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MICROFINANCE REGULATION: LESSONS FROM BOLIVIA, PERU AND THE PHILIPPINES

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TABLE OF CONTENTS

01.
Introduction 4

02.
Regulation and Supervision
a. Prudential Regulation 5
b. Non-Prudential Regulation 5
c. Defining Microfinance 7
d. Risk-Based Supervision 7

03.
Country summaries
a. Peru 10
b. Bolivia 12
c. Philippines 15

04.
Conclusion 18

References 23

01.

INTRODUCTION

The purpose of this paper is to discuss the regulation and supervision of institutions involved in microfinance to understand better what "best practices" might be in this respect by examining in depth some "good practices" in three countries. All three of these countries have been receiving the highest rankings from the Microscope[01] for the environments that they provide in support of microfinance – and for their regulatory frameworks and practices in particular. Two of the three countries are from Latin America, Bolivia and Peru, and the third, the Philippines, is Asian, but with Spanish traditions similar to Latin America. The first section of the paper defines what is meant by prudential regulation and the respects in which it differs from non-prudential regulation. Following that, microfinance is defined, differentiating "micro" carefully from small and medium enterprise finance with which it is often inappropriately grouped. Then the discussion turns to regulation and supervision, defining risk-based supervision in particular, which has become the norm worldwide in recent years for approaching prudential regulation and supervision of all types of financial institutions, but especially those that take deposits from the public or whose size and operations can pose systemic risks for the rest of the financial sector.

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01 The Microscope is a publication of the Economist Intelligence Unit in collaboration and funding from the Multilateral Investment Fund (MIF), a member of the Inter-American Development Bank Group; CAF—development bank of Latin America; and the Netherlands Ministry of Foreign Affairs through grant funding at International Finance Corporation (IFC). Available at www.fomin.org.

02.

REGULATION AND SUPERVISION

a. Prudential Regulation

To begin it is important to understand the difference between prudential and non-prudential regulation and to appreciate the overriding importance of prudential regulation while not neglecting non-prudential regulation. To differentiate, the standard approach is to see prudential regulation as dealing with the systemic risks that a financial institution can pose if its failure can easily lead to the failure of other financial institutions. The most obvious case, and what largely determines the focus of prudential regulation, is institutions that take deposits from the general public, as the failure of a deposit-taking institution can spread dramatically to otherwise sound institutions if depositors' fears based on the initial failure engender "runs," with depositors rushing everywhere to turn their deposits into cash. Prudential regulation is also seen as protecting depositors who are generally believed to be poorly informed about the potential risks that a deposit-taking institution may face.[02]

b. Non-Prudential Regulation

Non-prudential regulation basically plays a complementary role, dealing mainly with transparency and consumer protection (e.g., standards for accounting and external audits, clear definitions of effective interest rates, rules and mechanisms for dispute resolution, etc).[03] One important element of transparency is the implementation of recogni-

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02 Prudential regulation is often combined with deposit insurance to protect these unwary depositors and inhibit runs, but deposit insurance without effective prudential regulation can be a "recipe for disaster," as no one will be monitoring the risks of deposit-taking institutions.

03 Anti Money Laundering (AML) and Know Your Client (KYC) might also be considered among non-prudential regulations.

zed accounting standards, the use of qualified external auditors with clear mandates to produce appropriately audited financial statements, and the appropriate availability of financial statements, especially audited ones. Non-deposit-taking entities require sources other than depositors to supply their funding (e.g., government agencies, donor entities and private investors), and these potential funders need to require such transparency. In order to make rational funding decisions.

With respect to the other elements of non-prudential regulation, those dealing primarily with consumer protection (e.g., clear and consistent definitions of effective interest rates and mechanisms for dispute resolution that are reasonably rapid and low cost), most regulatory agencies have clear rules about the need to have unambiguous definitions of effective interest rates (e.g., that include fees and indicate clearly whether interest is charged against the initial balance of the loan or the declining balance). Notwithstanding the apparent importance of transparent interest rates for borrower decisions, many lenders report that borrowers have little or no concern with effective interest rates and instead focus their attention on the *amount of interest to be paid*. In fact, this may be the relevant decision variable for many borrowers as they are primarily concerned about the total cost of a loan, including the transaction costs involved in obtaining and repaying a loan, as well as interest.[04] A resulting lack of borrower attention to effective interest rates may make efforts focused on interest rate transparency less useful than generally supposed.

Dispute resolution can be even more challenging, with countries taking highly diverse approaches to dispute resolution. Furthermore, different entities and types of entities even within the same country often take very different approaches to dispute resolution, so that there are few clear patterns with respect to mechanisms for dispute resolution and their effectiveness.[05] Furthermore, these differences are not due simply to the different types of institutions involved or the different procedures used, but more importantly to the costs incurred and delays encountered.

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04 In the 1970s and 1980s small farmers were often called stupid for their focus on amounts of interest to be paid rather than effective interest rates, but in that era of heavily subsidized interest rates for agricultural credit the amount of interest to be paid needed to be compared with the transaction costs that would be incurred, especially in obtaining the loan.

05 An exception is the case of credit unions where a committee of credit union members (e.g., the vigilance or audit committee) is an explicit part of credit union structure to deal with disputes, as well as various other issues.

c. Defining Microfinance

It is essential to point out a few key characteristics of microfinance that are sometimes overlooked and can be especially important in order to understand some of the challenges facing regulators. Although the term "microfinance" comes from a longer phrase, "microenterprise finance," it is in fact *not* enterprise finance in the way that small and medium enterprise finance is where funding is obtained to facilitate some aspect of the enterprise. Economists (and likewise entrepreneurs themselves) often speak of the key motive of profit maximization, but for the micro-entrepreneur the guiding principle is not profit maximization but rather risk minimization. Furthermore, risk minimization implies diversification, which further implies that the micro household will have a number of different sources of cash inflows to survive, which in turn makes it essential for the potential lender to understand the overall cash flows of the micro household.

Indeed, lenders typically complain of the time and effort that they must spend with the micro household in creating a detailed picture of all the cash flows in order to know how much they can lend and how to structure the loan (e.g., its repayment schedule). In any case, visiting the potential borrower provides an opportunity to form a judgment of borrower "character," which is the other key element in micro lending decisions since the costs of formalizing collateral are prohibitive given the small size of a micro loan.[06] Furthermore, these costs facing the lender imply that, even with seemingly very high interest rates, the initial micro loan will almost certainly be unprofitable, so that borrower retention rates become virtually as important as loan repayment rates in determining ultimate profitability (cf., relationship banking principles).

d. Risk-Based Supervision

Given the obviously overriding importance of focusing on risk for effective prudential regulation, it is somewhat surprising that risk-based supervision did not come to the fore earlier, but it is now clearly the accepted basis for implementing prudential regulation. Perhaps the earliest paper discussing risk-based supervision for developing countries (published in 2000), although not directed specifically toward microfinance,

06 In comparison, the costs facing a lender that is analyzing the essential aspects of a small or medium enterprise itself are much greater and far more important given the far less diversified nature of a small or medium entrepreneur.

provides a useful summary of the key elements of the risk-based approach as well as tracing its development, comparing it with traditional approaches to supervision, and noting its adoption as underlying Basel's Core Principles.[07]

An overriding theme of risk-based supervision is that the primary role of the supervisory agency is not itself to try to control risks directly but rather to assess the capacity of regulated entities to manage their risks. To do this, the four basic components of an entity's risk management system are assessed: identification of risks; measurement of risks; control of risks; and monitoring of changes in risks and controls. In traditional banking, six risks are seen to account for the vast majority of losses: credit risk, operational risk, liquidity risk, market risk, interest rate risk and foreign exchange risk. However, for most microfinance institutions, the last three risks may be relatively unimportant, while reputational risk, which is not among those listed above, may be quite important.[08]

About the same time as the paper referenced above was published, case studies were carried out in three developing countries (Bolivia, Peru and the Philippines, among the pioneers in microfinance) on an appropriate application of risk-based supervision specifically to microfinance.[09] With the growing interest in microfinance and in best practice risk-based approaches to its regulation and supervision, these early cases studies have been largely superseded by recent publications sponsored by leading international agencies: Association of Supervisors of Banks of the Americas, "Guidelines of Principles for Effective Regulation and Supervision of Microfinance Operations," 2010; Consultative Group for the Poorest (CGAP), "Microfinance Consensus Guidelines: A Guide to Regulation and Supervision of Microfinance," April 2011; and World Council of Credit Unions (WOCCU), "Model Regulations for Credit Unions," February 2008. Coincidentally, based on current rankings in the Microscope, these same three countries are to be examined in depth as leading examples of success in providing a supportive regulatory environment for microfinance.

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07 Thomas Fitzgerald and Robert Vogel, "Moving Towards Risk-Based Supervision in Developing Economies," Harvard Institute for International Development, CAER Discussion Paper No. 66, May 2000. The adoption of risk-based supervision by Basel may be somewhat of a "mixed blessing," as regulators worldwide are now pressured to claim to apply risk-based supervision whether or not what is required for its implementation is fully understood.

08 The importance of credit risk and operational risk should be immediately clear and in any case will become apparent in the subsequent discussion. Liquidity risk comes from the importance of borrower retention rates, which requires a micro lender's ability to provide follow-on loans immediately, while reputation risk likewise involves borrowers' perceptions of the future performance of the micro lender.

09 Arelis Gomez, German Tabares and Robert Vogel, "Microfinance, Bank Regulation and Supervision: The Bolivian Case Study," US Agency for International Development, August 2000; Arelis Gomez, Thomas Fitzgerald and Robert Vogel, "Regulation and Supervision of Microfinance Activities: The Philippine Case Study," US Agency for International Development, November 2000; and Thomas Fitzgerald and Robert Vogel, "Proposed Framework for the Regulation and Supervision of Microfinance Institutions in Peru," Inter-American Development Bank, December 2001.

For the five variables pertaining directly to regulation in the Microscope for 2012, out of a maximum score of four, Peru had two scores of four, two scores of three and one score of two, and, among the five two had improved from the prior year. Bolivia had four scores of three and one score of two, and, among the five, one had improved from the prior year. The Philippines had one score of four and four scores of three, and, among the five one had improved from the prior year.

03.

COUNTRY SUMMARIES

a. Peru.[10]

When Peruvian regulators began to take formal notice of microfinance in 1997, a micro loan was defined according to the assets and sales of the entity being financed. However, because of practical difficulties in assuring the accuracy of such figures, this was soon changed to the amount borrowed, up to US$30,000, with the risk profile also taken into account in supervision. Later, the upper limit for micro loans was reduced to US$7,000 with loans below that amount not requiring formal collateral, and with collateral defined flexibly for larger amounts. Furthermore, microfinance is defined by the activity itself and not by the type of institution, and with regulation therefore according to the activity and not to the institution. Nonetheless, the supervisory process takes differences among institutional types into account, but always with the main focus on risk, with added capital required for added risks. What is especially important for effective regulation and supervision is an understanding of how the risk profile is analyzed, as this is an element that has allowed the development of microfinance in Peru. In particular, the assessment of borrower risk takes into account an evaluation of two essential aspects: the capacity for repayment, that is, a careful evaluation of the borrower's cash flow; and the willingness to repay, which differentiates between new clients, for whom a detailed understanding of the key characteristics of the client are required, and those with prior experience with credit, for whom it is the experience with the lender together with the historical information to be found in the credit bureau.[11] For the organization of Superintendency staff, the basic division is between those supervising banks and those supervising entities substantially involved in microfinance. Cooperatives in-

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10 Basic data: population - 29.6 mllion (July 2012 est.); GDP - US$173.5 billion (2011 est.); GDP per capita - aprox. US$5,900. For a detailed discussion of microfinance in Peru focusing on its development, including the support provided by the regulatory environment for this development, see Lucy Conger, Patricia Inga and Richard Webb, "The Mustard Tree: A History of Microfinance in Peru", Universidad de San Martin de Porress, 2009. See also Greta Bull and Felipe Portocarrero, "Success Stories in Microfinance: Peru," presented at the FOROMIC in 2009, with an up-dated version in the IFC Ask FM library.

11 Until 2001 only loans above US$5000 had to be reported to the credit bureau, but since then all loans must be reported – even if only a single Sol.

volved in finance fall under the regulation of the Superintendency but are in fact supervised by the Federation of Cooperatives, but with oversight and technical assistance provided by the Superintendency and members of its staff. (Multi-purpose cooperatives are not allowed to be involved in finance.)

According to the Microfinance Information Exchange (MIX), which is the standard worldwide for international data comparisons of microfinance, Peru is clearly among the leaders in Latin America (as it is for its regulatory environment for microfinance as indicated below by the Microscope). According to the MIX, as of the end of 2011 Peru had US$8.8 billion in micro loans outstanding to 3.6 million active micro borrowers, more than 10 percent of its population, with an average loan size of US$2,500, less than half of its per capita GDP. It is also important to note that Peru's microfinance industry is largely self-funded through deposits, with $6.6 billion in deposits from 3.5 million depositors, almost as many as borrowers. Furthermore, among entities rated as transparent in their reporting to MIX, Peru has 19 with more than US$100 million in loans outstanding, the majority of which have more than 100,000 active borrowers. In addition, an important indicator of Peru's flexible regulatory framework for microfinance, noted further below, is the variety of these large institutions: one commercial bank; two rural banks; ten municipal banks; and five finance companies, with just one "Edpyme," the only type of entity among this group that cannot take deposits, though nonetheless subject to some regulation by the Superintendency. Furthermore, in the MIX data are some forty additional microfinance entities that are somewhat smaller in size, including several credit unions. In fact, overall there are 160 credit unions in Peru, plus some 50 NGOs. Although NGOs have no formal supervision, they have a supporting entity that promotes transparency with requirements parallel to those of the Superintendency, thereby hoping to promote eventual graduation to "Edpyme" status.

In the Microscope for 2012 Peru has continued to maintain the highest ranking among the 55 countries surveyed for its environment for microfinance, and especially for its regulatory framework and practices. The Microscope emphasizes the stability and openness of Peru's regulatory framework, with its reasonable capital adequacy requirements and minimal bureaucratic impediments, as well as its focus on financial inclusion and its absence of interest rate controls or subsidies. As discussed above, this has resulted not only in a large and growing microfinance sector, but also in a wide variety of participants in microfinance and an apparent ability to withstand the shocks that, since 2008, have impeded all kinds of finance in so many part of the world. The Microscope also highlights Peru's supervisory practices, especially its approach to loan-loss provisioning and on-site inspection procedures with particular attention to the adequacy of internal controls, as well as its on-going removal of rules that impede flexibility and efficiency. While not directly part of regulation and supervision, Peru also scores the highest in the Microscope's measures of the supporting institutional framework, which covers not

only transparency in both accounting standards and interest rates as well as client protection but also the effectiveness of its credit bureaus for microfinance and innovations in policies and practices for transactions using agents such as mobile phones and POS arrangements.

Finally, it is important to emphasize that Peru's microfinance sector has continued to grow since the severe global downturn in 2008 and to maintain its long-standing performance standards. For example, the number of borrowers has continued to grow steadily from 2008 to the present, while interest rates have tended to fall, though not with the same consistency as the growth in borrowers. During this period, while the shares of Peru's microfinance entities in loan amounts and total assets of the overall finance system have remained stable, the share of deposits has increased notably. On the other hand, while the share of capital of microfinance institutions has tended to fall during this period relative to the total for the financial system, this ratio remains well above the ratios for the other three variables, indicating the relative financial strength of the microfinance sector. In particular, capital adequacy ratios for microfinance institutions remain well above required levels, levels that are in turn well above the 10 percent that Peru requires for banks (8 percent is the international standard) to account for cyclical factors and portfolio risks stemming from loan concentration among other factors. In addition, provisioning, which reduces the amount of capital, begins when a micro loan is just one week overdue and climbs steeply to 100 percent after only 120 days. Furthermore, the liquidity of microfinance institutions is well above required level for both domestic and international currencies. Notwithstanding the strictness of the foregoing requirements and the excellent compliance, a former Peruvian bank superintendent recommends that further attention should be focused on improving governance and the risk management capabilities of microfinance institutions.

b. Bolivia[12]

Without doubt Bolivia has been a pioneer in the development of microfinance, certainly in Latin America, and at least equal to the earliest progress made elsewhere in the world. A surprising aspect was Bolivia's initiation of microfinance directly after a period of hyper-inflation in the mid-1980s that had brought major financial and economic instability. The liberalization that followed the hyper-inflation (e.g., closure of government banks and elimination of controls over interest rates as well as other inappropriate government interventions) provided an important basis for the development of microfinance, while the huge informal sector indicated needs and possibilities. The initial mi-

12 Basic data: population - 10.3 mllion (July 2012 est.); GDP - US$24.6 billion (2011 est.); GDP per capita - aprox. US$2,400.

crofinance entities were non-profit (NGOs), but a bank was soon able to enter the field because the Superintendencia de Bancos y Entidades Financieras (SBEF, the Bolivian financial regulator) changed from a traditional focus on institutional type to characteristics of the loan portfolio, while also becoming more flexible in not enforcing rigid requirements for loan collateralization and, later, placing greater reliance on the analysis of borrower cash flows. Such flexibility was extended in the mid-1990s by allowing a new type of entity, Fondos Financieros Privados (FFP), with lower capital requirement and other elements of flexibility, while also allowing FFPs to capture deposits from the public with authorization from the SBEF. A truly amazing expansion of microfinance followed, but as with many such booms came a subsequent crisis, created in large part by an explosion of consumer lending whose lending techniques (e.g., credit scoring) became confused with microfinance, together with the boom itself that led to multiple credit sources and general over-borrowing. The collapse and departure of several consumer lenders, along with the development of a credit bureau and lender attention to this source of information, helped to hasten the recovery that began in 2001 and was accompanied even by falling interest rates due to improved lending techniques and greater competition.

The Microfinance Information Exchange (MIX), shows the development of Bolivia's situation by the end of 2011, with US$3 billion in micro loans outstanding to 1 million active micro borrowers. Since Bolivia is a far smaller country than Peru, with just one third of the population and less than one seventh of the GDP, these figures make it comparable to Peru in relative terms and thus show that Bolivia continues to be among the leaders in microfinance in Latin America. Like Peru, Bolivia's microfinance industry is also largely self-funded with $2.6 billion in deposits at microfinance institutions, but – unlike Peru – its 2 million depositors are double the number of its borrowers. Furthermore, among the microfinance entities rated as transparent in their reporting to the MIX, Bolivia again compares favorably with Peru in relative terms, having ten with either more than US$100 million in loans or more than 100,000 active borrowers. Also – like Peru – Bolivia's flexible regulatory framework allows for a variety of entities to participate in microfinance, and, of the ten noted above for their size, three were commercial banks (two of which had up-graded from FFP status), four were FFPs, two were Instituciones Financieras de Desarrollo (IFDs; Financial Bolivian Non-Governmental Organizations), and one was a credit union. In addition, a large number of other credit unions, more than 20, are included in the MIX database for Bolivia as participants in microfinance. These are "open" credit unions, that is, they are regulated by the Autoridad de Supervisión del Sistema Financiero (ASFI; current Bolivian Financial Regulator) and can take deposits from non-members as well as from members and also carry out other types of financial operations. There are also 59 credit unions that are "closed" and thus cannot take deposits or carry out other financial operations with non-members (and members must be, in principle, either employees of a particular enterprise or residents of a particular communi-

ty). The closed cooperatives were regulated by the Dirección General de Cooperativas (Governmental office in charge of cooperatives) until recently when the supervision of those deemed qualified was to pass to the ASFI, while the others were to be liquidated, but these changes have not yet be implemented.

In the Microscope for 2012 Bolivia has continued to rank very high in its overall environment for microfinance, second only to Peru among all the 55 countries surveyed. For its regulatory framework and practices Bolivia is also second only to Peru among Latin American countries, while being second worldwide for its supportive institutional framework for microfinance. The Microscope further emphasizes the continuing growth of microfinance in Bolivia, where its importance has increased to the point that it now accounts for 37 percent of financial activity in the country, mainly by regulated entities (banks and FFPs), but with the currently unregulated IFDs contributing 4 of the 37 percent. In addition, the Microscope praises Bolivia's industry associations for contributing to this good performance, FINRURAL (Association of non-regulated MFIs) for assisting the unregulated IFDs and other NGOs, and ASOFIN (Association of Regulated MFIs) for promoting increased efforts by regulated entities to serve small depositors. The Microscope also underlines the ambitious efforts of the ASFI, as the regulatory agency moves to assume responsibility for more elements of the financial sector (e.g., the IFDS and closed as well as open credit unions), while also strengthening required accounting standards and moving into consumer protection and financial inclusion.[13] This ambitious agenda has caused the Microscope to express some concern about the ability of the ASFI to accomplish so much, especially since it has lost some of its key personnel due to a recent supreme decree that forbids public sector employees to be paid higher cash salaries than the president. In addition, ASFI is risking a significant loss of independence by being placed under a government ministry. The Microscope is also concerned about the uncertainty created by the lengthy delays in the passage of the new banking law that is to incorporate many of these proposed changes in the ASFI's regulatory responsibilities. Yet another concern of the Microscope is the widespread fear that the new banking law will incorporate controls over interest rates. Another change from earlier policies noted by the Microscope is two new government banks, one which recently launched a micro credit program for rural areas, while the other is to provide for funding microfinance entities that on-lend for productive activities. With this possible funding may come requirements to dedicate a portion of loan portfolios to productive activities, especially in the agricultural sector, and possibly with limits on interest rates.

13 The IFDs may present particular challenges for the ASFI not only because of their large numbers, many quite small, but also because of their non-profit ownership that can result in weak governance and makes it difficult to secure additional funding if and when that is needed.

Although data from the MIX and elsewhere continue to show that Bolivia has a strong and growing microfinance sector, with the Microscope also giving Bolivia very high marks for its environment for microfinance, concerns are nonetheless expressed about the future direction of Bolivia's microfinance environment. While this may be unfortunate for Bolivia, the current situation there can be quite instructive, perhaps more so than if Bolivia simply remained on a steady course. There is a saying, heard far more often in Spanish than in English, that "the perfect is the enemy of the good." In the present case of Bolivia, efforts by the government to "perfect" the environment for microfinance, especially expanding the roles of its regulatory agency, may be generating uncertainty in at least two respects: does ASFI have sufficient capacity to carry out this expanded mandate; and exactly what form will the enabling law take, when and if it is finally passed. Uncertainty is universally seen as bad for performance of a country's financial sector, at least lessening the demand for financial services and likely also increasing problems with loan recovery. Whether or not this happens in Bolivia, there can be a lesson for other countries about potential damage from uncertainty about government policies.

c. Philippines: [14]

Like many countries, the Philippines had a long history of subsidized lending and massive government interventions in credit markets for marginalized sectors. Prior to 1997, there were 86 subsidized directed credit programs implemented by more than 20 government non-financial agencies. Recognizing the inefficiencies and ineffectiveness of these programs, in 1997 the government issued its National Strategy for Microfinance, which states clearly the objective of establishing a viable, sustainable market for microfinance through the adoption of market-based principles for credit markets. This led to several executive orders as well as landmark legislation that mandated the adoption of market-based interest rates and the non-participation government non-financial agencies in credit markets. Such agencies were no longer given budgetary appropriations for any implementation of credit programs. Moreover, government financial institutions were allowed to provide funds only at the wholesale level for retail microfinance institutions. Furthermore, under the General Banking Act of 2000, the Bangko Sentral ng Pilipinas (BSP; Central Bank of the Philippines) was mandated to issue rules and regulations that recognize the special characteristics of microfinance. This policy environment prompted increased participation by the private sector, which led to the development and growth of microfinance in the Philippines. From only a handful of entities engaged

14 Basic data: population - 104 million (July 2012 est.); GDP - US$213 billion (2011 est.); GDP per capita - aprox. US$2,000.

in microfinance in 2000, there are now almost 2,000 institutions (including especially rural banks, cooperatives and NGOs) providing microfinancial services to several million clients, with commercial banks even becoming involved microfinance, in particular in providing wholesale funds to retail entities.

According to the Microfinance Information Exchange (MIX), the Philippines is clearly among the leaders in world in reaching down to it poorest citizens with financial services. According to the MIX, as of the end of 2011 the Philippines had about US$600 million in micro loans outstanding to 3.2 million active micro borrowers. This yields an average loan size under US$200, less than one tenth of Philippine per capita GDP, thus indicating that micro loans are likely reaching down to the poorest Filipinos. It is also important to recognize that the Philippines' microfinance industry is significantly self-funded through deposits, with almost US$400 million in deposits from 4.3 million depositors. Furthermore, with significantly more depositors than borrowers, the average deposit size is not even as much as US$100, so that Philippine microfinance entities are almost certainly providing deposit services to among the poorest Filipinos. Among entities rated as transparent in their reporting to MIX, eight have over 100,000 borrowers, and 16 have over US$20 million in micro loans outstanding, with three of these not far from US$100 million.

In the Microscope for 2012 the Philippines has continued to rank highest, along with Peru, among the 55 countries surveyed for its regulatory framework and practices, as well as fourth for its overall environment for microfinance. The Microscope commends the Philippines in particular for the focus of its microfinance regulation and supervision on risk management, rather than on collateral, its explicit differentiation of consumer loans from micro loans, and in dealing effectively with four different types of banks (rural, thrift, cooperative and commercial banks, mainly through affiliates). The Central Bank (BSP) has also unified the different supervisory offices for the different types of banks, while allowing for different risk profiles, and has a special examination group dedicated to micro and SME finance. The BSP has recently shown its flexibility by introducing "Microfinance Plus," which doubles the upper limit on such loans in order to accommodate the best micro borrowers under more stringent conditions. On the other hand, the BSP has moved to raise capital requirements for rural and thrift banks to limit their proliferation, but these requirements differ by head office location, which may offer opportunities for "regulatory arbitrage" (while for rural cooperative banks these requirements remain especially low). In addition, the importance of non-bank entities in Philippine microfinance presents a major challenge, not only because of their major roles, but also because of their questionable regulatory and supervisory situations. While cooperatives are allowed to take deposits from members, they are not currently supervised because the Cooperative Development Authority (CDA) is over-burdened by its dual responsibilities for promotion as well as regulation and by the extremely large

numbers of both financial and non-financial cooperatives (including many problematic multi-purpose cooperatives involved in finance). The situation for NGOs is even more problematic, not only because of their major importance in microfinance, but also as they are largely unsupervised, only reporting data to the Securities and Exchange Commission (SEC), while effectively taking deposits through "build-up savings" (compensating balances) for loans.

As microfinance has grown, an increasing concern for the welfare of clients has appeared among the stakeholders, with the BSP (supported by other agencies) issuing a circular prescribing transparency for interest rate calculation. To address financial inclusion, and considering that about 40 percent of the country's municipalities are still unbanked, the BSP has recently allowed the establishment of micro-banking offices (MBOs), which are allowed to provide a range of transactional services.[15] While the microfinance sector continues to grow and reach an increasingly large number of those in the low-income sector, several issues still need to be addressed. With an increased number of borrowers and microfinance entities, the Microscope recognizes the importance of a well-functioning credit bureau. Unfortunately, despite the passage of a law in 2008 and the approval of implementing rules and regulations in 2009, the Government-sponsored credit bureau has yet to start operations, as the initial capital has not yet been provided, nor has an office been established, nor is there an initial work plan or initial staffing. The varied supervisory environment for each of the three types of institutions providing microfinance services is also a concern. While all type of banks engaged in microfinance are under risk-based supervision, cooperatives and microfinance NGOs are not. Despite issuance of some rules and regulations for cooperatives engaged in financial operations, the CDA has yet to provide necessary staffing for supervision, nor does it have capacity for risk-based supervision. Similarly, NGOs are only required to declare that they are engaged in microfinance operations and to submit annual financial statement to the SEC.

15 Indeed, the Philippines had already become a leader in mobile phone banking to help achieve this kind of outreach.

04.

CONCLUSION

There is little doubt that risk-based supervision has become the norm worldwide in recent years for approaching prudential regulation and supervision for all types of financial institutions. In spite of a similar consensus that institutions that take deposits from the public or whose size and operations can pose systemic risks for the rest of the financial sector should be subject to prudential regulation (implemented through risk-based supervision), this norm has not been so simple to apply. What constitutes systemic risk can clearly be subject to controversy, but even "taking deposits from the general public" can be open to varying interpretations: are members of credit unions the "general public," and do compensating balances against loans constitute deposits? Nonetheless, these questions must be answered in practice, and the answers are not always the same as can be seen from the preceding discussion of regulatory and supervisory practices in even the three countries that have the highest rating for "regulatory framework and practices" in the Microscope.

Furthermore, returning to risk-based supervision itself, which virtually everyone subscribes to, in part because "Basel" has decreed that it is the norm, there are clear differences in interpretation and especially in application (though not so much among the three highly rated countries examined here). There are seen to be nine risks, six of which are judged to be major risks, and, most importantly, the starting point for implementing risk-based supervision is to analyze the capability of the supervised entity to manage these risks. Nonetheless, many regulatory agencies base their supervision on calculating the value of loans with a particular number of days overdue, typically 30 or 90, subtracting the value of formal collateral "backing" each of these loans and requiring provisions for the remainder. Not only is this far from analyzing the capacity to manage risks, but it is also at variance with micro lending, which rarely uses formal collateral (because of the costs involved relative to the size of the loan) and which normally takes some action as soon as a micro loan is even one day overdue.

Looking briefly at the main risks that need to be analyzed in microfinance, it is clear that credit risk itself is of major importance, but operational risk is often just as important, in particular in judging whether the microfinance entity has the capacity in its information technology and management information systems to track thousands of loans (a number that may be necessary for institutional sustainability) on a daily basis. In addition, because of the importance of loan officer performance for sustainability, almost all microfinance entities pay loan officers in part on an incentive basis according to numbers of loans (both new and repeat) and repayment rates. Thus, these loan officers have incentives to "invent" non-existent borrowers and report repayments that have not been made, so that a highly capable internal audit function is required to control this operational risk. Liquidity risk is also likely to be especially important, not only for the usual reasons for any financial institution, but especially in microfinance because of the need for liquidity for follow-on loans that are almost always a major incentive for good loan repayment performance.[16]

The foregoing discussion raises two crucial aspects of a regulatory entity's approach to the structure of regulation and supervision, which can be especially important for microfinance, that is, should regulation be organized according to institutional type or according to the types of loan predominating in a lender's portfolio and, further, how should supervisory personnel be deployed in these respects? Clearly, a large commercial bank with nationwide coverage is far different institutionally from a small, local non-bank entity that happens to take deposits, at least in that for the former the ability to delegate effectively to local branches while still controlling these branches is a major challenge, while for the latter it is likely to be lack of diversification. In fact, in one of the countries discussed in some detail, the Philippines, the central bank's (BSP) supervisory staff is divided into units according to the type of bank supervised: (1) commercial banks; (2) thrift banks (which consist of a variety of mid-range entities); (3) rural banks (which are small but not necessarily rural); and (4) cooperative banks. Nonetheless, because virtually all micro lending takes place in thrift and especially rural banks, this has not created a situation where staff is expected to supervise entities with significant micro loan portfolios without having the expertise necessary to understand the crucial aspects of microfinance. In any case, because of specific risks arising from an institution's particular type of loan portfolio, the consensus among experts in regulation and supervision is that responsibilities should be organized according to portfolio type rather than institutional type. Focusing on the types of loans rather than institutional types can also help to promote flexibility as seen in the variety of entities providing microfinancial services in both Bolivia and Peru. Furthermore, given the bad experience

16 A fairly standard regulatory reaction to liquidity problems at a supervised entity (or problems of other types as well) is to suspend lending, but this is likely to prove disastrous for a microfinance entity because borrowers, observing that follow-on loans are not available, will not repay their current outstanding loan balances.

in Bolivia with the incursion of consumer lenders into microfinance, it is important to understand the lending technology in use and not simply assume that because consumer and micro loans look alike on the surface (e.g., small loans, with short maturities and frequent repayments) they are alike.

A further dimension of such differences, which has direct relevance to understanding risks as the basis for risk-based supervision, are the distinct roles of credit scoring and credit bureaus. Credit scoring has been shown to be extremely useful for consumer lending where just a few variables beginning with employment status can reveal the likelihood of good repayment performance by a borrower, thereby covering the major risk. On the other hand, as discussed at the beginning of this paper, the so-called micro-entrepreneur has neither a particular enterprise nor a traditional job with an employer. Rather, the micro-entrepreneur and the related family – in order to diversify to minimize their risks – have a variety of activities that provide a variety of *cash flows* that must be mapped and analyzed in order to assess repayment potential and decide the best structure for the loan (e.g., duration and size and frequency of repayments). This almost inevitably requires a visit to the potential micro borrower, usually at the home, which is almost always costly relative to the size of the loan, but which provides an opportunity to assess the *character* of the borrower by observing the family and the condition of the home, and likely talking to some neighbors as well. All this is highly important, especially given the likely absence of formal *collateral*, but the information collected about *cash flow* and *character* would be extremely difficult to convert to a credit score of the type (and reliability) used in consumer lending.[17]

Although credit bureaus and credit scoring can be closely linked, with credit bureaus providing useful information for credit scoring, they are definitely not the same thing, as credit bureaus simply collect information about borrower repayment patterns and report this to potential lenders. In fact, in Bolivia it was the expansion of credit bureau activity, and thereby the exposure of over-indebtedness, that helped recovery from the severe problems that evolved from the inappropriate use of credit scoring for microfinance because it had been so helpful in consumer finance. On other hand, Peru has consistently been at the forefront in the development of credit bureaus and their application to microfinance, while in the Philippines leaders in microfinance have been pushing strongly for a first-class credit bureau, but the government has been slow in implementing one. These experiences have led to some clear recommendations for successful implementation of credit bureaus: regulated financial entities should be required to report with the reporting of loans complete, not just because the omission

17 A related point is that the costs of this visit are extremely unlikely to be covered by even the highest interest and fees that could be charged, so that borrower retention rates (follow-on loans) are likely to be essential for the lender's sustainability and thus should be an important part of the supervisory assessment of risk.

of small loans will make them useless for microfinance but because there will be no good way to know if all large loans have been reported (e.g., those to related parties); data reported should include positive elements not just negative; given this positive data, it is important to prevent client stealing through "fishing expeditions," so that requests for credit reports must specifically name the borrower; borrowers should be protected against erroneous information through the right to view their information periodically and to seek redress if the information is inaccurate. Practical aspects include how long data should be retained and how frequently it should be up-dated, while access should be rapid and low cost. With all these conditions met, belonging to credit bureaus should be highly attractive, and the requirement for "outsiders" (e.g., phone and electric utilities, merchants selling on time, unregulated lenders, etc.) should focus on their reciprocity (providing complete information to the credit bureau in order to participate).

There has been increasing interest in "responsible finance," especially within the microfinance industry, that has resulted in some pressure for regulatory agencies to move into consumer protection in addition to prudential regulation. In the Microscope, as well as elsewhere, this has tended to focus on transparency and dispute resolution, with two aspects of transparency being involved: interest rates and standardized accounting that includes audited and publicly available financial statements. In addition to helping to protect consumers, transparency in accounting may provide a parallel boost to microfinance by providing support for entities that want to transform into regulated, deposit-taking institutions. If various elements of responsible finance, especially accounting transparency, are imposed on entities that do micro lending but do not fall under prudential regulation, this may help promote their transformation into regulated, deposit-taking institutions as they will no longer have that transparency hurdle to overcome. The possible impact of accounting transparency may seem remote, but it can be an important step toward a more formal, business-like approach to lending and to all the supporting activities that are required for lending, so that these possible collateral benefits should not be totally ignored.

There is a saying that "small is beautiful," but in regulatory and supervisory activities, this is typically a question, "is small beautiful," or perhaps more appropriately, "can small be beautiful?" Small microfinance entities are often seen by regulatory and supervisory agencies to be a major nuisance because of the costs of supervising large numbers of small entities, presumably a necessary activity if these entities take deposits, which is a certainty in the case of credit unions, but is also possible in the case of small microfinance entities that require potential borrowers to build up savings before borrowing or require compensating balances for loans. A typically regulatory response to this supervisory problem is to have high initial capital requirements, which is in fact recommended

in some of the highly-regarded papers on regulation and supervision in microfinance.[18] Rather than effectively banning such entities, which in the case of credit unions often causes political furor about the rights of individuals to assemble and act collectively, a technical approach based on the question of diversification risk seems more appropriate. Most credit unions, small ones in particular, are either employer based or community based, and for those that are employer based the main risk is the sustainability of the employer. For small community-based credit unions, which typically exist in small cohesive communities where credit union members know each other well and can easily monitor each other's behavior, the main risk is again lack of diversification (e.g., a rural community in which most crops fail due to weather), which cannot be undone by a regulatory agency. For small microfinance entities, which are highly unlikely to take deposits from the general public, the benefits of insisting on transparency (see discussion elsewhere) can likely resolve saving build-up and compensating balance issues better than intrusions by supervisors.

18 See, for example, Robert Peck Christen, Kate Lauer, Timothy R. Lyman and Richard Rosenberg, "Microfinance Consensus Guidelines: A Guide to Regulation and Supervision of Microfinance," CGAP, 2012.

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