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Regulation and Supervision of Microfinance Institutions: A Proposal for a Balanced Approach

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Today, microfinance institutions (MFIs) are providing financial services to millions of the world’s most impoverished citizens, who were once deemed “unbankable” by traditional banks due to their lack of credit history and collateral. Although MFIs experienced limited success upon their creation, it is currently estimated that between 1,000
and 2,500 MFIs provide access to financial services for around sixty-eight million clients in over 100 different countries.\(^2\) While great strides have been made in reaching those people who were traditionally ignored by the banking industry, some estimate that MFIs are still reaching fewer than 5 percent of the potential microfinance clients, due, at least in part, to a lack of a formal regulatory framework.\(^3\)

The crux of the problem is this—more regulation of MFIs is needed, but too much regulation may make it impossible for MFIs, which by their nature require flexibility, to survive.\(^4\) A more uniquely tailored regulatory framework is necessary in order to allow MFIs to offer more services, reach more clients, and, ultimately, become more self-sufficient. While it is clear that some regulation is necessary, how much regulation and what form it will take remains unclear. Moreover, regulation can easily become overbearing, and the cost of compliance may become so high as to defeat the ultimate goal of MFIs, namely, giving the world’s poorest citizens access to financial services. As noted by USAID, the goal of any reform of the regulatory framework of MFIs “should be to create an environment that supports the expansion of financial services to the poor, thereby increasing access.”\(^5\) In effect, a tension exists between increasing regulation, thus allowing more services to be offered and ensuring that the regulation enacted does not become so overbearing as to force MFIs out of existence.

This paper suggests a balanced approach to that regulation in order to minimize the overall cost and maximize flexibility in the regulatory framework, thus achieving the ultimate goal of sound financial services providers and increased access to clients. In order to accomplish these goals, this paper proposes that prudential regulation should be used as minimally as possible due to its high cost, both to the MFIs that are regulated and to the nations implementing the regulatory framework. Because it is seemingly impossible to reach the objectives of “1) protecting [a] country’s financial system by preventing the failure of one institution from leading to the failure of others, and 2) protecting small depositors who are not well positioned to monitor the institution’s financial sound-


\(^4\) Globalenvision.org, *The History of Microfinance*, Apr. 14, 2006, http://www.globalenvision.org/library/4/1051/ [hereinafter Globalenvision] (noting that if regulations place interest rate ceilings too low, MFIs may not be able to cover the cost of servicing their loans, and will thus be forced out of existence).

ness themselves," some prudential regulation is warranted.\textsuperscript{6} This paper notes, however, a number of issues that may be dealt with through non-prudential regulation, thus retaining a more flexible system for MFIs and decreasing the overall cost of regulation. Only with this type of regulation will microfinance institutions become self sufficient, thus reaching their ultimate potential in eliminating world poverty by providing the maximum number of financial services to the maximum number of clients.

This paper will first address, in Part II, the background of the microfinance industry, which will include a general explanation of microfinance and the services that are encompassed within that term. Many people are familiar with the term microlending, but some may fail to recognize that other microfinance services, such as microsavings and microinsurance, also have great potential in reducing worldwide poverty. This will be followed by a short history of microfinance, from its earliest beginnings to the modern-day successes of MFIs, such as Muhammad Yunus's Grameen Bank in Bangladesh, and the techniques that these entities used to achieve their success.

Part III of this paper will then turn to the regulation and supervision of microfinance institutions. Specifically, this section will discuss why regulation and supervision of MFIs is currently necessary and when a particular geographic region may be ready to implement a more formalized regulatory and supervisory framework. It is important to note that attempting to increase regulation, or sometimes even bringing to light current practices of MFIs, may cause these entities to come under greater scrutiny. While greater scrutiny may be necessary, it is important to ensure that scrutiny from legislatures and the general public does not have any unintended detrimental effect on existing MFIs. As some practitioners have noted, even though certain activities of microfinance institutions are warranted (such as charging higher interest rates), "it may still prove difficult to defend them when they are subject to broad (and uninformed) public discussion."\textsuperscript{7} Part IV will then delve deeper into the different types of regulations that may be implemented within a microfinance regulatory framework.

When developing regulations for MFIs, regulators must choose between prudential regulation and non-prudential regulation. Prudential regulation is that which "governs the financial soundness of licensed intermediaries' businesses, in order to prevent financial-system instability and losses to small, unsophisticated depositors."\textsuperscript{8} In general, prudential regulation is more expensive than non-prudential regulation, which re-


\textsuperscript{7} Id. at 11.

\textsuperscript{8} Id. at 6.
quires no third-party oversight and may not be necessary to resolve many of the issues currently facing MFIs. Part IV will discuss each of these types of regulation in depth, including what issues may be addressed by each and when each form may be appropriate.

Finally, Part V of the paper will make a modest proposal for proper regulation of MFIs. This proposal will suggest a system that balances the need for more stringent regulation with the flexibility needed to make MFIs functional as well as other countervailing interests. The system must balance the need for prudential regulation with the high costs of such a system. Some prudential regulation is needed in order to allow MFIs to take deposits and thus become more self-sufficient; however, this regulation must not become so overbearing or costly so as to make compliance next to impossible. Ultimately, the regulatory framework must balance the risks facing individual depositors and the financial system as a whole with the goal of providing greater access to financial services to those individuals who have been traditionally “unbanked.” While regulation is certainly important, and the creation of sound MFIs is one of the goals of increased regulation, the ultimate goal is to decrease poverty throughout the world by increasing the poor’s access to financial services. Stated another way, regulators should not try to completely eliminate the risks facing microdepositors and the growing microfinance industry; it would simply be too expensive and lead to the demise of all but the largest MFIs. Instead, regulators should attempt to maximize access to financial services while ensuring that the entities providing those services are financially sound. In order to fully understand this proposal, some general background information is necessary.

II. BACKGROUND INFORMATION

Before continuing, it is important to understand exactly what microfinance is and the history of the organizations that have provided these services over time.

A. WHAT IS MICROFINANCE

Microfinance is defined by the Microfinance Alliance as “financial services targeting and catering to clients who are excluded from the traditional financial system on account of their lower economic status.” This term can encompass a variety of services including microcredit, microsavings, and microinsurance. These services are provided by microfinance institutions that typically specialize in offering financial services to low-income populations. While all MFIs are dedicated to providing these services, the structure of these organizations is anything but uniform. The

9. See id. at 7.
PROPOSAL FOR BALANCED APPROACH

typical MFI is some form of a financial “Non-Governmental Organization” (NGO), but other organizations including credit unions, cooperatives, private commercial banks, and even non-bank financial institutions do exist. Typically of the form that these institutions take, their goal is the same: to reach the “poor sectors of the economy” and provide financial services to those individuals on a “sustainable basis.” In the future, the fulfillment of that goal may have much less to do with how these entities are organized and much more to do with the regulatory structure in which they operate.

Perhaps the most well-known microfinance service is “microcredit,” or “the extension of small loans to micro-entrepreneurs who lack collateral and do not qualify for traditional bank loans.” The term microcredit has, over the years, included an astonishing number of credit arrangements including money lender credit, loans from friends and relatives, or even loan shark-type credit, recognized by its extremely high—if not usurious—interest rates. That being said, within the scope of this paper, microcredit will mean a more formalized form of microlending. Specifically, it will be a service provided by NGO or non-NGO MFIs, generally offered on a non-collateralized basis, and targeted at the poor so that they may help themselves overcome poverty. This is a crucial portion of the microfinance industry in that it provides the very poor with access to capital and thereby gives them the ability to jump-start an income-generating activity, such as a small business. Although microcredit is the most recognized microfinance service, microsavings may prove to be just as important to the sustainability of MFIs without donor and governmental help.

Microsavings may be defined as a service offering small deposit accounts “to lower income families or individuals as an incentive to store funds for future use.” In general, these very small savings accounts work much like any other savings account except that minimum balance requirements are either very low or nonexistent and the amount of money stored in these accounts is much smaller. Despite the small amount stored in each individual account, many believe that mobilizing these small savings funds may be the key to creating self-sufficient, sustainable MFIs that can function without the help of NGOs or foreign donors. Microsavings has taken a backseat to microcredit in the past,

12. Id.
13. Id.
18. Id.
and many MFIs do not currently offer microsavings services. Experts, however, believe that if given the opportunity, microfinance clients would utilize these services.\textsuperscript{20} If this is the case, then mobilizing these savings could “contribute to self-sustainability by providing the MFI with cheaper funds than those from the interbank market.”\textsuperscript{21} Not only would poor savers be given somewhere to store their money for future use, but also the poor borrowers would benefit from expanded lending operations due to the stable funding source of the deposits.\textsuperscript{22} Microcredit and microsavings are the two services most pertinent to the discussion of regulation and supervision presented in this paper, but it is important to note that these services are by no means exhaustive of those offered by MFIs. Because they are beyond the scope of this paper, microinsurance and more obscure microfinance services will not be discussed.

B. THE HISTORY OF MICROFINANCE

Although the techniques, organizations, and services offered to microfinance customers are ever-changing, and modern MFIs and the actual products they offer bear little resemblance to the entities and services utilized in the past, the basic premise of microfinance is not a new concept.\textsuperscript{23} In fact, informal savings and credit groups have been in existence throughout the world for centuries, including the ‘’susu’ of Ghana, ‘chit funds’ in India, [and] ‘tandas’ in Mexico,” among many others.\textsuperscript{24} Although it was not until the 1970s when the global microfinance movement really took hold—beginning with lending experiments in the impoverished villages of Latin America and Asia—formalized microlending and microsavings institutions have been around for hundreds of years.\textsuperscript{25}

One of the earliest formal microlending organizations, the Irish Loan Fund, began in Ireland in the early 1700s and was actually started by Jonathan Swift, the well-known author.\textsuperscript{26} These donor-financed institutions initially began as charities attempting to alleviate the poverty-stricken citizens of rural Ireland.\textsuperscript{27} Although they initially offered interest-free loans, the enactment of a new law in 1823 allowed the funds to accept interest-bearing deposits and to charge interest on loans.\textsuperscript{28} It was this new law, allowing the acceptance of deposits, and the regulation and supervision that accompanied the law, which allowed the Irish Loan Fund

\begin{thebibliography}{9}
\bibitem{20} Id. at 1.
\bibitem{21} Id. at 2.
\bibitem{22} Id. at 1.
\bibitem{24} Id.
\bibitem{25} Microfinance Alliance, supra note 10; See also Globalenvision, supra note 4.
\bibitem{26} Globalenvision, supra note 4.
\bibitem{28} Id.
\end{thebibliography}
to eventually grow into over 300 funds throughout Ireland.\textsuperscript{29} In fact, at the pinnacle of the Irish Loan Fund, the organization was lending to 20 percent of all Irish households on a yearly basis—no small feat for one of the first attempts at formalized microfinance.\textsuperscript{30} This is perhaps one of the earliest examples of the successes of a formalized regulatory and supervisory framework. By allowing the mobilization of deposits through enabling legislation, and coupling that with appropriate regulation, these Irish Loan Funds achieved self reliance and sustainability that is not often found, even in today’s microfinance institutions.\textsuperscript{31}

Over time, various forms of MFIs continued to emerge to serve the rural poor throughout Europe and Latin America.\textsuperscript{32} Almost all of these institutions had similar objectives, namely, “increased commercialization of the rural sector, by mobilizing ‘idle’ savings and increasing investment through credit, and reducing oppressive feudal relations that were enforced through indebtedness.”\textsuperscript{33} Interestingly enough, some of these institutions opted to utilize a supply-side approach to the problem and offered subsidized loans and below-market interest rates.\textsuperscript{34} Unlike the Irish Loan Fund, which offered loans at higher rates, but also offered higher rates on deposits, these government subsidized schemes almost inevitably failed.\textsuperscript{35} Perhaps history was teaching another lesson—that substantial regulation and supervision for independently functioning MFIs is ultimately more successful than government intervention and donor dependence. But, it was not until the 1970s that the modern microfinance movement began.\textsuperscript{36}

Much like many of the microfinance institutions before them, Muhammad Yunus and the Grameen Bank offered the impoverished of Bangladesh an opportunity to free themselves from poverty by offering small loans to those traditionally passed over by commercial banks.\textsuperscript{37} The beginnings of this enterprise were modest, loaning only twenty-seven dollars to forty-two stool makers; but Grameen Bank now includes over “5.5 million members with greater than $5.2 billion in dispersed loans.”\textsuperscript{38} Despite the fact that traditional lenders believed the poor to be uncreditworthy and lacking in skills or the financial wherewithal to allocate borrowed funds towards their most efficient use, Grameen Bank has proved them wrong.\textsuperscript{39} In fact, Grameen Bank currently reports a repayment rate of 98 percent on its loans.\textsuperscript{40} It has shown that “poor house-

\textsuperscript{29} Id.; Globalenvision, supra note 4.
\textsuperscript{30} Globalenvision, supra note 4.
\textsuperscript{31} See Does History Matter? supra note 27, at 2.
\textsuperscript{32} Globalenvision, supra note 4.
\textsuperscript{33} Id.
\textsuperscript{34} Id.
\textsuperscript{35} Id.; Does History Matter?, supra note 27, at 2.
\textsuperscript{36} Microfinance Alliance, supra note 10.
\textsuperscript{37} The Microfinance Revolution, supra note 2, at 9.
\textsuperscript{38} Id.
\textsuperscript{39} Id.
\textsuperscript{40} Microfinance Alliance, supra note 10.
holds can benefit from greater access to credit and that the provision of credit can be an effective tool for poverty alleviation. . .[as well as proving]. . .that institutions do not necessarily suffer heavy losses from lending to the poor."41 Much of the success of Grameen Bank may be attributed to its unique "group lending" idea. Essentially, potential borrowers organize themselves into groups, and if anyone in the group defaults on their loan, then the rest of the group is unable to receive future credit.42 This essentially takes the credit risk off the bank and places it squarely upon those wishing to receive loans. Because almost every borrower has an interest in having access to future credit, they organize themselves with individuals believed to be creditworthy and take a hands-on approach to ensuring that all borrowers within their group meet the payment schedule.43 History does appear to show that by utilizing this unique group lending approach in conjunction with a formalized regulatory and supervisory framework (which would, allow for the enactment of deposit taking legislation) the creation of self sufficient, sustainable, MFIs is completely within the realm of possibility. But, for the majority of MFIs today, one of the main ingredients that makes all of this possible is missing—the formalized regulatory structure.

III. REGULATION AND SUPERVISION OF MICROFINANCE INSTITUTIONS

Before examining the different types of regulation that may be used to create a uniquely tailored regulatory framework for microfinance institutions, one must understand why regulation and supervision are necessary and when it is appropriate to adopt a new regulatory framework.

A. WHY ARE REGULATION AND SUPERVISION OF MICROFINANCE INSTITUTIONS NECESSARY?

To be sure, microfinance has seen some success stories, and, certainly, evidence from a variety of programs from around the globe supports the proposition that microfinance is a benefit to the poor.44 Not only has microfinance proven to be an aid to the monetary problems of the individuals it serves, but also “access to financial services. . .translates into broader social benefits, including improved health. . .; increased educational participation; and greater gender equality.”45 Despite its successes, there are a number of reasons why a change to the current microfinance system is in order, and a number of reasons why microfinance should be

41. The Microfinance Revolution, supra note 2, at 11.
42. The Microfinance Revolution, supra note 2, at 12.
43. Id. at 12.
45. Id. at 4-5.
regulated. These reasons include benefits "such as improved self-sustainability of microfinance institutions, protection of savings, safeguarding the stability of financial systems, mitigation of risk due to currency mismatches, prevention of money laundering and of funding terrorism." Although some question the legitimacy of every regulation proponent’s claims, others suggest that the potential benefits of increased regulation are only limited by the number of individuals you survey.

In a recent CGAP occasional paper, it seemed that every proponent of regulation had its own reasoning. Many MFIs believe, as does the author, that regulation is essential for MFIs looking to fund themselves. Others believe that “regulation will promote their business and improve their operations,” and still others suggest that regulation is key in speeding the emergence of sustainable MFIs. Even local authorities in regions where MFIs are operating have their own justifications for regulation; they “are sometimes troubled by the weakness of many MFIs, and unimpressed with the coordination and supervision being exercised by the donors who fund them. They want someone to step in and clean up a situation that they think is hurting the development of microfinance in their country.”

If truth be told, each of these justifications for a formalized regulatory framework has some merit, but more importantly, these justifications are interrelated, and the logical relationship between them is complex and almost circular. The very same regulation that may serve to allow deposit taking will ultimately lead to a more self-sufficient MFI, and thus the increased outreach of these institutions to the individuals demanding their services. But, to put it plainly, the main problem facing microfinance is that, currently, it is not a sustainable, self-sufficient enterprise, and it is not reaching enough people. Both of these problems stem, at least to some extent, from the fact that formal regulation and supervision is lacking.

In 2001, it is estimated that “more than 1,000 microfinance programs around the world had reached approximately 20 million borrowers.” Today, these numbers have grown and it is estimated that between 1,000 and 2,500 MFIs are currently serving around 67.6 million clients. Of those 67 million individuals, “more than half of them come from the bot-

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48. Id.
49. Id. at 2.
50. Impact of Government Regulation on Microfinance, supra note 44, at 2 (noting that, “‘Scaling up’ will require increasing the scope (number of individuals reached), impact (effect on the well-being of borrowers), and depth (ability to reach the poorest of the poor) of microfinance.”).
51. Id. at 6 (citing, A. Granitsas & Deidre Sheehan, Grassroots Capitalism, Far E. Econ. Rev. 39 (2001)).
52. The Microfinance Revolution, supra note 2, at 10.
tom 50 percent of people living below the poverty line. That is, some 41.6 million of the poorest people in the world have been reached by MFIs.\textsuperscript{53} While this seems to be a sizeable increase and is certainly a step in the right direction, there are plenty of individuals who still lack access to financial services. In fact, in 2003, the World Bank estimated that even in Bangladesh, where the microfinance market is very well developed, only 18.4 percent of potential clients were reached.\textsuperscript{54} This is commendable, but Bangladesh is only a best-case scenario; microfinance services in other parts of the world are reaching far fewer individuals.\textsuperscript{55} In Brazil, it is estimated that only 0.4 percent of the poor are being reached.\textsuperscript{56} To put this problem into perspective, some have estimated that the existing unmet demand for financial services is in the neighborhood of 360 million households, or 1.8 billion people, worldwide.\textsuperscript{57} The question then becomes, if the idea of microfinance works, why are more people not being reached?

The simple answer to that question is that modern-day MFIs do not have access to enough funds to reach all of the individuals in need.\textsuperscript{58} Even in 1996, the Consultative Group to Assist the Poor (CGAP) recognized that reaching this unmet demand will require more funding than donors and governments alone can provide.\textsuperscript{59} From their outset, many MFIs were NGOs and relied, almost solely, on donors for the funds that they would lend to potential borrowers at subsidized interest rates.\textsuperscript{60} Many times these organizations also received substantial assistance from governments that provided them with lump-sum grants in order to assist with their lending efforts.\textsuperscript{61} Unfortunately, little has changed since the outset of MFIs, and most are still operating under this system. Although some MFIs may be operating in this manner because it is easier than to try to change, part of the problem is also the current legal and regulatory framework that does not allow NGOs to accept deposits or access funds from other commercial sources.\textsuperscript{62} The emerging consensus is clear: "achieving an order of magnitude change in the scale of microfinance will require deposit mobilization."\textsuperscript{63} In fact, some even believe that continuing to rely on these subsidized funds is detrimental to the MFIs.\textsuperscript{64} So long as these funds are available, MFIs will likely never reach self-sus-
tainability or reach as many clients as possible. If we know that with more money MFIs will reach more people, and we know that so long as MFIs rely on donors and governments, those funds will never be adequate, we must then ask, where will that money come from?

Perhaps the answer is easier to find than it first appears. In fact, many MFIs have expressed interest in increasing “their outreach by raising funds from commercial sources, including” taking deposits from the same pool of customers that they provide with lending services. The problem lies in the fact that many MFIs are currently organized in such a way that they are not licensed to take these deposits, and current regulatory frameworks, which do allow for the taking of deposits, do not cover these types of entities. “Since these institutions do not have financial licenses, they cannot leverage their resources by capturing deposits. . .[and] [t]he requirements for a regular banking license are too high for the institutions interested in poor clients.” Herein lies one of the strongest justifications for a formalized regulatory framework for MFIs. Without this new regulation, MFIs are destined to occupy much the same position that they do right now—providers of microcredit to a small portion of the world’s poor, but only with the help of donors and governments. While that position in and of itself is not a negative thing, a system in which MFIs reached a much greater percentage of potential clients and in which a greater number of MFIs were self-sufficient is much more desirable.

The necessity of regulation, then, is easily stated. Microfinance should reach more people and should become more self-sufficient, but neither of these is possible without greater access to funds. Access to more funds is only possible when deposit taking is enabled and reliance on donors and government grants ceases. Deposit taking itself, then, necessitates regulatory and supervisory oversight. Without more regulation and supervision, it would not be prudent to allow MFIs to take deposits and without taking deposits, MFIs will likely continue to rely on donor and government funds. “Practitioners and academics alike agree that the future for microfinance lies in developing a well-regulated microfinance environment that will allow the poor to access a wide variety of financial services, effectively linking them to the developed sectors of the economy.” That being said, care should be taken not to implement a regulatory scheme before a particular region is ready to fully and effectively implement it.

65. Id.
66. Focus No. 4, supra note 3, at 1.
67. The Rush to Regulate, supra note 47, at 12.
68. Id.
69. Focus No. 4, supra note 3, at 1.
71. Id.
72. Id. at 5-6.
B. Timing the Implementation of a New Regulatory Framework

While the general consensus is that a more formalized regulatory framework that provides for appropriate enabling legislation and proper oversight will ultimately benefit the microfinance industry as a whole, not all countries—and the MFIs operating within them—are currently ready to undertake such a task.\textsuperscript{73} The challenges that face countries wishing to maximize the productivity of their MFIs lie not only in deciding what type and how much regulation is appropriate, but when the implementation of that framework is appropriate.\textsuperscript{74} While developing the perfect framework may seem to be more in line with moving ahead in the microfinance industry, if one does not take time to adequately consider how that framework will be implemented and the possible hurdles that supervisors and MFIs will face, the "planning of frameworks can lead us into an alluring cloud-land of elegant structures that can't be implemented."\textsuperscript{75} Even "[t]he most carefully conceived regulations will be useless, or worse, if they can't be enforced by effective supervision."\textsuperscript{76} As some suggest, a country's current reluctance to place MFIs under more formal regulation and supervision may have less to do with them turning a blind eye to the needs of the poverty stricken within their borders than it has to do with lack of current supervisory capabilities.\textsuperscript{77} In some countries, the mainstream commercial banking system may be so unstable, and the oversight of that system so challenging, that a supervisor simply lacks the time or resources to adequately perform any new regulatory roles.\textsuperscript{78}

The first factor in determining a country's readiness, or necessity, for financial regulatory reform is whether the current regulatory system "inappropriately inhibits" the poor's access to financial services.\textsuperscript{79} It is important to remember that in this assessment, one should only be concerned with "inappropriate" inhibition and that some regulations that prohibit MFIs from taking certain actions are needed and reasonable.\textsuperscript{80} An example of this type of prohibition would be not to hold NGOs "to any sort of financial standards or oversight [in] taking deposits."\textsuperscript{81} While one of the main goals of new regulation may be to set up a framework in which MFIs are able to take deposits, we should recognize that without that proper oversight and supervision, which presumably is not in place, the ability to accept deposits is unwarranted.\textsuperscript{82} "Inappropriate" inhibi-

\textsuperscript{73} See The Rush to Regulate, supra note 47, at 2.
\textsuperscript{74} See id.
\textsuperscript{75} Id.
\textsuperscript{76} Id.
\textsuperscript{77} See Rush to Regulate, supra note 47, at 3.
\textsuperscript{78} See generally id.
\textsuperscript{79} USAID Programming Tool, supra note 5, at 16.
\textsuperscript{80} Id. at 15.
\textsuperscript{81} Id.
\textsuperscript{82} See id.
tion could include regulations that severely limit an MFI's ability to extend credit. The question, "[Does] the current regulatory framework inappropriately inhibit access to finance among the poor?" is perhaps one of the most important questions in ascertaining whether a particular region is ready for regulatory reform.

By researching and analyzing the data necessary to answer this question, one should be able to determine if a new regulatory framework is likely to have any effect on the poor's access to financial services at all. If the answer to this question is "yes," then it is likely that a new framework is warranted because the current one presumably keeps "larger scale commercial financial institutions from . . . providing financial services to poor households" and keeps "small financial institutions (such as unregulated NGOs) from growing larger, attracting greater and more diverse sources of private capital, and providing a wider array of financial services." A "no" answer suggests that the lack of available financial services to the poor is related to factors other than the regulatory framework, such as a lack of capacity building or market demand. While this question is important, several other factors must be taken into consideration.

The second factor to consider is the existing workload of the financial regulator and the capacity for this regulator to implement a new regulatory framework for microfinance institutions. The question one should try to answer in regard to this issue is, "Does the financial regulator have the potential capacity to undertake new responsibilities that would increase access to finance?" Unfortunately, financial regulators in many countries are already stretched to their limits just trying to manage the existing commercial banking system. Microfinance institutions do not typically operate in the most stable regions of the globe, and the regulators responsible for financial soundness in those regions may be faced with an inadequate staff, a shortage of resources, and a "political minefield" in which to accomplish their duties. Essentially, answering this question will determine if enacting a new regulatory framework would ultimately have any effect on alleviating the problem of the poor's limited access to financial services.

If this question may be answered with a "yes," then "[t]he regulator has a strong grasp of its responsibilities in overseeing the existing financial system and has the resources and technical capacity to undertake potential new responsibilities to overcome regulatory obstacles to access to fi-

83. Id.
85. Id.
86. Id. at 19.
87. Id.
88. The Rush to Regulate, supra note 47, at 2-3
89. Id. at 3.
Unfortunately, many times this question will be answered with a "no." This "no" suggests that the regulator is already being asked to operate above its capacity and is currently unable to meet its responsibilities. In this case, "Any additional work would be overly burdensome, and any regulatory development affecting access to finance could not be carried out in a sufficient manner to achieve any level of success. Any new regulation would likely have no impact on access to financial services." While this article suggests that new regulation and increased supervision is key in achieving far-reaching and self-sufficient microfinance institutions, this regulation is simply not feasible if there are no resources available to put the framework into action.

The third factor that USAID suggests should be considered is the existence of an influential public or private advocate for regulatory reform. This "champion," as USAID terms the advocate, could be either an individual, or, preferably, a group of individuals, who understand the complexities of microfinance regulatory reform and may help to initiate a reform process, either with their political or moral authority. While a champion for reform is a good thing, those hoping for new regulation should be sure not to choose a champion who fails to adequately grasp the ins and outs of microfinance and may push for potentially damaging reform, such as "interest rate caps or the prudential regulation of small credit-only institutions." Assessing this factor will allow proponents of reform to decide whether now is the right time to push for new legislation, or if they should wait until there is a greater consensus of individuals who believe reform is in the best interest of the microfinance industry. Perhaps equally as important as assessing the existence of a champion is determining if there is a "detractor," or an individual, or group of individuals that opposes the reform of microfinance regulation. It is almost certain that proponents will have to overcome some opposition, but if that opposing power has significant influence, politically or otherwise, regulatory reform may not be immediately possible.

The fourth factor for consideration may be viewed from the perspective of the organization pushing for reform. The pursuance of any type of regulatory reform will typically take the efforts of some outside organization. Before that organization undertakes such a task, it should decide whether it has the capacity to actually help in that situation. That organization must evaluate whether it has the available resources, an adequate understanding of the microfinance problems facing a region, and suffi-
cient positioning within the region to effect change. Although some development-based organizations, who don’t have the knowledge or the resources necessary to implement change, may want to assist MFIs in achieving more favorable regulation within a specific region, it may be best for that organization to step aside and let other more adequately positioned groups take the lead.

To be sure, a more formalized regulatory framework and the increased regulation of microfinance entities, have the ability to effect positive change on the problem of access to financial services, but not all regions and not all MFIs are currently ready to pursue that change. While this paper suggests that increasing regulation of microfinance entities may ultimately lead to MFIs having greater outreach to the world’s impoverished citizens and to MFIs becoming more sustainable and self-sufficient entities, it is important to realize that regulatory reform is not currently appropriate for microfinance sectors in every region. Assuming that regulation is appropriate, in that the current regulatory framework is inhibiting access to financial services, and the supervisor, or newly created supervisory organization will have the ability to effectively implement a new regulatory scheme, the next question is “What specific type of regulation is appropriate?”

IV. PRUDENTIAL AND NON-PRUDENTIAL REGULATION

The main purposes of enhanced regulatory regimes for microfinance institutions are clear: “to encourage the formation of new MFIs and/or to improve performance of existing institutions,” and to attain the ultimate goal of “increasing the volume of financial services delivered and the number of clients served.”

What appears to be less clear is what types of regulation will be needed and to what extent each of those types should be utilized. In general, there are two types of regulation, prudential and non-prudential. “Regulation is ‘prudential’ when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions.” Regulation for any other purposes may be termed “non-prudential.” Generally, prudential regulation is more complex, more difficult to administer, and more expensive than non-prudential regulation, which leads to the important principle of avoiding the use of “burdensome prudential regulation for non prudential purposes—that is, purposes other than protecting depositors’ safety and the soundness of the financial sector as a whole.” In order to achieve the goals of improved access to microfinance services and improved sustainability

99. Id.
100. See, generally, USAID Programming Tool, supra note 5, at 15-23; see also, Rush to Regulate, supra note 47.
101. Consensus Guidelines, supra note 6, at 8.
102. Id. at 7.
103. See id.
104. Id.
and self-sufficiency of MFIs, a combination of these two types of regulation, as well as some enabling regulation, will be necessary.\textsuperscript{105} While this is true, care must always be taken to ensure that the regulation enacted is both feasible for the countries and the MFIs in terms of resources and expenses and will result in the desired consequences within the microfinance industry.

A. PRUDENTIAL REGULATION

As mentioned previously, prudential regulation is used to avoid a banking crisis, or a failure of the financial sector as a whole, and to protect depositors.\textsuperscript{106} If supervisors do not limit their focus to these two issues, "resources can be wasted, institutions can be saddled with unnecessary compliance burdens, and development of the financial sector can be constrained."\textsuperscript{107} Interestingly, "[e]ven where it has hundreds of thousands of customers, microfinance today seldom accounts for a large enough part of a country's financial assets to pose serious risk to the overall banking and payments system."\textsuperscript{108} While at some later date it is plausible that systemic risk issues must be taken into consideration, prudential regulation is not currently needed to address issues of this type.\textsuperscript{109} This being said, it is clear that some prudential regulation will be necessary in order to facilitate deposit taking by MFIs. But, what is also clear is that prudential regulation is neither needed nor warranted to address many of the issues facing MFIs today.\textsuperscript{110} Many of those issues may be addressed with non-prudential regulation and will be discussed in part B of this section. Before discussing the possible benefits of prudential regulation, it is important to note that creating new, less-burdensome regulation for microfinance institutions does have the potential to cause undesirable effects.

Some claim that prematurely opening a new "regulatory window," presumably one that does not have requirements that are as stringent as those required of traditional banks, too soon, may result in a "proliferation of under-qualified depository institutions, and create a supervisory responsibility that cannot be fulfilled."\textsuperscript{111} Problems resulting from this prematurely opened window included the licensing of a number of unsound rural banks and the expending of excessive supervisory resources...

\textsuperscript{105} See Focus No. 4, supra note 3, at 1.
\textsuperscript{106} USAID, Microenterprise Development Brief, Regulation and Prudential Supervision for Microfinance Programs—Making the Leap into Formal System 1 (1995) [hereinafter Microenterprise Development Brief].
\textsuperscript{107} CONSENSUS GUIDELINES, supra note 6, at 16.
\textsuperscript{108} Id. at 7.
\textsuperscript{109} Id. at 7-8.
\textsuperscript{110} Id. at 8.
\textsuperscript{111} Id. at 8; see also, Patrick Meagher, Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice [hereinafter Meagher] (2002) at 6, available at http://www.bwtp.org/arcm/mfdm/Web%20Resources/Advanced%20MF%20Resources/Microfinance%20regulations%20in%20developing%20countries%20Oct02%20(IRIS).pdf.
to rectify the situation. While this danger should certainly be considered, this does not mean that regulation of some MFIs cannot prove to be useful, in fact necessary, for the further development of microfinance's outreach to potential clients.

Without a doubt, the prudential regulations imposed on MFIs will need to look different than those typically imposed on regular banks. MFIs are unique entities and face a number of challenges that typical banks do not, such as high unit costs of lending and more rapid decapitalization due to geographically concentrated portfolios and "contagious delinquency." Because microfinance providers have to face this different set of issues and operate in a somewhat different manner than traditional banking, these issues will need to be addressed.

1. Capital Adequacy

As mentioned previously, microfinance portfolios are almost always concentrated in terms of geography, thus making these portfolios more volatile, due to a lack of diversification, and prone to "contagious delinquency," due to the lack of collateral securing the loans. Even though many MFIs post excellent repayment rates, once delinquency begins and repayment ends within a particular area, an MFI's portfolio can deteriorate very quickly. Because microfinance borrowers are incentivized to repay loans solely from their expectation of future access to credit, delinquency can spread like a disease. When one borrower sees that other borrowers are not repaying their loans, they lose their only incentive to pay because the delinquency of others has made it less likely that the MFI will be around in the future to loan to them. If a microcredit client fully believes that the lending institution will fail before that client has the opportunity to receive further loans, the client loses the incentive to repay his or her current loan.

Due to this heightened risk of decapitalization, it seems that MFIs should actually be subject to higher capital adequacy requirements than are applied to normal banks. Although some claim that this "will tend lower the return on equity in microlending, thus reducing its attractiveness as a business," this is likely a hurdle that MFIs will have to overcome—at least until the industry proves that it is capable of adequately managing risks and that the supervisors are able to respond in an expeditious manner to any problems.

112. Consensus Guidelines, supra note 6, at 8.
115. Consensus Guidelines, supra note 6, at 21.
116. Id.
117. Id.
118. Id.; Impact of Government Regulation on Microfinance, supra note 44, at 13-14.
119. Consensus Guidelines, supra note 6, at 22.
2. Relaxation of Unsecured Lending Limits and Loan Loss Provisions

While regulations significantly limiting unsecured lending in traditional banks may be appropriate, these types of regulations, which would limit unsecured lending to, for example, 100 percent of an institution’s equity base, are inappropriate for MFIs. Likewise, regulation “requiring 100% loan loss provisioning for all unsecured loans (at distribution vs. when delinquent) are inappropriate for microfinance.” This first type of regulation would severely limit the ability of MFIs to operate successfully, because it would make it impossible for an MFI to “leverage its equity with deposits or borrowed money.” If MFIs are to achieve sustainability, it appears that they will definitely need the ability to leverage their equity. As for the second type of regulation, while it may be inappropriate to require 100 percent provisioning up front (before delinquency occurs), once a loan becomes delinquent, the fact that the loan is unsecured justifies more aggressive provisioning than would be required of a traditional bank’s collateralized portfolio. Still other types of prudential regulation will need revision before they are applied to MFIs.

3. Loan Documentation

While some sort of loan documentation is almost always necessary for prudential regulation, “[g]iven the nature of microfinance loan sizes and customers, it would be excessive or impossible to require them to generate the same loan documentation as commercial banks.” Where regulation would require financial statements of borrowers’ businesses or evidence that those businesses are formally registered, the regulations should be waived for micro-sized loans. As is pointed out by Hubka and Zaidi, there are a very limited number of microentrepreneurs that even have formally registered businesses, not to mention formal financial statements, as would be required to complete typical loan documentation. Instead, what may be appropriate for microloans is a simple assessment of the borrower’s cash flow. This type of documentation would be fairly simple to implement and would provide significant data on a particular borrower’s ability to repay his or her loan. Moreover, by allowing MFIs to operate with less paperwork, the overall costs of operating an MFI and the costs associated with each microloan are kept at a minimum. This is extremely important to the ultimate success and self-sustainability of the microfinance industry as a whole.

120. Impact of Government Regulation on Microfinance, supra note 44, at 13; Consensus Guidelines, supra note 6, at 22.
122. Consensus Guidelines, supra note 6, at 22.
123. Id. at 23.
124. Id.
125. Id.
127. Consensus Guidelines, supra note 6, at 23.
128. Id.
Although this is just a small selection of issues that will need to be addressed, each of these issues will be important to the overall goal of achieving the requisite prudential regulation necessary to make deposit-taking possible, while working to keep the costs of prudential regulation down. While it is important that this regulation do its job in insuring the strength and soundness of the financial institutions being regulated, it is equally important that the regulation not become so overbearing as to limit the outreach of microfinance institutions. After all, the ultimate goal of any regulatory framework to the microfinance industry is to increase the number of clients served and the number of services offered by MFIs, and thereby decrease poverty on a global scale.

B. Non-Prudential Regulation

As has been noted, "[m]icrofinance as an industry can never reach its full potential until it as able to move into the sphere of prudentially regulated institutions, where it will have to be prudentially supervised." However, that being said, there are a number of issues facing MFIs that may be solved without prudential regulation, thus decreasing the overall cost and increasing the flexibility within a regulatory framework. The non-prudential regulatory issues span a wide spectrum and include "enabling the formation and operation of microlending institutions; protecting consumers; preventing fraud and financial crimes; setting up credit information services," as well as a host of other issues. A few of the more important ones will be addressed below.

1. Permission to Lend

In a number of countries, activities that are not specifically prohibited are "implicitly permissible." In these countries, the legal and regulatory framework will rarely prohibit an NGO-MFI from providing lending services to that country's poor. Although this is true in some countries, other countries disallow lending "unless there is an explicit legal authorization" for such an activity to occur. If this is the case, new non-prudential regulation should be introduced providing for lending capabilities for non-deposit-taking MFIs. This regulation will usually be fairly simple and may not provide for much more "than a public registry and permit-issuing process." While this type of regulation does not enable deposit taking, which this paper argues is key to the ultimate success of MFIs, it is a stepping stone to that ultimate goal. In fact, it is completely plausible that many MFIs will need to start with lending services and

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129. Id. at 26.
130. Id. at 10.
131. Id.
132. See Consensus Guidelines, supra note 6, at 10.
133. Id.
134. Id.
135. Id.
work their way into a fully operational and self-sustainable MFI with both deposit-taking and lending capabilities.

2. **Consumer Protection**

The consumer protection issues may be divided into two sub issues, namely "protecting borrowers against abusive lending and collection practices, and providing borrowers with truth in lending—accurate, comparable, and transparent information about the cost of loans."\(^{136}\) "There is often a concern about protecting microcredit clients against lenders who make loans without enough examination of the borrower's repayment capacity."\(^{137}\) While these issues certainly warrant regulation, many times there is another body that may perform these functions other than the prudential supervisory authority.\(^{138}\) This will free up resources for the prudential supervisory authority to address those problems that do require prudential regulation while lowering the costs to the MFIs.

Moreover, the truth in lending requirements should not require prudential regulation either. Perhaps one of the most important issues within this "truth in lending" subset is the requirement of lenders to express their pricing as effective interest rates.\(^{139}\) As discussed previously, the administrative cost of servicing a portfolio is much higher if that portfolio is composed of many tiny loans as opposed to a few larger loans.\(^{140}\) Because of this, "microlending usually cannot be done sustainably unless the borrowers pay interest rates that are substantially higher than the rates banks charge to their traditional borrowers."\(^{141}\) Many times, requiring the lending institutions to disclose these rates as "effective rates" will be met with public disapproval and political backlash even where these rates make both moral and financial sense.\(^{142}\) This being the case, some question whether it is appropriate to require microlenders to disclose this information in this way, especially because microborrowers have repeatedly shown that they are willing to pay these higher rates necessary to cover the costs of operating a portfolio filled with microloans.\(^{143}\) It is clear that full disclosure should be made as to what is expected of each client and the terms of each microloan, but every effort should be made to avoid unwarranted disapproval by the public or politicians that may be less than fully educated about the microfinance industry.

Although it is clear that prudential regulation will ultimately be necessary in order for microfinance institutions to reach their full potential, a number of issues facing MFIs do not require prudential regulation. By dealing with these issues using non-prudential regulation, the costs of reg-

\(^{136}\) *Id.*

\(^{137}\) *Id.* at 11.

\(^{138}\) *Id.*

\(^{139}\) *Id.*

\(^{140}\) *Id.*

\(^{141}\) *Id.*

\(^{142}\) *Id.* at 11

\(^{143}\) *Id.*
ulation are kept down, and the flexibility within the framework is maximized.

V. CONCLUSION

The proposal of this paper, then, is straightforward. Some prudential regulation is necessary in order for microfinance to reach its full potential. As of now, MFIs lack the funds necessary to reach all the customers demanding financial services and to become self-sufficient entities. The easiest way to increase access to funds is to allow these institutions to take deposits from the same customers to which they currently extend credit. This deposit taking capability, however, should not be given without some prudential oversight. It is important to understand that while some prudential regulation is needed in order for MFIs to reach the ultimate goals of increased access to financial services and increased self-sustainability of MFIs, too much prudential regulation will lead to the demise of MFIs. Prudential regulation is expensive and hard to implement; this being the case, those issues that may be dealt with without prudential regulation should be.

The ultimate regulatory framework within which microfinance institutions will operate should be a balanced one—one that balances the need for oversight and supervision in order to protect customer's deposits with the need to keep costs low and flexibility high for microfinance institutions. MFIs are unlike traditional banks; the cost of doing business is higher, and in many ways they face more substantial risks. Without greater flexibility and lower costs, the ultimate goal of increasing the amount of services provided to the world's poor may never be met.

While the regulatory frameworks adopted in each region will necessarily differ to some degree in order to accommodate issues specific to a region, the basic structure of the regulatory system might consist of a prudential regulatory agency and a regulatory board comprised of members of the microfinance industry. This paper suggests establishing a prudential regulatory agency in each region in which MFIs will operate. The number of tasks with which this agency will be charged should be limited in order to keep the resources used by this agency to a minimum and the costs of running the agency low, both for the country in which the agency is established and for the MFIs, which are regulated by this third-party supervisor. As discussed previously, if this third-party supervisor does not limit its focus to ensuring depositor safety and ensuring the soundness of the MFI sector as a whole, then "resources can be wasted, institutions can be saddled with unnecessary compliance burdens, and development of the financial sector can be constrained."144 Because today the microfinance sector of many economies is not large enough to pose a significant risk to the banking system as a whole (even if a large number of MFIs were to fail), the most important concern of this agency will be

144. Id. at 16.
depositor protection. This prudential regulatory agency, should have the ability to review an MFI’s compliance with guidelines set by the regulatory board, and ultimately grant an institution deposit-taking status. Without a “deposit-taking license” or some form of an affirmative grant of deposit-taking status from this agency, MFIs would be limited solely to microlending activities. The deposit-taking status of an MFI should be reconsidered annually by reviewing the MFI’s compliance with the guidelines and standards set by the regulatory board.

A regulatory board composed of managers and directors of the MFIs themselves could then handle the non-prudential regulation of the microfinance industry. This board could set guidelines and standards that MFIs will need to meet on a yearly basis in order to maintain deposit taking status. By allowing the industry to regulate itself and set its own standards, the costs of regulation may be kept to a minimum. Moreover, the standards set will be in line with what is reasonable and achievable within the microfinance industry. Because the individuals setting the standards work in the industry, they will better understand what is possible and needed in terms of regulation and standards that should be met. This being said, care should be taken to ensure that regulations are firm enough to have the desired response. With self-regulation, there is also the potential for the guidelines to become too lackadaisical in performing their function of ensuring sound MFIs. This problem can be curbed by the oversight of a third-party regulatory agency. After all, it is this agency that will ultimately determine if a particular MFI achieves deposit-taking status.

It may even be possible to implement a “test period” for new MFIs hoping to achieve deposit-taking status. In essence, these entities would work to comply with the guidelines for some period of time, say three to five years, before they would be eligible for licensing by the prudential regulatory agency. After showing the non-prudential regulatory board that it is capable of operating in a way that complies with the guidelines for an extended period of time, then that MFI should become eligible to be licensed. Of course, the opposite is also true. Any MFI that fails to meet the standards set by the industry itself may have its deposit-taking license removed. By splitting the duties of regulation and supervision between a small, focused, regulatory agency and a broader regulatory board comprised of industry participants, costs may be kept to a minimum and flexibility may be placed in the regulatory framework.

Before any step is taken toward a new regulatory framework, it is important to make sure that a particular geographic region is ready for that new regulation. Reviewing the four factors recommended by USAID may help in making this determination. These four factors include the current status and characteristics of the regulatory framework within the country, the capacity of a financial regulator to properly carry out the supervisory role after implementation of a regulatory framework, the existence of some public advocate who may sway politicians and help to
educate the public as to what the reform means, and the opportunity for some outside organization to effect change within the region.\textsuperscript{145} Only when these factors suggest that a region is ready for new regulation should such a project be undertaken. Moreover, it is important to note that every region will require tailoring the specific regulatory framework to its needs and the implementation process of that new framework will look different in each area.

Even history provides some guidance on how the ultimate regulatory framework should look. By allowing the mobilization of deposits through enabling legislation and coupling that with appropriate regulation, the Irish Loan Funds of the 19th century achieved self reliance and sustainability not often found even in today's microfinance institutions.\textsuperscript{146} In direct contrast to the Irish Loan Funds, the subsidized loan programs utilized throughout Latin America rarely saw success.\textsuperscript{147} The answer seems to be clear then. Only if enabling legislation is allowed, supervision of the entities is increased, and MFIs are allowed to pursue their own best interest in operations, will MFIs ultimately achieve their goal of self-sustainability and their goal of increasing access to financial services for the poor.

\textsuperscript{145} USAID Programming Tool, supra note 5, at 15.
\textsuperscript{146} See Does History Matter?, supra note 27, at 2.
\textsuperscript{147} Globalenvision, supra note 4.