DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

REGULATION AND SUPERVISION OF MICROFINANCE

To reach large numbers of people, microfinance must eventually move into institutions that are licensed and supervised by a country's financial authorities. A licensed institution can offer savings services to its clients and multiply its own equity capital by capturing deposits. Because microfinance is different from conventional banking, the banking laws and regulations in most countries will eventually need some adjustment to accommodate licensed microfinance. However, not all countries need to address regulation in the near term.

What is microfinance regulation and supervision?

"Regulation" refers to the set of government rules that apply to microfinance. Supervision is the process of enforcing compliance with those rules. Microfinance providers that take deposits need "prudential" regulation. This type of regulation protects their financial soundness to prevent them from losing small depositors' money and damaging confidence in the financial system. Prudential regulation—which mandates, for instance, capital-adequacy requirements and rules for provisioning loan losses—is relatively difficult, intrusive, and expensive because it involves understanding and protecting the core health of an institution.

"Non-prudential" rules—e.g., screening out unsuitable owners/managers or requiring transparent reporting and disclosure—tend to be easier to administer because government authorities do not have to take responsibility for the financial soundness of the organization.

Microfinance needs different treatment than normal banking primarily because microfinance assets consist of many small, uncollateralized (that is, unguaranteed) loans. Areas of regulation that typically require adjustment include unsecured lending limits, capital-adequacy ratios, rules for provisioning loan-losses, and minimum capital requirements.

Should microfinance be regulated?

The following considerations should guide decisions about whether to regulate microfinance:

- *Credit-only MFIs*. Prudential regulation is needed only when there are depositors to protect, so it is not appropriate for credit-only MFIs that fund themselves from donors or commercial loans. Such MFIs may require relatively light non-prudential regulation.

- *Small community-based organizations*. Some community-based deposit-taking organizations are so small or remote that effective prudential supervision would be too expensive. Unsupervised deposit-taking institutions are risky. But other options that clients use for savings (cash, livestock, etc.) may be even riskier, so that shutting down such organizations may not improve depositor safety. Most regulators facing the question have decided to let these small intermediaries operate without prudential regulation and supervision, as long as their assets and number of clients remain below defined size limits.

- *Country conditions*. To take deposits safely, MFIs have to be profitable enough to cover their costs, including the financial and administrative costs of the deposits they collect. Otherwise, losses will eventually erode depositors' money. It may make sense to wait until a critical mass of MFIs meets this qualification before setting up a licensing regime for microfinance. In countries that have implemented microfinance regulation smoothly and effectively, the regulation has tended to follow rather than lead the development of the industry.

CGAP 1818 H Street, NW Washington, DC 20433
Tel: 202 473 9594 Fax: 202 522 3744 E-mail: cgap@worldbank.org Web: www.cgap.org
CGAP European Office c/o The World Bank 66, avenue d'Iena 75116 Paris FRANCE

Focus on supervisory capacity before, not after, regulation

When the government licenses financial institutions to take deposits, it implicitly promises depositors that it will keep their money safe. Licenses should be issued to MFIs only if there is reasonable assurance that this promise can be fulfilled. Experience so far supports several lessons:

- Supervisory capacity in most developing and transitional countries is limited. Supervisors often have their hands full with a troubled banking system, which is understandably their primary concern.
- Setting minimum capital requirements too low risks the proliferation of small institutions, stretching thin supervisory capacity past its ability. Minimum capital requirements should be high enough to limit licenses to the number of institutions that can be supervised effectively.
- Occasionally central banks have successfully delegated some supervision to third parties, while retaining authority and oversight. "Self-supervision" by bodies controlled by the supervised institutions, however, has virtually never been effective in developing countries.
- Prudential supervision of savings and loan cooperatives should be done by a specialized financial authority, not by the government agency responsible for all cooperatives.

What is the appropriate role for donors in microfinance regulation?

- In countries with interest rate ceilings, donors should make the removal or relaxation of these ceilings their top priority. Donors can also help educate politicians and the public to understand why sustainable MFIs have to charge relatively high interest rates.
- In some legal systems, especially in formerly socialist transitional countries, non-bank institutions (e.g., NGOs) need explicit legal authorization to lend. In such cases, donors should encourage regulatory changes that allow credit-only institutions to lend without prudential licenses and supervision.
- Before supporting the design of a new type of financial license, donors should first ensure that careful financial and systems analysis has verified that several strong, licensable MFIs exist. Otherwise, donors should not require microfinance regulation as a condition for assistance.

Regulation in Uganda. Good donor practice played a major role in Uganda's microfinance legislation, passed in 2002. The timing was right for regulation because the Ugandan microfinance sector was well-developed, with three to five MFIs nearly ready to become licensed deposit-taking institutions. GTZ worked closely with the Ugandan Central Bank (BOU) to develop a framework for licensing, regulating, and supervising deposit-taking MFIs. In consultation with the BOU, USAID's SPEED project is helping to build the capacity of these institutions to intermediate client deposits. Stakeholder consultation and the technical strength of donor teams are key success factors.

- Even if microfinance is not yet ripe for regulation, donors should prepare the groundwork by encouraging MFIs to follow sound accounting principles and disclose their financial results publicly.
- Donors should approach regulation from a financial-sector perspective, recognizing that microfinance can be provided by many different types of institutions. This will prevent too narrow a focus on one model.
- When donors encourage a government to license MFIs, they should include supervision experts in the technical teams that design regulations. Donors should also make sure that project budgets include the technical and financial resources needed to set up effective supervision. Ongoing supervision costs are substantial, so realistic plans to pay for these costs must also be made.

Author: Richard Rosenberg, with inputs from Timothy Lyman, Joanna Ledgerwood, and CGAP staff. The note synthesizes Robert Peck Christen, Timothy Lyman, and Richard Rosenberg, *Guiding Principles for Regulation and Supervision of Microfinance,* Microfinance Consensus Guidelines (Washington, D.C.: CGAP, 2003).

Where to go for more information: Robert Christen and Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, CGAP Occasional Paper No. 4 (Washington, D.C.: CGAP, April 2000). Hennie van Greuning, J.S. Gallardo, and Bikki K. Randhawa, *A Framework for Regulating Microfinance Institutions* (Washington, D.C.: The World Bank, 1999). A. Hannig and E. Katimbo-Mugwanya, eds., *How to Regulate and Supervise Microfinance? Key Issues in an International Perspective* (Kampala: Bank of Uganda/German Technical Cooperation (FSD) Project, 2000). These and other documents on this topic can be found on www.microfinancegateway.org.