70605

Microfinance Consensus Guidelines

A GUIDE TO REGULATION AND SUPERVISION OF MICROFINANCE

by
Robert Peck Christen, Kate Lauer, Timothy R. Lyman and Richard Rosenberg

Public Comment Version, April 2011

Microfinance Consensus Guidelines

A GUIDE TO REGULATION AND SUPERVISION OF MICROFINANCE

TABLE OF CONTENTS

PREFACE

This Guide updates CGAP's 2003 *Guiding Principles on Regulation and Supervision of Microfinance*.[1] The revisions reflect continuing developments since the first edition in the global state of financial access for poor and low-income customers, including the following:

- Increased attention to financial services beyond microcredit
- Entry of new providers and delivery mechanisms
- Stepped up funding from the private sector and quasi-commercial public investors
- Acceleration (in specific countries) in the pace of transformations of microfinance institutions from nonprofit to for-profit
- Competitive saturation of microcredit markets in a growing number of countries, which can increase portfolio risk and heighten consumer protection issues
- New and rapidly evolving regulatory frontiers, such as the regulation of bank and nonbank agents and e-money issuers
- Integration of microfinance into mainstream finance institutions and markets
- Consequent attention of international financial standard-setting bodies to financial inclusion issues

In contrast to the situation eight years ago, most policy makers, donors, and private investors involved in microfinance now appreciate that poor and low-income people, like the rest of us, want and need a variety of basic financial services.[2] The ability of the market to respond to such demand depends not only on providers understanding the demand and developing sustainable, low-cost ways to provide such services, but also on having an enabling policy and regulatory environment. Appropriate regulation and supervision of financial service providers is therefore critically important in bringing to poor and low-income people the financial services they need and want. We hope that policy makers will find this updated Guide useful as they confront that challenge.

[1] CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions, and offers advisory services to governments, microfinance providers, donors, and investors.

[2] Even when low-income people have no access to a formal financial institution, they actively use a spectrum of informal providers for loans, savings, insurance, and fund transfers. See for example: Rutherford, Stuart.1999. *The Poor and Their Money*. Oxford: Oxford University Press; and Collins, Daryl, Jonathan Murdoch, Stuart Rutherford, and Orlanda Ruthven. 2009. *Portfolios of the Poor: How the World's Poor live on $2 a Day*. Princeton, NJ: Princeton University Press.

INTRODUCTION

In the past decade, financial authorities in most developing and transitional economies have put more emphasis on bringing formal financial services to the large numbers of the world's poor. For many, the question has been whether and how to regulate "microfinance"—a term that evokes a particular set of services, providers, and customers. But the question is now being posed in broader terms: what kind of regulation and supervision will help to achieve full *financial inclusion* through the extension of financial services to the billions of poor and low-income people who are presently excluded? Even more broadly, how should we regulate and supervise the financial system as a whole in a way that balances financial access, financial stability, financial integrity, and consumer protection?

This balancing effort requires policy makers to weigh the potential benefits of regulatory action against potential limitations on access due to the costs of compliance and enforcement. As emphasized throughout this Guide, effective and efficient regulation should be proportional: costs should not be excessive when measured against the risks, although both are difficult to measure and there will very likely be differences of opinion among regulators, providers, and consumers.[3] However, this balancing is particularly important to financial access, where cost reduction is crucial for expanded outreach.

Scope. This Guide addresses the regulatory and supervisory issues that are specifically and distinctly relevant to formal financial services for poor and low-income people.[4] In some countries, state institutions serve many such customers, but their regulatory and supervisory treatment tends either to parallel that of nonstate actors or to be too diverse to be capture easily in generalizable terms. This Guide, therefore, focuses on private actors—both for-profit and nonprofit.

Audiences and format. Financial regulators and supervisors are the primary intended audience. But this Guide may also interest a wider audience, including not only the other national or subnational authorities whose decisions affect financial services, but also the service providers and other local stakeholders who participate in the decision-making process and live with the results, as well as staff of international agencies who encourage, advise, and support governments on financial inclusion policy.

Some readers will use this Guide as a general introduction to the full range of topics covered; others will consult it as a reference on specific issues. Most sections begin with key points (in shaded boxes), followed by discussion and analysis.

On some of the issues covered here, experience justifies clear conclusions that will be valid everywhere with few exceptions. On other points, the experience is not clear, or the answer depends on local factors, so that no straightforward general prescription is possible. On these

---

[3] See Porteous, David. 2006 "The Regulator's Dilemma."

[4] To avoid cumbersome repetition of the term "poor and low-income," we often refer to clients as simply "poor." Readers should understand that the term refers to a broader group that includes both poor and other low-income clients.

latter points, the Guide suggests frameworks for thinking about the issue and identifies factors that need special consideration.

Country-specific factors. Although the key points and analyses in this Guide are based on country experiences, discussion of country-specific examples has been intentionally avoided. Instead, the focus is on extracting from experiences around the globe general principles and recommendations that may be relevant in many differing country contexts.[5] It is critical to underscore the importance of country context when considering the issues presented in this Guide, or drawing conclusions from the specific experiences of any other country. The relevant country context includes the existing regulatory framework, retail providers' level of development, the capacity and constraints of supervisors, and other political, economic, historical, and cultural factors. It is dangerous for policy makers to use another country's regulatory regime as a template without a thorough examination of country-specific factors that will inevitably call for different treatment.

In what sense is this Guide a consensus document? The material in this Guide was developed in consultation with a wide range of regulators, supervisors, and other experts. (Key contributors are listed in Appendix A.)[6] Although experts working on these topics do not agree on all points, there are wide areas of consensus. Based on our consultations, CGAP believes that the main messages of this Guide command general agreement among most of the specialists with wide knowledge of past experience and current developments in regulation and supervision for financial inclusion.

Other resources. Because this Guide focuses on issues that are specific to poor people's financial services, it does not address many broader principles of financial sector regulation and supervision. For these broader issues, readers can consult the core principles and other publications of the relevant standard setting bodies, particularly the Basel Committee for Banking Supervision, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, the International Association of Deposit Insurers, and the Financial Action Task Force.[7] Increasingly, these standard-setting bodies are considering

---

[5] See, e.g., Trigo Loubière, Jacques et al. (2004), p. 3 (arguing against "criticizing one country as having a deficient framework or another as having an exemplary one" and for the premise that "each framework reflects the realm of possibilities that were present as microfinance entered the financial picture" and advocating that "designers of new microfinance regulation, and the international advisors who propose microfinance frameworks … take these realities into account").

[6] Acknowledgment of these contributions does not imply that the individuals or their organizations have endorsed all the contents of the Guide.

[7] Basel Committee for Banking Supervision: *Core Principles for Effective Banking Supervision* (http://www.bis.org/publ/bcbs129.htm); Basel Committee on Payment and Settlement Systems: *Core Principles for Systematically Important Payment Systems* (http://www.bis.org/publ/cpss43.htm); International Association of Insurance Supervisors: *Insurance Core Principles and Methodology* (http://www.iaisweb.org/__temp/Insurance_core_principles_and_methodology.pdf); International Association of Deposit Insurers: *Core Principles for Effective Deposit Insurance Systems* (http://www.bis.org/publ/bcbs156.htm); Financial Action Task Force: FATF Standards comprised of the *Forty Recommendations on Money Laundering and the Nine Special Recommendations on Terrorist Financing* (http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236920_1_1_1_1_1,00.html)

microfinance and financial inclusion explicitly in the context of their respective mandates.[8] The contents of this Guide are generally consistent with both broader principles of those bodies and with any specific guidance they have issued about financial inclusion issues.

Besides the increasing volume of relevant guidance from the global standard-setting bodies, a variety of think tanks, civil society organizations, and industry groups have also made recommendations about regulation and supervision for financial inclusion.[9] These are included, together with the relevant guidance from the standard-setting bodies, in the Bibliography.

Organization. The Guide is organized as follows:

- Part I discusses preliminary issues that set the stage, such as the definitions of microfinance and microcredit, financial inclusion as a regulatory objective, and the difference between prudential and nonprudential regulation.
- Part II discusses prudential regulation of depository institutions engaged in microfinance.
- Part III looks at the challenges surrounding supervision of depository institutions engaged in microfinance.
- Part IV discusses areas of nonprudential regulatory concern that affect both depository and nondepository institutions engaged in microfinance.
- Part V addresses the regulatory issues relevant to branchless banking.
- Part VI discusses regulation of microinsurance, especially when it is sold or administered by microfinance providers.

---

[8] See, e.g., BCBS *Microfinance Activities and the Core Principles for Effective Banking Supervision* (http://www.bis.org/publ/bcbs175.htm); G20 *Principles for Innovative Financial Inclusion* (http://www.g20.utoronto.ca/2010/to-principles.html), and *Multi-Year Action Plan on Development* (http://www.g20.utoronto.ca/2010/g20seoul-development.html)

[9] See, for example the Center for Global Development's *Policy Principles for Expanding Financial Access* (http://www.cgdev.org/content/publications/detail/1422882/); the SMART Campaign's *Client Protection Principles* (http://www.smartcampaign.org/about-the-campaign/smart-microfinance-and-the-client-protection-principles); and the WSBI's *Position Paper on the Regulation of Microfinance Services* (http://www.wsbi.org/uploadedFiles/Position_papers/0608.pdf)

Part I. PRELIMINARY ISSUES

This Part opens with a discussion of some basic terms used in this Guide. (The Glossary in Appendix B covers a much longer list of terms.) We turn then to enabling regulation—that is, regulation adopted with the explicit purpose of promoting the formation or improving the performance of providers serving the financially excluded poor. Next we discuss regulatory definitions of microfinance and microcredit, which may be quite different from the definitions of those terms as used in general discussion. Then we explore the distinction between prudential and nonprudential regulation of microfinance—a distinction with significant practical consequences, both for regulators and providers. This discussion of preliminary issues concludes by examining the question of whether to focus regulation on institutions providing microfinance services, on microfinance activities regardless of provider, or on some combination of the two.

1a. Terminology: What Is “Microfinance”? What Is “Financial Inclusion”?

The modern microfinance movement started with a focus on microcredit in many countries and only later embraced the importance for poor people of savings, money transfer, and insurance services.[10] Microcredit still looms large in the self-image of most providers who identify themselves as “microfinance institutions.” However, the evolution of the vision for full financial inclusion has been accompanied in recent years by a marked vocabulary shift away from “microfinance” and towards “financial access,” “financial inclusion,” and similarly broad terms. This Guide uses the terms “microfinance” and “microcredit” in part because this terminology is already used in relevant regulation in many countries, and we can expect the trend to continue.[11]

In this Guide, “microfinance” refers to the provision of formal financial services to poor and low-income people, as well as others systematically excluded from the financial system.[12] As noted earlier, the use of the term “microfinance” in this Guide refers not only to a range of credit products (for business purposes, for consumption smoothing, to fund social obligations, for emergencies, etc.), but also savings, money transfers (payments and remittances), and insurance.

What does “financial inclusion” mean, and how does this concept differ from the broad definition proposed for “microfinance”? In this Guide “financial inclusion” refers to the policy goal of reaching all financially excluded households with a full range of responsibly delivered, affordably priced, reasonably convenient, formal financial services. In many developing countries and transitional economies, this includes large numbers of households that are not considered poor or even low income by local standards, as well as most small and medium size enterprises (SMEs) (at least with respect to access to credit).[13]

---

[10] Financial cooperatives have a different history in much of the world, and have been taking savings for many generations in many countries since long before the modern microfinance movement.
[11] It appears that there may be a new wave of regulation focused specifically on microfinance and microcredit in countries facing over-heated microcredit markets.
[12] “Formal” indicates services provided by an institution that is legally registered with a government authority.
[13] Many regulatory issues in SME finance (such as borrower insolvency rules) are of limited relevance in microfinance and are therefore generally not explored in this Guide.

As used in this Guide, the term "microcredit" or "microloan"[14] has four important dimensions:

1. A microloan is typically much smaller than a conventional bank loan, although there is no universally agreed maximum
2. With occasional exceptions, the loan has either no collateral or unconventional collateral that rarely would cover the lender's loss if the client defaults
3. The borrower is typically self-employed or informally employed (i.e., not salaried)[15]
4. The lender typically uses the common microlending methodology described below[16]

This definition is not intended to include typical consumer credit (and more generally, this Guide does not address the regulation of consumer credit), which typically involves scored lending to salaried people (e.g., credit cards or deferred payment for purchases).[17]

As used in this Guide, the term "common microlending methodology" refers to the methodology developed over the last four decades that involves some or all of the following:

- The lender's personal contact with the borrower
- Group lending, or individual lending, based on an analysis of the borrower's (or borrower's household) cash flow as opposed to scoring[18]
- Low initial loan sizes, with gradually larger amounts available in subsequent loans
- An understanding that borrowers who repay their loans faithfully will have prompt access to follow-on loans
- A "compulsory savings" requirement that must be satisfied by the borrower prior to receiving the loan to demonstrate the borrower's willingness and ability to make payments and/or to provide a partial "cash collateral" for the loan

This common microlending methodology is perhaps the most important distinguishing feature of microcredit from a regulatory and supervisory perspective and is critical to many discussions in this Guide.

What is a "microfinance institution" (MFI)? As used in this Guide, this term refers to a formal institution whose *primary* business is providing financial services to the poor.[19] The range of institutional types delivering one or more microfinance services includes a wide variety of

[14] The terms "microcredit" and "microloan" are used synonymously in this Guide, although the terms "credit" and "loan" have distinct legal definitions in some regulatory systems.

[15] Perhaps the most commonly used term for microcredit clients is "microentrepreneur" although it is increasingly widely acknowledged that the microcredit proceeds may be used for purposes other than investment in the borrower's microenterprise.

[16] For various reasons, this broad working definition would not be suitable for defining "microcredit" in regulation. See "1c. Regulatory Definitions of 'Microfinance' and 'Microcredit'."

[17] This is certainly not to suggest that microcredit is not used for consumption purposes—but rather that there are distinctive regulatory and supervisory issues in typical scored lending approaches to consumer lending that are not discussed in this Guide.

[18] Some MFIs use statistical scoring techniques to supplement, but not to replace, assessment by loan officers in direct contact with the borrower.

[19] Many organizations engaged in microfinance—in particular, domestic and international NGOs—give equal or greater priority to nonfinancial services, such as business training, agricultural training and inputs, health services, and education.

nongovernmental organizations (NGOs); commercial finance companies (sometimes referred to as nonbank finance companies); financial cooperatives of various types; savings banks; rural banks; state-owned agricultural, development, and postal banks; and commercial banks, as well as a large array of state-backed loan funds. Many of these institutions offer financial services to the poor alongside products targeting more affluent clients, and not necessarily as a primary business activity, in which case we refer to them not as MFIs but as "other microfinance providers." This distinction can be important: often the types of risk that regulation and supervision are intended to mitigate will be different in the context of a diversified financial service provider.

This Guide focuses on the following institutional types: NGO MFIs, commercial microlending companies, commercial banks, microfinance banks, and financial cooperatives. In some cases, both NGOs and financial cooperatives[20] are discussed separately from other types of MFIs owing to their distinctive attributes. As previously noted, this Guide does not discuss the regulation of state-owned institutions or programs, as their regulatory and supervisory treatment tends either to parallel that of nonstate actors or to be too diverse to be captured easily in generalized terms. For similar reasons, the regulation and supervision of savings banks fall beyond the scope of this Guide.[21]

[20] Notwithstanding the significant role that financial cooperatives play globally in providing the poor with financial services (including in particular, savings), this Guide addresses only briefly the potentially different treatment that should be accorded to financial cooperatives. Although all financial cooperatives—which go by many different names, including credit unions, savings and credit cooperatives or SACCOs, *cajas*, *caisses*, cooperative banks, among others—are membership-based and have in common the "one member one vote" rule, there are also wide variations in their structure and attributes across countries and regions. This is due in part to the three distinct traditions underlying most models (German, French/Canadian, and Anglo-American), as well as differences in their operations and in the size and composition of their membership. And in contrast to banks and insurance companies, member-based financial intermediaries have no global standard-setting body, which can help in the development of commonly agreed terms, concepts, and principles (as has been the case for banks, savings banks, securities firms, and insurance firms).

[21] The World Savings Bank Institute (WSBI) has articulated general principles with respect to the regulation of microfinance as well as recommendations for specific regulatory measures, although these measures are not aimed towards the regulatory regime for savings banks in particular. *WSBI Position Paper on the Regulation of Microfinance Services (2008).*

1b. Financial Inclusion as a Regulatory Objective; Regulation as Promotion

- To craft and enforce appropriate regulation with a financial inclusion objective, regulators need to understand the distinctive characteristics of microfinance, including the clients, the products and services, the institutions providing them, and the lending methodologies they employ.

- Problems often arise due to inadequate communication and coordination among financial regulators and other government agencies whose responsibilities may impinge on institutions delivering microfinance.

- Costs imposed (on the regulated institutions and on the regulator) by regulation and supervision should be proportionate in relation to the risks involved (given that with microfinance, cost reduction is crucial to expanded outreach).

- To the extent possible, regulation should aim to be institution-neutral, both to create a level playing field that fosters competition and to reduce risk of regulatory arbitrage.

- In creating new windows for microfinance, regulators need to be alert to the possibilities of regulatory arbitrage. Some countries create special microfinance windows with one sort of activity in mind, and then are surprised to find that the window is also being used for other activities that the regulators might not have been so keen to promote.

The prevailing view of regulation and supervision of financial institutions centers on minimizing the risks to the financial stability of the institutions and the financial system as a whole in a cost-effective manner.[22] Regulating and supervising with the additional objective of promoting financial inclusion introduces three new vectors of responsibility and risk: new service providers, new customers (who are likely unfamiliar with formal financial institutions and their products), and new products and delivery methods, such as branchless delivery channels. The ability of regulators to craft appropriate regulation and to supervise effectively depends on their understanding of the particular characteristics of microfinance, including the clients, the products and services, and the institutions providing them.

As noted, increasingly, the central question posed in regulating microfinance is being framed as how to approach regulation and supervision of the financial system as a whole in a way that balances financial *access*, financial *stability*, financial *integrity*, and *consumer protection*. This is

[22] This is accomplished through (*i*) defining ownership requirements and permitted activities, (*ii*) requiring institutions to meet certain performance norms, (*iii*) building systems to keep the supervisor informed about the institutions' operations, and (*iv*) equipping the supervisor with appropriate tools, including powers to intervene and staff. Increasingly, regulators are focusing on financial providers' relationships with each other (e.g., competition, cooperation) and with their customers (e.g., bank secrecy, consumer protection), as well as on preventing criminal use of financial markets such as money laundering or financing of terrorism.

a complex and constantly changing balance that requires a continual cost-benefit analysis[23] and that often involves more than one regulator: not just the financial regulator but also other government agencies, including the consumer protection agency, the competition agency, the social welfare agency, law enforcement authorities, and others. Unless there is robust communication and coordination among these bodies, substantial problems are likely to result.

Much of the regulation now being enacted for microfinance is motivated at least in part by an explicit objective to promote poor people's access to formal financial services. To begin with, regulation can be promotional simply by enabling or facilitating basic microlending. In some countries, reform is required to establish clear legal authority for nonbank entities to engage in lending (see "4a. Permission to Lend"). This is important because in many markets commercial actors have typically been willing to enter microfinance only after experimentation by NGOs or other noncommercial lenders.

Regulation can also be promotional by adjusting norms so that existing institutions can reach new customers or expand the range of services offered (for instance, by removing interest rate caps that make small loans unprofitable, or by adjusting prudential norms to facilitate the licensing of deposit-taking MFIs). And regulatory change can make investment in microfinance more appealing (for example, through favorable tax treatment). Finally, regulation can enable the formation of new kinds of MFIs. Regardless of its objective, regulation should aim where possible to be institution-neutral, both to create a level playing field that fosters competition and to reduce risk of regulatory arbitrage.[24]

Special "windows" for microfinance

Often, a new "special window"—that is, a distinct regulatory category—is created for microfinance. In some countries, new regulation has created a series of special windows for microfinance (with the possibility of graduating from one to the next). The approaches include enabling the following:

- Nonbank microlending institutions
- Nonbank deposit-taking institutions (both to offer the poor a savings alternative and to access deposit funding for lending operations)
- Some combination of these two, which is sometimes referred to as a "tiered approach".

[23] The calculation of costs and benefits is not easy. Costs include those of the regulated institutions and those of the regulator, neither of which may be easy to calculate *ex ante*. Some benefits (e.g., consumer protection) are hard to quantify. Stakeholders value risks and benefits differently, and the risks of nonregulation may not be fully apparent before a crisis.

[24] Competition is touched on only briefly in this Guide. However, the central aim of competition policy (maximization of consumer welfare) is likely to be different in countries with a high percentage of poor people. In such countries, competition can increase the unequal distribution of assets and opportunities. Thus the distributional aspects of maximizing consumer welfare (i.e., how wealth is distributed among the society, including to the poor) are of great importance when crafting and enforcing competition policy.

Although the starting point should be an examination of the existing legal framework to determine what, if anything, is holding back the market, the decision to open a new window is often driven largely by the political economy. Experiences in countries around the world show that a new window that removes a barrier to nonbank microlending (such as an explicit or implicit prohibition of lending by nonprofits) is likely to increase the number of customers served. By contrast, where the regulatory objective of a new window is to enable deposit-taking, results have been more mixed. Sometimes the binding constraint has been scarcity of motivated entrepreneurs and investors, or lack of competent managers who can run a lending operation solidly enough so that it can safely be funded with deposits. In such cases, opening a special window by itself may not have much promotional effect. (See "2a. New Regulatory Windows for Depository Microfinance: Timing and State of the Industry.")

Create a new framework or amend an existing one?

If a new special window is to be created, should this be done by amending existing financial sector laws and/or regulations, or by creating new ones? Whichever approach is taken, the new institutional type(s) should be incorporated into the basket of rules that apply to similar institutions offering similar services (e.g., financial consumer protection and treatment in bankruptcy).

Incorporation in the existing framework makes regulatory harmonization more likely, and inconsistent or unequal treatment less likely. This applies both to the initial regulatory reform as well as to future amendments.[25] However, local factors will determine the advisability of this integrated approach versus creating a separate new framework. Policy makers may be reluctant to open up the banking law for amendment because they don't want to trigger a review of other issues that have nothing to do with microfinance.[26] It is especially important that any new deposit-taking institution be subject, as banks typically are, to insolvency rules that give depositors priority over other unsecured creditors.

Regulatory arbitrage

If a new window involves a more lightly or favorably regulated environment, existing institutions and new market entrants may contort to qualify as MFIs. Such speculation among regulatory alternatives, or "regulatory arbitrage," can leave some institutions under-regulated. Also, a new microfinance window may be used for businesses that are quite different from what policy makers had in mind when creating it. For instance, consumer lenders (who generally target salaried borrowers) have used a licensing form that was intended for microfinance (where lending usually focuses on borrowers without formal employment) specifically to benefit from the higher usury rate applicable to microlending. Commercial banks that cannot meet increases in the minimum capital requirement or other prudential requirements for banks have, in some

---

[25] When changes are implemented via regulations (as opposed to laws), future adjustments are typically much easier to implement, given the fewer procedural obstacles to adopting, amending, or repealing regulations as compared with legislative acts.
[26] The decision has at times been influenced by a donor's technical assistance package that includes a new draft "microfinance law" (often based on another country's law). This is seldom, if ever, an approach appropriately tailored to the local context.

instances, been relicensed under a microfinance window, without having the motivation or knowledge necessary to serve low-income customers effectively. In at least one case, many of the newly licensed MFIs that had previously been underperforming banks failed, tainting the entire concept of microfinance in the country.

1c. Regulatory Definitions of “Microfinance” and “Microcredit”

Regulatory definitions of “microfinance” and “microcredit” should be tightly framed to meet specific regulatory objectives and should not simply be drawn from general literature on microfinance.

Earlier, we gave broad definitions of “microfinance” and “microcredit” as those terms are used in the discussion throughout this Guide. Those definitions usually will not be suitable for use in a given country’s regulation (see “1a. Terminology: What Is ‘Microfinance’? What is ‘Financial Inclusion’?”). An appropriate *regulatory* definition must be based on a clear articulation of the country- and situation-specific objective(s) the regulation is meant to serve. For instance, if the purpose is adjusting prudential norms for depository MFIs, it may be appropriate to define “microcredit” in terms of a specific maximum loan amount. However, the same definition may not be appropriate for determining whether an NGO MFI serves a sufficient public benefit to deserve a profit tax exemption.

[Begin box 1]

Box 1. Crafting a regulatory definition of “microcredit”

There is no standard regulatory definition of “microcredit” that would be suitable for global use. However, some general practical cautions emerge from the experience of countries that have crafted their own definitions for a variety of regulatory objectives:

1. ***Use of funds.*** *The definition should not require that the loan be used to fund a microenterprise. First, this would interfere with the other valid reasons for which poor people borrow; second, money is fungible, and numerous analyses of the actual use of microcredit show that a significant portion of the money is indeed not invested in a microenterprise, even where this is the ostensible purpose of the loan and even where such a purpose is required by regulation. Most microloan customers are in fact microentrepreneurs, but this does not mean that they use their loan proceeds for microenterprise purposes. Financial services including microloans can be crucially important for poor households not only to finance income-producing activity but also to allow payment of regular consumption expenses despite irregular and unreliable income streams. In addition, microloans (and other services) enable families to accumulate sums of cash that are large enough to deal with emergencies, sporadic opportunities, or major social obligations.*

2. ***Maximum amount****. Regulators who set a maximum loan amount for microlending face a delicate balance. If the ceiling is set too low, successful clients wanting loans that exceed*

it are forced to look beyond their MFI (perhaps without assurance of obtaining a loan elsewhere), and lenders are less able to balance the costly small loans in their portfolio with less costly large loans. On the other hand, too high a limit dilutes the low-income targeting and increases the risk of regulatory arbitrage. A two-pronged approach may help to strike the right balance: (i) a maximum average outstanding loan balance for the entire microcredit portfolio and (ii) a higher maximum initial amount for any microloan (aggregating multiple loans to a single borrower for purposes of this calculation).[27] *The limit on average loan size preserves overall targeting, while the higher limit on individual loan size allows some flexibility.*

3. ***Defining the customer**. Defining the target customer in regulation is often tempting, but can pose practical challenges. For example, a definition that refers to "poor" customers could exclude low-income unbanked persons who are both needy and potentially profitable borrowers—at least if there is any expectation that the limit on client income will actually be enforced. In practice, demonstrating or enforcing compliance with such a limit could also be very difficult and expensive.*

   Microcredit is sometimes defined in terms of lending to microentrepreneurs (people who earn their income from work outside the formal sector). Even if the policy maker intends a tight focus on this clientele, it may be sometimes more practical to introduce a degree of flexibility, for instance by including the households of microentrepreneurs or by requiring that microentrepreneurs constitute the majority of borrowers.

4. ***Requirements with respect to collateral**. To differentiate microcredit from conventional retail bank loans, the definition may require that the loan be uncollateralized or lightly collateralized. Depending on the regulator's vision of the scope of the MFI license (assuming this is the purpose of the regulation), any definition of microcredit as un- (or under-) collateralized should have some flexibility built in. For instance, microborrowers who own no collateral and start off with small unsecured loans occasionally succeed in growing their enterprises and raising their income to the point that they acquire substantial assets that could be pledged as normal collateral. Moreover, some MFIs accept collateral to enhance repayment incentives, even when the value of the collateral would not be enough to make the lender whole in the event of default.*

5. ***Defining "microcredit" in law or in regulations**. If economic circumstances change or the original definition proves problematic in practice, a definition of "microcredit" that has been enshrined in law requires the full legislative process to change. Definitions in regulations typically can be adjusted more easily. In some countries, legal protocol requires a certain level of specificity in the law, but still leaves room to permit important details to be determined in regulations.*

[End box 1]

---

[27] Note that two different measuring rods are involved here: the average *outstanding loan balance* of a microcredit portfolio tends to be a little more than half of the average *initial disbursed amount* of the loans in the portfolio. Thus, if the average outstanding balance (loan portfolio divided by number of active loans) is capped at 200 and the initial disbursed amount of any individual loan is capped at 2000, this would mean that the maximum for any single loan would be roughly five times the allowable average of loans across the portfolio.

A regulatory definition of "microcredit" may be challenging, but defining "microsavings" is a much simpler matter, mainly because such a definition is rarely needed. Restricting the income level or other characteristics of depositors usually would be counterproductive. Typically, the purpose of an institution awarded a depository microfinance license is to serve the needs of poor and low-income customers. Even on that assumption, deposits captured from more affluent customers serve that purpose as long as they are used to fund loans to the lower income customers. In fact, a common funding pattern in deposit-taking MFIs is that most of their *depositors* have very small account balances, but most of their deposit *funding* comes from a minority—often a small minority—of accounts with larger balances.

However, even if there is no apparent need for a regulatory definition of "microsavings" in creating a special window for depository microfinance, deposit size limits may still be relevant, depending on the regulatory objective. For example, several countries have capped savings balances and transaction sizes for certain accounts in an attempt to define categories of lower risk that will justify relaxing anti-money laundering and combating the financing of terrorism (AML/CFT) requirements.

1d. Prudential and Nonprudential Regulation: Objectives and Application

Absent extraordinary circumstances, nondepository MFIs should not be subjected to prudential regulation and supervision.[28]

Views differ on whether compulsory savings as part of a loan product should be treated as "deposits" that trigger prudential supervision, but good arguments can be made in many contexts not to do so, especially if the MFI is not lending out these funds.

When a deposit-taking institution becomes insolvent or lacks adequate liquidity, it can't repay its depositors, and—if it is a large institution—its failure could undermine public confidence enough so that the financial system suffers a run on deposits or other system-wide damage. Prudential regulation involves the government in overseeing the financial soundness of these institutions and intervening if the health of one (or more) of them comes into question.

In contrast, "nonprudential" regulation—which is also referred to as "conduct of business" regulation—does not involve monitoring or assessing the financial health of the regulated institution.[29] Nonprudential regulation of microfinance tends to focus on three main types of objectives: (*i*) protecting consumers of financial services, (*ii*) enabling a range of institutions that provide a mix of appropriate products and services, and (*iii*) providing governments with information to carry out economic, financial, and criminal enforcement policy. Some nonprudential regulation is subject to general enforcement, including civil and criminal

[28] Some traditions of financial sector regulation—notably those with historical ties to France—apply prudential regulation to all types of lending institutions, regardless of their potential to jeopardize systemic stability.
[29] The use of the term "conduct of business" regulation may be more common. However, this term encompasses a narrower range of regulation relating to the conduct of the provider vis-à-vis consumers and other providers and would not typically include topics such as taxes and ownership limitations.

prosecution and private rights of action. Other nonprudential regulation may be enforced by specific regulatory bodies.[30]

Sometimes a rule serves both prudential and nonprudential objectives. Effective consumer protection-related regulation of lending, for example, can lead to better asset quality, which in turn contributes to an intermediary's overall financial health—even though this is not the primary regulatory objective.

There is wide recognition that compliance with, and enforcement of, prudential regulation is usually more complex, difficult, and expensive than nonprudential regulation, for both the regulator and the regulated institution. This can be particularly problematic in some developing countries where regulators and supervisors are already stretched to capacity with their mainstream banking and insurance sectors.

Why do governments impose prudential regulation on banks and other financial intermediaries, but not on nonfinancial businesses? Banks, much more than other businesses, fund their operations with "other people's money," mainly deposits from the public. This creates incentives for managers to take inappropriate risks. More importantly, it exposes banks to deposit runs in which loss of confidence by depositors in one bank can spread quickly to depositors in other banks, threatening to destabilize the entire banking and financial system, with serious consequences for all other sectors of the economy. There is wide agreement that the cost of prudential regulation is justified when the stability of the financial system or the safety of depositors is at risk.

A lending-only MFI obviously poses no risk to its depositors (it has none), is not subject to depositor runs, and thus is unlikely to provoke a contagion of depositor runs that destabilizes the financial system.

[Begin box 2]

Box 2. A systemic rationale for applying prudential regulation to microlending-only institutions

Are microlenders that are funded by sources of capital other than public deposits engaged in financial intermediation that needs to be prudentially regulated? (See Appendix C for a discussion of nondepository MFIs' sources of funding and their potential regulatory ramifications.) In general, the answer is a firm no.

Lending-only MFIs can't create depositor runs, but some observers have pointed out that they can occasionally create contagious "borrower runs." During the global financial crisis of 2008–2009, more than one country experienced such a contagion effect in its microcredit market. If an MFI is failing, then it is common for borrowers to stop repaying their microloans: a key factor in determining the repayment of a microloan is the borrower's belief that the MFI will extend a

[30] For example, permission to lend and reporting requirements may be enforced by the regulator of the particular type of institution; financial consumer protection may regulated by the financial regulator or a consumer protection body; AML/CFT will typically be regulated by a country's financial intelligence unit.

new loan upon repayment of the old. If a major MFI fails, borrowers at other institutions may have doubts about their own lender's solidity and the reliability of its implicit promise to give the borrowers future loans if they repay the current one. If this happens, other MFIs can be contaminated by the original MFI's repayment problems. In at least one country, due to the large number of borrowers served by the MFIs, the government (via a state-owned institution) funded the acquisition by an MFI of another MFI (one of the country's largest) to prevent such a contagion effect and to avoid losses by the commercial banks that had large loans outstanding with the MFIs.[31]

Does the possibility of borrower runs justify prudential regulation of lending-only MFIs? Four factors warrant examination: systemic risk, cost of prudential regulation and supervision, who should bear the risk of loss, and capacity to supervise effectively:

1. ***Systemic consequences.*** *The failure of one or more microlending institutions would typically not imperil a country's whole banking and financial system. Even when microlenders serve huge numbers of customers, their assets will seldom account for a large percentage of the country's financial assets.*[32] *A rare exception might be found in cases where wholesale loans to MFIs are a major part of the assets of a country's banks, although the more direct and appropriate route is to improve supervision of the banks' lending practices (as opposed to imposing prudential regulation on lending-only MFIs).*

2. ***Cost****. Prudential supervision is costly for both the supervisor and for the supervised. And the experience has been that it costs substantially more to supervise MFI assets than an equivalent volume of normal bank assets. Absent subsidy, sustainable institutions pass such costs on to their clients. In the case of depository institutions, the costs of prudential regulation and supervision are likely to be less than the costs of bailing out the financial system. In contrast, the failure of microlending institutions will typically not require a systemic bailout.*

3. ***Risk of loss****. The failure of a microlending institution results in the loss of investors' and donors' funds (as well as a loss of service—temporary or, in some circumstances, permanent—to the institution's clients). Investors and donors can mitigate this risk by supervising their investee institutions. Where no deposits are involved, there is no loss of the public's money.*

4. ***Capacity to supervise****. Retail depositors are generally not in a position to evaluate the management and condition of the banks that hold their funds. In contrast, owners, lenders, and donors can and should supervise the microlending institutions in which they invest.*

---

[31] See Chen, Greg, Stephen Rasmussen, and Xavier Reille. 2010. "Growth and Vulnerabilities in Microfinance." Focus Note 61. Washington, D.C.: CGAP. http://www.cgap.org/gm/document-1.9.42393/FN61.pdf

[32] In rare cases, MFI assets loom large in a country's financial system, but in those cases the MFIs are typically already prudentially supervised because they take deposits.

In the great majority of circumstances, these factors do not add up to a good case for prudential supervision of nondepository microlenders.[33]

[End box 2]

As part of their lending methodology, some MFIs require compulsory savings from their borrowers in advance of loan disbursement and/or during the life of the loan. This requirement tests the client's ability and willingness to make regular payments, and provides "cash collateral" that protects a portion of the loan. Should MFIs that take compulsory savings, but not voluntary savings, be treated as deposit-takers and subjected to prudential regulation? Views on this question differ.

Usually, clients of MFIs that take compulsory savings are net borrowers: the compulsory savings amount is typically a (small) fraction of the customer's loan size so the clients owe the MFI more money than the MFI owes them. If the MFI fails, these customers can protect themselves by the simple expedient of not paying their loans.

On the other hand, there are times when the customer has little or no loan balance outstanding (usually at the end of the term of an amortizing loan or between loans). At those times, the compulsory savings can exceed the loan balance, and the customer is in a net at-risk position. This fairly small degree of risk has to be weighed against the costs of prudential supervision.

Several countries have taken a middle path on this issue, requiring prudential licensing for any MFI that intermediates clients' compulsory savings (i.e., lends them to other borrowers), but not for MFIs that keep the savings in an account with a licensed bank or invested in low-risk securities. Where savings are segregated this way, thought should be given to protecting the customers' prior claim on those funds in the event the MFI fails.

1e. Regulate Institutions or Activities?

Should microfinance be regulated as a set of products and activities or according to institutional form of the service provider? The approach depends on the regulatory issue being addressed as well as the country's general approach to financial sector regulation and supervision. Possible approaches include "functional" (where supervision is determined by activity), unified or "integrated" (combing prudential and nonprudential regulation and supervision), and "twin peaks" (i.e., separated "pillars" for prudential and nonprudential regulation and supervision). In many countries that use a unified or twin-peaks approach, nondepository institutions fall outside of the supervisory regime.

Some *prudential* rules depend on institutional type: for instance, different kinds of institutions may call for different rules about permitted activities or capital adequacy. In contrast, most *nonprudential* standards applicable to microfinance services would generally be appropriate regardless of institutional type providing them. In particular, there is a strong argument that

[33] The authors acknowledge that some regulators, particularly in countries with links to the French regulatory tradition, disagree with this position.

financial consumer protection and combating money laundering and terrorist financing are better achieved through a single set of rules applicable to all providers of a given service.

Sometimes, regulation by activity (instead of by institutional type) makes good sense as a matter of principle, but is not feasible as a matter of political economy. For example, it may not be easy to get regulation adopted that puts upstart market entrants on a level playing field with established market incumbents.

Part II. PRUDENTIAL REGULATION OF DEPOSIT-TAKING MICROFINANCE

Calls to move microfinance beyond microcredit have focused more attention on prudential regulation of depository microfinance. The primary reasons for prudential regulation of depository institutions are (1) to protect the country's financial system by preventing the failure of one institution from leading to the failure of others, and (2) to protect small depositors who are not well positioned to monitor the institution's financial soundness themselves.[34] If prudential regulation does not focus closely enough on these two objectives, scarce supervisory resources can be wasted, institutions can be saddled with unnecessary compliance burdens, and development of the financial sector can be constrained.

2a. New Regulatory Windows for Depository Microfinance: Timing and the State of the Industry

As previously discussed, a number of countries have created new regulatory windows for depository microfinance, and many others are considering such a step. Policy makers should begin by determining whether and how the existing financial sector regulation hinders institutions from providing savings services for the poor or from raising other deposit funding to expand their microcredit services. If existing regulation does not present a barrier, or if the real binding constraint lies elsewhere, then a new window will not necessarily improve access. And even if the existing regulation (whether unduly burdensome, restrictive, or otherwise inappropriate) inhibits or interferes with the formation and operation of depository institutions serving poor people, it may be preferable for a variety of reasons to amend the existing regulations instead of embarking on the toilsome and complex task of creating a new window.

The likelihood that a new window for depository microfinance will substantially expand financial services for the poor depends on whether there will be a critical mass of qualifying institutions. Thus, it is important for policy makers and regulators to determine (*i*) which actors—existing NGOs, domestic entrepreneurs, or foreign investors—are likely to respond to a new window, and (*ii*) whether those actors are likely to have the management skill to run safe depository microfinance.

If the expectation is that over the medium term the new depository window will be used mainly by existing NGO MFIs that want to "transform" into depository institutions, then regulators should first assess the practical capacity of the leading institutions to undertake such a transformation. In particular, have these microlenders demonstrated the ability to run a loan business that is stable and profitable enough so that it can safely be funded with public deposits? In this context, the actual financial performance and prospects of existing MFIs is a crucial element that often gets too little attention in discussions of regulatory reform. In making such an assessment, regulatory staff who are inexperienced with the special dynamics of microcredit will need to draw on expert assistance.

[34] Insurance companies and securities firms are also subject to prudential regulation. The regulation of microinsurance when delivered by MFIs and other microfinance providers is addressed in Part VI; the regulation of securities firms is beyond the scope of this Guide.

On the other hand, policy makers may see the new window as a means of attracting investment in start-up depository MFIs, more than as a path for transforming NGO MFIs. Here again, they need to think practically about who the likely takers will be. If they are hoping for "greenfield" (i.e., start-up) operations based on foreign investment and technical expertise, are there any identifiable actors on the scene who are likely to be interested? If local startups are expected, there are several factors worth considering:

- Has the profitability of microfinance, or at least microcredit, been demonstrated in the country yet? Otherwise it may be hard to interest entrepreneurs and investors.
- Does the country have experienced microcredit managers who can teach a new staff how to make and collect microloans?
- How entrepreneurial is the country's private sector? The regulatory window that would draw dozens (or hundreds) of entrants in one country might draw relatively little interest in another country with a less entrepreneurial culture.

Several countries have built technically sound new regulatory windows for microfinance but have seen little response. Conversely, most of the successful new depository windows are in countries that already had a strong microcredit industry before the window was put in place. It would overstate the point to claim that a new window will *never* spark the emergence of new services and service providers when little had been going on previously. In a few countries, a new prudential licensing window for small rural banks (not necessarily doing microfinance) resulted in many new institutions providing service to areas previously without access. However, supervision proved much more difficult than anticipated. In each case, many of the new banks failed, and the bank regulator had to devote significant resources to cleaning up the situation. Nevertheless, many of the new banks did not fail and continue to provide ongoing rural services.

2b. Rationing Prudential Regulation and Minimum Capital

- Minimum capital should, in principle at least, be set high enough to ensure that the institution can cover the infrastructure, management information system (MIS), and start-up losses to reach a viable scale.

- In creating a new window for depository microfinance, it is important to assess supervisory capacity and set the minimum capital requirement high enough to avoid overburdening the supervisor.

- Where possible, it is usually preferable to set minimum capital through regulation rather than legislation. Among other advantages, this makes it easier for supervisors who are new to microfinance to start with a manageable number of new licensees, reserving the option of reducing minimum capital and licensing more institutions as experience is gained.

Supervisors have limited resources, so there is a trade-off between the number of new institutions licensed and the likely effectiveness of the supervision they receive. And when measured as a percentage of assets supervised, the cost of effective prudential supervision is higher for microcredit portfolios than for normal bank loans. Finally, overstretched supervisory capacity can result in reputational issues for the supervisor as well as potential losses to depositors. These reasons, among others, present strong arguments for rationing the number of licenses, especially at an early stage. The most common tool for this rationing is the minimum capital requirement—that is, the minimum absolute amount that owners must invest as equity in an institution seeking a license to accept deposits.[35] The lower the minimum capital, the greater the likely number of entities that will have to be supervised.

The minimum capital requirement should ensure that the institution has adequate capital to fund its operations, including the necessary infrastructure and MIS.[36] In countries where depository microfinance is a relatively new business, MFIs often can't raise the large amounts of capital needed for a banking license, so many countries set lower minimum capital for MFIs than for conventional banks. Microfinance advocates who see regulation primarily as promotion usually want very low minimum capital requirements, making it easier to obtain new licenses. Supervisors who will have to oversee the financial soundness of new deposit-taking institutions know there are limits on the number of institutions they can supervise effectively and therefore usually favor higher minimum capital requirements.

In principle, allowing more licenses tends to foster competition and access to services. But this doesn't mean that the right policy is to enable the formation of many small deposit takers. In most microfinance markets, the vast majority of the clientele is being reached by five to 10 large MFIs.[37] In these markets, the licensing of even sizable numbers of small market entrants is unlikely to lead to sufficient increases in outreach to justify the additional supervisory burden.

When policy makers are opening an MFI depository window for the first time, there is considerable uncertainty about how much burden it will put on supervisory resources, and how long it will take supervisory staff to learn the distinct dynamics of microfinance. Given this uncertainty, some regulators make a reasonable decision to err on the side of conservatism at first, permitting the requirements to be adjusted later when the authorities have more experience with the demand for licenses and the particularities of microfinance supervision. Obviously, such flexibility is easier if minimum capital is specified in regulations rather than in the law.

2c. Adjusted Prudential Standards for Microfinance

[35] Qualitative licensing requirements also serve to limit new entrants.
[36] In practice, the minimum required capital is likely to be based *not* on calculations of operational costs but instead on what other countries have done. Nevertheless, policy makers should keep these costs in mind when setting the requirement.
[37] For example, according to MIX Market data (www.themix.org), the top five MFIs in India account for 15.4 million of the total 26.4 million clients served by the 85 MFIs reporting data in 2009. This holds up in other markets across different regions, e.g., Bolivia (65 percent), Bosnia and Herzegovina (66 percent), and Ghana (53 percent). In some countries with hundreds of MFIs, the overall amount of services provided would barely show an impact if the smallest 50 percent or even 75 percent of them closed down. In India the smallest 50 percent of MFIs reporting to the MIX in 2009 accounted for only 3.6 percent of total borrowers. This is similar to 2009 data in Bolivia (9.1 percent), Bosnia and Herzegovina (23.3 percent), and Ghana (15 percent).

Some prudential norms developed for conventional banking don't fit well with the risks and requirements of microfinance. Whether microfinance is being developed through specialized stand-alone depository MFIs, financial cooperatives,[38] or as special product lines within retail banks, the regulatory issues discussed below will generally require reexamination.[39] The list includes the most common issues, but other rules may require adjustment in some countries. Many of the adjustments relate to distinctive features of microlending, reflecting the fact that microfinance differs from conventional banking more on the credit side than on the deposit side.

Permitted activities

Regulation—including any proposed new regulation that provides for depository microfinance—should clearly define the types of permissible activities that a prudentially regulated institution may engage in.

Regulation may permit certain institutions to engage only in lending and deposit-taking (or initially only lending, with deposit-taking being permitted later subject to supervisory approval). Other institutions may be allowed to provide money transfer or foreign exchange services. Regulation may also define the scope of activities of an institution by defining and restricting the concept of "microcredit."

Managers of newly licensed MFIs may not have much experience with managing the full range of banking activities and risks (e.g., asset and liability management). Permission to engage in sophisticated activities should usually be based on management capacity and institutional experience. For example, depository microfinance providers may be well-equipped to serve as microinsurance agents, but are unlikely to be well-positioned to underwrite insurance risk. See "6b. MFIs and Microlending Banks in Microinsurance."

Capital adequacy

There are strong arguments (and recent experiences) that support the imposition of higher capital adequacy standards for specialized depository MFIs than for banks.

Regulators require banks to hold capital that is adequate when measured against the size and riskiness of the bank's assets and its off-balance sheet exposure. The capital adequacy ratio (CAR)—the ratio of equity to risk-weighted assets—is a primary focus of bank supervision.

A higher CAR means less risk to depositors and the financial system. But a higher CAR also means less funding from deposits, which lowers profits and makes the intermediary less attractive for investors. However, a high CAR may not hamper a new MFI very much in its initial years given that it will require more time to build its microloan portfolio than a

[38] Financial cooperatives may require further differentiated treatment, including in particular the minimum capital requirement.
[39] See Basel Committee on Banking Supervision. 2010. *Microfinance Activities and the Core Principles for Effective Banking Supervision* Bank for International Settlements: Basel, Switzerland. http://www.bis.org/publ/bcbs175.pdf

commercial bank will require to build a conventional loan portfolio. In the case of MFIs, both of these effects can reduce poor people's access to financial services. The regulator needs to balance safety and access when setting capital adequacy norms.

There have been years of debate about whether specialized MFIs should have a tighter capital adequacy requirement (i.e., a higher ratio) than diversified commercial banks. Four reasons have been advanced for imposing a higher CAR on MFIs:

- *Particular features of a microloan portfolio.* Well-managed MFIs typically have maintained excellent repayment performance, with delinquency often much lower than in conventional retail banks. However, the repayment performance of a microloan portfolio can deteriorate much more quickly than a conventional retail bank portfolio. First, microloans are usually unsecured (or secured by assets that are insufficient to cover the loan plus collection costs). Second, the borrower's main incentive to repay a microloan is the expectation of access to future loans.[40] When a borrower sees that others are not paying back their loans, his own incentive to continue paying declines because the outbreak of delinquency makes it less likely that the MFI will be able to reward the borrower's faithfulness with future loans. And if a borrower has no collateral at risk, he may feel foolish repaying his loan when others are not. Thus, outbreaks of delinquency in an MFI can be contagious. (This risk is lower in the case of a commercial bank with a diversified portfolio of which microloans are a part.) As a general rule, if an MFI's annualized loan loss rate rises above 5 percent, or over 10 percent of its portfolio is late by more than 30 days, management must correct the situation very quickly or the situation is likely to spin out of control.

- *High administrative costs.* MFIs' administrative costs are high relative to the size of the individual loans. As a consequence, to stay afloat, MFIs' need to charge interest rates that are higher than that of the typical commercial bank loan.[41] When loans are not being repaid, the MFI is not receiving the cash it needs to cover the costs associated with those loans. Because an MFI's costs are usually much higher than a commercial bank's costs per unit lent, a given level of delinquency will decapitalize an MFI much more quickly than it would decapitalize a typical bank.

- *Maturity of management and systems.* In many countries, MFIs do not have a very long track record and tend to have less experienced management and staff than banks. This is an especially important issue in the case of a transforming NGO MFI: the pretransformation staff has little experience with the particular challenges of asset and liability management of a deposit-taking institution.

- *Limitations of supervisory tools.* In many countries, the supervisory agency has little experience with judging and controlling microfinance risk. Additionally, a few important

[40] This is true not only for individual microloans but also for group-based microloans.
[41] This is because the costs of making loans don't vary directly in direct proportion to the amount lent; a portfolio containing a large number of small loans will be inherently more costly than a portfolio of the same face value but containing a smaller number of larger loans. However, many MFIs could increase efficiency, thus reducing administrative and operational costs.

supervisory tools work less well for specialized MFIs (see "Supervisory Tools and Their Limitations").

- *Portfolio diversification issues.* MFI loan portfolios are not concentrated in a few large loans. But they are often confined to one or two loan products with substantial covariant risks. In addition, some MFIs operate in a narrow geographic area.

In response, those who argue that capital adequacy requirements should be no higher for MFIs than for conventional banks have pointed to long years of stability and solid loan collection in licensed MFIs. They also stress the importance of a level playing field between MFIs and banks.

However, recent experience has suggested that the long-term risks in microlending may be higher than they appeared to be at earlier stages. In particular, more microcredit markets are reaching saturation as competitors hungry for market share expand very quickly. Recent outbreaks of serious over-indebtedness and collection problems in some maturing markets strengthen the argument for a higher capital adequacy requirement for those institutions with assets comprised mainly of uncollateralized microcredit.

Capital adequacy for financial cooperatives and their networks

Financial cooperatives present a particular issue when defining capital for CAR purposes. All their members have to invest a minimum amount of "share capital" in the institution. But unlike an equity investment in a bank, a member's share capital may usually be withdrawn when the member leaves the cooperative. From the vantage of institutional safety, such capital is not very satisfactory: it is impermanent, and could easily be withdrawn at precisely the point where it would be most needed—when the cooperative gets into trouble. On the other hand, capital built up from retained earnings—sometimes called "institutional" capital—is not subject to this problem. One approach to the issue is to limit members' rights to withdraw share capital if the cooperative's capital adequacy falls to a given level. Another approach is to give cooperatives a few years to build up a required level of institutional capital, after which time capital adequacy is based solely on such retained earnings.

Financial cooperatives sometimes create federations whose main purpose is advocacy and perhaps technical assistance. In other cases (for instance in Francophone settings) the federation structure may involve much more financial and operational integration between retail cooperatives and their federation. The latter sort of federation may be sufficiently integrated so that the member cooperatives can be treated as a single conglomerate for supervisory purposes, especially where the federation manages the assets and liabilities of the network, has considerable control over the actions of the member cooperatives, or creates a mechanism like a deposit insurance fund that reimburses depositors if a network member fails. In such circumstances, arguably a consolidated capital adequacy ratio for the whole federation might be sufficient, without having to applying a ratio to each member. However, a consolidated ratio risks inequitable distribution of capital (e.g., where one cooperative has riskier and possibly higher earning assets than its capital would support). At least one country takes a middle path, imposing a consolidated capital adequacy ratio on the network and a "lighter" ratio on each member.

Unsecured lending limits and loan-loss provisions

- A microloan portfolio should not be limited to a specified percentage of the lenders' equity nor burdened with a high general provision requirement simply because the loans are not conventionally collateralized.

- Absent special circumstances, performing microloans should have the same provision requirement as other loan categories that are not particularly risky. However, the provisioning schedule for *delinquent* microloans that are uncollateralized should be more aggressive than the provisioning schedule for secured bank loans.

Regulations often limit unsecured lending by a bank to a specified percentage of the institution's equity. This kind of rule is inappropriate for unsecured microcredit portfolios that use the common microlending methodology (see the definition of "common microlending methodology" in "1a. Terminology: What Is "Microfinance"? What Is "Financial Inclusion"?). Such portfolios have generally performed well without collateral. Limiting microlending to some fraction of an institution's capital would make microlending by specialized MFIs impossible. It would also make microcredit less appealing for diversified banks. This does not imply that microloan portfolios never deteriorate, but that well-implemented microlending methodologies can generally mitigate credit risk effectively.

Bank regulations often require high (sometimes 100 percent) loan-loss provisions for all unsecured loans (except loans to other licensed intermediaries) at the time they are made, even before they become delinquent.[42] This is obviously impractical for microcredit. Even if the MFI later recovers the provision expense when the loan is collected, the accumulated charge for current loans would produce a massive under-representation of the MFI's real net worth.

To meet these two problems, a few regulators have treated guarantees, particularly group guarantees, as "collateral" for purposes of applying such regulations to microcredit. This can be a convenient solution to the problem, cosmetically at least, if all microlenders use guarantees. However, group guarantees are less effective than is often supposed. Many MFIs do group-based lending but do not ask for guarantees. Many others ask for guarantees but do not enforce them. Group-guaranteed microloans do not have substantially higher repayment rates than nonguaranteed individual microloans.[43] The most powerful source of security in microcredit tends not to be the MFI's use of group guarantees, but rather the strength of its lending, tracking,

[42] Regulations often impose a small general provision requirement (e.g., 1 percent) on all loans, or all loans of a certain class, that is required to be booked when each loan is disbursed. Such general provisions recognize that all loans carry repayment risk, even those that have not yet experienced a payment delay.

[43] There is evidence that in some cases the impact of group lending versus individual lending on repayment rates is either negligible or can actually *lower* repayment rates. For example, Gine and Karlan (2010), in a long-term field experiment in the Philippines, found that switching from group to individual lending did not impact repayment rates. Similarly, results of laboratory-based testing of this hypothesis found that, absent different peer monitoring systems, "performance is mostly similar across group and individual lending schemes." (Cason, et al., 2008)

and collection procedures, as well as the credibility of the institution's promise that clients who repay will have access to the services they want in the future.[44]

The more straightforward solution, at least where it is supported by the historical collection experience among microlenders in the market, is to waive the equity limitation and/or the prohibitively high general provisioning requirement for unsecured loans in qualifying microcredit portfolios (i.e., those using the common microlending methodology—see the definition of "common microlending methodology" in "1a. Terminology: What Is 'Microfinance'? What Is 'Financial Inclusion'?)". General provision requirements should usually be the same for uncollateralized microloans as for normal secured bank loans.

However, once a microloan falls delinquent, doubt is cast on the borrower's willingness and ability to pay. The implicit contract between borrower and MFI—that faithful repayment will lead to future services—may be breaking down. This is especially true for shorter loan terms with more frequent repayments. After 60 days of delinquency, a three-month unsecured microloan with weekly scheduled payments presents a higher likelihood of loss than does a two-year loan secured by real estate and payable monthly. Because there is no collateral to fall back on, the provisioning schedule for *delinquent* microloans should be more aggressive than the schedule for secured bank loans.

Liquidity and foreign exchange risk

- Specialized MFIs may need higher, rather than lower, liquidity requirements.
- Many MFIs carry substantial foreign-currency liabilities but may be inexperienced in assessing and managing currency risk.

In some countries, regulators have imposed less stringent liquidity requirements on depository MFIs than on other depository institutions. This may make it easier for the MFIs to operate, but it is not always clear how lower liquidity requirements are justified from a safety point of view. Indeed, there is an argument that MFIs may need more, not less, liquidity than banks. Faced with liquidity problems, banks can often stop lending for a while to conserve cash. But MFIs cannot stop lending without undermining borrowers' motivation to repay their outstanding loans (see "3a. Supervisory Tools, Enforcement Mechanisms, and Limitations vis-à-vis MFIs"). The situation is further exacerbated when MFIs do not have access to emergency liquidity from the central bank or to the market sources of liquidity that banks rely on.[45]

Increasingly, many MFIs are raising large amounts of debt capital from foreign lenders. MFI managers may not be familiar with foreign exchange risk and tools for managing it. (In many developing countries, there are in fact no opportunities to hedge; in those circumstances, often

[44] See Chen, Greg, Stephen Rasmussen, and Xavier Reille. 2010. "Growth and Vulnerabilities in Microfinance." Focus Note 61. Washington, D.C.: CGAP, for a discussion of the problems resulting from an erosion of the microlending discipline. http://www.cgap.org/gm/document-1.9.42393/FN61.pdf
[45] Special liquidity rules that might be appropriate for a specialized MFI with a portfolio consisting largely of microloans may be unnecessary for a universal bank if microloans make up a small part of its portfolio.

the MFIs make their loans in foreign currency and the borrowers assume the risk, which is not a satisfactory solution from a client welfare perspective.) Supervisors must be able to evaluate how effectively an MFI can measure, monitor, and control currency mismatch between its portfolio of microloans (typically in local currency) and any foreign currency funding. [46] There should be limits on an MFI's net open position in each currency, in relation to the institution's capital or earnings.[47]

Loan documentation

Given the size of microloans and the nature of the borrowers, loan documentation requirements need to be lighter for microcredit than for conventional bank retail lending.

With a typical microloan, there is no collateral appraisal or registration, no formal financial statements for the borrower's business, and no evidence that the business is formally registered or in compliance with tax obligations. Such requirements must simply be waived for microloans.

Typically, a microloan file should include the following:

- The loan application
- A copy of the customer's ID (or acceptable substitute documentation)
- The loan appraisal (at least for individual loans, where the appraisal should usually include an analysis of household cash flow)
- Information regarding the customer's previous repayment performance with the MFI (if applicable)
- A credit report, if the MFI participates in a credit reference service
- The loan approval by the relevant committee or manager[48]
- The executed note
- An amortization schedule.

However, when an MFI makes repeated short-term (for instance, three-month) loans to the same customer, it should not be required to repeat the cash-flow analysis and credit report for every single loan. Frequency and timing of updates to the credit analysis of a borrower should be based on written policies, not *ad hoc* determinations.

---

[46] To protect against such a mismatch, an MFI may want to index its microloans to the foreign exchange rate, especially if there is no possibility to buy a hedge. Some countries prohibit indexing as microfinance clients are likely less well-equipped to deal with the consequences of a drop in the value of the local currency. In other countries, clients may be accustomed to indexing and taking the risk. If indexing is permitted, the MFI should be required to explain to its clients the risks that they are undertaking. See "Consumer Protection" for a detailed discussion of disclosure requirements.

[47] Basel Committee on Banking Supervision. 2010. *Microfinance Activities and the Core Principles for Effective Banking Supervision* Bank for International Settlements: Basel, Switzerland. p. 21. http://www.bis.org/publ/bcbs167.pdf?noframes=1

[48] It is usually not feasible to require microloan applications to be approved above the branch level.

Restrictions on co-signers as borrowers

Regulations sometimes prohibit a bank from lending to a person who has co-signed or otherwise guaranteed a loan from that same bank. This creates problems for institutions using group-lending mechanisms in which group members are liable for each others' loans.

Branching requirements

> Branching requirements should be re-examined, but not necessarily eliminated, for microfinance.

Banks' hours of business and location of branches are often strictly regulated in ways that could make it impossible to serve microfinance clients profitably—particularly those living in more remote and sparsely populated areas. For instance, client convenience might require operations outside normal business hours or the operation of a mobile branch, or cost considerations might require that staff rotate among branches that are open only one or two days a week. Other nonprudential requirements related to branches—security requirements (e.g., armed guards, vaults) or infrastructure rules (e.g., wheelchair accessibility)—could also make it too costly for MFIs to open branches in poor, remote, or sparsely populated areas. Clients' need for access to financial services has to be balanced against the security risks inherent in holding cash.

Reporting

> The content and frequency of reports should enable supervisors to conduct the analyses needed for effective supervision of a depository MFI. However, regulation needs consider the circumstances of its supervised institutions, which may not be able to comply with some requirements applicable to banks.

Reporting to a supervisor can add substantially to the administrative costs of an intermediary, especially one that specializes in very small transactions. In addition, some requirements may not be feasible—for instance, transportation and communication conditions can sometimes make daily reporting virtually impossible. Typically, reporting requirements are simpler for depository MFIs and microfinance programs than for conventional retail banking operations. However, they should include the following to enable supervisors to monitor key risk indicators: periodic financial statements, reports of external and internal audits, and information on portfolio quality, leverage, prudential ratios, operating costs, funding structure, liquidity position, foreign exchange exposures, and interest rate repricing gaps.[49]

Some countries require MFIs to report to and make use of a credit bureau. Such participation can be especially important in microcredit markets approaching saturation, where there is higher risk of borrowers piling up multiple loans that in the aggregate exceed their repayment ability.

---

[49] See BCBS. 2010. *Microfinance Activities and the Core Principles for Effective Banking Supervision* Bank for International Settlements: Basel, Switzerland. http://www.bis.org/publ/bcbs167.pdf?noframes=1.

Reserves against deposits

Many countries require banks to maintain reserves (held as cash in the bank's vault or by the central bank) equal to a percentage of deposits or certain types of deposits (time deposits may be excluded). Some countries exempt institutions with total reservable deposit liabilities below a specified amount.

Insider lending

With respect to MFIs that are not member-owned and are receiving favorable regulatory treatment because of their focus on poor clients, it is hard to see a reason for allowing any insider lending, except perhaps small welfare loans to employees.

Regulators often limit the amount a bank can lend to insiders (e.g., board and management) and other related parties, because such loans can pose conflicts of interest: a generous loan that is good for the inside borrower may not be good for the bank as a whole. In the case of NGO MFIs and other MFIs getting regulatory advantages because they are serving poor people, it is unclear why *any* insider lending should be allowed, except for perhaps small welfare loans to employees. Member-owned financial cooperatives may need an exception: their members might be unwilling to assume management or board roles if that meant giving up their access to loans.

Notwithstanding the social orientation of MFIs, fraudulent insider lending is not unknown. Where insider lending is allowed, there should be conflict of interest rules (e.g., requiring inside borrowers to recuse themselves from any decisions about their loans.) Such rules ought to extend to financial cooperatives, many of which have also had problems with abuse of insider lending. Loans that help insiders purchase shares in the MFI raise both conflict of interest and capitalization issues. Some countries prohibit such lending, or allow it only if the capital/asset ratio is above a specified percentage.

To whom should special prudential standards apply?

When creating new regimes for depository microfinance, regulators should take care that full-service banks and other financial institutions (not just MFIs) are enabled to provide microfinance services.

It is worth reiterating that several of the adjustments mentioned have to do with particular financial products and operational methodologies, not particular institutional types. These adjustments should apply not only to specialized MFIs, but also to microfinance operations in financial cooperatives, commercial banks, and other prudentially licensed providers.[50]

[50] Basel Committee on Banking Supervision. 2010. *Microfinance Activities and the Core Principles for Effective Banking Supervision* Bank for International Settlements: Basel, Switzerland. http://www.bis.org/publ/bcbs167.pdf?noframes=1

If a conventional retail bank decides to offer microfinance products, or to partner with an MFI to offer those products, it should have a clear regulatory path to do so. Regulators and supervisors should want to encourage such developments. When microcredit is a small part of a diversified retail bank portfolio, the risk and cost of supervising the microfinance activity are much lower. Moreover, a level playing field in terms of the prudential standards helps to stimulate competition.

[Begin box 3]

Box 3. Basel core principles and depository microfinance

In 1997, the Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements, in cooperation with supervisors from member and nonmember countries and other international standard-setting bodies, identified 25 Core Principles for Effective Banking Supervision. These principles—revised in 2007 to reflect important changes in banking regulation worldwide—set forth the de facto standard in regulation and supervision of banks.

BCBS has acknowledged that nonbank depository institutions that do not hold a significant proportion of deposits in a financial system should be subject to a form of regulation commensurate with the type and size of their transactions, and has recently issued guidance for applying the 25 principles to microfinance activities in depository institutions. The guidance notes the following:

- *Licensing requirements should be tailored to the size and nature of the particular institutions' activities and the systemic risk posed by these institutions. In connection with licensing, the types of permissible microfinance activities (including microcredit in particular, to distinguish it from other loan types) should be clearly defined in the regulations.*
- *Differences between microfinance and commercial banking should be understood and taken into consideration when assessing risk management processes and techniques. Specifically regarding MFIs, the loan portfolio is their primary asset so supervisors should focus on credit risk in particular and should have specialized knowledge of the labor-intensive microlending methodology (see the definition of "common microlending methodology" in "1a. Terminology—What Is "Microfinance"? What Is "Financial Inclusion"?).*
- *Provisioning and reserves for microloans should be tailored rather than grouped with other loan categories.*
- *Liquidity requirements should reflect MFIs' high rate of growth and fewer backup liquidity sources as well as the particular behavior of microfinance assets and liabilities.*
- *Assessment of operational risks as well as internal controls and audit procedures should take into consideration, if applicable, the decentralized nature of the microlending methodology as well as the use of technology and agents (or other contractual and outsourcing arrangements).*

Source: BCBS. 2006. Core Principles for Effective Banking Supervision; BCBS. 2006. Core Principles Methodology. BCBS. 2010. Microfinance activities and the Core Principles for Effective Banking Supervision.

[End box 3]

2d. Transformation of NGO MFIs into Licensed Intermediaries[51]

To facilitate transformation of NGO MFIs into for-profit companies licensed to accept retail deposits, regulators may want to consider temporary or permanent adjustment of certain prudential requirements: ownership diversification rules, requirements that managers have prior banking experience, and prohibitions against use of a transferred loan portfolio to satisfy initial capital requirements.

MFIs often start up as nonprofit NGOs, but later want to take deposits in order to fund their growth and to provide savings services to their customers. Regulators concerned about financial inclusion usually view this kind of evolution favorably (although there may be nonprudential concerns regarding the treatment of the NGO's assets, particularly its grant funding, given that typical NGO transformations are in essence privatizations).

The transformation of an NGO MFI into a bank or other form of for-profit depository institution can happen in a variety of ways.[52] Most commonly, the NGO transfers all or part of its loan portfolio and other assets, liabilities, and employees to a new or previously existing company.[53] In return, the NGO receives an equity interest in the company or payment in the form of cash or debt. Transformations often face regulatory obstacles, and regulators may want to consider relaxing some of these.

Ownership suitability and diversification requirements

Often, an NGO undergoing transformation will want to have a significant ownership interest in the new company, but common owner suitability and diversification requirements can pose serious problems. For instance, regulatory approval for significant owners of the new licensed company may depend on their ability to respond to a capital call. However, many NGOs would not be able to raise additional cash in a hurry if the new MFI gets in trouble. Regulators have waived this requirement (at least temporarily) to enable the transaction to proceed; in some

---

[51] The nonprudential regulatory issues that arise in the context of the transformation of an NGO MFI (including additional restrictions on NGO ownership of for-profit companies) are discussed in "Nonprudential Regulatory Issues—NGO Transformations into For-Profit Companies." Some of the prudential issues discussed in this section also apply when a for-profit nondepository institution transforms into a licensed intermediary.
[52] In most of these cases the term "transformation" is a misnomer. When an NGO MFI "transforms," it usually does not change from one type of institution into another. Rather, it transfers its business to another institution. In a handful of countries, the law does in fact allow a nonprofit (usually a company limited by guaranty) to re-register as a company with owners, thus undergoing a true transformation.
[53] In the absence of a clear path for transformation, NGOs in some countries have used more convoluted transactions to transform.

cases, there has been a permanent waiver in recognition of the financial and institutional stature of the particular NGO.

Prudential regulations often specify a minimum number of owners for depository institutions, as well as a maximum percentage interest for any owner or group of related owners. But a maximum ownership interest of 20 percent (for instance) would force the transforming NGO to find at least four additional owners.[54] When the NGO is forced to find additional investors, it may be in a poor bargaining position when it comes to getting a fair piece of the new company in return for what it is contributing. Shareholder diversity requirements have also been waived (in some cases, temporarily) for NGO MFI transformations.

Ownership limits can also pose an issue for an NGO that wants the social mission of the microfinance operation to be maintained. This can be harder to ensure when regulations force the NGO out of a controlling position. The NGO may not be able to recruit investors who share the same social vision. Continuation of the NGO's control (or strong influence) over the business may or may not be desirable, depending on the local situation and government policy. [55]

Board and management qualification requirements

The "fit and proper" requirements for board members and senior managers of licensed financial institutions may include prior professional experience in finance.[56] If the regulation requires managers to have prior experience in a bank or other depository institution, it can pose a problem in the common case of managers whose prior work was limited to the credit-only NGO that is transforming.

Loan portfolio as part of minimum capital

Current rules may stand in the way of an NGO that has little else beyond its loan portfolio to satisfy the minimum capital requirement for the new depository institution. Some countries completely prohibit the exchange of shares for a loan portfolio (sometimes only with respect to satisfying the initial capital requirement; in other countries, the prohibition is absolute). Elsewhere only performing loans can be transferred. Even if there is no limit on how much capital may be contributed in kind (whether a loan portfolio or other asset), the noncash contribution should be valued by an independent expert.

---

[54] In some transformations, the NGO MFI has brought in clients and/or managers as owners. If managers or directors receive shares in the new company at below-market prices, ethical and legal questions arise. Such arrangements could violate the spirit or even the letter of laws restricting the distribution of a public benefit NGO's assets. See Rhyne, Elisabeth, Ira Leiberman, Brian Busch and Stephanie Dolan. 2010. "Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations." Washington, D.C.: Calmeadow and the Center for Financial Inclusion.
http://www.microfinancegateway.org/gm/document-1.9.40606/AligningInterests_wCaseStudies.pdf

[55] At least one country has required by regulation that the transforming NGO remain a majority owner of the for-profit company to which it has transferred its portfolio, to help protect against asset stripping after completion of the transaction.

[56] Fit-and-proper rules for licensed deposit-taking institutions are based on both professional skill and moral character. Lending-only MFIs do not require prudential regulation so the fit-and-proper test for board and management of such MFIs need not include the same professional experience as the test for depository institutions.

One approach to converting old portfolio into safe capital is to offer a provisional bank license that lets the new institution engage only in lending, not deposit-taking. During the provisional period, the NGO contributes the cash proceeds collected on its existing loans as share capital in the new company. (The customers who repay the NGO can then receive their follow-on loans from the new licensed company.) Once the contributed cash satisfies the minimum capital requirement, the supervisor issues an unrestricted license that allows deposit-taking. This approach allows the NGO to convert its old loan portfolio into capital in the new company. At the same time, it avoids burdening the new company with any collection risk on the old portfolio, so there is no need for any valuation of that portfolio.

2e. Deposit Insurance

> If a country requires commercial banks to participate in a deposit insurance scheme, then it would usually be preferable to impose the same requirement on prudentially supervised deposit-taking MFIs as well (including at least larger financial cooperatives).

Countries have increasingly been introducing explicit deposit insurance schemes not only for financial system stability but also to limit the use of implicit (and open-ended) government guarantees.[57] An explicit or formal deposit insurance scheme has two advantages over implicit government guarantees: increased transparency about obligations to depositors and a limitation (at least in theory) of the government's financial obligations in the event of bank failure.

In most countries, all prudentially regulated commercial banks have to participate in the deposit insurance scheme. In an increasing number of countries, financial cooperatives and deposit-taking MFIs are also invited or required to participate, provided they are prudentially regulated. This makes depositor protection more consistent and levels the playing field among providers. Where nonbank deposit-takers are regulated and supervised differently from banks, some countries have subjected them to separate deposit insurance schemes.[58]

---

[57] IADI Web site: www.iadi.org/deposit.html.

[58] In some countries, financial cooperatives have formed a stabilization fund—typically when there is no deposit insurance. All participants in the stabilization fund pay a fee based on a percentage of their deposits; in the event of a liquidity or solvency problem, a participating cooperative can draw on the fund. When the fund is not managed by an independent body, problems can arise in determining which institutions to stabilize.

Part III. PRUDENTIAL SUPERVISION ISSUES IN DEPOSIT-TAKING MICROFINANCE

Decades of experience around the world with many depository institutions that are *not* conventional retail banks—including financial cooperatives, mutual societies, rural banks, village banks, and depository MFIs—have demonstrated that there is a strong and nearly universal temptation to underestimate the challenge and cost of supervising such institutions effectively—that is, in a way that will keep the strong majority of them reasonably safe and stable.

When various stakeholders start discussing legal frameworks for depository microfinance in a country, it is relatively easy and interesting to craft regulations, but harder and less attractive to do concrete planning for cost-effective supervision. In relation to the assets being supervised, specialized MFIs are much more expensive to supervise than full-service banks. The result is that supervision sometimes gets too little attention in the process of regulatory reform—perhaps on the (often incorrect) assumption that whatever supervisory challenges created by the new regulation can be addressed later, by pumping extra money and technical assistance into the supervisory agency for a while. The result may be regulation that is not enforced (which could be worse than no regulation at all) or excessively expensive.

Early and realistic attention to supervision issues is crucial because the government takes on a fiduciary responsibility when it grants licenses to mobilize retail deposits. Citizens should be able to assume that the issuance of a prudential license to a financial intermediary means that the government will effectively supervise the intermediary.[59] Before deciding to authorize the issuance of licenses to depository financial institutions, a government needs to be clear about its ability to fulfill this undertaking.

3a. Supervisory Tools, Enforcement Mechanisms, and Limitations vis-à-vis MFIs

- Assessing microcredit risk requires specialized examiner skills and techniques that differ substantially from the ones that supervisors use for conventional retail bank portfolios.

- Some supervisory tools—such as capital calls and forced asset sales and mergers—work less well for MFIs than for conventional retail banks, and some, such as stop-lending orders, may actually be counter-productive.

Microcredit portfolio supervision

Conventional bank audit and inspection procedures do not provide enough assurance about microcredit portfolio quality, which is the predominant locus of risk in MFIs. Loan-file documentation is a weak indicator of microcredit risk. Sending out confirmation letters to verify account balances is usually impractical, especially where client literacy is low. Inspectors can usually test the bulk of a commercial bank's loan assets by examining a relatively small number

[59] By "effective" supervision, we mean supervision that is sufficient to flag most problems before it is too late to fix them. No supervisor can prevent all problems.

of its largest loans. In contrast, testing a microloan portfolio calls for much more extensive sampling among thousands of tiny loans. In supervising microlending, the main reliance is on close review of the institution's systems and policies for lending, collection, credit risk management, and internal controls, as well as the actual performance of its portfolio. Such analysis requires knowledge of microfinance methods and operations, along with experienced interpretation and judgment. Specialized techniques and expertise are essential.[60] Supervisors new to microfinance sometimes underestimate the need for additional examiner training.

Stop-lending orders

When a bank is in trouble, supervisors sometimes issue a stop-lending order to keep the bank from taking on further credit risk until its problems have been sorted out. A commercial bank's loans are usually collateralized, and most of the bank's customers do not necessarily expect an automatic follow-on loan when they pay off their existing loan. Therefore, a commercial bank may be able to stop new lending for a period without destroying its ability to collect its existing loans. The same is not true of most MFIs, where immediate follow-on loans are the norm. As discussed earlier, when an MFI stops issuing repeat loans for very long, customers lose their primary incentive to repay, which is their confidence that they will have timely access to future loans when they need them. When an MFI stops lending, many borrowers stop repaying, making a stop-lending order to an MFI counterproductive, at least if there is any hope of salvaging its uncollateralized portfolio.

Capital calls

When an MFI gets in trouble and the supervisor issues a capital call, NGOs may not have enough liquid capital available to respond. Donors and development-oriented investors often have plenty of money, but may have lengthy internal procedures for approving and disbursing, and a low appetite for taking additional risk in a crisis. Thus, when a problem surfaces in a supervised MFI, some of its shareholders may not be able to respond promptly to a capital call (although this is becoming less of a problem with the increasing commercialization of microfinance).

Asset sales or mergers

A typical MFI's close relationship with its clients may mean that loan assets have little value in the hands of a different institution. When a commercial bank fails, its collateralized loan assets can often be saved by transferring them to a solid bank, or by effecting the merger or acquisition of the bank in trouble. This will seldom work with microloans.[61]

---

[60] See, e.g., Robert Peck Christen and Mark Flaming. 2009. "Due Diligence Guidelines for the Review of Microcredit Portfolios." Washington, D.C.: CGAP, http://www.cgap.org/gm/document-1.9.36521/DueDiligence_TechGuide_ENG.pdf; and MicroSave. "Internal Audit and Control Toolkit." http://www.microsave.org/toolkit/internal-audit-and-control-toolkit; and Isern, Jennifer, Julie Abrams, and Matthew Brown. 2008. "Appraisal Guide for Microfinance Institutions." Washington, D.C.: CGAP. http://www.cgap.org/gm/document-1.9.2972/MFIResourceGuide.pdf

[61] See Rozas, Daniel [in collaboration with Godfrey Jjooga Ssebukulu]. 2009. "Throwing in the Towel: Lessons from MFI Liquidations" at http://www.microfinancegateway.org/gm/document-1.9.38716/Throwing%20in%20the%20Towel_%20%20Lessons%20from%20MFI%20Liquidations.pdf.

The fact that some supervisory tools do not work very well for microfinance certainly does not mean that MFIs cannot be effectively supervised. However, regulators should weigh this fact when they decide how many new licenses to issue at first, how much demonstrated past performance to require for transforming MFIs, and how conservative to be in setting prudential standards such as capital adequacy.

3b. Costs of Supervision

In relation to the assets being supervised, specialized MFIs are much more expensive to supervise than full-service banks¸ both for the supervisor and the MFI**.** Donors who promote the development of depository microfinance should also consider providing transitional subsidy for supervising the resulting institutions—particularly in the early stages when the supervisory staff is learning about microfinance and there are a small number of institutions to share the costs of supervision. Donors can also play an important role in funding the training of supervisors. However, in the long term, the government must decide whether it will subsidize these costs or have MFIs pass them on to their customers.

3c.Where Should the Microfinance Supervisory Function be Located?

At first blush, placing supervision of deposit-taking MFIs in the same authority that supervises commercial banks would seem a natural choice. But banking supervisors do not always think this responsibility is the best allocation of their scarce supervisory resources, especially in cases where they are not confident that they have the staff they need even to supervise the big commercial banks adequately. So alternative models, mainly “delegated supervision” and “self-supervision,” are sometimes proposed.

Within the existing supervisory authority?

> In most cases the best supervisor for depository microfinance will be the authority responsible for commercial banks.

Having the bank supervisor supervise depository MFIs takes advantage of existing skills (even though additional specialized skills need to be developed), lowers the incentive for regulatory arbitrage, and may better preserve the political independence of supervision. Separate supervisory bodies have not always had the professionalism, the skills, the teeth, and the independence to do a good job. This has proved especially true in cases where supervision of financial cooperatives is left with the same agency that supervises all cooperatives.

Whether there is a need to create a separate microfinance supervision department within the banking authority varies from country to country. With or without a separate department, supervisory staff often view jobs in nonbank supervision as less attractive than working on bank supervision. Work with nonbank institutions usually offers less prestige, less contact with top officials, and fewer chances for lucrative job offers from commercial banks. If management wants a strong and stable cadre of microfinance examiners, it needs to take these dynamics into account. Ideally, MFIs would be supervised by dedicated staff or, if there are not enough MFIs to justify this, then general supervisory staff with specialized training.

If a single regulatory scheme is going to embrace both lending-only MFIs and prudentially licensed deposit takers, the question of whether the banking supervisor should oversee both becomes a little more complicated. There are arguments for having the one agency supervise both. There is a (modest) degree of overlap in the functions—e.g., both microlenders and deposit-taking MFIs will be subject to most of the same consumer protection regulation. The banking supervisor may have more political independence and putting lending-only MFIs under the banking authority might smooth their transformation into licensed deposit-takers. Finally, there may be no other suitable agency.[62]

However, consolidating prudential and nonprudential regulation of microfinance within the banking authority can create a substantial risk of confusion about the appropriate treatment of nondepository institutions, possibly leading to over-regulation of them. As argued earlier, nondeposit-taking microlenders seldom pose major systemic risk and never put depositors at risk, so they don't need prudential regulation and supervision, which is complex, costly, and intrusive.

Delegated (or auxiliary) supervision

It is not easy to delegate supervision effectively.

Delegated or "auxiliary" supervision refers to an arrangement where the government financial supervisor delegates direct supervision to an outside body, while monitoring and controlling that body's work.[63] Delegated supervision is perhaps most common for financial cooperatives (see "Supervision of financial cooperatives") but some countries have considered it for other nonbank financial institutions as well.

Delegated responsibilities may include data collection and processing, off-site monitoring, on-site inspections, recommendations for action, corrective enforcement, cease and desist orders, and (rarely) intervention and liquidation. For prudential supervision, agencies other than the bank supervisor may lack adequate resources and expertise, operational independence, and remedial powers to fulfill their responsibilities.

To date, there are not many successful examples of delegated supervision. Delegated supervision seems to have worked, for a time at least, when the principal supervisor closely monitored and had effective control of the quality of the delegated supervisor's work. This requires a significant investment of time and resources of the delegating supervisor.

Where this model is being considered, it is important to have clear answers to four questions:

1. Will the delegated supervision cost much less than direct supervision would?
2. If the delegated supervisor proves unreliable and its delegated authority must be withdrawn, is there a realistic fallback option available to the government supervisor?

---

[62] This may be the case in particular in small countries, where it would not be cost-effective to set up a new agency.
[63] In some countries the constitution prohibits outside delegation of supervisory powers and responsibilities. In those cases, it may be possible to frame some degree of de facto delegation as "contracting out support functions."

3. When a supervised institution fails, which body will have the responsibility and ability to clean up the situation by intervention, liquidation, or merger?
4. Who will pay the costs of the delegated supervision and the government supervisor's oversight of it?

Self-regulation and supervision

True self-regulation and self-supervision is almost always a gamble against very long odds.

When policy makers decide that it is not cost-effective for the government financial supervisor to directly oversee large numbers of nonbank deposit-takers (especially small ones), they may consider self-regulation as an alternative. Discussion of self-regulation tends to be confusing because people use the term to mean different things. In this Guide, "self-regulation" means prudential regulation (or supervision) by a body that is *effectively controlled (whether in law or in fact) by the regulated entities*, not by the government supervisor.

Self-regulation of financial intermediaries in developing countries has been tried many times, and has rarely been effective in protecting the soundness of the regulated organizations. (Nonprudential self-regulation, including some consumer protection issues, is a different matter and may occasionally be more successful.) One cannot assert that effective self-regulation in these settings is impossible in principle, but it can be said that self-regulation is almost always an unwise gamble, against very long odds (due to the inherent conflicts of interest), at least if the supervision is really expected to enforce financial discipline and conservative risk management.

Sometimes regulators have required certain small intermediaries to be self-regulated, not because they expect the supervision to be effective, but because this is politically more palatable than admitting publicly that these deposit-takers will be unsupervised. While self-regulation probably will not keep financial intermediaries healthy, it may have some benefits in getting institutions to begin a reporting process or in articulating basic standards of good practice. The question to be weighed in the balance is whether depositors are being given a true picture of how effectively (or not) their deposits are being protected.

Supervision of financial cooperatives

Financial cooperatives—at least the larger ones—need prudential supervision by a specialized financial oversight agency that has the requisite skill, independence, resources, and powers.

Financial cooperatives of widely ranging types are the primary providers of financial services to the poor in significant parts of the world. In many countries, financial cooperatives are licensed under a general law on cooperatives and supervised by a government agency that oversees all kinds of cooperatives, including cooperatives focused on production, marketing, and other nonfinancial activities. These agencies may have the legal responsibility for prudential supervision of the safety of deposits;[64] however, as noted earlier they almost never have the resources, expertise, or independence to do the job effectively. In some countries, the cooperative agency is not politically independent of the cooperatives it supervises.

Financial cooperatives fund their lending mainly with members' shared deposits and savings, so some argue that they don't need to be prudentially supervised because they do not put the *public's* deposits at risk.[65] In fact, when the common bond among members is geographic (i.e., membership is open to anyone living in the given area), there is not much practical difference between members and the public: a nonmember can make a deposit simply by joining and paying a nominal membership fee. Practically speaking, when it comes to deposit taking, such a cooperative isn't very different from a bank. While the members have the right to elect the board, few may be interested in spending the time to stay abreast of the cooperative's financial condition. Thus, aside from very small institutions, cooperative members may be in no better a position to supervise management than are the depositors of a conventional retail bank. In fact, many countries report that poor governance is a major source of failure in financial cooperatives.[66] Thus, the fact that financial cooperatives serve "members only" does not mean they don't need prudential supervision—with the possible exception of very small cooperatives and those that include only employees of a given company (where the company may be an implicit guarantor of deposits).

Countries may establish separate agencies to supervise financial cooperatives. Alternatively, the bank regulator may establish a specific department for financial cooperatives (or at least for cooperatives with assets or members above some minimum threshold), or the bank regulator may delegate authority to an independent body—typically a federated network of cooperatives. In the case of networks, the supervisor will supervise the federation and have the same enforcement powers applicable vis-à-vis any other supervised entity. The federation will in turn supervise its members in accordance with prudential regulations developed by the supervisor. Having the supervisor set the prudential standards is critical to addressing potential conflict of interest issues. Such federations should have, at a minimum, an independent audit department, an MIS for the network, consolidated data, and uniform operational procedures.[67] Using a delegated structure requires political resolve, willing participation of the institutions involved, and a significant initial investment of time and money.

---

[64] Such responsibility may be implicit even if the regulations contain no specific prudential standards.
[65] In some countries, local law permits financial cooperatives to take deposits from the public.
[66] See BCBS, "Microfinance Activities and the Core Principles for Effective Banking Supervision," noting that the cooperative structure entails an inherent conflict of interest because the "owners are also borrowers and depositors," which can result in "poor credit underwriting and management, inappropriate loans to related parties and frauds." (p.21, Focus Note 37)
[67] No federation should be permitted to conduct asset and liability management of the network if it does not have these technical tools.

The case of small member-based intermediaries

- In some cases, the best solution may be to allow formal but very small member-based deposit-takers to continue operating even though they cannot be effectively supervised.
- Weak supervision can be worse than no supervision if it leads depositors to expect levels of protection that cannot in fact be delivered.

Ideally, all institutions taking deposits, regardless of size, should be subject to effective supervision. Some member-based intermediaries take deposits but are so small, and sometimes so geographically remote that they cannot be supervised on any cost-effective basis, no matter which body is doing the supervision. (Today, there are many countries that have large numbers of such small institutions operating without any supervision.) This poses a practical problem for regulators. Should these institutions be allowed to operate without prudential supervision? Or should minimum capital and other requirements be enforced, effectively closing these institutions down?

Supervision for all. Some regulators have initially inclined to the latter course. They argue that institutions that cannot be supervised are not safe, and therefore should not be allowed to take small depositors' savings.[68] After all, are not small and poor customers just as entitled to safety as large and better off customers?

But this analysis is too simple if it does not consider the actual alternatives available to the depositor. Poor people can and do save frequently, sometimes moving more of their income in and out of savings vehicles than better off people do.[69] Where formal deposit accounts are not available, they use savings tools such as putting cash under the mattress, keeping livestock, buying building materials, joining informal rotating savings and credit clubs, or placing money with neighbors or relatives. All of these vehicles are risky, often riskier than a formal account in a small unsupervised intermediary.[70] Closing down the local institution may in fact raise, not lower, the risk faced by local savers by forcing them back to less satisfactory forms of savings.

Supervising merged or federated cooperatives. In some countries, the supervisor has encouraged or required financial cooperatives to merge into a single cooperative large enough to allow cost-effective direct supervision, or to group themselves into a federations or other networks that (as noted) supervises its members under prudential norms developed by the supervisor. But size, distance, isolation, and a history of autonomous operation may sometimes make merger or even meaningful federation impractical, and as noted earlier, delegated supervision has an uneven history and may not greatly reduce supervision costs.

[68] Regulators sometimes hope that, instead of shutting down, these small intermediaries will merge to form larger ones that can be supervised more easily. But various forces, including the practical economics of branch operation, challenges of geographic isolation, or vested interests of local management, can often make this impractical.

[69] E.g., Collins, Daryl, Jonathan Murdoch, Stuart Rutherford, and Orlanda Ruthven. 2009. *Portfolios of the Poor: How the World's Poor Live on $2 a Day.* Princeton, NJ: Princeton University Press.

[70] E.g., Wright, Graham and Leonard Mutesasira, "Relative Risk to the Savings of Poor People," Microsave 2001. http://www.microsave.org/system/files/research_papers/The%20Relative%20Risks%20to%20the%20Savings%20of%20Poor%20People%20-%20Wright%20et%20al_0.pdf

Approval to take deposits but no supervision. Other policy makers have sought an intermediate course, giving small intermediaries some kind of approval to take deposits, but without committing the supervisor to effective prudential supervision. But this risks misleading depositors about the effectiveness of the oversight the institution is actually getting. When a deposit-taking institution displays any kind of government authorization, many depositors assume that the government is exercising oversight of the safety of their deposits. If the supervisor is not in a position to fulfill this expectation, it is better not to allow it to be created.

If very small intermediaries are allowed to take deposits without being subject to prudential supervision, then an argument can be made that their customers should be advised explicitly that no government agency is monitoring the health of the institution and that they need to form their own conclusions based on their knowledge of the individuals running the institution. Questions about the feasibility and effectiveness or practical enforceability of such an approach are not easy to answer.

Part IV. NONPRUDENTIAL REGULATORY ISSUES

When the first edition of this Guide appeared in 2003 prudential regulation of deposit-taking MFIs was the main focus. More recently, nonprudential issues have become more prominent—notably consumer protection and prevention of financial crimes, such as money laundering and terrorist financing.

Nonprudential issues—those that do not require the government to involve itself in protecting the financial health of providers—span a wide spectrum and generally apply to both depository and nondepository institutions. Nonprudential issues tend to be less complex and costly to monitor than prudential issues, both for regulators and providers. But nonprudential regulation is not cost-free. At best, the cost is passed on to customers; at worst, access is restricted when the cost makes a given service or clientele unprofitable for providers. So just as with prudential regulation, policy makers have to be cost-conscious in designing nonprudential measures, always balancing expected benefits against regulatory costs, and looking for less costly means to pursue a policy goal.

Careful consideration should be given to determining which regulator would be most appropriate (see “3c. Where Should the Microfinance Supervisory Function be Located? *Within the existing supervisory authority?”).* In addition, when multiple agencies have an interest in regulated institutions, effective communication and coordination is essential, especially for regulations that will apply to different types of institutions.

4a. Permission to Lend

- The regulatory framework should—absent particular local factors, such as extreme corruption in the NGO sector—permit both NGOs and commercial companies to engage in microlending.

- Issuance of a permit to engage in microlending should be straightforward, involving a public registry and a simple process.

In some legal systems, any activity that is not prohibited is implicitly permissible. In these countries, NGOs and other unlicensed entities are free to lend as long as there is no specific legal prohibition; no regulatory reform is needed to allow them to do so.

In other legal systems, an institution’s power to lend—at least as a primary business—is at best ambiguous unless there is an explicit legal authorization for it to conduct such a business. This ambiguity is particularly common in the case of NGO legal forms. In still other legal systems, only prudentially licensed and regulated institutions are permitted to lend, even if no deposit taking is involved. In these cases, a simple way to expand poor people’s access to credit is to adopt regulation authorizing nondepository MFIs to lend. These institutions would not require prudential regulation because there is no depositor risk and little, if any, systemic risk.

Issuance of a permit to engage in microlending should be straightforward, involving a simple registration process with a public registry. Document or information requirements should be linked to specific regulatory objectives (e.g., identification of responsible parties, fit-and-proper screening of principals, etc.). Where the objective is to enable lending by NGOs, modification of the general legislation governing NGOs may be needed as well.

4b. Reporting and Institutional Transparency

If regular reporting is required of lending-only MFIs, then the requirements should be tailored—both in terms of content and frequency—to the regulatory purposes and should be much lighter than prudential reporting by deposit-takers would be. In addition, the requirements should be harmonized as much as possible with reporting requirements imposed by other regulatory authorities (e.g., the regulator of NGOs).

Nonprudential reporting by microlenders often includes (*i*) basic institutional information that is updated only when necessary (e.g., location, legal status, capital structure, officers and board) and (*ii*) periodically collected information about operations (e.g., financial statements and indicators of scale and portfolio quality). These reports can serve several objectives:

- Conducting “market reconnaissance,” so financial authorities know what is happening in financial market areas that are not prudentially regulated
- Assisting authorities in combating money laundering and the financing of terrorism
- Providing data for benchmarking purposes, so managers and stakeholders can compare their MFI’s performance with its peers’
- Improving MFIs’ institutional accountability
- Fostering competition.

All of the *non*prudential objectives listed above can be achieved without the more burdensome (i.e., detailed, technical, and frequent) requirements of prudential reporting.

Indeed, except for preventing money laundering and terrorist financing, one can reasonably ask whether the government needs to be involved at all in collecting or setting standards for reports by nondepository microlenders. In many cases, the agency collecting nonprudential reports will not need a deep understanding of the microlending business. The function might even be delegated to a private body such as an MFI association. Whatever the body, it should be clear that its role is to monitor reporting compliance, not to address insolvency risk. Ideally, reporting requirements would be harmonized with requirements other agencies to whom microlenders report—e.g., the regulator of NGOs.

4c. Consumer Protection

Financial services do not always help everyone who uses them, and financial providers do not always treat customers fairly. In particular, rapid growth in credit markets that are approaching saturation can lead to over-lending and other behavior not in customers' best interests. As a result, regulators are paying increased attention to financial consumer protection, focusing on three broad themes:

- Adequacy and transparency of information—giving clients accurate and understandable information about pricing and terms
- Fair treatment—avoiding abusive lending and collection practices and other unethical treatment of clients
- Recourse—providing clients with an effective mechanism for addressing complaints and resolving errors or disputes[71]

In addition, attention is being paid to identifying (or establishing) an appropriate regulator for financial consumer protection.

Financial consumer protection deserves particular attention when applied to low-income clients who may have little education, little experience with formal financial services, and few formal providers to choose from.[72]

[Begin box 4]

Box 4. Level playing fields, equal treatment

As much as possible, all providers of a given financial service should be held to the same consumer protection standards. If consumers need protection from misleading loan information (for instance), they deserve the same protection whether the lender is a bank, an MFI, or a retailer selling appliances on credit. Applying the same rules to all providers builds consumer confidence in formal finance and reduces the risks of both regulatory arbitrage and unethical players undermining responsible providers through unfair competition.

Similarly, all microfinance clients should be entitled to the same protection. There is little if any difference between an individual microentrepreneur and a small microenterprise in the use of financial services, especially in the case of microenterprises with no employees outside the family. However, in many countries, consumer protection law safeguards only individuals, not businesses. Policy makers might consider extending consumer protection to microenterprises. If this is done, "microenterprise" should be defined. Definitions in the literature tend to focus on

---

[71] Brix, Laura, and Katharine McKee. "Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance."

[72] The Center for Financial Inclusion (CFI) has done significant work on client protection principles for microfinance (www.centerforfinancialinclusion.org). CFI's "six principles" are transparency, responsible pricing, appropriate collections practices, ethical staff behavior, fair complaint handling, client privacy, and avoiding over-indebtedness. The Smart Campaign has developed good practice guidelines to help MFIs follow these principles (www.smartcampaign.org).

number of employees, caps on sales and/or assets, absence of registration with governmental authorities, accounts that are not segregated from the household accounts of the owner, and unsophisticated, "nonmodern" technology and processes.

[Box 4 ends]

Important complements to consumer protection regulation are the knowledge, awareness, and financial skills of customers themselves. Policy makers in many developed countries, and in an increasing number of developing and transition countries, are exploring efforts to increase the "financial capability" of customers. The term "financial capability" refers to the knowledge, understanding, skills, attitudes, and especially behaviors that people need in order to make sound personal finance decisions, suited to their social and financial circumstances. Regulation may play some role here, but the topic is not primarily a regulatory one, so it is not treated further in this Guide.

Adequacy and transparency of information

Microfinance providers should be required to give clients clear and complete information about services offered, including their terms and costs. However, with respect to microloans, the standard annual percentage rate (APR) may not be the most effective way to communicate costs to low-income borrowers.

For less experienced financial consumers in particular, disclosure rules should emphasize plain language and simple presentation (e.g., font, format, timing, and location of disclosures; no complex formulas or calculations).[73] Where there are low levels of literacy, disclosure rules should ensure effective communication to those who cannot read.

Transparency-related rules often seek to promote comparison shopping and price competition by standardizing disclosure content, forms, and wording, as well as formulas for calculating consumers' costs and returns.[74] It is not clear, however, whether complete and accurate information—including, in particular, disclosure of APR on loans—will affect consumers' behavior as much as expected. Moreover, approaches to disclosure designed for more affluent consumers in developed countries may not always work well, at least without modification,

[73] Rules should, however, be sufficiently flexible to permit the development of new channels, such as branchless banking. For instance, requiring that a bank or MFI employee provide all information to the customer in writing before the service is contracted would, without further clarification, prohibit the opening of accounts through agents. See "Branchless Banking—Consumer Protection."

[74] Careful consideration should be given to the type of standardized measure. For example, although APR may make comparison shopping easier, consumers may find the "total cost of credit" figure plus the repayment schedule easier to comprehend and prefer using it to assess affordability and choose from among loan offers. FSD-Kenya. "Definition of a Standard Measure for Consumer Interest Rates in Kenya: A Scoping Study." See Tiwari, Akhand, Anvesha Khandelwal, and Minakashi Ramji's "How Do Microfinance Clients Understand their Loans?" (effective lending rate may not be suitable for microborrowers).

when serving poor consumers in developing and transition countries.[75] And more is not always better. At some point the volume of disclosure produces diminishing returns, so the focus should be on simplicity, quality, and clarity, not quantity.

Fair treatment

Fair treatment of customers includes both sales practices and post-sale operations. Fair treatment is regulated by general principles, such as nondiscrimination, prohibiting coercive tactics, and confidentiality of client data, as well as through the regulation of specific products and practices. Fair treatment issues are taking on new urgency among policy makers in countries where microcredit markets are becoming over-heated and risk of client overindebtedness appears high. Policy makers may be tempted by interventions—such as interest caps—that can restrict access.

Discrimination

Regulation should prohibit discrimination—whether against women or a particular race, caste, religion, or ethnic minority.

Many of those who are discriminated against for their sex, race, caste, or otherwise are also poor. Prohibiting such discrimination can be an important part of regulating for financial inclusion. However, some regulators may allow providers to limit their services to women, or to some other group that is more likely to be the victim than the perpetrator of discrimination.

Coercive sales and abusive lending and collection practices

- Regulation should address aggressive or coercive sales practices as well as "predatory" lending designed to take advantage of borrowers' lack of education or experience.

- Restraints on abusive collection practice may be needed, but care is required in defining what is abusive.

Possible regulatory tools include standard loan forms and disclosure rules, recourse mechanisms for consumers, basic registration of all credit providers, and constraints on debt-to-income ratios. Regulations should also prohibit misleading advertising. Crafting clear and enforceable definitions of prohibited behavior is not easy but at a minimum should include inappropriate threats.

Some microlenders' have articulated a "zero-tolerance" policy toward delinquency, based on a concern that uncollateralized microlending is sustainable only if repayment rates are kept very high. But over-literal implementation of such a policy can lead to aggressive collection practices that damage borrowers and their households. Possible regulatory tools include rules against

[75] See, e.g. FSD-Kenya. "Definition of a Standard Measure for Consumer Interest Rates in Kenya: A Scoping Study" p. 21; and Tiwari, Akhand, Anvesha Khandelwal, and Minakashi Ramji. 2008. "How Do Microfinance Clients Understand their Loans?" p. 4.

intimidation and coercion, the establishment of official debt resolution and renegotiation channels, and due process for seizing and auctioning pledged goods.[76]

Over-indebtedness

In light of the 2008–2009 global financial crisis and widespread over-indebtedness in some developed countries, policy makers have become more alert to the risk that too many clients of retail credit, including microcredit, are becoming over-indebted.[77] In fact, when fast growing, competitive retail credit markets reach a saturation point, higher levels of over-indebtedness are more the rule than the exception. (Microcredit markets can reach saturation—that is, supply can catch up with demand—at fairly low penetration levels; at any given point in time, large proportions of eligible borrowers simply do want a microloan.)[78] In the absence of reliable credit reporting systems that reach microcredit borrowers in a given country (and indicate a borrower's total outstanding indebtedness to formal lenders), the only practical indicators of over-indebtedness are (*i*) the collection performance of the lending institutions and (*ii*) debt-to-income ratios (which may be collected by lenders). Collection statistics are trailing indicators that for the most part reveal problems after they have occurred. In some circumstances, clients' inability to repay may take a long time to show up in a lender's repayment statistics. Without adequate internal controls, loan officers may roll over unpayable loans, or clients may repay one loan by taking out another from a different source.

Assessment of a loan applicant's cash flow and repayment capacity is a cornerstone of sound loan underwriting. A reliable credit reporting system can tell lenders about an applicant's outstanding debt and repayment record with other formal lenders. (See "Part IV. Nonprudential Regulatory Issues—4d. Credit Reporting Systems".) However, credit reporting systems don't capture borrowing from informal sources, which may be substantial. In addition to preventive measures, there can also be curative measures like debt counseling and legal remedies.

Interest rate caps

> Interest rate caps can restrict access by making it impossible to serve small or remote borrowers. It may be politically difficult to set a cap that is high enough to cover the unavoidable costs of microlending and a profit margin high enough to attract capital to low-income financial services.

---

[76] Porteous, David, and Bridget Helms. 2005. "Protecting Microfinance Borrowers." Focus Note 27. Washington, D.C.: CGAP http://www.cgap.org/p/site/c/template.rc/1.9.2571/; Porteous, David. 2009. "Consumer Protection in Credit Markets." Focus Note 1. Cambridge: Financial Access Initiative; Brix, Laura, and Katharine McKee. 2010. "Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance." Focus Note 60. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.42343/. For consumer lending to salaried employees, some countries have banned automatic collections like payroll deductions.

[77] There is no simple, commonly accepted definition of the term "over-indebtedness." Some associate it with borrowers who can't repay their loans. Others would include borrowers who can repay, but only at the expense of sacrificing basic household consumption needs. Clients with multiple outstanding loans are not necessarily over-indebted, although multiple borrowing is statistically correlated with higher delinquency in most (but not all) of the empirical studies to date.

[78] Anand, Malika, and Richard Rosenberg. 2008. "Are we Overestimating Demand for Microloans?" Brief, April 2008. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.2724/

The frequent calls for regulatory caps on microloan rates are countered with the argument that caps tend to hurt poor people's access to credit by making it unprofitable to offer very small loans or loans to widely dispersed rural borrowers. (This is primarily due to administrative costs, which are much higher for microlending in proportion to the amount lent than for conventional retail bank lending,[79] although many MFIs could reduce their administrative costs through increased efficiency.) The limited empirical evidence available supports this concern, and also suggests that when interest rate caps are not carefully written or cannot be rigorously enforced, prices may become less transparent as lenders start using fees and commissions to pad their loan income.[80]

In theory, interest rate caps could be set at a level that permits sustainable microfinance operations while eliminating excessive profits. But achieving that balance can be politically difficult for the government agency that has to identify (and implicitly sanction) a particular rate. Most people do not understand why tiny loans require high interest rates, so it tends to shock the public conscience when MFIs are allowed to charge very high rates to poor borrowers. Furthermore, there is no one "sustainable" interest rate even within a given microcredit market. Loan sizes and other cost factors can vary widely, and an interest rate that would produce huge profits on $1,000 loans might not even cover costs on $100 loans.

Even in the absence of interest rate controls, rates have been dropping in most microcredit markets (although there have been instances in which MFIs have immediately reduced their rates in response to public criticism, demonstrating that rates can in some markets fall even lower than they have already). The interest rates of some MFIs are high in their market and produce profits that most people would regard as excessive, but the percentage of poor borrowers that are paying such rates appears to be quite small.[81]

A reasonable alternative to caps is effective disclosure combined with steps to help consumers understand the product and pricing. This—together with additional efforts to publish comparative prices among lenders—has served in some markets to bring down interest rates, spurring more effective competition among MFIs and other financial service providers.

[79] It obviously costs less to make and manage a single loan of $1 million versus 10,000 loans of $100 each. Rosenberg, Richard, Adrian Gonzalez, and Sushma Narain. 2009. "The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?" Occasional Paper 15. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.9534/

[80] E.g., Campion, Anita, Rashmi Kiran Ekka, and Mark Wenner. 2010. Interest Rates and Implications for Microfinance in Latin America and the Caribbean. IDB Working Paper 177. Inter-American Development Bank. http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35121757; The Smart Campaign. 2010. Responsible Pricing: The State of the Practice. The Smart Campaign. July. http://www.smartcampaign.org/storage/documents/Tools_and_Resources/Responsible_Pricing-The_State_of_the_Practice.pdf Helms, Brigit and Xavier Reille. "Interest Rate Ceilings and Microfinance: The Story So Far." CGAP Occasional Paper 9. http://www.cgap.org/gm/document-1.9.2703/OP9.pdf.

[81] Rosenberg, Richard, Adrian Gonzalez, and Sushma Narain. 2009. "The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?" Occasional Paper 15. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.9534/

Data privacy and security

Effective protection of microfinance clients' privacy—so that information about them is collected, stored, viewed, and used only in proper ways by designated people—requires clear regulation on bank secrecy and other data privacy, including specific rules that permit lenders to share reasonable client and loan information with credit bureaus where they exist.

Protecting clients' private financial information is usually addressed in bank secrecy laws. Such laws rarely extend to MFIs that are not prudentially regulated, although there may be general data privacy rules that protect individuals.

Breaches of privacy can result from client behavior, such as failing to protect a password, so consumer awareness is an important complement to regulation. Regulation can in turn reinforce consumer awareness, for example by requiring providers to cover such basics in their disclosure (although many will do so without regulatory compulsion, simply as a matter of good business judgment, including as a means to combat fraud by employees or agents).

Enforcing such a wide array of privacy-related regulation can be challenging, given the potential variety of regulators involved—especially for cross-border services and data. Civil penalties may be effective to enforce some privacy protections, but sanctions for others should be, and typically are, a matter of criminal law.

However, there may be trade-offs between data privacy rules and the goal of greater financial access for the poor. For example, in a country without credit information systems that reach microborrowers, informal information sharing among microlenders may be the only way to protect against dangerous levels of cross-borrowing (even though such data sharing would violate current bank secrecy and consumer data privacy protections in many countries).[82]

Recourse

The consumers' ability to lodge complaints and seek redress is an important part of financial consumer protection. For most microfinance consumers, judicial recourse will not be a viable option for many reasons (including expense and time), so the focus needs to be on alternatives.

As a first step, providers should have, and can be required to have, a professional and easily accessible complaints-handling process. This internal dispute resolution process is more likely to be adequate if regulators oversee it as part of their normal supervision procedures. Some regulators choose to require standardized reporting on complaints data and resolution status. If internal dispute resolution is unsuccessful, other avenues of recourse may be feasible, such as

[82] Informal information sharing among MFIs presents the risk of a consumer being unfairly blacklisted, especially as there is no mechanism (or incentive on the part of the MFIs) for correcting old or inaccurate information.

civil society organizations, industry associations, mediators, or ombuds schemes;[83] regulators themselves may be in a position to offer an alternative recourse channel.

Recourse for microfinance consumers should feature simple, plain-language processes, little or no cost to the consumer, a trusted recourse provider, and convenient access points, such as call centers, walk-up complaint desks, or borrower group meetings. Customers may need assistance in filling out and submitting written complaints forms.

Regulators' review of complaints data is a useful tool to identify patterns of abuse and inform future consumer protection policy decisions. Absence of complaints is not always a good sign; consumers may not know how to file a grievance, or may be intimidated by the process. Lack of trust in governments and financial institutions may lead consumers to doubt that their concerns will be heard, so transparent processes are particularly important, and new recourse initiatives should include measures to educate customers about their options.

An appropriate regulator

Choosing an appropriate regulator for financial consumer protection is an issue in both developed and developing countries. The three most common options are (*i*) a financial regulator (whether the banking regulator or a regulator of nonbank financial institutions), (*ii*) a specialized financial consumer protection authority, or (*iii*) the general consumer protection body, if one exists.

Choosing a financial regulator has a few advantages over relying on a general consumer protection body. First, a financial regulator will be familiar with the products in question. Second, providers may be more responsive to a financial regulator given their desire to keep in good standing. However, very few regulators around the world have responsibility for the full range of financial service providers that might be engaged in microfinance activities. The financial regulator is often reluctant to undertake additional responsibilities, including consumer protection enforcement. In contrast, a specialized financial consumer protection regulator may create a more level playing field across different providers offering similar products and services.

Whatever the decision, it is essential to clarify the scope of authority of all the relevant agencies as well as their relationships with other bodies regulating the same institutions.

4d. Credit Reporting Systems

- It is critical for the healthy development of microfinance to foster the development of broad and deep credit information databases that include current loan balances and negative and positive information on the past payment behavior of poor customers, particularly in markets approaching saturation.

- Credit bureaus that draw from comprehensive payment data sources are more helpful to microlenders and borrowers than bureaus that are limited to microcredit data.

[83] Ombuds schemes involve an independent body or individual that investigates and mediates consumers' grievances.

[Begin box 5]

Box 5. The benefits and challenges of credit reporting in microfinance

Credit reporting systems offer important benefits both for financial institutions and for their clients. By collecting information on clients' status and history with a range of credit sources and possibly other parties to whom payments are regularly made, credit bureaus allow lenders to assess risk more accurately and less expensively. (Some argue that very small MFIs or those using a lending methodology that relies on community knowledge such as group lending have less need of credit report data. However, even these institutions have reason to be concerned about multiple indebtedness and have sometimes expressed interest in such reports.) At the same time, they allow borrowers to create "reputation collateral" based on their payment histories. Without a credit bureau, a borrower's faithful repayment of a loan is known only to the institution that made that loan; with a credit bureau, repayment of a loan from one formal lender makes it easier for the borrower to get loans from other lenders who have access to the credit reports. Thus credit bureaus both allow lenders to be more aggressive in lending without physical collateral and strengthen borrowers' incentive to repay.

In developed countries, the combination of credit bureaus and statistical risk-scoring techniques has massively expanded the availability of credit to lower income groups in recent decades. In developing countries, credit reporting has made important gains over the last decade. However, in many of the poorest countries, credit reporting has not yet been adopted, and adoption remains uneven even in many emerging markets. In countries that have credit reporting, low-income consumers are often left out due to minimum loan size reporting thresholds (set by regulation or by the credit bureaus themselves), exclusion of the MFIs from the credit bureaus (by regulation or by practice), or MFIs' lack of interest in participating. When MFIs compete for customers, particularly in more saturated markets, over-indebtedness and default rates have been seen to rise quickly in the absence of reliable credit reports on those applying for loans.

Credit reporting entails risks as well as benefits. Corrupt database managers may sell information to unauthorized parties. Inaccurate information in the database can hurt borrowers, although guaranteeing them access to their own credit histories can lower this risk. Lenders may respond too conservatively to reports, automatically denying credit when there is any negative data in an applicant's record. A database that includes both negative information (about missed payments) and positive information (about good repayment) allows a more complete picture of creditworthiness to emerge.

[Box 5 ends]

While financial regulators often establish and house a public credit registry, the development of a private credit information market depends on the legal framework. Private credit bureaus raise confidentiality issues, especially when banks (which are typically subject to bank secrecy regulation) participate.[84] Sometimes these issues can be handled simply by standard loan agreements in which the borrower authorizes the lender to obtain the borrower's credit report and to share information with a credit bureau.

Private credit bureaus tend to have some important advantages over public credit registries. Private bureaus generally collect data from a wide variety of sources including utilities and retailers. They collect both positive and negative data. They tend to use modern information technology. And sometimes they offer value-added services like credit scoring.

However, there are often obstacles to including MFI data in credit bureau reports. MFIs' small loan volume can be cumbersome and costly for credit bureaus to handle, MFIs may not have the information systems or the data quality needed to meet credit bureau requirements, and sometimes MFI customers may not have the national identification documents that credit bureaus require. Further, the cost to MFIs of obtaining credit reports can be high in relation to loan size, especially if the MFIs don't enjoy the volume discount price that large commercial banks get.

If few of the participating lenders in a credit bureau serve microborrowers, then the data may not be very useful for MFIs. For this reason, it is important for private credit bureaus to include alternative sources of payment history, such as utilities or retailers. Private credit bureaus may be established just for microfinance (e.g., by an association of MFIs)—in countries where MFIs are not bound by bank secrecy rules, a credit bureau formed solely for MFIs may have cost and access advantages. But as noted, all other things being equal, credit bureaus that draw from more comprehensive payment data sources are more helpful to microlenders and borrowers.

If the private sector has not developed a credit bureau that adequately serves the microfinance sector, there may be a case for government involvement, such as (*i*) adopting regulatory incentives for credit reporting—for instance, lower provisioning for loans made using a credit report; (*ii*) mandating MFIs and other lenders to share credit histories, which effectively requires them to organize a credit bureau for themselves; or (*iii*) requiring the sharing of credit data among all licensed credit bureaus, which is typically accomplished by having the public credit registry share its data with the private credit bureaus on a low-cost or no-cost basis.

4e. Limitations on Ownership, Management, and Capital Structure[85]

[84] Public credit registries typically do not face the same legal hurdles regarding privacy and, more specifically, bank secrecy, because these issues are generally clearly addressed in the relevant banking and banking authority legislation.
[85] Some ownership limitations are discussed in "Prudential Regulation of Depository Microfinance—Transformation of NGO MFIs into Licensed Intermediaries—Ownership suitability and diversification requirements." This section focuses on the nonprudential requirements, which are applicable to both depository and nondepository institutions.

Restraints on foreign investment or management can sometimes be a significant obstacle to the development of financial services for the poor. NGOs should be permitted to own shares in for-profit MFIs that specifically target the poor.

Restraints on foreign investment or management can sometimes be a significant obstacle to the development of financial services for the poor.

"Greenfield" (i.e., start-up) operations as well as NGO transformations can be hindered by currency, citizenship, shareholder diversification, and foreign investment rules. In quite a few countries, foreign financial and technical inputs have been important in the progress of microfinance. It can be problematic if MFIs face prohibitions or severe limitations on the participation of foreign equity holders, borrowing from foreign sources, or employment of noncitizens in management or technical positions. In some countries, the microfinance business may not attract many domestic commercial investors for some years yet, so limitations on foreign investment can impede the expansion of services.

Laws applicable to nonprofits may also prohibit or otherwise impede a domestic or foreign NGO from holding an interest in a financial institution. In some countries the prohibition is rooted in the idea that nonprofit organizations should support themselves exclusively from donations, and not from earning a surplus from the sale of goods or services, although this view is less common today than a decade ago.[86] Concerns about NGO ownership based on this outmoded view should be addressed by clarifying the relevant NGO regulation.

4f. NGO Transformations into For-Profit Companies[87]

- Creating a clear legal path for NGO MFI transformations can be an important enabling reform, and may involve changes in nonfinancial laws and regulations—particularly the legal framework for NGOs.

- Regulators should address the risk of asset-stripping presented in the transformation of a public-benefit NGO into a privately owned institution.

A large number of MFIs in developing and transitional countries still operate as locally formed NGOs or projects of international NGOs. Many NGO MFIs plan to transform into a for-profit company, to access commercial funds, to offer services that an NGO is not permitted to offer, or to comply with a new legal requirement.[88] The most common transformation transaction

[86] Today, there is a growing consensus that an NGO MFI that generates net revenues does not violate its nonprofit status if it uses this surplus to fund its work, provided it does not make distributions to private parties, or otherwise use the surplus to benefit insiders (e.g., by paying above-market salaries).

[87] Some transformation issues are discussed in "Prudential Regulation of Depository Microfinance—Transformation of NGO MFIs into Licensed Intermediaries—Ownership suitability and diversification requirements." This section focuses on the nonprudential requirements, which are applicable to both depository and nondepository institutions.

[88] In many cases, an NGO may transform into a nondepository institution instead of deposit-taking institution, undertaking this more limited transformation to comply with a new legal requirement or to access equity capital and

involves the transfer by the NGO of its loan portfolio and other assets, liabilities, and employees to a new or previously existing company in exchange for shares in the company or payment in the form of cash and/or debt.

An NGO is an ownerless legal entity that is required by law and its charter to serve a public benefit purpose rather than the private interests of its founders, managers, or other insiders. In contrast, for-profit companies are run for the benefit of their owners. Most transforming NGO MFIs will want an ownership interest in the new entity to ensure that it continues the mission (e.g., serving the poor). At the same time, NGO transformations typically involve the entry of new investors. Who those investors are and how much of the new company they own will depend not only on practical considerations but also applicable domestic regulation.

If policy makers want to create a framework that helps NGO MFIs turn into for-profit companies, they often need to consider adjustments in several other areas of regulation, not just financial regulation.[89] In particular, NGO law in many countries is not very clear or well developed, especially regarding complex questions at the boundary of what may and may not be considered appropriate for an entity serving the public interest. In some countries, there may be ambiguity regarding whether a public benefit NGO can transfer its portfolio and other property to a for-profit company. There may also be a legal prohibition on an NGO owning a commercial company, legal limits on foreign participation, or other ownership suitability requirements applicable to financial institutions. Such restrictions may not prevent transformations but can result in the use of artificial and sometimes inappropriate or inefficient structures to capitalize the new company.

Transformations present an opportunity for asset-stripping (i.e., inappropriate transfer of the NGO's assets to private pockets), which is often a violation of NGO law although the legal provisions may be less than clear or not well-enforced. Insiders can strip assets through excessive compensation, or the award of shares in the new company (usually to managers and board members) for less than their value. Asset-stripping is also an issue when outside investors are introduced. What percentage ownership does the NGO get for its contribution of portfolio, systems, know-how, and intangibles like customer relationships? And what percentage is appropriate for those who bring new cash investment to the table? As yet there are no standard valuation benchmarks in terms of price/book value or price/earnings ratios, so it may not be obvious if a "sweetheart" deal is enriching private shareholders at the expense of the MFI.[90]

---

increased commercial borrowings without taking on the additional regulatory burdens of being a depository institution. See the discussion in "Limitations on Ownership, Management, and Capital Structure" as well as in "Transformation of NGO MFIs into Licensed Intermediaries" regarding the prudential issues triggered when the transformed institution takes the additional step to become licensed to accept retail deposits.

[89] In most countries, the disparate bodies of regulation involved do not contemplate, and have never before been applied to, microfinance transformations. Some countries have required NGO MFIs to transform, usually in an effort to improve regulation and general organization of the sector. While there can be benefits of this approach, forcing transformations in a tight timeframe can also be disruptive for existing MFIs and their clients.

[90] O'Donohoe, Nicholas P., Frederic Rozeira de Mariz, Elizabeth Littlefield, Xavier Reille, and Christoph Kneiding. 2009. "Shedding Light on Microfinance Equity Valuation: Past and Present." Occasional Paper 14. Washington, D.C.: CGAP, February. http://www.cgap.org/gm/document-1.9.9021/OP14.pdf

Measures to prevent stripping of an NGO's assets include (1) requiring NGO insiders to recuse themselves from the negotiations if they or related parties would be receiving shares in the transformed entity[91] or be employees of the new private company and (2) bringing in a respected, independent person with valuation expertise to judge the fairness of the transaction. Such expert valuations are often costly.

4g. Secured Transactions

Legal and judicial reform to support secured transactions—in particular, a collateral law and accessible collateral registries—can often facilitate microfinance, even though typical microcredit is effectively unsecured.

Borrowers, lenders, and the national economy all benefit when not only real estate but also moveable and intangible assets can be pledged as collateral for loans. In many developing and transitional economies, it is expensive or even impossible to create and enforce a security interest in moveable or intangible collateral. Sometimes there are also constraints that make it hard for lower income people to use their homes and land as collateral.

Reform of secured transaction regulation is likely to benefit the middle class more than typical microborrowers, given that many microloans are so small that registration of collateral would not be cost-effective, even if the borrower has property to pledge. Many of the assets of the poor would not be suitable for pledging even under reformed regulation. And, of course, effective microlenders know how to recover loans without collateral. Nevertheless, in some countries the microloan clientele—especially at its upper end—includes borrowers who could provide worthwhile collateral if the regulatory framework is conducive. Where this is the case, MFIs frequently take a pledge of whatever property the borrower can offer, to increase repayment incentives—even if the loan amount is significantly higher than what the property would bring at a foreclosure sale.

4h. Financial Crime[92]

Three financial crime topics predominate in the regulation of microfinance: anti-money laundering and combating financing of terrorism (AML/CFT), fraud and related financial crimes (particularly pyramid investment schemes), and identify fraud. Particularly in the last few years, AML/CFT has perhaps commanded the most international attention. But from the perspective of poor customers of financial services, both pyramid investment schemes (also known as Ponzi schemes) and identity fraud loom very large as well.

AML/CFT

[91] If key NGO insiders recuse themselves, there can be a risk that the other NGO stakeholders who are left to make the decisions may be uninformed and may unintentionally drive too soft a bargain in negotiating with the new private shareholders

[92] Financial crime can lead to an institution's insolvency, so prevention of financial crime can serve both prudential and nonprudential purposes.

Applying the AML/CFT rules for conventional banking to tiny microfinance transactions can seriously limit access unless risk-based adjustments are allowed.

Almost all countries have committed themselves to implement the Forty-Nine Recommendations of the Financial Action Task Force (FATF), the international standard-setting body for AML/CFT. Key AML/CFT controls include (*i*) customer due diligence measures such as verifying customers' identity—sometimes referred to as "know your customer" rules or "KYC", (*ii*) record-keeping, and (*iii*) reporting of unusual and suspicious transactions to the authorities. The FATF Recommendations extend to a wide range of services and activities, including the acceptance of deposits from the public, the provision of consumer credit, and the transfer of money or value in both the formal and the informal sector (although enforcing rules for informal transactions poses obvious challenges).

The problem is that the delivery of microfinance could be severely restricted if providers have to meet the AML/CFT requirements established for conventional retail banking and typical bank customers. When applied to hundreds of thousands of very small transactions involving poor customers, the normal AML/CFT rules can increase operating costs significantly. These higher costs can make it impossible to serve some poor customers viably. In any event, the costs will be passed on to the customers.

Over the last few years, awareness has grown that the financial integrity goals of AML/CFT regulation and the financial inclusion goals of microfinance can reinforce each other rather than conflict.[93] In particular, bringing people from the untraceable world of cash and informal finance into the traceable realm of formal financial services makes law enforcement easier. The FATF Recommendations allow flexibility for national-level regulation to take a risk-based approach: policy makers can decide whether reduced or simplified controls are enough to safeguard low-risk activities against abuse. And although low value doesn't necessarily mean low risk of money laundering or terrorist financing, many countries have already implemented special AML/CFT treatment for microfinance and other small-value financial transactions.

But important challenges remain. In many countries, the most significant challenge will be adjusting KYC rules to take into account the limited formal identification available to poor people and to allow alternatives (e.g., verification of identity by a village leader). Some countries are accelerating efforts to improve the availability and use of national identification cards or unique identification numbers to address this challenge.

Once an identified customer has a relationship with service provider, AML/CFT risks in subsequent transactions can be mitigated by imposing caps on transaction sizes, monthly flow-through, and balances, as well as by implementing software and staff training to identify suspicious transactions. The cost of producing and storing required records may also present a challenge. As noted earlier, the inherently high administrative costs of large numbers of small

[93] See Isern and de Koker. 2009. "AML/CFT: Strengthening Financial Inclusion and Integrity." Focus Note 56. Washington, D.C.: CGAP. http://www.cgap.org/gm/document-1.9.37862/FN56.pdf

transactions makes cost containment crucial to microfinance outreach. If regulations permit electronic rather than paper records of KYC verification, the cost of record keeping goes down dramatically.

Fraud, pyramid investment schemes, and related financial crimes

In many countries, the existing anti-fraud and financial crime regulation may be adequate to address abuse connected to the provision of microfinance services, or may need amendment only to add any new categories of institution to the regulatory landscape. Often the most pressing need is to improve enforcement of existing laws.

Financial institutions, including MFIs, can fall victim to or be used as vehicles for fraud and related financial crimes. For instance, loan officers may invent fictitious borrowers or embezzle customers' payments; managers may misappropriate grant funds; or criminals may set up a fake MFI or branch, take deposits, and then flee.

Pyramid investment schemes are prevalent in many developing and transition countries and occur in developed countries as well. In pyramid schemes, a high-yielding investment (or deposit) is promised; early investors (or depositors) are in fact paid the high returns promised, but out of the investments (or deposits) of subsequent victims.

Pyramid schemes are especially relevant to microfinance when they target victims who are less educated and experienced with financial services. The schemes sometimes assume, or mimic, a regulatory form that is also used by legitimate microfinance providers—for example, pyramid schemes have often been structured as financial cooperatives. In the short term, this hurts legitimate institutions that lose customers to the high-yielding pyramid providers. Once the scheme collapses, it can have long-term consequences for poor customers' trust in legitimate institutions (as well as in the regulator). Outrage at the government's failure to prevent large-scale pyramid schemes has had serious political consequences in quite a few countries, even to the extent of regime change.

Unfortunately, there is no simple regulatory answer to pyramid schemes. The available tools are those used to attack financial fraud generally. However, to reduce the risk of poor enforcement (whether due to corruption or otherwise), it may be advisable to give a specified government agency explicit responsibility for pyramid schemes, including the authority to close them down and refer their perpetrators for prosecution. If there is more than one agency involved in regulating and shutting down these schemes (which is not infrequently the case, as such activities could involve bankruptcy investigations, criminal investigations, asset forfeiture, and the like), then it may be necessary to establish an intragovernmental body representing the key agencies that should act against pyramid schemes.[94]

[94] The members of the task team would need to evaluate their capacities and powers to identify schemes promptly and ensure that the agencies jointly are able to close down the schemes, trace and repay investor funds, and take appropriate law enforcement action against the managers of the scheme.

Identity fraud

In most countries, identity fraud and theft are recognized as crimes. The focus should be on improved enforcement of the existing criminal sanctions and other data protection and privacy measures.

Identity fraud in financial services involves assuming another person's identity, or a fictitious identity, to procure financial services or appropriate funds. Microfinance providers can be both victims and facilitators of identity fraud. For example, fraudsters may assume fictitious identities and falsify information about their cash flow to get loans they don't intend to repay, or may assume the identity of a borrower with a solid credit rating for the same purpose. Identity theft is relatively easy when illiterate victims can be induced to sign documents they can't understand. It can also result from a data security breach, or because the victim is induced relinquish a password or personal identification number.

4i. Tax Treatment of Microfinance[95]

- Favorable transaction tax treatment should be based on the type of activity or transaction, regardless of the nature of the institution and whether it is prudentially licensed.
- It is reasonable to argue that NGO MFIs should be treated the same as other public-benefit NGOs when the tax in question is a tax on net profits.
- Profit-tax deductions for expenses that are available to banks should also be available to other providers of similar services.

The wide disparity in tax systems and other local factors may call for differing results, but in most countries the discussion can at least be organized around the distinction between taxes on financial transactions and taxes on net profits arising from such transactions.

Taxation of financial transactions and activities

In principle at least, it is normally preferable for institutions of different types to pay the same transactions taxes if they are conducting the same activities. In some countries, favorable tax treatment with respect to financial transactions (e.g., no value-added tax on loans, no tax on interest revenue) is available only to prudentially licensed institutions, even though the favorable tax treatment has little relationship to the particular objectives of prudential regulation. In other countries, financial transaction taxes affect financial cooperatives differently from banks. Absent other considerations (e.g., special allowances for nonprofits), favorable transaction tax treatment

[95] Taxation of insurance products present many unique questions not applicable to providers of credit, savings, and money transfer services, and is not addressed in this section.

should be based on the type of activity or transaction, regardless of the nature of the institution and whether it is prudentially licensed.

Taxation of profits

With respect to taxes on net profits, there is a respectable argument that NGO MFIs should be treated the same as other public-benefit NGOs. Exemption from profits tax is based on the principle that the NGO is rendering a recognized public benefit (in this case, serving the poor) and does not distribute its net surpluses into the pockets of private shareholders or other insiders; rather, it reinvests any surplus to finance more socially beneficial work. To be sure, there are always ways to evade the spirit of this nondistribution principle, such as excessive compensation and below-market loans to insiders. However, the most sensible way to deal with this risk is usually better enforcement of NGO law, rather than taxation of NGO profits

In many countries, cooperatives are treated as noncommercial entities because of their mutual benefit orientation and are therefore exempt from profit tax despite the fact that they may distribute their net surplus among the member owners. Opinions vary as to whether these institutions deserve public subsidy even though MFIs organized as companies that provide the same services to the same customers are ineligible. In some countries, it appears that MFIs that normally would have been set up as joint stock companies are instead set up as cooperatives solely to secure a profits tax exemption.

Rules for tax deductibility of expenses (such as reasonable provisioning for bad loans) should apply consistently to all types of institutions subject to a profits tax, regardless of whether they are prudentially licensed. Yet this is not the case in many countries, because the tax rules were drawn up with only banks in mind. Moreover, if prudential regulations require more aggressive provisioning of a delinquent microloan portfolio than a conventional loan portfolio, then the microlender’s profits tax deduction should also vary accordingly.

Part V. REGULATING THE USE OF BRANCHLESS BANKING TO SERVE THE POOR

- Branchless banking—using technologies (such as mobile phones and smartcard readers to transmit transaction details) and existing retail establishments to act as the principal customer interface—holds the promise of significantly expanding financial access by lowering transaction costs.

- A suitable regulatory framework for branchless banking must include (*i*) conditions for banks' and nonbanks' use of agents or other third parties as the primary customer interface; (*ii*) an appropriate, flexible, risk-based AML/CFT regime; (*iii*) a clear regulatory regime for the issuance by nonbanks of electronically stored value; (*iv*) consumer protection tailored to the branchless context; and (*v*) regulatory space in the payments system that allows (at least in the long term) broad interoperability and interconnection.

In developed and developing countries, more and more people are making and receiving payments using technology such as payment cards and mobile phones instead of cash. These technologies are also being used for other financial services, including withdrawals, deposits, and savings. And in a few instances, these technologies are being used to disburse loans and collect repayments. This is branchless banking: the delivery of financial services outside of conventional bank branches, using third parties such as retailers as the principal interface with customers, and relying on technologies such as card-reading point-of-sale (POS) terminals and mobile phones to transmit the transactions details. Because it uses existing physical and technological infrastructure (e.g., mobile phones, retail stores), branchless banking may be able to reduce costs (potentially radically) and improve convenience, and thus reach many customers who are presently unbanked or underbanked.[96]

A key determinant in the development of branchless banking is the regulatory environment. Are there clear regulations and clear authority over the different areas involved in branchless banking? Or are the regulations silent on the important issues, such as who may issue electronically stored value against receipt of cash (e-money)? Are retail outlets and other third parties allowed to serve as service providers for banks and other financial institutions, or are licensed intermediaries the only ones who can provide payments and other cash-in/cash-out services (e.g., deposits and withdrawals)? Is the retail payment system available (and affordable) to branchless banking providers that want to serve low-income clients? Are the AML/CFT regulations too burdensome to allow development of branchless banking models? Are consumers protected from the different risks posed by branchless banking and its use of agents and other third-party actors?

[96] While branchless banking is not new (e.g., automatic teller machines [ATMs] and POS devices in retail outlets have been available for decades), the use of branchless banking by populations who haven't been served by traditional branch-based banking *is* new, as are some of the actors involved—e.g., mobile phone network operators.

In many countries, industry innovation has been ahead of the policy makers.[97] In a few countries branchless banking has thrived because of the absence of regulation.[98] But in the long run, the success and safety of branchless banking will depend on appropriate and coordinated regulation and supervision across the relevant regulatory domains, including banking, payment systems, and telecommunications. Services from some branchless banking providers (e.g., banks) will already be subject to financial regulation and supervision while services from others (e.g., mobile phone companies) will not. (See Box 6.) The regulatory challenge is to implement a process that creates space for innovation and competition while balancing financial security and consumer protection. This process involves crafting regulation, monitoring its implementation and making necessary adjustments, and ensuring the capacity of the various regulators as well as coordination among them.

[Begin box 6]

Box 6. Bank-based and nonbank-based models

It is useful to group branchless banking models into (i) those where the customer has a contractual relationship with a bank or a similar licensed institution ("bank-based") and (ii) those that do not involve banks, where the customer has a contractual relationship with a nonbank service provider such as a mobile phone network operator ("nonbank-based"). In the bank-based model, the customer is dealing with a financial institution that is prudentially regulated and supervised. This is usually not the case for the nonbank-based model. But in the nonbank-based model, regulated financial institutions almost always play some role in protecting customer funds, even if they do not have the direct contractual relationship with the customer. For instance, the nonbank provider may keep its cash "float" in a bank account.

[End box 6]

Diagnostic work during the past several years suggests that the following regulatory issues are key for developing branchless banking:

- The use of third parties to handle cash-in/cash-out functions and other customer interface tasks like account opening
- A risk-based approach to AML/CFT regulation that reflects the lower risks presented by small-value products and services
- Appropriate regulation of nonbank payment providers and e-money issuers to protect customer funds
- Meeting the particular consumer protection challenges raised by (*i*) inserting a third party between the customer and the provider of financial services and (*ii*) the use of remote communications

[97] Some regulators have intentionally delayed the crafting of branchless banking regulations, preferring to watch the early development of the industry and to design the rules later, when the problems and benefits of the new channels are clearer.
[98] In some countries without branchless banking regulation, progress in branchless banking may be partially due to avoidance of some of the costs that regulations impose on bank transactions.

5a. Agents and Other Third-Party Arrangements

- Limitations on the nature and qualifications of agents and other third parties need to be crafted carefully to avoid limiting outreach to target clients.
- Rules that prevent third parties from acting on behalf of a financial institution to open customers' accounts or to handle cash typically need to be changed.
- Regulation should be clear about the financial service provider's liability for the acts of its third-party contractors.

Branchless banking depends on the use of agents or other third parties to perform the direct customer interface functions—including most importantly taking in and disbursing cash. While there must be some limits on whom may act as a third party, and which functions can be performed by them, regulators need to understand that overly tight restrictions can seriously impede outreach to the unbanked and under-banked population.

The use of pre-existing third-party actors to reduce costs and expand outreach is essential to any branchless banking model. Unbanked and under-banked customers need convenient means of reducing cash to electronically stored value and turning it back into cash, as well a convenient means of establishing a relationship with a trusted financial service provider. The third-party actor (for instance a local merchant or airtime reseller) may be an agent acting on behalf of the service provider as principal, which typically involves the principal being liable for all actions that the agent takes pursuant to the agency agreement. Or there may be some other type of contract: a services agreement, a partnership, a joint venture, or an alliance. The term "agent" is often used to refer to any third party that acts as the principal customer interface. (In some countries, the term "correspondent" or "facilitator" is used.) However, it is more accurate (even if cumbersome) to use the more inclusive term "third party," because the term "agent" implies a legal relationship where the service provider is more likely to be legally accountable to the customer for the acts of the third party.

Any third-party arrangement raises several regulatory issues. First, applicable rules may restrict the type of legal entity (e.g., commercial entity, nonprofit, individual, or other) permitted to act as an agent or other third party for a bank. There may be criteria that a third party must meet (e.g., a business license or minimum capital). Limitations on the nature and qualifications of agents and other third parties need to be crafted carefully to avoid limiting outreach to target clients. It is especially important to allow local retailers to act as third parties.

Second, the rules should be clear about which services third parties can perform. Some countries prohibit banks from using third parties for core management functions (e.g., internal audit, approving loans); others prohibit the use of third parties to open accounts or handle cash. If regulators want to extend financial access by enabling branchless banking, rules that prevent third parties from opening accounts or handling cash typically need to be changed. This involves adopting a risk-based approach to AML/CFT rules and permitting agents (and other third parties subject to adequate bank oversight) to verify customer identity. Such third parties must be given appropriate training and technology.

Third, regulation should be clear about the financial service provider's liability for the acts of its third-party contractors. With respect to agents in particular, it is appropriate to hold a principal liable for its agent's actions taken in connection with the agent's specified duties and responsibilities, including compliance with relevant regulations (e.g., AML/CFT requirements, consumer protection provisions). The principal—that is, the financial service provider—is often not well-positioned to prevent fraud and other criminal wrong doing by outside parties, and cannot be expected to do anything to guard against certain risks, such as "fake" agents who take cash from the public without the principal's knowledge.

5b. AML/CFT

> In some countries, branchless banking cannot develop without risk-based adjustment of KYC and other AML/CFT rules.

Branchless banking requires a risk-based approach to AML/CFT. There are two primary obstacles: (*i*) many low-income individuals cannot present the documentation normally required to establish identity and (*ii*) many national AML/CFT regimes do not leave room for remote account opening (e.g., the customer submits data electronically, which are then verified with independent, third-party information) or, as discussed in Section 5a, account opening by agents (such as KYC verification entrusted to third parties).

However, FATF Recommendations allow for reduced KYC in situations where there is reduced risk of money laundering and terrorist financing,[99] such as the small transactions typical of most branchless banking. Several countries have already adapted their AML/CFT rules to the realities of low-income clients with limited access to formal documentation, and remote transactions conducted through unsophisticated third-party retailers.[100]

5c. Nonbank Issuers of E-Money and Other Stored-Value Instruments

> Nonbank e-money issuers should be subject to appropriate regulation and supervision, including liquidity and solvency-related requirements.

Many countries have, or are considering, regulation of nonbank issuers of e-money and other stored-value instruments (e.g., prepaid cards).[101] However, e-money issuers in developing countries are usually not very large, so regulators today are less concerned with systemic risk and more concerned with protecting the "float" (i.e., the public's funds held in the form of e-money by the e-money issuer). Regulators can mitigate the risk posed to customers and the financial

[99] FATF Interpretative Note to Recommendation 5.
[100] See earlier discussion of risk-based approaches to AML/CFT and Isern and de Koker (2009).
[101] Arguably, if nonbank e-money issuers attract large amounts of repayable funds and are not prudentially regulated, they could pose risks for the financial system.

system by restricting the use of the float so that the funds are not at substantial risk. Most commonly, the float has to be held in low-risk, liquid assets such as government securities, or in deposit accounts at prudentially licensed institutions. When the float is held in a bank account, it should be isolated from claims of the e-money issuer's creditors (e.g., by keeping the funds in a trust account for the benefit of customers, and prohibiting an issuer from using the float as collateral).[102]

5d. Consumer Protection

Branchless banking raises a new layer of consumer protection concerns because of its use of third parties as the principal customer interface, the potential physical distance between customer and provider, and relatively inexperienced customers.[103]

The third party should be required to disclose that it is an *intermediary* so that customers know they are not dealing directly with the service provider. Clear display of pricing and fees should also be required, not only for transparency purposes, but also to reduce the risk that customers are overcharged or steered to a particular provider if the third party represents several. There should be a clear display of recourse mechanisms. Long-distance recourse can be challenging, especially for less sophisticated customers, but providers can be required to offer a simple complaint mechanism using the same technology that is used to transmit transaction details.

5e. Payment Systems: Access, Interoperability, and Competition

The development of new branchless banking models may be inhibited if nonbanks are not permitted to participate in the national payment system.

In some countries, nonbanks are prohibited by law from participating in the payment system; in others, nonbanks are excluded not by law but by the decisions of the existing payment systems and their participants regarding access and price. Allowing nonbanks into payment systems can increase financial access, but introduces new risks across industries and, when international firms are involved, across countries.

In some countries, regulators have required payment systems to accept certain types of institutions and have regulated maximum fees. Under certain circumstances, regulators have required participants in a payment system to give competitors a specified time period to "catch up" with technological developments and join the system. However, a policy like this may discourage innovation because market participants may not invest in research and development if forced to share their work. While efficiency and competition may ultimately be advanced by interoperability of payment products, regulators have to balance the risk of discouraging innovation.

[102] For a detailed discussion of these measures, see Tarazi, Michael, and Paul Breloff. 2010. "Nonbank E-Money Issuers: Regulatory Approaches To Protecting Customer Funds." Focus Note 63. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.45715/

[103] Dias, Denise, and Katharine McKee. 2010. "Protecting Branchless Banking Customers: Policy Objectives and Regulatory Options." Focus Note 64. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.47443/

5f. Interagency Coordination

Establishing a formal or semi-formal coordination body among the various agencies regulating actors and activities of branchless banking can make a substantial difference in creating a regulatory environment where branchless banking models can thrive.

Branchless banking brings together actors from different industries—including industries outside the financial sector, such as telecommunications and retail distribution, so regulation and supervision of branchless banking is likely to involve more than one agency. Ambiguities or overlaps in jurisdiction among the differing regulatory authorities can result in weak enforcement or conflicting regulation. For instance, a telecommunication regulator might be stricter than the financial regulator about AML/CFT requirements, or the perspective of a central bank's consumer protection division might differ from the perspective of a national consumer protection body with experience only in product liability. Effective coordination among these regulators can be crucial.

Part VI. REGULATING MICROFINANCE PROVIDERS IN MICROINSURANCE

6a. What Is Microinsurance?

Defining microinsurance

While legal definitions vary, insurance generally denotes a contract by which an insurer, in return for a premium, undertakes to provide specified benefits depending on the occurrence of specified contingencies (i.e., uncertain future events). Microinsurance could be described as insurance with small benefits and premiums, or as risk-pooling instruments for the protection of poor households.[104] This Guide adopts the definition used by the International Association of Insurance Supervisors (IAIS) and the Microinsurance Network, namely: "insurance that is accessed by [or accessible to] the low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which should include the [IAIS] Insurance Core Principles)."[105]

Increasingly, insurance regulators are adopting regulatory definitions of microinsurance. These definitions vary, depending on local context and differing regulatory objectives.[106] If the regulatory objective is to accommodate microinsurance by means of less strict requirements, the definition may specify the features of a lower risk product (e.g., short contract terms).[107] A regulatory definition may also be used to designate products that qualify for subsidies or are subject to quotas.[108]

Roles in delivering microinsurance

The party responsible for paying benefits when the specified contingency happens—that is, the party bearing the insurance risk—is the "underwriter." Insurance, including microinsurance, is generally required by regulation to be underwritten by a licensed, prudentially regulated insurance company, although there are countries that permit institutions (including MFIs) to underwrite insurance without a specific license.[109] The underwriter of microinsurance often is not directly involved with the customers. Rather, an "insurance intermediary" (often an MFI)

---

[104] See "Issues in Regulation and Supervision of Microinsurance" International Association of Insurance Supervisors (IAIS) and the Microinsurance Network, formerly known as the CGAP Working Group on Microinsurance. June 2007.
http://www.iaisweb.org/__temp/Issues_Paper_in_regulation_and_supervsion_of_microinsurance__June_2007.pdf
The paper analyzes the provision and regulation of microinsurance in light of the IAIS Insurance Core Principles.
[105] Ibid.
[106] Sometimes a definition may appear in a policy statement (and not in regulation) or may be informally adopted or applied by industry.
[107] In addition to the term of the policy, other features that can impact the risk of an insurance product include (1) the size of the benefit payable under the policy (with lower benefits implying lower risk); (2) the nature of the risk event covered (some insured events happen with more predictability than others; e.g., mortality rates in a given population of large enough size tend to be more predictable than disability or critical illness events, which tend to be less frequent and more subject to claims management and definitional uncertainties); and (3) the complexity of the product (insurance contracts with numerous options and complex features will be harder for the insurer to price correctly and it will be more difficult to set aside appropriate funds to meet future claims).
[108] This type of regulation falls beyond the scope of this Guide.
[109] To diversify its own risk, an insurance company typically "reinsures" the insurance risk it takes on. Given that reinsurance is available only for licensed insurers, this Guide does not address the regulation of reinsurance.

typically manages the customer relationship, handling sales, premium collection, policy administration, claims assessment, and settlement.

Types of microinsurance products

The range of microinsurance products includes credit life insurance, life insurance, funeral insurance, disability insurance, health insurance, and various kinds of property insurance, including specialized agricultural insurance. Sometimes more than one type of insurance may be "bundled" together as a package, such as life insurance and funeral insurance. (See "6c. Regulation of Microinsurance Sales—*Bundling*".)

6b. MFIs and Microlending Banks in Microinsurance

Because of their established relationship with the target customers of microinsurance, MFIs and banks delivering microcredit (and other products) to the poor often offer an attractive infrastructure for delivering microinsurance products as well. Many such existing providers of other microfinance services are motivated to offer microinsurance products to their clients out of a desire to expand their range of formal financial services.

MFIs as insurance underwriters

- Regulators of MFIs that engage in underwriting or intermediation of microinsurance products should coordinate their supervision of such MFI activities with the insurance regulator.

- With the important exception of credit life insurance, MFIs are generally not well positioned to underwrite microinsurance—that is, to bear and manage the insurance risk.

In most countries the underwriting of insurance is regulated by a separate body of insurance law and regulations, and supervised by a separate insurance supervisor. However, today, microinsurance is underwritten by a range of entities—for profit and nonprofit, private and public—depending on the jurisdiction and model.[110] Insurance law normally prohibits an institution that underwrites insurance from offering other financial services. Similarly, banking and microfinance regulation often prohibit banks and depository MFIs from underwriting insurance. Granting loans and taking deposits requires skills that are different from those required in managing insurance risk

[110] There is disagreement regarding whether a nonprofit (or *any* unregulated entity) should be permitted to underwrite insurance. Those opposed argue that absent prudential regulation, and supervision, the complexity of managing the business and risks involved pose too great a risk for the consumer and, if the institutions and amounts at risk are large enough, for the financial sector.
Those who favor a looser approach argue that if the regulatory framework for licensed institutions is not conducive to serving the poor, then unlicensed, unregulated entities should be able to provide microinsurance below a specified threshold (measured, for example, by policy size or gross assets). They argue that an activity-based regulatory regime could address some of the risks through consumer protection and other requirements. But such activity-based regulation is not likely to address prudential risks like inadequate capital structure, inadequate actuarial analysis and pricing, or inadequate reinsurance.

Credit life insurance is a special case because it poses little risk. (See "*The special case of credit life insurance*".) MFIs that might underwrite other microinsurance products—typically financial cooperatives and nondepository microlenders—are probably not in a position to subject their insurance liabilities to actuarial analysis and consequently often do not have adequate reserves to guarantee that claims can be paid when due. Also, MFIs are generally riskier as underwriters than insurance companies due to the often small risk pool of the customer base, the high likelihood of covariant risk among them, and the absence of reinsurance options for MFIs.

However, mainstream insurers in many countries—particularly poorer ones where the insurance market is typically under-developed across the board—may not have any interest in serving the customers targeted by MFIs. To fill this gap in the market, policy makers in some countries allow MFIs to underwrite a special category of lower risk microinsurance with lower compliance burdens. To assure separate management of the insurance risk involved, the regulator may require the MFI to establish a separate legal entity for its underwriting operations and to manage the insurance risk based on insurance principles.

MFIs as insurance intermediaries

Established MFIs can be well positioned to serve as intermediaries on behalf of insurance underwriters: the MFIs have an existing relationship and delivery infrastructure with target clients for microinsurance.

MFIs can be attractive intermediaries for microinsurance because they have both close contact with large numbers of low-income clients and a delivery infrastructure (branches, loan officers, cash handling systems, and at least simple MIS). However, taking on the role of intermediary is an investment and requires new skills at all levels of the MFI. Insurance intermediation also raises a variety of regulatory and supervisory issues for MFIs (see "6c. Regulation of Microinsurance Sales").

Sales. Where MFIs successfully sell microinsurance on behalf of an insurance underwriter, sales agents require proper training. The MFI knows its clients and is, at least in theory, in a good position to ensure that the products being sold are appropriate to their needs and their household's capacity to pay.

Collecting premiums and paying claims. Most MFIs have cash-in-and-out functions that can be leveraged for microinsurance as well. Some MFIs may help smooth premium collections. For example, a borrower group may temporarily cover the premium payment for an individual member who is short on cash.

Policy administration. MFIs with strong processes and MIS can handle policy administration for insurers. On the other hand, weaknesses in these areas can be exacerbated by taking on microinsurance policy administration responsibilities alongside the lending business of the MFI.

Claims assessment and settlement. The MFI's close and regular interaction with the clients enables it to assess claims quickly. The MFI may have an incentive to act in clients' interest and help them manage the claims process, but this may create a conflict of interest when the MFI assesses claims.

Microlending banks in microinsurance

In all countries, regulation will place at least some conditions on the roles a conventional retail bank can play in either underwriting insurance or serving as an insurance intermediary. Banks including microfinance banks are often precluded under their respective laws from being involved in any aspect of underwriting insurance and may also be precluded from intermediating insurance or may be limited to intermediating only those products in which the bank or microfinance bank has an insurable interest (i.e., only covering the outstanding value of the loan, with coverage terminating once the loan has been repaid, and not providing coverage beyond the term of the loan or to family members of the borrower).

The special case of credit life insurance

There is a strong argument that credit life insurance underwritten by the microlender itself should be treated not as insurance but rather as a feature of the loan contract.

Credit life insurance issued by a microlender cancels a borrower's loan balance in the case of her death. The MFI doesn't have to disburse any cash, so that the "insured" borrowers face no risk that their "claim" won't be honored: the family of the deceased borrower can enforce its claim by simply by not paying off the rest of the loan, as long as the family is aware of the existence of the policy. There is a strong argument, therefore, that in such cases pure credit life insurance is simply one of the terms of the loan contract that should be clearly disclosed (both the pricing and the policy's terms, including the identity and rights of the beneficiaries). The MFI's risk is limited to the loan amount, and its aggregate mortality risk will be much smaller (and more predictable) than the repayment risk that the MFI assumes on its loans to the vast majority of its borrowers who don't die while repaying.

Thus there should be no need to involve the insurance authority. Since the risk of loss is only to the MFI (and it is a minor one), it seems reasonable that it should be supervised by the banking authority, or by no one in the case of unlicensed lending-only MFIs. This issue should be worked out between the banking authority and the insurance authority. These observations apply to pure credit life insurance, where the only benefit is cancellation of outstanding debt. If other benefits (e.g., funeral expenses or other cash payments) are included, then normal insurance risk is created and normal principles of insurance regulation should be brought to bear.

6c. Regulation of Microinsurance Sales

The nature of insurance (a promise to pay upon the occurrence of an uncertain future event) means that insurance sales are vulnerable to abuse. Regulation of insurance sales normally takes one of three forms: (1) control of the persons who can sell insurance and the extent to which they can be involved in the process of selling; (2) control of the commissions payable for insurance sales; and (3) in some countries, control of the sales process itself.

Sales agents

To facilitate the selling of insurance by MFIs, insurance regulation should permit MFIs and their employees (acting as representatives of their MFI) to be sales agents.

Regulation of insurance sales typically allows payment of commissions (or other remuneration) only to registered brokers and agents. Given the limited involvement of brokers in the intermediation of microinsurance, this discussion is limited to agents.[111]

If regulations allow legal entities to register as insurance agents, then each type of institution found in the microfinance sector should be permitted to register as an agent.[112] Regulation typically sets minimum educational as well as training requirements for persons wishing to register as agents. In situations where an MFI (or its employees) can register as agent, these requirements should not be unduly high to avoid excluding the typical profile of persons in the microfinance sales force. Lower requirements for microinsurance agents will usually be reasonable given the simpler products and lower risks involved.

Commissions

If adequate competition exists in the microinsurance market, then commission caps should be imposed with great caution, if at all. Preferably, both the level and structure of commissions should be left to the market to decide.

Many countries impose caps or price controls on the level of commission payable on different categories of insurance policies (e.g., the commission on a life policy may not exceed a certain low percent of the value of the premium). They may even go further and regulate how the commission is to be paid (e.g., upon the entering into of the policy contract or as when the individual premiums are paid). Commission caps—especially percentage-based caps—can limit access in the case of microinsurance since even a small nominal commission can be a high percentage of a small premium. Insurance will reach poor customers only when compensation structures are adequate to attract agents. Also, commission caps may be evaded unless regulations are thorough enough to cover all forms of compensation to the agent and unless enforcement is strong.

[111] Agents act on behalf of an insurer, selling its products to clients and sometimes engaging in the other insurance intermediation activities noted. Brokers act on behalf of the insured and must advise them on the best insurance coverage and underwriter for their particular needs. This normally involves, as a minimum, analyzing the needs of the potential client. The process of analyzing needs and providing advice is generally too expensive to undertake for low-premium, low-margin microinsurance policies. The services of brokers therefore tend to be too expensive for individual microfinance clients, and brokers are at most involved in brokering a master policy between an MFI and the insurer.

[112] An exception occurs where banks and microfinance banks are precluded from intermediating insurance, or are limited to intermediating only those products in which the bank or MFI has an insurable interest (e.g., credit insurance that covers only the outstanding value of the loan, terminates once the loan has been repaid, and includes no other benefits for the borrower's family). See "Microlending banks in microinsurance."

Group sales

Sales of group products should be permitted, provided that each individual receives a policy certificate and the insurer receives the names and other relevant information of each individual policyholder.

To take advantage of the aggregation provided by MFIs, insurance is normally sold to their clients on a group basis: the risk of the group (as opposed to individual client risk) is assessed to determine the risk premium. Some countries permit selling to groups only when membership in the group is closed (e.g., only employees of a particular company can become policyholders) and prohibit selling to voluntary or open groups (i.e., where there is no barrier to joining the group solely for purposes of obtaining insurance). A requirement that the agent analyze the financial position of each microfinance client before providing advice or selling a product could easily price microinsurance sales out of the low-income market. It should therefore be avoided unless it is essential to address particular abuses that cannot otherwise be corrected through the control of agents or appropriate disclosure.

In some cases, the MFI is the group policyholder on behalf of the individual clients, and the insurer may not have the names and contact details of individual clients. In this case, the insurer will be underwriting an agreed number of persons for agreed risks, yet the individual clients will have recourse against the MFI only (and not against the insurer as the ultimate risk carrier) unless otherwise provided for in the policy. This arrangement is not desirable from a consumer protection point of view. At a minimum, in the case of group policies intermediated by an MFI, regulation should therefore require that the MFI (*i*) issue policy certificates to the individual policyholders indicating the name of the insurer and evidencing its liability to pay claims and (*ii*) communicate to the insurer the names of the policyholders, their contact details, and the names of beneficiaries.

Disclosure, claims

- MFIs involved in selling microinsurance policies should be subject to minimum disclosure requirements.

- Supervisors should monitor complaints and claims ratios for microinsurance products sold by MFIs and take measures (e.g., cooperate with the insurance supervisor to deal with abusive insurers) if there are many complaints or the claims ratios are very low.

Minimum disclosure should include the premium amount, who is underwriting the policy, the duration of coverage (and with respect to credit life insurance, any options for extending coverage beyond the loan period), commission payable, any exclusions, how to institute a claim, and recourse mechanisms. Experience has shown that even if regulation requires choice and disclosure, protection of clients may be limited because they don’t understand the terminology, have trouble assessing the premium in light of the value of the covered risk, and may not know enough to file a claim when a risk event occurs. The sale of microinsurance through the credit channel is open to particular abuse, due in part to clients' eagerness to obtain the loan (and not risk losing it while shopping for insurance coverage). It is therefore important for supervisors to monitor compliance.

As with other financial products, microinsurance clients need protection from complex and unintelligible policies. This may include the requirement to use simplified language and standardized terms in policy contracts, a limitation on the length of policy documents, or the requirement to provide a simple one-page summary of policy terms. It may also include a prohibition against certain types of exclusions that clients do not understand.

Even if products are sold subject to regulatory requirements, they may not necessarily provide good value to the client. This is evidenced in low claims ratios and may be due to clients' limited understanding of products (even with simplification requirements) or complicated claims processes. Supervisors should therefore monitor the claims ratios for microinsurance products sold by MFIs and take additional measures—including the introduction of codes of conduct for MFIs providing insurance and cooperation with the insurance supervisor to deal with abusive insurers—if there are many complaints or the claims ratios are too low.

Bundling

- When insurance products are bundled, clients may get insurance they don't want at prices that may be excessive because the MFI has a captive clientele.
- Consumer protection rules can help ensure that clients understand the bundled products and their pricing clearly.

Bundled microinsurance products combine multiple kinds of benefits in a single policy. For example, a credit life policy may also include additional components bundled into the same policy, such as funeral insurance on the borrower or insurance on a product bought on credit (covering the product's value in the event of loss or damage).

The bundling of insurance and credit, particularly making the extension of credit conditional on the purchase of an insurance policy, creates particular consumer protection difficulties. The client may not be aware that she has purchased an insurance policy. Alternatively, the insurance component and what it covers may be stated in an opaque way and the client may not be aware what she is signing up for (e.g., funeral or disability insurance when the client already has such coverage). She also may not know the price of the insurance component, making comparison shopping (even if only a theoretical possibility) impossible. This creates a captive insurance market for the credit provider and the opportunity to charge a premium that may be substantially higher than on the open market (i.e., it may not reflect the underlying risk).

In addition, insurance policies bundled with credit typically expire when the credit is repaid. While this makes sense in the case of credit life insurance, it does not make sense for other types of insurance coverage (e.g., funeral insurance) if the client cannot continue it after repaying the debt. When such insurance is tied to having an active loan, it could encourage clients to borrow too often—in theory at least.

Consumer protection rules can help ensure that clients understand the bundled products and their pricing clearly. Outright prohibition of bundling could be another option, though few countries have resorted to it. For the reasons noted, these concerns may be less serious in the case of pure credit life insurance.

Part VII. SUMMARY OF KEY OBSERVATIONS, PRINCIPLES, AND RECOMMENDATIONS

7a. General Issues

- Regulators and supervisors need to understand the particular characteristics of microfinance, including the clients, the products and services, and the institutions providing them. (See p.13.)
- Local context is critical when considering approaches used in another country. It is dangerous for policy makers to use another country's regulatory regime as a template without a thorough examination of country-specific factors that will inevitably call for different treatment. (See pp. 13-15.)
- Regulation is a balancing act. Decisions about regulation should weigh the seriousness of a risk against the cost of regulating for both the supervisor and the supervised institutions, as well as the feasibility and likely effectiveness of supervision. (See p. 13.)
- To the extent possible, similar services should be subject to similar regulation, both to create a level playing field for providers and to reduce risk of regulatory arbitrage. (See p.13.)
- Interagency coordination is critical when there is more than one regulator overseeing a financial service provider. (See p. 13.)

Regulatory definitions

- Regulatory definitions of "microfinance" and "microcredit" should be tightly framed to meet specific regulatory objectives, and not simply drawn from the general literature on microfinance. (See p. 16.)
- A definition of "microcredit" should not require that the loans be used for business purposes. (See p.16.)
- If a maximum loan size is defined, consider a two-pronged approach that sets a cap for any individual loan as well as a much lower cap for the average outstanding balance of the entire microcredit portfolio. (See p.16.)

Regulatory "windows" for depository MFIs

- Policy makers and regulators should assess the market before creating a new window for depository MFIs. In most countries where a new microfinance window has been successful in expanding outreach, there was already a critical mass of profitable credit-only MFIs before the special window was opened. (See p. 23.)
- If existing regulation does not present a barrier to the formation or operation of an institution providing savings or other financial services to the poor, or if the binding constraint lies elsewhere (such as a shortage of skilled managers and interested investors), then a new window will not necessarily improve access. (See p. 15.)
- When creating a new regulatory window for depository microfinance, policy makers should be alert for the possibility of regulatory arbitrage. Some microfinance windows have been

used by businesses quite different from what policy makers had in mind when opening them. (See p. 15.)

- Prior to creating a new window for depository microfinance, it is important to assess supervisory capacity and set the minimum capital requirement high enough to avoid overburdening the supervisor. (See p. 24.)

7b. Prudential Regulation

- Nondepository MFIs should not be subject to prudential regulation, absent extraordinary circumstances. (See p. 18.)
- Views differ about whether compulsory savings as a part of a loan product should be treated as "deposits" that trigger prudential regulation, but good arguments can be made in many contexts not to do so, especially if the MFI is not lending out these funds. (See p. 18.)

Minimum capital

- In principle at least, minimum capital for a new window for depository microfinance should be set high enough to ensure that the institution can pay for the infrastructure, MIS, and start-up losses needed to reach viable scale. (See p. 24.)
- Minimum capital also serves to ration the number of licenses. It is important to assess supervisory capacity and set the minimum capital requirement high enough to avoid overburdening the supervisor, especially at first. (See p. 24.)
- It may be preferable to set minimum capital through regulation rather than legislation. Among other advantages, this makes it easier for supervisors who are new to microfinance to start with a manageable number of new licenses, reserving the option of reducing minimum capital and licensing more institutions as experience is gained. (See p. 24.)

Adjusting prudential standards for microfinance

- Regulation that provides for depository microfinance should clearly define the types of permissible activities that a licensed, prudentially regulated institution may engage in. (See p. 26.)
- There are strong arguments to support the imposition of higher capital adequacy standards for specialized depository MFIs than for banks. (See p. 26.)
- Microcredit should not be limited to some percentage of equity or burdened with a high general provision requirement simply because the loan is not conventionally collateralized. (See p. 29.)
- Absent special circumstances, microloans (specifically, those made using the common lending methodology) should have the same general provision requirement as other loan categories that are not particularly risky. (See p. 29.)
- Because there is no collateral to fall back on, the provisioning schedule for *delinquent* microloans should be more aggressive than the schedule for secured bank loans. (See p. 30.)

- Depository MFIs may need higher, rather than lower, liquidity requirements. (See p. 30.)
- Many depository MFIs carry substantial foreign-currency liabilities but may be inexperienced in managing currency risk. (See p. 30.)
- Given the size of microloans and the nature of the borrowers, it is not cost-effective (or practical) to require the same loan documentation for microloans that is required for commercial bank loans. (See p. 31.)
- Restrictions against borrowings by co-signers can cause problems for some microlending methodologies (in particular, group lending). (See p. 32.)
- Branching requirements merit re-examination—but not necessarily elimination—in the microfinance context. (See p. 32.)
- Reporting requirements should be simpler for depository MFIs and microfinance programs than for conventional banking operations. (See p. 32.)
- For MFIs that are not member-owned and are receiving favorable regulatory treatment because of their focus on low-income clients, it is hard to see a reason for allowing any insider lending, except for small welfare loans to employees. (See p. 33.)
- Special prudential adjustments for microfinance should also be available to conventional banks that want to offer microfinance products, or partner with an MFI to do so. (See p. 33.)
- If there are viable NGO candidates for transformation into a depository institution, regulators may consider temporary or permanent relaxation of some licensing requirements that can pose problems—such as ownership diversification rules, restrictions on investment by NGOs or foreign parties, requirements that managers have prior banking experience, or use of loan portfolio to meet minimum capital requirements. (See p. 35.)
- If a country requires commercial banks to participate in a deposit insurance scheme, consideration should be given to imposing the same requirement on prudentially regulated and supervised deposit-taking MFIs (including large financial cooperatives). (See p. 37.)

7c. Prudential Supervision

- Assessing microcredit risk requires specialized examiner skills, and techniques that differ substantially from the ones that supervisors use for conventional retail bank portfolios. Staff who supervise microfinance need specialized training and experience. (See p. 38.)
- A stop-lending order is counter-productive for a distressed MFI, at least if there is any hope of salvaging its portfolio, because many borrowers will stop repaying if they do not expect follow-on loans to be available in the future. (See p. 39.)
- NGOs and some other socially motivated owners may not be able to respond promptly to a capital call. (See p. 39.)
- It can be problematic to merge a distressed MFI or sell its assets. An MFI's close relationship with its borrowers may mean that its loan assets will have little value in the hands of another institution. (See p. 39.)

- As a percentage of assets under supervision, MFIs are much more expensive to supervise than conventional retail banks. (See p. 40.)
- The most appropriate supervisory body for depository microfinance is usually the supervisory authority responsible for commercial banks. (See p. 40.)
- It is difficult to delegate supervision effectively. Where this model is being considered, there should be clear answers to four questions: (1) Will the delegated supervision cost less than direct supervision would? (2) If the delegated supervisor proves unreliable and its delegated authority must be withdrawn, is there a realistic fallback option? (3) When a supervised institution is in trouble, which body will have the responsibility and ability to clean up the situation? (4) Who will pay the costs of the delegated supervision and the government's oversight of it? (See p. 41.)
- True self-regulation—where the supervising body is effectively controlled by the supervised institutions—has been tried many times and has rarely proved effective in developing countries. (See p. 42.)
- Financial cooperatives—at least the larger ones—need prudential supervision by a specialized financial oversight agency (or at least a federated network of cooperatives that is itself supervised by a financial regulator) that has the requisite skill, resources, powers, and independence. (See p. 42.)
- In some cases, it may be advisable to allow formal but very small member-based deposit-takers to continue operating even though they cannot be effectively supervised. Weak supervision can be worse than no supervision if it leads depositors to expect levels of protection that cannot in fact be delivered. (See p. 44.)

7d. Nonprudential Regulation

Permission to lend

- The regulatory framework should permit both NGOs and commercial companies to engage in microlending, absent particular local factors, such as extreme corruption in the NGO sector. (See p. 46.)
- Issuance of a permit to engage in microlending should be straightforward, involving a public registry and a simple process. (See p. 46.)
- Where the objective is to enable lending by NGOs, modification of the general legislation governing NGOs may be needed as well. (See p. 47.)

Reporting

- Reporting requirements should be linked to specific regulatory objectives (e.g., identification of responsible parties, fit-and-proper screening of principals, etc.). Lending-only institutions shouldn't be burdened with the level of reporting that is needed for prudentially supervised deposit-takers. (See p. 47.)

Consumer protection

- Consumer protection is based on the principles of adequacy and transparency of information, fair treatment, and recourse. (See p. 48.)

- Microfinance providers should be required to give clients clear and complete information about the services offered. However, the standard annual percentage rate (APR) may not be the most effective way to communicate costs to low-income microborrowers. (See p. 49.)
- Regulation should prohibit discrimination—whether against women or a particular race, caste, religion, or ethnic minority. (See p. 50.)
- Regulation may need to address aggressive or coercive sales practices, “predatory” lending designed to take advantage of borrowers’ lack of education or experience, and abusive collection practices. (See p. 50.)
- Interest rate caps can restrict access by making it impossible to serve small or remote borrowers. It may be politically difficult to set a cap that is high enough to cover the unavoidable costs of microlending and a profit margin high enough to attract capital to low-income financial services. (See p. 51.)
- Protection of microfinance clients’ privacy requires clear regulation, including rules to permit lenders to share reasonable client and loan information with credit bureaus. (See p. 53.)
- Consumers’ ability to lodge complaints and seek redress is an important part of financial consumer protection. For most microfinance customers, judicial recourse will not be a viable option, so the focus needs to be on alternatives. (See p. 53.)

Credit bureaus

- Credit bureaus can make a major contribution to loan access for low-income clients. When credit bureaus include positive data, borrowers who have no collateral can translate their faithful repayment to one lender into credit access with other lenders as well. Credit bureaus can increase competition, reduce over-indebtedness, and bring down the cost of lending. (See p. 55.)
- Credit bureaus that draw from comprehensive sources of payment information are more helpful for microlending than credit bureaus that are limited to microcredit data. (See p. 54.)

NGO ownership of for-profit MFIs

- NGOs should be permitted to own shares in for-profit MFIs that specifically target the poor. (See p. 57.)

Transformations

- The regulatory framework and tax regime should permit one or more clear paths to transformation from an NGO MFI into a for-profit company, and NGOs should be permitted to own shares in for-profit MFIs that specifically target the poor. (See p. 57.)

- When NGO microfinance operations are moved into a for-profit vehicle, financial and NGO regulators can reduce the risk of asset stripping by requiring NGO insiders to recuse themselves from the negotiations if they or related parties may receive shares or employment in the for-profit company. Regulators may also require an independent expert review of share pricing when shares in the new company are divided between the NGO and private investors. (See p. 57.)

Secured transactions

- Legal and judicial reform to support secured transactions—in particular, a collateral law and accessible collateral registries—can often facilitate microfinance, even though typical microcredit is effectively unsecured. (See p. 59.)

Financial crimes

- Applying the AML/CFT rules for conventional banking to tiny microfinance transactions can seriously limit access unless risk-based adjustments are allowed. (See p. 60.)
- The existing anti-fraud and financial crime regulation may be adequate to address abuse connected to microfinance services (including identity fraud and pyramid schemes). Often the most pressing need is to improve enforcement of existing laws. (See p. 61.)

Tax issues

- Favorable transaction tax treatment should usually be based on the type of activity, regardless of the nature of the institution and whether it is prudentially licensed. (See p. 62.)
- It is reasonable to argue that NGO MFIs should be treated the same as other public benefit NGOs with respect to taxes on profits. (See p. 62.)
- Rules for tax deductibility of expenses (such as reasonable provisions for bad loans) should apply consistently to all types of institutions subject to a profit tax, not just to banks. (See p. 63.)

7e. Branchless Banking

- Branchless banking—using technologies (such as mobile phones and smartcard readers to transmit transaction details) and existing retail establishments to act as the principal customer interface—holds the promise of significantly expanding financial access by lowering transaction costs. (See p.64.)
- Limitations on the nature and qualifications of agents and other third parties need to be crafted carefully to avoid limiting outreach to low-income clients. (See p. 66.)
- Rules that prohibit third parties from acting on behalf of a financial institution to open customers' accounts or to handle cash typically need to be changed. (See p. 66.)
- Regulation should be clear about the financial service provider's liability for acts of its third-party contractors. (See p. 67.)
- In some countries, branchless banking cannot develop without risk-based adjustment in Know-Your-Customer and other AML/CFT rules. (See p. 67.)

- Nonbank e-money issuers should be subject to appropriate regulation and supervision, including liquidity and solvency-related requirements. (See p. 67.)
- Branchless banking raises a new layer of consumer protection concerns because of its use of third parties as the principal customer interface, the potential physical distance between customer and provider, and relatively inexperienced customers. (See p. 68.)
- The development of new branchless banking models may be inhibited if nonbanks are not allowed to participate in the national payment system. (See p. 68.)
- Establishing a formal or informal interagency coordination body can contribute substantially to the development of branchless banking. (See p. 69.)

7f. Microinsurance

- Regulators of MFIs that engage in underwriting or intermediation of microinsurance products should coordinate their supervision of such MFI activities with the insurance regulator. (See p. 71.)
- With the exception of pure credit life insurance, MFIs are generally not well positioned to underwrite microinsurance—that is, to bear and manage the insurance risk. (See p. 71.)
- Established MFIs can be well positioned to serve as intermediaries on behalf of insurance underwriters: MFIs have an existing relationship and delivery infrastructure with target clients for microinsurance. (See p. 72.)
- There is a strong argument that credit life insurance underwritten by the microlender should be treated not as insurance but as a feature of the loan contract. (See p. 73.)
- To facilitate the selling of insurance by MFIs, insurance regulation should permit MFIs and their employees (acting as representatives of the MFI) to be sales agents. (See p. 74.)
- If adequate competition exists in the microinsurance market, then commission caps—especially percentage caps—should be imposed with great caution, if at all. (See p. 74.)
- Sales of group microinsurance products should be permitted, provided that each individual receives a policy certificate and the insurer receives the names and other relevant information of each individual policyholder. (See p. 75.)
- MFIs selling microinsurance policies should be subject to minimum disclosure requirements. (See p. 75.)
- When insurance products are bundled, clients may get insurance they don’t want, at prices that may be excessive because the clientele is captive. Consumer protection rules may be necessary to make sure that clients understand the bundled products and their pricing. (See p. 76.)

Appendix A. AUTHORSHIP AND ACKNOWLDGEMENTS

The principal writers of this Guide are Robert Peck Christen, director of the Financial Services for the Poor initiative at the Bill & Melinda Gates Foundation; Kate Lauer, policy advisory consultant to CGAP; Timothy R. Lyman, senior policy adviser at CGAP and chief of CGAP's Government and Policy Team; and Richard Rosenberg, senior advisor at CGAP.

Many financial regulators and supervisors from around the world reviewed drafts of this Guide and improved it with their suggestions. We list below the ones who contributed most substantially. With respect to them, as well as all the others whose help is acknowledged further below, naming them here does not imply that they or their institutions have "endorsed" all the contents of this Guide. The authors alone are responsible for its final content. At the same time, based on our consultations with these regulators and supervisors, we are confident that the positions taken in the Guide are consistent with the views of the large majority of those consulted.

[Regulatorsto be listed in bullets as below. For sitting regulators, give institution, or give individual(s) and institution, or mix the two ways of identifying them]

This Guide draws on research and writings from many institutions, including the Alliance for Financial Inclusion, the Asian Development Bank, the Basel Committee on Banking Supervision at the Bank for International Settlements, the Center for Global Development, the Financial Access Initiative, the G-20 Financial Institutions Expert Group and its Subgroup on Access through Innovation, the Inter-American Development Bank, the International Association of Insurance Advisors, the World Bank, the World Council of Credit Unions (WOCCU), World Savings Bank Institute, our colleagues at CGAP of course, and many others.

In particular, we would like to name and thank the experts who produced initial drafts of specific sections:

Microinsurance: Hennie Bester (Centre for Financial Regulation and Inclusion (CENFRI)), Doubell Chamberlain (CENFRI), Christine Hougaard (CENFRI)

Consumer Protection and *Box 3: Basel Core Principles and Depository Microfinance:* Laura Brix (at the time of drafting, consultant to CGAP; currently with FDIC)

Deposit Insurance: Laura Brix and Jasmina Glisovic-Mezières (CGAP)

Data Privacy and Security: Denise Dias (CGAP)

Financial Crimes: Louis de Koker (University of Deakin)

and those who provided important critical review of and commentary on specific sections:

Branchless Banking: Michael Tarazi (CGAP)

Branchless Banking—Consumer Protection: Denise Dias (CGAP)

Supervision of Financial Cooperatives: Denise Dias (CGAP), Laurent Lhèriau (consultant to CGAP)

Nonprudential Regulatory Issues—Reporting and Institutional Transparency: Djibril Maguette Mbengue (CGAP)

Nonprudential Regulatory Issues—Credit Reporting Systems: Margaret Miller (CGAP)

We sought and received important insight, opinions, and feedback from Karla Brom (consultant to CGAP), Greg Chen (CGAP), Carlos Cuevas (Bill & Melinda Gates Foundation), Frederique Dahan (EBRD), Xavier Faz (CGAP), Mark Flaming (consultant to CGAP), Adrian Gonzalez (MIX), David Grace (WOCCU), Kathryn Imboden (Consultant to CGAP), Dean Karlan (Yale University, Innovations for Poverty Action), Kate McKee (CGAP), Rafe Mazer (CGAP), Ceu Pereira (World Bank), Steve Rasmussen (CGAP), Xavier Reille (CGAP), and Stefan Staschen (consultant to CGAP).

Appendix B. GLOSSARY

Varying terminology used in the discussion of microfinance regulation sometimes leads to confusion. This Guide uses the following general definitions:

AML/CFT (Anti-Money Laundering Combating the Financing of Terrorism). Legal requirements, controls, and practices designed to detect and prevent money-laundering, the financing of terrorism, and other illicit activities.

Branchless banking. The delivery of financial services outside conventional bank branches, often using third parties (such as small retailers) and relying on information and communications technologies (such as card-reading point-of-sale terminals and mobile phones).

Common microlending methodology. A lending methodology generally developed in the 1970s that involves most, but not necessarily all, of the following:

- low initial loan sizes, with gradually larger amounts available in subsequent loans
- loan appraisal based on personal contact rather than scoring[113]
- group lending, or individual lending, based on analysis of the borrower's likely cash flow
- relatively frequent loan repayment periods—usually weekly or monthly
- an understanding that borrowers who repay their loans faithfully will have prompt access to follow-on loans
- sometimes a compulsory savings requirement that must be satisfied by the borrower prior to receiving the loan to demonstrate the borrower's willingness and ability to make payments and/or to provide a partial "cash collateral" for the loan

Compulsory savings (also referred to as forced savings, obligatory savings, or compensating balances). Savings that many MFIs (typically lending-only institutions) require of their borrowers, both to demonstrate the borrower's ability to make payments and to serve as security for the repayment of the loan. The cash is posted by the borrower with the MFI and sometimes deposited by the MFI at a commercial bank in an account (sometimes a trust account). If the funds are held in trust, they cannot be intermediated by the MFI. If the savings are intermingled with the MFIs' funds, then the MFI effectively uses the funds for its lending operations.

Credit bureau. A private agency or firm established either as a profit-making venture by entrepreneurs (with or without financial institution owners) or as a cooperative association by a group of lenders that gathers and provides consumer credit information. This information can be used to assess an individual's creditworthiness and other factors important to a lender when determining whether to grant a loan. The term "credit bureau" can also be used to refer to a public credit registry (defined below).

Credit registry. A database maintained by a government agency (e.g., the central bank) to which regulated financial institutions are typically required to submit loan and payment information. In

---

[113] Some MFIs use statistical scoring techniques to supplement, but not to replace, assessment by loan officers in direct contact with the borrower.

many countries, only regulated financial institutions can access information from a public credit registry.

Delegated regulation/supervision. Regulation or supervision that is outsourced by a primary prudential regulatory and supervisory body to another body, such as a federation of retail institutions. Typically, the delegating body retains responsibility for the performance of the body to which regulation or supervision is delegated.

E-money. Monetary value represented by a claim on the issuer that is (*i*) stored on an electronic device, (*ii*) issued on receipt of funds of an amount not less in value than the monetary value issued, (*iii*) accepted as a means of payment by parties other than the issuer, and (*iv*) can be converted into cash. In practice, the customer exchanges cash at a retail agent in return for an electronic record of value. E-money is usually stored on an issuer's system that is accessed by customers via phone, Internet, or plastic card (most often using magnetic strips, bar codes, or near-field communications).

Financial cooperative. A member-owned financial intermediary, such as a savings and credit cooperative (known as SACCOs in East Africa), credit union, or cooperative bank. The members share an economic stake in the outcome of cooperative's operations and govern by a "one member, one vote" principle—that is, each member of a financial co-op has one vote regardless of the amount of money that she has invested. Financial cooperatives typically engage in both lending and deposit-taking, with members' money (from membership shares and deposits) typically funding all or most of the coop's lending activity.

Financial intermediation. The process of accepting repayable funds (such as funds from deposits or other borrowing) and using these to make loans.

Fit and proper (specifically in the context of financial regulation). A minimum set of requirements and/or competencies applicable to those individuals with a controlling interest in, as well as members of the senior management and governing board of, a financial institution. Requirements often include the absence of a criminal record and personal bankruptcy and (particular with respect to senior management and board members) prior professional experience with a depository institution.

Greenfield institution. A newly established institution.

Interoperability. The ability of firms to use electronic communications systems to share and exchange information and services, normally by means of a common messaging system.

Know your customer (KYC). Due diligence that banks must perform on potential customers (also referred to as customer due diligence [CDD]) to ascertain and verify the identity of a client. Common KYC requirements include the provision of national identification cards and documentary proof of home address and employment.

Microcredit. Small-scale credit typically provided to self-employed or informally employed poor and low-income individuals and microenterprises. Other common features of microcredit include lending methodology characterized by familiarity with the borrower, lack of collateral, expectation of a follow-on loan, and very small loan amounts (although the size of microcredit loans varies from country to country.)

Microfinance. The provision of formal financial services to poor and low-income people and those systemically excluded from the financial system.

Microfinance institution (MFI). A formal (i.e., legally registered) entity whose primary activity is microfinance.

National payments system. A country's institutional and infrastructure arrangements and processes for making payments (specifically by commercial banks and the central bank).

Nongovernmental organization (NGO). An institution that does not have "owners" (in the sense of parties with an economic stake in the outcome of the entity's operations) and has one or more enumerated public benefit purposes, as stated in its constituent documents (and often as required by law). Because there are no owners to elect it, an NGO's governing body may be self-perpetuating (i.e., the body chooses its own successors) or chosen by third parties, such as a general assembly of nonowner members or founders. The capital structure of NGOs is distinguishable from other institutional types because their initial equity base is typically grant-funded, and they can't raise additional equity by issuing shares or otherwise bringing in new owners. (The only means of raising funds is through borrowings, grants, and other donations.) In most regulatory systems, NGO MFIs are not permitted to mobilize voluntary savings from retail customers, so the overwhelming majority are microlending-only organizations.

Over-indebtedness. There is no single definition for over-indebtedness, as "how much is too much?" is a question that will vary for each individual borrower and loan. Some of the more widely accepted signal points that a client or group of borrowers may be approaching levels of over-indebtedness include consistently poor repayment rates over a period of time (one to two years), multiple loans, and loan payments being made notwithstanding extreme family or personal hardship. However, each of these factors can also exist without there being an over-indebtedness problem.

Payment system. A funds transfer system with formal and standardized arrangements and common rules for the processing, clearing and/or settlement of payment transactions.

Prudential (regulation or supervision). Regulation or supervision that governs the financial soundness of licensed intermediaries' businesses, in order to prevent financial-system instability and losses to small, unsophisticated depositors.

Regulation. Binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations).

Regulations. The subset of regulation adopted by an executive body, such as a ministry or a central bank.

Retail payment system. A payment system, such as an automated clearing house or a payment card scheme, that processes retail payment instruments.

Self-regulation/supervision. Regulation or supervision by a body that is effectively controlled by the entities being regulated or supervised (whether in law or in fact).

Supervision. External oversight and engagement aimed at determining and enforcing compliance with regulation.

Transformation. A change of an MFI from one organizational type to another. The most common type of transformation is from an NGO MFI into a (new or previously existing) licensed financial institution ("Newco") and is effected via the transfer by the NGO of all or part of its loan portfolio and other assets, liabilities, and employees to Newco in exchange for shares in Newco or payment in the form of cash, debt, or a combination thereof (by Newco or its other shareholders or founders). In some instances, Newco may be a bank or other form of depository MFI. Other types of transformation include (*i*) a for-profit lender becoming a deposit-taking institution, (*ii*) a member-based organization transferring its assets to a licensed financial institution (with a similar exchange as noted above) and (*iii*) an NGO transforming into a member-based organization.

Appendix C. MICROLENDING INSTITUTIONS AND THEIR FUNDING SOURCES

Nondepository microlending institutions fund their lending from various sources other than public deposits.

Donor funds. Historically, MFIs have been supported, at least in their start-up phase, by grant funding from donors of one type or another, including bilateral and multilateral development agencies, international NGOs, foundations, and private benefactors. Some donors support MFIs through loans with below-market interest rates. (Market rate loans are discussed in “Semi-commercial and commercial borrowing and equity investment.”)

Compulsory savings and other cash collateral. Many MFIs require their borrowers to post cash with the institution (both before and during the period of a loan), both to demonstrate the borrower’s ability to make payments and to serve as security for the repayment of the loan. This cash collateral is sometimes held by a third party (such as a commercial bank) in a trust account, and in those situations, it is not intermediated by the MFI. In many countries, a nondepository MFI that intermediates compulsory savings would be in violation of the banking law.

Members’ savings and other repayable funds. In some countries, most microfinance is provided by financial cooperatives that typically fund their lending largely or entirely from their own members’ redeemable share capital and savings. It is sometimes argued that because these institutions take and intermediate deposits and other similar repayable funds only from members and not from “the public,” they need not be prudentially supervised. This argument is problematic, first, because when a financial cooperative becomes large, its members are typically in no better a position to supervise management than are the depositors in a commercial bank, and second, because the boundaries of membership can be very porous, allowing many cooperatives to accept virtually anyone as a member.

Semi-commercial and commercial loans and equity. Many MFIs now get a substantial portion of their funding from loans and equity investments by investors whose interest rates and other terms are (or are close to) purely commercial investment terms. Such investors include from international microfinance investment vehicles (MIVs), other institutional investors that target social-purpose investments, commercial banks, and ordinary investors who have no social objectives. In some countries, MFIs can issue commercial paper, bonds, or similar instruments in the local securities markets.

Wholesale deposits, deposit substitutes and other “near deposit” investments marketed to individuals. Although in many countries, all these instruments tend to be bought by large, sophisticated investors, in some countries such investments are marketed widely to the public—that is, to individuals who may not be in a better position to monitor their investment than a typical retail depositor in a commercial bank. There is no global consensus on how to regulate such instruments; the best approach is likely to depend on country-specific factors. Some argue that the buyers of these instruments ought to be able to make their own analysis of the financial soundness of the issuing institution: the issuer would be subject to securities regulation (and not, merely by virtue of issuing such instruments, to prudential regulation), which generally focuses on insuring complete disclosure of relevant information, rather than giving any assurance as to the financial strength of the issuer. Others, less impressed by the distinction between wholesale and retail deposits or skeptical about the local securities law and enforcement, insist that any institution issuing such instruments and intermediating the funds be prudentially regulated.

Appendix D. BIBLIOGRAPHY

Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group. 2010. “Principles and Report on Innovative Financial Inclusion.” Seoul: G20, September.

Alexandre, Claire, Ignacio Mas, and Dan Radcliffe. 2010. “Regulating New Banking Models That Can Bring Financial Services to All.” Seattle, Wash.: Bill & Melinda Gates Foundation.

Anand, Malika, and Richard Rosenberg. 2008. “Are we Overestimating Demand for Microloans?” Brief. Washington, D.C.: CGAP, April.

Armendáriz de Aghion, Beatriz, and J. Morduch. 2005. *The Economics of Microfinance*. Cambridge: MIT Press.

Ariely, Dan. 2009. *Predictably Irrational.* New York: Harper Collins.

Barr, Michael S., Sendhil Mullainathan, and Eldar Shafir. 2008. “Behaviorally Informed Financial Services Regulation.” Washington, D.C.: New America Foundation, October.

Barth, J. R., Gerald Caprio, and R. Levine. 2006. *Rethinking Bank Regulations: Till Angels Govern*. Cambridge: Cambridge University Press.

Basel Committee on Banking Supervision. 1997. “Core Principles for Effective Banking Supervision.” Basel: Bank for International Settlements (BIS), September.

———. 1998. “International Convergence of Capital Measurement and Capital Standards.” Basel: BIS.

———. 2004. “International Convergence of Capital Measurement and Capital Standards: A Revised Framework.” Basel: BIS.

———. 2006a. “Core Principles for Effective Banking Supervision.” Basel: BIS, October.

———. 2010. “Core Principles for Effective Deposit Insurance Systems.” Basel: BIS, November.

———. 2006b. “Core Principles Methodology.” Basel: BIS, October.

———. 2010. “Microfinance activities and the Core Principles for Effective Banking Supervision.” Basel: BIS, August.

Basel Committee on Banking Supervision, International Organization of Securities Commissions, International Association of Insurance Supervisors (IAIS) (The Joint Forum). 2005. “Outsourcing in Financial Services.” Basel: BIS, October.

Basel Committee on Banking Supervision and International Association of Deposit Insurers (IADI). June 2009. “Core Principles for Effective Deposit Insurance Systems.” Basel: BIS.

Basel Committee on Payment and Settlement Systems. 2001. “Core Principles for Systematically Important Payment Systems.” Basel: BIS, January.

Bester, H., D. Chamberlain, and C. Hougaard. 2008. “Making Insurance Markets Work for the Poor: Policy, Regulation and Supervision: Evidence from Five Country Case Studies.” Cape Town, South Africa: Cenfri.

Bradford, Terri, Matt Davies, and Stuard E. Weiner. 2003. “Nonbanks in the Payments System.” Kansas City, Mo.: Federal Reserve Bank of Kansas City.

Brix, Laura, and Katharine McKee. 2010. “Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance.” Focus Note 60. Washington, D.C.: CGAP, February.

Brom, Karla. 2009. “Asset and Liability Management for Deposit-Taking Microfinance Institutions.” Focus Note 55. Washington, D.C.: CGAP, June.

Campion, Anita, Rashmi Kiran Ekka, and Mark Wenner. 2010. “Interest Rates and Implications for Microfinance in Latin America and the Caribbean.” IDB Working Paper 177. Washington, D.C.: Inter-American Development Bank.

Caprio, Gerard, P. Honohan, and D. Vittas. 2002. *Financial Sector Policy for Developing Countries: A Reader*. Washington, D.C.: World Bank.

Caprio, Gerard, Jonathan L. Fiechter, Robert E. Litan, and Michael Pomerleano, eds. 2004. *The Future of State-Owned Financial Institutions*. Washington, D.C.: Brookings Institution Press.

Caprio, Gerard, Jr., Asli Demirgüç-Kunt, and Edward J. Kane. 2008. “The 2007 Meltdown in Structured Securitizations: Searching for Lessons, Not Scapegoats.” Policy Research Working Paper 4756. Washington, D.C.: World Bank, Development Research Group, Finance and Private Sector Team, October.

Carmichael, Jeffrey. 2009. “Regulation by Objective—The Australian Approach to Regulation: Statement to the US Senate Committee on State Homeland Security and Governmental Affairs.” Singapore: Promontory Financial Group, May.

Cason, Timothy N., Luta Gangadharan, and Pushkar Maitra. “Moral Hazard and Peer Monitoring in a Laboratory Microfinance Experiment.” Institute for Research in the Behavioral, Economic, and Management Sciences: Paper No. 1208. West Lafayette, Ind.: Purdue University.

Claessens, Stijn, Patrick Honohan, and Liliana Rojas-Suarez. 2009. *Policy Principles for Expanding Financial Access.* Washington, D.C.: Center for Global Development, October.

CGAP and the World Bank. 2009. *Financial Access 2009*. Washington, D.C.: CGAP and the World Bank.

CGAP and the World Bank. 2010. *Financial Access 2010: The State of Financial Inclusion through the Crisis.* Washington, D.C.: CGAP and the World Bank.

Chatain, Pierre-Laurent, John McDowell, Cédric Mousset, Paul Allen Schott, and Emile van der Does de Willebois. 2009. "Preventing Money Laundering and Terrorist Financing: A Practical Guide for Bank Supervisors." Washington, D.C.: World Bank.

Chen, Greg, Stephen Rasmussen, and Xavier Reille. 2010. "Growth and Vulnerabilities in Microfinance." Focus Note 61. Washington, D.C.: CGAP, February.

Christen, Robert Peck, Richard Rosenberg, and Veena Jayadeva. 2004. "Financial Institutions with a 'Double Bottom Line': Implications for the Future of Microfinance." Occasional Paper 8. Washington, D.C.: CGAP, July.

Christen, Robert Peck, and Mark Flaming. 2009. "Due Diligence Guidelines for the Review of Microcredit Portfolios." Washington, D.C.: CGAP.

Cirasino, Massimo, and Jose Antonio Garcia. 2007. "Retail Payment Systems to Support Financial Access: Infrastructure and Policy." Washington, D.C.: CEMLA and the World Bank.

———. 2008. "Measuring Payment System Development." Financial Infrastucture Series: Payment Systems Policy and Research. Working Paper. Washington, D.C.: World Bank.

Claessens, Stijn, Patrick Honohan, and Liliana Rojas-Suarez. 2009. "Policy Principles for Financial Access." Report of the CGD Task Force on Access to Financial Services. Washington, D.C.: Center for Global Development, October.

Collins, Daryl, Jonathan Morduch, Stuart Rutherford, and Orlanda Ruthven. 2009. *Portfolios of the Poor: How the World's Poor Live on $2 a Day*. Princeton, N.J.: Princeton University Press.

Collins, Daryl, David Porteous, and Jeff Abrams. 2010. "Prudential Regulation in Microfinance." Policy Framing Note 3. Cambridge: Financial Access Initiative.

———. 2010. "Interest Rate Policy. Cambridge: Financial Access Initiative." Policy Framing Note 4. Cambridge: Financial Access Initiative.

Committee on Payment and Settlement Systems. 2003. “Policy Issues for Central Banks in Retail Payments.” Basel: BIS, March.

———. 2005. “Central Bank Oversight of Payment and Settlement Systems.” Basel: BIS, May.

———. 2006. “General guidance for national payment system development.” Basel: BIS, January.

Cull, Robert, Asli Demirgüç-Kunt, and Jonathan Morduch. 2006. “Financial Performance and Outreach: A Global Analysis of Leading Microbanks.” World Bank Policy Research Working Paper 3827. Washington, D.C.: World Bank, February.

———. 2008. “Does Regulatory Supervision Curtail Microfinance Profitability and Outreach?” New York: Financial Access Initiative, October.

———. 2009. “Banks and Microbanks.” New York: Financial Access Initiative, September.

Cull, Robert, Lemma Senbet, and Marco Sorge. 2004. “Deposit Insurance and Bank Intermediation in the Long Run.” BIS Working Papers, No. 156. Basel: BIS, July.

Cuevas, Carlos E., and Klaus P. Fischer. 2006. “Cooperative Financial Institutions: Issues in Governance, Regulation and Supervision.” World Bank Working Paper No. 82. Washington, D.C.: World Bank.

Dawney, Emma, and Hetan Shah. 2005. “Behavioural Economics: Seven Tips for Policymakers.” London: The New Economics Foundation.

De Ville, Alex, Quentin Lecuyer, and Sophie Weisner. 2009. “Does Foreign Ownership in Microfinance Interfere with Local Development?” ADA Discussion Paper. Luxembourg: ADA, December.

Demirgüç-Kunt, Asli, Edward J. Kane, Baybars Karacaovali, and Luc Laeven. 2005. “Deposit Insurance around the World: A Comprehensive Database.” Washington, D.C.: World Bank.

Demirgüç-Kunt, Asli, Edward J. Kane, and Luc Laeven. 2006. “Determinants of Deposit-Insurance Adoption and Design.” Policy Research Working Paper No. 3849. Washington, D.C.: World Bank, January.

———. 2006. “Deposit Insurance Design and Implementation: Policy Lessons from Research and Practice.” Policy Research Working Paper No. 3969. Washington, D.C.: World Bank, July.

Demirgüç-Kunt, Asli, Thorsten Beck, and Patrick Honohan. 2008. *Finance for All? Policies and Pitfalls in Expanding Access.* Washington, D.C.: World Bank.

Dias, Denise, and Kate McKee. 2010. "Protecting Branchless Banking Customers: Policy Objectives and Regulatory Options." Focus Note 64. Washington, D.C.: CGAP, September.

Drake, Deborah, and Elisabeth Rhyne, eds. 2002. *The Commercialization of Microfinance: Balancing Business and Development.* Bloomfield, Conn.: Kumarian Press, Inc.

Emran, M. Shahe, and Joseph E. Stiglitz. 2009. "Financial Liberalization, Financial Restraint and Entrepreneurial Development." Washington, D.C.: Institute for International Economic Policy, January.

European Bank for Reconstruction and Development (EBRD). 2007. "Mortgages in Transition Economies: The Legal Framework for Mortgages and Mortgage Securities." London: EBRD.

European Union Payment Service Directive. 2007. 2007/64/EC of 13 November.

FSD-Kenya. 2009. "Definition of a Standard Measure for Consumer Interest Rates in Kenya: A Scoping Study." Nairobi: FSD-Kenya.

Fiebig, Michael. 2001. "Prudential Regulation and Supervision for Agricultural Finance, Agricultural Finance Revised No. 5." Rome: Food and Agriculture Organization of the United Nations (FAO)/Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).

Flaming, Mark. 2007. "Guaranteed Loans to Microfinance Institutions: How Do They Add Value?" Focus Note 40. Washington, D.C.: CGAP, January.

G-20. 2008. "Declaration: Summit on Financial Markets and the World Economy." Washington, D.C.: G-20. http://www.g20.org/Documents/g20_summit_declaration.pdf.

Gine, Xavier, and Dean Karlan. 2010. "Group versus Individual Liability: Long-Term Evidence from Philippine Microlending Groups." Washington, D.C.: World Bank.

Gonzalez, Adrian. 2007. "Resilience of Microfinance Institutions to National Macroeconomic Events: An Econometric Analysis of MFI Asset Quality." MIX Discussion Paper No. 1. Washington, D.C.: Microfinance Information Exchange (MIX), July.

Goodhart, Charles, Philipp Hartmann, David Llewellyn, Liliana Rojas-Suarez, and Steven Weisbrod. 1998. *Financial Regulation: Why, How and Where Now?* London: Bank of England.

Goodhart, C. A. E. 2000. “The Organizational Structure of Banking Supervision.” Basel: Financial Stability Institute, BIS, November.

Hannig, Alfred, and Edward Katimbo-Mugwana, eds. “How to Regulate and Supervise Microfinance? Key Issues in an International Perspective.” Financial Systems Development (FSD) Project 2000, FSD Series No. 1. Kampala, Uganda: Bank of Uganda – German Technical Co-operation Financial Systems Development (FSD) Project.

Helms, Brigit. 2006. *Access for All: Building Inclusive Financial Systems*. Washington, D.C.: CGAP.

Helms, Brigit, and Xavier Reille. 2004. “Interest Rate Ceilings and Microfinance: The Story So Far.” Occasional Paper 9. Washington, D.C.: CGAP, September.

InterAmerican Development Bank. 2004. “Principles and Practices for Regulating and Supervising Microfinance.” Washington, D.C.: InterAmerican Development Bank.

IAIS and CGAP Working Group on Microinsurance. 2007. “Issues in Regulation and Supervision of Microinsurance.” Basel: IAIS, June.

International Association of Deposit Insurers. 2009. “Core Principles for Effective Deposit Insurance Systems” Basel: BIS, June.

International Association of Insurance Supervisors. 2003. “Insurance Core Principles and Methodology.” Basel: BIS, October.

International Association of Insurance Supervisors and CGAP Working Group on Microinsurance (renamed the Microinsurance Network). 2007. “Issues in Regulation and Supervision of Microinsurance.” Basel: International Association of Insurance Supervisors, June.

The International Bank for Reconstruction and Development and the World Bank. 2008. “Payment Systems Policy and Research. Balancing Cooperation and Competition in Retail Payment Systems: Lessons from Latin American Case Studies.” Financial Infrastructure Series. Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank, November.

Isern, Jennifer, David Porteous, Raul Hernandez-Coss, and Chinyere Egwuagu. 2005. “AML/CFT Regulation: Implications for Financial Service Providers That Serve Low-Income People.” Focus Note 29. Washington, D.C.: CGAP, July.

Isern, Jennifer, and Louis de Koker. 2009. “AML/CFT: Strengthening Financial Inclusion and Integrity.” Focus Note 56. Washington, D.C.: CGAP, August.

Isern, Jennifer, William Donges, and Jeremy Smith. 2008. “Making Money Tranfers World for Microfinance Institutions: A Technical Guide to Developing and Delivering Money Transfers.” Technical Guide. Washington, D.C.: CGAP, March.

Isern, Jennifer, Julie Abrams, and Matthew Brown. 2008. “Appraisal Guide for Microfinance Institutions.” Technical Guide. Washington, D.C.: CGAP.

Karim, Nimrah, Michael Tarazi, and Xavier Reille. 2008. “Islamic Microfinance: An Emerging Market Niche.” Focus Note 49. Washington, D.C.: CGAP, August.

Kumar, Kabir, Claudia McKay, and Sarah Rotman. 2010. “Microfinance and Mobile Banking: The Story So Far.” Focus Note 63. Washington, D.C.: CGAP.

Lauer, Kate. 2008. “Transforming NGO MFIs: Critical Ownership Issues to Consider.” Occasional Paper 13. Washington, D.C.: CGAP, May.

Ledgerwood, Joanna, and Victoria White. 2006. *Transforming Microfinance Institutions: Providing Full Financial Services to the Poor.* Washington, D.C.: The Internaional Bank for Reconstruction and Development and the World Bank.

Lhériau, Laurent. 2009. *Précis de réglementation de la microfinance. Agence Française de Développement, Département de la Récherche*. Paris: Agence Française de Développement.

———. 2005. “Réglementer la microfinance : un état des lieux.” *Techniques Financières & Développement*, n° 78. March. http://esf.asso.fr/portail/article.php3?id_article=134.

———. 2005. “Développement durable et financement de l’eau potable : une étude juridique à partir de cas en zone franc.” *Techniques Financières & développement,* n° 80. September.

———. 2002. “La microfinance commerciale en zone urbaine: quelles possibilités et quelles perspectives en zones franc?” *Techniques Financières et Développement*, n° 68, October–November. http://esf.asso.fr/portail/IMG/TFD68_Article_LHERIAU.pdf.

———. 1998. “La réglementation sur les réseaux mutualistes bancaires dans l'UMOA (loi Parmec).” *Cahiers Juridiques et Fiscaux de l'Exportation*, n° 5.

Llewellyn, David T. 2006. “Institutional Structure of Financial Regulation and Supervision: The Basic Issues.” Paper presented at “Aligning Supervisory Structures with Country Needs”, World Bank seminar. Washington, D.C.: June.

Lyman, Timothy R., Mark Pickens, and David Porteous. “Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance.” Focus Note 43. Washington, D.C.: CGAP, January.

Männle, Manfred. 2003. “Interoperable Mobile Payment— A Requirements-Based Architecture.” *Wirtschaftinformatik 2003*. Heidelberg, Germany: Physica-Verlag. September.

Mullainathan, Sendhil, and Sudha Krishnan. 2008. “Psychology and Economics: What It Means for Microfinance.” Cambridge: Financial Access Initiative, April.

MicroSave. 2011. Internal Audit and Control Toolkit. Utta Pradesh: MicroSave. http://www.microsave.org/toolkit/internal-audit-and-control-toolkit

Mwenda, Kenneth K., ed. 2002. *Banking and Microfinance Regulation and Supervision: Lessons from Zambia*. Parkland, Fla.: Brown Walker Press.

Napier, Mark. 2011. *Including Africa—Beyond Microfinance*. London: Centre for the Study of Financial Innovation.

O’Donohoe, Nicholas P., Frederic Rozeira de Mariz, Elizabeth Littlefield, Xavier Reille, and Christoph Kneiding. 2009. “Shedding Light on Microfinance Equity Valuation: Past and Present.” Occasional Paper 14. Washington, D.C.: CGAP, February.

Organisation for Economic Co-operation and Development. 2009. “Financial Consumer Protection (Progress Report).” Paris: Organisation for Economic Co-operation and Development, 24 March.

Pickens, Mark, David Porteous, and Sarah Rotman. 2009. “Banking the Poor via G2P Payments.” Focus Note 58. Washington, D.C.: CGAP, December.

Porteous, David. 2004. “Making Financial Markets Work for the Poor.” Johannesburg: FinMark Trust.

———. 2005. “The Access Frontier as an Approach and Tool in Making Markets Work for the Poor.” London: DFID.

———. 2006. “The Regulator's Dilemma.” Cambridge: FinMark Trust. www.finmarktrust.org.za.

———. 2009. “Consumer Protection in Credit Markets.” Policy Focus Note 1. Cambridge: Financial Access Initiative, July.

———. 2009. “Competition Policy in Microcredit Markets.” Policy Framing Note 2. Cambridge: Financial Access Initiative, December.

Porteous, David, Daryl Collins, and Jeff Abrams. 2010. “Prudential Regulation in Microfinance.” Policy Framing Note 3. Cambridge: Financial Access Initiative, January.

———. 2010. “Interest Rate Policy.” Policy Framing Note 4. Cambridge: Financial Access Initiative, January.

Porteous, David, and Bridget Helms. 2005. “Protecting Microfinance Borrowers.” Focus Note 27. Washington, D.C.: CGAP.

Rhyne, Elisabeth. 2002. “The Experience of Microfinance Institutions with Regulation and Supervision.” Presented at the 5th International Forum on Microenterprise, Inter-American Development Bank, Rio de Janeiro, 20 September.

———. 2009. *Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at the Bottom of the Pyramid*. New York: McGraw Hill.

Rhyne, Elisabeth, Ira Leiberman, Brian Busch, and Stephanie Dolan. 2010. “Aligning Interests: Addressing Management and Stakeholder Incentives During Microifnance Institution Transformations.” Washington, D.C.: Calmeadow and the Center for Financial Inclusion.

Rosenberg, Richard. 2010. “Does Microcredit Really Help Poor People?” Focus Note 59. Washington, D.C.: CGAP, January.

Rosenberg, Richard, Adrian Gonzalez, and Sushma Narain. 2009. “The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?” Occasional Paper 15. Washington, D.C.: CGAP.

Roth, J., M. J. McCordand, and D. Liber. 2007. “The Landscape of Microinsurance in the World’s 100 Poorest Countries.” Appleton, Wis.: Microinsurance Centre. www.microinsurancecentre.org

Rozas, Daniel. 2009. “Throwing in the Towel: Lessons from MFI Liquidations.” September. http://www.microfinancegateway.org/gm/document-1.9.38716/Throwing%20in%20the%20Towel_%20%20Lessons%20from%20MFI%20Liquidations.pdf

Rutherford, Stuart. 2000. *The Poor and Their Money*. Oxford: Oxford University Press.

Rutherford, Stuart, and Sukhwinder Singh Arora. 2009. *The Poor and Their Money*. Second Edition. UK: Practical Action Publishing.

Seibel, Hans Dieter. 2003. “History matters in microfinance.” *International Journal of Microfinance and Business Development*. Small Enterprise Development. Vol. 14, no. 2 (June), p. 10–12.

Staschen, Stefan. 1999. “Regulatory and Supervision of Microfinance Institutions: State of Knowledge.” Eschborn: GTZ.

———. “Legal Frameworks in 11 Countries Worldwide.” Division 41, Economic Development and Employment Promotion. Eschborn: GTZ.

The Smart Campaign. “Client Protection Principles.” Washington, D.C.: The Smart Campaign. http://www.smartcampaign.org/about-the-campaign/smart-microfinance-and-the-client-protection-principles.

The Smart Campaign. 2010. “Responsible Pricing: The State of the Practice.” Washington, D.C.: The Smart Campaign, July.

Steele, William F., and David O. Andah. 2003. “Rural and Micro Finance Regulation in Ghana: Implications for Development and Performance of the Industry.” Africa Region Working Paper Series No. 49. Washington, D.C.: World Bank, June.

Tarazi, Michael, and Paul Breloff. 2010. “Nonbank E-Money Issuers: Regulatory Approaches to Protecting Customer Funds.” Focus Note 62. Washington, D.C.: CGAP.

Tiwari, Akhand, Anvesha Khandelwal, and Minakashi Ramji. 2008. “How Do Microfinance Clients Understand their Loans?” Chennai, India: Centre for Microfinance.

Trigo Loubière, Jacques, Patricia Lee Devaney, and Elisabeth Rhyne. 2004. *Supervising & Regulating Microfinance in the Context of Financial Sector Liberalization: Lessons from Bolivia, Colombia and Mexico.* Somerville: ACCION.

United Nations. 2006. “Building Inclusive Financial Sectors for Development.” (Also referred to as the Blue Book.) New York: United Nations, May.

Van Greunig, Hennie, Joselito Gallardo, and Bikki Randhawa. 1999. *A Framework for Regulating Microfinance Institutions,* Vol. 1. Washington, D.C.: World Bank.

Villacorta, Omar, Begoña Gutiérrez-Nieto, and Carlos Serrano-Cinca. 2010. “The New Regulation Framework of Bolivian NGO Microfinance Institutions. Perceptions on Risk Management, Solvency and Social Performance.” Saragossa: University of Saragossa.

Walker, David, and Joshua Lattimore, Canada Deposit Insurance Corporation. 2008. “CDIC-IADI: International Deposit Insurance System Survey: Current Designs and Trends.” Powerpoint presentation prepared for World Bank seminar on deposit insurance, in Washington, D.C., 21 October.

Weiner, Stuart E. “The Federal Reserve's Role in Retail Payments: Adapting to a New Environment.” Kansas City: Federal Reserve Bank of Kansas City.

Weiner, Stuart E., Terri Bradford, Fumiko Hayashi, Richard J. Sullivan, Zhu Wang, and Simonetta Rosati. 2007. “Nonbanks and Risk in Retail Payments.” Paper presented at the Joint ECB-Bank of England Conference on Payment Systems and Financial Stability, in Frankfurt, 12–13 November.

Wright, Graham, and Leonar Mutesasira. 2001. “Relative Risk to the Savings of Poor People.” Utta Pradesh: Microsave. http://www.microsave.org.

World Savings Bank Institute. 2009. “Beyond Microcredit: The Role of Savings Banks in Microfinance—Experiences from Latin America, Africa and Asia.” *Perspectives 59*, July.

———. 2008. “Position Paper on the Regulation of Microfinance Services.” Brussels: World Savings Bank Institute, June.