6 Regulation of Nonbank Microfinance Institutions

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6.1 Background

The regulatory environment for nonbank MFIs is crucial if they are to develop and innovate. On the one hand, if MFIs are to flourish they should be able to operate relatively freely. Lack of regulation may help to explain why the microfinance sector has developed much further in Bangladesh than in other countries. As noted by Carpenter (1997, 15):

> In Bangladesh, the unique circumstances of no regulatory oversight and a large, well-funded NGO community had resulted in the ad hoc evolution of sophisticated and innovative MFIs seeking to alleviate poverty

Lack of regulation may have encouraged the growth of microfinance in Bangladesh

On the other hand, it is clear that most MFIs are not operating on a sound basis. For instance, an international survey of MFIs conducted by Sustainable Banking with the Poor (1996) found that numerous MFIs did not have accurate accounting systems. The authors asked:

> If some managers of microfinance institutions are unable to answer questions about their own costs and arrears without the help of outside experts, how can they be expected to run sustainable financial institutions? Clearly, a greater emphasis on financial monitoring and reporting using standardized accounting is needed (p. 4).

Low operational standards of most MFIs are an argument for their regulation and supervision

MFIs that do not meet basic operational standards are not likely to reach large numbers of poor clients on a sustainable basis. The task is therefore to find cost-effective ways of improving the standards of the large numbers of MFIs that are not currently operating on a sound basis, while at the same time avoiding restrictions that impair their efficiency or effectiveness and meanwhile encouraging them to be innovative.

6.2 Non-prudential Regulation

Most countries have processes for registration of NGOs, cooperatives, and other institutions engaged in microfinance which do not usually involve central banks. However, there are cases where central banks become involved in the registration or licensing of certain categories of MFIs. By far the most prominent example is Nepal, where the central bank is the main regulatory and monitoring body for the licensed nonbank MFIs, consisting of NGOs and cooperatives. Other examples include the following:

(i) In PRC, the rural and urban credit cooperatives come under the control of the central bank. It is probably better to regard them as “near-banks” rather than nonbank MFIs.

(ii) In the Kyrgyz Republic, the central bank is involved in regulating three categories of nonbank financial institutions engaged in microfinance. These are credit unions, the Kyrgyz Agricultural Finance Corporation (KAFC) and the Savings and Settlement Company. The latter is in fact owned by the central bank.

(iii) In PNG, the central bank is responsible for the regulation of savings and loans societies.

(iv) In Viet Nam, the Law on Credit Institutions, which is implemented by the Government and central bank, provides that banking activities of nonbank

While central bank regulation of nonbank MFIs is not the rule, there are cases in Asia and the Pacific

organizations shall be subject to the relevant provisions regarding permitted banking activities. This implies that such organizations are legally subject to regulation by the central bank.

Some countries impose ceilings on the interest rates MFIs can charge borrowers. In most cases, these are prescribed in anti-usury laws or result from the policies of various government agencies, rather than being imposed by the central bank. However, there are a number of cases where the central bank does in fact control the interest rates charged by certain categories of nonbank MFIs. For instance:

(i) Under the Financial Intermediary Societies Act, 1998 in Nepal, it is proposed that licensed MFIs will decide their on-lending interest rates and inform the central bank. The central bank will have the power to ask MFIs to revise their interest rates. Thus, interest rates will be under the ultimate control of the central bank. However, MFIs will also be permitted to levy fees for services rendered.

(ii) In PNG, the central bank has imposed a 12 percent per annum ceiling on lending rates charged by savings and loan societies.

(iii) In PRC, the central bank sets interest rate ceilings for rural credit cooperatives (RCCs). RCCs are permitted to set rates up to 50 percent higher than the commercial banks. At present, this equates to interest rates of between 10 and 11 percent per annum, flat (although it is worth noting that a typical loan is repayable by a single installment at the end of the loan period).

Central banks also restrict interest rates of MFIs in some countries

(iv) In Vanuatu, the central bank has the power to apply interest regulations to “any person having as a principal or incidental object of his business the extension of credit.” However, such regulations have not been applied in practice.

Interest rate restrictions impede the development of sustainable microfinance, and it would be appropriate for central banks to remove any such restrictions within their control. Even where such restrictions do not result from central bank actions, central banks may be able to lend their prestige and influence to efforts directed at their removal.

6.3 Prudential Regulation and Supervision

General Principles

It is generally accepted that financial institutions should be subject to prudential regulation and supervision for two main reasons: (i) to protect depositors, particularly small depositors, from loss of their savings if the financial institution becomes insolvent, and (ii) to ensure the financial system as a whole does not become unstable through loss of confidence as a result of major financial institutions becoming insolvent.

Unless they are extremely large, MFIs are not likely to threaten the stability of the financial systems in which they operate. This suggests that MFIs should generally not be subject to prudential regulation and supervision unless they accept savings. It also highlights the fact that savings mobilization is a particularly difficult issue for central banks and other regulators. On the one hand, savings facilities provide a valuable service to clients, and can be important in reducing poverty. On the other hand, mobilizing savings places an onerous responsibility on an institution to ensure that the savings of clients are not at risk. Central banks need to decide to what extent and in what forms nonbank MFIs should be permitted to mobilize savings.

Prudential Regulation and Supervision of MFIs

The argument for regulating and supervising any financial institution rests on:

- the need to protect depositors from loss of their savings
- the need to maintain confidence in, and stability of, the financial system.

This suggests that:

- MFIs that do not collect deposits need not be regulated
- central banks need to decide whether and how nonbank MFIs should take deposits.

There are also a number of practical issues influencing the decision as to which MFIs should be subject to prudential regulation and supervision. Most importantly, subjecting all MFIs to prudential regulation and supervision would impose a heavy burden on central banks and/or other supervisory agencies. In most countries in the Asia-Pacific region, central banks have insufficient resources to undertake their core functions, including maintenance of monetary stability and prudential regulation and supervision of the banking system, let alone to regulate large numbers of MFIs.

It would be impractical for central banks to attempt to supervise all MFIs, and probably ineffective as well

Also, given the limited administrative resources and government and regulatory failures in most countries, the nominal imposition of prudential regulation and supervision would not necessarily result in better performance by MFIs. In many countries banking systems are not sound even though they are regulated by central banks. Indeed, in some countries the unregulated MFI sector appears to perform better than the regulated banking sector. In a number of countries in East Asia, lack of attention to prudential regulation and supervision of banking systems contributed to the financial crisis which began in 1997.

Moreover, inappropriate regulation could well do considerable harm. Most central banks do not have a unit responsible for microfinance, and do not have sound knowledge and understanding of the requirements of MFIs. In the absence of significant changes in methods of regulation and supervision, placing MFIs under the supervision of the existing supervisory agencies would likely stifle them. As suggested, the growth of the microfinance sector in countries such as Bangladesh owes much to the absence of a regulatory framework, which has allowed some MFIs to develop cost-effective and innovative methods for reaching poor clients on a sustainable basis.

Application to Microfinance Institutions

Based on these considerations, it is possible to reach some tentative conclusions as to which MFIs should be regulated. First, there appears to be a consensus that credit-only MFIs should generally be free from prudential regulation and supervision. As noted, the objective of protecting depositors does not apply to such MFIs. There may be a case for prudential regulation and supervision of credit-only MFIs large enough to threaten the viability of the financial systems in which they operate (if indeed there are any such MFIs).

Second, most commentators argue that MFIs requiring members to make savings deposits simply to get loans should also be not subject to prudential regulation and supervision. The rationale is that obligatory deposits are simply part of the loan contract, and further that most members are net debtors, most of the time. Hence, the risk of members' losing their savings is relatively low.

Some nonbank MFIs (for example, in Bangladesh) are now attracting substantial voluntary deposits, including from nonmembers. It is difficult for a central bank to ignore this

Third, Christen and Rosenberg (2000) argue that prudential regulation and supervision should not apply to MFIs that do not mobilize "substantial amounts of voluntary deposits." This approach does not appear to be entirely satisfactory. In Bangladesh, for example, some MFIs that were previously credit only such as ASA and BURO, Tangail, are now offering voluntary savings services and attracting significant deposits. In the case of ASA, "associate members" who are not borrowers may also make voluntary savings. The argument for prudential regulation and supervision of MFIs appears stronger as the volume of voluntary savings they hold becomes more substantial. However, the problem is to determine what threshold to apply. The level at which voluntary deposits become "substantial" will vary from country to country.

An alternative approach may be to allow MFIs to take savings on the condition that they are deposited with a licensed financial institution as quickly as possible. Here, the MFI could not use such savings to finance its lending, nor for any other purpose other than to pay out withdrawals. Christen and Rosenberg (2000) note that it would also be necessary to ensure that depositors have a priority claim if the MFI fails, so that their deposits are not used to pay off other creditors.

Fourth, it does not appear practical to extend prudential regulation and supervision to all MFIs mobilizing savings from members, such as credit unions, cooperatives, and self-help groups. In principle, prudential regulation and supervision may be appropriate to protect their members' savings. Certainly, in most if not all countries in the Asia-Pacific region, numbers of such institutions have become dormant and savings have been lost. In practice, however, the small size and large numbers of such institutions would make prudential regulation and supervision prohibitively expensive. Some commentators such as Christen and Rosenberg (2000) have suggested there should be an explicit "lower boundary," based on assets, number of members, or other appropriate variable, below which such institutions would be free of regulation. They note that appropriate thresholds are country specific, and difficult to specify in each case. Christen and Rosenberg suggest that one option for institutions below any declared threshold may be to require prominent and frequent disclosures to depositors that their deposits are unprotected.

Fifth, it is generally accepted that institutions accepting deposits from the public should be subject to prudential regulation and supervision. Institutions not subject to prudential regulation and supervision should not be permitted to mobilize public deposits. This raises the issue of minimum capital and other requirements for licensed financial institutions. It also leaves open the possibility that certain categories of small financial institution should be restricted in the types of savings facilities they offer, as is done with rural banks in Indonesia.

Regulation of Nonbank MFIs — Some Conclusions

- Credit-only MFIs should generally be free of prudential regulation and supervision.
- Similarly, MFIs accepting savings simply as a condition for loans should not be regulated.
- It may be possible to set a "threshold" below which savings mobilization is unregulated.
- Alternatively, any savings might have to be deposited with a licensed financial institution.
- It does not appear practical to regulate the full range of nonbank MFIs.
- However, any institution accepting deposits from the public should be regulated and supervised.

6.4 Regulation by Special Law for Microfinance Institutions

The Latin American countries of Bolivia and Peru have established special laws for MFIs, with regulation conducted by the banking supervisor. Nepal has also established such a law, as discussed in the next section.

It has been suggested that MFIs not accepting deposits should not be subject to prudential regulation and supervision. Hence, the main objective of a special law for MFIs should be to establish a regulatory framework for MFIs to enable them to offer savings facilities. A secondary objective could be to confer a regulatory "stamp of approval" upon MFIs wishing to access commercial funds from sources such as commercial banks or investors.

Any MFI law should be aimed at strengthening MFIs which accept savings and giving a "stamp of approval" to qualified institutions

As noted by Valenzuela and Young (1999), there are different views on the desirability of having a special law for MFIs. Some argue that such a tiered approach is necessary because licensed financial institutions are unwilling to engage in microfinance and because banking regulations are unfavorable to it. Others argue that such laws will result in regulatory fragmentation, and that it is better to reform banking laws discouraging of microfinance. Nevertheless, where it proves impossible to reform banking legislation, special laws may be the "second best" option.

Christen and Rosenberg (2000) argue that, in deciding whether to establish special laws, the fundamental question is whether the country has MFIs suitable for licensing but unable to use an existing window. To be allowed to accept deposits, MFIs would need to demonstrate that they can meet the full commercial cost of doing so, implying they would need both to be close to full financial self-sufficiency and to have appropriate risk management strategies in place. Licensing institutions that cannot meet this test would be inconsistent with protection of depositors.

In most countries, there are few if any MFIs that meet this test. This suggests that strengthening the capacity of MFIs is a higher priority than establishing a special law for MFIs in most countries. For these reasons, Christen and Rosenberg (2000, 28) argue that:

> … we would be inclined to wait until a few microcredit NGOs (or managers) had proved for two years or so that they can manage their loan portfolios profitably enough to pay commercial costs on whatever portion of their funding the licence would allow them to leverage from outside resources.

Perhaps strengthening MFI capacity is a higher priority than specific MFI legislation

Nevertheless, they believe the future of microfinance lies in licensed settings, because only such environments will permit massive, sustainable delivery of financial services to the poor. Over the longer term this appears to require enactment of special laws for regulating MFIs, the reform of banking laws to ensure they are compatible with microfinance, or both.

6.5 Prudential Regulation and Supervision in Practice

Developments in Nepal, Bangladesh, and India

In practice, nonbank MFIs are generally not subject to prudential regulation and supervision by the central bank or any other agency. The only exception among the

Prudential regulation and supervision of nonbank MFIs by a central bank occurs only in Nepal, although it is a live issue in both India and Bangladesh

countries in the study is Nepal, and only in those cases where the central bank has granted limited banking authority to a number of MFIs in exchange for their submitting to regulation and supervision. There has also been considerable debate in Bangladesh and India as to whether MFIs should be subject to prudential regulation and supervision. These developments are instructive for other countries in the study where the debate has not yet progressed so far.

In Nepal, the central bank has granted limited banking authority to a number of MFIs. As previously mentioned, by 1998 some 30 NGOs and 29 cooperatives were registered with the central bank to undertake limited banking transactions. This approach, which is comparable to a special law for MFIs, is unique among the countries in the study. Other MFIs that have not been granted limited banking authority are not subject to any regulation by the central bank.

Limited banking licenses granted to NGOs and credit cooperatives in Nepal brought these institutions under central bank scrutiny

The degree of regulation for licensed nonbank MFIs is much lower than it is for banks, and differs between NGOs and cooperatives. NGOs face no capital adequacy requirements but are required to limit their loans to less than NRs100,000 ($1,440) per individual. They must also build a reserve fund through an allocation of 10 percent of their operating profit, as a provision for loan loss. However, since most NGOs operate at a loss this requirement has little practical effect. Hence, the prudential regulations facing licensed NGOs are not very rigorous. Neither are the provisions linked to the nature or volume of savings mobilization by NGOs. While they do not specifically address the issue of savings mobilization, it is generally assumed that the regulations allow unlimited mobilization of savings from members, but do not permit savings mobilization from nonmembers.

Licensed cooperatives face minimum capital requirements and must maintain a capital adequacy ratio of 8 percent of risk-weighted average assets. They also face more stringent loan classification and provisioning norms than even the commercial banks. Licensed NGOs and cooperatives are also obliged to submit data on their financial operations to the central bank. Despite these various requirements, however, supervision is poor. Supervision is at best random and perfunctory, and at worst virtually nonexistent.

New legislation in 1998 brought all Nepali MFIs under central bank control, but the bank is in no position to exercise this responsibility

Despite the deficiencies already identified, these arrangements have paved the way for a number of the larger NGOs in Nepal to obtain experience as financial intermediaries operating between the formal financial sector and the broader NGO movement. Some now have the confidence to seek licensing as development banks. One has already done so, and several others are seeking licenses.

Under the Financial Intermediary Societies Act which came into effect in November 1999, the central bank is supposed to license and regulate all microfinance NGOs. The central bank is in no position to fulfill these responsibilities. Like the previous regulations, the Act is silent on the issue of savings mobilization by NGOs. It is imperative that flaws in the Act be corrected.

Nonbank MFIs in Bangladesh are currently not subject to prudential regulation and supervision. However, there has been considerable debate among stakeholders in the country about these issues. The World Bank has commissioned a study to consider a regulatory framework for microfinance, and the Credit and Development Forum, a network organization for MFIs, conducted a workshop on this issue in January 1999.

In Bangladesh, the need for a specific microfinance law is widely accepted

Most stakeholders in the microfinance sector consider there is a need to enact a separate law for microfinance. Proponents of such a law argue that it is necessary to protect clients' savings, and to encourage commercial banks to establish linkages with MFIs. However, the largest and most influential MFIs oppose any kind of regulation, apparently because they are concerned it would lead to bureaucracy and the imposition of control, in a situation where they have operated with considerable autonomy to date.

Based on the discussions that have taken place so far, an "MFI Act" would likely include provisions that:

(i) MFIs with more than 5,000 or 10,000 members (around 50 to 100 MFIs) would become subject to regulation and supervision.

(ii) Such MFIs would have clear permission to mobilize deposits, including from nonmembers, provided they are established specifically for the purpose of microfinance and do not advance loans greater than Tk50,000 ($1,010).

(iii) In return for acceptance of a regulatory framework under the new law, such MFIs would be exempt from the requirements of existing legislation.

An issue is to determine which institution in Bangladesh should have regulatory authority

There appears to be no institution with an unchallenged claim to undertake the role of regulator. Given the central bank's difficulties in the supervision of the formal financial sector, any role assigned to it would have to be undertaken with caution. It presently lacks not only the staff capacity to add the regulation of microfinance to its many roles, but it also appears to lack the required understanding and professional expertise in microfinance. The consensus among stakeholders is that there is a need to establish a separate superintendency for MFIs.

One option may be to establish the independent microfinance regulator as a subsidiary of the central bank, but to ensure its independence by having separate premises and an independent board consisting of researchers and other eminent persons acceptable to MFIs as well as the central bank. In the longer term it could be absorbed into the mainstream operations of the central bank as a regular microfinance supervision division.

The framework proposed for Bangladesh would impose regulation on credit-only MFIs

The debate in Bangladesh has been largely conducted within a conceptual framework that links the MFI's right to mobilize savings with its obligation to accept prudential regulation and supervision. This framework also proposes that prudential regulation and supervision be triggered by certain thresholds in terms of numbers of members, on the basis that it would be unrealistic for any agency to supervise all of the MFIs currently operating in Bangladesh. On the other hand, the proposed framework also appears to cover credit-only MFIs that meet the membership threshold, although it is not clear on what principle such MFIs should be subject to prudential regulation and supervision. Further, there does not appear to have been much discussion so far of the specific regulatory standards that would apply to MFIs.

In India, the central bank initiated a task force to consider regulation of microfinance and related issues

In India as in other countries, there is currently no prudential regulation and supervision of nonbank MFIs. However, in 1998 the governor of the central bank established a NABARD task force on microfinance to "arrive at a conceptual policy framework for sustainable growth of microfinance in the country encompassing issues in policy, regulation, financing and capacity building."

The final report of the task force was presented in October 1999. Among the key recommendations were the following:

(i) Regulation and supervision of MFIs would be introduced by means of self-regulation organizations (SROs) recognized by the central bank.

(ii) All MFIs would be required to register with a regulatory authority. However, regulation and supervision would be limited to those MFIs that have mobilized savings in excess of Rs200,000 ($4,650). MFIs with savings deposits in excess of Rs2.5 million ($58,000) would be registered with and regulated by a national rather than a regional authority.

(iii) Reserve requirements would be introduced. For organizations with client savings in the range Rs200,000 to Rs2.5 million, 10 percent of savings would have to be placed in bank deposits. For organizations with client savings in excess of Rs2.5 million, 15 percent of savings would be so deposited. These larger organizations would also have to comply with prudential norms specified by the central bank.

(iv) MFIs covered by these provisions would be permitted to mobilize savings from their clientele of the poor only as an element in financial services provided to

A Regulatory Framework for India: Recommendations of the NABARD Task Force

- Self-regulation of all MFIs under organizations created for the purpose.
- Registration of all MFIs with a regulatory authority.
- External regulation and supervision of MFIs mobilizing savings in excess of a threshold.
- Imposition of reserve requirements, calibrated to the volume of savings held.
- Savings to be mobilized only in the context of the loan contract, not from nonmembers.

them. MFIs mobilizing deposits from the public would not be covered by these provisions and would have to be licensed as banks.

The task force recommendations also apply the concept of a threshold that would trigger prudential regulation and supervision, and suggest some form of delegated supervision. However, there are a number of unanswered questions, including the relationship between the central bank and the SROs, and the powers of the SROs to enforce compliance. At the time of writing, the recommendations were under consideration by the central bank.

Lack of Clarity for Savings Mobilization

Savings mobilization is a zone of confusion. No country has a clear and workable policy framework for MFIs

The analysis suggests that the nature and extent of any savings mobilization by an MFI should provide the trigger point for prudential regulation and supervision. Unfortunately, this is an area of confusion in most if not all of the countries included in the study. In almost all countries there are significant legal restrictions on savings mobilization by nonbank MFIs, but these laws are either ignored by central banks or implemented in piecemeal fashion. The following examples illustrate some of the issues, but are by no means exhaustive. It is fair to say that no country in the study has established or implemented a workable policy framework that makes it clear to MFIs when they can mobilize savings.

In Bangladesh, a number of leading MFIs are now offering voluntary savings facilities to members, and at least one is offering such facilities to “associate members” who receive no other services from the institution. While deposit mobilization, particularly from nonmembers, is in clear contravention of banking legislation, the central bank has not attempted to hinder these activities.

In a number of countries, including India and Bangladesh, central banks turn a blind eye to savings mobilization by MFIs

In India, nonbank MFIs are not permitted to accept deposits from the general public. Indeed, the legality of their accepting client savings as deposits is questionable. However, as in Bangladesh, the Indian central bank has tended not to interfere.

In Nepal, current regulations governing the licensing of MFIs do not address the issue of savings. By implication, they allow the unlimited mobilization of deposits from members. Without being explicitly stated, the general assumption is that savings mobilization from nonmembers is not permitted even for licensed MFIs. The new Financial Intermediary Societies Act, 1998 specifically prohibits MFIs from working as financial intermediaries without obtaining a license but, somewhat confusingly, makes no provision for deposit mobilization. To this extent, it appears to prohibit savings mobilization by MFIs.

Recent legislation in both Nepal and PNG has created uncertainties

In PNG, the central bank has until now been content to allow the small number of active MFIs to undertake deposit taking on a small scale. However, there has recently been considerable controversy surrounding unauthorized deposit taking by pyramid operators. The need to outlaw such deposit taking may create an unsympathetic environment for MFIs. A law passed in April 2000 makes it explicit that the taking of deposits as a business needs either a license or some form of exemption. In tabling the Bill the Prime Minister said that some of the requirements would not apply to savings and loans societies and smaller "genuine" schemes, but it remains to be seen how the new law will apply in practice.

In PRC, any financial intermediation conducted by unregulated institutions such as MFIs is illegal. Externally supported MFIs which are implementing international models of microfinance on a pilot basis have no status in national law, although they are approved by local authorities. The central bank has opted to tolerate these experiments so far, so long as they remain quantitatively insignificant.

In some countries, such as the Philippines, MFIs adopt legal fictions to describe their deposit taking

In the Philippines, credit MFIs are not permitted to mobilize savings from members. Some have been mobilizing savings from their member-borrowers and booking these as capital build-up, group funds, or mutual savings funds. The central bank has chosen to adopt a hands-off policy with respect to this practice, provided it is not abused. Its position is that unless the law explicitly mandates it to regulate these institutions, it will not do so.

In Sri Lanka, MFIs may not legally accept deposits. The prohibition applies to deposits from members as well as nonmembers, and includes savings collected as a compulsory condition for receiving a microfinance loan. Any such savings must be deposited in a regulated financial institution and may not be used by the MFI for re-lending. However, in practice, the prohibition on mobilizing savings has generally not been applied strictly and some government-supported microfinance programs have encouraged savings mobilization by participating MFIs.

Central banks in all countries need to clarify the legal situation with respect to savings mobilization by MFIs

In all countries, it would be appropriate for the central bank to clarify the legal situation regarding savings mobilization by MFIs. While in most cases central banks have tolerated limited savings mobilization by MFIs, this situation is not altogether satisfactory. There is always the possibility of sanctions against such MFIs if they are technically operating outside the law. This is especially the case if political developments (as in Sri Lanka in the past) or activities by unscrupulous operators (as in PNG recently) give rise to pressures to clamp down on "illegal" savings mobilization. Moreover, the lack of clarity makes it difficult for a central bank to distinguish between "appropriate" and "inappropriate" forms of savings mobilization by MFIs. The general principles outlined previously provide a basis for central banks to develop a workable framework for savings mobilization by MFIs.

Regulation of Credit Unions and Cooperatives

Credit unions and cooperatives are permitted to mobilize the savings of their members for on-lending. In most countries these bodies are regulated by a registrar of cooperative societies or similar official, rather than the central bank. Such regulation does not amount to prudential regulation and supervision. There is also generally an apex body that exercises some supervision over primary societies. In most countries these arrangements have not led to effective supervision, and large numbers of credit unions have become dormant with members losing their savings.

While credit unions and cooperatives are most commonly regulated by agencies other than the central bank, the central bank plays a role in four of the countries included in the study. In the Kyrgyz Republic, credit unions are regulated by the central bank under a presidential decree, and laws and supervision "norms" have been drafted to legalize them fully. The central bank has delegated supervision

In four countries, central banks are involved in regulating credit unions and cooperatives

to the Financial Company for the Support and Development of Credit Unions because it does not have the staff to supervise them itself.

As noted, in Nepal the central bank is the main regulatory body for those cooperatives with limited banking licenses. These cooperatives are subject to a minimum capital requirement, a capital adequacy ratio of 8 percent of risk-weighted assets, and stringent loan classification and provisioning norms. However, supervision is poor.

In PNG, the governor of the central bank is also the registrar of savings and loans societies, and the central bank is responsible for regulation and supervision of these societies. However, the limited audit resources of the central bank make it difficult for it to do its job. No audit inspections were conducted during 1997 and none was expected to occur during 1998, although visits to two societies per year were supposed to be scheduled.

In PRC, rural credit cooperatives (RCCs) are regulated by the central bank, which has created a separate department for the supervision of cooperative finance institutions. RCCs are required to have a minimum “registered capital” of Y1 million ($120,000). They are also subject to prudential regulations concerning reserve deposits, the capital adequacy ratio, the loan/deposit ratio, minimum liquidity, single borrower limits, and provisions for doubtful debts. It is not clear how effective the central bank is in supervising RCCs, but in April 1999 the governor stated that 60 percent of RCCs had satisfied the current regulations in full.

In the case of Vanuatu, responsibility for regulating credit unions is vested in the financial services commissioner. However, the central bank should assume this responsibility. In the context of the small financial system of Vanuatu, it is appropriate that the central bank be the major agency responsible for monitoring all financial institutions.

In small countries, central bank responsibility for credit unions and cooperatives may be the most cost-effective solution

In some countries, there may be a sound case for the central bank to assume responsibility for regulating cooperatives and credit unions. This is especially likely to be the case in smaller countries such as PNG, Vanuatu, and possibly Kyrgyz Republic, where it is not cost effective to create separate agencies for regulating different types of financial institutions.

It should be stressed, however, that such regulation by the central bank would generally not involve formal prudential regulation and supervision of primary cooperatives or credit unions. There is commonly a large number of such institutions, often located in remote areas and frequently lacking a businesslike approach and sound financial records. As demonstrated by the examples of Nepal and PNG, it would not be possible for central banks to undertake prudential regulation and supervision of primary societies in a cost-effective manner, if at all. Hence, central banks would not be in a position, and nor should they be expected, to vouch for the soundness of primary societies. Instead, in such cases the role of central banks would be to supervise the activities of the relevant apex bodies, and to provide general institutional and policy support.

Other Issues

There are some cases where the central bank has regulatory responsibility for certain categories of MFIs, but has delegated supervision to another institution. One example is credit unions in the Kyrgyz Republic, where the central bank has delegated the supervision role to the Financial Company for the Support and Development of Credit Unions. Another example is the village credit institutions (BKD) in Indonesia. BKD are typically very small and number more than 5,000. While, in principle, responsibility for their supervision resides with the central bank, they are in fact

supervised by Bank Rakyat Indonesia (BRI). BRI is paid by the central bank for this service. Christen and Rosenberg (2000) note that while BRI's supervision of the BKD appears to work well, this is perhaps because BRI and the BKD have a very close relationship independent of BRI's supervisory role. Hence, this experience cannot necessarily be replicated. Yet there is another example of delegated supervision in Indonesia, where the class of small financial institutions known as LDKP are supervised by provincial development banks, the BPD. While this might appear to strengthen the case for delegated supervision, Christen and Rosenberg point to a number of disadvantages of delegated supervision as a model for wider application.

Central banks sometimes delegate supervision to other agencies

It was suggested that MFIs that mobilize voluntary savings, and MFIs that mobilize savings from members, should be subject to prudential regulation and supervision where they exceed a certain threshold. As noted, this approach has been suggested in Bangladesh and India. To date, however, there appears to be only one example of its actually being legislated. In Vanuatu, a law passed in 1999 provides for prudential regulation and supervision of credit unions or cooperative societies which have deposits or loans of at least Vt10 million ($78,420). At present, however, there are no credit unions or cooperatives that exceed this threshold.

6.6 Performance and Reporting Standards

If it is accepted that prudential regulation and supervision are not appropriate for most categories of MFIs, it is necessary to consider other means of establishing standards for the microfinance sector. While it is very unlikely that all MFIs would adhere to such standards, they offer the potential to improve the operations of the larger and more businesslike MFIs, and thereby increase the sustainability of the microfinance sector as a whole.

How to establish standards of operation for MFIs in the absence of prudential regulation and supervision?

In countries where there are significant second tier microfinance institutions that lend to retail MFIs, one possible approach for ensuring that MFIs operate on a sound basis is through the lending policies of those second tier institutions. Such institutions are not regulatory agencies. But they can in practice require MFIs that borrow from them to meet certain performance and reporting standards. Where second tier institutions are major lenders there is strong incentive for retail MFIs to meet their standards, and it is likely that such standards will have broader influence throughout the microfinance sector. Some second tier microfinance institutions, such as Palli Karma Sahayak Foundation in Bangladesh and People's Credit and Finance Corporation in the Philippines, have been active in establishing standards for their retail MFIs and have begun to exercise influence to some degree.

Where second tier institutions are major lenders they can exert pressure on MFIs to meet standards

Another approach to establishing performance and reporting standards for MFIs is through self-regulation. Self-regulation may take a wide variety of forms, ranging from a voluntary code of conduct to which MFIs agree to adhere, to a rigorous licensing system administered by an apex body and backed by the force of law. In between, there is a range of possibilities with varying degrees of monitoring and compulsion. The feasibility of any particular mode of self-regulation depends on a number of factors, including whether there is an apex body that can represent MFIs as a whole, the quantum of resources available for monitoring and supervision, and the availability of incentives and/or sanctions to enforce compliance. Self-regulation can be an alternative to, or can supplement, other mechanisms for establishing performance and reporting standards. The most important initiative for self-regulation in the region to date is that taken by the Coalition for Microfinance Standards in the Philippines.

Yet another approach may be to establish an independent credit rating agency, which would rate MFIs according to pre-established performance standards. Ideally, ratings would be made public and used by all funding agencies, including second tier institutions, donor agencies, and commercial lenders. This would provide a powerful incentive for MFI compliance.

It is not appropriate or even possible for central banks to develop such performance and reporting standards unilaterally. Nevertheless, central banks may still be able to participate in the process. For instance, they may act in an advisory capacity in initiatives by funding agencies, or by MFIs in self-regulation, to develop performance and reporting standards. They may also contribute by monitoring second tier microfinance institutions and credit rating agencies. Second tier institutions are themselves financial institutions, and it is appropriate that they be subject to some prudential regulation and supervision by the central bank, especially where they are channeling government financial resources. In practice, none of the more prominent second tier institutions in the region is regulated by the central bank.

Approaches to Standard Setting for MFIs

Approaches to standard setting, other than prudential regulation and supervision by an external authority, include:

- influence exerted by second tier institutions
- various forms of self-regulation by MFIs themselves
- influence applied by publishing assessments of an independent credit rating agency.

There are two cases in which the central bank has been involved in helping to establish performance and reporting standards. In Nepal, the Centre for Microfinance (CMF), a network organization for MFIs, has recently commissioned two ratings of MFIs through an MFI rating agency. Discussions on how to carry the initiative forward have been held by CMF with bankers. The central bank has participated in these discussions, but appropriately CMF has taken the lead.

The central bank in the Philippines is also providing support in developing standards of performance for MFIs. It is a member of the Coalition for Microfinance Standards, which has developed standards for self-regulation by MFIs. As a member of the National Credit Council, the central bank is also helping to develop a chart of accounts for credit cooperatives.

The degree of central bank involvement in the development of such standards is likely to vary considerably from country to country. In countries with well developed microfinance sectors, the central bank may take more of a monitoring role, providing technical inputs where appropriate. In countries with fewer MFIs and without effective networks of MFIs or second tier institutions, the central bank may need to exercise more leadership and coordination. However, if central banks are to become involved in developing standards, it is important that they develop a sound understanding of the microfinance sector. Establishing standards for nonbank MFIs gives rise to issues very different from those associated with regulating and supervising banks. There is an increasing body of empirical and theoretical material for central banks to draw on in developing performance and reporting standards for MFIs.