, e.g., capital adequacy, risk management processes, liquidity risk management, operational risk, internal control and auditing and last but not least, supervisory approaches and reporting tools. Clearly, this constitutes a very positive step forward, one that will certainly help regulators strike the right balance between the risks posed by microfinance, supervisory costs and the role of microfinance in fostering financial inclusion.

3.3.2 Consumer Protection

Having reviewed the main issues of attention in the prudential area, what are the main points of focus in the field of consumer protection? As mentioned in the first section of this paper, microfinance activities typically raise two main concerns for regulators: (1) abusive lending and loan collection techniques, and (2) opaque and excessive loan pricing practices. Let us consider the regulatory challenges in each of these areas.

3.3.2.1 Abusive Lending and Loan Collection Techniques

In principle, problems of multiple lending and abusive loan collection practices could be easily handled through specific consumer protection rules and penalties. However, in many developing countries, such laws remain poorly designed or fail to reach microfinance activities due to their perceived "marginal" effect on often politically and socially neglected communities of individuals. Furthermore, to the extent that MFIs often operate in very remote areas, it can be difficult to enforce any rigid rules. In this context, microfinance professionals generally consider that

[15] See Bank for International Settlement (2010).

soft measures, such as codes of conduct and self-regulation promoting responsible lending will be more effective at protecting consumers than strict rules. As Peck Christen et al. (2003) further recommend, such initiatives should aim at developing best practices in terms of due diligence (e.g., know your customers (KYC) processes, creditworthiness assessment, and so on) and adequate and transparent information to customers (especially at the pre-contractual stage). They should also aim to promote ethically acceptable loan collection techniques (avoid "predatory" lending, prohibit discrimination, respect privacy) and provide customers the possibility of lodging complaints and seeking redress in case of mistreatment.

Positively, the microfinance industry has developed a number of initiatives in recent years to encourage proper consumer protection in the field of microfinance. One of the most well-known is the so-called Smart Campaign. Launched in 2009, this initiative sets six core principles to protect MFI clients from potentially harmful financial practices, such as the avoidance of over-indebtedness, transparent pricing, appropriate collection practices, ethical staff behavior, a mechanism for redressing grievances, and privacy of client data. Another very positive development has been the emergence of well-defined "social performance assessment" instruments (e.g., the CGAP Poverty Assessment Tool[16] and Cerise Social Performance Indicator[17]). These indicators provide an additional set of criteria for the monitoring of MFIs' governance, their compliance with their mission and social goals, and their performance in terms of poverty outreach. Today, these indicators form the benchmark of most social performance assessment of MFIs and are also commonly used by microfinance rating agencies and social investors. Though they are no panacea, it is hoped that such measures will contribute to the development of healthy lending practices in the microfinance industry.

Regarding the problem of multiple lending, it can be efficiently addressed through the creation of so-called "credit bureaus." These consist of common databases which contain information on individual's borrowing and paying habits. Partner MFIs can consult this data to assess the creditworthiness of their clients. In developed countries, the combination of such registers and statistical risk-scoring techniques has massively expanded the availability of credit to lower-income groups while protecting high-risk borrowers from over-indebtedness. In developing countries, the emergence of such cooperative solutions has been slower due to a range of technical problems (such as client identification), but it is gradually building up. Indeed, most Latin American countries now have a credit bureau, which is either state-owned or private. This is a positive step forward, although, as the experience of Banex in Nicaragua[18] illustrates, some challenges remain. Indeed, free riding is common among data providers, and MFIs are often reluctant to provide the credit bureaus with accurate data, especially in times of economic downturns. The control of such credit bureaus is thus a challenge for regulators.

3.3.2.2 Excessive and Opaque Loan Pricing Practices

The issue of excessive and opaque interest rates is perhaps one of the most challenging and controversial regulatory debates in microfinance today. Indeed, while professionals and regulators generally agree that excessive interest rates are simply not acceptable considering the social mission of microfinance—especially when applied by highly

[16] For further details on the CGAP Poverty Assessment Tool, see Henry, Sharma, Lapenu, and Zeller (2003).
[17] For further details on the Cerise Social Performance Indicator, *see inter alia*, Cerise (2005).
[18] Banex is short for *Banco del Exito* (Successful Bank), and is an MFI in Nicaragua. It is also the sixth largest financial institution in Nicaragua that offers services to micro, small, medium, and large enterprises. The bank has its roots in FINDESA, an NGO providing microfinance services. In September 2008, FINDESA acquired the license to work as a bank, thus transforming it into the Banex. Further information is available from the official website of the MIX, which is one of the premier online sources for microfinance-related issues, at http://www.mixmarket.org/mfi/banex.

profitable and stock exchange-listed institutions such as Compartamos[19] and SKS[20]—they have so far failed to agree on the solution. Historically, governments have often used mandatory interest rate ceilings to fight excessive rates. This was again the reaction of the Indian government when faced with the repayment crisis in Andra Pradesh in October 2010. However, as Helms and Reille (2004) postulate, microfinance professionals have generally opposed such capping measures for the following reasons:

First, high interest rates are not necessarily a sign of inefficiency or extreme profiteering. In order to break even, an MFI needs to set loan charges at a level which is high enough to cover its various costs and local risk and inflation. Due to the specific nature of microfinance activities, MFIs typically face much higher operational costs than conventional banks. This is due to the fact that they usually operate in more remote areas and (manually) process a large number of very small loans (high transaction and overhead costs). Furthermore, MFIs often work in regions where domestic inflation is high and where economic, social and political risks are significant. All these factors contribute to the charging of high interest rates. In this context, microfinance experts fear that, by setting an interest rate ceiling, regulators will end up imposing a rate that is simply not high enough for MFIs to cover their basic costs. This is turn may challenge both their sustainability and the type of services they can deliver to the poor (constrained social mission).

Second, some studies, such as those produced by Helms and Reille (2004) and CGAP (2004), have shown that, where they have been enforced (e.g., in Indian states, Bolivia, Brazil, Laos, China, and so on), interest rate ceilings have typically resulted in lower provision of tiny loans and more opaque pricing structures (thus hurting poor people) rather than effectively lower and transparent rates. This is because MFIs try to compensate for the reduction of revenues through all kinds of hidden fees.

Finally, while there is no doubt that some MFIs continue to utilize prohibitive interest rates, a number of studies have shown that outliers, such as Compartamos and SKS, remain marginal.[21] Indeed, in most countries market competition is playing its role and is conducive to lower interest rates.

All in all, while microfinance professionals usually agree on the need to control excessive interest rates, they do not support the introduction of usury limits. Instead, they recommend the lowering of microcredit rates through measures aiming at promoting competition and transparency of pricing policies. In 2008, in an effort to promote such practices, the microfinance industry launched the **Global Initiative for Fair and Transparent Pricing**. This initiative aims to ensure "truth-in-lending" by encouraging all MFIs to publish effective annual percentage rates (APRs). It also provides educational material about the challenges of interest rate charging in microfinance. It is hoped that such information will discourage regulators and policy-makers from introducing distortive rate ceilings.

3.4 Facing the Challenge of Supervision

So far, we have focused our discussion on some of the major regulatory challenges facing policy-makers when trying to develop a legal framework for microfinance institutions and their activities. However, as pointed out by Peck Christen and Rosenberg (1999, p. 4), "the most carefully conceived regulations will be useless or worse, if they can't be enforced by effective supervision." This brings us to the other critical dimension of the regulatory debate of microfinance: the challenge of supervision.

[19] Compartamos is a Mexican bank and the largest microfinance bank in Latin America, serving more than 2 million clients. Further details concerning Compartamos are available at its official website at http://www.compartamos.com/wps/portal/Inicio.

[20] SKS is a non-banking finance company whose mission is to eradicate poverty by providing financial services to the poor. Its activities span 19 states in India. Further information concerning the SKS is available from its official website at http://www.sksindia.com/.

[21] See, for example, Ehrbeck, Leijon, and Gaul (2011).

Considering the complexity of the financial sector and the inevitable resource constraints that weigh on public authorities, oversight of the financial system always represents a tricky issue for regulators. Nonetheless, as outlined by Peck Christen et al. (2003), microfinance raises three specific additional concerns:

The first relates to the **inadequacy of standard supervisory tools**. Indeed, a number of traditional inspection and audit instruments are not fit for microfinance. For example, bank portfolio supervision based on loan-file documentation is ill-suited since such information is typically lacking or poorly reported by MFIs. Instead, supervisors must rely more on a careful analysis of the MFI's lending systems and its historical performance. Assessing microcredit risk will thus require specialized examiner skills and techniques, as well as extensive experience of MFIs lending practices. Other key examples are **capital calls** and **stop-lending orders**. While commercial banks can easily adapt to such requirements, this is not necessarily the case with MFIs. Indeed, these often run on short liquid capital, and their ability to suspend lending is very limited given the negative impact it would have on the collection of existing loans. These limitations mean that supervisors must very carefully assess the nature and maturity of MFIs prior to deciding how many licenses to issue, and how conservative to be in setting prudential standards.

The second concern relates to the **cost of supervision**, both for the oversight body and for the MFIs (i.e., compliance costs). These tend to be substantial for microfinance (more than for standard banking) given the number and diversity of activities that compose the sector, the high degree of decentralization and the more labour-intensive nature of inspecting MFIs portfolio. Where financial resources are limited, policy-makers need to estimate supervision costs realistically and identify a sustainable mechanism to pay for them, prior to embarking on major regulatory initiatives or reforms.

Finally, there are also substantial non-financial costs linked to regulation and supervision, such as the potential cramping of competition and/or the stifling of innovation. These are usually unintended, but can have significant negative impacts on microfinance activities. Regulators should therefore weigh these potential impacts carefully when considering the introduction of new regulatory measures.

In conclusion to this second section, microfinance regulation and supervision is necessarily complex and filled with challenges. Blindly extending domestic prudential rules and consumer protection laws will not work. Specific adjustments are necessary to capture the particular nature of microfinance activities while, at the same time, ensuring a safe financial system and allowing MFIs to fulfill their social mission of financial inclusion. Whereas "hard" regulation is inevitable in some areas, in others, soft legislation may be more effective, cost-efficient and appropriate. In recent years, the microfinance industry has developed a number of such regulations, particularly in the field of consumer protection. While no panacea, such measures should be actively supported by policy-makers since they will be instrumental in leading MFIs to begin sound reporting processes and in articulating basic standards of good practice.

Having reviewed the main dimensions of the debate on the regulation and supervision of microfinance, we will now look at the specific case of Indonesia, which has extensive experience in the field of microfinance. As we shall see, there are major lessons to be learned from this experience, both regarding the nature of regulation and the oversight of microfinance.

4.0 Microfinance Regulation in Practice: Lessons from Indonesia

Indonesia has a long tradition in microfinance that dates back to the last century. A large number of institutions offer microfinance services in the country, including:[22] commercial banks (mainly the Indonesian People's Bank (BRI, or *Bank Rakyat Indonesia*) through its specialized microfinance "Units"), rural and village banks (e.g., Rural Banks (BPR, or *Bank Perkreditan Rakyat*) and the Village Banks (BKDs, or *Badan Kredit Desa*)), non-bank MFIs (Rural Funding and Credit Institution (LDKPs, or *Lembaga Dana dan Kredit Pedesaan*)), credit cooperatives, and Islamic MFIs. The main financial products offered by these MFIs are loans and deposit facilities, although this is now rapidly changing (an increasing number of MFIs are providing money transfer services). The microfinance sector in Indonesia is large. The total number of MFIs at the end of 2006 was about 53,000, or around 7 times the number of branches of commercial banks. These MFIs collectively served about 18.6 million people (or 8.5 per cent of the population), lent out US$2,057 million (or 6 per cent of bank lending), and mobilized savings at US$3,102 million (or 3 per cent of bank deposits) (Meagher, Campos, Peck Christen, Druschel, Gallardo, & Martowijoyo, 2006).

As extensively reported by Robinson (1998) and Meagher et al. (2006), Indonesia's approach to regulating microfinance has been one of trying to make optimal use of its diversity of small institutions—mainly sponsored by the state—while introducing enabling policies to commercialize its microfinance sector in line with the liberalization of the Indonesian economy and banking system in the early 1980s. Corrective legislation only came later, mainly with the Asian Financial Crisis in 1997–98.

A first major reform package was introduced in 1983. It freed interest rates and abolished credit ceilings for banks. These reforms successfully set the stage for MFIs to charge cost-recovery interest rates and to become financially sustainable. Meanwhile, the progressive phasing out of government's direct intervention in the banking sector improved the efficiency, governance and the professionalism of banks. It was during that time that BRI was fully restructured and transformed into what is known today as one of the most successful flagship of Asian microfinance (Seibel, 2005). The government facilitated this adjustment by providing seed capital, start-up loans, and technical assistance. The next deregulation initiative was launched in 1988 (known as "PAKTO 88"). This reform removed most banking industry entry barriers, allowing commercial banks to extend their branch networks throughout the country. The 1988 reforms also led to the creation of a formal second tier of banks (the rural banks or BPR) which benefited from lower minimum reserve requirements. Interestingly, while these liberalization measures positively contributed to the rapid increase and outreach of microfinance institutions,[23] they were not accompanied by adequate banking supervision (Meagher et al., 2006: pp. 49–53). Indeed, the Bank of Indonesia (BI) lacked both the independence and power to cope with the rapidly growing banking industry and enforce financial discipline. As a result, an increasing number of banks started taking unsound credit decisions and failed to comply with legal lending limits, with little intervention by BI. The Banking Act of 1992 introduced new reforms aiming at addressing some of these weaknesses,[24] but this somehow came too late. By the mid-1990s, several banks were on the brink of bankruptcy, and it is only because of the Asian financial crisis in 1997–98 that major reforms were implemented.

[22] In parallel to this "formal" microfinance structure, Indonesia also has an important informal credit and savings scheme comprising RoSCAs (known as "Arisan"). Literally millions of Indonesians are involved in such arrangements and they are by no means the exclusive preserve of the poor.

[23] Lending and saving performance of Indonesian MFIs improved dramatically from 1983 to the 1990s.

[24] The 1992 Banking Act of 1992 reforms included simplifying banking categories into general commercial banks ("Bank Umum") and BPRs and defining the scope and activities of each category. It also strengthened minimum capital requirements for commercial banks to US$1 million and US$100,000 to US$200,000 for BPRs (depending on their localization).

As a matter of fact, the microfinance sector weathered the financial crisis quite well, and it was actually the BRI microfinance units that saved BRI from bankruptcy.[25] However, the Indonesian government's response to the crisis had major implications for the whole banking sector, including microfinance activities (Banking with the Poor Network and SEEP, 2009). In 1998, new regulations were introduced to strengthen both BPR and non-bank MFIs. The new rules stipulated that BPRs may only be established with a BI business license and forbade them from having foreign shareholders. They also significantly increased minimum capital requirements.[26] Other prudential decrees, such as those for loan loss provisioning, minimum capital requirements, assessment of asset quality, lending limits, and financial reporting, were implemented to improve prudential banking practices in line with Basel 2 standards. The 1998 Banking Act also led to the creation of a deposit guarantee scheme for the banking system.

As far as the strengthening of supervision is concerned, the 1998 Banking Act imposed the transfer of the licensing authority from the Ministry of Finance to BI, and compliance-based supervision was complemented with risk-based supervision. In 1999, a new law gave a full mandate to BI to act independently in carrying out monetary policy. In line with this mandate, BI eventually relinquished its role in banking supervision to a new independent financial institution, the Financial Services Supervisory Agency (LPJK, or *Lembaga Pengawas Jasa Keuangan*). This authority is today in charge of supervising all banks and non-bank financial institutions. However, there are some exceptions. Village banks, or BKDs, remain supervised by Bank BRI branches and cooperatives, both of which are also under the direct supervision of the Ministry of Cooperatives and SMEs under the Cooperatives Law. The costs of supervision in all cases are covered by the respective agency in charge of oversight.

All in all, the experience of Indonesia demonstrates that states can play an important catalytic role in developing the right regulatory environment for microfinance. In particular, they can generate the necessary enabling institutional and regulatory reforms (including deregulation). They can also stimulate the development of innovative financial structures (e.g., BRI units) and help gearing seed money and technical assistance during the initial phase of the reforms. However, the experience of Indonesia also clearly demonstrates the importance of supervision and the need for independent oversight structures.

[25] BRI Units benefited from more professional management, more regionally diversified portfolios, and depositors' "flight to safety" in response to the implicit guarantee of BRI deposits. Other MFIs were rather insulated by their focus on marginal areas and populations.

[26] MCRs were increased for BPRs operating in the Jakarta region from Rp 50 million (US$5,000) to Rp. 2 billion (US$200, 000), and to Rp 1 billion (US$100,000) for BPRs operating in provincial capitals. MCR for commercial banks were set at Rp 10 billion (US$1 million).

5.0 Conclusion

Appropriate regulation and supervision of microfinance is critically important in bringing the poor and vulnerable communities the financial services they need. In order to reach its full potential and further grow as a credible development tool, the microfinance industry must eventually be able to enter the area of licensed, prudentially supervised financial intermediation. The critical question, however, remains how best to regulate and supervise this industry given its various specificities and its broader social mission. As emphasized by Peck Christen et al. (2011, p. 7), "any regulatory and supervisory initiative for microfinance will have to balance on the one hand the need for financial stability, resilience, integrity and consumer protection with, on the other hand, the need to preserve financial inclusion, innovation and healthy competition."

As we have seen in this paper, microfinance regulation and supervision is necessarily complex and filled with challenges. It is also very contextual. Blindly extending domestic prudential rules and consumer protection laws will not work. Specific adjustments will be necessary to capture the specificities of microfinance activities, both in the field of prudential and non-prudential regulation. Regulators will also have to weigh the potential costs of regulation and supervision, including the potential unintended consequences of regulation, in particular with regard to innovation and competition. Regarding supervision, adequate oversight mechanisms are critical for the proper framing of microfinance activity, but, like regulation, these measures have costs, both for public authorities and MFIs. Such costs must be realistically estimated and sustainable supervisory mechanism foresee. Finally, as the experience of Indonesia clearly illustrates, the development of the microfinance industry requires both enabling and corrective legislation.

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