International Colloquium on Microfinance - UNCITRAL

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Effective Regulation and Supervision of Microfinance Operations

"The devil is in the details"

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Content

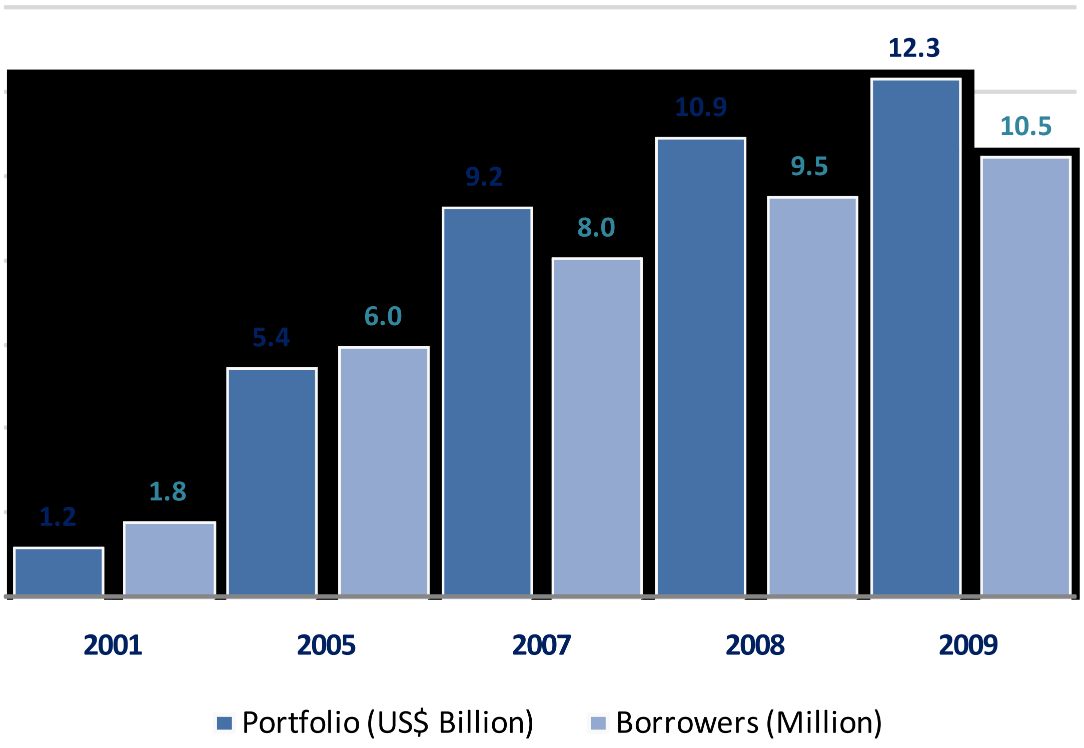
I. Microfinance in Latin America and the Caribbean

Evolution

- The story begins in 1972, Projeto Uno, Brazil
- IDB Small Projects Program, no sovereign guarantee (1978)
- The growth of these early microfinance institutions was funded largely by grants and soft loans from donors
- The focus in these early years was on providing working capital to urban microenterprises
- Today microfinance is increasingly provided by deposit-taking institutions which work under some type of financial supervision.
- Nonetheless, the industry has not developed uniformly across the region. Institutions, regulation and the overall business environment varies greatly.

Market development

The microfinance market grew rapidly from 2001 to 2009. While growth has slowed, it remains positive.



Source: Pedroza, P. (2010). “Microfinanzas en América Latina y el Caribe: El sector en cifras”

Microfinance portfolio and clients by country

País	Número de instituciones	Cartera microcrédito (US$) 2009	Número de clientes de microcrédito 2009	Crédito promedio (US$)
Argentina	10	20.910.780	29.139	718
Bolivia	23	1.169.804.753	815.090	1.435
Brasil	158	745.285.427	995.835	748
Chile	6	913.784.759	236.143	3.870
Colombia	39	1.393.056.370	1.384.623	1.006
Costa Rica	16	607.152.135	93.955	6.462
Ecuador	92	1.704.075.216	966.917	1.762
El Salvador	90	289.173.876	294.834	981
Guatemala	36	361.579.221	359.021	1.007
Guyana	1	3.787.200	2.862	1.323
Haití	4	41.172.174	59.961	687
Honduras	25	126.002.890	166.208	758
Jamaica	5	10.501.541	24.739	425
México	33	763.238.547	2.326.072	328
Nicaragua	25	232.262.414	351.037	662
Panamá	10	114.549.285	25.740	4.450
Paraguay	8	294.517.671	153.793	1.915
Perú	59	3.217.881.231	1.866.098	1.724
República Dominicana	14	213.309.995	273.429	780
Uruguay	30	12.170.073	9.368	1.299
Venezuela	1	95.596.643	36.105	2.648
Total	**685**	**12.329.812.201**	**10.470.969**	**1.178**

Four Andean countries (Bolivia, Colombia, Ecuador and Peru) have 60% of the microcredit portfolio and about 50% of customers in the region.

Microfinance and financial deepening

- **Diversity:** Countries such as Nicaragua, Bolivia, El Salvador and Ecuador show higher microfinance penetration levels estimated at 30 percent, while countries such as Venezuela, Argentina, Uruguay and Brazil, have levels lower than five percent
- **Non correlation:** Growth of the microfinance sector is not directly related with better financial deepening. On the other hand, having deep financial systems (total credit / GDP), does not guarantee a developed microfinance industry, such is the case of Chile and Panama

País	Población estimada 2009 (1)	Fecha encuesta de hogares	Número de personas-Categoría Ocupacional: Patrón y cuenta propia (2)	Número de clientes de microcrédito 2009	Penetración microfinanzas % 2009 (3)	Crédito total/ Producto Interno Bruto % 2008
Argentina	40,278,906	2009	5,056,318,00	29,139	0,6	23,5
Bolivia	9.861.078	2007	1.753.101.87	815.090	46,5	43,1
Brasil	193.553.528	2008	20.107.241.52	995.835	5,0	45,0
Chile	16.967.265	2009	1.536.166	236.143	15,4	71,2
Colombia	45.650.006	2009	8.647.006	1.384.623	16,0	34,8
Costa Rica	4.577.534	2009	530.108	93.955	17,7	43,8
Ecuador	13.632.429	2009	2.987.898	966.917	32,4	28,4
El Salvador	6.167.017	2008	801.761	294.834	36,8	42,8
Guatemala	14.043.452	2006	1.869.577	359.021	19,2	33,1
Honduras	7.471.005	2009	1.316.537	166.208	12,6	n.d.
México	109.582.052	2008	10.302.895	2.326.072	22,6	27,6
Nicaragua	5.748.855	2005	736.325	351.037	47,7	35,8
Panamá	3.453.105	2008	350.193	25.740	7,4	89,6
Paraguay	6.348.613	2008	1.130.442	153.793	13,6	n.d.
Perú	29.164.081	2009	6.479.406	1.866.098	28,8	n.d.
República Dominicana	10.087.074	2009	1.641.260	273.429	16,7	19,7
Uruguay	3.590.084	2009	410.539	9.368	2,3	26,5
Venezuela	28.580.055	2007	7.732.004	36.105	0,5	23,4
Total	**548.756.140**		**73.388.778**	**10.383.407**		

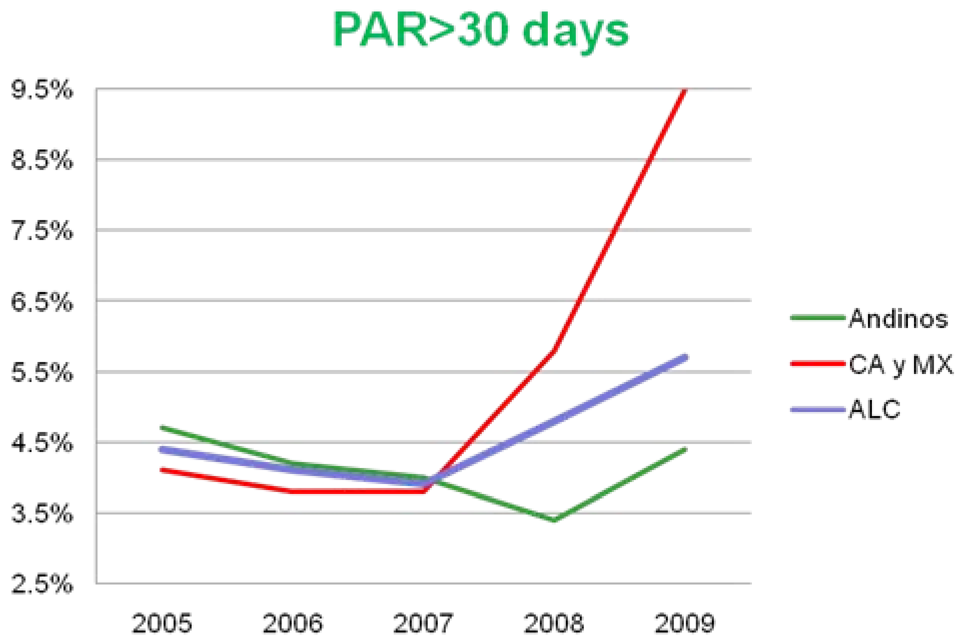
Microfinance performance

Portfolio-at-Risk

- Increased default rates starting in 2008.
  Not the typical ~ 4% default rate anymore

- In 2009, PAR> 30 days
  CA and Mexico 9.5%
  Andean countries 4.4%

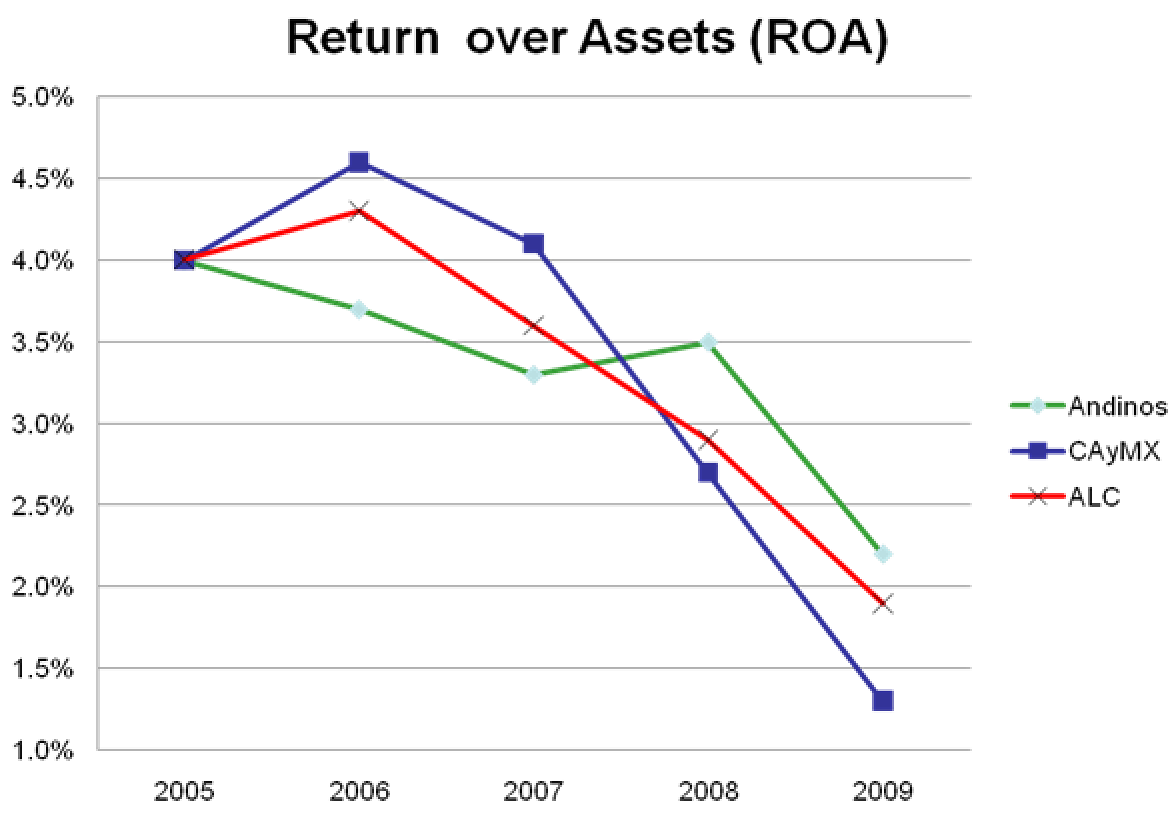
  Regional Average ~ 5.5%



Source : The Mix, August 2010. (428 MFIs)

Microfinance performance

Profitability



Source : The Mix, August 2010 (428 MFIs)

Microfinance performance

Interest rates

Nominal financial revenues/Average loan portfolio (as a proxy for interest rates)[1]
(Selected countries circa 2009[2])

Country	Microfinance ratio (a)	Bank ratio (b)	Microfinance premium (a)-(b)
Argentina	60.8	18.6	42.3
Bolivia	20.2	14.9	5.3
Brazil	23.7	15.6	8.1
Chile	32.1	6.4	25.7
Colombia	30.7	12.4	18.3
Dominican Republic	33.1	19.0	14.1
Ecuador	20.4	12.8	7.6
El Salvador	22.9	11.1	11.8
Guatemala	25.3	17.3	8.0
Haiti	51.3	n.a.	n.a.
Honduras	32.2	18.9	13.3
Mexico	74.2	21.0	53.2
Nicaragua	25.9	18.8	7.1
Panama	31.1	8.5	22.6
Paraguay	25.6	16.8	8.8
Peru	29.1	15.1	14.0
Uruguay	41.1	16.8	24.3
Venezuela	24.4	19.6	4.8
Regional weighted average[3]	**28.6**		

Sources: MFI data were collected from MIX Market, microfinance networks, regulators, interviews and data questionnaires, and web sites. Data for MFIs include both regulated and non-regulated institutions.

Bank data includes 375 banks. Data were collected from banking associations affiliated with the Latin American Banking Federation (FELABAN), the FELABAN Financial Bulletin, the central bank of Argentina, Paraguay and Uruguay, the Superintendency of Banks of the Dominican Republic and the Superintendency of Banks of Panama.

(1) Ratios are weighted by total loan portfolio.

(2) Data are for December 2009. Where 2009 data were not available, December 2008 data have been used.

(3) This calculation includes all available data from MFIs whose microcredit portfolio represents more than 30% of their total loan portfolio (349 institutions).

Additional information and data updates can be found at www.iadb.org/micamericas.

Microfinance performance

Interest rates

Regional microfinance average 28,6%

Extremes

	Microfinance	Banks	Premium
Bolivia	20.2%	14.9%	5.3%
Mexico	74.2%	21.0%	53.2%

Microfinance and the global financial crisis

Change in vocabulary

Before	After
Public/multilaterals crowding out private sector	Public-private partnerships
Counter-cyclical	Not independent of macroeconomic events
Portfolio growth rate of 30-40%	~13%-15% in 2009, higher thereafter
Arrears: under control	Arrears: increasing with some restructuring required
Savings mobilization: optional	Savings mobilization: highly desirable (~40% of total funding)
Regulated institution: optional	Regulated institution: increasingly necessary
Funding: size	Funding: size, stability and diverse
Portfolio: Growth	Portfolio: Sustainable growth and appropriateness of products
"I know my institution strengthens and weaknesses"	"I should take a second look to my institution strengthens and weaknesses" Renewed focus on building management capacity, increasing cost efficiency, improving credit methodology, improving corporate governance.

Microfinance and failed experiences

- One recipe does not work for every institution
- Macroeconomic crisis does not necessarily cause bankruptcy
- Factors such as asset composition and integrated risk management strongly the affect asset quality of microfinance institutions
- Abundant and easy access to funding may have negative implications
- Absent shareholders/Investors affect negatively institutions (e.g weak accountability standards)
- **Bad governance, regulation, and exposure to political risks are some of the top factors that affect the industry**

** Taking the good from the bad in Microfinance: Lessons learned from failed experiences in Latin America, 2010*

Microfinance and failed experiences

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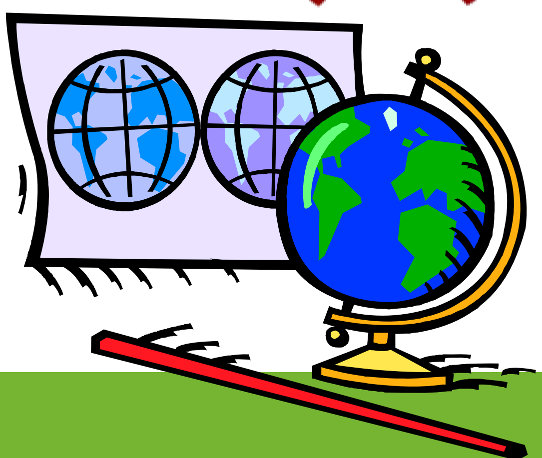
Key constraint in microfinance: Building robust institutions

** Taking the good from the bad in Microfinance: Lessons learned from failed experiences in Latin America, 2010*

Microfinance diversity

Microcredit maybe close to a commodity, microfinance institutions and countries are not.



II. Microscope on Business Environment

Microscope tool

The Microscope is a tool that measures the "external" conditions to develop microfinance:

- Regulatory framework
- Investment climate
- Institutional development

Commissioned to the Economist Intelligence Unit (EIU) by FOMIN, CAF and the IFC (through the Netherlands Technical Assistance Trust Fund)

2007 and 2008 versions included only LAC countries
In 2009, it went global. In 2010 it included the comparative analysis of 54 countries (21-LAC)

Microscope tool

Regulatory Framework (40%)

- Regulation of microcredit operations
- Formation and operation of regulated/supervised MFIs
- Formation and operation of non-regulated/supervised MFIs
- Regulatory and examination capacity

Investment Climate (20%)

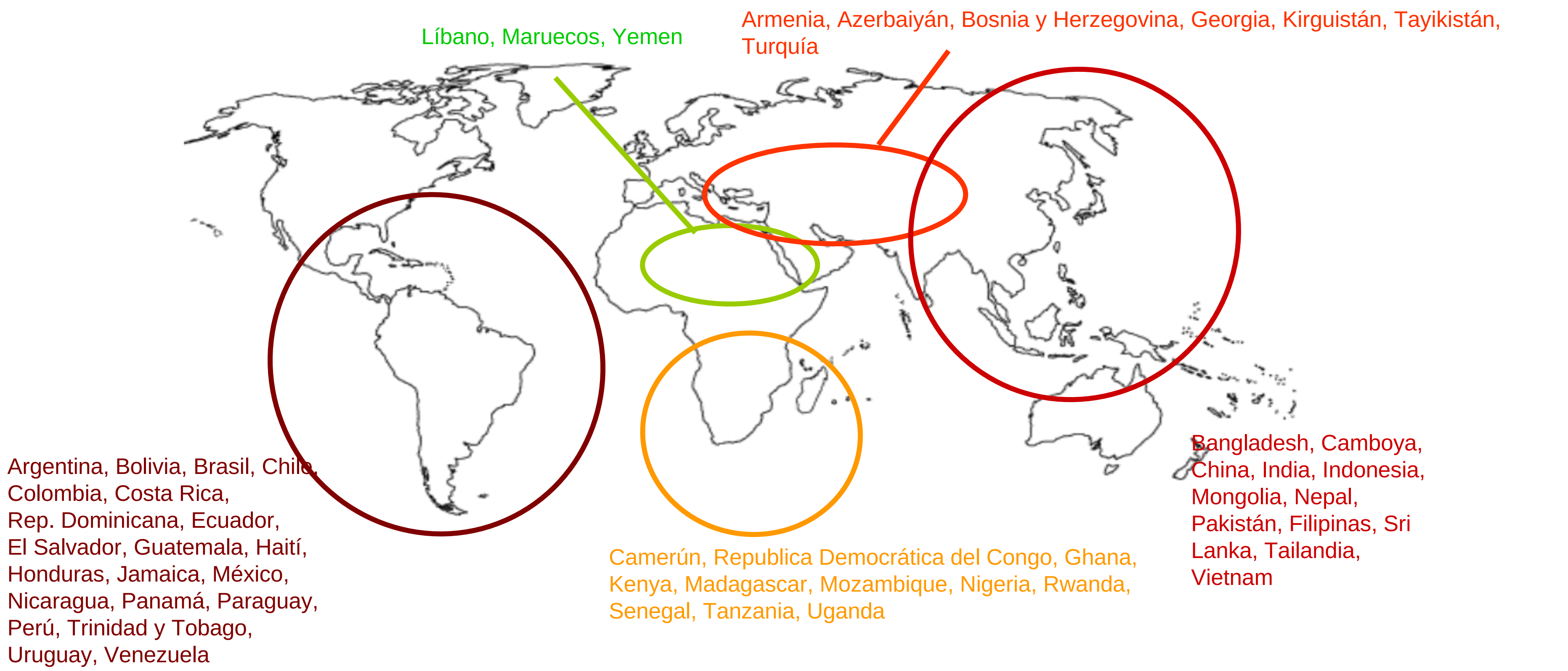
- Political stability
- Capital market development
- Judicial system
- Accounting standards
- Governance standards
- MFI transparency

Institutional Development (40%)

- Range of MFI services
- Credit Bureaus
- Competition

Interviews + Online survey + Available public info. → **Analysis and normalization** → **“Microscope” Index**

Microscope outreach - 2010



Microscope country results - 2010

Rank	Country	Score	Score change since 2009
1	Peru	74.3	+0.5
2	Philippines	71.8	+3.3
3	Bolivia	69.6	-2.2
4	Ghana	64.9	+4.0
5	Pakistan	64.8	+8.3
=6	Ecuador	61.3	+1.7
=6	El Salvador	61.3	+3.8
8	India	59.1	-3.0
9	Colombia	56.8	-1.8
10	Kenya	55.0	-0.8
11	Uganda	53.9	-3.6
12	Kyrgyz Republic	53.0	-3.2
13	Nicaragua	52.3	-6.3
14	Chile	52.0	+4.0
15	Paraguay	52.0	+2.5
16	Cambodia	51.0	-3.2
17	Panama	50.8	-
18	Honduras	49.8	+0.5
19	Guatemala	49.5	-2.3
20	Dominican Republic	48.7	+1.7
21	Georgia	48.7	+3.7
22	Armenia	47.6	+3.7
23	Mexico	47.3	-
24	Tanzania	46.2	-2.2
25	Tajikistan	45.7	+5.3
26	Brazil	45.0	+1.0
27	Yemen	44.4	+2.3
28	Nigeria	44.2	+4.8
=29	Costa Rica	42.4	-
=29	Rwanda	42.4	+3.9
31	Madagascar	41.3	+9.0
32	Bosnia	40.4	-2.7
33	Bangladesh	39.5	-3.2
34	Mozambique	38.6	-1.7
35	Nepal	38.1	+8.1
36	Cameroon	37.3	+5.7
37	Argentina	36.7	+5.8
=38	Azerbaijan	35.9	+7.0
=38	China	35.9	+1.8
40	Haiti	35.7	+2.3
41	Indonesia	35.3	+0.2
42	Sri Lanka	34.2	-6.2
43	Senegal	32.5	-0.1
44	Mongolia	30.4	+0.4
45	Morocco	30.3	-
46	Uruguay	29.8	+1.5
47	Democratic Republic of Congo	27.8	-9.1
48	Turkey	27.4	-2.8
49	Lebanon	26.3	-3.0
50	Thailand	24.6	+3.3
51	Jamaica	23.3	-0.3
52	Vietnam	22.7	+1.2
53	Trinidad and Tobago	21.9	-1.0
54	Venezuela	21.6	-2.5

Microscope LAC results - 2010

	Overall score Country	2010 Score	YoY change
1	Peru	74.3	+0.5
2	Bolivia	69.6	-2.2
=3	Ecuador	61.3	+1.7
=3	El Salvador	61.3	+3.8
5	Colombia	56.8	-1.8
6	Nicaragua	52.3	-6.3
7	Chile	52.0	+4.0
8	Paraguay	52.0	+2.5
9	Panama	50.8	-
10	Honduras	49.8	+0.5
11	Guatemala	49.5	-2.3
12	Dominican Republic	48.7	+1.7
13	Mexico	47.3	-
14	Brazil	45.0	+1.0
15	Costa Rica	42.4	-
16	Argentina	36.7	+5.8
17	Haiti	35.7	+2.3
18	Uruguay	29.8	+1.5
19	Jamaica	23.3	-0.3
20	Trinidad and Tobago	21.9	-1.0
21	Venezuela	21.6	-2.5

There is a variety of market profiles in the region, a trend that is evident among the three category scores of the Microscope Index.

The top five countries of the region are among the ten best countries in the 2010 Global Microscope Report (54 countries).

	Regulatory Framework Country	2010 Score	YoY change
1	SUB-SAHARAN AFRICA	61.9	+0.6
2	ALL COUNTRIES	52.0	-0.2
3	EASTERN EUROPE/CENTRAL	51.8	-0.9
4	SOUTH ASIA	51.3	+2.5
5	ALL ASIA	50.5	+1
6	EAST ASIA	50.0	-
7	LATIN AMERICA/CARIBBEAN	48.2	-1.5
8	MIDDLE EAST/NORTH AFRIC	47.9	+2.1

	Investment Climate Country	2010 Score	YoY change
1	EASTERN EUROPE/CENTRA	50.4	+2.5
2	LATIN AMERICA/CARIBBEAI	47.8	+1.1
3	ALL COUNTRIES	45.2	+1.7
4	MIDDLE EAST/NORTH AFRI	44.8	+0.3
5	SOUTH ASIA	43.2	+2.4
6	ALL ASIA	42.3	+2.6
7	EAST ASIA	41.7	+2.7
8	SUB-SAHARAN AFRICA	40.1	+1.9

	Institutional Development Country	2010 Score	YoY change
1	SOUTH ASIA	45.0	-1.7
2	LATIN AMERICA/CARIBBEAN	44.8	+2
3	ALL COUNTRIES	35.3	+1.2
4	ALL ASIA	34.0	-
5	EASTERN EUROPE/CENTRAL ASIA	29.8	+3.6
6	SUB-SAHARAN AFRICA	28.0	+0.8
7	EAST ASIA	26.2	+1.2
8	MIDDLE EAST/NORTH AFRICA	13.9	-2.8

Source: Economic Intelligence Unit (2010). “Global microscope on the microfinance business environment”

Microscope country details – 2010

a. In the report:

Key characteristics
<u>and</u>
changes from last year

Nicaragua

Key characteristics of the microfinance business environment:

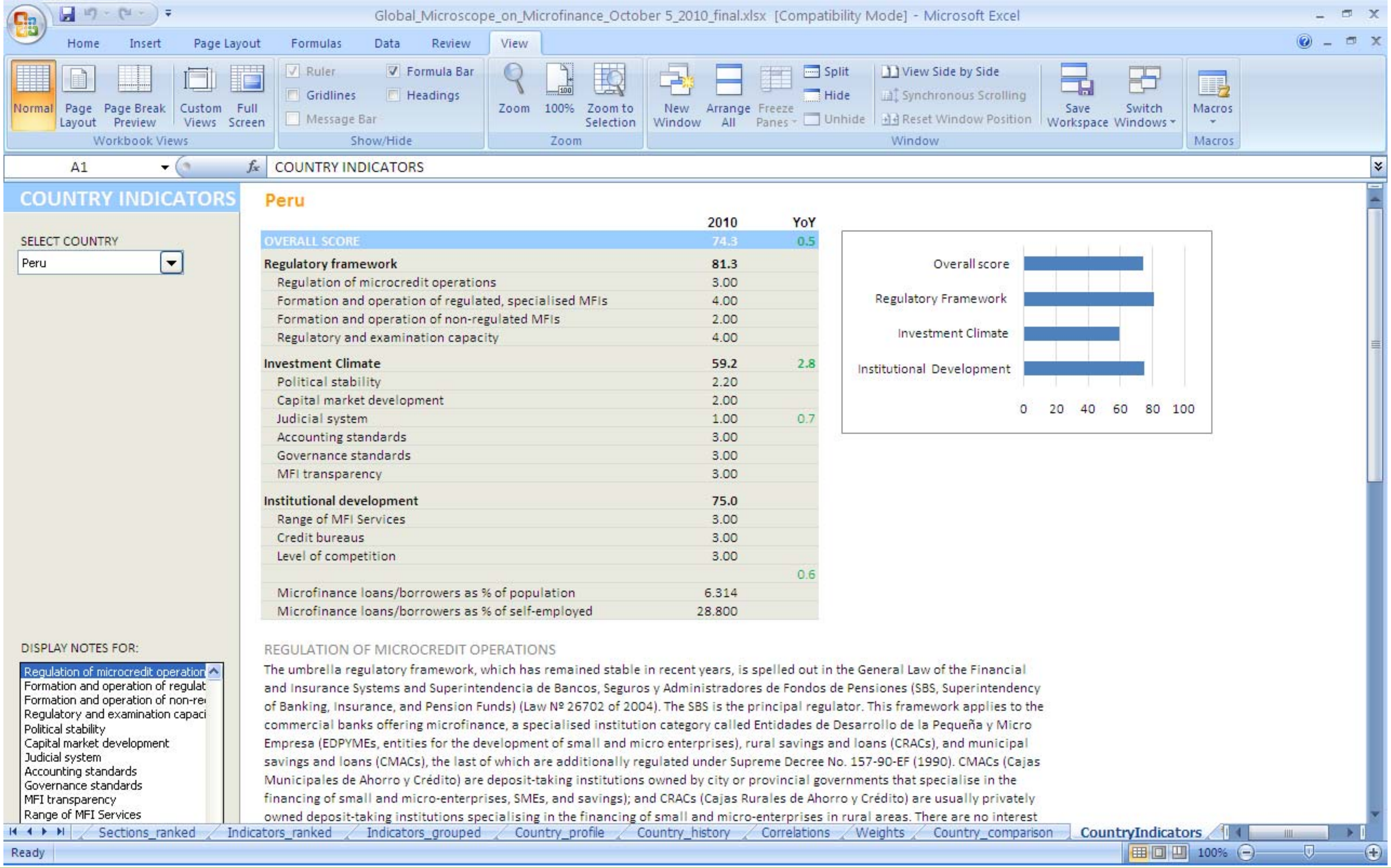
- Microfinance institutions have expanded rapidly in Nicaragua in recent years. The lack of interest from the main banks in financing small producers has created a large, unmet demand for rural credit facilities.
- The absence of an adequate legal framework for microfinance continues to make it difficult for the industry to flourish, as most institutions remain unregulated.
- A powerful debtors' movement called the Movimiento No Pago (the Non-Payment Movement) has garnered strong political support in the executive branch and in the legislature, re-shaping both public policy and the attitudes of borrowers in ways that undermine microfinance. A resulting debt moratorium will now drastically reduce the extension of credit to new clients as microfinance institutions see their portfolio risk rise and their funding (which is mainly external) suspended or withheld.
- The microfinance sector is competitive but highly fragmented, with a limited range of available services. Transparency and accounting standards are reasonably good, but governance standards are poor.

Key changes and impacts since last year:

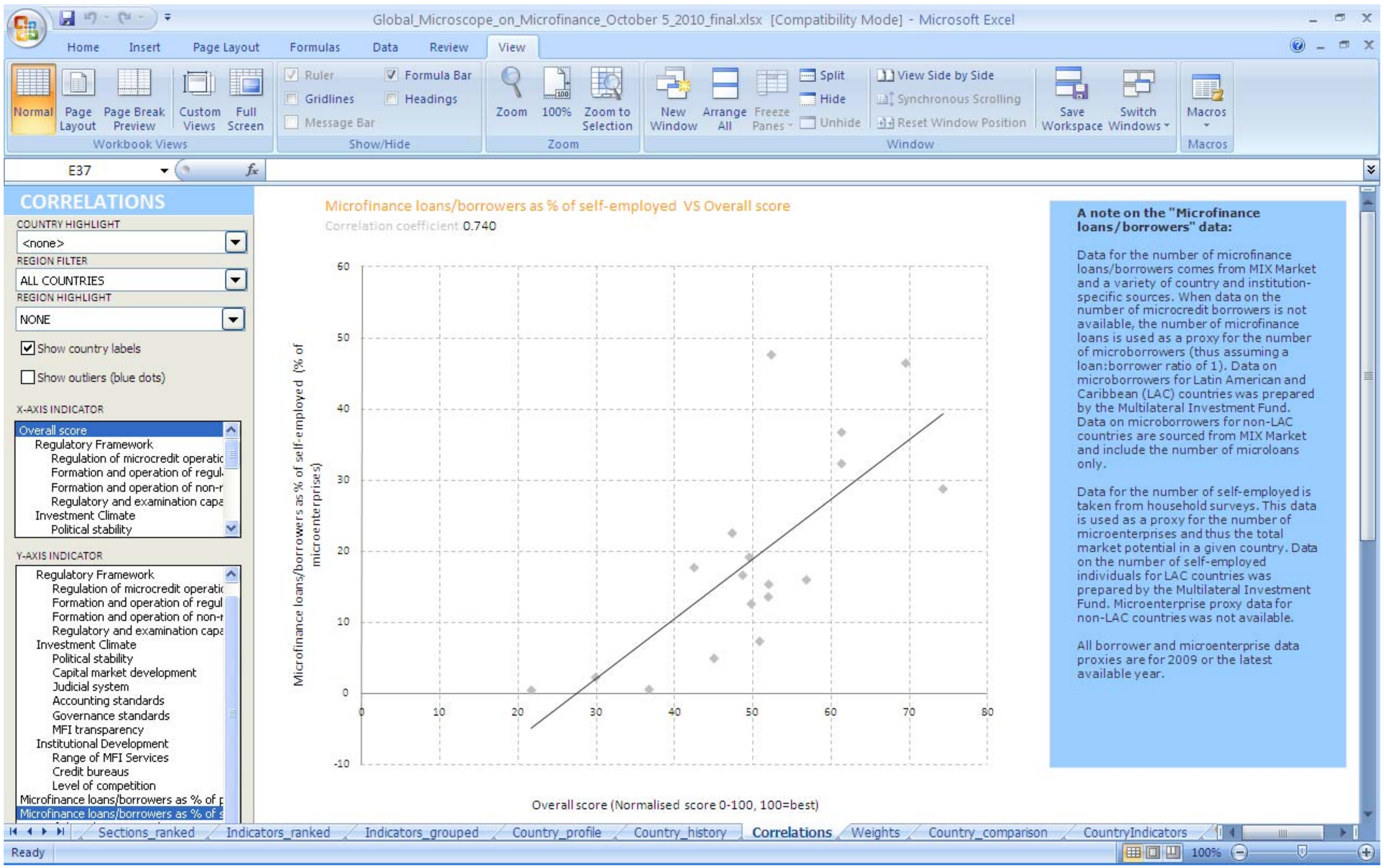
- The new moratorium law for microfinance debtors further threatens an already reeling microfinance sector—particularly its non-regulated non-governmental organisation (NGO) segment—given artificially low caps on restructuring agreements. The moratorium also creates a moral-hazard effect on the larger borrowing community.
- Hopes for revisions in the existing microfinance law have been dashed in the wake of economic crisis and the debtors' movement. Also dashed are the hopes of NGOs that they would obtain a clear path to becoming regulated financial institutions capable of capturing deposits.
- NGOs are particularly affected by the decline in international funding that began in 2009 and continues in 2010, owing to the debt moratorium. Between US$60m and US$90m of international funding lines were not renewed last year, and another US$70m was at risk as of June 2010.
- Serious governance problems have come to light in some non-regulated microfinance institutions, and the sector in general has suffered under the weight of mounting arrears and defaults.
- Along with other micro-finance lenders, a commercial bank specialising in micro-lending, Banco del Exito (Banex), has been undermined by a combination of the global economic downturn and the impact of the Movimiento No Pago. In late May the institution announced that a group of international creditors had agreed to accept shares in the bank in lieu of repayment of outstanding loans, as Banex owed a total of US$85m to 28 different creditors in March. The proportion of its loans that had fallen into arrears reached 25% of its total portfolio.

Microscope country details – 2010

b. In an attached excel file



Microscope correlation– 2010



III. Principles for Effective Microfinance Regulation and Supervision

The Guidelines and its inception

-In early 2008, a Working Group was created by the Association of Bank Supervisors of the Americas (ASBA) to provide guidelines for its members

- The Working Group (**Bolivia, Brazil ,Colombia, Peru, El Salvador, Mexico, USA -FDIC)** met regularly with FOMIN support

- The Working Group discussion was supplemented by a survey sent to all regulators in the region in addition to a survey to more than 150 microfinance stakeholders

- The results were summarized in a "guidelines" (December 2010) document

-The aim was to provide regulators with a practical guide to set effective norms and regulations. It also considers microfinance institutions that do not work under financial supervision

- Draws on the experience of the most successful microfinance markets in LAC

The Guidelines

- The guidelines has three major sections:

1. Preconditions for effective regulation and supervision
2. Regulation and supervision of microfinance institutions
3. Regulation and supervision of microcredit operations

Assumption: Only the “financial” part of microfinance can and should be supervised by the financial supervisor.

The Guidelines – some preconditions

- Freedom to set prices (or any type of mandatory limit or quota)
- Clarity on regulatory status
- Unified accounting systems for supervised and non- supervised financial institutions
- Aim to comprehensive credit bureaus. Avoid specialized systems
- Product and price transparency
- Consumer protection and information for all users of financial services (not only for those clients of supervised financial institutions)
- Mechanisms for rapid resolution of minor disputes

The Guidelines – regulation

- While deposit taking is the "moving" regulatory force, the supervisor should always monitor the risks outside the system (eg. Ponzi schemes).

- Normal "fit and proper" (no less strict) conditions apply to licensing microfinance institutions. However, special attention should be paid to: "sweat capital", donors' contribution and initial intent, portfolio value and potential of conflict of interests.

- Public information is crucial. Suggested public metrics include:

  Portfolio-at-Risk
  Loan losses
  Effective interest rates

The Guidelines – regulation

- Clear microcredit definition (some elements):

  a small loan amount

  paid mainly with proceeds of a micro/small business but cash-flow analysis include all sources of income/expenses of the typical "household-enterprise"

  granted with specialized high-touch (personal contact) credit methodology

- An ideal "portfolio" breakdown is: microcredit, consumption, commercial/corporate and mortgage/housing lending

The Guidelines – regulation

- Microcredit methodology (some inherent elements) :

  Credit applicant with his/her ownn business

  No exclusion solely based on lack of formal documentation

  There maybe no collectable collateral

  Consultation with credit bureau

  Cash flow analysis and balance prepared by loan officer

The Guidelines – regulation

- Microcredit portfolio-when to allow it?

  Proven market need

  Clearly established credit methodology

  Adequate personnel

  Technological infrastructure for close monitoring of clients and loan officers

- Loan losses reserves requirements (generic and specific) should take elements such as

  Number of days past due (one day means past due)

  Number of times of rescheduled loans

“ A microcredit stops generating income the first day the loan becomes past due”

The Guidelines – supervision

- Specialized knowledge within the supervisory authority

- Processes to monitor/prevent over-indebtedness

- Sound off-site and on site procedures for microcredit portfolio supervision . Key example:

  Supervisor uses portfolio sampling procedures and visits clients

LESSONS

- **Regulation follows financial innovation (not the other way around).** The microcredit experience (over 30 years) is the most clear example.

- **Go local.** Peer-to-peer learning can have the greatest impact.

-**Regulators are not policy makers.** Regulation and supervision must ensure that sound practices (and institutions) are in place. Not more, not less.

FOMIN

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