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Recommendations for Proportionate Regulation and Supervision of Microfinance

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UNCITRAL Colloquium on Microfinance

Outline of discussion

I. The Basics
II. Prudential Regulation
III. Prudential Supervision
IV. Non-Prudential Regulation
V. Branchless Banking
VI. Microinsurance

The Basics

- What does proportionate regulation and supervision mean?
- What is the difference between prudential and non-prudential regulation and supervision?
- What institutions providing financial services to the poor are subject to such regulation and supervision?
- Who are the regulators and supervisors of such institutions and their microfinance activities?

The Basics: What does proportionate regulation and supervision mean?

- Costs are proportionate to risks (of no reg/sup) and benefits (of reg/sup)
- Measuring costs and benefits?
  - Costs include both those of the regulated institutions and of the regulator
  - Some benefits (e.g., consumer protection) are less tangible and risks of non-regulation are only apparent in crisis
  - Various stakeholders may place different value risks and benefits

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The Basics: Prudential vs. non-prudential regulation

- Prudential regulation typically applies to financial institutions that (i) take retail deposits & lend from them and (ii) can, in the event of failure, pose a systemic risk
- Prudential supervision involves protecting the financial health of the regulated institution to prevent systemic risk
- Non-prudential regulation involves regulatory objectives that can be achieved regardless of the financial health of the regulated institution
- Examples of non-prudential regulation include:
    - consumer protection regulation (other than depositor protection)
    - public reporting requirements
    - regulation on financial crimes

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The Basics: Prudential vs. non-prudential regulation *(continued)*

- Prudential regulation and supervision are expensive – both for the supervisor and the microfinance institution (because it is labor-intensive to protect the financial health of the regulated institution)
- Sustainable microfinance institutions have to pass the extra cost on to customers in the form of higher interest rates
- Prudential regulation and supervision of microfinance institutions that do not take deposits from the public (or otherwise present systemic risk) is therefore inadvisable

The Basics: Who provides microfinance services?

A variety of institutions are involved in the provision of microfinance services, each regulated differently, including:

- non-governmental organizations (NGOs)
- commercial finance companies (sometimes referred to as “non-bank finance companies”)
- financial cooperatives and other member-based savings and loan organizations
- specialized microfinance banks
- commercial banks

The Basics: Who provides microfinance services? *(continued)*

- Others include: savings banks, rural banks, state-owned agricultural banks, development banks and postal banks, as well as a large array of state-backed loan funds
- (Regulation of these varies widely by country)
- Depending on the country, these institutions may subject to regulation and supervision based on their institutional type, their activities or both

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The Basics: What services are microfinance services?

- Microfinance is not just about credit, as low-income people need a full range of services
- Microcredit: not just microenterprise credit, but also credit to:
  - smooth consumption
  - enable asset purchases
  - fund social obligations
- Beyond microcredit low income people need:
  - safe places to save
  - safe and affordable ways to make payments & move funds
  - safe ways to pool risk (microinsurance)

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The Basics: Who regulates and supervises microfinance?

Different regulatory bodies oversee the various areas of regulation:

- Prudential regulation and supervision involves banking and insurance supervision authorities, as well as specialized supervisory bodies in some countries
- Non-prudential regulation covers a variety of topics and therefore involves a variety of regulators, depending on the country and type of service provider, such as:
  - NGO regulatory body
  - Consumer protection agency
  - Financial Intelligence Unit

Prudential regulation of microfinance

- Many prudential requirements applicable to depository institutions require adjustment when applied to microfinance institutions and activities, including:
  - Capital requirements
  - Loan provisioning
  - Reporting
  - Loan documentation
- Many of the differences in regulation and supervision of microfinance relate to the distinctive features of a common microlending methodology developed over the last several decades

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"Common microlending methodology"

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
- group lending, or individual lending based on analysis of the borrower's likely cash flow
- an understanding that borrowers who repay their loans will have access to follow-on loans

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Prudential supervision of microfinance

- Supervision of microfinance institutions and microfinance activities also differs from the "standard" prudential supervision of conventional retail banking
  - Assessing microcredit risk requires specialized examiner skills and techniques that differ substantially from the ones that supervisors use for normal retail bank portfolios.
  - Some enforcement and recovery tools work less well for MFIs than for banks--e.g., stop-lending orders, capital calls, mergers, and asset sales.
- These differences are primarily due to the use of the "common microlending methodology"

Minimum capital requirement

- Minimum capital for deposit-taking institutions should be set high enough to ensure that the institution can cover the infrastructure, MIS, and start-up losses to reach viable scale
- In addition, the requirement can serve to limit the number of licenses so that they do not overwhelm the supervisor
- It is usually preferable to set minimum capital through regulation rather than legislation.
  - easier to start with a small number of new licensees and, in the future, reduce the minimum capital requirement and license more institutions
- Minimum capital for non-depository microlenders is a market entry barrier, so consider carefully before imposing

Capital Adequacy

Capital adequacy requirement should be higher for MFIs than commercial banks even though well-managed MFIs typically have lower delinquency rates

- A microloan portfolio can deteriorate much more quickly than a normal bank portfolio (due both to the “common microlending methodology's” dependence on repeat loans and lack of diversification in microloan portfolios)
- High administrative costs per microloan means that delinquencies can quickly decapitalize an MFI
- Many MFIs do not have significant management experience and the supervisor often has little experience with microfinance risk

Permitted Activities

- Managers of newly licensed MFIs may not have much experience with managing the full range of banking activities and risks (for example, foreign currency hedging)
- Permission to engage in sophisticated activities should usually be granted or withheld in light of management capacity and institutional experience

Unsecured lending limits and loan loss provisions

- Microcredit should not be limited to a percentage of equity or burdened with a high general provision requirement simply due to the fact that microloans are not conventionally collateralized
- However, because there is no collateral to fall back on (among other reasons), the provisioning schedule for *delinquent* microloans should be more aggressive than the provisioning schedule for secured bank loans

Loan documentation

- Loan documentation requirements need to be lighter for microcredit than for normal bank lending given the nature of the borrowers and the size of microloans
- The typical microloan will not have collateral appraisal or registration
- The typical borrower will not have:
  - formal financial statements for her business
  - evidence that her business is formally registered and in compliance with tax obligations

Reporting

- Reporting to a supervisor can add substantially to the administrative costs of an institution, especially one that specializes in very small transactions
- Some requirements may not even be feasible: transportation and communication conditions can sometimes make daily reporting virtually impossible
- Reporting requirements should be simpler for depository MFIs than for normal commercial bank operations but should enable supervisors to monitor the key risk indicators

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Branchless banking

- A suitable regulatory framework for branchless banking should permit the use of agents and other third parties as the primary customer interface
- In addition, it should provide for:
  - a risk-based AML/CFT regime
  - adequate protection of e-money issued by nonbank entities
  - consumer protection that accounts for differing risks due to the use of agents

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Microinsurance: The role of MFIs

- Products: credit life, life, disability, health, and property insurance
- MFIs play two primary roles in microinsurance:
  - Intermediating between insurance company and customers (sales, premium collection, policy administration, claims assessment/settlement)
  - Underwriting (but primarily credit life insurance tied to microloans)
- Underwriting insurance products other than credit life typically requires a separate insurance license (for which typical MFIs are unlikely to qualify)

Regulating and supervising MFIs and microinsurance

- For MFIs intermediating microinsurance (i.e., serving as an agent or broker), the main regulatory issues revolve around consumer protection (transparency, pricing) and bundling of credit life with other products (that customers might not need or want)
- For MFIs underwriting microinsurance other than credit life, the main issues relate to the typical regulatory issues for insurance companies, which are universally regulated separately from banks

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