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Economic Cooperation

# 2002

## APEC Economic Outlook Symposium

Microbanking Development,  
Regulation and Supervision  
in the Asia-Pacific Region



A P E C E c o n o m i c C o m m i t t e e

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## FOREWORD

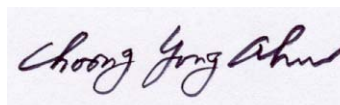
Microbanking has become a central goal in the development strategy of many economies around the globe, by ensuring access to financial services for poor and low-income households and micro-enterprises. In the APEC region, microbanking intermediaries have expanded their outreach during the last decade, setting in motion a process of change from an activity that was entirely subsidy dependent to one that can be a viable business and which has come to the forefront of development discussions concerning poverty reduction.

In response to this, APEC's Economic Committee included a policy paper led by Mexico on "Microbanking Development, Regulation and Supervision in the Asia Pacific Region" as the structural chapter of the 2002 APEC Economic Outlook.

The 2002 APEC Economic Outlook Symposium held in Mexico City, Mexico on 25–26 July 2002, was conducted under the auspices of the APEC Economic Committee. The event was hosted by the Mexican Government through its Ministry of Finance and Public Credit and brought together the expertise of the World Bank, the Inter-American Development Bank and the Asian Development Bank. In all, 260 participants attended the event, including 80 delegates from 16 of APEC's member economies. Expert speakers from a number of institutions were invited, including the Bank Rakyat, BlueOrchard Finance, Desjardins and USAID; government officials from Australia; Canada; the People's Republic of China; the Philippines; Chinese Taipei; Chile; Malaysia; Indonesia; New Zealand; Thailand; Papua New Guinea; Korea; Peru; Japan; the United States; and Mexico; academics from the Universities of Querétaro, Colima and Udine; and private sector experts from Standard and Poors, the Ford Foundation, Price Waterhouse & Coopers, and Deutsche Bank.

During the two day symposium, there was a wide-ranging discussion on the subject of sustainable microbanking intermediaries and the various strategies to foster diverse and high quality microbanking services. The presentations covered both conceptual and empirical grounds, and were all extremely insightful. The symposium explored the need to focus on developing financial infrastructure, building viable institutions, and creating a policy environment conducive to microbanking. Based on the experiences reviewed in the study, it concluded that the APEC region is at the forefront of the microbanking industry. The inputs for this structural chapter on microbanking of the 2002 Outlook report were partly collected and revised during the symposium.

The present volume compiles the papers presented and discussed at the symposium. Publishing the proceedings, by promoting a wider understanding of the ideas exchanged at the event, will help as a foundation for future research on the provision of microbanking services, as well as deepen the understanding of recent economic trends and developments in the region.



Choong Yong Ahn  
Chair, APEC Economic Committee  
2002

## **WELCOMING SPEECH BY JONATHAN DAVIS**

DISTINGUISHED MEMBERS OF THE PRAESIDIUM,  
LADIES AND GENTLEMEN:

It is with great pleasure that I speak to you today as a representative of the Mexican National Banking and Securities Commission, celebrating this meeting of the APEC Economic Committee which will address the topic of microbanking, its operation and development in member economies, and its regulation and supervision.

We thank the APEC Secretariat, particularly its technical committee, for the valuable support they have given us for the celebration of this event. We would also like to thank the experts of the Asian Development Bank (ADB), the World Bank (WB), the Inter-American Development Bank (IADB) and the Bank of National Savings and Financial Services (BANSEFI) who are here with us.

It is a source of great satisfaction to us that, for this event of transcendental importance for the economies of the Pacific Basin, Mexico was chosen as this year's host. We welcome all of you!

Analysis of the evolution that microfinance has experienced in our economies shows that, from being an activity performed primarily by private parties, microfinance initiatives have been gradually transforming into institutionalized financing schemes; moving from a deregulated scenario towards a formal financial system with clear rules and appropriate supervision.

Microfinance has been successfully incorporated into different sectors of economic activity, particularly in rural areas where micro-enterprises and micro-entrepreneurs have developed, giving a great impulse to such regions.

Microfinance therefore constitutes a valuable economic alternative that has contributed to combating poverty, acting as a provider of financial services to a section of the population that traditional banking has not been able to reach. For this reason many Pacific Basin economies have proposed the establishment of this kind of financial intermediary, with the aim of launching diverse projects and activities that will support their social and development programs in a relevant manner.

As regulators, we consider that to accomplish adequate incorporation of these financial intermediaries within the formal financial system, it is imperative we recognize the differences between them, such as their size, type of operation, degree of maturity and level of operation, so that they will be able to be included in an appropriate regulatory scheme. This classification will promote an increasing supply of services to channel credit adequately, to foster savings and to develop local projects that benefit a great segment of the population. Additionally, this will realize a fundamental objective: to protect the users of these kinds of financial services.

In Mexico, popular savings and credit as well as microbanking operations have existed for over 50 years, since the "*cajista* movement" was born. This in turn gave birth to the *cajas populares*, organized as civil associations based on an efficient self-regulatory system.

By the end of 1991, "savings and loans societies" were created in order to operate in the popular savings and credit market. That same year the creation of a system of rural cooperatives known as *cajas solidarias* was promoted, but was not incorporated to the formal financial system and thus was not subject to the regulation and supervision of financial authorities.

In 1994, the new Cooperative Societies General Law included for the first time in Mexico the concept of the savings and credit cooperative as a form of consumer cooperative. Most of the former *cajas populares* were transformed into cooperatives, while the rest became savings and loans societies. This scheme substantially modified the original organization and structure of the operation of cooperatives in Mexico.

With the aim of adjusting and modernizing the popular savings and credit system, in June 2001 a corresponding law was enacted which only recognizes two legal forms as key parts of the system: the savings and loans cooperatives and the popular financial societies, and the latter will have to be constituted as marketing societies.

Simultaneously, a new law was enacted to transform the *Patronato del Ahorro Nacional* created over 50 years ago to the Bank of National Savings and Financial Services (BANSEFI). The new institution has a broader scope of action than its predecessor since it has to support the development of the new popular savings and credit system. It does this by coordinating assistance from the Federal Government, training and technical assistance, the development of technological infrastructure, and other services.

The regulation and supervision of the system and its intermediaries remains in charge of the National Banking and Securities Commission (CNBV). The CNBV will use a mechanism of auxiliary supervision headed by the federations that will establish specially created supervision committees. Consequently, federations will share the responsibility of preserving the financial soundness of their affiliated entities and of supervising them, ensuring that they comply with the relevant legal dispositions.

Besides their auxiliary supervisory duties, federations will be able to offer corporate services to their affiliated entities, including technical, judicial and financial counseling, training, coordination of activities, representation in international fora, organizations and others. Federations will be grouped in confederations which will manage the Depositors Protection Fund.

This Protection Fund will be a trust fund which will receive the quota deposits that each entity will contribute based on its revenues. The Confederation will be responsible for constituting the trust fund and designating the members of the technical committee. The Fund will aim at covering the deposits for a previously established maximum amount.

Lastly, I would like to take this opportunity to express my gratitude for the support and technical assistance provided by international organizations such as *Desjardins* of Quebec, Canada, the World Council of Credit Unions (WOCCU), the German Confederation of Savings and Credit Cooperatives (DGRV), the Foundation of *Caissees Populaires* of Germany, and the Spanish Confederation of Savings Cooperatives (CECA).

To our distinguished expositors and participants in general, I welcome you to Mexico City wishing you the best so that this trade of experiences, knowledge and ideas be of great value and usefulness for everyone.

Thank you very much!



**WELCOMING REMARKS  
BY DR MOISÉS SCHWARTZ ROSENTHAL**

Mr Jonathan Davis, President of the National Banking and Securities Commission,  
Dr Choong Young Ahn, President of the APEC Economic Committee,  
Representatives from the APEC economies,

Ladies and gentlemen,

As a representative of the host economy of the Asia-Pacific Economic Cooperation Forum for 2002, and on behalf of the Mexican Ministry of Finance, it is my pleasure to give the warmest welcome to the delegates from APEC member economies, distinguished experts from the international development community, and representatives from the Mexican microbanking community—what we call in Mexico the *Sector de Ahorro y Crédito Popular*.

I would also like to express my utmost gratitude to the APEC Secretariat for providing the funds without which this symposium would not have been possible, to the APEC Economic Committee for its active support to the Microbanking Initiative, and to the Mexican staff for the outstanding organization of this event. Likewise, I want to thank all the speakers who will be sharing their experiences and perspectives, as well as the National Banking and Securities Commission and the Bank for National Savings and Financial Services of Mexico for their generous support.

Over the past two decades, the Asia-Pacific region has seen an increasing interest in consolidating solid and well-regulated domestic financial systems. However, we cannot complete this challenge without considering the need to expand, on a sustainable basis, its reach to the poorest and most vulnerable segments of the population.

We have defined microbanking as the provision of a wide array of financial services—including primarily savings and loans—to the traditionally unbanked population. Microbanking has gained increased relevance in the international arena as a tool of social development, a means to abate poverty, and as a profitable and sustainable business in itself.

Although microbanking is particularly relevant for the less developed economies, it should be pointed out that it has been ever-present, to a greater or lesser extent, in many industrialized economies. Indeed, microbanking experiences in industrialized economies go back to the late nineteenth century and their success lies in the fact that this activity has become an integral part of their domestic financial systems. The experiences of the credit unions in Canada and the United States are certainly prime examples of this.

The mounting importance and complexity of microbanking, coupled with the potential occurrence of insolvency episodes among microbanking institutions, has highlighted the need for an appropriate regulation and supervision framework, as well as for a specific strategy for the development and strengthening of this sector.

Microbanking is of particular interest for Mexico since the development of a popular credit and savings system has been stated in the National Program for Development Financing (PRONAFIDE) 2002–2006, as one of the main pillars of the government's strategy to strengthen national savings. As it provides alternative financial means for overcoming poverty and the lack of opportunities among the most vulnerable segments of the population, it has been incorporated as a centerpiece of social policy.

The regulation and supervision of microbanking activities is a relatively new topic and still open to intense debate. However, this debate revolves not on whether microbanking should or should not be subject to regulation, but rather on the way it should be regulated and supervised. The experiences that will be presented in this symposium will reflect a wide diversity, depending on each particular economy's institutional setting, and will provide valuable lessons...

In all we can expect a rich and valuable discussion, covering a wide array of topics, ranging from the benefits of microbanking for microenterprises and other specific segments of the population, to more complex issues dealing with the institutional and legal setting for effectively regulating microbanking intermediaries; the role of credit bureaus and rating agencies, as well as the importance of new sources of funding.

Finally, I would like to inform all of you that in addition to this symposium, Mexico has elaborated a study on the development, regulation and supervision of microbanking in the APEC region, which will be published as the structural chapter of the *APEC Economic Outlook for 2002*. I would like to take advantage of this opportunity to thank several APEC economies, as well as leading experts from the Asian Development Bank, the Inter-American Development and the World Bank, for their active participation.

We hope that this symposium, together with the published study, will succeed in calling the attention of the APEC community as a whole, including its Economic Leaders, to the relevance of microbanking for economic development, and ultimately for improving the living standards of our societies.

Thank you.

**OPENING ADDRESS  
BY DR CHOONG YONG AHN**

Mr. Davis, Mr. Rosenthal, distinguished guests, ladies and gentlemen...

It is a great pleasure and honor to be here this morning to address such esteemed participants from the APEC economies and leading scholars from around the world. Before I start, I would like to take this opportunity to give special thanks to Mexico for its warm hospitality and excellent leadership in preparing this important gathering. I would also like to express my gratitude and congratulations to the Economic Committee (EC) Symposium Organizing Committee members for their hard work in preparing for the symposium as well as providing the structural chapter of the *2002 APEC Economic Outlook* report.

An annual publication of the Economic Committee since 1995, the preparation of the *Economic Outlook* has become an important part of the EC's work program. This report reviews recent economic developments in the region and the economic performance and prospects of APEC member economies. It also addresses topical structural issues that are key to understanding these developments and trends, and provides an analytical foundation for policy-oriented work and discussions by APEC Senior Officials as well as other APEC fora.

As most of you are aware, the EC Symposium is an annual event traditionally hosted by the economy leading the outlook report. The symposium allows the APEC EC members as well as leading scholars to gather in one place to share information regarding the theme at hand.

The APEC Economic Outlook Report has been prepared through the collaborative efforts of all member economies, with one economy volunteering for the role of coordinator. However, this year, we have two separate coordinators: the EC Chair's Office and Mexico. The EC Chair's Office leads the first chapter of the report in analyzing the economic performance and prospects of the APEC member economies, while Mexico leads the structural chapter titled, "Microbanking Development, Regulation and Supervision."

During the past few years, microbanking has received increasing attention, especially from developing economies and international financial institutions. Microbanking has proven to be a very useful tool for providing financial services to lower-income segments of the population, as well as to micro-enterprises.

Currently, a wide array of financial products and services such as credit, savings, insurance, and remittance services is offered by a broad range of intermediaries, including credit unions, credit cooperatives, thrifts, savings banks, commercial and state banks, as well as non-governmental organizations (NGOs).

It is worth noting that microbanking intermediaries are frequently not considered as components of the formal financial system because they have a relatively limited weight in terms of their overall mobilization of financial resources, despite the fact that they serve a significant number of people. Nonetheless, the mounting importance and complexity of microbanking, coupled with the potential occurrence of insolvency episodes among microbanking institutions, has highlighted the need for an appropriate regulation and supervision framework, as well as for a specific strategy for the development and strengthening of this sector.

In this sense, the regulatory reform of the financial sector is essential, and it should encompass every aspect of national financial systems, including those institutions that provide services to the low-income population. Thus, it is essential to study these institutions, particularly their

microbanking regulation and supervision experiences, across the APEC economies before embarking on a regional policy dialogue on the topic.

In this context, the Senior Officials' Meeting (SOM) held at Shenzhen, China, welcomed Mexico's intention to continue pursuing human capital building during its chairmanship of APEC in 2002, focusing on micro-enterprises and gender issues.

Considering these points, it is proposed that the APEC economies engage in an initiative consisting of a comparative study of microbanking regulation and supervision in the Asia-Pacific region, particularly those intermediaries that provide savings services, aimed at the following objectives:

- a) Reviewing recent experiences of APEC member economies regarding the regulation and supervision of these financial activities, considering specifically how it has contributed to the development and strengthening of more sophisticated intermediaries.
- b) Analyzing complementary promotion policies and specific institutions or mechanisms devoted to supporting microbanking activities.
- c) Assessing the concrete effects of microbanking on the targeted beneficiaries, that is, the low-income population and micro-enterprises demanding its services.

The results found in the case studies from APEC member economies will be extremely helpful for the developing economies in APEC. The importance of sustaining economic growth and development in the APEC region has a lot to do with how microbanking is developed, regulated and supervised. Without a regulatory environment conducive for growth, microbanking cannot develop fully.

The primary objective of the symposium is to obtain as many views and perspectives as possible to include as inputs into the preparation of the 2002 *Economic Outlook* report. The symposium seeks to evaluate the on-going debates of the challenges and perspectives of microbanking. Furthermore, the results of analytical work on the key factors for development, regulation, and supervision of microbanking will be presented.

The symposium seeks to draw wisdom from the experiences and research of advanced member economies for many creative policy recommendations for the development of microbanking in member economies.

It is my hope that in the next two days of meetings we will be able to not only focus on the supply-side of microbanking, but also the demand-side. As mentioned previously, I would like to see chapters one and two linked in such a way that we can draw policy implications for the APEC economies. As in the past, the results of this research will be used not only by the APEC economies, but also by Senior Officials and Finance Ministers. The EC continues its efforts to find ways to integrate the Finance Ministers' Process with the Senior Officials' Meeting to further the growth and development of the APEC member economies. I would like to encourage continued efforts for cooperation and collaboration as well as the constant search for new ways of working together. This report is essentially a collaborative work of the APEC economies, the intellectual community and practitioners.

I look forward to hearing your ideas on policy implications and other issues.

Thank you.

**KEYNOTE ADDRESS  
BY JAVIER GAVITO MOHAR**

**STRATEGY TO DEVELOP THE POPULAR BANKING SECTOR IN MEXICO**

Prof Ahn Choong-Young,  
President of the APEC Economic Committee,  
Ladies and gentlemen:

It is an honor to participate in this symposium on “Development, Regulation and Supervision of Microbanking in the APEC Region”, and be able to share with you some aspects of the development and institutional strengthening policies of the popular banking sector in Mexico instrumented by President Fox’s administration.

In Mexico, popular banking has been permitted to deliver financial services for some sectors of the population for several decades, thus proving its viability. Lack of access to traditional banking services resulted from the reduced income of these groups or because they lived in small and/or distant localities.

When analyzing the experiences of economies with mature popular financial systems—such as Germany and Canada—one can observe prudential regulation similar to that applicable to commercial banking, and the incorporation of relevant best international practices. Consequently, it is pertinent to try to establish a link between regulation and supervision and the development of microbanking—as the name of the symposium proposes; to study the regulation and supervision of popular banking, or microfinance as it is commonly referred to in the Asia-Pacific region, not only focusing on regulation and control but also considering the sustainable development of the sector given the security offered by its regulation. Likewise, it has been proven that governments can play a relevant role in the promotion and strengthening of microbanking through the implementation of well-designed strategies, oriented towards generating economies of scale and promoting the efficient operation of intermediaries.

In this sense, one of the main pillars of the financing for development policy established by the Mexican Ministry of Finance, through Secretary Francisco Gil Díaz, consists of completing and deepening the financial system through the incorporation of a greater number of regulated intermediaries, in order to expand banking services to more segments of the population. This is aimed at increasing national savings and, at the same time, offering access to the low-income population to formal financial services in competitive conditions and with greater judicial security, and thus extend to them the benefits resulting from economic openness and globalization. On the other hand, policies to alleviate poverty are expected to include an instrument that facilitates the conversion of the development of capacities in the population—promoted by programs such as Oportunidades, Procampo and *Fomento a la Vivienda*—into opportunities to generate permanent sources of income, such as owning a patrimony. This can be achieved through financing productive projects and acquiring housing, among other products and financial services.

Savings institutions or *Cajas de Ahorro* in Mexico emerged as an initiative by communities—sometimes a church group—more than five decades ago. The first attempts to regulate them took place at the beginning of the 1990s. However, the existence of gaps in the cooperatives legislation was used by some people to conduct illegal operations and, although this situation occurred only in certain institutions, it affected the image of the whole sector. In April 2001, Congress approved the Popular Savings and Credit Law, taking the first step towards regulating and supervising this sector. This new institutional agreement respects the form in which the

sector was organized traditionally—in federations and confederations—and takes as a reference best international practices concerning regulation, supervision and accounting standards.

As I pointed out, the abovementioned reflects the government's priority: the development of popular financing schemes in a broader sense. That is, searching to consolidate the social banking sector, which is composed of two types of institution: those in the popular banking sector (financial entities and cooperatives) whose main characteristic is that they receive savings, offer credit and have an expanded presence (this group of entities is the main focus of the symposium since they are generally subject to regulation and supervision and thus are formal or semiformal financial intermediaries); and institutions devoted to microcredit which do not receive savings, have a targeted presence and focus their activities on offering credit to the low-income population and those in extreme poverty.

It is estimated that approximately 600 intermediaries operate in the popular savings and credit sector in Mexico. As a result of the creation of a new census, today we have operative, financial and technological information of 388 of the 600 entities.

In the new institutional arrangement for the popular savings and credit sector, besides the establishment of a new legal framework that includes regulation and supervision mechanisms—in this case auxiliary supervision—a new bank has begun operations: The Bank of National Savings and Financial Services (BANSEFI). It offers financial products custom-made for the sector and promotes and facilitates the modernization of the Popular Savings and Credit Entities (EACPs) in technology, information services and training among other areas.

Another role that BANSEFI is currently undertaking consists of supporting the *cajas de ahorro's* transition process to regulated intermediaries. The transition period to adjust to the new legal framework, as envisaged in the Popular Savings and Credit Law, contemplates a two-year interlude. Let us remember that that interlude began on 4 June 2001, the day the law was published in the government's Official Journal. After that date, the entities will have to make the necessary adjustments to fulfill the requirements of the law and of their own prudential regulation. This is, without a doubt, a complex transition process which is treated from different fronts and with the support of the international community. The international community has showed interest in the process that the Mexican popular finance sector is going through.

One of the main components of support during the transition is the “Project for Strengthening the Savings and Credit Sector and the Creation of the Rural Microfinancial Capacity”, financed with a credit recently approved by the World Bank and a grant by the Multilateral Investment Fund (FOMIN), an institution of the Inter-American Development Bank. The project aims to offer:

- Training and technical assistance to strengthen the operation of the popular savings and credit entities.
- The construction of a technological platform for the sector in order to enhance its effectiveness in developing, operating and distributing financial products and services in the entities' subsidiaries. In order to do so it is crucial to connect, in real time and through a single system, the entities and the federations, confederations, BANSEFI, and the financial authorities.
- A dissemination campaign that allows the population to be informed of the objectives and benefits of the Popular Savings and Credit Law and that is able to place the sector's network, which I will elaborate upon later.

The part of the project that corresponds to the Program of Technical Assistance to Rural Microfinancing (PATMIR), which is part of the Ministry of Agriculture, Farming, Rural Development, Fishing and Food (SAGARPA), aims to offer schemes of sustainable development through solidarity groups in regions of extreme poverty, with the objective of

supporting the growth of these organizations and thus contributing to their eventual transformation into regulated entities.

Other schemes of support to the entities during the transition process are: the works of the National Association of Mexican Notaries, in order to facilitate the change of judicial form; counseling in structuring federations, with the support of the Foundation of *Caisses Populaires* of Germany for International Cooperation and the Government of Germany; the works in collaboration with the Mexican Institute of Public Accountants to conduct a fiscal analysis of all tax obligations that the entities will have from now on; and, as I have mentioned, the elaboration of studies of, and diagnosis of, the sector. Additionally, institutions such as the World Council of Credit Unions (WOCCU) and the US Agency for International Development (USAID) are offering direct support to various institutions within the sector.

We consider that it is convenient to conduct periodic assessments of the impact of microfinance in the targeted population in order to ensure that the objectives of the strengthening and developing strategy of the sector are being met.

It worth mentioning that in each step that has been taken there has been a broad consensus in the sector, which has generally proved to have an interest in being regulated and accept the support programs. Since this is a key factor for growth, the sector will be able to offer more products and services to its clients and participate in more sophisticated markets.

Over the last two months, much work has been done regarding the pilot programs to build the Sector's Net, the 'Net of the People'. This is a unique net that groups together subsidiaries of the popular savings and credit entities and of BANSEFI in order to distribute financial products and services. The basis of the net is the connection between entities using a technological platform designed and built by BANSEFI. It is estimated that this year 445 entities' subsidiaries will be able to join the net, together with 590 subsidiaries of BANSEFI, a total of more than 1,000 selling establishments. It has been further estimated that this number could reach 3,000 distributing establishments over the next three years. We consider this project to be of great importance because it will allow the connected entities to achieve economies of scale and offer formal financial services to regions and populations where access to traditional banking services is difficult.

Governmental support of the different social development programs can also be delivered through the net, as can other services such as remittance transfers, at low cost for the targeted beneficiaries. This process will incorporate more low-income Mexicans within the banking system. In January 2002, agreements with several Ministries were formalized to distribute many programs, first through BANSEFI and then through the unique Sector Net. Agreements were signed with the Ministry of Health in order to deliver savings and charging services for the popular insurance bonus; with SAGARPA to distribute the payments of PROCAMPO; with the Ministry of Social Development to distribute the payments of *Oportunidades* and other programs that are currently being developed in that Ministry; and with INFONAVIT the agreement of savings prior to housing was renewed so that workers would have direct access to financing once they have saved. in BANSEFI, 15 percent of the amount of credit they are entitled to.

It is important to note that the assistance given by *Oportunidades* is done primarily through women, often housewives, and that scholarships are primarily awarded to girls to counter their high levels of school desertion, particularly in the later years of basic education.

Government assistance is paid through BANSEFI and then through the Sector Net following the opening savings accounts. Besides making the payments transparent, this system allows the beneficiaries to better manage their resources. However, it is worth stressing that the popular savings and credit sector adds value to these government programs by educating the lower-

income population to better manage their savings so that they can access other financial products and services, promoting their incorporation into the banking system.

The popular finance sector has great potential for development. Today it services more than 3.5 million people but it is estimated that the potential market might be 20 million. This potential is reflected by the entry of new participants in this market and by the increasing number of low-income Mexicans joining the financial system. A deep, solid and competitive financial system will allow the most unprotected sectors to have the necessary conditions and instruments to access better levels of welfare and will promote a more balanced regional development.

Nonetheless, it is crucial to conduct the transformation process of regulated entities and future growth of the sector in an orderly manner. In order to do so the support of the international community is key. It is thus very appealing to discuss these issues with such a valuable group of public officials and experts as the one gathered here. I thank APEC and the Mexican governmental bodies involved for their efforts in organizing this international cooperation forum. I am certain that during the following days new ideas will emerge which will contribute to the strengthening and institutionalizing of the transition process of the popular savings and credit sector in Mexico.

Thank you very much.



# **THE RELEVANCE OF MICROBANKING TO APEC**

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## **ABSTRACT**

The 2001 Declaration of APEC Leaders reaffirmed their commitment to the Bogor goals of free and open trade and investment. It also canvassed issues of globalisation and shared prosperity and the need for social safety nets to protect the vulnerable in a globalising world economy. The impression of a growing APEC interest in matters of distribution and equity was heightened by the Leaders' call for APEC to build on its plan of action for SMEs and to 'place special emphasis on micro-enterprises'.

Mexico is responding by hosting two international meetings in 2002. They are a Symposium on Microbanking, for the Economic Committee (July) and a High Level Meeting on Micro-enterprises (August). Not all economies are equally convinced that these topics are relevant, either to their own domestic concerns, or to their priorities for APEC. The challenge is for these two meetings to demonstrate the relevance of microbanking and micro-enterprise development for every member economy, and to show the need for a 'whole-of-APEC' response to issues of common concern.

This symposium defines microbanking quite broadly. It includes provision of financial services to micro-enterprises, but also to 'low-income segments of the population'. This includes individuals and households as well as enterprises. Institutions providing microbanking services include formal and informal entities, and regulated and unregulated ones. The definition covers the disparate circumstances of the full range of APEC economies. It provides an excellent basis for discovering issues of common concern.

'Financial exclusion' is the issue of common concern. In every APEC economy, some proportion of enterprises, households or individuals is excluded from access to financial services for a variety of reasons. This exclusion requires a response, and the process of overcoming financial exclusion can be given the generic label of 'microbanking'. In developing member economies, microfinance may be the form of microbanking offering most promise. In developed member economies, the appropriate solutions may be more heterogeneous.

Based on the definition of microbanking, the household, and not the individual or the micro-enterprise, is the most appropriate unit of analysis. Households may be both units of production and of consumption. In the developing economies they are both of these. The household-based micro-enterprise is the most numerous business entity and the greatest source of employment. Microbanking in such countries can raise the productivity of households as producers as well as increasing the welfare of households as consumers.

In the developed economies, micro-enterprise is insignificant and the household is predominantly a unit of consumption. There are household production units in developed economy agriculture, but these are highly capitalised enterprises, not micro-enterprises. Financial exclusion impacts negatively on the consumption of a proportion of households, and microbanking can improve their welfare as consumers. The paper includes a brief discussion of financial exclusion in Australia, to illustrate the applicability of microbanking in one developed economy.

APEC can take up issues of microbanking within its established process of ECOTECH (economic and technical cooperation). ECOTECH activities in the various working groups were, from 1990, the earliest expression of Asia-Pacific economic cooperation in pursuit of common goals. The ECOTECH process continues and has recorded some successes.

TILF negotiations (trade and investment liberalisation and facilitation) came to dominate the APEC process after the Bogor goals were agreed in 1994. But the economic crisis from 1997 demonstrated the need for continuing attention to the foundations of development, as well as exposing the limits of APEC's comparative advantage in negotiating further reductions in border barriers to trade. This paper argues that APEC's comparative advantage lies in its capacity for economic and technical cooperation, and that ECOTECH complements the TILF agenda. ECOTECH has moved to the heart of APEC, and TILF is not achievable without it.

Despite successes, ECOTECH suffers from flaws. There is a proliferation of ECOTECH projects (more than 300 of them). Many have been the 'pet' projects of particular member economies with limited engagement of other economies. While the overall ECOTECH program has been worthy, it has not achieved either visibility or impact. APEC has not succeeded in launching any ECOTECH project of sufficient scale and scope to capture the imagination of all Leaders and to catalyse substantial private investment.

APEC needs a 'landmark' ECOTECH project (or perhaps a small number of such projects) to dramatise the real potential of ECOTECH as a process. Microbanking could form a worthy element in such a landmark project, since it acts to improve economic efficiency in all economies. It also contributes to the 'sharing of prosperity' called for by the Leaders in Shanghai.

Microbanking's contribution to economic efficiency derives from its capacity to promote financial deepening, particularly in the developing APEC economies. Secondly, it promotes the export competitiveness of developing economies by supplying low cost wage-goods and services demanded by industrial workers, thus helping to keep labour costs low. It contributes to the sharing of prosperity in all economies by raising the consumption levels of financially excluded households. In developing economies it assists poor households to meet both their production and consumption needs. And in all economies it assists female-headed households.

The most important outcome of this symposium will be a strategy for promoting microbanking and micro-enterprise in APEC. The simplest option (the 'default option') would be an ECOTECH project to add to the 300 or so projects already commenced. But Mexico has higher goals for APEC than that. A more innovative approach would be to put microbanking/MED into a context provided by other recent ECOTECH goals announced by the Leaders. The outcome of the recent Merida dialogue on globalisation and shared prosperity is also helpful in defining that context.

APEC Leaders made their first specific and verifiable ECOTECH commitment at Brunei in 2000. This was a pledge to secure universal Internet access across the region by 2010, at least at the community level. At Shanghai in 2001, Leaders focused on human capacity-building, with particular reference to the 'New Economy'. But the ECOTECH process has so far lacked continuity. It does not yet have procedures to assure that successive APEC Chairs progress the commitments steered through by their predecessors. Thus the Brunei IT pledge has not secured the necessary momentum to become 'mainstreamed' into the APEC process. Nor has the Shanghai human capacity-building agenda, although it has demonstrated a capacity to catalyze private sector investment.

This paper suggests that the microbanking symposium should call for an initiative at Los Cabos later this year. This initiative would bind the Leaders' commitments to IT access and human

capacity building together with a complementary program for microbanking and MED. This would become the landmark ECOTECH activity, and could give the necessary visibility, coherence and momentum to economic and technical cooperation within APEC. It could catalyze private sector resources and (while not itself an 'aid' program) would be complementary to bilateral and multilateral programs of development assistance, as well as addressing issues of common concern to all the APEC member economies.

## 1. Introduction

The 2001 Declaration of APEC Leaders reaffirmed their commitment to the Bogor goals (and drew a ‘roadmap to Bogor’ which takes into account issues of globalisation and the ‘new economy’) as well as committing to the opening of a new World Trade Organisation (WTO) round in Doha. Less conventionally (at least in terms of APEC’s historic preoccupations) the Declaration includes an instruction to ministers and officials to ‘build on APEC’s Integrated Plan of Action for SMEs and place special emphasis on micro-enterprises’.

In placing issues of micro-enterprise development on the APEC agenda, the Leaders appeared to demonstrate an interest in ‘development’ in a more multidimensional sense than heretofore, and a new concern for issues of distribution and equity. This impression was reinforced by their call for member economies to develop and strengthen ‘social safety nets’ to protect the vulnerable and by the proposals to commence an APEC dialogue on ‘globalisation and shared prosperity’ and to conduct a Ministerial Meeting on Women in 2002.

By convening this international symposium on microbanking, Mexico is extending the Leaders’ concerns for micro-enterprise development and ‘shared prosperity’ to a new field of economic policy. This is concerned with a particular form of financial sector development, the creation of ‘microbanking’ institutions.

A problem arising from the new focus on micro-enterprise development and microbanking is that some economies, particularly the most developed, may question its relevance, either to their own domestic concerns or to their priorities for APEC. To respond convincingly to any such misgivings it will be necessary to demonstrate a significance for micro-enterprise development and microbanking in every economy, and to show the need for a ‘whole of APEC’ response to issues of common concern.<sup>1</sup>

A High Level Meeting on Micro-enterprise (HLMME), to be convened in August at the initiative of Mexico, is also concerned with issues of financial services for micro-enterprise, although it ranges across a broader landscape than this microbanking symposium. The HLMME is to consider issues of financial services for micro-enterprise and other matters such as capacity-building and regulatory frameworks relevant to the goal of developing a flourishing micro-enterprise sector. By contrast, this microbanking symposium is concerned with a more discrete issue.

We need to think about how the issues thrown up by the two meetings convened by Mexico in 2002, on microbanking and micro-enterprise respectively, relate to those of the Economic Committee and the SME Working Group of APEC. It will be important for us to consider how these issues might be progressed most effectively within the APEC process, rather than dropping quietly out of sight after this year.

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<sup>1</sup> During the decade or more I have been associated with the Foundation for Development Cooperation, it has developed two primary streams of research and advocacy. The first, from 1991 to date, has been concerned with microfinance, from a financial sector development perspective. The second has been concerned with the economic and technical cooperation agenda of APEC. In this latter cause, the Foundation has convened a Policy Dialogue Group of independent observers of APEC periodically since 1995. This group has been consulted by successive SOM Chairs and has contributed to defining and advancing the ECOTECH agenda in a unique ‘second track’ process. The confluence of these two primary interests of the Foundation in 2002 was quite unexpected, but represents a welcome opportunity to synthesise our experiences in these hitherto unrelated fields. I am grateful to my colleagues Andrew Elek and Paul McGuire for commenting on sections of this paper.

## 2. The Microbanking Initiative

The microbanking initiative with which this meeting is concerned is aimed at:

- a) Reviewing recent experiences of APEC member economies regarding the regulation and supervision of these financial activities, considering specifically how they have contributed to the development and strengthening of more sophisticated intermediaries.
- b) Analyzing complementary promotional policies and specific institutions or mechanisms devoted to support microbanking activities.
- c) Assessing the concrete effects of microbanking on the targeted beneficiaries, that is, the low income population and micro-enterprises demanding its services. (www.shcp.gob.mx/ec2000)

For the purposes of this initiative, microbanking is defined as

‘an activity consisting in the provision of small-scale financial services, such as credit, savings, insurance, and remittance services, which are targeted towards low-income segments of the population and micro-enterprises. This activity can be undertaken by a broad array of intermediaries, ranging from non-governmental organizations (NGOs) to credit unions, thrifts, savings banks, commercial banks, state banks, etc.’ (www.shcp.gob.mx/ec2000).

This definition is broad, encompassing financial services demanded by both micro-enterprises and 'low -income segments of the population'. Further, financial service providers defined as 'microbanks' include both formal regulated financial institutions and a range of registered and unregistered entities operated by voluntary or civil society organisations. The definition is crafted to cover the disparate circumstances of the full range of APEC member economies, from the most to the least developed. This is useful because it permits the issue to be generalised, and its relevance to all economies explored.

## 3. Generalizing the Microbanking Issue for All APEC Economies

If microbanking is to be seen as relevant to all economies, it is necessary to frame the discussion in a manner capturing the diversity within APEC. One way of approaching this is to accept that in all APEC economies, whether 'developed' or 'developing', and whether market-based or transitional, there are population subgroups which are not adequately served by formal financial systems, nor by conventional financial institutions, especially the banks.<sup>2</sup> This failure of service can be described as 'financial exclusion' and the definition of microbanking clearly anticipates such situations. The concept of financial exclusion, observable to a greater or less degree in all APEC economies, provides a basis for generalising the issue of microbanking. Microbanking can be seen as a response to the common problem of financial exclusion.

Financial exclusion occurs in developing member economies, where the informal or unremunerated sector is of major importance as a source of livelihood for the poor.

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<sup>2</sup> A classification of economies for the purpose of this paper, focusing on aspects of financial sector development as it relates to microfinance and microbanking, is as follows:

**a) Developing market economies**

Brunei Darussalam, Indonesia, Malaysia, Papua New Guinea, Philippines, Thailand, Mexico, Peru, Chile.

**b) Transitional (developing) economies**

People's Republic of China, Viet Nam, Russia.

**c) Developed market economies**

Japan; Republic of Korea; Canada; Australia; New Zealand; Hong Kong, China; Chinese Taipei, Singapore; the United States.

Considerations such as geographic isolation, low population density and gender also play a part in determining patterns of unequal access in economies where financial sector development is limited. Particular sectors, notably smallholder and peasant agriculture, with their associated post-harvest and off-farm economic activities, pose special challenges for financial service provision. A general problem in the developing member economies is the inability of many lower-income people to meet lenders' requirements for formal physical collateral.<sup>3</sup>

Financial exclusion occurs also in developed economies, where the forces of privatisation and rationalisation impelled by the internationalisation of finance have wrought massive structural changes in domestic financial markets. In some cases such restructuring has led to the withdrawal of conventional financial institutions from particular geographic areas or demographic categories. In other cases, increasing economic and social polarisation has caused conventional financial institutions to focus their services on 'high yield' market segments and to neglect others. Gender is a variable influencing access in developed member economies as well as in the less developed.

Thus in all APEC economies there are groups whose members, in consequence of this denial of service, face obstacles in realising their economic and social potential. This is most commonly because their income levels and the quantum of their financial service needs are pitched substantially lower than those of the population groups which have access to formal financial services. This is not to say that the deprived subgroups are necessarily minorities. Indeed they may be a majority by number, though certainly not by share of income, within their economies. In the least-developed economies of APEC formal financial institutions may serve only between 25 and 50 per cent of populations.

Microbanking is a concept obviously applicable to developing country circumstances, but less obviously so in the depopulated farmlands of the Australian 'outback' or in blighted inner urban areas of the US. And what is described as 'micro' in the operations of the Vietnam Bank for the Poor differs enormously from the 'microcredit' operations of Women's World Banking, Japan, an NGO working with female micro-entrepreneurs in the latter country. But in each of the cases mentioned, Viet Nam and Japan, outback Australia and inner city Chicago, attempts are being made to develop alternative, non-conventional, financial service delivery mechanisms for households without access.

In the developing member economies, 'microfinance' is a useful summary term to capture the variety of financial service mechanisms being developed to meet the needs of financially excluded households. 'Microfinance' (in its various manifestations) is the form of 'microbanking' most applicable in those economies. Annex 1 contains a brief description of the most common models of microfinance.

However 'microfinance' is an unhelpful term to apply in the circumstances of developed economies, for a host of reasons. These include the limited success of developing economy microfinance models when transposed to the setting of high income countries. Effective solutions to financial exclusion in developed economies are likely to be a good deal more heterogeneous than the various models of microfinance which prove successful in the developing economies of APEC.

#### **4. The Household as the Basic Unit of Analysis**

The definition of microbanking we have been given includes 'low-income segments of the population' among the clients of microbanks. I suggest this should be interpreted as referring to households. Households may serve dual roles as productive units and as units of consumption.

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<sup>3</sup> As Hernando de Soto has shown, land tenure and land titling deficiencies often prevent the poor from collateralising assets they have accumulated.

In developing member economies, households are the primary units of both production and consumption. Households are the basis of the great majority of micro-enterprises in those economies, and micro-enterprise itself is the most common mode of productive activity. By contrast, while in the most developed APEC economies there are some household production units organised as micro-enterprises, micro-enterprise itself is not a significant element in their economic systems. Hence the principal economic function of the household in the developed economies is as a unit of consumption.

In this paper I argue that, in the developing member economies, the household and the micro-enterprise are one and the same and any distinction between household expenditures for production and consumption is problematic. Microbanking services are properly directed to satisfying both the production and consumption needs of the household. Microbanking services can improve the productivity of household enterprises while also increasing the welfare of households as consumption units.

The financial service needs of poor households are simple but their satisfaction can be life enhancing. They need access to convenient, liquid and safe deposit services which are protected against inflation by positive real rates of interest. With savings in reserve, householders are able to smooth their consumption expenditures in the face of uncertain income streams. Savings provide a shield against catastrophic events which, by forcing the vulnerable to divest productive assets, would otherwise tip them over the dividing line between meager sufficiency and poverty. Microinsurance is a related financial product with potentially profound welfare benefits. Similarly, poor households which make their living in a myriad of activities in the informal sectors of developing member economies, many of them either landless or with insufficient agricultural land, need access to credit to increase the productivity of their labour or to free them from exploitative financial relationships.

By contrast, micro-enterprise in the developed member economies is of quite limited significance; production is very largely external to the household. In these circumstances we should see the role of microbanking as being primarily to serve the consumption needs of households and the communities in which they live. In these developed economies, the relevance of microbanking to APEC's concerns is that it has the potential to contribute to 'shared prosperity' among households excluded from conventional financial services. And to the extent that this ameliorates the impact of market-opening measures in developed economies, on those who would otherwise bear a disproportionate share of their costs, microbanking could increase the political feasibility of moving towards the Bogor goal of free and open trade and investment.

## **5. Financial Exclusion in a Developed Economy: Australia**

I want to illustrate the general relevance of the concept of 'financial exclusion' by referring to the developed APEC economy with which I am most familiar. Australian researchers have studied the consequences for households and communities of financial exclusion, defined as 'the processes that prevent poor and disadvantaged social groups from gaining access to the financial system'. Connolly and Hajaj noted the withdrawal of commercial banking services from particular geographic areas and social categories, compelled by forces of rationalisation and restructuring, discussed above in section 3.

According to the researchers, [t]he most basic, and the most important financial service for most Australians is the bank account. The provision of a bank account is essential for receiving pay and benefits and making and receiving payments. Having a bank account is no longer a mere convenience—it is a prerequisite for engaging in the economic process.<sup>4</sup> According to

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<sup>4</sup> Connolly C & Hajaj K, Financial Services and Social Exclusion, Financial Services Consumer Policy Centre, University of New South Wales, Sydney, 2001. <http://www.fscpc.org.au>

these Australian researchers, the impacts of the withdrawal of services are suffered by households and small business (although there is no discussion of microenterprise, *per se*, in this study).

In Australia, there have been a number of responses, both governmental and community-based, to the removal of banking services and consequent financial exclusion. They include the establishment of 'transaction centres' for financial services in post offices, supermarkets and other places in communities from which the banks have departed. They include the emergence of 'Community Banks' in a growing number of towns and suburbs, facilitated by a 'franchising' operation in which a particular dynamic provincial bank offers citizen groups access to its banking license under a strict set of conditions as to capital commitment, community involvement and operational standards.

The responses also include initiatives by the Australian credit union movement to fill financial service gaps in some communities. The Australian credit unions are, quite apart from their responses to these more recent changes in the Australian financial landscape, an interesting and instructive study of alternative approaches. They have undergone progressive modernisation and embraced technology, and reach out to new communities, including Aboriginal people and migrants.

There is also some evidence of the reinvigoration of a nineteenth century social institution, the 'friendly society' as a base for providing access to financial services to the long-term unemployed and low income families. Efforts are being made to associate friendly societies and credit unions with RoSCAs (rotating savings and credit associations) which operate along traditional lines among the recently-arrived in some migrant communities. Other initiatives are being taken by voluntary welfare agencies to free low -income earners (the 'working poor') who do not have access to bank credit from dependence on so-called 'payday lenders' who operate at the factory gate. The other developed member economies of APEC could no doubt provide similarly heterogeneous lists of popular initiatives to address problems of financial exclusion.

## **6. The Mandate for Microbanking's Introduction into APEC**

Mexico's advocacy of microbanking as an initiative for APEC 2002 responds directly to the Shanghai APEC Leaders' Declaration of October 2001. As mentioned above, the declaration emphasized development, distribution and equity, as well as introducing 'globalization and shared prosperity' to APEC's agenda. For the Leaders to affirm the importance of these issues was not to de-emphasise APEC's goals of free and open trade and investment, as agreed by the Leaders at Bogor in 1994. Instead, it recognised that APEC also has the explicit goal of narrowing the disparities between member economies in levels of development. This is not controversial; the Manila Declaration of 1996, which codified APEC's agenda for economic and technical cooperation (ECOTECH), was quite unambiguous on the subject.

The Manila Declaration also implied that the reduction of economic disparities *within* member economies is an appropriate goal of economic and technical cooperation. It stated that promoting 'the full participation of all men and women in the benefits of economic growth' is a 'guiding principle' of ECOTECH.

By placing micro-enterprise development on the agenda of APEC's Small and Medium Enterprise (SME) Working Group, APEC Leaders have given prominence to an issue that affects the lives of a majority of households in developing member economies (and at least some households in all economies). It reflects an appropriate response to the issues of 'globalization and shared prosperity' cited by the Leaders in Shanghai, and certainly has the potential to support the 'full participation of all men and women' called for in Manila. Mexico,



as chair of the APEC process throughout 2002, has responded by adopting micro-enterprise development (and, associated with this, microbanking) as a major theme for APEC this year.<sup>5</sup>

Mexico has shown leadership in submitting an initiative on microbanking development, regulation and supervision to the APEC Economic Committee. By proposing to devote the 'structural' chapter of the 2002 APEC Economic Outlook to an examination of this subject, Mexico has placed issues of microbanking at the centre of an influential document presented annually to the Leaders. In doing so it has accepted the challenge to demonstrate the relevance of microbanking to the central economic agenda of APEC. This will require Mexico to consider issues of economic efficiency, in addition to the equity and distributive goals encapsulated in the term 'shared prosperity'.

## **7. Economic and Technical Cooperation in APEC**

APEC can take up microbanking as an issue most appropriately as a new element in the 'economic and technical cooperation' (or ECOTECH) process. And just as some member economies may have reservations about the relevance of microbanking to their domestic concerns, some also may fear the neglect of APEC's supposed 'main game', the TILF (trade and investment liberalisation and facilitation) agenda. Any such apprehension is uncalled for.

Although TILF has dominated the APEC process for most of its short history, it is useful to be reminded by two champions of Asia-Pacific economic cooperation that 'APEC set out with the broad aim of sustaining the momentum of successful economic growth in East Asia and the Pacific'.<sup>6</sup>

Consistent with this 'broad aim', activities which have come to be known as ECOTECH were commenced from the very beginning. Thus, according to the inaugural SOM Chair:

*When APEC was established in 1989, the process was expected to deal with far more than international trade and investment. By 1991, APEC working groups had commenced exchanging information, identifying shared interests and options for co-operative activities in ten aspects of economic development, ranging from human resource development to transport and telecommunications. The Committee on Trade and Investment (CTI) was not established until 1993.*

*However, following the Bogor commitment of APEC Leaders to the vision of free and open trade and investment by 2010/2020, promoting trade and investment liberalisation and facilitation (TILF) soon overshadowed other aspects of the APEC process. The Osaka Action Agenda relegated ECOTECH to the status of a separate, and somewhat secondary, endeavour of APEC.<sup>7</sup>*

Nevertheless, policy-makers in some APEC economies, particularly developing ones, were determined to prevent the eclipse of ECOTECH. Thus in 1996, under Philippine leadership, the Leaders adopted the *Manila Declaration on an Asia Pacific Economic Cooperation Framework for Strengthening Economic Cooperation and Development*. According to the 1996 SOM Chair, the *Declaration* was a response to the need

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<sup>5</sup> However the SME Working group appears to regard 'micro-enterprise' as consisting of the smallest enterprises in the formal, trade-oriented, sector. The Working Group may not be sufficiently sensitive to the concerns of informal household-based enterprises. Definitional confusion may account for discrepancies in the reporting of data by particular economies. See Annex 2 for a discussion of this issue.

<sup>6</sup> Andrew Elek and Hadi Soesastro (1999), 'ECOTECH at the heart of APEC: Capacity building in the Asia-Pacific region'. Brisbane, The Foundation for Development Cooperation, page 9.

<sup>7</sup> Andrew Elek (2000), 'Capacity-building in the Asia Pacific: a way forward for ECOTECH'. Brisbane, The Foundation for Development Cooperation, page 10.

*to develop a clear conceptual framework which allowed economic cooperation and development cooperation being promoted jointly by APEC governments to be clearly distinguished from 'old-style' foreign aid, which carried overtones of patron-client relations, policy conditions and leverage. A new model of development cooperation was needed, based firmly on the guiding principles of mutual respect and mutual benefit which underline the APEC process.*<sup>8</sup>

The *Manila Declaration* sets out goals for economic and technical cooperation, including 'sustainable growth and equitable development', the reduction of economic disparities, improved economic and social well-being of the APEC peoples, and a deepened 'spirit of community' among them. It defines guiding principles for ECOTECH which reflect the APEC culture of mutual respect and mutual benefit referred to in the quotation above, together with genuine partnership and consensus. Finally, it lists a number of specific themes to be pursued as priorities in economic and technical cooperation among the members.

The economic crisis from 1997 demonstrated the need for continuing attention to the foundations of growth. It exposed severe deficiencies in economic policy and institutions, including the need to rebuild domestic and international financial architectures. This has focused attention on the potential for economic and technical cooperation between member economies to contribute to the rebuilding process.

Over the same period, and in response to the same forces at work in the global economy, APEC has developed a better understanding of its own limitations as a vehicle for negotiating further reductions in border barriers to trade. During the crisis, and with a new round of WTO negotiations thought likely to commence, Andrew Elek and Hadi Soesastro commented that

*As a voluntary process of cooperation, APEC is not likely to provide an effective framework for negotiating and enforcing involuntary reforms of trade and investment policies... the negotiation of involuntary reforms should be left to the WTO.*<sup>9</sup>

So, if APEC does not have comparative advantage in the negotiation of involuntary trade reforms, perhaps it has an edge in the field in which it took its earliest steps? Elek and Soesastro suggested that

*Having built up new channels for region-wide communications, APEC leaders and officials do have comparative advantage in designing options for economic and technical cooperation which can draw on information, experience, expertise and technology from throughout the region and make it available widely to many Asia-Pacific economies.*

They argued that, in consequence of the crisis, ECOTECH had 'moved to the heart of APEC', and that

*Rather than attempting to mimic WTO negotiations within the region, APEC governments can develop cooperative strategies to prepare the ground for successful WTO outcomes.*

This would involve both strengthening individual economies to meet the challenge of further liberalisation and a concerted approach among APEC members to a new WTO round. Elek and Soesastro argued for

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<sup>8</sup> Federico Macaranas, 'Foreword', in Andrew Elek (ed) 1997, 'Building an Asia-Pacific Community: development cooperation within APEC'. Brisbane, The Foundation for Development Cooperation.

<sup>9</sup> Andrew Elek and Hadi Soesastro (1999), 'ECOTECH at the heart of APEC', op. cit., page 15.

*an integrated view of the APEC process within which all cooperative activities are seen as ways to strengthen the capacity of Asia-Pacific economies to reach their full potential for sustainable economic growth [and] ... to enhance their productive resources and to allocate them in an increasingly efficient and sustainable way.*

In practice, ECOTECH has suffered from a proliferation of activities, organised by the working groups or via *ad hoc* arrangements. There have been well over three hundred projects in total since 1989. Most of these activities have been small, involving the collection and exchange of information. Many have been in the nature of 'pet' projects of the member economy sponsoring and funding the activity, and have involved relatively few other member economies. The very diffusiveness of this set of activities has prevented ECOTECH from demonstrating its value conclusively.

APEC has not so far succeeded in launching any ECOTECH project of sufficient scale and scope as to capture the imagination of all its leaders or to catalyse substantial business support. APEC badly needs one or a small number of landmark ECOTECH projects to dramatise the potential benefits of its cooperative approach to development. It should reflect the agreement of APEC Leaders, expressed collectively, to assure appropriate political support and the certainty of follow-up by successive APEC Chairs. I will return to this subject in section 9, below, in the context of discussing a strategy for promoting Mexico's microbanking and micro-enterprise initiatives within APEC.

## **8. The Relevance of Microbanking to APEC**

The arguments for microbanking's relevance to APEC, and hence for its incorporation into APEC's program of economic and technical cooperation derive from a number of sources. These include microbanking's potential to contribute to the economic efficiency of all economies and hence to their capacity to engage in free and open trade and investment. They also include microbanking's capacity to promote that sharing of prosperity for which the APEC Leaders have called. These attributes make microbanking a highly appropriate addition to the ECOTECH agenda.

### **a) Microbanking's contribution to economic efficiency**

In all economies, developed as well as developing, microbanking can contribute to the process of financial deepening, which is an important concomitant of economic development. Broadly speaking, financial deepening is observable in increases in the stock of financial assets (as measured, most commonly, by M3) relative to the flow of economic activity (as measured by GNP). Higher-income economies tend to have 'deeper' financial systems than lower-income economies. Moreover, when comparing economies at similar levels of development, those growing relatively fast tend to be financially deeper than slower-growing ones.

As far as I am aware, no central bank in the world actually counts the deposits of non-regulated microbanks in its measure of M3. Financial sector authorities are slow to appreciate either the nature or significance of microbanking as an instrument for financial service delivery to the poor or its capacity to support financial deepening. In fact, with the possible exception of Bangladesh, the transactions of microbanking institutions are of minimal significance in the financial aggregates of all economies, so the lack of interest in measuring them is understandable.

Nonetheless, there is real significance, in terms of financial sector development, in the extension of savings facilities to millions of poor householders. This is true no matter how low the mean balance of their accounts. The poor, especially in the developing economies, can demonstrate a surprisingly high propensity to save. This is particularly true if they have access to safe, liquid, deposit facilities bearing positive real rates of interest. Extension of financial

services to the poor, especially deposits, lays the foundation for a cumulative process of financial deepening.

A second important contribution to economic efficiency relates to the developing economies and concerns their competitiveness in international trade. Micro-enterprises in these economies are, as previously discussed, mainly household-based and are the most numerous units of production as well as the largest source of employment. It is true that micro-enterprises, especially the typical ‘survival’ enterprises of the poor, make little direct contribution to exports. However in some economies, for example Chinese Taipei, there are well established supply-chain relationships in export industries which reach down into the household-based micro-enterprise sector. Lower wage rates paid in that sector can be a factor in the international competitiveness of economies where such relationships prevail.

The most important (if indirect) contribution to export promotion of micro-enterprises consists in their capacity to supply wage-goods and services to the industrial workforce. For developing economies to exploit comparative advantage in manufacturing based on low labour costs, it is necessary for workers to have access to low cost wage-goods and (particularly) services. It is the comparative advantage of micro-enterprise to produce such goods and services, which can form a substantial proportion of the consumption -basket of manufacturing workers. This is especially the case where workers in export-oriented manufacturing are employed away from their homes and families, as is often the case.

This relationship between micro-enterprise and export-oriented industry is seen, for example, in the neighbourhood of the *maquiladores*. These are manufacturing and assembly plants, many of them established with foreign capital and clustered along Mexico’s northern border with the US, producing for the US market. The *maquiladores* grew rapidly in numbers and employment with the benefit of market-opening measures agreed under NAFTA.

Micro-enterprises have sprung up around the *maquiladores* to serve the needs of an industrial workforce. Street stalls supply food and drink, while other micro-entrepreneurs offer ‘home stay’ accommodation, minibus transport, outdoor haircuts, tailoring and a host of other workers’ needs. Microbanking institutions can play an important role in increasing the productivity and profitability of such micro-enterprises, by funding the capital requirements of micro-entrepreneurs.

Microbanking institutions serving the needs of industrial workers can contribute to export competitiveness in other ways. By providing deposit services they can assist industrial workers to accumulate savings. And by providing funds transfer services, they can reduce the transaction costs of remittances to families. By increasing the net rewards of participation in the industrial workforce, such services tend to reduce wage pressures in export industry.

#### **b) Microbanking’s Contribution to ‘Shared Prosperity’**

To repeat a point made in the previous section, microbanking could be regarded as trivial in financial terms, in the sense that the transactions of microbanking institutions would scarcely register in the consolidated balance sheets of the financial sectors of any APEC economy. However these transactions are significant in the lives of millions of poor people who are not served by formal financial institutions.

The crude ‘trickle-down’ analogy for the diffusion of the benefits of growth may be discredited. But if, for heuristic purposes, we were to adopt that analogy and pursue its implications, microbanking could be described as a mechanism which opens capillary systems to enable the benefits of growth to flow to poor and low income people, and to facilitate their participation in it.

The Shanghai Declaration, as we have seen, called for member economies to develop and strengthen 'social safety nets' to protect the vulnerable. It also proposed an APEC dialogue on 'globalisation and shared prosperity' (subsequently commenced at Merida in May 2002) as well as calling for a ministerial meeting on women.

The focus on micro-enterprise at Shanghai is consistent with these statements of concern for distributional equity. Firstly, micro-enterprise conducted at the household level provides income to poor and low income people in the developing member economies. Action to improve the productivity of these micro-enterprises will have direct distributional benefits.

Microbanking can assist the sharing of prosperity in developing economies by assisting poor households to meet both their consumption and production needs. In developed economies, microbanking can raise the consumption levels of the financially excluded. And in all economies, female-headed households are over-represented among the poor, and stand to gain disproportionately from access to microbanking services.

## **9. A Strategy for Promoting Microbanking in APEC economies**

The value of exploring solutions to financial exclusion through microbanking will be greatest in the developing member economies, where the degree of exclusion is greatest. These are the economies in which household-based micro-enterprise is most significant as a form of economic activity.

However, all member economies stand to benefit to some extent from the cooperative examination, within the APEC framework, of issues of financial service provision for financially excluded households. There will be particular value in bringing together the experience of microbanking mechanisms in Asia and Latin America, where rather different approaches are being taken. Similarly, there will be value in comparing the approaches taken to reducing financial exclusion in the developed member economies. APEC needs a process by which every member economy could discover and institutionalise appropriate forms of microbanking for its circumstances.

The simple and obvious solution would be to initiate a discrete project on microbanking, perhaps in the broader framework of a micro-enterprise development (MED) project, but in all other respects similar to many of the several hundred 'good ideas' which have so far been progressed under the ECOTECH framework. That could be described as the 'default option'. I believe Mexico has higher ambitions for microbanking and MED.

A more innovative solution might be to place Mexico's concern for microbanking and MED in the context of other priorities for economic and technical cooperation set by the Leaders at recent annual meetings. For this we should start with the Leaders' commitment, given at Brunei Darussalam in 2000. This was for the APEC economies to achieve Internet access, at least at the community level, for all the people of the region by 2010. This was the first such agreement by Leaders to a specific and verifiable ECOTECH goal.

Brunei assured some follow-up for this goal in 2001 by agreeing with China to the joint sponsorship of a High Level Meeting on Human Capacity Building, in Beijing in May 2001. This event was concerned with capacity building for the 'New Economy', *inter alia*. There have since been some follow-up commitments of business resources in support of the Brunei goal (for example, a Chinese regional training initiative supported by major international IT corporations and a recent agreement between Mexico and Microsoft).

However it is not clear that there is sufficient momentum yet for the Brunei Internet access goal to be pursued coherently and successfully in an ECOTECH framework. APEC has not

developed mechanisms, such as those which exist for the prosecution of the Bogor trade goals, to push forward major ECOTECH commitments.

This account of recent APEC history is relevant to Mexico's interest in microbanking and MED, and to its desire to see these important issues taken up by APEC. Are APEC's discussions and resolutions on these subjects during 2002 to be simply a 'one-off' exercise, politely neglected by future APEC Chairs? We must hope not.

A more valuable outcome would be to set a realistic goal for better access to financial services for micro-enterprises and households, backed by a substantive strategy to achieve that target. Such a new target would need to be, and be understood to be, a goal which complements the already agreed goals of free and open trade and investment and community-based access to ICT.

Earlier this year, at the Merida Dialogue on globalisation and shared prosperity, consensus emerged that APEC should give more emphasis to goals that complement the goal of free and open trade and investment. Specifically, it was thought APEC should give attention to issues that improve the distribution of the potential gains from free and open trade and investment. These could include improved access to basic needs and to income-earning opportunities.

It was also agreed at Merida that the Brunei Darussalam vision of community-based access to ICT by 2010 will be given renewed momentum by APEC leaders. This formulation gives us the direction to take, by providing a framework in which we can bind together previous agreements, to pursue mass access to ICT (Brunei) and human capacity-building (Shanghai), with Mexico's goals for MED and microbanking, all in a manner supportive of the Bogor goals of free and open trade and investment.

The next question is whether APEC can take a significant new initiative on microbanking and micro-enterprise at Los Cabos, without overcommitment and in directions consistent with ECOTECH goals agreed at Brunei and Shanghai. A consultation on ECOTECH was held at Acapulco, in August 2002, in association with SOM III. This will provide possibly the last opportunity in 2002 before the Leaders meeting to discuss the outlines of such an 'omnibus' proposal. Perhaps this symposium on microbanking could lay some of the foundations for further discussion in Acapulco.

It would also be necessary for APEC to differentiate such an activity from the bilateral development assistance activities of member economies, to assure that it is not seen as taking on "aid" functions. Instead, APEC could catalyse resources from agencies such as the World Bank and the regional development banks, providing them with new opportunities to build capacity in more efficient ways. The Brunei goal for ICT is capable of catalysing business sector resources, as has been shown by the agreements made by China and Mexico with leading international IT firms.

## **10. The Relevance of APEC to Microbanking**

Section 8, above, discussed the relevance of microbanking for APEC. In it I concluded that it had positive potential for both the sharing of prosperity and the economic efficiency of member economies, and thereby the capacity to support the achievement of the Bogor goals of free and open trade and investment.

It is now relevant to turn the question around and consider the relevance of APEC to microbanking. This is because microbanking (better known as 'microfinance' in developing economies and best known, although misleadingly so, as 'microcredit') is a well-established developmental tool employed in multi- and bilateral programs of development assistance. The

question of whether APEC has any particular comparative advantage in regard to microbanking must be considered.

Perhaps APEC has no more comparative advantage in regard to promoting microbanking than it does in promoting trade liberalisation, given the mandate of the WTO in the latter field. For that matter, the Telecommunications and Information Working Group, or numerous other APEC working groups, may appear to have no particular comparative advantage in their respective fields, given the existence of other specialised international agencies dealing with the issues concerned.

However, discovering APEC's comparative advantage in any cooperative process requires an understanding of its unique character. It is a group of economies closely linked by ties of trade and investment, whose members are at various stages of development and include transitional as well as market economies, drawn from both sides of the Pacific. The ECOTECH process draws its strength, as Elek and Soesastro point out, from the 'new channels for region-wide communication' created by APEC leaders, officials, academics and business leaders. These channels 'enable them to draw on information, experience, expertise and technology from throughout the region' and to disseminate it, both among the member economies, and more widely.

APEC's engagement with microbanking should be complementary to that of multilateral agencies and international financial institutions already active in the field. It should also complement the activities of bilateral programs of development assistance, being at all times careful to differentiate its programs from those of bi- and multilateral agencies, and to avoid any suggestion that it has become an 'aid' agency in the conventional sense.

Finally, there is another characteristic which emphasises the 'beyond aid' character of ECOTECH. This is that APEC's economic and technical cooperation is applied to solving problems and filling needs which are generalised to all the member economies, developed and developing, market and transitional. For all these reasons I have no doubt that APEC is relevant to microbanking, just as it is to exploring common approaches to a host of issues confronting the member economies.

Economic and technical cooperation between APEC member economies should be conducted on issues of microbanking, in the forms of policy dialogue, exchanges of information and technical cooperation. These activities should be directed, *inter alia*, to policy development appropriate to the circumstances of each economy. Technical cooperation between economies could contribute to institution building and human capacity building for the microbanking sector. Annex 3 provides a summary list of issues which could be addressed by such cooperation.

The scope of activities should be generalised to cover the range of alternative financial service delivery options practiced in member economies for the benefit of poor and low -income people who lack appropriate access to financial services from conventional sources. This would contribute to the more effective operation of micro-enterprise in those economies where it is of most economic significance and would support the more effective 'sharing' of prosperity in all economies.

## Annex 1

### Models of Microfinance in the Developing Member Economies

Among the proliferation of microfinance institutions (MFIs) in developing countries, a number of distinguishable models have emerged. The **Grameen Bank model** has been applied in many countries. It requires careful targeting of the poor through means tests, usually with a focus on women and intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. Some compulsory saving requirements are imposed, but in general quite limited voluntary saving occurs. Sustainability is achieved by increasing the scale of operations, and by decentralising control and carefully managing costs. While some other models have as their goal the creation of autonomous institutions, this is not expected of the individual borrower groups. In Bangladesh, where the greatest numbers of Grameen-inspired institutions exist, considerable innovation is being applied to this model.

The **Village Bank** is a widely replicated model, found mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications. Typically, an implementing agency establishes individual village banks with between 30 and 50 members and provides capital for on-lending to individual members. Individual loans are repaid at weekly intervals over 16 weeks, at which time the village bank returns the principal, with interest, to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of loan capital, and also encourages savings. Savings accumulated in a village bank can be loaned out to members. Village banks are intended to become autonomous institutions.

Somewhat less structured than village banks (and a good deal less so than Grameen banks) are **Credit Unions** (CUs). These are democratic, non-profit financial cooperatives owned and controlled by their members. CUs mobilise savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance.

A fourth model, based on **'self-help' groups** (SHGs) is somewhat similar to the village bank concept, although less structured. SHGs have around 20 members who should be relatively homogeneous in terms of income and social status. The primary principle of SHGs is the lending of members' savings but they also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typically, SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become freestanding institutions.

In a quite different category from the four models discussed above, each of which has strong voluntary elements involving the action of NGOs or community-based entities, is what might be called a **'rural financial systems model'**. As practiced in Indonesia, this model exhibits a diversity of regulated financial institutions providing rural financial services. These range from a national-level institution with substantial outreach and extensive networks to small, local institutions occupying particular market niches. Also, depending on the regulatory environment in a particular country it may be possible for an NGO to transform a successful MFI into a regulated financial institution, while maintaining its mission to provide microbanking services.



## Annex 2

### APEC's SME Working Group

The Small and Medium Enterprises (SME) Working Group reports to a ministerial-level meeting on SMEs, conducted annually as part of the APEC cycle. Ministers adopted an Integrated Plan for SME Development at their meeting in Kuala Lumpur in 1998. This plan, to which the Leaders referred in the Shanghai Declaration of 2001, notes that

*SMEs form the backbone of the economies of APEC. They employ as much as 80 percent of the work force, contribute 30 to 60 percent of the GNP and account for around 35 percent of total exports in the region. They also make up over 95 percent of all enterprises.*

From this description of the scope of the SME sector, it seems likely that self-employed workers in the informal sectors of the APEC economies are, in principle at least, covered by the mandate of the SME Working Group. This impression is strengthened by the Ministers' statement that

*The objectives of the Plan take into account the differences in the levels of development of each economy. In some of the developing economies there is also a need for special consideration of the interests of the micro-enterprises and SMEs operated and managed by women as they form the core of poverty alleviation and rural income augmentation programmes.*

Further, on the subject of women and micro-enterprise, Ministers noted that

*In the case of SMEs operated and managed by women entrepreneurs it is necessary to discern the extent to which these enterprises face gender-bias impediments in their attempts to seek financing, skills, technology and training, and in marketing their products. The interests of women entrepreneurs form an integral part of an overall approach to entrepreneurial development. Measures to address gender-bias impediments should seek to change mind-sets and publicise the fact that women have better repayment records—as experience with rural credit institutions testifies.*

The Ministers' comment on good repayment performance of women in rural financing appears to be informed by the much-publicised experience of microfinance institutions, such as the Grameen Bank, serving poor and low-income borrowers, especially women.

The objectives of the plan for SME development are stated as follows:

- to accelerate the pace of SME development in accordance with its growth potential in the APEC region
- to maximise SME efficiency goals along the region's key economic sectors—primary, industrial, trade and services
- to enhance SMEs' dynamism by facilitating their access to markets, technology, human resources and skills, financing and information
- to strengthen the resilience of SMEs so they can withstand adverse macroeconomic and financial developments including external shocks
- to achieve socio-economic goals through by using SMEs as a source of growth and employment especially in the rural sector of the developing economies of APEC

In regard to the financing difficulties of SMEs, the plan notes (in terms that apply perfectly well to micro-enterprises operated by the poor, and which explain why microfinance has been seized upon as the answer to their financing needs) that

*[they] have difficulties in defining and articulating their financing needs. The small size of these enterprises and the high transactions costs arising from the lack of collateral and thus high risks, explain the reluctance of bankers to provide financing.*

However the plan's discussion of measures to overcome these obstacles leaves one with the impression that, in practice, the SME Working Group is not concerned with either micro-enterprise development or the associated financing needs. It is suggested that

*...export credit refinancing schemes may be instituted to reduce the risks arising from exporting...and that ..[o]ther forms of financing should also be made known to the SMEs. These include equity financing, issue of debt and venture capital especially in the high-technology industries. SMEs also need to be trained in managing various financial risks, in particular those arising from exposure to foreign exchange volatility which has now become a major feature of globalisation.*

The SMEWG's concern is primarily with larger enterprises, those likely to be directly 'trade exposed'. It is not concerned with petty traders and the providers of services in the informal sector, still less with the 'survival enterprises' of the very poor. However, there are other measures proposed which do have relevance for the micro-enterprise sector as well as for SMEs, such as the suggestion that

*Member economy governments can set up credit guarantee corporations to insure commercial banks from default arising from advancing loans to SMEs without collateral...or that Documentation difficulties can be overcome by designing simple forms for loan applications rather than insisting that SMEs submit detailed project proposals.*

But overall it seems clear that the SMEWG has not yet given attention to the specific needs of financing for MED, particularly as it is found in the less developed economies, as distinct from those of its close but much larger relative, SME. Since the SME Working group has focused its attention so much higher up the scale, there must be doubt whether it is prepared to handle the agreement of principles for, and the conduct of cooperation concerning, micro-enterprise financing and MED issues between APEC member economies.

## Annex 3

### The Policy and Regulatory Framework for Microbanking

#### A. Policy objectives

1. Persuading all relevant agencies (both within the APEC structure itself, and domestically within the economies) to commit to the principle that creating mechanisms for sustainable microbanking is an objective of financial sector development
2. Creating an enabling policy environment for microbanking, starting with the freedom for service providers to set interest rates at levels which assure institutional sustainability and freedom of entry to the market by institutions, subject to their satisfying regulatory and prudential standards
3. Designing an appropriate domestic financial sector architecture: creation and/or facilitation of appropriate institutions, including some or all of the following:
  - dedicated microbanking services cells within commercial banks
  - licensed non-bank micro -financial institutions (for profit, non-profit)
  - reformed State rural and agricultural development banks
  - a viable and socially inclusive credit union movement
  - second tier institutions for microfinance institutions (MFIs)
  - ratings agencies for MFIs to facilitate capital raising
  - apex institutions for MFIs
  - deposit guarantee mechanisms for regulated MFIs
  - accountable civil society organisations performing financial and/or social intermediation.
4. Avoiding the unintended adverse consequences for microbanking of other financial sector policies, and of public policy more generally
5. Designing criteria and arrangements for direct member economy promotion of microbanking
6. Supporting capacity-building for staff of microbanks and supervisory authorities; establishing systems of accreditation to facilitate professionalisation
7. Finding the appropriate balance between assistance to financial and business development services for micro-enterprise
8. Supporting the commercialisation of microbanking, by means including the ‘downscaling’ of commercial bank operations and the ‘transformation’ of MFIs into regulated institutions
9. Creating a policy and regulatory environment for telecommunications which facilitates the introduction of ICT to all appropriate microbanking applications: transactions, training and public education, supervision

#### B. Regulatory and supervisory issues

1. Choice of institutions for regulation and supervision, and appropriate authority(s) to regulate and supervise
2. Performance and reporting standards for regulated microbanks

3. Prudential regulation, including capital adequacy liquidity loan provisioning
4. Governance standards and appropriate self-regulation for institutions
5. Development and application of risk-based supervision techniques appropriate for microbanks; application of ICT to data collection for off-site supervision and other purposes
6. Capacity-building for supervisory agencies and staff
7. Oversight of civil society organisations engaged in microbanking
8. Sensitive and supportive approaches to informal self-help financial activities.

**C. Operational issues**

1. Achieving operational and financial sustainability.
2. Benchmarking for performance and reporting standards.
3. Governance and transparency.
4. Managing arrears.
5. Savings mobilisation through development of attractive savings products.
6. Mobilising other financial resources for scaling up.
7. Human capacity building for staff, management and boards of MFIs, including the application of ICT for training.
8. Human resource management, including remuneration and career structures.
9. Effective management of group-based microfinance.
10. Creating mutually beneficial working relationships between regulated financial institutions and other MFIs and informal financial service entities: financial linkages and social intermediation.
11. Offering appropriate non-financial services; measuring and recovering their costs.
12. Harnessing ICT for operational efficiency.
13. New product development

# THE DESJARDINS MOVEMENT IN QUÉBEC

**Adriana Maturana**  
**Desjardins International Development, Canada**

## The Desjardins Movement

The Desjardins Movement is a network of credit and savings cooperatives that form a comprehensive financial group, offering diversified and competitive services to its members. It was the first financial institution in the province of Québec and the sixth in all Canada.

Desjardins was founded in 1900 by Alphonse Desjardins. At that time several beginning cooperative movements were in Europe, particularly in Germany and Italy. Desjardins chose to focus its business on organizing popular credit based on popular savings.

**Table 1: Statistics 2001**

Members	5,140,710
Number of cooperatives	879
Desjardins global assets	87 billion dollars (including those outside of Québec)
Cooperatives assets	71.5 billion dollars
Cooperatives average asset	75 million dollars
Directors	9,835
Employees	36,000

The success of Desjardins is based on the following conditions and on its cooperative sense:

### *Conditions for success:*

- Pragmatism
- Clear and prudent financial practices
- Well established and respected control systems
- Functioning and deontology rules
- Efficient supervisory schemes
- Adaptability of products to members' needs
- Convergence of actions
- Complementing economic efficiency with solidarity
- Contributions to local development

### *Cooperative Sense:*

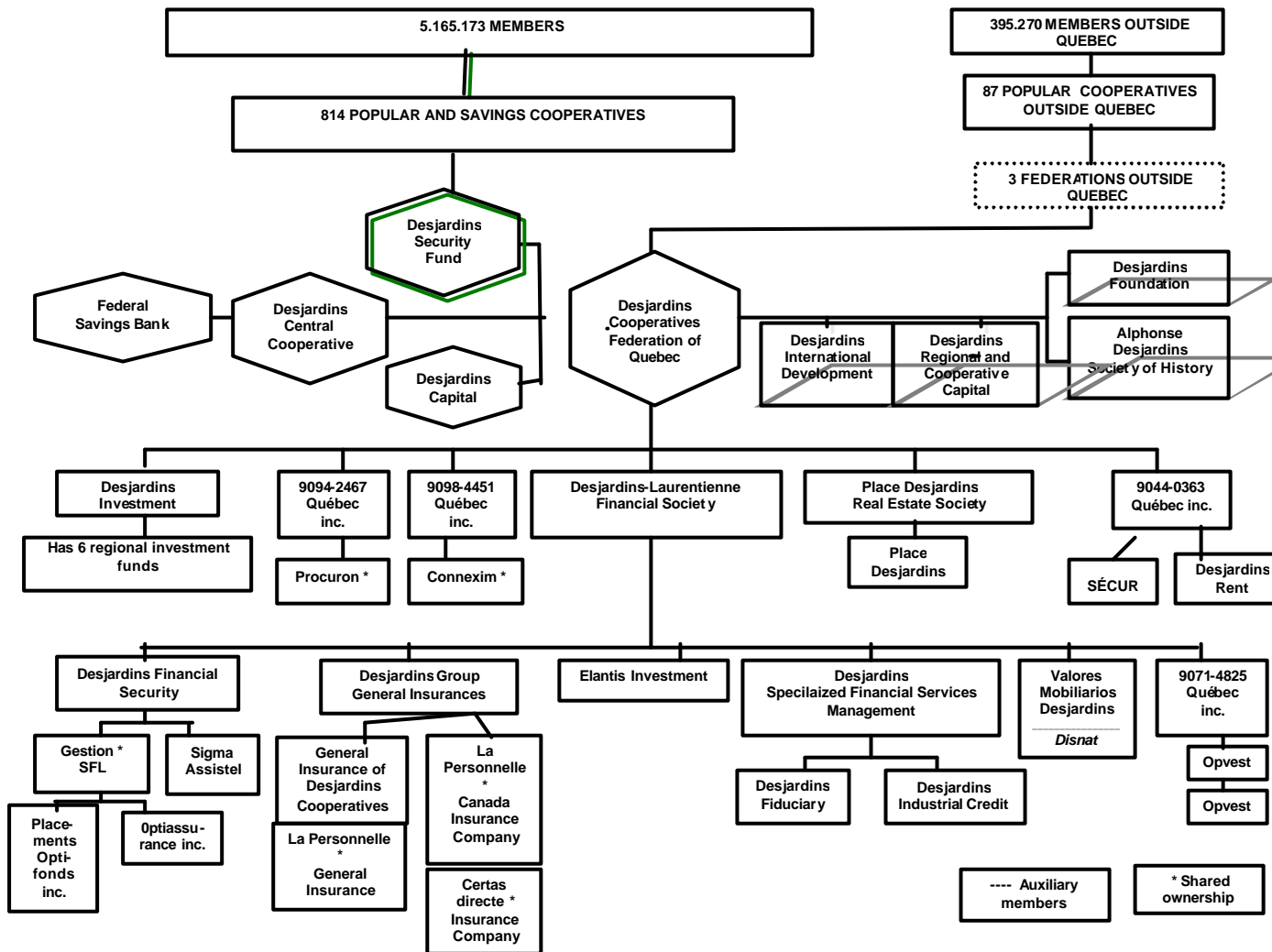
- Participation of members in property, power, surplus distribution, and the creation of inalienable collective patrimony
- The institution offers the best return to the community: 50 percent of its surplus (more than 300 million dollars) in return, grants, sponsorships and scholarships
- Important contribution by the cooperatives and the Movement to local and regional socioeconomic development
- Integration of cooperative values in commercial and managerial practices (solidarity products, freezing of utilization costs, etc.)
- Formation of members regarding cooperation, finance and economics

Cooperative distinction is reflected in the participation of members, ownership, power and distribution of results and inalienable patrimony.

The mission of the Desjardins Movement is to contribute to the economic and social well-being of members and their communities within limits compatible with the movement's scope. This can be achieved by: 1) developing an integrated cooperative network of secure and profitable

financial services, permanently owned and managed by its members, and a network of complementary financial companies, also member controlled, that offers a competitive yield, and; 2) promoting the education of the members, directors and employees regarding democracy, economics, solidarity, and, particularly, individual and collective responsibility.

**Figure 1: Desjardins' Structure**



### Cooperatives

The amounts managed by cooperatives are distributed in the following manner: 62 percent deal with up to 50 million dollars, 73 percent with up to 100 million dollars, 19 percent with amounts between 100 and 200 million dollars, and 8 percent with amounts greater than 200 million dollars.

The quotas of Desjardins cooperatives in Québec differ depending on the markets. In the personal savings market the quota is set at 46 percent, in the credit market the quota is 30 percent, while in the mortgage loans, agricultural loans and community loans markets the quotas are 38 percent, 41 percent and 23 percent, respectively. The rest of the market is divided among the main six Canadian commercial banks and new competitors.

Desjardins cooperatives offer a wide range of financial services and products including: 1) savings and investment services, such as traditional savings, mutual funds, real estate,

circumstantial products, fiduciary and patrimony management services; 2) financing, such as credit, mortgages, and car rental; 3) insurance (general insurance, life insurance, medical and travel); 4) other services for enterprises, such as treasury management, payment services, international services, etc.; and 5) automated services, such as the Desjardins multi-service letter and Interac networks, automated teller machines (ATMs), direct payments, direct deposits and withdrawals, transfers, purchase of investments and insurance, etc.

## **Background:**

### *1900–1920: The emergence of cooperatives*

During this period, 140 popular cooperatives were created. Lévis, the first cooperative, was established at the beginning of the 20th century and the Québec Parliament enacted its legislation a year later.

### *1920–1945: Rural crisis and expansion*

Due to the rural crisis a third of the existing cooperatives were closed. In response, the government awarded support to foster the reopening of cooperatives and agricultural unions promoted the creation of new cooperatives, reaching 900 by the end of this period. In 1932 a provincial association in charge of promotional activities and comptrollership was established in face of the need to implement a professional system to supervise the cooperatives.

### *1945–1970: Development of services*

During this stage, the number of cooperatives increased from 900 to 1300. The Desjardins Movement gained a significant financial status in both the province and the country as a whole. In 1949 a securities fund was created and the first marketing campaigns for savings products were launched. Over these 25 years, comptrollership and leaders' training were constantly strengthened. It became clear that support services and financial resources had to be shared among the cooperatives and that a strict surveillance system was necessary.

### *1970–1980: Integration of services*

In this period, the number of cooperatives stabilized, information on all operations was automated, services were integrated so that all cooperatives could offer a broader range of financial products, and capitalization was strengthened. Furthermore, financial support to enterprises was reinforced and specialist teams were formed in the federations. Desjardins became the main financial institution in Québec.

### *1990s: Time of challenges*

During the nineties, the cooperatives were reorganised in order to enhance their services and units specialized in international services were created. A re-engineering process began with the aim of offering a complete range of financial services. The development of electronic transactions took off with the establishment of ATMs, wider use of the Internet, etc. All these changes showed that organizations are living entities that must constantly adjust—or disappear.

## **Evolution of the Financial Scenario**

The biggest banks and insurance companies in the United States announced their mergers. In June 2001, a new federal banking law was enacted in Canada, allowing new parties to sell banking products and facilitating the implementation of foreign banks. Numerous new competitors entered the financial markets, while a more demanding clientele emerged who

exhibited a different behavior. Partners were better informed, demanding better quality services. Furthermore, globalization of financial markets brought new technologies to open the Canadian market.

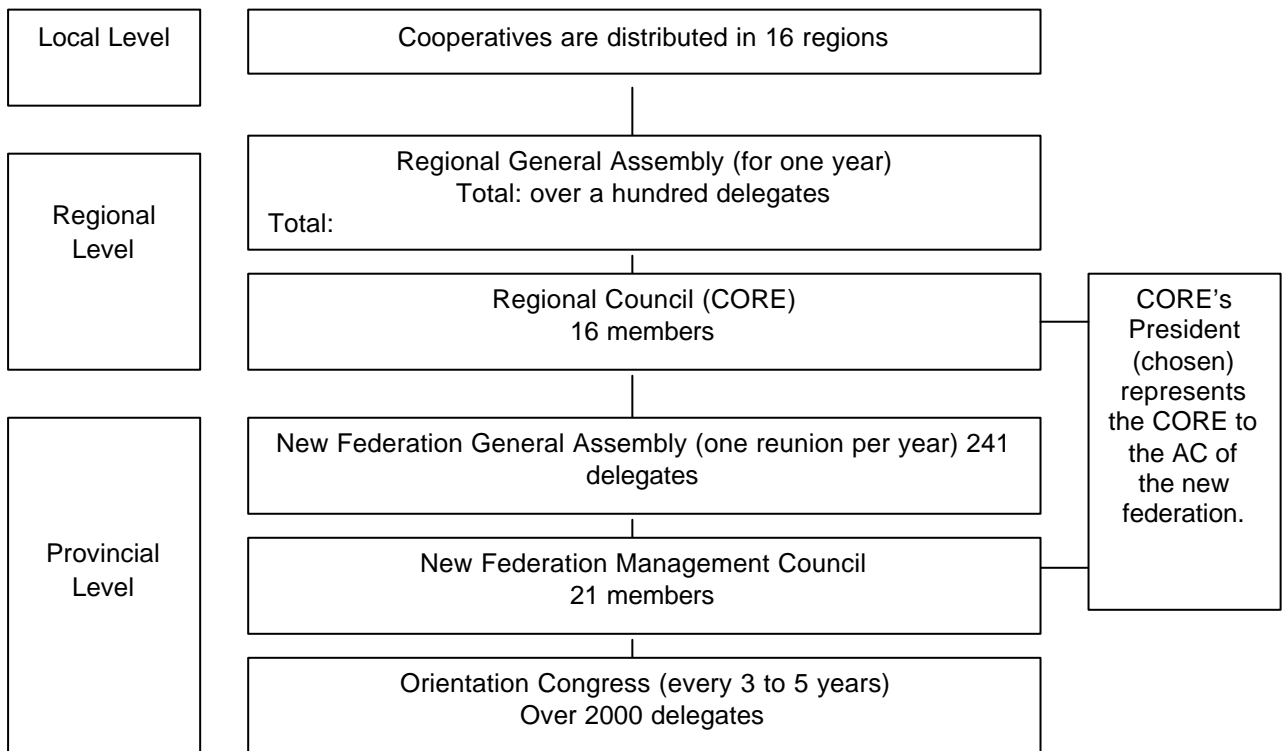
Desjardins' Management Council revised the decision making process in its network, reformed the cooperatives' support organisations, and did the following: 1) modified the operational structure and costs of second and third tier branches; 2) studied the productivity of each component; 3) reviewed the payments for the use of services; and 4) reviewed the guideline on minimum tariffs for individuals and enterprises.

Desjardins' guiding principles are the cooperative distinction and democratic character that places cooperatives as the basis of the movement; a flexible, efficient structure; and the ability to create substantial economies of scale within the network.

*21st Century: Desjardins Restructuring*

Eleven federations and the confederation were closed, and a unique federation was created. The number of cooperatives was reduced from 12,000 to 900 and the number of service centers and service points increased to 708 and 1,587, respectively. The number of ATMs also augmented to reach 2,600.

**Figure 2: Desjardins Democratic Structure**



In order to accomplish such changes competent diplomatic leaders, with credibility and perseverance were needed, as well as engaged personnel and well informed partners who trusted the institution. Respect for, and strict observance of, domestic and international law, guidelines and surveillance systems; and credibility–demonstrated with respect to partner service–of the financial security offered were also required. Desjardins believes that in the world of financial institutions it is not being the biggest that matters most, but being the best,



demonstrated by offering quality services inexpensively and in a financially secure environment.

### Concluding Remarks

It is important for leaders to be capable and have a clear vision, for every component of an organization to have a strong commitment; and that strict financial discipline is observed. Institutions should have a clear legislative framework to operate: in which legal recognition and authorization; efficient, professional and independent supervision; prudent financial policies, efficient internal controls, professional technical assistance; and financing capacity of the services offered.

“Our goal is to create a common patrimony, a capital under our control and always at our disposition, use of which will help to increase our legitimate influence to activate progress and, if necessary, protect us from unjust aggressions. That capital will be the greatest weapon at our service...” (*Alphonse Desjardins, founder of the Desjardins Movement*)

**Table 2: Outstanding Financial Facts**

Capital Ratio of the First category – BRI	12.95%
Total Capital Ratio	11.86%
<b>First Quality Credit Ratings</b>	
Standards and Poors	AA- (medium and long-term)
Moody's	AA3
Dominion Bond Rating Service	AA (Low)

### Other Data (2001)

Desjardins is the greatest force of financial advice and the biggest network of financial planners (900 in the whole Movement) in Québec. There are 1,080 advisors in patrimony management, 250 advisors in financial security and (up to 400 in 2002), and numerous specialized advisors in the subsidiaries network.

It also has the greatest physical presence in Québec, with 1,500 cooperatives and service centers and 2,633 ATMs (the biggest network of ATMs in Québec), as well as 40,000 terminals and 61 financial centers for enterprises (CFE).

**Table 3: Financial Profitability of the Five banks and Desjardins**

	<b>Haber (G\$)</b>		<b>Return on Equity (ROE) ( percent)</b>	
	2000	2001	2000	2001
Royale	13.5	18.2	17.7	15.4
CIBC	11.4	11.9	17.9	14.2
BMO	11.9	10.7	16.3	12.7
NS	13.0	14.6	16.1	16.0
TD	12.4	13.4	8.6	10.7
BN	3.8	4.1	14.6	14.4
Desjardins	4.8	5.2	11.4	12

Desjardins yield in the first quarter of 2002 was 16 percent.

## MICROBANKING: WHY AND HOW?

**Liza Valenzuela**  
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Microfinance refers to all financial services provided to micro-entrepreneurs as well as poor and low-income households. Generally, these loans range from about US\$2,000 to US\$5,000 which can be provided by all kinds of institutions, including credit unions, banks, and specialized institutions, among others. (For the terms of this study, microfinance will be used as a synonym of microbanking).

### Why is Microfinance Important?

One of the reasons is that the micro sector has a macro impact on the economy. This conclusion can be observed considering for one the large sector it represents: in most developing economies micro-enterprises (which are composed of less than 5 percent employees) provide well over 50 percent of total employment; and secondly the low access of the population to financial services, given the large numbers of poor households and micro- and small businesses who lack access to these services. A clear example of this importance is Papua New Guinea, where 62 percent of GDP derives from the informal sector.

The benefits at the economy level are evidenced in a higher rate of economic growth, through the creation of jobs and increased productivity as well as a greater provision of goods and services, and by financial sector deepening. A remarkable case of financial deepening has been Bolivia, as shown in the following table.

		1992	2001	Change
<b>Portfolio</b>	Portfolio Banks	2,400*	3,300*	38%
	Portfolio Microbanking	200*	775*	287%
<b>Borrowers</b>	Banks Borrowers	102,000	179,000	75%
	Microbanking Borrowers	93,000	451,000	385%
<b>Deposits</b>	Deposits Banks	1,200*	2,900*	142%
	Deposits Microbanking	194*	811*	318%
<b>Accounts</b>	No. of savings accounts in Banks	236,000	658,000	179%
	No. of savings accounts in Microbanking	224,000	797,000	255%

\* US dollars Million

Note: the population of Bolivia is 6 million.

On the other hand, microfinance has a micro impact on the economy as it benefits households and micro-enterprises. It alleviates poverty by increasing incomes, household and business assets and the overall quality of life. Furthermore, microfinance has important empowerment effects on women and communities.

Microfinance is indeed important for women, since among the poor, women are usually poorer than men and have smaller businesses. For this reason women have a higher participation than men in microcredit, reaching 70 percent in the case of USAID. In order to improve their access to credit, an innovative methodology was designed consisting of grouping guarantees instead of hard collateral, establishing small and affordable loans, and lending within their own communities. The effects on women have been increased self-esteem, leadership and status in the community.

But besides benefiting women, microfinance has had other positive effects at the micro level, such as increasing expenditure on education, housing and better nutrition, thus enhancing households, and creating new organizing skills to strengthen advocacy, thus benefiting the community as a whole.

### **How to Create a Microfinance Industry in Developing Economies?**

In order to promote the microfinance industry, the government has to act as a facilitator of an enabling environment for expansion and start-ups, and act as a facilitator of public goods allowing competition and maturity.

To this end, governments can promote good practices such as a stable and well-managed macroeconomic environment; a supportive legal and regulatory framework with a level playing field for small and medium enterprises; sound financial laws (private credit bureaus, movable assets laws, credit registries, letting NGOs lend, disclosure and transparency laws, etc.); a strong judicial system including small claims courts, contract enforcement and defaults processing; and an appropriate supervision of microfinance.

Likewise, governments should avoid over-regulation, such as fixing interest rates or fixing the activity or the region that must be financed, creating specialized institutions and government credit programs. Specialized institutions tend to have low barriers to entry and their sheer numbers cannot be supervised effectively, whereas in government credit programs people usually do not repay their loans.

### **How to Regulate and Supervise Microfinance?**

The regulation of microfinance has been the subject of a debate which can be summarized as follows: some scholars promote the expansion of financial services to the poor, letting a thousand flowers bloom, while others support guarding the overall health of the financial system.

These are the lessons so far. Firstly, to regulate and supervise microfinance, governments should only supervise important deposit-takers and not small, informal sector or community-based savings groups. Secondly, NGOs, as NGOs, should not capture deposits, instead a law should be passed to let them lend. Thirdly, if the government lacks the capacity to supervise, don't create new low-end institutional licenses because often these new and multiple institutions do not have the capacity to supervise themselves effectively. Self-regulation does not work. Fourthly, microbanking has important benefits to society and clients, but governments should beware of how it is promoted. A zealous promotion can frequently get governments involved directly as retailers or wholesalers, possibly creating inefficient institutions, while an extra cautious, more realistic, stance could hold microfinance innovation back. Thus, governments should play the role of a light-touch regulator. Fifthly, market-based supervision is lacking, more disclosure is needed, and, last but not least, we must not forget about developing public goods.

## **NATIONAL PROGRAM FOR FINANCING MICROENTREPRENEURS**

**Maria Del Carmen Díaz**

### **National Program for Financing Microentrepreneurs (PRONARIM), Mexico**

*“Microcredit has proven to be an effective tool to combat poverty through the creation of opportunities so that the poor can have access to financial services and resources”*

*Sulehuddin Ahmed*

The National Program for Microentrepreneurs' Financing (PRONAFIM) has a vision of developing a solid and sustainable system of microfinance institutions, able to support a greater number of unbanked people with entrepreneurial aptitudes through microcredits, thus creating new opportunities for development in poverty-stricken areas.

The PRONAFIM's mission is to foster a system of microfinance and microcredit institutions that support productive proposals from individuals and social groups that have an entrepreneurial spirit. It will distribute credit, especially in regions of high marginalization and poverty indices, in order for individuals and groups to generate higher levels of welfare for themselves and their families.

PRONAFIM is headed by a consulting board, with members from the Ministry of Economy, civil society and the program's General Coordination Office, which proposes general strategies and guidelines.

On the other hand, PRONAFIM's trustfund, known as FINAFIM, is headed by a technical committee, whose members come from the Ministry of Economy, the Ministry of Finance, the Ministry of Public Functions (previously SECODAM), the Ministry of Natural Resources and the Environment (SEMARNAT), and the Program's General Coordination Office, to manage, control and enforce actions related to achieving its objective.

The Program is organised by a General Coordination Office which oversees the Financial Support Office and the Institutional Strengthening Office.

From July to December 2001, this program has supported 12 microfinance and microcredit institutions with offices in 15 states of Mexico, enabling them to award a total of 61,000 microcredits. Likewise, it has benefited 536 members of microcredit and microfinance institutions by providing training and technical assistance and has channeled approximately 131,020 microcredit applications from the Ministry of Economy and the Presidency to microfinance institutions. Furthermore, PRONAFIM has also celebrated a Regional Microcredit Summit for Latin America and the Caribbean, with the participation of 37 countries.

PRONAFIM's general strategy is a policy of economic growth, structured and aimed at achieving the stated goals.



From January to April 2002, the number of microfinance institutions affiliated to PRONAFIM grew to 29 institutions in 21 states of Mexico. In May 2002, this number grew further, to 32 institutions. That same month, new institutions began to be developed in both the Gulf of Santa Clara (North-West of Mexico) and the Center for Education Services and Community Development (South-East).

PRONAFIM supports microfinance institutions through the following services:

1. Training
2. Consulting
3. Management systems
4. Technical assistance
5. Pre-operational expenses and asset investment
6. Establishment of subsidiaries
7. Lines of credit and other financial services
8. Incubation

Incubation is the first stage in the life of a microfinance institution. Credit is not yet delivered to clients since the incubation effort is aimed at the creation and strengthening of social networks, the definition of products and methodologies, and the promotion and establishment of basic infrastructure. The main requisites for incubation are:

- The Microfinance Institution's Project
- Legal form or legal form proposal
- Assets of over 50,000.00 pesos
- Background as a social organization
- Definition of the targeted beneficiaries
- Disposition to be trained

The Program gives different kinds of support to the new institutions, such as training, furniture (two desks, two chairs and archives desk), computers and financial support.

To open a subsidiary is to make operational a microfinance services center to broaden the scope of institutions that are operating. This service is offered in communities other than the ones where financial products and the methodology are currently offered, so that credits may be awarded to clients. The effort is focused on the definition, equipment and selection of personnel with the necessary experience.

To open a subsidiary the institution must:

- Have an authorized line of credit from PRONAFIM
- Define the geographical communications profile
- Describe the community's social profile
- Identify the previous financial services
- Specify the subsidiary's opening project
- Specify initial costs
- Present expenses flows for the first year in relation to the number of beneficiaries
- Have the necessary infrastructure, equipment and materials
- Propose mechanisms for control and follow-up
- Give complementary financial information upon request

The Program supports the opening of subsidiaries by offering to cover infrastructure expenses (in furniture and equipment) and operational expenses such as leases, telephone, electricity, miscellaneous and staff (including 2 credit advisors and one supervisor). The support given is

proportional to the level of marginalization of the targeted beneficiaries, according to the classification made by the Ministry of Social Development (SEDESOL) and the National Institute of Statistics, Geography and Computer Science (INEGI).

For further information on PRONAFIM please contact us at [pronafim@economia.gob.mx](mailto:pronafim@economia.gob.mx) or call 01525 57-29-91-00 ext. 5307 and 5348.



# EXAMINING SOME EXPERIENCES IN THE PHILIPPINES AND IN LATIN AMERICA

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## Introduction

The present paper attempts to provide some answers to seven questions that need to be addressed in thinking about an appropriate regulatory environment for microfinance. It also attempts to be clear in its underlying precepts, three in particular: (1) regulatory agencies for banks and other deposit-taking institutions will likely find it problematic for a variety of reasons to become involved with regulating micro-finance institutions that do not take deposits; (2) nonetheless, a "just say no approach" is not likely to be an optimal response to pressures for regulation from international donor agencies and micro-finance institutions themselves, and what is recommended here is the alternative of transparency to facilitate market based decisions; and (3) traditional approaches to regulation are unlikely to be either effective or efficient in dealing with deposit taking institutions that become significantly involved in micro-finance; what is required is not specialized regulation, which will further fragment financial markets, but rather a more thorough-going implementation of risk-based supervision—something already mandated by Basle standards.

While these precepts may be relatively simple and straightforward, albeit controversial to some, in the reality of implementation there are numerous complexities. To investigate this reality the paper draws heavily on regulatory experiences in the Philippines and in some Latin American countries, especially Peru. These experiences show that even defining what it means to take deposits from the general public is not necessarily simple, especially in the case of credit cooperatives. It points out that just achieving transparency provides a challenge beginning with the implementation of standardized accounting and performance indicators, followed by the promotion of auditing and perhaps rating agencies. Other major themes include: the importance of credit bureaus, not only to reduce the costs of information for microlenders but also to avoid multiple borrowing such as occurred in Bolivia and affected banks as well as micro-lenders; the special challenges of micro-finance in rural areas; and the importance of basing capital requirements on the riskiness of activities and the capacities to manage these risks. Perhaps most importantly the paper asks why banks still remain largely on the margin of micro-finance, despite their potential almost everywhere to become the predominant providers of micro-financial services, and whether moving more fully to risk-based supervision might help to unlock this potential.

## What Institutions Should Be Regulated?

Traditionally, only institutions taking deposits from the general public are subject to prudential regulation and supervision because the essential role of such regulation is to protect the stability of the financial system and, secondarily, to protect small depositors. To regulate other institutions can stretch the resources of the regulatory agency too far, so that it may not be able to do its essential job adequately. It can also involve the regulatory agency in providing *de-*

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<sup>10</sup> I would like to thank my IMCC colleagues who have contributed so much to my work on various projects involving micro-finance and its regulation, and especially Tom Fitzgerald with whom I have co-authored several papers on risk-based supervision and micro-finance. I would like to thank at least equally the donor agencies that have supported this work, in particular the United States Agency for International Development, the World Bank, the Asian Development Bank and the Inter-American Development Bank.

*facto* guarantees of the non-deposit liabilities of financial institutions that do not take deposits. In the case of microfinance, where donors and various government agencies are involved in promoting micro-finance institutions (MFIs), the regulatory agency can be drawn into possible conflicts of interest situations where it is expected to promote as well as to regulate. In any case, this does not imply that MFIs that do not take deposits should be freed from any regulation whatsoever, as all institutions, and financial institutions that deal with the public in particular, are appropriately subject to rules about fraud, consumer protection through transparency, and so forth.

To this point the Philippines has followed the traditional practice of subjecting only deposit-taking institutions to prudential regulation and supervision.<sup>11</sup> Although certain entities such as lending investors and pawnshops report to the Central Bank, Bangko Sentral ng Pilipinas (BSP), only the various types of banks that take deposits from the general public are subject to prudential regulation and supervision. Nonetheless, there are pressures from donor agencies, as discussed below, to regulate MFIs that do not take deposits, and there are also pressures from the MFIs themselves. These latter pressures seem to emanate from the view of many MFIs that being regulated will increase their credibility and thus allow them easier access to donor funds, and possibly also to commercial funds from lenders and investors. However, such a view may seriously underestimate the costs of regulation, not only the direct costs of compliance but also the indirect costs of being more constrained in lending and other activities and consequently less able to innovate. Moreover, as BSP staff have often pointed out, these MFIs could easily become regulated by transforming to rural banks (as some already have) which have low minimum capital requirements and allow the types of activities in which most MFIs engage.

### **What Should Be Done About MFIs That Do Not Take Deposits?**

As should be clear, this paper supports the position that bank regulatory agencies should regulate only deposit taking institutions. However, the paper also recognizes that there are pressures, originating mainly from international donor organizations, to regulate non-deposit-taking institutions involved in micro-finance, so that donors can thereby delegate their “due diligence” responsibilities to the regulatory agency.<sup>12</sup> These pressures must be recognized and responded to, while avoiding the pitfalls that can be associated with regulating non-deposit-taking MFIs. What is proposed in this paper is an approach focused on promoting transparency, so that the decisions of donors and commercial lenders and investors can be based on access to pertinent information that can allow appropriate market based decisions. In addition, it should be noted that the actions of MFIs and other non-deposit-taking lenders can affect the financial health of deposit taking institutions if deposit takers and non-deposit-takers lend to the same borrowers. Thus, it may be important to promote credit bureaus, whether in the public or private sector, that cover the full range of borrower debts, from unregulated as well as regulated lenders, small as well as large, and on-time as well as in arrears. Credit bureaus, together with other entities that can support greater transparency in micro-finance, are discussed more fully later in this paper where alternative arrangements for non-deposit-taking MFIs are dealt with in greater detail.

In the Philippines there are at least two important initiatives that are already focused on promoting transparency for institutions involved in micro-finance that are not regulated by the

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<sup>11</sup> Among the Latin American economies discussed in this paper for comparative purposes, the bank superintendencies in Brazil and Peru regulate various types of non-deposit-taking institutions, some of which engage in micro-lending, while the bank superintendencies in Guatemala and Honduras do not (or at least did not until recent changes in the laws in those two countries which are in the process of being implemented).

<sup>12</sup> Regulation is also often seen by donors and by the MFIs themselves as an aid in promoting the development of MFIs, which can potentially lead to conflicts of interest within the regulatory agency between promoting and regulating.

BSP. The first is a National Credit Council (NCC) effort, supported by USAID funding for the Credit Policy Improvement Program (CPIP) project, to develop a standard chart of accounts for deposit taking credit cooperatives, which are not regulated by the BSP and in fact are not effectively regulated at all. Rather than focusing initially on the thorny issues of who should regulate these cooperatives and how, the NCC has put together the interested parties (e.g., representative cooperatives, their federations, and various government agencies such as BSP, CDA, LBP, PDIC, DOF, etc.)<sup>13</sup> into a technical working group. The group first developed a chart of accounts and then the accompanying definitions and manuals, which have now been approved by these interested parties. As of the end of 2001, a set of proposed performance indicators were in final draft form awaiting approval by these same parties. The next step would, of course, be implementation, which would likely begin with a sample of leading credit cooperatives that have participated actively in the development process.<sup>14</sup> Even earlier, USAID also funded a project to develop performance standards for MFIs, but this project has not progressed as far, perhaps in large part because it did not begin with the essential first step of agreeing on a standard chart of accounts with standard definitions.

### **What Does Taking Deposits From the General Public Really Mean?**

The meaning of taking deposits from the general public must be carefully defined. Compensating balances, that is, deposits that are required to be maintained against loans, are not deposits from the general public because these deposits do not represent any risk to the depositors (who are still net debtors to the institution) or to the financial system in general. However, in many economies, including the Philippines and possibly some of the Latin American economies referred to earlier, MFIs are reported to take deposits from borrowers in excess of amounts borrowed and also sometimes to take deposits from non-borrowers. In such cases, it is clear that the laws and regulations against non-regulated financial institutions taking deposits from the general public are being violated, so that the issues become the more practical ones of how to detect such activities and what penalties should be imposed. Making the activities of MFIs transparent through standardized accounting and timely, accurate reporting, as mentioned above and elaborated later in this paper, should make detection straightforward. Available penalties should be sufficient to deter continuation, including ultimately the threat of liquidation, and also to deter other MFIs from following the same path.

The concept of the general public must also be carefully defined. In particular, whether depositors at credit cooperatives are members of the general public or not is a thorny issue that needs to be dealt with at some length. Among other things, it depends on whether the credit cooperative is closed (affinity based) or open (community based), the ease of becoming a member, and the size of the credit cooperative (what degree of internal surveillance can reasonably be expected). It can also extend to the way that share capital is defined and whether it can be withdrawn (or borrowed against) so easily that it effectively becomes a deposit substitute.<sup>15</sup> The complexities of finding appropriate definitions for the various aspects of credit cooperatives that are pertinent for determining an optimal structure for their regulation is explored in detail in *Annex I: The Regulation of Credit Cooperatives in Selected Latin American Countries: Brazil, Guatemala, Honduras and Peru, with Some General Observations and Recommendations*.

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<sup>13</sup> CDA is the Cooperative Development Authority; LBP is the Land Bank of the Philippines; PDIC is the Philippine Deposit Insurance Corporation; and DOF is the Department of Finance.

<sup>14</sup> As noted later, a similar process of developing standardized accounting for non-deposit-taking MFIs has been carried out in Guatemala and Honduras, the two economies that have traditionally not regulated non-deposit-taking institutions.

<sup>15</sup> MFIs may also attempt to avoid regulation by creating deposit substitutes, but transparency requirements should be able to reveal and control this.

## How Should Regulation Be Carried Out In Practice?

Another issue, which is often lost sight of in focusing on whether non-deposit-taking MFIs should be regulated, and if so by whom, is the appropriate approach to carrying out regulation in practice. It is widely observed that private banks have generally been reluctant to enter the micro-finance field. However, because of their size relative to MFIs, credit cooperatives and most other non-bank financial institutions, banks have the potential to dominate the micro-finance field. In fact, in most countries if banks placed only one or two percent of their loan portfolios in micro credits, they could easily account for half the market. Some have argued that the reluctance of bankers is due to their failure to be convinced that micro-finance can be profitable, or that micro-clients or micro lending techniques are too far removed from traditional banking. However, it is also possible that the supervisory approach of regulatory agencies can dissuade bankers from entering the micro-finance field. Clearly, a focus by regulatory agencies on formal guarantees and audited financial statements in evaluating loans can make micro lending more risky, as provisions against losses are more likely to be required for otherwise good micro loans. More generally, traditional approaches to regulation are likely to be biased toward requiring risk avoidance and against evaluating the ability of lenders to manage risks. Moving toward a formal and structured implementation of risk-based supervision, such as recommended by the new Basle standards, is likely to put an institution's abilities to manage risks (e.g., to mitigate and offset risks) in a more favorable light and thereby facilitate the entry of regulated lenders into micro-finance.<sup>16</sup>

During 1998 and 1999, CPIP carried out a study for the NCC of possible regulatory barriers to micro-finance in the Philippines, which was published at the beginning of 2000.<sup>17</sup> The main finding of this study was that, while BSP requirements for documentation and guarantees for loans were flexible enough to allow banks to carry out micro-lending, certain wording in the law and the accompanying BSP circulars, together with the discretion allowed BSP examiners, made Philippine bankers fearful that micro loans could easily be adversely classified and provisions required. In fact, bank examiners worldwide have a tendency toward risk avoidance, and hence to be skeptical about loans without traditional guarantees and documentation, unless they have been well-schooled in risk-based supervision and its focus on risk management capabilities including, in particular, mitigating and offsetting risks.

The new Philippine General Banking Law of 2000 (especially Sections 40, 43 and 44) and its implementation through Circular 272 of 2001 officially defines micro loans and thereby clarifies many of the ambiguities that may have been making bankers hesitant to enter the micro-lending field. In particular, the circular emphasizes that micro loans are based on cash flows and are typically unsecured and also makes clear that borrowers' financial statements (including tax returns) are not required for micro loans. Moreover, such loans are exempt from Monetary Board rules on unsecured loans so long as the lender can demonstrate competence in micro-lending (e.g., policies and procedures in conformity with micro-finance best practices, measures to ensure loan collection and an adequate monitoring system for loans). The extent to which the new law and the accompanying circular, as well as other aspects of risk-based supervision, have been effectively implemented by BSP examiners deserves to be closely monitored—as well as the ultimate impact of these changes on micro lending by banks.

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<sup>16</sup> See Thomas Fitzgerald and Robert Vogel, *Moving Towards Risk-Based Supervision in Developing Economies*, CAER II Discussion Paper No. 66, May 2000.

<sup>17</sup> Thomas M. Fitzgerald, Feliciano L. Miranda, Jr., David S. Murphy and Gerald C. Schulz, *Regulatory Barriers to Innovative Lending Practices: Traditional Approaches to Bank Supervision*, NCC/DOF/CPIP, January 2000.

## **Can Risk-Based Supervision Overcome Other Challenges Facing Micro-Finance Regulation?**

In addition to the obvious challenges to regulating institutions making large numbers of small loans for which there are neither formal guarantees nor traditional documentation, there are other challenges. Some of these challenges are important to meet whether or not risk-based supervision is effectively implemented. One example already mentioned is the important potential benefit from extending the coverage of credit bureaus to all types of lenders and to loan of all sizes. Another is that micro-finance and its regulation can likely be facilitated by improving the legal infrastructure and registries for moveable (personal) property mortgages. The frequent confusion between micro and consumer lending stemming from the similarity of the loan products (i.e., small loans for short periods of time) also needs to be overcome. This can be facilitated by understanding that the nature of the cash flows supporting repayment is totally different (irregular and uncertain revenues generated by micro-enterprise sales versus stable and relatively secure salary payments). Regulators must consequently be alert to the extent to which lenders are in reality sufficiently focused on understanding cash flows in evaluating potential loans and, in particular, the dangers from inappropriately using for micro-finance credit scoring models designed for consumer lending.

Another major challenge is that much of micro-finance is rural and consequently takes place in relatively isolated small towns and villages.<sup>18</sup> Doing such lending efficiently requires the ability to open small offices that may not require the same standards of physical security as large urban branches, nor have the same times of operation. In the Philippines additional capital is required for banks to open branches, which varies both by type of bank and by location of the branch.<sup>19</sup> In addition, there are security requirements with respect to illumination, locks, alarm systems, and cash vaults and their timing devices, as well as the need for other security devices that may be determined by the bank's security officer. The extent to which such requirements may add significantly to the fixed costs of establishing a bank branch, and thereby make it prohibitively costly to establish small branches, is a constraint on rural micro-finance potentially worth investigating in many economies. Furthermore, in the Philippines bank branches must be open for at least six hours per day during the five-day banking week, which may not be consistent with the expected volume of business. Also, to be open on Saturday or Sunday or before 8:00 am or after 8:00 pm, which may coincide with the needs of potential rural customers (e.g., due to market days), requires approval of the BSP. Risk-based supervision, with its focus on the capacity to manage risks, rather than on imposing arbitrary rules based on risk avoidance, is more likely to have the flexibility to deal with these challenges than are traditional approaches to regulation.

Capital adequacy, along with ownership and governance, are also seen to be important issues for micro-finance regulation. Some argue that the ownership and governance structures represented by MFIs and credit cooperatives are ideal for reaching micro-finance clients, while others argue that the structures of these institutions lack the required incentives for efficiency and sustainability compared to private banks and other for-profit institutions. While risk-based supervision does not ignore these issues, its orientation is less philosophical and more practical by focusing on risks and their management.<sup>20</sup> Specifically, in the Philippines as in many other

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<sup>18</sup> See *Annex 2: A Banking System under Pressure: Banking Decline in Rural Peru*, which shows the relative fragility of banking in rural areas, as well as the importance of regulated banks compared to other types of financial institutions in both micro and rural finance.

<sup>19</sup> See *Annex 3: Types of Banks, Capital Requirements and Branching in the Philippines*, which details capital requirements in the Philippines for various types of banks and their branches.

<sup>20</sup> Like traditional approaches, risk-based supervision covers ownership and governance by considering the moral character and technical knowledge and professional experience of prospective owners and high-level managers before granting charters for new banks and other deposit-taking institutions and, for institutions in operation, is concerned about how owners and managers are performing in fulfilling their responsibilities.

countries, there are different types of institutions with different permitted activities and different capital requirements (e.g., rural banks, thrift banks, commercial banks, etc.). Risk-based supervision does not ignore possible differences in risk stemming from ownership and governance arrangements, but rather focuses on the different levels of risk associated with the various permitted activities and thus on the amount of capital required to cover these risks. Risk-based supervision thus has the potential to be both more efficient and more flexible than traditional approaches as it begins by analyzing the risks associated with permitted activities in order to establish appropriate minimum capital requirements and capital adequacy ratios.

As noted above, in the Philippines additional capital is required when a bank opens a branch, which varies according to the type of bank and the location (and is zero for smaller types of banks in less populated locations). Moreover, there is a complex system of minimum capital requirements for different types of banks and for different locations, in addition to that for opening new branches, which is explained in detail in *Annex 3: Types of Banks, Capital Requirements and Branching in the Philippines*. To some extent these differences in minimum capital requirements are consistent with requiring more capital for permitted banking activities that are potentially more risky, as would be recommended by risk-based supervision. However, these differences appear to be motivated primarily by the desire to give smaller types of banks a competitive advantage and to create incentives for locating in less populated areas. While these are certainly worthy objectives, it is not clear if such variations in minimum capital requirements are the most appropriate way to attempt to achieve these objectives, especially if they are not consistent with the capacity to handle risks, as would be emphasized by the tenets of risk-based supervision. In particular, banks with limited area coverage are more likely to be exposed to systemic risks arising from the lack of possibilities for adequate diversification (e.g., taking care not to lend excessively to rice farmers in an area dominated by rice farming does not avoid the risks stemming from the impact of problems in rice farming on the rest of the local economy). In fact, an important difference between risk-based supervision and traditional approaches is that the former explicitly incorporates consideration of systemic risks.

The costs of micro-finance regulation and the adequacy of its financing are other potential challenges, about which there is relatively little specific evidence available. In the Philippines, it has often been stated that the costs to the BSP of regulating rural banks are far out of proportion to their importance in banking system deposits. However, this is a statement about the costs of regulating small institutions and not directly about the costs of regulating institutions with numerous small loans, although the two may largely coincide for Philippine rural banks, especially due to single borrower loan limits relative to capital that tend to confine most rural banks to relatively small loans. In the case of the SBS in Peru, with its regulation of most types of MFIs within a single SBS unit, it has been possible to compare the micro-finance regulatory costs incurred with the revenues received. Payments by MFIs to the SBS for their regulation totaled US\$148,000 in 1999 and US\$195,000 in 2000. Costs to the SBS of regulating MFIs were estimated to be US\$3,246,000 in 1999 and US\$3,022,000 in 2000, so that there was a deficit for MFI regulation of US\$3,098,000 in 1999 and US\$2,827,000 in 2000. For the SBS as a whole, the income received from regulated institutions was US\$25.2 million in 1999 and US\$25.1 million in 2000. Expenditures were US\$22.8 million in 1999 and US\$27.6 million in 2000, resulting in a surplus for 1999 of US\$2.4 million and a deficit of US\$2.5 million for 2000, which was covered by surpluses from prior years. It is thus clear that the regulation of MFIs by the SBS is heavily subsidized. The heavy subsidy for the regulation of MFIs may not be sustainable in times of major budgetary pressures and suggests, moreover, that major changes in the approach to regulation, possibly a movement toward risk-based supervision, are required for efficiency as well as for effectiveness.

## What Institution Should Regulate Micro-Finance?

According to the arguments presented in this paper, there should not be a specific regulatory agency for micro-finance. Whether micro-finance is regulated or not should depend on whether or not the institution offering micro-finance takes deposits from the general public or not. If it is a deposit taking institution, then it should fall under the regulatory agency for all such institutions, the BSP in the case of the Philippines, and be regulated according to the best practices of risk-based supervision as discussed above. The situation is more complex for credit cooperatives, as already mentioned, depending primarily on the precise nature of the relationship of depositors to the credit cooperative and, furthermore, on the willingness of the regulatory agency for deposit-taking institutions to undertake this task given the other demands on its resources.<sup>21</sup> Non-deposit-taking MFIs should not be regulated, but, as argued above, cannot be ignored either.

With respect to improving the regulation of deposit taking credit cooperatives in the Philippines, the first steps, as already mentioned, have been to adopt a standard chart of accounts with standard definitions and manuals for all credit cooperative and then to agree on performance indicators. The difficult task of categorizing which credit cooperatives take deposits from the general public and which take deposits only from a well-defined set of members still remains.<sup>22</sup> Moreover, the question currently under consideration must ultimately be answered: which institution should regulate the categories of credit cooperatives deemed to take deposits from the general public, noting that for implementation in the Philippines this will likely require changes in the cooperative law and possibly also in the general banking law, followed by technical assistance for the chosen regulatory institution(s).

The Cooperative Development Authority (CDA), the Philippine government entity currently responsible for the regulation of all types of cooperatives (and for their promotion as well), is unlikely to be an appropriate candidate to be the regulatory agency for deposit taking credit cooperatives. By institutional orientation and by the characteristics of its staff, the CDA is basically too devoted to promotion as compared to regulation and too burdened by its responsibilities for the entire cooperative sector. Moreover, even if the relevant laws were changed to make the CDA responsible solely for the regulation of deposit-taking credit cooperatives, the requirements for technical assistance and staff training would be daunting. Furthermore, even at the end of a long and costly process, the evidence from such attempts at reform in other economies suggests that the exercise would not be successful in strengthening the CDA sufficiently to allow it to regulate deposit taking credit cooperatives effectively.<sup>23</sup>

What are the realistic alternatives for the agency to regulate deposit-taking credit cooperatives in the Philippines? Although the BSP has been adamantly opposed to taking on this responsibility, perhaps it could be convinced to do so for the largest credit cooperatives that define their membership requirements so loosely that they are effectively taking deposits from the general public. The BSP could thereby better position itself to avoid the failures of these cooperatives—failures that could potentially have significant negative repercussions on the overall financial system, not just on other credit cooperatives. Another alternative could be to rely on the Land Bank of the Philippines (LBP) to become the regulatory agency for deposit

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<sup>21</sup> Bank regulatory agencies can also be significantly constrained by whatever approach to cooperative regulation may already have developed in the economy, including the tradition in many economies to have a single government agency that is responsible for all types of cooperatives and for their promotion as well as their regulation.

<sup>22</sup> As mentioned earlier, variations in credit cooperative definitions and operations that are relevant for determining an optimal structure for their regulation is explored in detail in Annex 1: The Regulation of Credit Cooperatives in Selected Latin American Countries: Brazil, Guatemala, Honduras and Peru, with some General Observations and Recommendations.

<sup>23</sup> This certainly has been the case for any such efforts undertaken in the Latin American economies under consideration.

taking credit cooperatives because of its long-standing close relationship to rural credit cooperatives and its consequent interest in their financial health. However, it must be recognized that there would be a potential conflict of interest in such an arrangement because the LBP's primary objective is to move its funds through these cooperatives to cooperative members and only secondarily to protect cooperatives' financial health. Moreover, in the case of a failing credit cooperative, the LBP would logically be more interested in recovering the funds that it had lent to the cooperative than in protecting the cooperative's depositors. Yet another alternative would be to create an entirely new regulatory agency, perhaps patterned on the NCUA in the United States. Finally, there is some support, mainly in the credit cooperative movements themselves, for self regulation, usually by the country's credit cooperative federation or some closely allied entity, but as yet there are few if any examples of success with this approach in developing economies.

### **What Exactly is The Alternative For Non-Deposit-Taking MFIs?**

As emphasized earlier, an environment for non-deposit-taking MFIs should be provided that encourages the provision of transparent information so that potential donors, lenders and investors can make well-informed market based decisions. As with Philippine credit cooperatives, the recommended starting point is the chart of accounts required for an economy's deposit taking institutions (e.g., banks), adjusted as necessary to international best practice standards (e.g., Basle or GAAP), and also taking into account possible simplifications stemming from the lack of deposit taking and other more complex banking activities in the typical MFI. Using the standard chart of accounts for an economy's banks as the basis for non-regulated MFIs allows for more effective comparisons among all types of institutions, economizes on audit costs, allows MFIs to transform themselves more easily into regulated deposit taking institutions should the desire and the possibility arise, etc. The standard chart of accounts of course includes standardized definitions as given in detail in the accounting manual(s) that accompany the chart of accounts.<sup>24</sup>

A non-regulated MFI wanting to access funds from donors or commercial lenders or investors would need to report its financial statements to a specific agency that has the responsibility for collecting and disseminating such information. While this could be the bank regulatory agency, the BSP in the case of the Philippines, this would probably not be the best option because the bank regulatory agency is likely already overburdened. Moreover, this might give the incorrect impression that MFIs are being regulated and not simply being transparent. In fact, the Microfinance Council has already been declared to be the preferred candidate to be the Philippine institution responsible for the collection and dissemination of uniform and transparent information on non-regulated MFIs, and possibly for other non-deposit-taking institutions as well. Failure of an MFI to make timely and accurate reports available could be disciplined by having the agency responsible for receiving these reports (e.g., the Microfinance Council) report this fact to the agency responsible for issuing the MFI's license or permit to operate, with the recommendation that this license or permit be revoked. Another option would be to follow a more market based approach and simply have the Microfinance Council report to any party requesting information that the required information had not been made available by the MFI.

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<sup>24</sup> In both Guatemala and Honduras, which traditionally have not regulated institutions that do not take deposits, USAID-funded projects are promoting the adoption and implementation of standardized accounting for MFIs. It is interesting to note that implementation is proceeding more rapidly in Guatemala where added incentives for implementation have been created by linking the new accounting to MIS and IT support for participating MFIs. Adoption and implementation have been slower in Honduras, even though standardized accounting based on what is required for the banking system is required for MFIs under the new Honduran law.



External audits by qualified auditors could also contribute to the transparency of nonregulated MFIs, but it would need to be determined if these should be required or voluntary (possibly differentiated according to the size of the MFIs because of cost, even after the introduction of standardized accounting). Regulatory agencies typically provide a list of approved auditors, but for MFIs in the Philippines the BSP might find it convenient to do this in conjunction with the Microfinance Council. Moreover, to be as efficient and effective as possible, auditors would need to be familiar with microfinance, which can be facilitated through the use of micro-finance audit manuals that have recently been developed by CGAP (the Consultative Group to Assist the Poorest, located at the World Bank). These micro-finance audit manuals might also be used to develop a standard scope of work for the external audits of non-regulated MFIs, as such MFIs may not always be “educated consumers” of external audit services.

Ratings by risk-rating agencies might also help to enhance the transparency of non-regulated MFIs and the role of markets in providing discipline. Currently USAID, CGAP and the Inter-American Development Bank are supporting the use of private risk-rating agencies by MFIs in various economies.<sup>25</sup> In the Philippines, ratings by approved risk-rating agencies could be required for non-regulated MFIs, or they could be voluntary, relying on market discipline in the latter case. The Microfinance Council might itself evolve into such a rating agency. The Microfinance Council might also expand to provide comparable data on credit cooperatives (and on rural banks and thrift banks with the cooperation of the BSP) in order to facilitate comparisons among all the main providers of micro-finance services. In any case, the promotion of transparency would not be expected to substitute for “due diligence” efforts by funding agencies, whether donors or private lenders or investors.

Credit bureaus (either in the narrow sense of a database or in a broader sense that includes an evaluation or rating function)<sup>26</sup> can provide an important means for reducing the information costs involved in granting loans.<sup>27</sup> Credit bureaus can be particularly useful in the case of small-scale borrowers where obtaining information directly from potential borrowers is likely to be especially costly relative to loan size. Moreover, when such potential borrowers (and their lenders) operate in the informal (unregulated) sector where guarantees and formal documentation are largely unavailable, the potential usefulness of other forms and sources of information is increased further. However, there is another reason to promote all-encompassing credit bureaus that may be even more important because it affects the entire financial system and not just the efficiency and effectiveness of MFIs. As mentioned early in this paper, there can be important feedbacks between regulated deposit-taking financial institutions and unregulated MFIs when borrowers access loans from both types of sources. Indeed, the failure to take the importance of this into account in Bolivia (clearly the leading Latin American country in micro-finance and its regulation) and to have debtor databases that included both

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<sup>25</sup> In Peru, risk-ratings by approved risk-rating agencies are required for banks and certain other regulated institutions. However, while this requirement has greatly expanded the market for risk-rating agencies, it appears to have led to a focus on the banking sector and possibly to the neglect of the MFI market.

<sup>26</sup> It is important to clarify the difference between a credit bureau and a “*Central de Riesgos*.” Whereas a credit bureau often provides some evaluation of borrowers, a *Central de Riesgos* is simply a database to which creditors supply information and from which entities allowed access to the database can obtain information on the outstanding debts and repayment histories of the debtors covered by the *Central de Riesgos*. A *Central de Riesgos* may be either government or privately owned, but in most Latin American countries they are within the central bank or the superintendency of banks. Participation may include just regulated financial intermediaries or all types of lenders, reporting may be either compulsory or voluntary, coverage may include just loans above a certain size or all loans, and may be all loans or only loans with repayment problems. As far as access, it may be limited just to participating institutions or anyone may request information on a particular potential borrower, and fees may be charged for participation and/or according to requests for information.

<sup>27</sup> See *Annex 4: The Development of Credit Bureaus in Peru*, which emphasizes the key elements that have made Peru's credit bureaus probably the most advanced in Latin America if not among all developing economies.

types of lenders, left the regulatory agency there unable to foresee a major element in the Bolivian financial crisis that has spread across both MFIs and banks.

To be as useful as possible, information in credit bureau databases needs to cover the total exposures of potential borrowers, that is, to include loans of all sizes from all types of lenders, regulated or not, to include loans without problems as well as those with repayment problems and, in so far as possible, to cover other types of financial obligations (e.g., guarantees for others, trade credit, utility bills, tax obligations, etc.). Given adequate computerized information systems, which are now widely available, and that timeliness and accuracy of reporting can be assured, there are no significant technical constraints to including obligations of all sizes no matter how numerous. However, there has been resistance in many Latin American countries to mixing regulated and non-regulated lenders in the same database, based ostensibly on an interpretation of the so-called "*secreto bancario*" as applying to loans as well as deposits (in spite of the original intent of banking secrecy to provide protection for depositors).

It has been even more problematic in some economies to include all loans, good as well as bad, in the credit bureau database. Lenders have no reason to fear sharing information on bad borrowers, but providing information on the outstanding loans of good borrowers to the database can be inhibited by lack of confidence in the security of the database, specifically the fear that credit bureau employees could be bribed to supply information on good borrowers to competing lenders.<sup>28</sup> Thus, the effectiveness of a credit bureau is more limited by coverage, and especially by the need to adopt policies that promote credibility, and hence participation, than by any technical constraints. A poor rural area of Guatemala provides striking evidence of this, as a group of MFIs using simple computer software set up a private credit database that has come to encompass virtually all lenders and all types of debt because of the credibility that the founding group was able to establish.

## **Main Conclusions and Recommendations**

Although institutional realities may vary widely from economy to economy, there are nonetheless some guiding principles that can be widely applicable. From the basic precepts of prudential regulation it is already clear that MFIs that do not take deposits from the general public should not be formally regulated by the superintendency for banks and similar institutions. However, it may not always be easy to define deposits from the general public, specifically in the case of credit cooperatives that ostensibly take deposits only from members but where in reality members can often include anyone from the general public. In fact, care must be taken not only in categorizing credit cooperatives but also in selecting an appropriate regulatory institution, if necessary, given that there is no recognized "best practice," or even a consensus, to recommend for implementation worldwide.

In carrying out regulation and supervision, traditional practices appear to be biased toward risk avoidance and hence against micro-finance. In addition, because good MFIs have very large numbers of very small loans, traditional practices that rely on reviewing significant proportions of loan portfolios tend to be costly. Rather than turning to specialized supervision for MFIs, which is likely to increase fragmentation in financial markets, a more thoroughgoing adoption of risk-based supervision, as recommended by the Basle standards, would seem to be a more promising approach. In addition, risk-based supervision is more likely to deal flexibly with the establishment and operation of small branches, essential for significant outreach of micro-finance into rural areas. At the same time, it is more likely to be sensitive to the potentially greater importance of systemic risks in rural areas where adequate diversification can be difficult. Moreover, in focusing on risks and the capacity to manage them, riskbased

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<sup>28</sup> Those requesting information from a credit bureau database are supposed to supply the name(s) of the potential borrower(s) for whom they want information and not to request lists of unnamed borrowers and their outstanding loans.

supervision can relate capital requirements to the risks of permitted activities rather than to potentially arbitrary standards.

The alternative proposed for MFIs that do not take deposits is transparency so that potential funding agencies, public or private, local or international, can make their own decisions based on accurate, timely and comparable information. Transparency, however, is easier said than achieved, as implementation requires standardized accounting consistent with what is required for regulated institutions and complemented by appropriate performance indicators. Increasing transparency can also require support to strengthen financial infrastructure, including better auditing services and perhaps rating agencies. Especially important can be credit bureaus that reduce the information costs of micro lending, while also protecting regulated institutions from non-transparent over-lending by institutions, including MFIs, that are not regulated.

## Annex 1

### **The Regulation of Credit Cooperatives in Selected Latin American Economies: Brazil, Guatemala, Honduras and Peru, with Some General Observations and Recommendations**

The issues of whether credit cooperatives take deposits from the general public or only from a restricted group of members and, for those that do take deposits from the general public, what could be the most appropriate approach to regulation, are not unique to one particular economy. In fact, these issues seem to confront credit cooperatives and government policymakers in economies around the world and have become more pressing in recent years with the increasing role that credit cooperatives can play in the field of micro-finance. This annex focuses on the credit cooperative movements in four Latin American economies and the current status of regulatory efforts in each one. Brazil, Guatemala and Honduras are discussed briefly, while Peru is analyzed in much greater detail because donor agencies and government policymakers are currently involved in a major effort to sort out many of the regulatory issues. The annex concludes with some observations and recommendations on the characteristics of credit cooperatives that should be given priority when making decisions about their regulation.

#### **Brazil<sup>29</sup>**

In Brazil credit cooperatives are only permitted to exist in the “closed” form, that is, they must be affinity based, which means that all members must have the same employer. The Superintendency Department of the Central Bank estimates that there are 1,200 to 1,300 credit cooperatives in Brazil. As of mid-2001, their total assets amounted to about US\$2 billion, perhaps 1 percent of the assets of Brazilian banks. All credit cooperatives are required to use a standard chart of accounts, to have external audits and to send figures regularly to the Superintendency, which then deals with credit cooperatives through off-site supervision. If the figures sent appear problematic, the credit cooperative is summoned to appear before the Superintendency to explain the situation firsthand in greater detail. If members complain about the operations of their credit cooperative, the problem is referred to the “central” of credit cooperatives in that region for investigation. Formerly the Superintendency worked in conjunction with these “centrals” to carry out regulatory functions, which included the regional “central” visiting affiliated credit cooperatives at least twice per year.

Under the constraint that only affinity-based credit cooperatives are legally allowed to exist, it is understandable why Brazilian credit cooperatives have contributed little to improving access to financial services for micro-enterprises or in general for individuals of modest means. Because membership of any Brazilian credit cooperative is limited to employees of a specific entity, self-employed micro-entrepreneurs are by definition excluded from membership in credit cooperatives, although micro-enterprises may be financed indirectly by family members who are employed by entities served by credit cooperatives. Furthermore, the existence of even 1,200 or 1,300 credit cooperatives provides no technical basis for the expansion of Brazil's credit cooperative system to include “open” or community-based credit cooperatives. Specifically, the skills required for extending credit to the employees of an enterprise are rudimentary, even more basic than consumer lending in general, as all that a loan officer need do is verify the salary and employment status of the credit cooperative member, together with the ability to deduct loan payments from the member's salary. Lending to members of an open or community-based credit cooperative requires far more sophisticated technical skills, whether or not the member happens to be a micro-entrepreneur. Consequently, a more broadly based

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<sup>29</sup> Taken primarily from Robert C. Vogel, "Brazil's Micro Finance Institutions; Regulatory Environment and Institutional Performance," paper prepared for the World Bank, February 2002.

credit cooperative system filling an important gap in access to financial services in Brazil could not be expected to emerge quickly even if current regulations were relaxed.

By definition, closed or affinity-based credit cooperatives cannot take deposits from the general public and thus would not fall into the category of financial institutions that generally would be subject to prudential regulation. The way such regulation is carried out in Brazil in practice suggests that the Superintendency is aware of the problematic aspects of the responsibility that it has undertaken with respect to credit cooperatives. To economize on the resources that could be required for full-scale regulation of such a large number of small institutions, supervision is all off-site, with credit cooperatives in fact coming to the Superintendency to deal with any problems identified. Furthermore, a standard chart of accounts and external audits are required to promote transparency, which further reduces the burden on the Superintendency. It should also be noted that the Superintendency has abandoned the practice of delegating supervision partially to the centrals in the region.<sup>30</sup> At the same time, it has continued to delegate member complaints to these centrals to avoid being drawn into responsibilities of that type. Nonetheless, officially regulating credit cooperatives, rather than simply having them report, can make the Superintendency responsible in some sense to those owed money in case of a credit cooperative failure.

### **Guatemala and Honduras<sup>31</sup>**

The credit cooperative movements in both Guatemala and Honduras suffered through difficult times in the 1970s and into the 1980s. In Guatemala, there was civil unrest for many years with serious negative implications for credit cooperatives, especially those in rural areas with significant indigenous populations. In Honduras, the problems were more within the credit cooperative movement itself, as the management of the federation used external funding from donors to manipulate individual credit cooperatives and thereby maintain control for its own benefit. For similar reasons in both economies, the situation was also characterized by a lack of effective credit cooperative regulation. In both Guatemala and Honduras, there was a single government agency responsible for the development and regulation of the overall cooperative sector, but given the specialized technical nature of financial intermediation carried out by credit cooperatives and the inherent conflict between regulatory and developmental objectives, the responsible agency could not fulfill its obligations. Moreover, in both economies the regulatory agency for the banking sector was totally unwilling to take on the responsibility for regulating credit cooperatives.

Efforts began in the mid-1980s to rehabilitate the credit cooperative systems in both economies, with financial support from the United States Agency for International Development (USAID) and with the technical collaboration of the World Council of Credit Unions (WOCCU). The approaches were different in the two economies, as the Honduras project focused on strengthening individual credit cooperatives and reforming the federation through the efforts of the credit cooperatives that had been successfully rehabilitated, while the Guatemala project focused on strengthening the federation and, through the federation, the individual credit cooperatives. While both projects were highly successful in strengthening the federation and a significant number of individual credit cooperatives, the result in Guatemala was a relatively centralized, top-down system, while in Honduras the individual credit cooperatives that had been successfully rehabilitated shared leadership with the federation management. Nonetheless, little progress was made on the regulatory side, as efforts to strengthen the government agency

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<sup>30</sup> Delegation to such bodies has typically performed poorly in Latin American countries, not only because such bodies usually lack adequate resources and expertise to carry out the supervisory function effectively but also because they suffer from a basic conflict of interest in that they are supposed to promote credit cooperatives while regulating them at the same time.

<sup>31</sup> Information has been taken primarily from work by IMCC and by the author on USAID-funded projects in Guatemala and Honduras.

responsible for credit cooperative regulation in each economy proved totally unsuccessful. Resources provided to these agencies failed to strengthen their regulatory capacities, while legal changes were not forthcoming in either country to refocus the cooperative agency on the credit cooperative system (rather than cooperatives in general) and on regulation rather than promotion and development. However, the credit cooperative federations in both economies have implemented standard forms of accounts with standard definitions and performance indicators for affiliated credit cooperatives that should ultimately make whatever option is selected with respect to regulation more effective and efficient.

Unable to rehabilitate the government agency responsible for cooperatives and unable to persuade the regulatory agency for banks that it should also attend to the regulatory needs of credit cooperatives, the credit cooperative leadership in both economies decided that the only option was to create their own regulatory agency. This effort was initiated first in Honduras through the creation of a private regulatory agency with voluntary participation. The main problem was that the regulatory agency was owned by the credit cooperatives to be regulated and had no legal means to discipline credit cooperatives that did not live up to regulatory standards beyond adverse publicity. In addition, some of the directors of the regulatory agency did not come from the most financially sound credit cooperatives. The Guatemalan regulatory agency is also private and a creation of the credit cooperative federation, but was initiated more recently so that its chances for success are less clear at this point. Nonetheless, it has three potential advantages: (1) it was begun as a rating agency so that collecting and providing transparent information, rather than imposing penalties, is its primary mandate; (2) it has strong financial and technical support from CGAP and also from WOCCU, neither of which was actively involved in the Honduran effort; and (3) the Guatemalan federation has much greater power over its affiliated credit cooperatives, especially because it controls a credit cooperative liquidity fund and a network through which the better (participating) credit cooperatives can clear inter-system financial transactions.

## **Peru<sup>32</sup>**

Credit cooperatives are divided into two groups according to the current law governing the Peruvian financial system, those that take deposits from the general public and those that take deposits only from members. Cooperatives that take deposits from the general public are regulated under this law, but in fact there are none as no credit cooperative has opted to state that it takes deposits from the general public, presumably to avoid the regulation that would be involved. Those that take deposits only from members are under the purview of the cooperative law and, consequently, are regulated by FENACREP (the Credit Cooperative Federation) under delegation from the SBS (Superintendency of Banks and Insurance). Because an “open” credit cooperative (one that is not affinity-based) can make it very easy for anyone to become a member, any individual from the general public can readily become a member of such a credit cooperative, and hence a depositor. Based on this fact, current law notwithstanding, some of the more aggressive Peruvian credit cooperatives, three in particular, have become as large as small banks. This blurring of the line between “deposits from the general public” and “deposits not from the general public,” is at the heart of the need to reform how credit cooperative regulation is structured in Peru.

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<sup>32</sup> Information taken primarily from Thomas Fitzgerald and Robert Vogel, “Proposed Framework for the Regulation and Supervision of Micro-Finance Institutions in Peru,” paper prepared for the Inter-American Development Bank, December 2001; and Felipe Morris, “Diagnostic and Recommendations Regarding the Regulation and Supervision of Savings and Credit Cooperatives in Peru,” paper prepared for the Inter-American Development Bank, May 2001.

Table 1 provides a breakdown of Peru's 193 credit cooperatives by type of cooperative and by type of loan, according to loan amounts outstanding.<sup>33</sup> As of mid 2000, there were 70 credit cooperatives not taking deposits, and another 67 small "open" credit cooperatives (assets less than US\$0.9 million) that together accounted for less than 10 percent of the total value of loans outstanding for the system. Both these categories of credit cooperatives are oriented heavily toward consumer lending, as are the 15 medium size "open" credit cooperatives (assets between US\$0.9 and US\$5.7 million) and the nine affinity-based credit cooperatives connected with the military. These two latter categories together accounted for slightly more than 20 percent of the total value of loans outstanding from the system. By far the most important category is the three large "open" credit cooperatives, accounting for more than 40 percent of the total value of loans outstanding and responsible for the overall predominance of commercial loans in credit cooperative portfolios. The last category, the 29 affinity-based credit cooperatives with deposits, account for slightly less than 30 percent of the total value of loans outstanding from the system, and these are the second most important commercial lenders after the large open credit cooperatives.<sup>34</sup>

**Table 1: Loans by Credit Cooperative Type and Loan Type (30 June 2000)**  
(amounts in thousands of US\$)

Credit Cooperative Type	Non-Deposit Taking	Deposit Taking					Total
		Affinity Based	Large	Medium	Small	Military	
<b>No. of Credit Cooperatives</b>	70	29	3	15	67	9	193
<b>Loan Type</b>							
<b>Commercial</b>	655	18,021	57,577	5,667	2,132		84,051
<b>SME</b>	50	1,496		2,449	816	136	4,948
<b>Mortgage</b>	101	7,220	2,538	764	243		10,866
<b>Consumption</b>	7,015	19,055	7,456	12,632	3,445	13,212	62,816
<b>Total</b>	7,820	45,792	67,571	21,512	6,636	13,348	162,681

Source: FENACREP

For Peruvian credit cooperatives, overdue loans have risen from 4 percent in 1995 to over 10 percent in the years since 1997. However, the overdue loan situation has worsened even more for the Peruvian banking system, although the credit cooperative figures may not be entirely accurate since, as detailed below, effective supervision is lacking under FENACREP. Overdue loans are lowest for affinity based credit cooperatives, are somewhat higher for large "open" credit cooperatives, substantially higher for medium size "open" credit cooperatives, and by far the highest of all for small "open" credit cooperatives. The three largest credit cooperatives have a much higher average loan size, US\$3,486, compared to the small cooperatives with an average size loan of only about US\$100. Likewise, the average deposit is US\$4,801 compared to US\$50. This reinforces the point that the three largest credit cooperatives are in fact more

<sup>33</sup> Commercial and micro loans represent 55 percent of overall credit cooperative loan portfolios, while consumer loans are 38 percent and housing loans are 7 percent. This lending pattern is heavily weighted toward micro and small business finance compared to credit cooperatives in most other Latin American countries. Another important aspect of the Peruvian credit cooperative system is its high concentration, as only three credit cooperatives account for 78 percent of deposits and 53 percent of loans.

<sup>34</sup> The importance of commercial loans in the portfolios of affinity-based credit cooperatives, where members would be expected to have salaried employment, suggests that other members of members' immediate families may have micro or small businesses that are financed indirectly through these credit cooperative loans. The difficulty of distinguishing between commercial and consumer loans is important to note, together with the twin difficulty that, within the household-enterprise unit, micro-enterprise loans may support consumption, and vice versa, given the fungibility of money and credit.

like small banks and thus need serious regulation like any deposit-taking entity.<sup>35</sup> Nonetheless, the smaller “open” credit cooperatives are more in need of attention given their problematic loan portfolios, but with the simultaneous need to recognize the disproportionately high costs of supervising all these small institutions or even requiring them to have external audits. Most obvious is the lack of a need to regulate affinity-based credit cooperatives heavily, given the effective common bond among members and thus the ease of obtaining pertinent information for lending and collecting loan payments, which is clearly reflected in the low overdue rates for loans from such credit cooperatives.

Until 1992 Peruvian credit cooperatives were covered by the LGC (General Law for Cooperatives) and regulated by INCOOP (National Institute for Cooperatives), which was located in Lima and which regulated only the credit cooperatives in Lima. Regulation was poor with no site visits, and information was deemed unreliable since there were few accountants, no standard form of accounts and no requirements for internal or external auditing. In addition, INCOOP was supposed to regulate 4,500 cooperatives of all types, and it delegated regulation outside of Lima to “regional INCOOPs” that depended on the state governments. INCOOP was liquidated by government decree in 1992, a year of crisis in Peru, and responsibility for credit cooperative supervision passed to the SBS. The LGSFS (General Law for the Financial System), passed in 1996, is now the basic law that covers credit cooperatives that take deposits from the general public (see article 282), but, as explained above, no credit cooperatives have opted to state that they take deposits from the general public. Supervision of credit cooperatives not taking deposits from the general public was delegated to FENACREP<sup>36</sup> in 1993 by government decree, which was updated in 1996, by the LGSFS, with SBS Resolution No. 0540-99 now covering the regulation of credit cooperatives that do not take deposits from the general public. In spite of these refinements, a number of discrepancies remain between the LGC and the LGSFS, and in particular credit cooperatives that do not officially take deposits from the public do not need a license from either the SBS or FENACREP, but, according to the LGC, simply to be inscribed in the public registry.

FENACREP has neither the human nor the financial resources to undertake credit cooperative supervision effectively. Moreover, even with adequate funding and human resource development, FENACREP would not be an appropriate regulatory entity for credit cooperatives because of the inherent conflict between regulating and promoting. Not only is FENACREP charged with promoting the development of the credit cooperative system, but is also owned and effectively controlled (at least to a significant extent) by the affiliated credit cooperatives that it is expected to regulate.

With respect to human resources, FENACREP has only 16 employees, of whom six are dedicated to supervision. One senior person (formerly at the SBS) and two young economists work in the area of control (off-site supervision). In the area of inspections (on-site supervision) there are three accountants, with the lead position vacant. The area of control was only created in 1996 and, with only three staff, cannot handle information from 193 credit cooperatives, especially since it has no standardized approach, and lacks an effective manual. Moreover, much of the information submitted is said to be incomplete and of poor quality. FENACREP requires the seventy largest credit cooperatives, comprising 95 percent of system assets, to submit external audits annually, but it is not clear if this is in fact enforced. About 40 on-site inspections are carried out per year, with a focus on the three largest credit cooperatives and 26 others, which are seen to have serious problems and represent 12 percent of system assets. In the case of on-site inspections, there appears to be an adequate manual derived from the one used by the SBS, but it is in need of updating.

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<sup>35</sup> The three largest credit cooperatives also reportedly make loans to non-members, another reason to subject them to bank-like regulation.

<sup>36</sup> FENACREP was founded in 1959 and officially recognized in 1965 under resolution No. 264 of INCOOP. Currently it has 134 affiliates and supervises 193 credit cooperatives.



Under its arrangement with the SBS, for its regulation activities FENACREP is to charge between 0.58 and 2.0 per thousand of assets, with a minimum charge of US\$142 per credit cooperative. Projected revenues for the year 2000 were US\$372,000, of which about US\$330,000 was to come from fees for regulation, which is consistent with FENACREP's arrangement with the SBS. FENACREP's expenditures for 2000 were projected to be US\$385,000, the majority for salaries, but were not broken down according to activities such as regulation. This would have resulted in a small deficit, but as of the end of August 2000 revenues, exceeded projections, and expenditures were lower, leaving a surplus rather than a deficit. Before drawing any conclusions about the costs of credit cooperative regulation and the adequacy of its financing, it is useful to compare this with the costs incurred by the SBS in regulating MFIs. As stated in the body of the paper, costs to the SBS of regulating MFIs were estimated to be US\$3,246,000 in 1999 and US\$3,022,000 in 2000. It is thus clear that the amount spent by FENACREP on regulating credit cooperatives must be totally inadequate. FENACREP is spending less than US\$400,000 per year to supervise 193 credit cooperatives, while the SBS spends over US\$3 million to supervise a far smaller number of MFIs, which have approximately the same amount of assets in total as the 193 credit cooperatives.

### **Some General Observations and Recommendations**

Perceived problems of ownership and governance in credit cooperatives, especially the failure of members to participate actively or even to be informed about the affairs of their credit cooperatives, are often cited as their most important weakness.<sup>37</sup> In the present analysis the basic starting point is the definition of capital and especially the operational aspects of different types of capital. First, institutional capital, which consists (at least in healthy credit cooperatives) mainly in retained "earnings" plus various reserve accounts built up for special purposes, needs to be separated from share capital that has been contributed by, and effectively belongs to, individual members. Institutional capital is available for the special purposes indicated and, more importantly, to cover losses that might occur in bad years. It would only be distributed among members (after satisfying prior claims) if the credit cooperative were to be liquidated. On the other hand, the share capital that an individual member has contributed can be withdrawn when that member leaves the credit cooperative. Since credit cooperatives, especially those with financial problems, typically make it difficult (or at least time consuming) for a member to resign and to withdraw contributed share capital, members wanting to resign often resort to taking "Pautomatic loans," which normally can be disbursed in just one day and can be up to 90 percent of a member's share capital. The purpose of automatic loans is, of course, to give liquidity to members' share capital, which is rightly seen as a highly attractive attribute of share capital, and not to circumvent transparency by allowing members to resign effectively without resigning officially through the designated procedures.

The analysis of credit cooperative capital has two important implications for regulatory purposes. First, unless it is made impossible for credit cooperative members to withdraw their share capital expeditiously (undesirable because of the importance of liquidity and of the right to disassociate that comes with the right to associate), it is only institutional capital that stands fully behind the obligations of the credit cooperative and thus can be counted fully for fulfilling minimum capital requirements and capital adequacy ratios. Second, because members' share capital can be made effectively as liquid as deposits, an arbitrary regulatory distinction between credit cooperatives that operate with member deposits and those that operate only with share capital will likely be no more effective in dealing with highly aggressive credit cooperatives

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<sup>37</sup> Many experts concerned about the state of credit cooperative regulation in Latin America have also focused on perceived ownership and governance problems. The view here on possible inherent weaknesses in credit cooperative ownership and governance is more agnostic, based in part on the fact that private for-profit banks have likewise failed in significant numbers, typically imposing losses that are far greater than those imposed by failing credit cooperatives.

than the distinction between taking deposits only from members and taking deposits from the general public. Given the ability to blur the distinction not only between deposits from members and deposits from the general public, but also between deposits and share capital, some reliance has to be placed on the concept of a “club” whereby freely associating members are expected to know and police each other effectively (aided, of course, by a government's commitment to deal with fraud) in order for credit cooperatives to be distinguished effectively from banks. Otherwise, if all credit cooperatives, even the smallest, are treated as if they were deposit-taking banks, and thereby required to comply with what is required for even the simplest category of bank, small groups of individuals of modest means will be thwarted in their efforts to join together to help each other, and related innovations in the delivery of financial services will likewise be thwarted.

Because of the importance of effectively taking deposits from the general public in determining the appropriate regulatory category, differentiating “open” or “community based” credit cooperatives from “closed” or “affinity-based” credit cooperatives is essential. By their nature, the latter cannot take deposits from the general public and thus would never fall into the category of being regulated like banks. Moreover, the management of risk is entirely different, such that “closed” or “affinity-based” credit cooperatives can be given much greater leeway.<sup>38</sup> Lending limited to employees of a single enterprise, given that the enterprise itself does not have serious economic problems, requires little more than verifying employment status and prospects and having arrangements that permit loan payments to be taken out of salaries. In effect, it is consumer lending with highly simplified credit scoring models rather than lending to micro-entrepreneurs with variable and uncertain incomes.

Credit cooperative size—in number of members, in assets and in branches—becomes important not only because of the more likely presence of club-type relationships in smaller groups but also because of costs. The costs of just maintaining accounting records according to even a simplified version of the form of accounts required for regulated financial intermediaries could be unrealistically high for credit cooperatives that are very small. Such requirements could effectively stop the initiation of new credit cooperatives, especially if it is true, as supposed, that credit cooperatives can (even should) emerge from the voluntary cooperation of individuals of modest means. To this must be added the costs of external audits and then the costs of supervision itself, divided somehow between the regulatory agency and the regulated institution. To balance the goal of openness (to permit cooperation and innovation) with the importance of protecting depositors and especially the stability of the financial system, size must clearly be taken into account. It would be both uneconomical and repressive to regulate credit cooperatives that do not have branches and have only a small number of members and a small amount of assets.

The basic recommendations are that, for regulatory purposes and after taking into account the way membership is defined (affinity based or open) and the way shares and deposits are defined, size should be an important factor in putting a credit cooperative into one of three groups:

Larger, open, deposit taking credit cooperatives with flexible membership requirements that allow the general public effectively to be depositors and that exceed a certain size would be regulated, basically like banks.

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<sup>38</sup> In Peru, as shown above, affinity-based credit cooperatives are the category with the lowest proportions of loan amounts overdue.

All affinity-based credit cooperatives and some intermediate range of open credit cooperatives (depending on size, flexibility of membership requirements and characteristics of deposits and shares) would be required to report their financial statements, using standardized accounting and supported by external audits as deemed appropriate.

The very smallest credit cooperatives would receive no regulatory attention unless membership requirements and share and deposit characteristics were defined in ways that effectively allowed the general public to be depositors.

## Annex 2

### A Banking System under Pressure: Banking Decline in Rural Peru

The Peruvian banking system, which includes finance companies and leasing companies as well as banks, has been on a downward trend since at least the end of 1999.<sup>39</sup> From a high of US\$15,084 million in total loans outstanding at the end of 1999, that figure fell to only US\$13,428 million as of the end of March 2002. This almost exactly parallels the behavior over the same period of commercial credits, by far the largest component of bank lending, but the smaller categories have behaved quite differently. Mortgage loans for housing have remained highly stable, ranging from a low of US\$1,039 million at the end of 2000 to a high of US\$1,076 million as of the end of March 2002, a maximum variation of less than 4 percent, compared to the decline of over 11 percent for both commercial credits and total loans outstanding. Consumer credits have also declined sharply over the period, from US\$1,109 million at the end of 1999 to US\$933 million as of the end of March 2002, a decline of more than 15 percent. On the other hand, micro-enterprise credits have risen from US\$223 million at the end of 1999 to US\$315 million as of the end of March 2002. While in percentage terms, this is a gain of more than 25 percent, it does not fully offset the decline in consumer lending.<sup>40</sup>

ASBANC's statistics also show a marked deterioration in loan portfolio quality, with a major increase in loans classified as loss as well as an increase in doubtful loans, although the amounts classified as deficient and needing special attention actually declined somewhat. The most notable trend was not, however, in the deterioration in the quality of bank loan portfolios but rather in the withdrawal of banking activities from rural areas. While bank deposits in Lima were largely stable from the end of 1998 through March 2002, reaching a low of US\$10,239 million at the end of 2000 and a high of US\$10,976 million at the end of 2001, deposits in provinces outside metropolitan Lima fell steadily from US\$2,119 million at the end of 1998 to US\$1,751 million by March 2002, a decline of more than 15 percent. Even more pronounced has been the fall in loans outstanding in the provinces outside metropolitan Lima, from US\$2,711 million at the end of 1998 to US\$1,391 million by March 2002, a decline of almost 50 percent from the initial level, such that the provinces have become net suppliers of funds (deposits minus loans). On the other hand, loans outstanding in metropolitan Lima fell from US\$11,310 million at the end of 1998 to US\$9,145 million by March 2002, a decline of less than 20 percent. Moreover, the declines in deposits and loans outside of Lima were widespread, affecting even the provinces with substantial banking activity (e.g., Arequipa, Ancash, Ica, La Libertad, Lambayeque and Piura). Clearly, overall banking activity outside metropolitan Lima, not just agricultural credit, is matter of concern, and the decline in rural banking has not been offset by non-bank financial institutions, as shown below.

The importance of the decline in banking activity outside of the Lima metropolitan area is emphasized when banks are compared with other financial institutions.<sup>41</sup> For example, as of September 2001, total loans outstanding from banks amounted to US\$10,587 million, as compared with US\$212 million for *Cajas Municipales*, US\$64 million for *Cajas Rurales*, and US\$41 million for EDPYMEs. While banks accounted for over 88 percent of total loans outstanding, the institutions mentioned above accounted for less than 3 percent, while the other two categories of financial institutions (finance companies and leasing companies) accounted for the remainder, just under 9 percent. Moreover, the amount of bank loans outstanding just for micro-enterprises amounted to US\$273 million, plus another US\$777 million for

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<sup>39</sup> Figures provided by the *Asociacion de Bancos del Peru* (ASBANC).

<sup>40</sup> In many economies there is considerable overlap between consumer and micro-enterprise lending, due not only to the way financial institutions may categorize their loans for reporting purposes but also to the fungibility between household and enterprise receipts and expenditures.

<sup>41</sup> See ASBANC, *Boletín Financiero y Económico*, September 2001.

consumption, making it clear that banks account for at least half of the lending to finance micro-enterprise activities. Turning to agricultural lending, as of October 2001, bank loans made for agriculture amounted to US\$373 million, plus another US\$33 million from leasing and finance companies, with *Cajas Municipales*, *Cajas Rurales* and EDPYMEs together contributing US\$48 million, or just under 11 percent.<sup>42</sup> Unless there were a true revolution in lending by non-bank financial institutions private banks will continue to provide the majority of formal financing for agriculture, as well as being a major player in micro-enterprise finance.

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<sup>42</sup> See ASBANC, “El Sector Agropecuario a Octubre 2001.”

## Annex 3

### **Types of Banks, Capital Requirements and Branching in the Philippines**

In the Philippines, all commercial banks can offer all normal types of deposit accounts (savings, time, demand, etc.) and various types of loans and credits, as well as common trust funds, with a minimum capital requirement of 2.8 billion pesos (US\$56 million). Expanded commercial banks, with minimum capital of 5.4 billion pesos (US\$108 million), can additionally offer investment banking services, and all commercial banks can also offer foreign currency deposits and derivative products with BSP approval. The various types of thrift banks (savings and mortgage banks, stock savings and loan associations, and development banks) can offer savings and time deposits, loans and credits of various types, and common trust funds, but demand deposits and foreign currency deposits are subject to a minimum asset size and BSP approval. In addition, certain types of thrift banks can also act as collection agents and correspondents and can offer certain specialized services such as the issuance and trading of mortgages.

An important difference between commercial banks and thrift banks is that minimum capital for thrift banks is determined by location rather than by activity, with 400 million pesos (US\$8 million) required for Metro Manila, but only 64 million pesos (US\$1.28 million) elsewhere. For rural banks, the main difference again pertains to the minimum capital required according to bank location, with 32 million pesos (US\$640,000) required for Metro Manila, 16 million pesos (US\$320,000) for the next two largest cities (Cebu and Davao), and a range from 8 million pesos (US\$160,000) to 3.2 million pesos (US\$64,000) for smaller cities and municipalities, depending on size. Permitted activities are similar to those for thrift banks, with savings and time deposits allowed for all rural banks, but demand deposits requiring a minimum asset size and BSP approval. In addition, rural banks are permitted to offer loans and credits and correspondent services and to be collection agents, depositories for government funds, and estate trustees.

Most other rules imposed by the BSP are essentially the same for all types of banks. Most importantly, the minimum ratio of capital to assets of 10 percent is the same for all. Similarly, loan provisioning requirements and loan to deposit ratios are the same for all types of banks. While ceilings on loans to related parties and on loan amounts outstanding to any given individual or entity are essentially the same for all types of banks, the implications are quite different. Specifically, a single borrower limit of 25 percent of unimpaired capital applies to all types of banks, but this has very different implications for the sizes of clients that can effectively be served according to the amount of capital required. This of course is clearly recognized by the BSP in the way that it identifies the type of clientele that each type of bank is expected to serve. In particular, micro-finance is seen to be the province of thrift banks and especially rural banks. This is consistent with the lower minimum capital requirements, and hence likely lower maximum loan sizes, for thrift banks outside of Metro Manila and for rural banks in all locations, but especially those in smaller cities and municipalities.

Nonetheless it is not clear if the substantial differences in minimum capital requirements correctly reflect the risk management responsibilities implied by the permitted types of activities. Furthermore, the differentiation in minimum capital requirements provides strong incentives for thrift and rural banks to locate and establish their branches in smaller cities and municipalities in general, and outside Metro Manila in particular. While this is undoubtedly what is intended by the BSP and by Philippine government policy in general, it is unclear if this is the best way to provide such incentives given the implications for the capacity to handle risk. An important topic for further analysis could thus be the implications for the risks and risk management capacities of minimum capital requirements that are strongly differentiated by

location, as seen from the perspective of risk-based supervision in particular. At the same time, it would be necessary to analyze what alternative incentive structures could be used to promote banks to locate in smaller cities and municipalities and especially outside Metro Manila if this continues to be BSP and government policy.

As mentioned above, additional capital is required to establish bank branches, and this also varies by type of bank and by location. For commercial banks, the amount is 20 million pesos (US\$400,000) in the National Capital Region and Cebu and Davao, and 10 million pesos (US\$200,000) elsewhere. While these amounts are small relative to the minimum capital requirements for commercial banks, they would clearly make it unattractive to open small branches to serve micro-entrepreneurs and other low income individuals. For thrift banks, the additional capital to open a branch ranges from 10 million pesos (US\$200,000) in the National Capital Region and Cebu and Davao, to 5 million pesos (US\$100,000) in smaller cities and larger municipalities, to 3 million pesos (US\$60,000) in medium-sized municipalities, to nothing in the smaller municipalities. For rural banks, it is 5 million pesos (US\$100,000) in the National Capital Region, 2.5 million pesos (US\$50,000) in Cebu and Davao, and between 1.25 and 0.5 million pesos (US\$ 25,000 to US\$ 10,000) for all but the smaller municipalities, where it is again nothing. As in the graduated minimum capital requirements, these structures are clearly designed to favor smaller banks and the opening of branches in less urban locations. Nonetheless, these additional capital requirements do raise the cost of opening branches in almost all locations and have little or nothing to do with the level of risk or the ability to handle risks. It would thus seem worthwhile to reconsider the advisability of these capital requirements relative to other measures to encourage banks to open branches in less urban areas and to give a competitive advantage to smaller types of banks.

## Annex 4

### The Development of Credit Bureaus in Peru<sup>43</sup>

In Peru, the regulatory agency for banks and insurance (SBS) operates a credit database (*Central de Riesgos*) to which all regulated institutions are required to supply information on all loans. In addition, there are two private credit bureaus in Peru that supplement this information with information reported to them by lenders of all types, non-regulated as well as regulated, with coverage also including other types of creditors (e.g., suppliers of electricity, water and telephone services, members of the Lima Chamber of Commerce, credit card processors, pension funds, etc.) and even tax payments. By 1997 there were three private credit bureaus, but recently Riesgo Cero, the first private credit bureau established, could no longer compete profitably and closed. Of the two remaining credit bureaus, INFOCORP, owned 51 percent by Equifax and 49 percent by *Banco de Credito* and *Banco Wiese*, has come to dominate CERTICOM, which is owned jointly by several other banks.

Three aspects have been especially important in the development of credit bureaus in Peru, which have set that economy apart from most of the rest of Latin America. The first is the broad coverage of the SBS credit bureau, including non-bank institutions such as *Cajas Municipales*, *Cajas Rurales* and EDPYMEs, as well as financieras, and including all loans and not just delinquent loans.<sup>44</sup> The second, supported by technical assistance from the Inter-American Development Bank, was the extension of SBS credit bureau coverage in 1998 to loans of all sizes, from the initial coverage of only loans greater than US\$4,500. The third has been the ability of private credit bureaus to acquire information from the SBS credit bureau and to mingle this information with information from non-regulated institutions (something limited by the so-called “*secreto bancario*” in many other Latin American economies).

The Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME), an organization supported by the United States Agency for International Development (USAID), has also been helpful in promoting the expansion of credit bureau coverage. Specifically, COPEME has an arrangement with INFOCORP, now by far the dominant private credit bureau, under which INFOCORP provides access to its credit information to COPEME's affiliates at a discounted price.

In return, COPEME's affiliates are expected to supply information to INFOCORP, so that INFOCORP can expand its coverage to include non-regulated NGOs that engage in micro-lending. Nonetheless, the extension of INFOCORP's coverage has been limited by a lack of disciplined reporting (e.g., timely and consistent) by non-regulated institutions (also including the “semi-regulated” credit cooperatives), as well as by resistance to reporting all debtors, good as well as bad. Even in the case of COPEME's affiliates reporting may not be entirely satisfactory, perhaps due to a lack of specific incentives.<sup>45</sup>

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<sup>43</sup> Based on J.E. Austin Associates, “Case Studies of Selected Credit Bureaus in Several Latin American Countries” (Peru, pp. 815), October 2001, and “Risk Mitigation as a Cost-Effective MicroFinance Strategy: Case Study of the IDB-Peru Global Micro-Enterprise Credit Program” (pp. 6.16), March 2000; interviews with Julio Best Morla and Alfonso Higuera Suarez, respectively, Gerente General and Sub-Gerente of INFOCORP, and work by the author in other Latin American countries.

<sup>44</sup> *Cajas Municipales* are savings and loan institutions owned by local governments; *Cajas Rurales* are privately owned saving and loan institutions located in rural areas; EDPYMEs are micro-finance NGOs that are regulated; and financieras are finance companies that typically specialize in consumer credit.

<sup>45</sup> Credit bureaus in some economies limit access to information to those institutions supplying information, or at least offer these institutions a discounted price on requests for information.



The success of private credit bureaus in Peru is best illustrated by current figures for the dominant credit bureau (with 80 percent of the market) INFOCORP. Specifically, INFOCORP has more than six million records on firms and individuals and processes more than 400,000 requests for information each month. Nonetheless, INFOCORP also reports certain constraints that hinder its operations. One is delays at the SBS credit bureau in receiving, processing and providing information, but INFOCORP has overcome this in part by soliciting information directly from the major regulated institutions, especially banks. Another is that most non-regulated entities provide information only on bad debtors; in fact, only the water company reports good payers as well as bad ones. Also, as mentioned above, many unregulated entities such as micro-credit NGOs and credit cooperatives report only sporadically and/or do not provide information in a consistent format.

The failure of certain types of institutions to appreciate the potential usefulness of credit bureau information is further reflected in requests for information from INFOCORP. EDPYMEs and micro-credit NGOs, mainly located in Lima, are major users of INFOCORP information, making 4,000-8,000 inquiries per month. Outside of Lima, *Cajas Municipales* are the main users (over 2,000 inquiries per month), with *Cajas Rurales* making only about 1,500 requests per month, and credit cooperatives only a few hundred.

Lower participation outside Lima partly reflects the different mix of regulated and non-regulated entities outside Lima, as compared to within Lima, plus the fact that the less complete the coverage, the lower the value of credit bureau information for all potential users. INFOCORP also reports that economies of scale are an important factor constraining its efforts outside Lima, as a special effort to expand coverage in Arequipa did not yield profitable results and was discontinued. It is thus important to identify whether the predominant barrier in rural areas is economies of scale hindering credit bureau profitability or the preponderance of non-regulated institutions with their lower rates of participation and lack of timeliness and consistency in reporting. If lack of economies of scale is predominant, then subsidizing start-ups in areas outside Lima might be helpful, whereas if inadequate participation by non-regulated institutions is more important, then incentives to improve the quality of participation could be more effective.<sup>46</sup>

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<sup>46</sup> Sometimes, however, rural areas can take the lead. For example, in a rural area of Guatemala a group of MFSIs, using simple computer software, set up a credit database that has come to encompass virtually all lenders and types of debt because of the credibility that the founding group was able to establish.

## MOVING TOWARDS RISK-BASED SUPERVISION IN DEVELOPING ECONOMIES

**Thomas Fitzgerald and Robert Vogel**  
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### **Introduction**

Advances in technology, the ability of money to move around the globe at the speed of light, innovative products and services, interrelations among economies, and a larger participation by developing economies have made the world of finance a far more complex place. Adding to this the liberalization that has occurred across the economic and financial spectrum in almost every part of the world raises a number of important questions, three of which are addressed in this paper:

Are government regulatory institutions, especially those in developing economies, keeping up with the pace of change?

Where does micro-finance, an innovation of special interest for development because of its promise of expanded access to financial services for the poor, fit into the regulatory scheme?

Can current regulatory techniques detect less-obvious risks—such as the foreign exchange risks that precipitated the recent crisis in Asia—that have become part of the new financial world?

The answer to the first question is “no”: government regulatory institutions, in most cases, are not keeping up with the rapid pace of change. At one end of the spectrum, exotic activities involving derivatives and hedge funds often require sophisticated approaches to assess risks and potential rewards. These approaches are beyond the capabilities of most bank examiners and usually require the talents of specialists. The answer to the second question lies at the other end of the spectrum. There is much debate but little consensus about where micro-finance fits into the regulatory scheme. Many regulators view micro-finance as a relatively unsophisticated area of finance, but in reality it requires considerable competence to practice and to supervise. The answer to the third question is, unfortunately, now well-known. Current regulatory techniques were not effective in detecting the risks associated with the foreign exchange inflows and the accompanying lending in foreign exchange that led to the recent economic problems in Asia and Latin America.

There is no doubt that alternatives to traditional forms of banking supervision need to be considered and, as economies develop and improve their supervisory capabilities, they will need to define the types of supervision that they want to practice. Traditional forms of supervision are important regulatory tools but have some severe limitations. In particular, they are labor intensive and narrow in focus, as they look at many transactions to assess the condition of individual financial institutions at a point in time. Although traditional forms of supervision will undoubtedly remain important tools in the repertoire of regulators' approaches to supervision, more dynamic approaches to supervision will be needed as financial systems become more liberalized and developed. These approaches must be able to address not only the current condition of individual banks but also their likely future performance, including their managements' ability to deal with risks caused by the economic environment over which they may have little or no control. Since banking systems usually reflect the economic environments in which they operate, regulators need to be able to translate economic information into potential risk factors for the banking system (systemic risks). Risk-based supervision addresses these issues.

The objective of prudential regulation and supervision is a banking system that is safe and sound. This objective could be largely achieved by having banks hold only assets with as little risk as possible (e.g., only short-term government debt), but this would defeat another objective of the financial system to provide financial services to facilitate economic efficiency and growth, and to spread the benefits of growth as widely as possible, especially through appropriate lending policies and practices. Risk-based supervision, practiced rigorously, can promote safety and soundness while also opening possibilities for innovation in order to facilitate the widest availability of financial services. For example, risk-based supervision treats mitigating risks and offsetting risks as valid approaches to risk management, whereas traditional forms of supervision tend to be biased in favor of risk-avoidance and hence against innovative products and services for new types of clients.

This paper provides insights regarding differences between traditional supervision and risk-based supervision, and suggests that risk-based supervision has a role in the supervision of financial institutions across the entire financial spectrum in developed as well as developing economies. Currently, outside the United States, there is no uniform approach to risk-based supervision. This paper was written in part to promote consistency in approaches and to add discipline to the subject by providing background information and outlining the basic elements that are at the heart of risk-based supervision. This is not a highly technical paper designed for bank supervisory personnel, but rather for policymakers interested in seeing improvements in regulatory effectiveness. Nonetheless, it attempts to be rigorous in explaining as precisely as possible in a relatively brief paper the key elements of risk-based supervision. It is well known that risk management is a crucial element of banking, and hence of banking supervision, but this paper goes on to recognize that, to be effective, risk-based supervision must embody certain basic elements. As the paper will show, risk-based supervision is not simply a matter of looking in some general way at the more obvious risks of banking.

The first part of this paper discusses and compares the characteristics and merits of traditional forms of supervision and risk-based supervision in their ability to achieve the objectives of safety and soundness on one hand and wider access to financial services on the other. The remainder of the paper looks at the riskiness of bank lending in two specific areas and the ability of supervision to detect this riskiness, and the resulting implications for access to credit. In the first case, the identification of problems like those that led to the Asian financial crisis shows that what appears to be low risk lending may not in fact be so low risk and that excessive lending can occur; i.e., there can be too much access to credit, the risks of which may not be detected by traditional approaches to banking supervision. In the second case, recent innovations have developed new techniques for lending at low cost and low risk to potential small-scale clients, but these clients may nonetheless be denied access to credit if traditional approaches to banking supervision are applied.

## **A Brief Comparison of Traditional Supervision and Risk-Based Supervision**

At the risk of oversimplifying the differences in approaches to supervision, traditional supervision focuses more on *quantifying problems and minimizing risks* in individual financial institutions, while risk-based supervision focuses more on the *quality of risk-management systems* and the *recognition of systemic risks to the banking system caused by the economic environment*.

The results of traditional supervision and risk-based supervision can vary greatly. Traditional supervision often results in quantifying problems, correcting symptoms of problems, and instructing banks to *avoid risks* that seem too high. Risk-based supervision assesses the quality of risk-management practices, addresses causes of problems, and makes recommendations that give banks options on how to minimize the adverse consequences of risk-taking. One of the options might be to allow banks to take the risks and experience the losses associated with the risks so long as banks charge interest and fees that more than offset the losses and thus yield a profit. The traditional approach tends to limit a bank's ability to serve the economic community's needs by limiting the risks a bank can take, whereas risk-based supervision allows banks to take risks so long as the banks demonstrate the ability to manage and price for risks. Risk-based supervision thereby allows banks to meet more of their economic community's needs. Traditional supervision tends to apply a cookie-cutter approach to supervision in which all banks are treated alike, often at the lowest common denominator. Risk-based supervision treats banks differently depending on each bank's demonstrated ability to manage risks. It does not penalize well-managed banks by making them operate under standards designed to keep weak, poorly managed banks solvent.

This paper does not suggest replacing traditional supervision with risk-based supervision in all instances. There are appropriate places for each approach. When bank supervisors are dealing with institutions that are known, or thought, to have serious problems that may threaten solvency, there is then a need to quantify problems, which can best be accomplished using traditional forms of supervision. Traditional supervision provides a snapshot of an institution's condition at a point in time. It is transaction-oriented and usually more labor intensive than risk-based supervision, thereby straining the scarce resources of most regulators. However, the worse the condition of a financial institution, the greater the need to quantify problems with precision. In healthy banks, where the likelihood of failure is not an issue, there is less need to quantify problems with great precision.

Risk-based supervision assigns the highest priority to areas of highest risk. Management of those areas is evaluated, along with systems designed to optimize income while managing risk and minimizing the adverse consequences of risk-taking. Transactions are tested to the extent necessary to validate the competence of management and the integrity of systems. It is important to evaluate the stability of management and systems in order to gain confidence that a bank will continue to operate in a safe and sound manner between supervisory inspections.

### **Historical Background: The Origins of Risk-Based Supervision**

Banks are, by definition, in the business of taking and managing risk. For centuries bankers have assessed and managed risk intuitively, without the benefit of a formal and generally accepted framework or common terminology. For as long as there have been bank regulators, they too have assessed risk without the benefit of a formal framework and common terminology. This was possible because of the narrow scope of products and services offered by banks.

No longer is it sufficient to understand just the primary risks associated with a product or service. Secondary risks and obscure risks have accounted for significant losses in recent years.

It can readily be observed that traditional methods for looking at risk are being strained and are often inadequate in today's environment.

On 28 February 1979, in a statement before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Comptroller of the Currency John G. Heimann announced the creation of the Multinational Banking Division within the Office of the Comptroller of the Currency. In that statement he announced in part "We are particularly proud of two fundamental innovations in our office's approach to bank examinations. We believe that our new examination procedures, which emphasize a qualitative review of a bank's condition and management and rely heavily on the National Bank Surveillance System—a computer-based data and ratio-analysis system represents an important advance in the state of the art." The adoption of the "new examination procedures" was referred to as the top-down approach to supervision, while the more traditional (transaction analysis) approach was referred to as the bottom-up approach. Comptroller Heimann went on to say "An equally fundamental departure is our creation of a Multinational Banking Division, which will supervise our largest and most complex banking institutions. The establishment of what is, in effect, a new region for the regulation and supervision of the multinationals recognizes the reality that these entities are fundamentally different from the great majority of the institutions which we examine and supervise...."

Because of the complexities and unique characteristics of multinational banks, one of the first responsibilities of the Multinational Banking Division was to develop new and more dynamic approaches to supervision. Two options were considered: develop individual examination procedures, tailored to the specific needs of each multinational bank, which would have been prohibitively time-consuming and would have required constant updating; or develop a supervisory framework that provides a consistent approach to all banks and, at the same time, is flexible enough to adjust to the many differences among banks and among the myriad of products, services, and activities banks provide. The latter prevailed.

After several months of assessing then current practices, a meeting with senior bank examiners was held in San Francisco on 27 February 1980, to discuss new approaches to examining and supervising multinational banks. At that meeting it was decided that examiners should relate the results of examinations to risk exposure, specifically those risks that can have the most adverse impact on capital, liquidity, and compliance with laws, and to the potential effects that risks have on the future of the institution under examination. It was also decided at that meeting that examinations would focus on areas of highest risks. So began the road towards risk-based supervision.

During the mid- to late 1980s, the development of risk-based supervision was interrupted by the failure of hundreds of banks and thrift institutions in the United States. The Office of the Comptroller of the Currency and other regulators spent most of their resources quantifying problems in troubled institutions. Although regulators did not formally practice risk-based supervision at that time, elements of risk-based supervision were blended with traditional supervision. Regulators focused resources on institutions known to present the greatest risk to the financial system. Since the greatest risks were credit risks, large numbers of individual loans were reviewed in order to quantify problems and evaluate the adequacy of loan-loss reserves and capital. Traditional approaches were appropriate in these situations because it was already known that risks were high and that management and management systems were strained and, in many cases, inadequate.

After the debacle in the banking and thrift industries that occurred during the 1980s, regulators had a much greater appreciation of the importance of understanding systemic risks and the effects of the economic environment on individual institutions and banking systems as a whole. Moreover, as financial institutions returned to health, the importance of evaluating how well they are managed and the adequacy of their risk-management systems was also more fully

appreciated. Risk-based supervision thus re-emerged and by 1994 became the preferred approach to supervision.

The work that started in the early 1980s to address problems associated with examining large, complex banks has resulted in what is today commonly referred to as risk-based supervision. In seeking a common approach to examining a group of widely diversified banks, the foundation was laid for developing a common approach to supervision that can be adapted to highly diverse banking systems. Just as risk-based supervision overcame the need to develop different approaches to examining large banks with different organizational structures and different approaches to delivering products and services, risk-based supervision also overcomes the need to develop different supervisory approaches for different types of financial institutions.

#### **Four Recent Contributions That Enhance Banking Supervision**

In recent years four advances have occurred that enhance banking supervision in general and risk-based supervision in particular. The first two are associated with the Bank for International Settlements in Basle, Switzerland: the Basle Capital Accord, and the Core Principles for Effective Banking Supervision, promulgated in September 1997 by the Basle Committee on Banking Supervision. The others are the CAMEL (Capital, Asset Quality, Management, Earnings, and Liquidity) bank rating system and the realization that collateral based lending is not necessarily low risk lending.

The Basle Capital Accord provides a more consistent approach to capital adequacy requirements by introducing a uniform set of international standards. The Core Principles for Effective Banking Supervision, promulgated by the Basle Committee on Banking Supervision, set out the minimum standards that are considered necessary for effective supervision. Several of the principles embrace risk-based supervision and encapsulate the concepts developed at the Office of the Comptroller of the Currency over the past twenty years. However, because the Core Principles is a brief document and covers a variety of topics, it cannot fully explain the key differences between risk-based supervision and traditional regulatory practices or provide a systematic explanation of all the basic elements that would enable a regulatory agency to implement risk-based supervision.

The CAMEL rating system for financial institutions has come into wide use in recent years and is generally considered to be an important tool for banking supervision. It is used to record the results of supervisory activities, but its use does not depend on a specific approach to banking supervision. Collateral based lending has traditionally been perceived by many bankers to be low risk, and many supervisors in developing economies rely heavily on the existence of collateral to be able classify bank loans as low risk. As discussed below, however, collateral based lending can have some unintended results.

#### **The Basle Capital Accord**

The Basle Capital Accord of July 1988 and subsequent amendments set out internationally agreed- on standards for determining capital adequacy. The Accord of 1988 defines what constitutes capital and assigns weights to various categories of assets and off-balance-sheet activities. Its primary benefits are that:

capital adequacy is evaluated from economy to economy using common measurements; weightings are assigned based on perceived risks (e.g., the perception that little or no capital is required to support low risk, highly liquid assets, while more capital is required to support the same amount of higher-risk, less liquid commercial loans); and risks to capital are counted for capital adequacy purposes whether they appear on or off the balance sheet.

Prior to the Basle Accord there was no uniform approach among economies for determining capital adequacy. Most economies used what is commonly referred to as the capital leverage ratio. This ratio measures the amount in the capital account relative to total assets. Each regulator determined what could be included as capital (such as common stock, the types of preferred stock, reserves, etc.) and the minimum amount of capital that was acceptable. This approach to determining capital adequacy did not differentiate according to the quality and liquidity of assets. Therefore, when regulators required banks to decrease their leverage ratios, many banks simply reduced the amount of highly liquid, high-quality, low yielding assets on their books. This improved the capital ratio but did not reduce the risks to capital and had the adverse effect of reducing liquidity. At the same time, banks also sought to improve their leverage ratios by shrinking their balance sheets in other ways. They started selling risk assets and engaging in activities that involved risks that did not appear on their books. By assigning different risk weights to assets, the Basle Accord removes the disincentive to carry large amounts of high-quality, highly liquid assets on the books, so that liquidity can be improved without adding stress to the capital base. The Basle Accord also captures categories of risk that are present but do not show on balance sheets.<sup>47</sup>

### **Core Principles for Effective Banking Supervision, Promulgated September 1997 by the Basle Committee on Banking Supervision**

The Central Bank Governors of the G10 countries have endorsed the Core Principles for Effective Banking Supervision, including a Compendium.<sup>48</sup> The document states in part: "The Basle Core Principles comprise twenty-five basic Principles that need to be in place for a supervisory system to be effective. The Principles relate to:

Preconditions for effective banking supervision	Principle 1
Licensing and structure	Principles 2 to 5
Prudential regulation and requirements	Principles 6 to 15
Methods of ongoing banking supervision	Principles 16 to 20
Information requirements	Principle 21
Formal powers of supervisors	Principle 22
Cross-border banking	Principles 23 to 25

The document goes on to state that "The Principles are minimum requirements and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries." The total document, including appendices, is forty-four pages double spaced and is an excellent document for building the framework for an effective supervisory system, but it does not go into great detail on any single subject. Principles 11, 12, and 13 are the most relevant to riskbased supervision.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

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<sup>47</sup> The Basle Accord should not be confused with risk-based supervision. The Basle Accord assigns risk-weightings to broad categories of assets, but it does not prescribe a particular approach to banking supervision the way traditional approaches or risk based supervision does. The Basle Committee on Banking Supervision offers many publications that deal with risks in banking systems.

<sup>48</sup> The Basle Committee also worked with country authorities not in the G-10 in developing the Principles.

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk-management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.

The present paper augments these Principles by defining the three dimensions of risk and the three methods for gauging the adverse consequences of risk-taking. It also discusses the six categories of risks that have historically resulted in the overwhelming majority of losses in banking systems.<sup>49</sup>

### **CAMEL Financial Institutions Rating System**

CAMEL is the most widely used financial institutions regulatory rating system in the world. The primary purpose of the CAMEL regulatory rating system is to identify financial institutions with greater-than-desirable levels of regulatory concern. In addition to the C, A, M, E, and L component ratings, there is usually an overall summary or composite rating for each institution. Composite ratings are used to identify institutions of concern, while component ratings isolate particular aspects of institutions that give rise to concerns. CAMEL in and of itself is not associated with any particular approach to financial institution supervision. It is used to record the results of a wide variety of reviews of financial institutions in both the formal and informal sectors.

Much of the world continues to use CAMEL, though in some highly developed countries an "S" has recently been added to CAMEL, resulting in CAMELS.<sup>50</sup> The "S" has been added to capture the dynamics of financial markets that impact the institutions being rated. As financial instruments such as derivatives become more exotic, and imbedded risks become less obvious, the risks associated with these and other complex financial instruments need to be reflected in some way. The "S" also reflects an evaluation of stress tests performed to gauge the impact of market movements, both up and down, and of management's overall ability to manage exposure. Whereas CAMEL ratings can be assigned using more traditional approaches to supervision, it would be difficult to assign accurate "S" ratings without using risk-based supervision.

Implicit in CAMEL ratings is the level of risks in financial institutions. Usually, the higher the risks in an institution, the more adverse the CAMEL rating. However, CAMEL is not a risk rating system. CAMEL does not focus on specific risks or actions taken to minimize the adverse consequences of risk-taking.

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<sup>49</sup> Furthermore, the present paper deals primarily with financial risks, and thus there are some important risks that are not addressed. These are risks that are less financial in nature and, historically, have not been assigned responsibility for large losses in large numbers of banks. These include risks such as legal compliance risks and reputation risk and risks associated with strategic planning.

<sup>50</sup> "S" stands for Sensitivity to Market Risks.



There are in fact three ways to minimize the adverse consequences of risk-taking:

*avoiding risk* involves not taking the risk or putting limits on the amount of risk to be assumed;

*mitigating risk* involves implementing internal controls and risk management practices and hiring people with greater levels of expertise; and

*off-setting risk* involves charging higher interest rates and fees for higher levels of risk and/or higher operating costs.

Regulators and institutions usually desire favorable CAMEL ratings, which means to many regulators lower levels of risk exposure. The easiest way to maintain lower levels of risk is to use *risk avoidance*. This stands in contrast to the other two ways of managing risks, which are *mitigating risks* and *offsetting risks*. Risk avoidance requires less skill for bankers and regulators than taking risks and managing them. Risk avoidance also tends to cause financial institutions to do two things: limit the scope of products and services offered; and exclude people at the lower end of the socioeconomic scale. On the other hand, financial institutions that understand how to manage risk can take greater risks and offer more products and services to a greater number of customers across the economic spectrum and, at the same time, remain profitable and maintain satisfactory CAMEL ratings. Regulators who understand how risk is managed can be more tolerant of institutions with higher risk-profiles accompanied by better risk-management systems. This has significant consequences for the less advantaged in societies, who are usually perceived as higher-risk customers, especially in the area of loan products.

In some developing economies, regulators take a critical view of unsecured lending because they view it as a higher-risk form of lending. Often, when unsecured lending is observed, adverse CAMEL ratings are assigned. This approach has the effect of restricting the amount of credit available to small-scale entrepreneurs for whom formal documentation and collateral is neither available nor required for an adequate assessment and management of risk. Bankers and regulators usually take the position that collateralized lending is a less-risky form of lending, but there are a number of misconceptions regarding collateral-based lending.

### **Misconceptions about Collateral-Based Lending**

There is a widespread perception that collateral-based lending is less risky than unsecured lending. Such thinking is especially prominent in developing economies, although it is not limited to them. Collateral-based lending is often used to mask deficiencies in financial institutions and regulatory agencies. Bankers and regulators who are not skilled credit analysts and who do not understand loan structuring often feel more comfortable with collateralized loans. By collateralizing loans, the burden of managing the risk is shifted to the borrower. Attempts to avoid risks by substituting collateral for sound credit judgment and credit risk management often lead to problems, as in the agricultural lending crisis in the United States in the 1980s. The crisis was caused in no small part by the false sense of security that came with collateral-based lending. Farmers eager to expand their operations bought land at inflated prices with expectations of lofty farm commodity prices. Both farmers and bankers took comfort in knowing that real estate provided underlying support for loans. When farm commodity prices failed to reach lofty expectations, collateral values plummeted to levels consistent with the income that the land could in fact generate at lower commodity prices. Many farmers and bankers failed, as the land could not generate sufficient income to repay loans; this was compounded when farmers and bankers tried to sell the collateral in crowded and depressed markets.

In developing economies, much of the lending done is secured by real estate as bankers and regulators perceive collateralized lending to be the least risky form of lending. Both want to minimize the risks associated with lending. The perception is that people are afraid of losing their real estate and will therefore repay their loans. Such thinking can lead to problems. The worst aspect of collateral lending is that it produces a false sense of security for bankers and regulators. Because of this false sense of security, some bankers fail to exercise the basic disciplines that are critical to sound lending and thereby risk doing harm to themselves by building unsound loan portfolios. Collateral lending can also be more harmful to borrowers than not granting them credit in the first place.

Some of the problems caused by having a false sense of security from collateral based lending are:

Lenders rely on the value of the collateral and do not do a proper analysis of the borrower's finances.

Because lenders do not do a proper analysis of borrowers' finances, which includes understanding the cash flows of borrowers, loans are not structured properly payments are not matched to the point in time when borrowers have cash to make payments.

With loans to small, marginal borrowers, loan structuring is especially important because borrowers are living on low cash levels. If payments are due before borrowers have cash, borrowers will be unable to make payments. If payments are due too long after borrowers have cash, the cash will be diverted to other uses and will not be there when payments are due.

Efforts to strengthen individual loans, by relying on collateral, can result in less obvious and unintended weaknesses.

What happens when collateral based loans are not structured properly? Often, high delinquencies result. High delinquencies are troublesome for a number of reasons:

Delinquencies bring into question the creditworthiness of borrowers and will probably make them appear to be poor credit risks the next time they apply for loans.

- Delinquency creates unnecessary stress for borrowers when they are unable to repay.
- Delinquency promotes bad habits and poor credit disciplines for borrowers who may be borrowing for the first time.

Collecting delinquent loans is expensive in terms of time taken from more productive endeavors.

Delinquency can cause liquidity problems.

- Since most funds for new loans come from the repayment of existing loans, fewer borrowers can benefit from available funds.
- In deposit-taking institutions, depositors may not have timely access to their funds.

Underwriting standards are the criteria used for granting credit, and loan structuring is matching loan payments with cash flows of borrowers. Failure to do appropriate credit analysis and loan structuring are two leading causes of loan problems and high delinquencies. There is nothing wrong with taking real estate as collateral, but it is not always necessary for sound lending. It should be taken out of an abundance of caution. It should not be relied on as the

primary support for most loans. It should be viewed as a secondary source of repayment and should not substitute for sound underwriting decisions and proper structuring. All lending should be done on a financially sound basis. This is true regardless of the size of the loan. Collateralized lending is not by definition less risky and, if not viewed properly, can produce a false sense of security and lead to poor lending practices.<sup>51</sup>

### **Differences between Traditional and Risk-Based Supervision**

One of the easiest ways to explain the differences between traditional supervision and risk-based supervision is to use an analogy. Evaluating the health of a financial institution is similar to evaluating the health of a person. A person in generally good health goes to a doctor for an annual physical check-up. The doctor checks the vital signs, checks the functions of vital organs, checks for ailments that commonly afflict people who are the patient's age and gender, inquires about his or her lifestyle, eating habits, exercise habits, family history, etc., and makes a judgment about the health of the patient and about risk factors that may affect the health of the patient. The doctor usually will not spend a lot of time and resources running tests for possible ailments unless there are symptoms, high-risk factors, or other reasons to suspect specific health problems. On the other hand, if the patient is known or thought to be in poor health, or at high risk, the doctor will run many more tests in order to assess the health of the patient. Where health problems are detected, extensive testing will probably be done to evaluate the extent of the problems, the extent of the harm that has been caused, and the treatment necessary for healing.

The examination of a financial institution should be similar to the physical examination of a person. If an institution is thought to be in generally good health, the supervisory approach taken should differ from that taken if the institution is known or thought to be in poor health, or at high risk. If an institution is well managed and thought to be in generally good health, a risk-based approach is appropriate. The vital signs (the adequacy of capital, liquidity, and compliance with regulations) should be checked, functions of vital organs (performance indicators for the major functions of the institution, i.e., the loan portfolio, asset/liability management, liquidity, earnings, etc.) should be tested, risk factors should be evaluated, symptoms of problems assessed, and systems and management practices tested. Regulators should not spend a lot of time and resources running tests (doing detailed, transaction oriented examinations) for possible problems unless there are symptoms, management weaknesses, or other reasons to suspect problems. The key phrase is "in well managed institutions." On the other hand, if an institution is known or thought, to be in poor health or at high risk, a more traditional or bottom-up approach would be appropriate. The regulator should do transaction testing in order to assess the health of the institution. Where problems are detected extensive reviews should be done to evaluate the extent of the problems, the extent of the harm that has been caused, and the actions necessary for rehabilitation. Audit activities may even be necessary to define and quantify problems.

Risk-based supervision saves regulatory resources and promotes a more safe and sound financial system. It saves resources because it focuses regulatory resources on areas of highest risk and usually requires substantially less transaction testing. It promotes a more safe and sound financial system because at the heart of risk-based supervision is an assessment of how well institutions manage risk. By getting institutions to do a better job of managing risks as opposed to correcting symptoms of problems, as is often the case with traditional supervision, regulators focus their actions on correcting causes of problems and thereby requiring improvements in management practices and management systems.

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<sup>51</sup> There are certain types of loans for which collateral is the primary source of repayment, such as loans for inventory and crop loans. For these types of loans, reliance on collateral may be more appropriate. Proper loan structuring is always appropriate.

Risk-based supervision is a higher form of supervision than others. It is not practiced at the exclusion of traditional supervision. Like the doctor who detects symptoms or high-risk factors and prescribes extensive testing to determine the nature and extent of problems, regulators who find symptoms of problems or high-risk factors and less-than-satisfactory risk-management practices should do sufficient transaction testing to determine if problems exist and, if so, their nature, cause, and extent.

### **Traditional Forms of Supervision**

If asked, most banking regulators would say their role is to maintain the safety and soundness of the banking systems for which they are responsible, for the purpose of promoting economic activity in the economy where they are located. Safety and soundness are difficult to define because there are no limits to how safe or sound a financial institution can be, and therefore they are not easy points from which to start a discussion of banking supervision. It is easier to start the discussion at the other end of the spectrum. Banks fail for two reasons: either they run out of capital or they run out of liquidity (or they run out of both). Unsafe and unsound banking practices are practices that threaten a bank's capital or liquidity. Traditionally, regulators have used their powers to help banks avoid unsafe and unsound practices. Often this is done by telling banks to reduce or avoid risks that are perceived as threats to capital or liquidity. It is not a very sophisticated approach but neither are many of the traditional methodologies used in making these determinations.

In many economies that do not practice risk-based supervision, bank examinations are very closely tied to accounting and auditing principles. Traditional supervision often fails to account for the different levels of knowledge and confidence that regulators have regarding the institutions supervised, and therefore the same procedures and approaches are applied to all institutions almost equally. These are known as bottom-up examinations. Their primary focus is on the accuracy of the balance sheet, including loan loss reserves, the income statement, and the adequacy of traditional internal controls that are primarily designed to prevent fraud. Their primary objectives are balancing journals, reviewing large numbers of individual transactions such as loans, and quantifying problems based on the aggregate of transactions reviewed. This approach has merit for determining the current condition of a financial institution and quantifying current problems but provides little insight into future performance and does not put the onus of accurate record keeping and problem identification and correction where it rightfully belongs, which is on management and the directorate. Also, corrective actions are often directed toward the symptoms of problems rather than the causes of problems.

Transaction reviews quantify problems as opposed to qualifying problems. This may seem like a subtle nuance—after all, a problem is a problem—but the supervisory reactions to each type are dramatically different. In cases where problems are quantified, the supervisory response is usually to take actions that are directed towards reducing the size of the problem. The trouble with this approach is that it usually addresses only the symptoms of the problem without addressing the causes of the problem. Therefore, even after problems seem to be resolved, there is a high probability that they will return. By contrast, top-down, and risk-based supervision focus on qualifying problems by identifying system flaws and poor management practices that cause both current or potential problems. Where problems are deemed to be significant, the supervisor may employ transaction analysis to quantify them in order to determine more precisely to what extent capital and liquidity are at risk and to prescribe appropriate remedies.

Bottom-up supervision requires a great deal of technical knowledge and skill, but is the least-sophisticated approach to financial institution supervision. It is labor intensive and strains the resources of most regulatory institutions that employ it. It usually does not differentiate among high-, medium and low risk activities. Because it often addresses the symptoms of problems instead of the causes, it frequently leads to remedies that promote reducing risks as opposed to employing techniques to manage risks better. Reducing risks is a form of avoiding risks that

has a tendency to reduce the variety and volume of products and services offered to the public. This includes credit to small-scale borrowers who may be considered less creditworthy (discussed below in detail).

Bank examiners are not, or should not be, auditors. Examiners should be financial, risk, and compliance analysts. Assuring the accuracy of bank records is the responsibility of bank management, and assuring adequate audit coverage is the responsibility of the directorate. Regulators should use their powers to ensure that bank management and directors fulfill their respective responsibilities. To do otherwise strains scarce regulatory resources and runs counter to regulators' responsibilities to ensure that the financial institutions for which they are responsible are properly managed.

### **Risk-Based Supervision**

Risk-based supervision is an enhancement of top-down supervision. Top-down supervision was developed in the 1970s. It focuses examination resources on an overall financial analysis of the financial institution under review, and it documents and tests policies, procedures, systems, and management practices. Unlike the bottom-up approach, transaction testing is done to test compliance with stated policies, procedures, systems, and practices, not for quantifying each problem disclosed without regard for significance. When problems are disclosed, corrective actions are directed toward correcting the causes of the problems, not just the symptoms.

A common analogy used to describe top-down supervision is an assembly process for making boxes. If one wants to assure that quality boxes are produced, one can either examine every box produced and correct each individual defect, or one can take random samples of the boxes produced and, when a problem is identified, determine the cause of the problem and correct it. Fixing the cause of the problem will help ensure that boxes produced in the future are of high quality and will eliminate the need to devote resources constantly to correcting defective boxes.

If loan policy in financial institutions sets out certain underwriting criteria, a sample of loans would be reviewed to determine compliance with the criteria. Those same loans would also be tested for credit quality. If problems are identified, they would be defined and actions would be directed towards correcting the causes for the problems rather than just correcting the problems found in the individual loan. The problems with the individual loan are usually just symptoms of larger problems. If credit quality is determined to be the problem with the sample loans, but the loans are in compliance with underwriting standards, then changes in underwriting standards may be appropriate. At this point there is no attempt to quantify problems unless the examiner suspects that the problems are significant enough to undermine the safety and soundness of the institution. In the top-down approach, problems are identified and defined, and the root causes for the problems are addressed. If problems are identified that, in the opinion of the supervisor, significantly impact the safety and soundness of the institution, then bottom-up examination techniques may be necessary to quantify the problems in order to assess the adequacy of capital and liquidity.

Risk-based supervision enhances top-down supervision in three ways. First, it focuses supervisory resources on the areas of highest risk within individual financial institutions. Second, it uses a common framework and common terminology, developed specifically for risk-based supervision, to assess risks and evaluate management practices, policies, and procedures in the context of managing risks; that is, optimizing returns while minimizing the adverse consequences of risk-taking. Finally, it incorporates an assessment of management's ability to deal with risks beyond the control of management, such as systemic risks and risks in the economic environment in which the financial institution operates.

Risk-based supervision requires a greater understanding of the institutions being supervised and of the environment in which they operate. It requires an understanding of the risk profile of the institution under examination in order to identify areas of greatest risk and therefore deserving of greatest attention. It requires an understanding of the nature of risks, together with management's ability to deal with both internal and external risks. Once the areas of greatest risk have been identified, the examiner reviews the risk-management systems in those areas.

There are the four basic components of a risk-management system that are reviewed to assess management's ability to manage risks:

- identification of risks;
- measurement of risks;
- controlling risks; and
- monitoring changes in risk profiles or changes in the corresponding controls.

At the heart of risk-based supervision is evaluating how well financial institutions manage risks. In order to understand risk-based supervision, one must first understand risk management. The following section provides an outline of elements that make up risk-management systems.

### **Basic Elements of Risk-Management Systems**

Risk-based supervision has gained considerable popularity in recent years. It has been embraced in the Basle Core Principles and promoted by the World Bank and the International Monetary Fund (IMF). Due in part to its newness, there is not yet a consensus on how to practice risk-based supervision. The three federal banking regulatory agencies in the United States (the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency) have adopted similar approaches. Other developed economies are in the process of adopting different approaches, according to unpublished drafts reviewed by one of the authors of this paper. One purpose of formalizing risk-based supervision in the United States was to develop a common framework and common terminology for practicing and communicating assessments of risks in the banking system. One of the purposes of this paper is likewise to increase the consistency of frameworks that are being developed as risk-based supervision spreads around the world.

The authors believe there are basic elements that should be understood by bankers and banking supervisors and incorporated in their respective approaches to risk assessment and risk management. These elements are a modest enhancement of the Basle Core Principles.

1. The six most common risk factors in financial institutions that account for an overwhelming majority of losses are:

- Credit Risk
- Liquidity Risk
- Market Risk
- Operational Risk
- Interest Rate Risk

- Foreign Exchange Risk

There are other risks that should be considered by bankers and banking supervisors, such as legal, reputation, and strategic risks. Although these are important categories of risk to consider in individual institutions, historically they have not accounted for large losses at a large number of financial institutions. Inflation risk is reflected in market risk and in interest rate risk. In highly inflationary economies, inflation risk may be broken out as a separate category of risk. Other significant risks peculiar to a particular institution or group of institutions should also be considered.

2. There are three dimensions of risk:

- Size (Amount) of the Risk
- Duration (Length of Time) of the Risk
- Probability of Adverse Consequences

3. There are three ways to minimize adverse consequences of risk-taking:

- Avoiding or Placing Limits on Certain Activities (Risks)
- Mitigating Risks
- Offsetting Risks

4. The four components of financial risk management are:

- Identifying Risk-the categories of risk listed in element 1 above
- Measuring Risks understanding the dimension of risk listed in element 2 above
- Controlling Risks-ways to minimize the adverse consequences listed in element 3 above
- Monitoring Changes in Risks and Controls -developing reporting systems that identify significant changes in risk profiles or controls of significant products, services, and activities.

The following is an explanation of the six most common risk factors in financial institutions that have historically accounted for an overwhelming majority of losses:

**Credit Risk.** Credit risk is the financial exposure resulting from an institution's dependence on another party to make or keep it whole. Credit risk usually occurs in assets shown on the balance sheet, but it can also appear in off balance sheet accounts as some form of contingent obligation. It is acquired through actual or implied contractual agreements where an institution's funds are extended, committed, or otherwise exposed.

**Liquidity Risk.** Liquidity is traditionally defined as the ability of an institution to meet its obligations as they come due. This means an institution has the ability to accommodate a decrease in funding sources (i.e., deposits or borrowings), an increase in assets (i.e., loans or other commitments), and the ability to pay expenses as they come due.

**Market Risk.** Market risk is the potential adverse effect that external market forces can have on the value of an institution's assets, liabilities, and off-balance-sheet positions in marketable instruments, commodities, metals, etc. It arises from movements in markets. Inflationary expectations are usually reflected in market prices. However, in a highly inflationary environment, inflation risk should be broken out and treated as a separate category of risk.

**Operational Risk.** Operational risk is the exposure to loss resulting from the failure of a manual or automated system to process, produce, or analyze transactions in an accurate, timely, and secure manner.

**Interest Rate Risk.** Interest rate risk is the risk to an institution's net interest margin. The net interest margin is the difference between the amount of interest earned on assets (i.e., interest income from loans and investments) and the amount of interest paid on liabilities (i.e., interest expenses paid on deposits and borrowings). Interest income less interest expense equals net interest income or the net interest margin. Interest rate risk is the risk of not having sufficient interest income (and/or having excessive interest expenses) to maintain a net interest margin sufficient to pay expenses (salaries, rent, etc.), increase capital, and pay dividends.

**Foreign Exchange Risk.** Foreign exchange (FX) risk is the risk associated with doing business in two or more currencies. FX risk usually takes two forms: availability and price. FX availability risk deals with the degree of difficulty of converting one currency into another. This risk is highest in economies that have established controls to ration foreign currencies. FX price risk results from adverse changes in values of the foreign currencies in which an institution is doing business. It may result in a direct loss to an institution if the institution has to reprice/revalue its assets and/or liabilities to reflect movements in currency values; or the risk may be indirect, that is, if a customer of a financial institution is doing business in two or more currencies and is adversely affected by currency value fluctuations, the adverse effect of fluctuations could indirectly affect the financial institution. This can be especially true if the financial health of a customer is affected, and the customer then experiences difficulty in repaying borrowings.

In order to understand thoroughly the risk profile of a transaction or portfolio of transactions, it is necessary to assess all three dimensions of each type of risk present. Assessing risk involves more than just measuring the amount of dollars at risk. The following is an explanation of the three dimensions of risk:

**Size** is the dollar (or other currency) value at risk.

**Duration** is the length of time for which an institution will be exposed. Usually the greater the length of time, the greater the probability that circumstances will change. Circumstances may change for better or worse, so that duration viewed in isolation is neither positive nor negative.

**Probability of adverse consequences** evaluates the likelihood of circumstances changing in such a way as to cause an institution not to achieve desired results. For example, if an institution lends to a financially weak customer, the probability of adverse consequences (loss or failure to perform as agreed) is greater than lending to a financially strong customer.

Risk management encompasses all of the activities associated with minimizing the adverse consequences of risk-taking. These activities can be divided into three categories:

- avoiding risks;
- mitigating risks; and
- offsetting risks.



Understanding what these three categories encompass and the differences among them is at the heart of risk management. The following is an explanation of the three ways to minimize adverse consequences of risk-taking:

**Risk avoidance** is accomplished a number of ways. Policies outline, either directly or by implication, activities in which an institution will engage and those activities in which it will not engage. Placing prohibitions or limits on products or services is a way of avoiding risk or avoiding too much risk in a certain area. Conservative practices, in the absence of policies, are also a way of avoiding risks. This approach to minimizing the adverse consequences of risk taking is the most restrictive with respect to products and services offered by financial institutions and is the most unfriendly to small and marginal borrowers.

**Mitigating risk** encompasses steps taken, within a product or service, to reduce the adverse consequences of risk-taking. Mitigating risks usually involves additional direct or indirect expenses. Mitigating risk is often thought of in the context of internal controls. Without an accurate risk profile of a product or service, designing corresponding risk-management techniques and proper risk-management controls is difficult. The cost of steps taken to mitigate risks should be less than the potential adverse consequences of risk-taking. This is basic cost/benefit analysis.<sup>52</sup>

**Offsetting risks** involves taking risks and a willingness to take the losses associated with risk-taking, but charging interest and fees sufficient to cover losses and yield a profit. It may also involve using income from other activities to cover losses, as is usually the case with the introduction of new products and services.

The following is an explanation of the four components of risk management:

**Identifying Risk.** In order to manage risks, risks must first be identified. Almost every product and service offered by financial institutions has a unique risk profile composed of multiple risks. For example, at least four types of risks are usually present in most loans: credit risk, interest rate risk, liquidity risk, and operational risk (see element 1 above for the list of risk factors).

**Measuring Risks.** Once the risks associated with a particular activity have been identified, the next step is to measure the significance of each risk. Each risk should be viewed in terms of its three dimensions: size, duration, and probability of adverse occurrences (see element 2 above).

**Controlling Risks.** Once risks have been identified and measured for significance, there are basically three ways to control significant risks, or at least minimize their adverse consequences: avoiding or placing limits on certain activities/risks; mitigating risks; and/or offsetting risks (see element 3 above). It is a primary management function to balance expected rewards against risks and the expenses associated with controlling risks.

**Monitoring Risks.** It is up to management to establish management information systems (MIS) that accurately identify and measure risks (risk profiles) at the inception of transactions and activities. It is equally important for management to establish an MIS to monitor significant changes in risk profiles. A loan payment delinquency report reflecting loans that are not paying as agreed is one report that indicates possible changes in perceived risk profiles. Since many financial institutions depend heavily on their net interest margins for survival, an MIS that reflects the impact of changes in interest rate risk is very important. In general, monitoring risks means developing reporting systems that identify adverse changes in the risk

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<sup>52</sup> Often the terms "mitigating risks" and "offsetting risks" are used interchangeably. They are not interchangeable, as should be clear from the discussion in the text.

profiles of significant products, services, and activities and monitoring changes in controls that have been put in place to minimize adverse consequences.

Good risk management is not an expense to be minimized; it is not even revenue-neutral; it is a revenue enhancement tool and therefore a capital enhancement tool. Good risk management allows an institution to operate with a high level of precision. Too much risk with too few controls results in loss. Too many controls and limits, given the corresponding risks, result in loss by incurring unproductive and unnecessary expenses and by foregoing opportunities. Understanding the risk profiles of products and services, and balancing them with actions taken to reduce the adverse consequences of risk-taking, allows an institution to optimize revenues and maximize the use of capital.

There will come a time when financial institution executives will expect their managers to develop accurate risk profiles for the products and services for which they are responsible. These risk profiles will reflect the multiple facets of risks discussed in this paper. They will also reflect the actions taken to avoid, mitigate, and/or offset risks, and will factor in the rewards expected to be gained. As a result, bank executives as well as regulators will be in a better position to assess the balance among risks, costs, and rewards and their impact on capital and liquidity.

### **Comparing Traditional and Risk-Based Supervision in Two Cases**

The first part of this paper has been devoted primarily to comparing traditional regulatory practices with risk-based supervision at a conceptual level. For the remainder of the paper, the focus shifts to the effectiveness of risk-based supervision as compared to traditional practices in two cases that are currently of particular interest. It is argued below that the Asian financial crisis became a crisis rather than just a correction because of inadequacies in banking supervision; more specifically, it became a crisis because banks and their regulators were not fully aware of the exchange rate risks implicit in lending in foreign currencies to domestic borrowers operating in the non-tradable goods sector. What is then explored is whether risk-based supervision might have been better able than traditional regulatory practices to detect and deal with these risks. The second case is the regulation and supervision of financial institutions engaged in small-scale (micro) lending in developing economies. It is argued that traditional regulatory practices have typically focused on examining individual loan files for evidence of formal guarantees, collateral, and audited financial statements while neglecting the existence of systems to manage effectively the risks of such lending thereby discouraging non-regulated institutions from becoming regulated and banks from engaging in micro-lending. In contrast, risk-based supervision, with its focus on risks and risk management, is said to be more open (but not more lenient) to the provision of micro-finance services within the regulated financial sector, which potentially benefits low income individuals, small-scale enterprises, and non regulated institutions interested in becoming licensed.

### **Can Current Regulatory Techniques Detect Foreign Exchange Risk in Misplaced Dollar Lending?**

As the recent Asian experience has shown (and the Latin American one before that) a country must be able to manage inflows of foreign exchange effectively. If the country simply accumulates more and more foreign exchange, the domestic money supply will grow (foreign exchange assets of the central bank and the banking system are balanced by liabilities—the money supply) and, as is all too well known, can cause inflation. If the country attempts to control impending inflation through restrictive monetary policies, domestic interest rates will rise and encourage even greater inflows of foreign exchange. If the exchange rate is flexible, inflows of foreign exchange may tend to push the exchange rate higher, thereby encouraging more inflows if there are expectations of continuing appreciation of the exchange rate. The

combination of either higher inflation or a higher exchange rate, or both, makes export industries that have often been the key to rapid economic growth less competitive. However, since capital inflows and increasing stockpiles of foreign exchange are usually viewed positively, few governments have seen the need to implement policies to deal with potentially excessive capital inflows, or even to investigate how this might be done effectively. At least until recently, the risks that can be associated with large capital inflows have typically been underestimated.

Eventually, however, the combination of inflation and/or an overvalued exchange rate will hinder exports, so that a country's balance of trade (exports of goods and services less imports) will turn negative even though the balance of payments (which includes capital flows as well as goods and services) continues to be positive due to continuing capital inflows. Even with less-buoyant exports and increasing imports, the country's economic growth may continue unabated due to increased demand for domestically produced and consumed goods and services ("non-tradable") resulting from the changing terms of trade favoring non tradable. In fact, in many economies, including Mexico and the Asian Tigers in varying degrees, this growth has even become a "boom" focused on urban real estate development in particular. Inflows of financial capital persist because the country continues to look highly attractive to foreign investors as the credible policies that produced high growth and good returns continue to be in place. Even the capital inflows themselves promote higher returns for foreign investors as long as the foreign exchange rate continues to appreciate. Rather than being viewed as a signal of an impending correction, the deteriorating balance of trade may initially be seen as an appropriate counterpart to the inflows of financial capital.

Even though most "experts" in investing, foreign or otherwise, now eschew "timing," it must nonetheless be conceded that at some point there will be a correction involving outflows of capital and a depreciating exchange rate. The question is whether such a correction-one that could well be deemed healthy for such a country is likely to become a crisis. Earlier experiences in Mexico and elsewhere in Latin America, and more recently in Asia, suggest that this depends largely on the foreign exchange position of the banking system. Banking regulators and bankers themselves have long been sufficiently sophisticated to understand that a balanced foreign exchange position is warranted to hedge risks; that is, assets denominated in foreign currencies should be sufficient to balance foreign currency liabilities. Thus, when dollars flow in and are deposited as dollars in the country's banking system, bankers and banking regulators understand the need for dollar denominated assets, and these have often taken the form of loans denominated in dollars. If these loans have been made to producers of tradable goods, especially exporters, these producers will actually benefit from a devaluation that is the essence of a correction. Thus, exporters will easily be able to repay their dollar loans. If, however, borrowers with dollar loans are in the non-tradable goods sector and this is likely to be the case if the overvaluation has continued for a long time and has become substantial, thereby making non-tradables the more profitable sector-such borrowers will have great difficulty repaying dollar loans after the devaluation. The hedged position that bankers think they have is then illusory.

Urban real estate booms are just the most obvious examples of the imbalances that can develop when continuing substantial capital inflows are not dealt with effectively by government policies and are instead allowed to create a significantly overvalued exchange rate and thereby to promote a non-tradables sector that is unsustainably profitable for a moment. The subsequent collapse of the urban real estate market is often spectacular and thus subject to great finger-pointing after the fact. What is really important to understand beforehand, however, is that any lending in dollars to the non-tradables sector be it urban real estate or something else is essentially unhedged and hence highly risky. If banks implicitly have large unhedged foreign exchange positions through dollar loans to the non-tradable sector, they can easily be driven to insolvency by a significant devaluation of the exchange rate. Such bank insolvencies are likely to mean much higher interest rates for all borrowers, along with fiscal

costs to the government that will ultimately be borne by taxpayers. Thus correction turns to crisis.

To what extent are bank regulatory authorities, using traditional approaches to banking supervision, aware of the implied foreign exchange risks that can turn a correction into a crisis? Even if the extent of dollar lending to the non-tradable-goods sector can readily be estimated, can traditional approaches to banking supervision detect foreign exchange risks of this type in the banking system? Can risk-based supervision offer any advantages in these cases for either industrialized or developing economies?

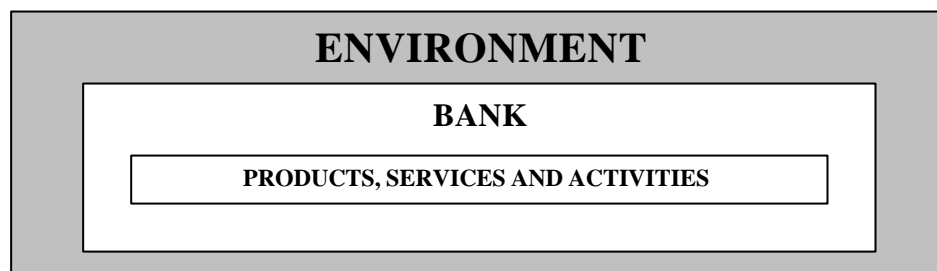
When banking regulators do a good job, it usually goes unnoticed. One of the primary missions of regulators is to maintain safe and sound banking systems that support economic activities in the economies where they are located. If they do their job well, problems are averted; and, when problems do arise, they are dealt with effectively with little or no fanfare. This makes it difficult to measure the effectiveness of regulators and the quality of supervision. It is impossible to measure problems that have been averted. It is impossible to measure what did not happen. On the other hand, it is easier to identify shortcomings involving problems that were not averted. The current Asian crisis is a problem that was not averted. Many fingers have been pointed and questions asked as to whether it could and should have been recognized earlier and why no one saw it coming. Suggestions are being made that risk-based supervision might have helped financial institutions and economies identify the problem earlier and thereby soften the blow.

It is difficult to say with great certainty, but risk-based supervision probably would have done a better job of identifying this problem. Most modern day banking crises typically have had one thing in common-an excessive allocation of capital to particular markets, whether the markets are defined by geography, type of lending, or industry. Traditional forms of supervision focus on individual institutions with little analysis of the economic environment in which they operate. Traditional supervision does not incorporate geographic and industry analysis into the assessment of an individual bank's products and services. Traditional supervision focuses on the internal operations of individual institutions. Risk-based supervision considers both internal and external factors that affect the conditions of individual banks and the banking system as a whole. One element of risk-based supervision is that it tries not only to identify systemic risks caused by the economic environment in which banks operate but also management's ability to deal with them.

Recent history is replete with examples of banking problems that have resulted from excessive concentrations of capital in certain markets. In the United States, for example, there was over-lending and over-investment in conglomerates (large diversified corporations) in the 1960s, and then in the mid-1970s there was over-lending and over-investment in real estate investment trusts (REITs), followed by over-lending and over-investing in less developed economies (LD), then petro-dollar recycling, then the energy sector, followed by the agricultural sector, then real estate again, and now the Asian economic crisis. In all of these cases, the markets started out highly profitable, thereby attracting more and more capital. As these markets grew, traditional regulators did little to measure the depth and other characteristics of these markets; instead they evaluated the primary exposures of individual institutions (i.e., the relationships between individual institutions and their customers).

To investigate whether risk-based supervision could have done a better job reducing the adverse consequences of these earlier events, and especially of the Asian economic crisis, three aspects of risk-based supervision are relevant:

- Understanding the environment in which banks and banking systems operate;
- Understanding the risk profiles of individual institutions; and
- Understanding the risk profiles of the products, services, and activities that make up the individual institutions (and aggregating the risk profiles developed in this step develops the point above, the risk profile of the institution).



It is important for regulators to understand the economic and political environments in which the institutions for which they are responsible operate. In the case of the Asian economic crisis, it would have been beneficial for regulators to know the amounts of the capital inflows, the amounts of the inflows that were in the form of debt and equity, how they were deployed, the sources for repayment of debts, and the likelihood of capital withdrawals. As discussed above, many banks that lent in the Asian market lent in hard currencies and therefore appeared to have relatively balanced foreign exchange positions, with little apparent foreign exchange risk. However, as also noted above, belying the apparent balanced foreign exchange positions were loans made and payable in hard currencies to borrowers whose incomes were in local currencies. The sudden withdrawal of capital caused local currencies to plummet, making the repayment of hard currency loans difficult in many cases and impossible in others. It is clear that traditional forms of supervision failed to detect the risks that led to the Asian economic crisis. The practice of riskbased supervision, which breaks down the component risks in the loans and capital investments that led to the crisis, would likely have done a better job recognizing risks that were not intuitively obvious.

Understanding the economic environment and the systemic risks caused by environmental factors requires skills that are beyond the present capabilities of many traditional banking regulators, and is not part of the focus of most traditional approaches to banking supervision. Identifying systemic risks often requires coordinating information from various private and government sources. This implies that regulators should have the capability to gather and interpret such information. Information on the economic environment is important for a number of reasons. When issues and concerns arise, regulators can issue advisories to the banking system.<sup>53</sup> Also, information on the economic environment is important to field examiners in developing risk profiles of products and services and individual institutions since banking systems usually reflect the economic environments in which they operate. The lag factor is important to understand as the conditions of banking systems usually lag economic

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<sup>53</sup> With respect to regulators issuing advisories, care should be taken not to overreact to movements in markets and economic indicators. Advisories that cause banks to change their normal operating patterns dramatically can disrupt market activities and thus become self-fulfilling prophecies.

performance. It often takes months after an economic downturn to determine its impact on the banking system, and the reverse is also true, as it usually takes months after an economic recovery for the effects to be felt by the banking system. Over the past thirty years, lag time seems to be getting shorter. In the Asian economic crisis, the lag time was very short. Understanding the economic environment can provide regulators with information about emerging problems and, to the extent that lags exist, be used as a leading indicator regarding the probable future condition of the banking system.

Aggregating risk profiles for the products, services, and activities is the basis for developing overall risk profiles of individual banks. Developing risk profiles is not easy. It requires considerable knowledge, experience, and judgment. Also, it is not very precise. Institutions fall into three broad categories: high risk, medium risk, and low risk. In the United States, where all of the federal regulatory agencies employ risk-based supervision, summary risk profiles are not assigned to individual banks. Instead, regulators translate risk profiles into the more universally used CAMELS rating system. Perhaps as more economies, both developed and developing, move toward risk-based supervision, there will be a movement towards assigning composite risk ratings.

Using risk-based supervision techniques could potentially have helped identify problems as they emerged in Asia. Risk-based supervision assesses how well bank managers identify, measure, control, and monitor risks. For the loan portfolio of a bank lending in the Asian market, traditional supervision usually assesses only the primary risk associated with loan portfolios, which is credit risk. Since all products, services, and activities have profiles made up of multiple risks, risk-based supervision checks for the presence or absence of a minimum of six types of risks: credit risks, liquidity risks, market risks, operational risks, interest rate risks, and foreign exchange risks. Depending on a number of factors, regulators using a risk-based approach might have noticed that foreign exchange was a significant risk factor for the bank in question because it was a significant risk factor for major loan customers. Armed with better information about the economic environment, regulators using risk-based supervision might have been able to recognize the high-risk exposure. There is no assurance this would have happened, but it is certain that traditional approaches to supervision were not effective.

### **Regulatory Barriers to Incorporating Small-Scale Clients into the Formal Financial Sector**

The complaint is often heard that banks fail to provide financial services, especially credit, to creditworthy small-scale clients. Bankers argue that smaller-scale clients are much more costly and risky to serve than large-scale clients. This may be true given the lending procedures that most banks employ to deal with their traditional market niche of large-scale clients. Documentation in the form of audited financial statements and collateral based on land or heavy equipment seems appropriate for reducing credit risk of large-scale clients.<sup>54</sup> Such documentation can be relatively low cost if loans are relatively large in size, but the fixed costs of external audits and formal collateral may loom large in the case of small loans. In addition, audit reports may reflect tax considerations more than economic realities and, as noted elsewhere, collateral may be of questionable value if it has to be seized and sold on the open market. Consequently, traditional bank lending practices may not be as low risk as they seem. At the same time, traditional banking supervision practices may tend to endorse, and hence solidify, these lending practices in ways that not only limit the availability of credit to small-scale clients but also fail to deal with risks as well as more appropriate alternatives such as risk-used supervision.<sup>55</sup>

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<sup>54</sup> A focus on well-known persons as major clients can also seem like a basis for low-risk lending, but this can (and has) led to high concentrations of bank credit portfolios in small numbers of large loans to firms and individuals who have close ties to the bank.

<sup>55</sup> Collateral and documentation requirements that constrain credit for small-scale clients may not be just a

An important innovation in finance has been spreading in developing economies during the 1990s that has called into question assumptions about the universal applicability of traditional bank lending practices and traditional approaches to banking regulation and supervision.<sup>56</sup> Beginning mainly with non-governmental, non-profit organizations (NGOs), innovative techniques have been developed that allow lending to very small-scale clients (micro-entrepreneurs, in particular) on a profitable basis, so that these “micro-finance” NGOs can be sustainable without continuing subsidies from governments or donor agencies. In short, what was originally a charitable endeavor (credit for low income micro-entrepreneurs), is becoming a profitable activity for micro-finance institutions, and even for banks, if they are able to adopt new lending techniques and are willing to charge market rates of interest that cover all costs including a margin for profit (and which micro-entrepreneurs have readily been willing to pay, if loans can be immediately available and hassle-free).

In most economies, these innovative micro-finance institutions are not licensed or regulated because they do not take deposits, but rather have been funded primarily by contributions from governments and donor agencies (and sometimes by bank borrowings and by retained earnings in the case of the more profitable NGOs). Nonetheless, in recent years many successful micro-finance institutions have become interested in deposit taking as a complement to the credit services they provide to their clientele and especially as a potentially major source of funding to expand their outreach. In almost all economies, however, this requires that they become licensed and regulated—which has often not been easy, in part because of high initial capital requirements, but also because of suspicions of banking regulatory authorities regarding the leadership of micro-finance institutions (e.g. that they lack interested ownership and management with real banking experience). Also in question is their ability and willingness to deal effectively with risks. At the same time, banks (with some notable exceptions such as Bank Rakyat Indonesia (BRI) in Indonesia, Grameen in Bangladesh, and Bancosol in Bolivia) have remained highly skeptical of the possibility of doing micro-finance profitably, quite possibly because the techniques for successful micro-lending are so different from traditional bank lending practices. In any case, the historical development of micro-finance has led to focusing regulation on the special characteristics of micro-finance institutions in comparison with commercial banks instead of the risk characteristics of micro-finance products and clients.

Dealing with micro-finance is only one aspect of the challenges facing banking regulators. The entry of financial intermediaries into new market niches inevitably involves new products and services and new financial technologies, all of which have different risk characteristics and techniques for managing risks effectively. Regulatory authorities, like the financial intermediaries they supervise, must be flexible with respect to such innovations and must develop approaches to examination and supervision that focus on the most important risks and how they are being managed. Consequently, the basic issue for regulators is to develop approaches that encompass new products, services, and clients in general, not just micro ones. If regulators focus on institutional peculiarities (capital and ownership in the case of micro-finance institutions) rather than on risk characteristics of clients and products, regulators are likely to be faced with increasing fragmentation in their approaches to supervision (and even a kind of institutional schizophrenia). There is thus a growing need to develop supervisory

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reflection of perceived prudent banking practices but may also reflect bank regulation and supervision requirements.

<sup>56</sup> At the same time, in more developed economies as interest rate spreads have narrowed for traditionally favored large-scale clients, many commercial banks have tended to move “down-market” (e.g. into consuming lending) where new techniques are required to manage risks and control costs techniques that are distinct from, but have certain similarities to, those used in developing economies in lending to very small-scale, self-employed producers (micro-entrepreneurs).

approaches that assess the management of risk regardless of the type of financial activity or institution. Risk-based supervision facilitates this type of supervision.

In order to understand the potential advantages of alternatives to traditional regulatory practices (risk-based supervision in particular) for dealing with risks without unnecessarily constraining access to credit, it is useful to begin by reviewing what are seen to be the key differences of micro-finance clients and products. The most typical micro-finance product is a very small loan, usually short-term (almost always less than one year, unless the client is of long standing, and often less than 90 days). Most banks have developed lending practices that have relatively high fixed costs, but are nonetheless efficient for larger loans because they yield relatively low total costs. But these relatively high fixed costs make small loans unattractive. A view thus arose that small loans were necessarily high cost as well as high risk. However, the advent of viable microfinance institutions has shown that high fixed-lending costs are not necessarily immutable and that innovative technologies can be found to lower these costs substantially. In addition, viable micro-finance institutions have often achieved rates of loan recovery that are equal to or better than those of successful banks, thereby calling into question the perceived high risk of micro loans. To understand how sustainable micro-finance institutions have developed low-cost, low risk lending technologies that are substantially different from traditional bank lending technologies, it is necessary to understand some key characteristics of microentrepreneurs.

Two potentially problematic characteristics of micro-entrepreneurs are lack of traditional kinds of information about their businesses and lack of collateral to secure loans. Micro-entrepreneurs rarely have audited financial statements because this would be too costly and of little use to them. In fact, they often do not have written records of any kind. Moreover, given the close linkages between the household activities and the business activities of the typical micro-entrepreneur, written business records would give only a very partial picture of the financial circumstances of the micro-entrepreneur. In addition, being in the informal sector, micro-entrepreneurs rarely file tax returns or have any kind of registration or license indicating that they are even in business. From the viewpoint of usable collateral, even if a micro-entrepreneur had an asset that a lender might, in theory, try to sell to satisfy a debt, it may not be possible to ascertain if the asset is in fact owned by the micro-entrepreneur and not subject to prior claims, albeit informal ones. Formalizing and registering such collateral would almost certainly make loans prohibitively expensive for micro-borrowers and lenders. If a micro-loan officer cannot expect to use collateral and formal documentation in a significant way in the decision process, it is difficult to see how these elements could be of much use to an examiner from a regulatory agency.

Just because traditional types of information and collateral are not available does not mean that information is not crucial for successful micro-lending. Loan officers almost always construct simple cash flow statements (but rarely balance sheets and income statements), but instead of looking for micro-borrowers to provide cash flow information, loan officers usually elicit such information through a series of questions that cover not only business but also household activities. In addition, loan officers will be very interested in the appearance not only of the business but also of the household (and the latter is facilitated by the fact that micro-enterprise activities are often carried on either in or adjacent to the house). Furthermore, with many successful micro-lenders, a trained and experienced loan officer (which he/she must be before being sent off alone) can approve a micro-loan on the spot, without recourse to higher-level managers or loan committees, and perhaps even disburse it then and there. This technique is used for two main reasons: timeliness has been found to be highly valued by micro-finance clients; and higher-level managers and loan committees cannot contribute effectively to the decision process through traditional review procedures. Much of the information collected by loan officers is based on appearances in the house and business location; it is also relative to the hundreds of other micro-entrepreneurs that a trusted loan officer would have already visited at some point in his or her career, so that it would be very difficult to convey such



information in a way that could effectively be re-assessed by higher-level managers or a loan committee (or by bank examiners).

Because decision making is left largely in the hands of loan officers does not mean that loan officers should be unsupervised. As already indicated, he must be trained, must have substantial supervised experience, and must be given responsibility accompanied by the incentives (rewards and disincentives) that signify true responsibility. The other key to a decentralized system is the ready availability of management information required for monitoring and control. Just as successful micro-finance institutions have developed the information, monitoring, and control systems required for decentralized decision making, and accompanied these systems with appropriate responsibilities and incentives, so regulatory agencies might focus on these key elements in deciding if risks are adequately managed. A better understanding of micro-lending processes and the risks involved could change the task of regulatory agencies from examining thousands of individual micro-loans (with a close eye to evidence of collateral and formal documentation in credit files) to analyzing how micro-lending institutions are providing loan officers with training, responsibility and incentives and, in turn, monitoring, evaluating and controlling their performance.

Interest in the regulation of micro-finance institutions has prompted much to be written on this topic (see the reference section at the end of this paper). Considerable emphasis has been placed on analysis of regulatory laws and norms and not on the ways in which these laws and norms are applied by regulatory agencies. In micro-finance literature, there are always discussions of laws and norms, but rarely any discussion of how these laws and norms are applied in practice by bank examiners. A main reason for the lack of attention to examination practices is that analyzing bank examination practices is a highly labor-intensive activity requiring a review of examiner working papers and/or actual participation in bank examinations.<sup>57</sup> Study costs can be especially high in the case of micro-finance examination practices because of the extreme scarcity of individuals who have the requisite experience and expertise in both micro-finance and banking regulation and supervision.

Even though there are virtually no studies that contain first-hand analysis of bank examination practices as they pertain to micro-finance, it can nonetheless be supposed that this may be a problem area. The standard approach to on site bank examination, even as carried out by regulatory agencies that are regarded as advanced, may not be appropriate for micro-finance. Traditionally the vast majority of bank examiners' time and efforts at on site examinations has been devoted to examining credit files-in particular, delinquent and problem loans, all loans over a certain size, and a stratified sampling of remaining loans. For a bank with a typical loan size distribution, more than half of total loan amounts outstanding may be covered, and thus a similarly high proportion of all risk assets, since loans are likely to be the main category of risk assets. While such a procedure and allocation of time and effort may work well for a typical bank, this approach is clearly inappropriate for a bank that specializes in microlending, or for a micro-finance institution. First, without a very large sample, and hence a large allocation of time and effort, only a very small percentage of micro-loans will be examined. Second, since microlending decisions are not based in any significant way on traditional collateral or formal documentation such as audited financial statements, bank examiners will find little of interest in micro-loan credit files, perhaps just some very basic information on the

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<sup>57</sup> Regulatory agencies may also be cautious about having outsiders analyze their examination practices even if the intent is to improve current practices. Banking secrecy laws may severely limit circumstances under which outsiders can observe examinations because this may imply having access to information deemed confidential under the laws and norms governing banking supervision. In addition, officials of banking regulatory agencies may be concerned that problems may be discovered in the banking system that had not previously been noted and that such problems may be ascribed to inadequacies in banking supervision.

micro-entrepreneur together with the loan officer's notes about past cash flows and estimates of future ones.

Are there alternative approaches to deal with the unfavorable cost-benefit relationship of traditional examination practices as applied to micro-finance that could also reverse the trend toward regulatory fragmentation caused by the heavy focus on the special characteristics of micro-finance institutions? Among the main characteristics of successful micro-lenders are loans with low administrative costs for the lending institution and low transaction costs for the borrower. These, together with the characteristics of micro-entrepreneurs and micro-loan products discussed above, imply that decision-making must be decentralized and that loan delivery must likewise be decentralized to the vicinity of the borrower. Such decentralization places heavy reliance on adequate systems, not only to convey information between the field and headquarters on all aspects of loans and borrowers, and especially on the repayment status of each loan, but also for monitoring and control purposes. For example, each loan officer in the field must have immediate access to the information required to map out and coordinate visits to existing borrowers whose payments are about to come due or overdue, along with visits to potential new borrowers. Also needed is information on the institution's current and perspective overall liquidity position. Officials at headquarters must have immediate access to information from the field to aggregate information needed to monitor loan officers' performance, and this information must be verifiable and protected from self interested tampering. The importance of information systems for effective and efficient operating, monitoring, and control purposes suggests that these systems might be the main focus of examinations by regulatory agencies. Rather than examining individual loan files, it could be far more productive to examine information systems to determine if they are up to date, accurate, accessible, and adequately protected from unauthorized entries

The characteristics of micro-finance imply that traditional approaches to examinations of micro-finance activities are excessively costly. Moreover, the different interpretations of risk management held by bankers on one hand, and supervisors on the other, can contribute to misunderstandings. For supervisors, managing risk often means simply avoiding risk, while bankers (at least good ones) understand that risks can also be managed by mitigating risks (through better personnel and information systems for monitoring and control) and/or by offsetting risks (through appropriate pricing, that is, charging higher interest rates and fees on micro-loans). As an alternative simply to improving current regulatory practices, it may be worthwhile to consider changes that can unify approaches to regulation and supervision, rather than introducing further fragmentation. The risk-based approach to supervision does this by providing a consistent approach to supervision that is flexible enough to be adapted to all financial products and services.

There is little argument over the fact that micro-finance products and services, especially micro-lending, are different from traditional banking products and services. Debate continues over exactly what those differences are and, as a consequence, many attempts have been made to describe them. As part of the debate, the argument is often made that risks are different for micro-finance and therefore there is a need for a different regulatory approach and different sets of rules for micro-finance institutions. Part of the debate derives from a lack of common terminology and subtle differences in the use of terms. For example, are the risks in micro-loans different from those in more traditional bank loans? The answer is not really. But ask the question another way: is the risk profile of micro-lending different from the risk profile of other types of bank lending? The answer is yes. The difference is in the risk profiles, not in the set of risk factors. This sounds like a subtle difference, but it is crucially important for understanding the debate over the approach regulators should take in supervising micro-finance institutions and the micro-finance operations of commercial banks. Although the *set of risk, factors* is basically the same for traditional bank products and services and micro-finance products and services, the weights within the set of risk factors are different and result in very different risk profiles. Regulators currently supervise financial institutions that have many

different market niches. It can be argued that micro-finance is just another market niche and does not require special supervision and regulations.

All bank and micro-finance products and services have multiple risks in their profiles. One of those risks is always operational risk. To understand the differences in risk profiles for different products and services, it is necessary to break them down into their component parts. For example, as discussed above, there are six risks that account for an overwhelming majority of losses in financial institutions. The first and most obvious is credit risk. The others are operational risk (which includes operating costs), interest rate risk, liquidity risk, market risk, and foreign exchange risk. Market and foreign exchange risks are virtually nonexistent in most micro-finance activities.

Once the component risks have been identified, it is necessary to assess them on an individual loan and loan portfolio basis. For example, in a micro-finance institution the size of the credit risk associated with one micro-loan is very small (not the same as low) due to the size of the transaction, but the credit risk for the entire portfolio could be high, depending on the systems and processes in place. For a wholesale commercial bank (one that makes only large loans), the size of the credit risk associated with individual loans could be large and, as with the micro-loan portfolio, the credit risk for the portfolio could also be considered high. However, in the case of the wholesale commercial bank, operational risk may be low because of the number of eyes (controls) that look at each loan and check and double check the numbers, whereas in the micro-finance institution operational risk may be high for the opposite reasons. Therefore, by understanding the risk profiles and controls of the two examples, it would be appropriate for a regulator to take a different approach in the two institutions. In the micro-finance institution, more focus on systems and processes would be appropriate because of the small risk associated with individual transactions. In the commercial bank, more focus on individual loan transactions would be appropriate because of the higher risk associated with each loan, though operational risks would not be ignored.

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all, if not all, financial products and services, and to institutions large and small. In the two examples above, the types of risks are the same, but the emphasis put on evaluating them would differ. This disaggregation of the risks that make up the risk profiles of individual products and services is at the heart of risk-based supervision. By un-blurring the risks that make up each product and service, managers and banking supervisors are better able to understand risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. It is the responsibility of the management of each financial institution to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls, and monitors risks.

Risk-based supervision is a relatively new approach to supervising regulated financial institutions. While it is currently practiced in a consistent and systematic way by few regulators around the world, it is rapidly being recognized as the preferable approach to banking supervision. There is thus a need to bring more consistency among the regulators considering risk-based supervision and to familiarize more regulators with respect to the possible benefits of risk-based supervision. This could minimize the perceived differences in approaches needed to supervise traditional commercial bank activities compared to micro-finance activities, whether the micro-finance activities are in banks or in stand-alone institutions. It would also be helpful, for the sake of the debate over the supervision of micro-finance institution activities, if there were greater understanding that, while most financial products and services share a common set of risk factors, they can have very different risk profiles. The difference is in the risk profiles, not in the set of risk factors.

## Conclusion

Although risk-based supervision is a relatively new approach to banking supervision and has not yet been applied widely outside the United States in a consistent and rigorous fashion, it is nonetheless gaining recognition as the preferred approach as indicated by its inclusion in the Basle Committee's Core Principles for Effective Banking Supervision. The purpose of this paper has not been to teach risk-based supervision to bank regulators but rather to familiarize government officials and the professional staffs of donor organizations as to what it is and how it can improve supervision in two cases: when risks are hidden, as in the implicit foreign exchange risk in dollar loans to the non-tradable goods sector that played a major role in the Asian crisis; and when lending may be unnecessarily limited, such as to micro-entrepreneurs who lack traditional collateral or written records.

The timeliness and potential importance of risk-based supervision and its accompanying analytical tools are clear from the emphasis currently being given by such donors as USAID and the World Bank, for whom initiatives to resolve systemic problems in banks and other financial institutions in developing and transitional economies have become a high priority. As this paper makes clear, however, risk-based supervision is not designed to solve the problems of failing banks. In fact, traditional, transactions-oriented approaches to banking supervision are more appropriate because they are designed to quantify as precisely as possible the extent of losses that will need to be covered in either rehabilitation or liquidation. Rather, the special usefulness of risk-based supervision is to identify ahead of time risks that may cause serious problems in the future and to assess the ability of bank management to deal with the risks identified. Donor officials and economic policymakers will not have learned from reading this paper how to implement risk-based supervision in a target economy, but hopefully enough detailed information has been provided to understand how far the many economies that assert that they are already implementing risk-based supervision still have to go.

Among the important attributes and potential benefits of risk-based supervision discussed in this paper are that it:

- Provides a framework that offers two distinct advantages:
  - (1) establishes common terminology and approaches to evaluate risk and risk management in financial institutions; and
  - (2) is flexible enough to be applicable to all financial products and services and to all types of financial institutions from large banks to small credit unions.
- Considers external factors. Unlike traditional supervision, which focuses on the internal operations of a single institution, risk-based supervision considers external factors affecting not only individual banks but also the banking system as a whole.
- Provides a regulatory environment in which banks are not just pushed to avoid risks but can also mitigate and offset risks as acceptable risk-management practices.

The case study of the Asian crisis shows that traditional supervision practices failed to detect risks that were hidden in the economic environment of an over-valued exchange rate supported by capital inflows. Risk-based supervision, if understood and practiced consistently, could have helped bank supervisors alert bank managers of the need to identify, measure, control, and monitor the risks that were incorrectly assumed to have been dealt with by simply balancing dollar deposits with dollar loans. The case of potential small-scale borrowers, on the other hand, shows that traditional supervisory practices can push regulated institutions in the

direction of simply avoiding risks by requiring collateral and written records that these small-scale borrowers cannot often provide. Risk-based supervision allows a more flexible approach to such borrowers so long as the lender shows the ability to manage risks through appropriate systems and to offset risks by a willingness to charge interest rates that may seem high by traditional norms but are in fact not unattractive to small-scale borrowers because of low transaction costs.

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## MICROFINANCE REGULATION SWEEPING ACROSS LATIN AMERICA

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Something major has changed over the past few years. Starting in 1999, a wave of regulatory reform in the area of microfinance has swept across Latin America and the Caribbean. Until that year, only Bolivia and Peru had made efforts to create an appropriate regulatory and supervisory framework for microfinance. Today, more than 10 economies in the region have undertaken similar reforms, from Chile in the south to Mexico in the north.

What happened? What, apart from the events in Bolivia and Peru, set off this avalanche of regulatory reform and what does it mean for microfinance in Latin America?

Basically, the pressure for regulatory reform had been building on several fronts in the region since 1995. At that time, several highly successful and fast-growing nonprofit microcredit foundations began to emerge. One by one they sought to “transform” themselves into licensed and supervised intermediaries, typically in the form of finance companies and, sometimes, banks. Meanwhile, established commercial banks and consumer finance companies began eyeing the micro-enterprise segment with more interest as the high growth rates and financial returns experienced by some of the newly transformed institutions proved that micro-enterprise lending could be a profitable business. In both these cases, however, the institutions saw their ability to serve their clients hampered by a regulatory environment that did not take into account the particular features of microfinance.

The pressure of these trends, supported by a greater awareness of microfinance in general, started to converge in 1999. In that year, Brazil took measures to create a new financial entity specializing in microfinance. Soon other economies followed and today El Salvador, Honduras, Mexico, Panama, Chile, Paraguay, Venezuela, Colombia have all undertaken significant (though not always comprehensive) regulatory reforms to facilitate microfinance.

But will these reforms have the desired effect of expanding financing to the region’s micro-entrepreneurs? Put another way, might regulatory reform in some cases be bad?

Actually, it is quite possible to implement reforms that do not facilitate microfinance in the long run. A framework that does not adequately address the particular features and risks of microfinance will not serve these institutions and, consequently, not serve the people who depend upon them. For instance, a very inflexible and conservative approach may unduly restrict the supply and expansion of microfinance by not allowing financial institutions to adopt appropriate lending technologies. At the other extreme, well-intended efforts to promote microfinance may result in an overly lenient framework that enables and permits weak institutions to operate, which in turn may lead to bankruptcies, shaken confidence in a budding industry and poor people losing their savings.

**Table 1: Distinctive Features of Microfinance**

Category	Consumer/Commercial Credit	Microcredit
<b>Ownership and Governance</b>	<ul style="list-style-type: none"> <li>▪ Profit maximizing institutional and individual shareholders</li> </ul>	<ul style="list-style-type: none"> <li>▪ In the latter case, shareholders are mainly nonprofit institutional shareholders</li> </ul>
<b>Client Characteristics</b>	<ul style="list-style-type: none"> <li>▪ Diverse formal businesses and salaried individuals.</li> <li>▪ Geographically dispersed clients.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Low-income entrepreneurs with rudimentary family businesses and limited formal documentation.</li> <li>▪ Located in same area.</li> </ul>
<b>Lending Methodology</b>	<ul style="list-style-type: none"> <li>▪ Collateral and formal documentation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Character and cash flow analysis through on-site inspections</li> </ul>
<b>Product characteristic</b>	<ul style="list-style-type: none"> <li>▪ Larger amount</li> <li>▪ Longer term</li> <li>▪ Lower interest rate</li> <li>▪ Monthly repayment</li> </ul>	<ul style="list-style-type: none"> <li>▪ Smaller amount</li> <li>▪ Shorter term</li> <li>▪ Higher interest rate</li> <li>▪ Weekly or bi-weekly repayment</li> </ul>

*Source: Adapted from Tor Jansson, Village to Wall Street, IDB Working Paper, 2001.*

The issue of savings is crucial. On the one hand, it is one of the fundamental reasons why nonprofit microcredit foundations want to transform into regulated and supervised intermediaries. As these institutions have grown, so have their demand for funding. Savings is a vast and potentially inexpensive source of funding and, additionally, it's an attractive service that most microfinance institutions would like to offer their clients.

On the other hand, one of the fundamental responsibilities of bank supervisors is to make sure people do not lose their savings in failing institutions. They therefore need to make every effort to ensure that institutions that mobilize deposits from the public are appropriately regulated and supervised. By the same token, there is much less reason for bank supervisors to be involved if an institution is not allowed to mobilize deposits—supervisors have limited budgets and should focus on institutions and situations where ordinary people's money is at stake.

### **Recent Initiatives to Regulate Microfinance**

The pressure for regulatory reform often manifests itself in the political arena. In particular, nonprofit foundations have taken an increasingly active role in promoting legal reforms to facilitate microfinance. Such pressure has led some economies to create new types of financial institutions, precisely for the purpose of enabling nonprofit foundations to transform into financial intermediaries. Not unlike politics as usual, this is a high-profile response to a problem that could sometimes be better solved by more modest regulatory modifications.

There are two situations in which it may be appropriate to create a new type of institution to facilitate the transformation of nonprofit microcredit foundations into licensed and supervised financial intermediaries. First, if the minimum capital requirement for existing institutional forms (typically bank and finance company) is very high it could prevent, or at least delay, mature and well-managed foundations from entering the formal financial system. Second, if the existing institutional form that has the lower minimum capital requirement (typically the

finance company) is severely limited in the type of operations it can carry out—particularly in the area of savings mobilization—then it may simply be an unattractive form of institution for those microcredit foundations that want to enter the formal financial system.<sup>58</sup>

Consequently, if the minimum capital requirement for finance companies is reasonable (say 1 to 3 million US dollars) and if they are permitted to mobilize not only time deposits but also savings, then there is really not much of a reason to create a new type of institution for microfinance. And if finance companies cannot mobilize savings, then the first alternative should be to see if it is possible to change that restriction, rather than to create a completely new type of institution. There is no value in an unnecessary proliferation of institutions—it only makes the job of supervisors that much harder.<sup>59</sup> And, of course, if there are no large and mature foundations that are ready to transform into financial intermediaries, it is premature to create an institutional form to this effect.

So far, 11 different types of financial institutions have been created in Latin America wholly or partly for the purpose of facilitating microfinance, including in Bolivia, Brazil, El Salvador, Honduras, Mexico, Panama, Peru and Venezuela. On the face of it, the ones in Bolivia and El Salvador appear to be the most justified and balanced because: (a) they fill the role of both finance company and microfinance institution, thus avoiding a proliferation of institutions (as has occurred in Peru); (b) they are allowed to mobilize deposits from the public, and; (c) they have capital requirements that are low enough to enable the transformation of nonprofit foundations, but high enough to ensure sufficient financial strength to operate successfully as a regulated and supervised intermediary, and; (d) they are created as incorporated shareholder-based companies that, while far from perfect, is still the institutional form that provides the best set of checks and balances in terms of governance.

The justification for, and design of, the other nine institutions seem less convincing. In some cases, the required minimum capital requirement is too low to ensure that institutions can mount a sustainable operation; in other cases, the institutions are not permitted to mobilize savings, which begs the question why they are supervised in the first place. For instance, the minimum capital requirements for the institutions created in Mexico<sup>60</sup>, Honduras, Brazil and Peru are quite low, and in the cases of Brazil and Peru the institutions are not permitted to capture savings. The case of Honduras also stands out for another reason: it is the only example where nonprofit foundations will be permitted to operate as deposit-taking intermediaries while retaining their legal status as foundations (See table 2). In Venezuela, the high capital requirements for conventional banks, coupled with the lack of an institutional form such as finance company, means that the new institution fills a significant void. However, there are

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<sup>58</sup> In some Latin American economies the permitted operations for the finance companies are so limited that it is impossible to offer microfinance services through them. In Guatemala for example, finance companies cannot mobilize savings deposits and can only lend over the medium to long term. Since the ability to capture savings is one of the primary motivations in the transformation of NGOs, and microloans usually have a term of 3 to 12 months, the Guatemalan finance company is entirely unattractive for entities that wish to provide microfinance services.

<sup>59</sup> The bad reputation of finance companies in some Latin American economies has sometimes been mentioned as a reason for creating a new institutional form for nonprofit foundations that want to transform into formal financial intermediaries. However, if the reputation of finance companies is badly damaged, it might be better to eliminate that type of institution and create an institutional form that is flexible enough to accommodate the traditional activities of finance companies well as microfinance.

<sup>60</sup> The Mexican initiative is unique in that it also deals with microfinance through the lens of financial cooperatives. In this regard, Mexico is addressing an issue that is starting to catch the attention of supervisors all over Latin America: what to do with cooperatives. There are approximately 5,800 financial cooperatives in Latin America that collectively have a loan portfolio of about US\$4.1 billion, of which 30% to 40% is estimated to be in microloans.



few, if any, microcredit foundations in Venezuela that are mature or successful enough to actually transform into this new type of institution in the near future.

**Table 2: Regulated and Supervised Financial Entities Partially or Wholly Created for Microfinance**

Year	Country	Name	Legal Form	Min. Capital (US\$)	Deposits?
1980	Perú	Caja Municipal de Ahorro y Crédito (CMAC)	Municipally owned	270.000	Savings
1992		Caja Rurales de Ahorro y Crédito (CRAC)	Incorporated	270.000	Savings
1995		Entidad de Desarrollo a la Pequeña y Microempresa (EDPYME)	Incorporated	270.000	No
1995	Bolivia	Fondo Financiero Privado (FFP)	Incorporated	820.000	Savings
1999	Brazil	Sociedad de Crédito para el Microempresario (SCM)	Incorporated	53.000	No
2000	El Salvador	Sociedad de Ahorro y Crédito (SAC)	Incorporated	2.850.000 (1.140.000*)	Savings
2001	Venezuela	Banco de Desarrollo Especializado en Microcrédito (BEM)	Incorporated	2,370,000	Checking & Savings
2001	Honduras	Organización Privada de Desarrollo Financiero (OPD)	Nonprofit foundation	60.000	Savings
2001	Mexico	Sociedad Financiera Popular (SOFIPO)	Incorporated	45.000	Savings
2001		Sociedades Cooperativas de Ahorro y Préstamo (SOCAP)	Cooperative	45.000	Savings
2001	Panama	Bancos de Microfinanzas (BMF)**	Incorporated	3.000.000	Checking & Savings

Notes:

\* This lower minimum capital requirement is applicable if the institution only lends to small and microenterprises and if it only captures deposits from its borrowers.

\*\*The portfolio of these institutions must consist to at least 75% of loans smaller than 3% of the institutions' equity; the remaining 25% can be lent according to general bank limitations (maximum loan is 50% of equity).

In spite of the questions surrounding their creation, these new institutions will likely help expand microfinance. They will give microcredit foundations something concrete to strive for and grow into. The problem, of course, is that if the institutions are badly designed<sup>61</sup>, it could lead to widespread failures in the long run. And the stakes are high, because not only would the Latin American microfinance industry suffer a serious loss of credibility, but a very large number of low-income depositors could lose their life savings.

### The Importance of Defining Microcredit

Creating new institutions for microfinance, even when they are justified and designed, is not enough to provide a comprehensive regulatory framework for microfinance. The first and perhaps most important step toward this end is to implement appropriate regulations for microlending. These regulations, which should be based on the distinctive features of microlending as an activity and microcredit as a product, will ensure that *any* interested financial intermediary can provide this type of loans in an efficient manner while having to strictly recognize the revenues, expenses and risks arising from this activity. In essence it provides a level playing field for all intermediaries providing this type of credit, regardless of

<sup>61</sup> The information provided in this article is not sufficient to make a conclusive statement in this regard. The question of whether or not an institution is well designed depends on a several factors not examined in this article.

whether they are banks, finance companies, cooperatives or any other kind of regulated and supervised institution.

This type of regulation should be guided by three principles: flexibility, simplicity and automaticity—flexibility in interest rates, collateral and internal credit processes; simplicity in client documentation, loan delinquency and recuperation of collateral; and automaticity in portfolio classification, loan loss provisions and write-offs. Together, these basic rules provide room for innovation, lower the regulatory costs of compliance and subject microlending to a strict recognition of revenues, expenses and risks.

However, to implement these regulations in a reasonably consistent and efficient manner, the term “microcredit” must first be defined. This will allow the supervisory authorities to easily connect regulations on guarantees, client documentation, provisions, write-offs (etc) to this activity. Some economies have indeed defined microcredit in their regulations.

#### **Box 1: The PFDO – Civil Society Participation Gone Awry?**

The PFDO, or Private Financial Development Organization, was created by the Honduran Congress in February of 2001 after significant lobbying from local civil society organizations active in microenterprise development. Their intention was to eliminate the funding constraint faced by the nonprofit foundations that provide loans to microentrepreneurs and other low-income clients. The solution was to create an institutional form that would permit nonprofit microcredit foundations to operate as regulated and supervised financial intermediaries, which would in turn allow them to mobilize savings from the public.

But good intentions do not make a good institution. While the regulatory framework for the PFDO has some good aspects to it (for example minimum credit diversification standards and a prohibition to lend to related parties) there are a couple of major flaws in its design.

First, since the PFDO is constituted as nonprofit foundation, it has no owners (unlike an incorporated entity that has shareholders). Consequently, as there are no owners with money at stake, there are no strong and selfish interests to monitor the management of the institution. Second, the minimum capital requirement for the PFDO is only US\$60,000, much too low to reasonably guarantee that the institution can mount a sustainable operation while complying with the standards and requirements of the supervisory authorities. Third, the loans of the PFDO are subject to an interest rate restriction equal the maximum rate charged by commercial banks plus 3 percentage points. Given the high operating costs associated with microfinance services, this restriction could obviously prevent any institution operating as a PFDO from ever becoming financially sustainable.

These flaws should disqualify PFDOs from mobilizing deposits from the public. There’s just too much risk of failure.

In fact, the regulatory framework for the PFDO states that they should only be allowed to take deposits from their own “clients”, which would dramatically lower the risk *if it means that the PFDO can only have net borrowers*. However, neither the original law nor the regulations recently issued by the supervisory authorities specifically deal with this issue. Yet, since the definition of who is a client will determine the extent of the rights of the PFDO to mobilize deposits, this is likely to become a hotly debated issue between the Honduran Bank Superintendency and the nonprofit community. No doubt, should the definition of who is a client end up being very permissive, the Superintendency will have to protect depositors by developing additional norms and standards (for example high reserve requirements) that strengthen the stability and solvency of the nonprofit foundations that operate as PFDOs.

**Source:** Decree No. 229-2000, Gaceta Oficial, February 3, 2001

**Table 3: Definitions of Microcredit in four Latin American Economies**

<b>Economies</b>	<b>Definition</b>
Bolivia	A loan to a borrower—either individual, business or a group of individuals—for the purpose of financing small scale production, trade or provision of services, and where the repayment capacity of the borrower is based on the revenues generated by these activities.
El Salvador	A loan to a business with less than 10 employees or US\$5,700 in monthly sales.
Peru	A loan that finances production, commerce or the provision of services by individual or businesses whose assets (excluding fixed assets) are less than US\$20,000 and whose total indebtedness with the financial system is less than US\$20,000. Included in this definition are also those loans provided through credit cards, factoring, leasing and other forms of financing.
Venezuela	A loan provided, with or without interest, to users of the microfinance system for purposes of production, commerce or services and whose main source repayment capacity are the revenues generated from these activities. <sup>62</sup>

Sources: *Bolivia*: *Manual de Recopilación de Normas de la Superintendencia de Bancos y Entidades Financieras-SBEF (Título V, Capítulos II y III)*; *El Salvador*: *Decreto No. 849. Ley de Entidades no Bancarias*; *Peru*: *Reglamento para la Evaluación y Clasificación del Deudor y la Exigencia de Provisiones de la Superintendencia de Banca y Seguros (Capítulo 1, Sección 1.2)*; *Venezuela*: *Decreto No. 1.250, March 14, 2001*.

The definition of what constitutes microcredit must of course be based in part on the characteristics of the clients and their activities. The other important dimension that defines a microcredit is the size of the loan. Some economies, have tied the definition of microcredit to the number of employees or volume of sales of the micro-enterprise itself. However, that is not very user-friendly since it will make the process of determining if a loan is a micro-enterprise loan or a commercial loan relatively time consuming for the financial entity and hard to verify for the supervisory authorities.

Instead it would be more efficient and rational to have a definition of microcredit that includes a general description of the possible beneficiary (such as is the case in Bolivia) *and* a size limit for the loan itself (but no reference to the size of borrower’s business)<sup>63</sup>. For example, it would be reasonable to use the Bolivian definition but adding that it only applies to loans below, say, US\$5,000.<sup>64</sup> Such a limit, which focuses the definition on the instrument rather than the client, would enable much faster, simpler and automated mechanisms for classifying loans, establishing provisions, determining write-offs and a host of other matters. As a general rule, the limit should correspond to the loan amount where microlending methodology typically gives way to a more traditional methodology based on formal documentation and registered collateral. In most Latin American economies, this point is reached in the US\$5,000 to US\$10,000 range.

Of course, since the size of the micro-enterprise is not part of the definition, it is likely that a small percentage of non-micro-enterprises will inadvertently have their loans classified as

<sup>62</sup> The “microfinance system” consists of the entities that provide financial services to microenterprises. A microenterprise is defined as a self-employed person or a business with less than 10 employees or US\$103,576 in annual sales.

<sup>63</sup> The Bolivian authorities have instituted different cut-off amounts in different areas (such as client documentation, guarantees, provisions and so forth). Different cut-off limits may in certain cases be justified, but it can also create some confusion since any given loan will be treated as a microcredit in certain areas but not in others.

<sup>64</sup> The definition would thus be: A loan below \$5,000 to a borrower—either individual, business or a group of individuals—for the purpose of financing small scale production, trade or provision of services, and where the repayment capacity of the borrower is based on the revenues generated by the activities financed by the loan.

micro-enterprise loans. However, this imperfection would seem to be without any real consequence and well worth the gains achieved in terms of efficiency and simplicity, especially considering the fact that any definition of micro-enterprises based on sales or employees is itself arbitrary and imperfect.

Finally, although the regulatory framework is important, it is only half the story. The other half is supervision. Since most of the regulatory initiatives are still quite recent (apart from Bolivia and Peru), supervisory authorities have not yet developed effective processes, tools and practices of supervision. In fact, it would not be an exaggeration to say that supervisory authorities in several economies have been taken by surprise by the recent wave of legal and regulatory initiatives in the area of microfinance. Now, however, it is up to them to add the specifics to the regulations and figure out how to supervise this activity and the entities involved in it. Achieving the proper mix of regulations and supervisory practices that foster a competitive and sound microfinance industry will not be easy, but neither is it impossible. What is certain, though, is that it will require a sustained commitment on the part of the supervisory authorities.

**Box 2: Basic Principles for Regulating and Supervising Microfinance**

1. Only supervise microfinance institutions that mobilize deposits from the public. If the institution does not mobilize deposits, there is no compelling reason for the supervisory authorities to be involved.
2. Allow only incorporated, shareholder-based microfinance institutions and cooperatives (not non-profit foundations) to mobilize deposits from the public. Non-profit foundations have no owners with money at stake (in fact they have no owners at all) and therefore exhibit important weaknesses in terms of governance and institutional stability.
3. Do not create a new and distinct institutional forms specialized in microfinance for non-profit foundations that wish to operate as deposit taking institutions unless the existing institutional forms—such as bank or finance company—are unattainable (due to high minimum capital requirements, for instance) or carry important operational restrictions that cannot be easily changed (such as the inability to mobilize deposits).
4. Require the participation of private strategic investors in deposit-taking microfinance institutions that are formed through the transformation of non-profit foundations. Deposit-taking microfinance institutions are typically dominated by the original non-profit foundation and therefore need profit-minded investors as a counterweight.
5. Define microcredit as a new form of lending, distinct from consumer, commercial and mortgage lending. This will enable the simplification of rules and requirements for micro-enterprise loans.
6. Create simpler rules for risk classification, client loan documentation, collateral, loan loss provisions and write-offs for operations defined as microloans. In some cases the standards need to be stricter than current practice, in others more flexible; however, they should always be simple.
7. Focus supervision on: (i) the microfinance institution's governance and ownership, (ii) its lending methodology, and (iii) its internal control mechanisms and procedures.
8. Encourage the development and use of credit bureaus so that microfinance institutions can more easily assess the credit worthiness of potential clients and so that micro-enterprise clients can more easily use their credit histories to shop around with different financial institutions.

*Source: Manual for Regulating and Supervising Microfinance, IDB (forthcoming)*

## TRENDS IN THE REGULATION OF MICROFINANCE ENTITIES

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Current regulation aims for entities to operate soundly and establish adequate counterweights enabling them to avoid excessive risks in their decision-making and, ultimately, to confront such risks.

In turn, regulation is designed to anticipate problems by establishing the guidelines necessary to avoid entities being affected by these problems. This is known as “prudential regulation”.

Given the leverage assumed by popular credit and savings entities (EACPs), it is necessary to impose restrictions to control the risk to which deposits are exposed to and to minimize potential bankruptcies. Likewise, it is preferable that the authority controls the presence of potential problems through regulation and fosters the sound management of entities.

Prudential regulation responds to problems by establishing basic ground rules for sound management and molding the incentives that could at risk the patrimony of depositors. Prudential regulation therefore encompasses two concepts:

1. **Management guidelines:** which aim at establishing the procedures, actions and minimum controls regarding the operation and/or management of entities.
2. **Maintaining minimum indicators:** the purpose is to maintain the entity’s financial soundness so that they have the necessary resources to face future contingencies.

In order to determine the necessary regulation the entities’ size, operations and depositors’ risk need to be considered. The EACPs that will be formed will have different sizes and will perform various operations with diverse levels of complexity. A strict regulation will affect the costs of small entities with simple operations, while the contrary could generate laxity for bigger entities. The solution was to develop a differentiated prudential regulation.

Regarding management guidelines and minimum indicators, it is necessary to establish which criteria are applicable generally and which must be specific. *Regulation of minimum indicators* must be practically the same for each entity, only varying in the form of implementation. On the other hand, *management regulation* will have considerable differences depending on the type of institution (greater requirements for entities of greater size and access to more complex operations).

Segmentation of all entities and the need to establish a differentiated regulatory scheme has led to four levels of prudential regulation, where the differentiation criterion was the size of assets. This segmentation takes place due to fact that the implicit risk in operations performed by smaller entities (with fewer clients and assets) is not comparable to that of the bigger entities, and thus does not require the same level of control.

In this sense, the prudential regulation applicable to EACPs was created for four groups of entities, establishing their essential differences in order to avoid unnecessary regulatory costs. Management guidelines include risk management, internal controls and credit processes. Minimum indicators include minimum capital, liquidity, assets and liabilities diversification, portfolio provisions and capitalization for credit and market risks.

Regarding accounting legislation, the applicable differentiation policy makes a lot of sense. The smaller entities will hardly have the necessary infrastructure to perform the same accounting measures as the bigger entities. In this case, the benefit does not justify the costs.

However, the registration and evaluation criteria cannot be different for the same operation, so simple accounting criteria need to be established for entities in Level 1, ensuring that all topics are covered adequately. For entities at all the other levels, criteria consistent with the accounting legislation of other financial entities will be established.

The purpose of this regulatory scheme is threefold: 1) strive for the sound operation and management of entities through the management guidelines; 2) ensure that entities generate and maintain the necessary resources to face their obligations (minimum indicators); and 3) instrument a solid yet flexible regime, consistent with the regulation applicable to all other financial entities in Mexico, in order for it to adapt to the context and size of EACPs.

# **MICROFINANCE DEVELOPMENT, REGULATION AND SUPERVISION: THE CASE OF PAPUA NEW GUINEA**

**Flora Carruthers  
Bank of Papua New Guinea**

## **Demography, Geography and Background**

Papua New Guinea (PNG) lies wholly within the southern tropics, between longitudes 141° and 157° east of Greenwich and latitudes 1° and 12° south of the Equator. Approximately 85 percent of the land area is located on the eastern half of the island of New Guinea, the second largest island in the world. The total land area is 463,840 square kilometers with 8,300 kilometers of coastlines.

### **The Land**

For some regions, climatic and geographic conditions are main constraints to development and account, in part, for the persistence of spatial inequality within the economy. Isolated and inaccessible areas are the hardest to reach with government services while environmental constraints, such as high rainfall, poor soils or annual flooding, limit the agricultural development prospects for many rural communities. Topography and climate are also key factors determining the costs and appropriate modes of transportation and communication networks and the suitability and maintenance of physical infrastructure. Inter-regional road linkages remain limited and several urban centers, notably the capital city of Port Moresby, remain isolated. Air transport is the predominant mode of inter-provincial passenger travel and coastal shipping is still an important means of freight haulage between urban centers.

Because of the climatic conditions and the rugged terrain however, only around 13 percent (or 60,235 square kilometers) of the land area is suitable for agricultural cultivation.

### **The People**

According to the last census (in 2000), the total population was about 4.5 million. Papua New Guinea's crude population density of eight persons per square kilometer is one of the lowest in the world (NSO, 1994). Population density ranges from a high of 815 in the National Capital District (NCD) to a low of 1 in the Western Province. Using the effective arable area as the denominator (the physiological population density), density increases to 62 persons per square kilometer. The size and distribution of the population are the main constraints on the growth potential of the domestic market, which has remained small and segmented. A further consequence of the population size and distribution is that it limits the possible economies of scale to be derived from the provision of social and physical infrastructure.

The vast majority of the population still live in the rural areas, predominantly as subsistence farmers. With regard to Melanesian societies, the term "subsistence affluence" is often used to distinguish a situation where a family or clan is self-sufficient in producing what they need for their own consumption from one where they are only capable of producing enough to subsist. The enlargement of the exchange economy, or increasing monetisation, provides incentives for the rural population to produce cash crops without reducing their subsistence output and provides opportunities for developing non-farm income earning activities in village areas. The rural population is therefore a valuable economic resource with the potential to increase the overall productive capacity of the country.

## **Land Tenure**

An estimated 97 percent of the total land area is held under customary tenure systems with absolute ownership vested in a group or clan controlling its use and transfer. Most of the remaining 3 percent is alienated land acquired by the Australian administration for public purposes or for plantation development. Land is culturally important because of its connection to kinship and social institutions and, in economic terms, customary land tenure arrangements provide security for the 85 percent of the population who depend directly on the land for their well-being. In terms of economic development, the difficulty in acquiring title to, or use of, customary land for business activities is seen as a major constraint to private investment outside urban areas. The need to reach agreement with more than one owner adds to transaction costs while the insecurity of tenure is a disincentive to investment. Group tenure arrangements also limit the use of land as collateral, which in turn limits access to finance. The system of land tenure still remains a key factor affecting the organisation of agriculture and the difficulties it creates in acquiring land for commercial purposes has remained one of the most intractable problems confronting all post-independence governments.

## **Political Structure**

Papua New Guinea has a Westminster style parliamentary democracy with a single chamber and executive powers vested in the National Executive Council (NEC), chaired by the Prime Minister. The Prime Minister is elected by Parliament and duly appointed by the Head of State. The principles of government are expressed in a written Constitution, which provides for the powers and functions of the National Executive Council.

## **Poverty Issues**

According to a household survey done in 1996 by the World Bank, 31.0 percent of Papua New Guinea's population live below the poverty line of \$1 per capita per day. The incidence of poverty is high compared with economies with similar per capita income levels. Approximately 17 percent of the population cannot meet the basic requirement of 2,200 calories per day per adult equivalent, even if they spend all their income on food.

Both the extent of income-earning opportunities and the ability to respond to such opportunities are determined to a significant degree by access to the basic public services of transport, utilities, health, education, and financial services. Poverty reduction requires improved service delivery to rural areas. This was the intention of provincial and local government reforms introduced under the Organic Law of 1995, but effective implementation of devolution has been limited by capacity and funding constraints.

The incidence of poverty is linked to the ability to earn cash income to pay for non-food items, and to vary and improve diets. Almost 17 percent of the population living below the poverty line live in households where the household heads earns no cash income, relying solely on subsistence income. The poverty rate of these households is 47 percent. Poverty rates are also above the national average for households that earn cash income from tree crops (44 percent) and commercial agriculture (42.7 percent). These households account for 42.5 percent and 19.0 percent respectively, of the population living below the poverty line. Where household heads earn cash income from running a business or wage employment, poverty rates are much lower (at 25 percent and 17 percent, respectively). Although the latter households collectively account for 29 percent of PNG's total population, they account for only 14 percent of the population living below the poverty line. In general, increased provision of opportunities for earning secure cash incomes is needed to reduce the incidence and severity of poverty.



## **The Financial System**

Up to 1974 the financial system was essentially a small extension of the Australian system with policies decided by a management operating outside the economy. With independence, the PNG branch of the Commonwealth Bank of Australia was transferred to the PNG government and began its work as the first PNG-owned bank. It was renamed as the Papua New Guinea Banking Corporation (PNGBC), whose charter included the objective “to operate in the best interest of the people of Papua New Guinea”. Although, there was little utilization of trade or credit facilities by the local population, considerable use was made of savings account facilities. In 1970, Papua New Guineans held nine tenths of the total number of 400,000 savings accounts, which accounted for one third of the total value. From 1973 to 1986, PNGBC systematically extended the banking network to all provinces. In 1996, a local consortium founded the Bank of South Pacific (BSP), the first locally-owned private bank. At the beginning of this year, the PNGBC was sold to BSP as part of the government’s privatisation programme. Whether BSP maintains the extensive branch network PNGBC remains to be seen. There are currently only 4 commercial banks.

There are four tiers of institutions forming Papua New Guinea’s Financial system. (See appendix 1). Aside from the Bank of Papua New Guinea (BPNG), the system comprises three regulated tiers and one non-regulated. The commercial banks form the first tier. The second tier institutions are the bank-like financial institutions eg finance companies (which includes Village Finance Limited) merchant banks, and savings and loans societies, which play an important role in mobilising savings. They do not operate current accounts. The third tier is the rural development bank, insurance companies and brokers, and the stock exchange. They do not take deposits or operate current accounts as opposed to commercial banks. The fourth tier is a separate category and includes micro-finance non-government organizations (NGOs) and informal savings groups that provide financial services without any form of regulation or supervision.

Existing regulated and non-regulated financial institutions are offering deposit-taking facilities to some extent. All banks play the primary role in savings mobilization through passbook and transaction accounts. The bank’s network of the banks expanded in urban centres and agencies in remote areas until the mid-1980s when unsustainable operations costs due to law and order problems forced them reduce their network substantially: from 407 agencies in 1984, only 116 remained in operation in year 2001. The withdrawal of this financial service, particularly from the rural and more remote areas, has created a vacuum (and at the same time a niche) for informal savings groups to be established.

Most of the branch network was owned by the PNGBC which was taken over by BSP (a privately owned Philippine bank) at the beginning of this year under the governments privatisation programme. Following the takeover of PNGBC by BSP, it remains to be seen whether BSP will continue the branch network.

### **Providers of Microfinance Services**

Microfinance providers can be found in each of the different tiers that make up the financial system. The first, second and third tier institutions are from the formal sector.

#### *Banks*

The banks have only offered deposit services, and have played a key role in mobilizing savings in PNG. Compared with the strong involvement in mobilizing small savings, the banks are not significantly active in the field of micro-credit, citing the same reasons which have kept banks from microfinance operations in other economies. Loans are regarded too risky without collateral, too small and too costly to administer for any direct involvement. Furthermore, the

banks' existing structures do not allow them to become involved with the regular field visits and debt collections as required by microcredit. Physical coverage of banking services nationwide is low and declining. As of 31 December 2001 there were 164 branches and agencies of all commercial banks nationwide, down by 46 percent from 304 offices in 1995. Bank service access has also declined for many Papua New Guineans.

The bank-like financial institutions, the second tier, i.e. the SLSs, and Village Finance Limited (VFL) provide microfinance services.

### *Savings and Loans*

The Savings and Loans Societies (SLSs) were originally conceived in the 1960s by the Reserve Bank of Australia to promote financial education and development in rural areas, encourage savings, provide credit, and support small capital formation. With the strong technical and operational support of the Reserve Bank, the movement flourished. After independence the system of SLSs came under the supervision of the Bank of Papua New Guinea (BPNG). In the 1980s many SLSs ran into problems with high loan delinquencies due to mismanagement and inexperienced staff and to some extent the lack of effective supervision by the Bank of Papua New Guinea. Notwithstanding the original rural orientation of the SLSs, urban-based societies became increasingly important during the 1980s. Generally, urban societies are centred on common employment, and often secure contributions through payroll deduction schemes. The Savings and Loans Act was revised in 1995 to give the registrar of Savings and Loans (who is also the governor of the Bank of PNG) to effectively supervise and regulate the Savings and Loans Societies, including powers to appoint administrators and liquidators. Today there are only 20 SLSs in PNG with a total membership of 64,025 and a savings balance of \$29 million (equivalent to an average savings balance of \$737 per member). Since 1998, BPNG has carried out a revitalization program and introduced five new regional SLSs. Unlike the urban-based SLSs, the regional SLSs have between them established 44 branches. The requirement for a licence is a minimum of 500 people. No capital is required but for the regional based societies, the provincial government is asked to provide the seed funding. Management of the societies is appointed with the approval of the Bank of Papua New Guinea and have to meet fit and proper persons criteria. The bank also developed and introduced a code of conduct for directors and managers of the societies. To avoid the problems of the past, almost all SLSs have established a maximum loan amount equivalent to the amount of individual savings held with the institution.

### *Village Finance Limited*

Village Finance Limited (VFL) was founded in 1998 as a wholly-owned subsidiary of the PNGBC with initial capital of \$400,000 with a promise of an annual grant of \$240,000 to support its operations. It is a 'special purpose' financial institution established to deliver microfinance services throughout PNG. In 1999, VFL obtained a financial institutions license under the Banks and Financial Institutional Act, which requires targeting the underprivileged and returning all profits for investing in microfinance. VFL started field operations in 1999. With a group lending methodology, the company targets poor women in rural and urban areas. By December 1999, there were 156 outstanding loans with an average size of \$144 and a portfolio at risk of less than 5 percent. On the savings side, 376 compulsory and voluntary savings accounts exist, with an average balance of \$14. As of March 2000, VFL is authorized to extend individual loans of up to \$12,000. Unfortunately, the sale of PNGBC this year has significantly affected the liquidity of VFL and its operations. Currently, its operations are supported by a mining company, which now uses it as the vehicle to assist with the landowners financial needs.

### *Rural Development Bank*

Part of the third tier comprising nonbank financial institutions, the Rural Development Bank (RDB), founded in 1968, is one of the PNG economy's financial instruments to promote development in both urban and rural areas. The RDB maintains a small network with seven branches and 11 representative offices. It has always been a credit supply institution financed from PNG's budget. Unlike other development banks, it was never used as a conduit for foreign investment, although during the 1980s the World Bank and Asian Development Bank (ADB) established credit lines for on-lending for approved agricultural development projects. The closest products to actual microfinance that are provided through this bank are: (i) the women and youth mini loan scheme and (ii) the smallholder Agriculture credit scheme. Both these schemes are microfinance programs initiated and mandated by the government as a result of its policy to generate income and employment for women and youth and to promote small business for Papua New Guineans.

#### *Women and Youth Mini Loan Scheme*

The Women and Youth Mini Loan Scheme was established in 1994 with an initial government capitalisation of a revolving grant of K1.3 million (US\$0.2 million). The loan amount for any one project is limited to a maximum of K2,000 (US\$500) and carries a subsidised flat interest rate of four percent. Under the scheme, projects located in designated less developed areas are eligible for up to a grant of K800 (US\$200). Repayment period is up to 24 months and an application fee is charged while all other fees are waived. Security is minimal tending to rely more on a simple undertaking to repay the loan based on the recommendation of women and youth group leaders. As at end 1998, about 900 projects were approved amounting to K1.64 million. While 362 loans were fully repaid, the rest is still outstanding and active of which 461 loans (90 percent) are more than 6 months in arrears. RDB is still collecting these outstanding loans. Problems identified by the RDB include lack of organised committees (e.g. District Office Committee, Youth and Women Steering Committee and Provincial Committee) in most provinces except for Western Highlands, confusion over responsibility for loan supervision arising from the absence of a responsibility matrix, high transaction costs of loan supervision faced by the RDB, abuse of the scheme by agencies recommending loans for unviable relatives and friends, lack of market outlets for produce, free handout mentality by many borrowers, and a lack of management and marketing skills.

#### *Smallholder Agriculture Credit Scheme*

The Smallholder Agriculture Credit Scheme (SACS) is relatively successful. This scheme is administered by the RDB in conjunction with industry bodies including the Department of Agriculture and Livestock (DAL), the Coffee Industry Corporation, the Oil Palm Industry Corporation, the Cocoa Board and the Copra Marketing Board. The SACS was established in 1996 with an initial funding of K10 million from the national government. The scheme operates as a revolving fund where the loan repayments are reinstated. The maximum loan for any one project is K10,000 and interest is charged at five percent per annum. The RDB notes that this interest rate is five percent less than its normal lending rate to other agricultural project. A notable feature of the scheme is the combined resources and skills of the implementing agencies to provide an integrated service package, entailing finance, extension and other support facilities.

There is a clear responsibility matrix unlike the Women & Youth Mini Loan Scheme. Whilst the RDB is responsible for managing the funds, loan documentation, disbursement of loans and collection of repayments, the Department of Agriculture has the overall control of coordinating and sourcing of further funding. Industry bodies are tasked with the job of appraising projects and providing localised extension services to loan recipients. Loans approved as at end 1998

was K4.8 million (US\$1.2million) of which K3.96 million was disbursed. Of this, only 15 percent of these loans (243 loans) are in arrears.

#### *Oro Business Credit Scheme*

The RDB's third credit scheme of the RDB is the Oro Small Business Credit Scheme (OSBCS) which was established this scheme in 1997, in partnership with the provincial government (OPG). A Seed funding of K0.7 million was provided by the OPG and it was expected to be used as a revolving fund for the life of the scheme. The scheme sought to serve the inhabitants of Oro province engaged in village based productive activities. It operates in much the same way as the SACS whereby the OPG and the RDB combine their resources to extend credit to would-be borrowers as well as extension services and loan supervision. The scheme was phased out due to political interference in the management of the loans. This is a problem inherent in such schemes.

Because of the bank's bad experience in the mini loan schemes, a policy decision was made to restrict further microcredit schemes.

The non-regulated financial institutions form the fourth tier of the financial system and comprise various microfinance and microcredit schemes, basically the informal sector.

#### *Women's Credit Scheme programme*

The Women's Credit Scheme Programme (NCWP), started in 1988 with a few pilot projects in certain provinces, financed by the South Pacific Forum's Women's Bureau via the Asia Pacific Development Centre. The NWCP seeks to strengthen women's associations at the district level to serve as conduits for servicing the credit needs of group based, non-collateralized, rural and urban women borrowers. Overall, these programmes were found to be weak in both record-keeping and management, coverage was very low, and the women involved were not in the target group—poor. Most funds ended up not being used on productive activities except in one province, which placed a high and sustainable interest rate on loans, kept good records, and assiduously pursued clients for repayments. Despite the weaknesses, further support for expansion of the program subsequently came from the New Zealand government through the National Council of Women (NCW) to the provinces, through a cost-split arrangement with the Department of Religion, Home Affairs and Youth, who, with the National Council of women decided to implement the programme throughout PNG. To date, the NWCP is operational in approximately 60 districts. By December 2001, the estimated value of the loan portfolio was about \$200,000, with 1,750 loans outstanding and an average loan size of \$200. The portfolio at risk is 50 percent. Approximately 9,400 women are affiliated with the women's district credit associations for the purpose of credit.

#### *Lik Lik Dinau Abitore Trust*

*Lik Lik Dinau Abitore Trust* (LLDAT), the best-known and most-documented NGO engaged in microfinance in PNG, emerged from the collaboration of seven parties, including: government departments; PNGBC; United Nations Development Programme (UNDP); National Council of Women; and the Foundation of Law, Order, and Justice. The LLDAT began operation in 1994 with the objective of providing savings and credit facilities to very poor, mainly rural, women. It was founded explicitly to replicate the Grameen Bank model. Its target population is a minimum of 50,000 disadvantaged women in rural areas. The scheme lends both to groups and individuals through three branches and 71 centers. The loan duration is 50 weeks, repayments are made weekly and the recovery rate 96 percent. It has a savings membership of 1,123 and loan coverage of 1,120 borrowers. Loans are disbursed on a succession basis: K300, K750 and K800. *Lik lik Dinau* is well insulated and does not suffer from political interference. The interest rate charged on loans is 20 percent per annum with an effective annual rate of 40

percent. Unlike other schemes the success of LLDAT is the population density. The total number of loans disbursed was 1,459 valued at K440,500.

After a promising beginning, LLDAT's performance was severely affected by the lack of institutional capacity and liquidity problems. By December 1998, LLDAT had an outstanding loan balance of \$85,000, with 1,493 group members and an average loan size of \$195. To date, there are 2,704 group members affiliated with the trust. According to recent estimations, the portfolio at risk is over 50 percent.

#### *Putim na Kisim scheme (PnK)*

In response to the lack of adequate rural finance facilities, in 1995, the Lutheran Development Service (LDS) with the support of the Hanns Seidel Foundation of Germany (HSF), the Credit Union Foundation of Australia (CUFA) and AusAID funding, started the Putim na Kisim Project in parts of the highlands and mainland of Papua New Guinea. The aim was to establish savings cells at the village level as the basis for the development of rural saving and loan societies. The project is seen as a pure bottom-up approach, and thus as an alternative to the government revitalization program for SLSs. A vital role in the project is played by the integrated Yangpela didiman (young farmer) Program, run by the Lutheran Development Service for more than 25 years in the Morobe and Highlands regions. Through this programme village people are offered a ten-month course (*wokabaut skul*) to equip them to serve their people mainly in agriculture, fisheries and life skills as volunteer development workers. There are now more than 3,000 trained volunteers who have graduated from the scheme.

There are 20 saving cells operating in the framework of the pilot phase. The savings cells have 817 members, with total savings of \$29,000. The average individual savings balance is \$31. Lending is to start soon and the methodology will be similar to that applied by the SLSs: the loan amount will be determined by the individual savings balance, interest rates will be in the range of 10 percent per annum.

A prototype of PnK has been in operation since 1996 on Bougainville known as the Bougainville Microfinance Scheme (BMS). The main difference between the PnK and the BMS is that, unlike the former, the latter had no established large NGO network to operate along. Thus an NGO affiliate had to be built from scratch. Assistance towards establishing the BMS came from CUFA officials. By early August 1999 there were 13 schemes operating, with over 3,700 members and some K80,000 in deposits, with a monthly growth rate of 50 percent. Ausaid is now heavily involved in the scheme.

#### *The North Simbu Rural Development Project*

The North Simbu Rural Development Project established a microcredit scheme with the support of the Provincial Council of Women, and the Austrian Volunteers Service. The scheme targets women and applies a group approach, with loans given to individual members of the group. During the 16 months since inception, the project has processed a total of 630 loans, with 36 currently outstanding. The overall repayment rate is 94 percent, the average loan size \$200.

#### *VVN Savings Society*

The VVN Saving Society in East New Britain Province is an example of the informal savings schemes that exist throughout PNG. The society was established in 1997 through the initiative of a member of the village community. The 700 members save voluntarily, with a current savings balance of \$40,000. Funds are held in a group savings account with the PNGBC. There are no minimum balance requirements, and withdrawals can be made without limitations three days per week.

### *Informal Money Schemes*

Informal money schemes, the world-over, range from cash-based rotating savings and credit associations (ROSCAs) commonly used by peer and ethnic groups to systems of social credit or credit in kind. In PNG, major sources of informal credit are the extended family or clan (*wantoks*) and rural trade-store owners. New emerging sources now include semi-professional informal moneylenders in urban areas, who charge 30 to 40 percent per fortnight on short-term loans. Types of ROSCAs that now exist include *Wok meri* groups serving rural women, who pool funds for lending-on often with a small interest and *Sandes*, often involving working women who meet regularly and contribute an equal amount each for rotation.

Loans obtained from informal moneylenders are mainly for consumption purposes. The bulk of low-income and middle-income workers in the PNG urban centres are heavily dependent on informal money schemes such as *Sandes* and moneylenders to supplement income levels. Many of the informal moneylenders are themselves low-income earners who lend to both low- and middle-income earners. Their presence in government and company premises during paydays is clearly observable.

### **Profile of the Microfinance Industry in PNG**

All the above microfinance initiatives, either government-financed and mandated, or non government (including donors) mandated and financed, have a number of characteristics in common.

- i. They are scattered all over PNG and operate in isolation and without clear perspective.
- ii. Almost all of them suffer from lack of well-defined and transparent governance and management structures and capacity, have no effective information system and records, have limited knowledge of microfinance best practice and lack the ability to design appropriate savings and loans products.
- iii. Most of the schemes are targeted at women and start-up small businesses and are based on the Grameen Bank-type schemes that exist in South East Asia.
- iv. The managers and the loan officers lack even the basic training needed to adequately carry out their jobs.

In comparison to international best practice, (Table 1), Papua New Guinea microfinance providers still lags behind in almost all areas. This is especially evident in the areas of average loan size, the percentage of loans to women, the quality of the portfolio, operational self sufficiency and productivity.

**Table 1: Performance Indicators and International Standards**

<i>Objective</i>	<i>Performance Indicators</i>	<i>Performance Standards</i>
<b>Outreach</b> <ul style="list-style-type: none"> <li>• Depth</li> <li>• Scale</li> </ul>	<ol style="list-style-type: none"> <li>1. Average Loan Size</li> <li>2. Average Deposit size</li> <li>3. Percentage of Women</li> <li>4. Size of Customer base</li> <li>5. No. of Outstanding loans</li> <li>6. No.of Savings Accounts</li> </ol>	<p>&lt; Economies annual per capita income &lt; 1/3 of customer base</p>
<b>Sustainability</b> <ul style="list-style-type: none"> <li>• Portfolio Quality</li> <li>• Self-sufficiency</li> <li>• Productivity</li> </ul>	<ol style="list-style-type: none"> <li>7. First year of operations</li> <li>8. Nominal interest on Loans</li> <li>9. Effective interest on laons</li> <li>10. Interest on savings</li> <li>11. Portfolio at risk<sup>1</sup></li> <li>12. Operational self sufficiency<sup>2</sup></li> <li>13. Staff Productivity</li> </ol>	<p>&lt;10% &lt;100% within 3-7 years &lt;100 outstanding loans/loan officer</p>

<sup>1</sup> Portfolio at risk = balance of loans over 30 days late/total outstanding loans

<sup>2</sup> Operational self sufficiency = income/operational and risk costs

**Table 2: Profile of Microfinance Providers in Papua New Guinea <sup>1</sup>**  
**Key performance indicators as at 31 December 1999**

	<b>PNGBC</b>	<b>RDB</b>	<b>ENB SLS</b>	<b>Morobe SLS</b>	<b>VFL</b>	<b>LLDAT</b>	<b>NCWP</b>	<b>NSRDP</b>	<b>Pnk</b>	<b>WNBSav Soc</b>	<b>Total</b>
<b>Outreach</b>											
1. Average Loan size	K2,913	K3,067	K685	K825	K361	K487	K281	K500	-	-	K281-K3,067
2. Average Deposit size	K352	-	K662	K268	K48	K176	n.d	K39	K89	K143	K48-K662
3. Percentage of women	n.d	n.d	n.d	n.d	97%	100%	100%	100%	?		
4. Size of customer base (credit)	Approx70,000	Approx. 3,000	Apprx4 4,700	Aprox 1,000	376	2,704	8,200	600	Approx 500	Approx250	91,330 (21,330)
5. Number of outstanding loans	796	2,400	Approx 2,000	Approx 490	156	1,496	1,250	35	-	-	8,622
6. Number of savings accounts	465,765	-	12,039	1,837	376	2,704	8,200	98	817	700	492,572 (26,807)
<b>Sustainability</b>											
7. First year of operation	1974	1967	1993	1999	1999	1994	1996	1998	1995	1997	
8. Nominal interest rate on loans	18.25%	5%-22% flat	12%d.b	12% d.b	30%flat	35%flat	10% - 20% flat	20% - 25% flat	-	-	5% - 35%
9. Effective interest rate on loans	n.d	n.d	n.d	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>	<b>n.d</b>
10. Interest on Savings	2.5%-14%	-	6%								
11. Portfolio at risk <sup>2</sup>	Approx 40%	60%, 30%	<1%	<1%	3.9%	>50%	>50%	<10%	-	-	<1% - >60%
12. Operating at self sufficiency <sup>3</sup>	n.d	n.d	100%	n.d	18.51%	<30%	n.d	n.d	n.d	n.d	18.5% - 100%
13. Staff Productivity	n.d	n.d	700	173	26	135	6	18	n.d	n.d	6 - 700

1 ENB (East New Britain), LLDAT (Liklik Dinau Abitore Trust), NSRDP (North Simbu Rural Development project, NWCP (National Womens Credit programme), PNGBC, Papua New Guinea banking Corporation, PnK (Putim na Kisim), RDB (Rural development Bank), SLS (Savings and Loans, VFK (Village Finance Limited,

2 Balance of loans over 30 days late / /total loans outstanding

3 Income / operational and risk costs



The key performance indicators in Table 2 show the following:

- i. The average loan size ranges from K281 to K3,067. According to different sources, including the ADB and the UNDP, the actual demand for microcredit is in the range of K500 (working capital) up to K30,000 (fixed assets). The bottom end where the average loan is less than K300 is the result of credit schemes that target start-up businesses in the subsistence sector. These low credit amounts do not necessarily reflect the low income group that is served. They are sometimes the result of rationing the credit supply due to an excess of demand while there is a shortage of seed capital.
- ii. The average deposit is between K48 and K662. Banks and savings and loans societies usually require a minimum opening balance of K50 and K20, whereas most of the microcredit schemes apply compulsory group accounts with minimal weekly contributions per group member.
- iii. The existing microcredit schemes are almost exclusively targeting women, which is the result of the Grameen Bank lending methodology that is wide-spread in PNG. Only the regulated financial institutions do not use gender as an eligibility criteria for clients.
- iv. While the potential demand for microcredit is about 300,000 borrowers for all of PNG, the institutions analysed for this paper could cover an estimated potential demand of nearly 100,000 borrowers if they would use their institutional capacity at full potential. Without Papua New Guinea Banking Corporation (PNGBC), however, the client base for credit would be around 20,000. This potential demand is only met by the existing microfinance providers, with a total of 8,622 outstanding loans. The lack of credit funds and overall highly insufficient institutional capabilities explain the low outreach of microcredit in PNG.
- v. In contrast to the supply of credit, savings facilities are widespread throughout PNG. Nearly half a million people have a savings account, which falls in the category of microfinance. The bulk of the accounts is held by the PNGBC and the savings and loan societies. If those two institutions were discharged, non-licensed savings accounts would fall to less than 10,000.
- vi. Interest rates charged on credit range between 5 percent per annum flat and 35 per cent, equivalent to effective interest rates of up to 70 percent or more. It is evident that PNG micro-borrowers are not interest-sensitive. What is more important to the borrowers is the access to adequate credit facilities in terms of convenient access, speedy and uncomplicated procedures, timely disbursement, etc. rather than the direct financial costs. This indicates that microfinance providers in PNG could become self-sustaining if they could build up an efficient and effective management and institutional capacity.
- vii. Interest on savings is negative in real terms. The current annual inflation rate is around 10 percent, while financial institutions pay only up to a maximum of 6 per cent per annum for savings. The motive to save is mainly for security and the comfort of being able to withdraw money any time it is needed.
- viii. The quality of the loan portfolio in microfinance is far from acceptable, even when standards below international best practices are applied. Apart from a few examples where acceptable repayment rates are achieved on the costs of low productivity, the portfolio at risk is over 50 percent, which is well above the international best practice of 10 percent or lower for microfinance. This poor result could be explained by the definition of target groups (finance of start-up businesses of poor women of the

subsistence sector), the lack of systematic lending methodologies, and the general perception of microfinance as a mainly social issue.

- ix. Absence of, or deficiencies in, accounting are common among all the existing microcredit schemes. The institutions do not use a standard form of accounts and have no audited financial statements, which makes it difficult to compare the results. Even the regulated financial institutions do not account for microcredit operations separately and mix them up with their regular lending business. This makes it difficult, if not impossible, to obtain reliable information on the operational and financial self-sufficiency of the various microcredit schemes. Village Finance Limited (VFL) and *Lik Lik Dinau Abitore* Trust (LLDAT), the most professional microfinance institutions (MFIs), only reach a level of 18.51 percent (VFL) and nearly 30 percent (LLDAT) of operational self-sufficiency, after one (VFL) and six years (LLDAT) of operation. (ADB,1998; UNDP1999).
- x. Staff productivity is very low which indicates the lack of overall institutional capacity. Apart from the savings and loan societies, which reach considerable levels in productivity because their lending procedures are very simple, all microcredit schemes lie in the range of less than 30 outstanding loans per field officer. Only LLDAT has reached 135 loans with the cost of a portfolio at risk of more than 50 percent. Considering that most MFIs that have been analyzed rely on group-lending technologies, these figures are far below international standards, where the borrower per loan officer ratio in MFIs applying individual lending techniques is 250-300, and about 450-500 when group-lending predominates.(ADB, 1998)

These are also key constraints for an effective microfinance sector that can be eased over time through appropriate government actions, notably for investment in human capital, better service delivery (including access to finance by the rural areas), and infrastructure improvement. The issues of poverty-reduction and socio-economic inequalities can be addressed through private sector-led growth and employment creation. This is clearly outlined in the government's microfinance policy, which although still in draft is very well accepted and recognized.

### **The Microfinance Policy**

The objective of the policy is “to establish a framework that leads microfinance providers towards the enhanced institutional capacity, better access to refinancing mechanisms in order to assist and support the development of existing enterprises currently excluded from the mainstream financial services. By targeting profitable enterprises, it is the intention to foster private sector development and to contribute to the social and economic integration of the marginalised households in PNG”. It aims to enhance the institutional capacity of existing and future microfinance service providers. It includes the creation of appropriate regulatory framework as well as providing adequate refinancing mechanisms for the private sector to deliver new savings and credit products to the mass of the population that currently have difficulty in accessing financial services.

The Microfinance policy is consistent with the government's medium-term development strategy which includes “the development of a vibrant micro, small, and medium-sized enterprise sector to spearhead economic growth” and the small to medium-size enterprise (SME) policy which was developed with the UNDP in 1998 which, addresses and identifies the key issues and constraints hindering business development.

It is in this context that the government agreed to a microfinance project with the ADB in 1999. The rationale is based on the issues mentioned and the project is geared towards developing and strengthening Institutional Capacity by improving the governance structure, reviewing the

target market, reviewing and developing the credit and savings methodology, growth strategy, and financial and human resource management.

This is a major shift in terms of the development of microfinance in Papua New Guinea. Historically, microfinance in PNG has been developed almost exclusively under an integrated development or mainly social approach. Hence, social and poverty reduction goals dominate the governance structure of the existing microcredit schemes. Accordingly, cross-sectoral issues, e.g., gender, community development, real sector development, business training, etc., were the dominant objectives, and that meant that the relevant government departments determined the governance structures of most of microfinance schemes of PNG. The actual co-existence of the objectives “reach the poorest of the poor” and “achieving financial self-sustainability in the short run” has hampered the development of microfinance in PNG. Most of the schemes are replicas of the Grameen Bank based type of schemes. Unfortunately, this is not appropriate for Papua New Guinea. The structure of the economy, the land, topography and most importantly the population density limit the success of this type of scheme. It is well known that the success of the Grameen bank type schemes in South East Asian economies is because of their high population density which does not exist in PNG.

### **The Asian Development Bank/Papua New Guinea (ADB/PNG) Microfinance Project**

#### *Objective*

The overall objective of the project is to contribute to economic growth through the development of the private sector, creation of employment and the development of the financial system. The goal is to reduce poverty and integrate the majority of the poor into the mainstream development process. The specific objective is to provide sustainable microfinance services to the population at large.

#### *Scope of the project*

The project is made up of three components. Component A is mainly for capacity building of the MFIs through a microfinance competence centre (MCC). The services provided by the MCC will include public awareness and the development of public relations and public awareness for microfinance providers and their potential clients. In-house training courses to improve technical and organisational skills, including onsite TA training for MFIs, ranging from start up for newly MFIs, to support programmes.

Component B will develop new savings and loans products and delivery methods for financial services, and will support MFIs in implementing them. Specific attention will be given to linking community savings groups with financial institutions, including a pilot test that will involve the downscaling of commercial banks. Downscaling of commercial banks has been successful in some Latin American and Asian economies. A pilot microbanking scheme will be designed and set up in a remote part of the country to test the products and methodologies. Detailed documentation of the steps and processes will be an important part of the pilot project as it will be used as a guide for all new MFIs.

Component C is the establishment of the revolving finance facility, which will be done through the BPNG. It will provide the necessary funding for MFIs to achieve sustainability and expand their loan portfolios. Credit lines and equipment loans will be made available to MFIs for onlending to micro and small enterprises. The MFIs will have to meet certain criteria to be eligible to borrow from the revolving fund. An important aspect of this component is the development of legislation to supervise and regulate the MFIs.

It is through this project that PNG will hopefully bring about the changes needed to develop and strengthen the financial self-sustainability of the MFIs. It is only by becoming financially self-sustainable and profitable, that MFIs will win customer confidence and prove to the public and the regulators that they are capable of obtaining licenses as deposit-taking institutions.

### **Assistance to the Microfinance**

At the macro level, the financial system has received external support under the overall structural adjustment program. This comprises advisory services by the Reserve Bank of Australia, the International Monetary Fund (IMF) to review monetary policy. Both the IMF and the World Bank have assisted in the development and introduction of the Central Banking Act, the Banks and Financial Institutions Act, and the Life Insurance and Superannuation Acts. All this Legislation was passed in the parliament in year 2000. The World Bank, Ausaid and the IMF are assisting the Bank of PNG with financial system supervision, including supervision of non-banks and savings and loans societies. The Credit Union Foundation of Australia (CUFA) has also assisted the bank of PNG with the SLSs program.

External assistance to microfinance is rather fragmented, compared to assistance given to the Bank of PNG. External assistance from Ausaid, UNDP, the European Union (EU), and the World Bank ranges from setting up revolving credit funds as part of the large comprehensive rural development sector programs to the provision of seed money to village communities and womens groups. Most initiatives have aimed at income generation, particularly for women, and poverty reduction. International NGOs and volunteer organizations, church based institutions, private companies, Government (at all levels) and individuals are involved, but neither the government or any other institution or body has an overview of the assistance provided. Only the recent ADB assistance has attempted to have a very good coverage and overview of the microfinance industry in PNG. The ADB has tried to address the problems, constraints and shortcomings of existing microfinance schemes, what the potential is for microfinance, and how these can be addressed effectively to foster the growth of microfinance schemes and institutions to tie in with overall government policies for economic growth.

### **Supervision and Regulation of Microfinance schemes**

As seen above only the first three tiers of the financial institutions are supervised.

All banks and financial institutions that take deposits are licensed (excluding savings and loans societies and the RDB) and come under the Banks and Financial Institutions Act (BFIA). Banks have to have a minimum capital of K15 million while the other financial institutions have to have a minimum capital of K5 million. Savings and loans societies are licensed and supervised under the Savings and Loans Act.

Except for Village Finance Limited, none of the microfinance institutions are licensed, regulated or supervised. It can be seen that the minimum capital requirements for a microfinance scheme (K5 million) will be a real disincentive. The BFIA requires that “any institution that takes deposits is required to apply for a Financial Institutions License”. It has become a real dilemma for the BPNG. Something must be done about it but we are aware that we cannot implement the legislation effectively. We are also aware that implementing the BFIA will definitely kill the microfinance industry in Papua New Guinea. The only way forward, in my view, would be to develop legislation that will cater for both the savings and Loans societies and the microfinance schemes.

## **Summary**

Microfinance in Papua New Guinea has developed as a result of public policy concerns. However, there were two different but related policy concerns. The first was the need to promote financial education which would lead to greater development in rural areas, encourage savings, provide credit, and support small capital formation. The second was the need for employment creation and the encouraging of PNG's women to participate in development. The aim was to alleviate poverty and encourage economic development. However, over the 30 years since microfinance was introduced, the industry has really struggled. There have been a lot of problems, mainly as a result of the lack of governance and management capability, and to a large extent, the implementation of schemes that are not appropriate for PNG (given its short history of educational development, the structure of the economy and topography, and population). Assistance has been given by international agencies to try and develop the microfinance industry, but as mentioned earlier, there were no clear guidelines for the target groups. The ADB project in my view has addressed the problems, and constraints but has also highlighted that there is potential for the growth of microfinance in PNG.

## **MICROBANKING IN THE APEC REGION: THE PHILIPPINE CASE**

**Gil S. Beltran**

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The Philippine government has identified microfinance or microbanking as one of its key strategies to alleviate poverty. President Gloria Arroyo, in her state of the nation address in July last year, declared microfinance to be the cornerstone of the government's fight against poverty, and Finance Secretary Jose Isidro Camacho is one of its most vocal proponents.

### **Evolution/Development of Microfinance**

Microfinance is not new in the Philippines. Microbanking services started in 1906 with the development of the credit cooperative system by civic and regional groups. It was a private sector-led initiative that pioneered the provision of financial services to the relatively poor segments of the economy. Later, credit cooperatives grew as their clientele expanded to include professionals and salaried workers. Their expansion was attributed to the passage of the Agricultural Credit Associations Act in 1915 and the Cooperative Marketing Law in 1927. Their rapid growth was evident during the late 1960s when cooperatives were organized in every parish as a means of responding to the call of the Second Vatican Council to contribute to poverty alleviation and social injustice.

As early as the 1950s, the government directly intervened in the provision of financial services when funds were directly provided by various government agencies as a tool to combat rural insurgency. Government-directed credit programs (DCPs) intended to allow poor households engaged in micro-enterprises access to credit. The government acted both as financial intermediary and administrator of credit funds.

To complement the DCPs, the government started providing cheap and subsidized funds to formal banking institutions in the 70s. Rural banks, cooperative banks and thrift banks were used as lending conduits in the implementation of DCPs, particularly in the agriculture sector. These initiatives, however, did not result in a sustainable and efficient financial market that would cater to the needs of the poor.

As such, microfinance NGOs started to sprout and provide credit services to the poor in the early 80s. Their role as financial agents became more significant as they popularized microfinance, in terms of outreach, sustainability and efficiency. Most NGOs adopted the Grameen model in providing credit delivery as considerable support is available to Grameen replicators. Paradoxically, NGOs grew at a time when the economy and the poverty situation was deteriorating.

### **Directed Credit Programs**

Prior to the liberalization and deregulation of the financial markets in the 1980s, the Philippine government adopted a direct interventionist policy in providing credit due to political expediency and misconceived principles. The principles were:

1. Firstly, that financial market imperfections, notably information problems existed in the credit market. Not knowing that "the poor can pay" prevented formal lenders from extending loans to entrepreneurial who are poor but who may have the necessary skills and business acumen to set up small businesses.

2. Secondly, there was a perceived high credit risk in the agricultural sector which led to problems of funds accessibility. Small farmers were considered “non-bankable” and hence, this sector lacked access to adequate financial resources from formal credit.
3. Thirdly, there was a need to promote good and attractive projects essential for development and therefore the government must target these sectors and provide the necessary financing.

Subsidized loan programs for specific sectors became a common feature of the government’s credit policy. Through directed credit programs, it was believed that poor people would have better access to formal credit, an alternative to the informal moneylenders. Unfortunately, directed credit, viewed as a major solution to alleviating poverty, entailed huge fiscal costs, competed directly with private financial institutions and created severe distortions in the credit market, worsening the accessibility of the poor to financial services.

### **Paradigm Shift: From Interventionist to Market-Oriented**

The deregulation and liberalization of financial markets in the 1980s saw the elimination of directed credit for several reasons:

1. It incurred huge fiscal costs (in the form of interest and default subsidies) as many programs became financially unsustainable ;
2. It discouraged banks from acting as intermediaries between savers and borrowers as they relied more on cheap government funds for their lending operations;
3. It brought problems of loan recovery, troubled banks and overall economic stress; and
4. It failed to ease the poverty problem as the outreach of DCPs was very limited.

Consequently, policies moved toward more market-oriented financial markets. Major changes included: the adoption of market-based interest rates; the termination of subsidized rediscounting programs at the central bank; the consolidation of existing credit programs in the agriculture sector into a fund called the Comprehensive Agriculture Loan Fund; and the termination of direct lending by government agencies implementing credit programs.

To a large extent, the financial market reforms in 1986, helped reduce the degree of subsidies extended to the agriculture sector. But the number of directed credit programs persisted, and even grew in other sectors (especially industry and manufacturing), despite the market orientation of financial and credit policies. Various vested interest groups clamored for credit subsidies and more directed credit programs.

Notwithstanding the proliferation of government directed programs, the problem of accessibility to credit persisted. In 1993, various private socially-oriented groups recommended the rationalization of these programs and the creation of a policy environment conducive for credit.

### **Rationalization of Directed Credit Programs**

Efforts to rationalize directed credit programs led to the launching in 1993 of the Social Pact on Credit between the government and non-government organizations and people’s organizations seeking to improve low-income people’s access to formal credit. The pact became part of the Social Reform Agenda, the government’s blueprint to address the problem of poverty in the Philippines, and recommended the rationalization of directed credit programs to improve credit delivery to the poor. The government’s rationalization thrust through the pact led to the creation of the National Credit Council on 8 October 1993 under Administrative Order No. 86 (signed by President Fidel V. Ramos.)

The National Credit Council is mandated to:

1. Rationalize the use and delivery of government credit programs.
2. Develop a credit delivery system which incorporates capability upgrading and institutional strengthening mechanisms.
3. Encourage higher level private/business sector participation in the delivery of credit.
4. Define and rationalize the role of guarantee programs and guarantee agencies.

As a first step, in consultation with all stakeholders, the National Credit Council formulated the Philippine National Strategy for Microfinance in February 1997. The strategy was presented at the Second Microfinance Summit in New York in 1998.

### **Philippines' Strategy for Microfinance**

The overall vision is to have a viable and sustainable microfinancial market with more business/private sector participation to provide low income households and micro-enterprises better access to financial services. This will be achieved in a liberalized and market-oriented financial system. The government's role will be limited to providing the enabling policy environment to encourage greater business/private sector participation without direct competition from the government.

The microfinance policy is built on four principles:

1. Greater role of the business private sector microfinance institutions in the provision of financial services;
2. An enabling policy environment that will facilitate the increased participation of the business/private sector in microfinance;
3. Market-oriented financial and credit policies (e.g., market-oriented interest rates on loans and deposits); and
4. Non-participation of government line agencies in the implementation of credit and guarantee programs.

Based on these principles, the government will do away with supervised, subsidized and directed credit which only distorted the financial market and discouraged the participation of the business/private sector. Market-oriented policies will be implemented to ensure greater financial intermediation by the business/private sector.

Government line agencies will focus on their core mandate (providing capability-building and social preparation services to microfinance institutions) rather than lending. The credit from demand of micro-enterprises will be met by government financial institutions through wholesale lending to private MFIs using a variety of non-traditional and innovative sustainable approaches.

Strategies include:

- Implementing a market-oriented interest rate policy;
- Pursuing financial policy reforms with the end in view of removing existing distortions in the financial market (e.g., earmarking public funds for direct lending);
- Rationalizing all existing government credit and guarantee programs to encourage greater business/private sector participation in a market-oriented setting;
- Providing an appropriate supervisory and regulatory framework for MFIs that will enable them to develop new and innovative products;
- Establishing standards of performance and business practices to guide the operations of MFIs;
- Promoting broad-based savings mobilization, linking banking technology with microfinance technologies;



- Encouraging research and academic institutions to conduct studies; and convene policy level discussions that will promote awareness of microfinance as a sound commercial investment. These institutions will identify best practices in microfinance, and develop and install training and microfinance technology packages.

To implement these strategies, a number of laws and policies that espouse market-oriented financial credit policy and the rationalization of government directed credit programs have been enacted. These are the Social Reform and Poverty Alleviation Act; the Agriculture and Fisheries Modernization Act; the Amended General Banking Act; Executive Orders 138 and 110; and *Bangko Sentral ng Pilipinas* (BSP) Circulars.

The Social Reform and Poverty Alleviation Act formalized the policy shift and the direction of the credit policy away from directed credit and toward more market-oriented financial market. Among other things, the law rationalizes government- directed credit programs and guarantee programs promotes savings mobilization, emphasizes capacity-building of MFIs, and mandates government financial institutions instead of government line agencies as government financial channels.

The Republic Act 8435 or the Agriculture and Fisheries Modernization Act (AFMA) provided the initial impetus for the rationalization of government directed credit programs. The AFMA directs the Department of Agriculture to, within four years, phase-out directed credit programs in the agriculture sector and transfer all loan funds to a facility called the Agro-Industry Modernization Credit and Financing Program (AMCFP).

The AFMA also spells out the government's basic credit policy in terms of market-oriented interest rates and encouraging business/private sector participation in rural financial markets.

The New General Banking Act mandated the central bank's Monetary Board to consider the unique features of microfinance when drafting banking rules and regulations. As a result, the *Bangko Sentral ng Pilipinas* has taken into consideration the use in the schedule of loan amortization the projected cash flow of the borrowers for unsecured loans. Hence, microfinance loans may be amortized on a daily, weekly, bi-monthly or monthly basis, depending on the cash flow of the borrower.

The National Credit Council (NCC), spearheaded the issuance of Executive Order 138 which spells out the basic policies guiding the implementation of government credit programs. Under Executive Order 138, government non-financial agencies, departments or line agencies will no longer implement government credit programs. Instead, their role will be confined to their main mandate and line of expertise, i.e., the delivery of technical assistance, social preparation, basic support and infrastructure services to targeted clients to make them more viable and profitable.

Executive Order 138 provides that implementation of the DCPs will now be lodged with government financial institutions (GFIs) that have the necessary expertise and technology to undertake lending, so that these programs will be more effective and sustainable. Market-oriented interest rates will be the guiding principle when funds are lent out to encourage greater business/private sector participation in the delivery of financial services. While subsidized credits to the basic sector are phased-out, the government will concentrate more on capacity-building and support services to MFIs.

Directed credit programs to be implemented by GFIs shall be loaned-on wholesale to participating private financial organizations including community-based organizations. In turn, these private financial entities will retail the funds to improve accessibility and increase outreach. Cost recovery will be a primordial consideration to attain self-sufficiency and sustainability.

To provide marginalized sectors with greater access to credit, the active participation of community-based organizations such as cooperatives, NGOs and people's organizations will be fully utilized.

The BSP in coordination with the NCC has recently issued three circulars specifically focusing on microfinance. These circulars provide for the following:

1. Direct the Monetary Board to exempt microfinance loans from rules and regulations with respect to unsecured loans;
2. Relax the moratorium on the opening of new banks and branches of existing banks which are engaged in microfinance; and
3. Open up a rediscounting facility for microfinance.

To date, the BSP has granted new licenses to five microfinance-oriented rural and thrift banks, among which are the Opportunity Microfinance Bank, Inc. and the Micro-Enterprise Bank. One further application is being processed as a result of the issuance of these BSP Circulars.

The approval of Executive Order 110 is in keeping with the government's strategy of implementing a capacity-building program for microfinance institutions. The People's Development Trust Fund created under the Poverty Alleviation Act will be utilized for: consultancy and training services for microfinance institutions; scholarships or training grants for microfinance staff and officers; community organizing for microfinance, livelihood and micro-enterprise training services; livelihood/micro-enterprise project/program feasibility studies and research; and savings mobilization and incentive programs.

Credit cooperatives are considered one of the important microfinance institutions in the country. To strengthen the cooperatives, the government formulated a standard form of accounts with an accompanying accounting manual for credit cooperatives to ensure transparency and consistency in financial reporting. With this, and the establishment and implementation of performance standards for credit cooperatives, it is expected that this sector will improve its performance and strengthen their capabilities thereby increasing its outreach to deliver microfinancial services.

## **The Microfinance Sector at Present**

### *Outreach*

A study on the microfinance sector by the Microfinance Council of the Philippines showed that microfinance institutions have managed to reach only 7 percent of poor households, roughly 300,000 people. The regions with the highest number of clients and proportion of poor households covered are: Central Luzon (27%), Southern Tagalog (11%), Western Visayas (12%), and the Cagayan Valley (13%). On the other hand, areas relatively underserved are Western Mindanao, ARMM, Southern Mindanao, and the Cordillera Administrative Region. On a sectoral basis, agrarian reform beneficiaries and agricultural producers contain the largest numbers of poor people served by the formal financial sector.

NGOs have the widest outreach among the MFIs. This is due to the fact that the NGOs were the pioneers in this field. However, the number of NGO-MFIs is limited. Thus, in the NGO sector, a more aggressive expansion strategy per institution is being adopted.

Women have been the main clients of microfinance institutions. This is a major reason why many MFIs have been able to achieve the seemingly divergent objectives of expanding outreach among the poor, achieving high repayment rates, mobilizing local savings, and becoming financially sustainable.

There are a number of institutions involved in the delivery of microfinance services to the basic sectors. These are the rural banks, thrift banks, credit cooperatives and the microfinance NGOs. As provided for in the General Banking Act of 2000, thrift banks and rural banks are currently being supervised by the Bangko Sentral ng Pilipinas, while under Republic Act 6939, credit cooperatives are legally under the supervision of the Cooperative Development Authority (CDA). The microfinance NGOs are not being supervised by any oversight agency.

Commercialization of the microfinance sector has made headway over the years, but outreach has remained limited at 7 percent of poor households. As of March 2002, the Land Bank of the Philippines (LBP) has 1,536 accredited participating financial institutions (PFIs) for agricultural lending. They are rural banks, cooperative banks and cooperatives. As for lending to small and medium enterprises, the LBP has 402 participating financial institutions. The Development Bank of the Philippines (DBP) has 147 accredited financial institutions (cooperative banks, rural banks and thrift banks) and 20 cooperatives and NGOs. In the case of Peoples Credit and Finance Corporation (PCFC), their active financial conduits have increased from 49 in 1997 to 197 at present, of which 63 are cooperatives, 24 are cooperative rural banks and 30 are NGOs. In 1999, only 5 cooperative rural banks, 17 cooperatives and 6 NGOs were accredited.

The limited outreach of microfinance institutions could be due to a number of factors. But the most obvious are: the geographic dispersion of clients (the Philippines being an archipelago), lack of innovation and product diversification (many MFIs have adopted the Grameen style and never developed local innovations), lack of information (asymmetry in information), and the reality that microfinance is a new paradigm in delivering credit to the poor.

#### *State of Microbanking*

Information on the state of microbanking is scanty. An estimate made by the National Credit Council and the survey of the Microfinance Council of the Philippines in October 2001 showed that the number of microfinance institutions is in the range of 6,000 to 9,000, with savings mobilization of about US\$7,085 million and loans outstanding of US\$12,274.7 million.

**Table 1: Categories of Existing Intermediaries as of October 2001**

Categories of existing intermediaries	Number of institutions	Total number of branches	Amount of savings mobilized (in US dollars)	Amount of loans outstanding (in US dollars)
Non-governmental Organizations	600 to 800	Not available	328.1 million	758.6 million
Credit Unions	12	Not available	1.09 million	2.14 million
Credit Cooperatives	6,000 to 8,000	Not available	3,300 million	7,586 million
State-owned Banks	3	500 +	3,454.6 million	7,923 million
Private-owned Banks	25	Not available	1.99 million	5.79 million
Other (specify)				
Total	6,640 to 8,840		7,085 million	12,274.7 million

*Please note that the foregoing information in the table only comes from a) those institutions which reported information in the survey conducted in October 2001 by the Microfinance Council of the Philippines and b) the estimates of the National Credit Council. Therefore this table does not provide a comprehensive information on the actual state of microbanking in the Philippines.*

Most of these organizations belong to a network. For instance, the rural banks and the thrift banks belong to national federations called the Rural Bankers Associations of the Philippines

and the Chamber of Thrift Banks, respectively. The credit cooperatives, on the other hand, are mostly members of a national federation, a regional federation or a provincial federation. The microfinance NGOs, belong to a national coalition called the Microfinance Council of the Philippines.

The client base of MFIs is estimated at more than 300,000, with the majority (more than 200,000) handled by NGOs. Rural banks have almost 80,000 clients and cooperatives, 23,000 clients.

**Table 2: Financial Intermediaries and Client Information**

Categories of existing intermediaries or individual institution	Total number of clients	Percentage of individual clients (excluding companies, foundations, etc.)	Percentage of women	Percentage of micro enterprises/*	Percentage of clients in rural areas**/
Rural Banks (n=25)	76,825	n.a.	n.a.	n.a.	n.a.
NGOs (n=16)	217,024	n.a.	n.a.	n.a.	n.a.
Coops (n=12)	22,596	n.a.	n.a.	n.a.	n.a.
<b>Total 53</b>	316,445	n.a.	n.a.	n.a.	n.a.

Except for the NGOs, all microfinance institutions (i.e., rural banks, thrift banks and cooperatives) offer both credit services and voluntary savings services to their clients. The banks collect savings from the general public while the credit cooperatives only collect savings from their members. The NGOs, on the other hand, provide credit services to their clients. Most of the NGOs also collect compulsory savings from their clients. However, they claim that the savings they collect from their clients do not exceed the amount of the client's borrowings from the NGOs.

The state banks provide wholesale loans to microfinance retailers. Some commercial banks also provide this service to MFIs. While a number of microfinance institutions are interested in providing insurance services, there is yet not a single institution providing this service to its clients.

### **Future Initiatives**

The National Credit Council, in coordination with concerned stakeholders from both the government and the business/private sector, is currently working on the formulation of an appropriate regulatory approach and framework for microfinance to include bank and non-bank institutions. This framework will consider the unique characteristics of microfinance and review existing rules and regulations of regulatory bodies. Specifically, the regulatory framework will assess the current regulation and supervision of all microfinance intermediaries and will promote the establishment of accurate, reliable and transparent sets of financial information for all types of MFIs with the creation of a credit bureau and a risk rating agency, which will be business/private sector-led.

Other policy initiatives to be pursued include the identification of policy barriers to savings mobilization and promoting a broad-based savings mobilization, linking banking technology with microfinance technologies and the formulation of a government policy on guarantees.

With the rationalization of all the government credit programs, the greater participation of the business/private sector, and the government's continued efforts to create an enabling financial

policy environment conducive to the promotion and growth of viable, sustainable microfinance institutions and the enhancement of resource mobilization, the delivery of financial services to disadvantaged sectors will be more effective and efficient. This will lead to the realization of the role of microfinance as a cornerstone in the government's fight against poverty.

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## THE INDONESIAN CASE

### Rudjito Bank Rakyat, Indonesia

#### 1. Introduction

The term microbanking is often regarded as microfinance, therefore, in this paper the term microbanking refers to bank and other financial service institutions regulated by the government that provide deposit, credit and other financial services to low-income earners, the working poor and microentrepreneurs in rural and urban areas.

Microbanking has been regarded as a development tool particularly in promoting the rural economy and development of low-income people. Therefore the member economy government is paying much attention to strengthening the microbanking sector through establishing a regulatory framework, providing incentives and capacity building. This paper explores microbanking regulation and supervision with a special focus on Bank Rakyat Indonesia (BRI), the biggest microbanking institution in Indonesia.

#### 2. An Overview of Microbanking in Indonesia

Microbanking is a formal institution regulated under Banking Act No. 7, 1992, later revised by Act No.10, 1998, that encompasses commercial banks with microbanking windows and secondary banks (Bank Perkreditan Rakyat or BPR).<sup>65</sup> Microbanking in Indonesia is far advanced in terms of size and networks. In December 2001, the total number of microbanking networks was nearly 11,413, serving more than 40 million widely dispersed clients.

In general there are two popular forms of microbanking in Indonesia. They are the BRI-Unit system and the BPR system. The BRI-Unit is a division of BRI—a state owned commercial bank.<sup>66</sup> BRI-Units were established in the early 1970s. In 1984, BRI-Units were transformed into viable microbanking institutions by the introduction of the general rural credit product (KUPEDDES), followed by rural savings (SIMPEDES) and a time deposit. A detailed explanation of the BRI-Unit is presented in section 4.

The use of, BPR is often confusing when used to describe the BPR industry. To simplify the matters, this paper categorizes BPRs into three types: village banks (Badan Kredit Desa or BKD), rural fund and credit institutions (Lembaga Dana Kredit Pedesaan or LDKP), and old and new BPRs (BPR Gaya Lama and BPR Gaya Baru).

Village Banks (BKD) are regarded as a special type of BPR family. BKDs have a long history. They were established at the end of the nineteenth century under Dutch colonial rule in Java

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<sup>65</sup> The Banking Act recognizes two type of banks: First, commercial banks (bank umum) that have access to the central bank clearing system and offer a full range of banking products. Commercial banks encompass 27 regional banks owned by the provincial governments, 3 state owned banks, 93 private national banks, 41 foreign and joint venture bank; Second, secondary banks (Bank Perkreditan Rakyat or BPR), small size banks that have no access to the payment system although they offer a limited range of basic banking products such as deposit and lending.

<sup>66</sup> BRI was established in 1968 under National Law No. 21, 1968, its primary mission being the provision of rural and urban community banking services by mobilizing family savings and deliver credit products to micro, small and medium enterprises. At BRI's branches, the bank provides full banking services, such as loans to small and medium businesses, loans against salaries and pensions, and program loans for supporting agricultural activities and cooperatives. The branches also provide savings, current deposit and time deposit accounts. Recently, the branches and some BRI-Units in the big cities have introduced an on-line facility for savings account holders.

and Madura. In 1929, the colonial administration formally regulated BKDs in its *Staatsblad* on Village Credit Institutions and assigned the Algemeene Volkscredietbank (AVB-Bank) to supervise the institutions. During the immediate post-colonial period, the existence of BKDs was not specifically stated in the Banking Act of 1967, therefore the Ministry of Finance granted a collective business license to BKDs and regarded them as BPRs. Recently (December 2001), the number of BKDs was approximately 5,345, providing microcredit and saving products to 1.2 million clients in rural areas of Java and Madura.

Rural funds and credit institutions (LDKP) are the various regional microfinance institutions established between 1970 and 1990 by provincial administrations. Moreover the deregulation package in 1988 (PAKTO) and Banking Act No. 7, 1992, ordered the LDKP to adjust to the new rules for BPRs and seek a BPR license by October 1997. By the deadline for conversion to BPR, there were 625 LDKPs which had successfully converted to BPRs.

The old-style BPRs were established before 1988. They encompassed traders' banks (Bank Pasar). The new style BPR's were created after PAKTO in 1988. As microbanking institutions, BPRs (old and new types) offer loan and savings products, although they have no access to the central bank clearing system. Currently, the total number of BPRs (old and new style) is nearly 1,795, serving 6 million clients in both rural and urban areas.

In most cases BPRs have not performed well as the industry has suffered from a large number of losses due to unsound practices, particularly during the economic crisis. Up to December 2001 the central bank (Bank Indonesia) had closed 82 BPRs. The majority of problems are rooted in weak management, low capitalization, lack of internal control and insufficient supervision.

**Table 1: Summary of Microbanking in Indonesia**

	BRI-Unit	BPR			
		BPR-BKD	BPR Ex LDKP	Old Style	New Style
<b>Established</b>	In the early 1970s	The end of the 19 <sup>th</sup> century	Between 1970 and 1980	Before 1988	After 1988
<b>Location</b>	All Indonesia	Java and Madura	West Sumatera, Java, Bali and NTB	Mainly Java and Bali	All Indonesia
<b>Owner</b>	State	Village administration	Local government	Private, local government	Private, cooperative
<b>Legislation</b>	Banking Act	<i>Staatsblad</i> 1929, Banking Act	Presidential Decree No.71, 1992, Banking Act	Banking Act	Banking Act
<b>Regulator</b>	Bank Indonesia	Bank Indonesia	Bank Indonesia	Bank Indonesia	Bank Indonesia
<b>Supervisor</b>	Bank Indonesia	BRI for Bank Indonesia	Bank Indonesia	Bank Indonesia	Bank Indonesia
<b>No. of Units</b>	3,823	5,345	625	371	1,872
<b>Products</b>	Loans, savings and other services	Loans and savings	Loans and savings	Loans and savings	Loans and savings

### 3. The Regulatory and Supervisory Framework of Microbanking

There are many definitions of regulation and supervision since the terms are very complex. Regulation can be defined as a set of rules, while supervision refers to the activity of monitoring and enforcing the rules.

As a receiver of deposits, a microbanking institution has the biggest portion of its liabilities in deposits from third parties, while its assets mostly consist of loans. This creates a situation where the bank can invest the depositors' money in risky loans to gain as high a return as possible. Since there is asymmetric information between the depositors who place their money in the bank and the bank that will invest the money in loans, it is important to regulate and supervise the system. The basic principle for regulating and supervising microbanking is to protect the financial system from unsound practices by deposit-receiving institutions, particularly to protect small depositors. The presence of regulators and supervisors can maintain the soundness and safety of the banking system, to protect the interests of the banks, the depositors and the government.

In Indonesia, banks and public deposit-receiving companies are regulated under Banking Act No 7, 1992, revised by Banking Act No. 10, 1998. The Banking Act defines 2 groups of banks, commercial banks and secondary banks (BPR). The fundamental difference between commercial banks and secondary banks is that BPRs are excluded from the payment system since they are not allowed to offer checking (current) accounts. In detail, there are several differences that distinguish each category in terms of capital, ownership and operations.

**Table 2: Summary of Banking Regulations in Indonesia**

	<b>Commercial Banks<sup>67</sup></b>	<b>Secondary Banks (BPR)</b>
1. Minimum capital	Rp 3 trillion	Rp 2 billion if the operation covers the Capital city, Jakarta; Rp 1 billion in other provinces; Rp. 0.5 billion in other areas
2. Ownership	Not limited	Indonesian citizens only
3. Legal status	Limited liability companies (PT), cooperatives, regional government enterprises	Limited liability companies (PT), cooperatives, regional government enterprises
4. Operations	All banking services	May not provide checking accounts - no access to the clearing system, prohibited from foreign exchange transactions

Recently, Bank Indonesia imposed new regulations on BPRs in order to strengthen the capacity of the microbanking industry. These include increasing minimum capital requirements for new BPRs and ordering the existing BPRs to employ two managers (four-eyes principle) with substantial experience in banking.

The banking system's supervisory body is the central bank. Bank Indonesia, which plays a vital role by tasks licensing, regulating and supervising banks. However, these will be taken over by the bank superintendence authority at the end of 2002 as mandated in Central Bank Act No. 23, 1999.

Bank Indonesia directly supervises both commercial banks and BPRs through on-site and off-site supervision. On-site supervision is conducted periodically, i.e., once a year, or any time it is needed, or if a problem arises (special audit), while off-site supervision is based on the banks' obligation to submit periodical reports such as weekly, monthly, half-yearly and annual reports

<sup>67</sup> Including commercial banks with microbanking windows, i.e. BRI.



and any information required by Bank Indonesia. If any bank is unable to provide a report, the central bank has the right to impose sanctions on the bank. In addition, to supervise the banks, Bank Indonesia has developed a CAMEL-based statistical analysis to serve as an early warning device to reveal a variety of potential problems, including portfolio quality and liquidity, and to assess the soundness of banks. The CAMEL system consists of 7 ratios for measuring capital adequacy, quality of performing assets, profitability and liquidity, with 25 questions used to assess general and risk management.

**Table 3: The CAMEL Rating System**

	<b>Commercial Bank</b>	<b>BPR</b>
1. Capital	25%	30%
2. Assets quality	30%	30%
3. Management	25%	20%
4. Earnings	10%	10%
5. Liquidity	10%	10%

The CAMEL-based rating system is composed of and weighted as:

- C (capital), is measured by the capital adequacy ratio (CAR), with each bank obligated to achieve a minimum 8 percent to qualify as “sound”. Capital is composed of core capital and additional capital. Capital is weighted 25 percent for commercial banks, while for BPRs it is 30 percent.
- A (asset quality), is gauged using two ratios: classified assets to earning assets, and effective reserves against mandated reserves. Asset quality is weighted 30 percent both for commercial banks and BPRs. In addition, the ratio of classified assets to earnings assets is weighted 25 percent and effective reserves to mandate reserves is weighted 5 percent.
- M (management), is measured using a questionnaire to assess 10 aspects of general management and 15 aspects of risk management. The management aspect is weighted 25 percent for commercial banks while for BPRs it is only weighted 20 percent.
- E (earning), is measured by two ratios, return on assets (ROA), weighted 5 percent, and the ratio of operational cost to operational income in the last 12 months, weighted 5 percent. Earnings for commercial banks and BPRs are weighted 10 percent.
- L (liquidity), is assessed by two ratios, the loan to deposit ratio (LDR), weighted 5 percent, and the ratio of liquid assets to current liabilities (quick ratio), weighted 5 percent. Commercial banks and BPRs are weighted 10 percent for the liquidity aspect.

Each element of CAMEL is computed using a scale system from 0 to 100 then weighted according to the assigned weight. Banks that achieve 81 to 100 points are regarded as sound, 66 to 80 classified as fairly sound, 51 to 65 are categorized as less 51 points they are considered as unsound. In addition, a bank exposed to unlawful practices, such as internal conflicts, outside interference in management, or “window dressing” is automatically categorized as unsound.

#### **4. BRI Microbanking (the BRI-Unit System)**

The corner stone of microbanking in Indonesia was laid by Raden Bei Aria Wirjaatmadja—the founding father of Bank Rakyat Indonesia—when he established *De Poerwokertosche Hulp en Spaarbank der Inlandsche Hoofden* in December 1895 in Purwokerto Central Java. BRI became involved formally in microbanking in 1970, when the government of Indonesia wanted to achieve rice self-sufficiency by introducing BIMAS (Bimbingan Massal or Mass Guidance), a program to increase rice production by applying modern technology in rice cultivation. BRI

was appointed to support the program by establishing BRI-Units to channel subsidized credit to farmers involved in the *BIMAS* program.

The role of BRI-Units in channeling the credits for the *BIMAS* was as an agent of the government. The management of BRI-Units did not remotely follow sound financial institution principles since the credit disbursement was only to meet the targets, and was not profit oriented, no business incentives, and the products and services were not market oriented. In the early 1980s, despite the success of *BIMAS* in helping Indonesia achieve national rice self-sufficiency, losses on the credit program, caused by distortions in their loan extensions, made the BRI-Units unsustainable. Recognizing the failure of the *BIMAS* program, the government adopted a policy of transforming 3,600 BRI-Units from highly bureaucratized, heavily subsidized conduits for agricultural credit into self-sustaining and profitable financial intermediary units.

The transformation of BRI-Units took place within the context of overall financial sector deregulation. In June 1983, the government suspended ceilings on credits, removed controls on interest rates for both deposits and loans, and prioritized savings mobilization. These changes provided an opportunity for BRI to explore new services and products.

In the beginning of 1984, with the full support of the Ministry of Finance, the Central Bank and assisted by the Harvard Institute of International Development (HIID), BRI's management redesigned the BRI-Unit into a microbanking unit, including an operational system, products and organization that were suitable to the characteristics of the market.

- Structurally BRI-Units were separate from the branch offices, and operated as autonomous financial entities. Each BRI-Unit prepared its own financial statement and allowed management to identify clearly the financial health of the unit. Each BRI-Unit became a separate profit center and reconfigured its bookkeeping and accounting system to reflect the change.
- Staff accountability became closely associated with the performance of the BRI-Unit. Direct responsibility for loan approvals and repayment rested with unit staff, particularly credit officers.
- Branch offices supervised the BRI-Units and managed liquidity between each unit under its jurisdiction. The BRI-Units' income statements recorded transactions, such as interest paid on excess funds borrowed from the branch office and interest received on any excess liquidity.
- Internal supervision and audit capacities were also strengthened. The number of internal supervisors increased from one per six BRI-Units to one per four.
- A new lending product (KUPEDES) and savings product (SIMPEDES) were launched to meet the needs of the clients. Profit, which previously had not been a target for BRI, had now to be an important consideration for the bank in providing its services and products. Corporate culture had been changed and an incentive system was incorporated into the promotion ladders to motivate employees to perform better.

Since 1986 the BRI-Units have been a profitable and sustainable entity and they are internationally recognized as one of the leading microbanking institutions. Up to December 2001, the number of BRI-Units in the network was approximately 3,823 through Indonesia in both urban and rural areas. Since its development, BRI Units have disbursed nearly Rp 58.8 trillion (US\$5.6 billion) in KUPEDES to 28 million low-income people and microenterprises. At the end of 2001 there was about US\$949 million in KUPEDES credit outstanding to about 2.8 million borrowers. In 1997–1998, during the economic crisis, KUPEDES grew steadily, averaging 15 percent per year. Furthermore during the recovery period (1999 to 2000) lending growth increased significantly, by nearly 30 percent. On average, KUPEDES borrowers have

continued to pay back more than 97 percent of loans. The loan portfolio status (delinquency rate) has improved significantly, from nearly 5 percent in the early 1990s to less than 3 percent in 2001.

Before the transformation of the BRI-Units, total savings mobilized were Rp 26.6 billion (US\$30 million). As of December 2001, total BRI-Unit deposits amounted to Rp 21.9 trillion (US\$2.1 billion), mobilized through SIMPEDES, SIMASKOT (urban saving) and current (checking) account and time deposits. Total saving accounts numbered 27.1 million, representing almost 30 percent of the total number of savings accounts in Indonesia and serving over 12 percent of Indonesia's population.

During the BIMAS era, BRI-Units operational losses tripled from 1978-1979 and quadrupled from 1980-1984, but were covered by direct and indirect subsidies. After the transformation, BRI-Units reached the break-even point within eighteen months and have generated steadily increasing profits ever since, making the BRI-Units financially self-sustaining. The BRI-Unit profits (before tax) have risen from Rp 65 million (US\$35,000) in 1990 to Rp 1.3 billion (US\$129 million) in 2001. In addition, the financial ratio of return on assets (ROA) has increased considerably during a decade, from 3.0 percent to 5.8 percent.

**Table 4: BRI-Unit Performance 1990 2001**

	<b>1990</b>	<b>2001</b>
1. Loans outstanding	Rp 1.4 trillion (US\$750 million)	Rp 9.9 trillion (US\$949 million)
2. Number of clients	1.9 million	2.8 million
3. Loan Repayments	95.9%	97.8%
4. Deposits <sup>68</sup>	Rp 1.7 trillion (US\$919 million)	Rp 21.9 trillion (US\$2.1 billion)
5. Number of desositors	7.2 million	27.1 million
6. Profits	Rp 65 million (US\$35.269)	Rp 1.3 trillion (US\$129 million)
7. Return on Assets	3.0%	5 8%

Note: Exchange rates: December 1990: US\$ Rp 1,843; December 2001: US\$ Rp 10,400

Indeed, the success of BRI-Units is a result of BRI's commitment and the capacity of its management to combine a development finance approach with a business approach that is inherent in the BRI-Unit's system and products. In brief, there are several key factors in the success of the BRI-Unit system:

- *Simplicity.* The BRI-Unit system's, products, procedures, accounting system and supervision are designed to be very simple in order to keep the system efficient and effective.
- *Accessibility.* BRI-Units are easily accessible to poor people and microenterprises, who mostly live in remote areas.
- *Demand driven.* Loan and savings products are designed to fit the customers' needs and preferences.
- *Transparency.* In order to ensure that the simplicity concept works properly, the BRI-Unit works transparently.

<sup>68</sup> Including savings (SIMPEDES, SIMASKOT, TABANASBRI), time deposits and current deposits.

- *Cost recovery.* All costs incurred are covered by the BRI-Units' income.
- *Sustainability.* BRI-Units are profitable and self-sufficient entities, which allow the bank to achieve sustainable growth.
- *Continuous training.* BRI-Unit training programs have successfully enhanced the capacity of staff to deliver the appropriate services to the clients.
- *Supervision.* The BRI-Unit supervision system ensures that managers and officers comply with sound banking practices.

Equally importantly, BRI-Units have significantly contributed to the development of rural areas in Indonesia. Research shows that BRI-Units allow microenterprises and poor people to access financial support that is relatively rarely available in rural areas. Such support indirectly generates economic growth and, rural development, increases employment and people's incomes, as well as playing a part in enhancing microentrepreneurial skills and knowledge, particularly in the area of finance. BRI-Units have also been involved in transferring rural economic activities from the agriculture sector to other sectors, such as trade and industry, and contribute to national income through their profits and income taxes.

As a leading microbanking institution, BRI has a commitment to share its wealth of experience with other economies interested in microbanking as well as microfinance. In 1996, BRI established the International Visitor Program (BRI-IVP) under a partnership agreement between BRI and USAID. Furthermore, BRI has signed a partnership with the Consultative Groups to Assist the Poorest (CGAP), a World Bank affiliate organization, to develop the capacity building of BRI-IVP programs. At the moment, BRI-IVP provides Study Visit Programs and training programs such as Microcredit Operation, Saving Mobilization, Internal Control, Human Resource Management and Development, and On-the-Job Training at the BRI-Units. Between its inception in June 1996 to December 2001, BRI-IVP has been visited by 1,600 people from 36 economies.

## **5. BRI-Unit Regulation and Supervision**

As a window of a commercial bank, the BRI-Unit system is regulated under the Banking Act and overseen by Bank Indonesia, although there are some exceptions, i.e., in measuring the asset quality and loan reserve. As all banks are now required to move towards compliance with international standards, Bank Indonesia no longer treats the BRI-Unit system differently from other commercial banks.

Internally, there are three levels of supervision in the BRI-Unit system. At the head office, the supervision task is performed by the Microbanking Division, while at the regional level, the task is handled by the Micro-business department. At branch level, the branch manager directly oversees the BRI-Units. In this task the branch manager is assisted (depending on the number of BRI-Units in a branch), by an assistant microbanking manager (AMBM). The AMBM is responsible for visiting each BRI-Unit weekly, to review the reports submitted (on-site supervision) and to verify the reports. This responsibility may include supervising 6 to 12 BRI-Units.

Offsite supervision procedures in the BRI-Unit are well implemented through the Management Information Report (MIR) that encompasses financial performance and non-financial aspects. Regular reports must be provided by each BRI-Unit: daily, weekly, monthly, semi-annually and annually. The monthly progress report includes key performance indicators, which are tracked on a monthly basis to observe positive or negative performance trends. If a BRI-Unit's performance is poor, the AMBM visits the unit immediately and new loans may be withheld until the unit's performance improves.

**Table 5: BRI-Unit Supervision Reports**

<b>Report</b>	<b>Report Content</b>	<b>User</b>
1. Daily reports	Trial balance	Branch
2. Weekly reports	Liquidity report	Branch
3. Monthly reports	Progress report, balance sheet, income statement	Branch, Regional, and Head Offices
4. Quarterly reports	Personnel report	Branch, Regional, and Head Offices
5. Semi-annual reports	Past performance indicators for contest achievement	Branch and Regional Office
6. Annual reports	Balance sheet and income statement	Branch, Regional, and Head Offices

In order to minimize potential fraud, dual controls are applied. Specifically, one unit officer is responsible for issuing loan disbursement checks that are then signed by another officer. Staff involved in collusion or fraudulent practices are dismissed and prosecuted under the law.

From its establishment to July 2002, Bank Indonesia allowed BRI to measure the asset quality and loan reserves of BRI-Units differently. This policy was based on the characteristics of microenterprises, which are predominant in the BRI-Unit's loan portfolio. The BRI-Unit loan classification and reserve system are relatively conservative, compared with the central bank's criteria.

**Table 6: BRI-Unit Loan Classification and Reserves**

<b>Loan Category</b>	<b>BRI-Unit</b>		<b>Central Bank</b>	
	<b>Delinquency</b>	<b>Reserves</b>	<b>Delinquency</b>	<b>Reserves</b>
1. Current	On-time payment	3% x C	On time payment	1% x C
2. Special Mention	Late payment	25% x SM	< 3 months	5% x SM
3. Substandard	< 3 months	50% x SS	3-6 months	15% x SS
4. Doubtful	4-9 months	100% x D	6-9 months	50% x D
5. Loss	10-2 months	100% x L	> 9 months	100% x L

## **6. The role of BRI in Supervising Village-owned Banks**

The BKDs are owned and managed by the village administrations and supervised by BRI on behalf of the central bank. The role of BRI in supervising BKDs is based on *Staatsblad* No. 357/1929 and Banking Act No. 21, 1968. Presently, there are 5,345 BKDs, administered by the Program Credit Division in BRI's head office. The central bank bears the supervisory costs, which are calculated based on an annual budget prepared by BRI.

In addition to its regulatory oversight function, BRI provides loans to capitalize the BKDs, and sets loan interest rates, maximum loan sizes and savings interest rates. BRI is responsible for ensuring effective internal control of the BKDs. At BRI branches there are BKD supervisors (*Mantri*) to oversee 20 to 30 BKDs and they are required to conduct regular visits based on a monthly schedule. Additionally, there is a mobile bookkeeper who works with up to five BKDs.

The reporting system for BKDs is relatively simple compared to the one for BRI-Units. The BKDs produce a monthly balance sheet, income statement, portfolio report and special report

on deposits with other banks. These reports are collected by the BKD supervisor and finally reviewed by the central bank.

Undoubtedly, BRI has gained a significant benefit from this close relationship. As a borrower, a BKD pays loan interest and places the excess funds in BRI's branches. In addition, BKDs have come to function as an entry point for rural customers, thus building a relationship with BRI-Units.

## **7. Future Issues in the Microbanking Industry**

Currently, the banking industry, including the microbanking sector, is moving forward to recovery after the economic crisis of 1997–1998. In the future, there are some interesting issues that will influence microbanking development in Indonesia.

- **Growing Interest of Commercial Banks in Microbanking**

The economic crisis has changed the landscape of the banking industry in Indonesia. The banking system was in a state of collapse, with more than 70 percent of loans non-performing. The whole banking sector faced tremendous losses and failed to comply with regulations for continuing in operation. In effect, the number of banks has decreased from 222 to 164 and nearly all are under the recapitalization and restructuring program. Simultaneously, the crisis also transformed the structure of Indonesia business in. Recently, the informal sector that encompasses microenterprises and self-employed people has contributed strong figures to the growth of the economy and employment. Therefore many banks are attracted to compete in this sector. Several commercial banks, with wide networks throughout Indonesia, have established microbanking windows and expanded their coverage into sub urban areas. Some of them also cooperate with BPRs to channel loans to microenterprises and low-income people in rural areas. The significant consequence of this change is more competition in microbanking, offering more options to microentrepreneurs. In this context, the role of Bank Indonesia as a supervisory body is vital and more complex, particularly in protecting BPRs from hostile takeovers and unbalanced competition.

- **Deposit Insurance Scheme**

The banking crisis in Indonesia has provided valuable experience, proving that deposit insurance institutions are important in protecting the interests of depositors and maintaining the confidence of customers. At the moment, Indonesia does not have any deposit insurance scheme (DIS). Instead of a DIS, the government provided a blanket guarantee policy to protect depositors when several banks, including BPRs, were closed. At the same time, the government's ability to provide this guarantee is necessarily limited, therefore the existence of a DIS is strategically important in enhancing the banking industry, including microbanking. There are several interesting points to consider: first, the form of the deposit insurance institution, whether sponsored by the public or the private sector; second, whether membership is compulsory or voluntary; and third, risk coverage limits.

- **Financial Supervisory Authority**

The Central Bank Act No. 23, 1999, stipulates that the role of the central bank in licensing and supervising the banking sector will be eliminated at the end of 2002 and the supervision task will be transferred to a new financial supervisory authority (Otoritas Jasa Keuangan or OJK). However, the decision on whether commercial banks as well as commercial banks with microbanking windows and BPRs will be supervised by the same agency is still pending. The capacity of the new agency and the smooth transfer of supervisory responsibility are of the utmost importance to improving the soundness of the microbanking sector.

- **Microfinance Law**

Besides enhancing the microbanking sector, the government and Bank Indonesia are working on regulating the microfinance business, since the industry has grown that significantly in the last three years. It is proposed microfinance institutions be allowed to extend credits and collect funds from the public, but not to accept current accounts or take part in trade transactions, or foreign exchange activities. The proposal also classifies an activity as microfinance based on either deposits or capital; if the MFI has deposits of more than one trillion Rupiah, it will be required to change to a BPR and become subject to banking regulations.

## **8. Conclusion**

The experience from Indonesia, particularly BRI, points a number of important lessons regarding the microbanking sector and the supervisory framework.

- The microbanking sector in Indonesia has significantly contributed to promoting the informal sector and microenterprise development, particularly during the economic crisis. However, as a deposit-taking institution, microbanking should be regulated and supervised adequately in order to protect the depositor's interests and the whole industry.
- BRI-Unit is recognized as one of the largest and most successful microbanking institutions in the world. The key success factors of BRI in developing microbanking system are the commitment of the management and appropriate business principles such as simplicity, accessibility, demand driven, transparency, cost recovery, sustainability, continuous training and supervision.
- The BRI-Unit system is a good model for microbanking development, particularly in the building of an internal supervision framework. The role of BRI in supervising the BKDs is also an interesting casestudy in the supervising of small microbanking institutions.

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**Appendix 1: The Development of KUPEDES and SIMPEDES 1990–2001**

Year	KUPEDES		SIMPEDES	
	Outstanding (Billion Rp)	No. of Borrowers	Outstanding (Billion Rp)	No. of Accounts
1990	1,381.8	1,893,138	999.8	3,504,553
1991	1,455.7	1,837,549	1,334.1	4,459,870
1992	1,648.5	1,831,732	1,924.4	5,504,396
1993	1,957.4	1,895,965	2,697.2	6,661,408
1994	2,458.1	2,053,919	3,351.6	7,849,562
1995	3,191.2	2,263,767	3,784.6	8,899,734
1996	4,076.2	2,488,135	4,406.9	10,099,600
1997	4,685.4	2,615,679	5,338.2	11,669,502
1998	4,696.8	2,457,652	7,165.2	13,877,088
1999	5,956.5	2,473,923	9,514.8	15,790,741
2000	7,827.3	2,715,609	11,903.6	17,600,517
2001	9,873.1	2,790,192	15,801.7	24,204,794

# MICROBANKING IN CHINA

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In China, financial institutions are categorized by their ownership: such as state-owned, joint-equity and cooperative financial institutions, rather than by class of customers. Microbanking is conducted by both bank and non-bank institutions.

## **1. Brief Review on China's Financial Reform and Development**

China's banking system's development can be divided into following three stages:

### *The First Stage 1979 to 1986*

1. Four state-owned commercial banks (SOCBs) were established successively in 1979.

For a long time, China had a centrally-planned economic system, so there were no real commercial financial institutions and activities in China before 1979.

In February 1979 the Agriculture Bank of China (ABC) was reestablished as the first specialized bank in China engaging in financial business in both urban and rural areas. In March of the same year Bank of China (BOC) was separated from the People's Bank of China (PBC), as an independent economic entity under the direct control of the state council, specifically to conduct foreign exchange business. In August, the People's Construction Bank of China later called the China Construction Bank (CCB), was separated from the Ministry of Finance, to become another independent economic entity directly under the control of the state council, specifically to conduct fixed assets lending and medium- and long-term investment business.

2. The central banking system was established and commercial banking business was separated from the PBC in September 1983. In the meantime, the Industrial and Commercial Bank of China (ICBC) was established to conduct the commercial business that had been undertaken by the PBC before. Thereafter the PBC, as a central bank in China, has been endowed with special room for financial regulation and supervision.

3. In 1986, the state council promulgated the Temporary Regulation on Banking Management in China, which explicitly stipulated the fundamental function and responsibility, organizational structure and business scope of the central bank, specialized banks and other financial institutions. Thereafter the specialized banking system of China under the supervision of the central bank was formulated.

### *The Second Stage 1986 to 1998*

1. 12 joint-equity banks were set up from 1986 to 1996. These emerging small-and-medium-sized banks experienced a booming development process during this period.

In September 1986, the first joint-equity commercial bank in China, the China Communication Bank, was established with the approval of the state council. Thereafter the joint-equity banks experienced a period of continuous development, with 12 joint-equity banks being established. Now ten national joint-equity banks remain in operation, and their branches and subbranches can be found in major cities in regions with advanced economic development, while the other two have exited the market (one was closed and one was merged). By the end of 2001, the total

assets of these 10 banks reached 2,385.8 billion yuan, accounting for 14 percent of the aggregate assets of all Chinese banks. The establishment and development of the joint-equity commercial banks in China have been instrumental in promoting the competition of China's banking industry and in improving the efficiency of China's banking industry.

2. In December 1993 the state council enacted The Decision on Financial System Reform, which made clear the policy separation of financial business from commercial business and the transformation of specialized banks into real commercial banks. Based on the idea of separating policy loans from the SOCBs, three new policy banks, the China Development Bank, the Agricultural Development Bank, and the Export-Import Bank of China, were set up and began their operations in 1994.

3. This stage was also a period of financial legislation. Since 1995 four laws have been passed by the National People's Congress (NPC): the Law on the People's Bank of China, the Law on Commercial Banks; the Negotiable Instrument Law; and the Insurance Law, which also helped the formation of the system of "segregation of operation and of supervision among banking, securities, insurance and trust businesses".

### The Third Stage 1998-

Because of the impact of the Asia in crisis in 1997, China's external and internal economic environment have changed. Monetary policy changed from controlling inflation to preventing deflation, and is tasked with managing financial risk and ensuring the safety and soundness of the banking sector.

1. To enforce the segregation system of finance regulation by the independent operation between the PBC, the China Securities and Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC) must be ensured. This system is regarded as a firewall, used to block the flow of funds to over-speculative features and asset bubbles.

2. The organizational structure system of the PBC underwent significant restructuring in 1998. Thirty two provincial branches were revoked while nine new regional branches across provinces and two new operations offices were established in order to enhance the independence and effectiveness of financial supervision.

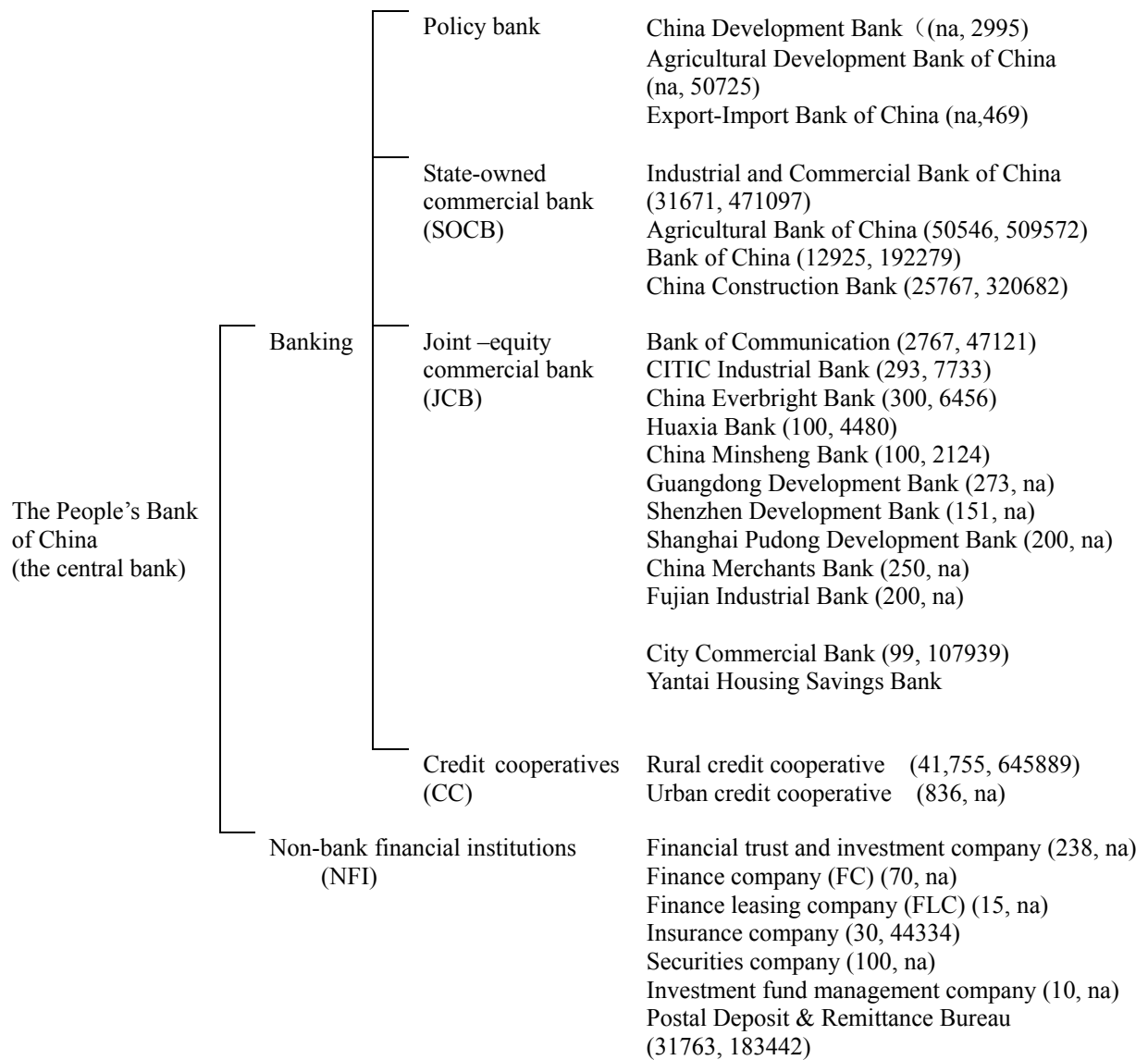
3. Special bonds totaling 270 billion yuan were issued by the Ministry of Finance of China to inject capital to four SOCBs in 1998. This helped increase the capital adequacy ratios in them and strengthened their ability to take risks.

4. China set up four asset management corporations (AMCs) in 1999. An amount of RMB1.4 trillion of bad assets were transferred from the four SOCBs to these AMCs. This enabled the NPL ratios of the SOCBs to decline and capital adequacy ratios to increase so as to ease financial risks at the micro level.

## **2. The Organization and Structure of China's Financial System**

Various types of financial institutions have been established in China, forming a financial system characterized by commercial bank domination, separation and cooperation in responsibilities and orderly competition among all financial institutions. By 31 December 2001, there were seven state-owned banks, 110 joint-equity commercial banks (including 10 national joint-equity commercial banks mentioned above), more than 100 securities companies, 30 insurance companies, 40,000 rural and urban credit cooperatives, and 190 foreign financial institutions. (See figure 1.)

**Figure 1: China's Financial System (31 December 2001)**



Note: The meaning of numbers in parentheses after each type of institution are as follows: (A, B) A = the number of institutions in this type, and B = the number of total staff working in those institutions

At the end of 2001, the total assets of financial institutions in China was 25,185 hundred million US dollars. 81 percent belong to various banking institutions, and 19 percent belong to non-banking financial institutions. China's financial structures can be seen in Table 1.

**Table 1: Balance Sheet of China's Financial Institutions (31 December 2001)**

Exchange rate: 8.2766 RMB/US\$

Units: 100 million Yuan

	All FIs	policy banks	SOCBs	JCBs	City CB	Urban CC	Rural CC	FTIC	FC	FLC	PDRB	FB
<b>Total assets</b>	<b>208443</b>	<b>17965</b>	<b>118943</b>	<b>23858</b>	<b>8817</b>	<b>1287</b>	<b>18916</b>	<b>5281</b>	<b>3512</b>	<b>213</b>	<b>5912</b>	<b>3739</b>
loans	118989	15696	69597	12244	4549	725	11971	1915	1968	125		1540
<b>Total liabilities</b>	<b>198909</b>	<b>17176</b>	<b>112886</b>	<b>22828</b>	<b>8493</b>	<b>1313</b>	<b>19203</b>	<b>4207</b>	<b>3220</b>	<b>178</b>	<b>5912</b>	<b>3492</b>
deposits	154780	553	96417	18485	6852	1071	17298	1992	2844	68	5912	554
<b>Total liabilities and equity</b>	<b>208443</b>	<b>17965</b>	<b>118943</b>	<b>23858</b>	<b>8817</b>	<b>1287</b>	<b>18916</b>	<b>5281</b>	<b>3512</b>	<b>213</b>	<b>5912</b>	<b>3739</b>
<b>Proportion of total assets</b>	<b>100.0</b>	<b>8.6</b>	<b>57.1</b>	<b>11.4</b>	<b>4.2</b>	<b>0.6</b>	<b>9.1</b>	<b>2.5</b>	<b>1.7</b>	<b>0.1</b>	<b>2.8</b>	<b>1.8</b>
<b>Proportion of total liabilities</b>	<b>100.0</b>	<b>8.6</b>	<b>56.8</b>	<b>11.5</b>	<b>4.3</b>	<b>0.7</b>	<b>9.7</b>	<b>2.1</b>	<b>1.6</b>	<b>0.1</b>	<b>3.0</b>	<b>1.8</b>

**Note:** FI—Financial institution; SOCBs State-owned commercial banks; JCBs—Joint -equity commercial bank; CCB—City commercial bank; CC—Credit cooperative; FTIC—Financial trust and investment company; FC—Finance company; FLC—Finance leasing company; PDRB—Postal Deposit & Remittance Bureau; FB—Foreign banks.

### 3. China's Microbanking Activities

In China, 64 percent of people lived in rural areas in 2000. They are the main low-income segments of the population. A survey on the income and expenditure of Chinese households shows that, in 2000, the *per capita* disposable income of urban residents was 6279.98 yuan, and the Engel's coefficient (the ratio of food expenditure to total expenditure) was 40 percent; while the *per capita* disposable income of the rural population was only 3087.80 yuan, and the Engel's coefficient was 48 percent.

China's banking sector shows an oligopoly by the four SOCBs in the urban areas, and it is still difficult for the rural low incomes segments to seek bank loans from the four SOCBs. The rural finance system, which currently is composed of three elements—commercial finance, policy finance and cooperatives finance, is developing very quickly as the market-oriented reform process advances.

Although rural credit cooperatives (RCCs) have the dominant position in rural areas, the provision of rural finance services is not limited only to RCCs. Other financial institutions such as the Agriculture Development Bank of China (ADBC), rural postal deposit institutions, the Agriculture Bank of China (ABC), etc., are also engaged in rural financial activities. The institutions mentioned above hold about 30 percent of the total financial assets in China.

What deserves special mention is that there actually is no standardized microbanking institution in China. However, in micobanking-type activities almost all banking and non-banking financial institutions are involved. There are four types of microbanking institutions that mainly or partly serve the low-income class and/or medium- and small-sized enterprises, namely, rural and urban credit cooperatives (RCCs and UCCs), city commercial banks and the Postal Deposit

& Remittance Bureau (PDRB). Their customers are mainly people on a low-income and/or medium- and small-sized enterprises. In the meantime the state-owned banks, the ABC in particular, also provide substantial financial services to rural areas.

#### 1. Rural credit cooperatives (RCCs)

RCCs whose main task is providing financial services to farmers and the agriculture sector to support economic development in rural areas first appeared in the early 1950s. Since then RCCs have been the major provider of funds and financial services to rural areas. By the end of 2001, the total assets of RCCs were 1891.622 billion yuan, accounting for 9.1 percent of the total assets of financial institutions. RCCs' lending to agriculture sector accounts for 77 percent of total lending to agriculture sector by all financial institutions.

In order to support agricultural production, RCCs actively promote small credit loans to farmer households. By the end of March 2002, the total outstanding agriculture loans of RCCs was 498.9 billion yuan, growing by 58.1 billion yuan, which is a 13.2 percent increase, compared with the level at the beginning of the year. The total outstanding loans to farmer households reached 368.4 billion yuan, an increase of 53.5 billion yuan, or say 17 percent, compared with the beginning level of the year. The PBC increased its lending to support agriculture by 26 billion yuan, aimed at supporting RCCs to give micro credit loans to farmer households in areas which suffered natural disasters in the middle and western parts of China.

By the end of March 2002, 28,992 RCCs (76.6 percent of all the RCCs in China) had begun to provide micro credit loans to farmer households. 36.3 million farmer households have this type of loan, accounting for 40.9 percent of those who need such loans.

#### 2. Urban credit cooperatives (UCCs) and city commercial banks

UCCs began to appear in late 1970s. In 1995, city urban cooperative banks (CUCBs) based on urban credit cooperatives, were established in some medium and large cities, and CUCBs were renamed as city commercial banks in 1998. The aggregate assets of these two types of financial institutions reached 1,010.4 billion yuan, accounting for 4.8 percent of total assets of all financial institutions. These institutions mainly serve urban residents and small and medium-sized enterprises.

3. The PDRB makes use of its advantage of widespread network to provide convenient financial services such as deposit and remittance to vast urban and rural areas. By the end of 2001, the outstanding deposits in PDRB nationwide reached 591.2 billion yuan, accounting for 8 percent of total deposits in China.

4. The four state-owned banks have been making great efforts in developing consumer credit business, providing financing services to urban residents for the purchase of durable goods such as homes and vehicles. According to the statistical information, by the end of 2001, the outstanding consumer credit in China had reached 699 billion yuan, a 40-fold increase compared with the level at the end of 1997. The ratio of consumer credit to total credit increased to 6 percent from less than 0.3 percent in 1997. The variety of consumer credit has also increased.

5. Since 1998 the Chinese government has carried out a series of policies regarding extending credit to assist education. This type of education consumption credit is aimed at college students from poor families, carries a low interest rate and has a convenient application process. According to preliminary statistics, total outstanding educational credit reached 2.41 billion yuan by the end of 2000.

6. As one of the measures to support rural economic reform, the ABC was rebuilt in February 1979. Its total deposits were 368 hundred million yuan and outstanding loans totaled 197 hundred million yuan at the end of 1980. Deposits and loans increased to 20,934 hundred million yuan (increasing about 57 times) and 16,349 hundred million yuan (increasing about 81 times), respectively by the end of 2001.

The ABC offered a type of poverty-reduction loan aimed at those with low-incomes. It extended a total of 21.3 billion yuan in such loans nationwide in 2000, and the outstanding loan reached 70.573 billion yuan at year-end. Moreover, 7.64 billion yuan of small poverty-reduction loans were extended to poor households in 2000. These were mainly aimed at supporting poor farmers trying to develop crop planting and/or animal farming and other various businesses based on market demand. The loans helped 3.54 million poor farmer households on the track of poverty-releasing.

7. The PBC conducted a survey on loan extensions to small and medium-sized enterprises in counties by county-level financial institutions in October of 2001. The result of the survey shows that, the lending to small and medium-sized enterprises by all financial institutions nationwide accounts for 43.6 percent of total lending. The credit demand satisfied ratio of the small and medium-sized enterprises in the counties surveyed, which is measured as the ratio between actual credit extended to the enterprises and their total of applications was 68.5 percent. The credit demand of small and medium-sized enterprises was broadly satisfied.

8. Local governments give their support to those on low-incomes in urban areas. First, banks provide small business-initiation loans with interest subsidized by the government, to unemployed urban people. Second, its re-employment funds support unemployed people who have participated in a re-employment training program to facilitate opening small community service enterprises. Third, the government can establish a guarantee fund for small loans and so support the financing needs of urban low-income earners wanting to initiate small enterprises.

9. Some international organizations such as the United Nations Development Program (UNDP) and the International Labor Organization also provide limited assistance in various forms to low-income earners in China.

#### **4. Reform, Development, Regulation and Supervision of Microbanking**

1. Since substantial changes have taken place in Chinese residents' income distribution structure—the pattern has changed from so-called “concentrating wealth in the country's hand” into one called “concentrating wealth in people's hand”. Residents, as the net depositors, hold much of China's financial resources. In the meantime, non-state owned small and medium-sized enterprises have been playing an increasingly big role in China's economic development, providing about 70 percent of total output. However, the microbanking activities that are aimed at providing financial services to residents, especially in low-income employment and small and medium-sized enterprises, is still less developed in China. Therefore China needs to develop its microbanking in order to provide convenient financial services to the residents and enterprises mentioned above.

2. Rural finance has been playing an important role in promoting agriculture production and rural economic development. However, with the increasingly market-oriented development trend in the rural economy, low-income rural residents' difficulty in getting loans is also increasing. Therefore the rural financial system has to be reformed so as to adapt to the demands of rural economic development. The contents of the reform include following: **first**, to restructure the systems of RCCs, UCCs and part of the city commercial banks based on their respective features, gradually disposing of their non-performing loans, injecting new capital and lowering the credit and operational risks; **second**, to restore the cooperative finance feature of the RCCs, making them real cooperative financial institutions whose shares are truly

voluntarily held by farmers and whose returns/profits are also jointly shared by farmers; **third**, to reform the organizational structure and to improve the corporate governance of RCCs, restructuring the RCCs and setting up rural commercial banks based on RCCs in some advanced regions, in order to separate the ownership, operating-management and supervision, and to generate a mutually restraining mechanism; and **fourth**, to re-establish the organizational framework of rural finance and make rural financial institutions into self-restrained administrative organizations. One possible method is to set up the Provincial United Association, or to use isolated regulation and independent deposit insurance.

3. The PBC continues to strongly support RCCs in order to promote economic development in rural areas. The PBC increased the re-lending credit line by 35 billion yuan in 2001 in line with the need to support the agriculture industry, taking the total re-lending credit line to RCCs to 70 billion yuan. For the purpose of supporting rural and agricultural development and promoting credit service quality of RCCs, the *Guidelines on Rural Household Micro-Credit by Rural Credit Cooperatives* was enacted 10 December, 2001.

4. China should consider developing more small financial institutions at the county level, in order to provide more financial services to low-income earners and small enterprises.

5. Continue the strict market access approval practice for financial institutions such as RCCs and UCCs.

Currently it is required that the number of shareholders of a RCC should not be lower than 500 and that of a UCC should be above 50; that the registered capital of a UCC and/or a RCC should not be lower than 1 million yuan; and at least 60 percent of the staff in UCC/RCC must have working experience of more than one year in the financial sector or have at least a middle-level finance-related educational qualification.

As to the senior management of RCCs or UCCs, it is required that he/she has more than six years' experience in financial sectors, or more than nine years' in economic sectors (including more than three years' in financial sectors).

## **5. Prospects for Microbanking**

1. Currently China is setting up a nationwide individual credit bureau system. With the establishment and improvement of such an individual credit system, I believe more low-income residents in China will be able to obtain financial services, including funding, by providing their own credit guarantee.

2. The Chinese government is establishing a financing guarantee system for small and medium-sized enterprises in order to relieve their financing difficulties.

3. It is intended to establish an agriculture insurance system and farmer households loan guarantee fund, and to study the deposit insurance system, in order to improve the credibility of RCCs and diversify the credit risk of RCCs, while they continue to play a linking role between financial sector and farmers.

4. The central and local government in China is considering putting more money in the budget to support the unemployed people who wish to start their own business.

Not too far in the future, I believe, microbanking will gain further development in China.

25 July 2002



# REFORMING THE CREDIT DEPARTMENTS OF FARMERS' ASSOCIATIONS IN CHINESE TAIPEI \*

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## 1. Introduction

At the early stage of Chinese Taipei's modern economic development, the dispersed locations of farmers' associations (FAs) attracted capital inflow from the farming areas, successfully channeling agricultural funds to cities. Moreover, generous earnings enabled FAs to undertake more business activities and to prosper. Between 1970 and 1990, the credit departments of the FAs have been growing healthily with the macro economy's expansion. From 1985 to 1994, the growth in their earnings was even more notable. Until a decade ago, these institutions had undoubtedly been an important factor behind Chinese Taipei's economic growth. However, since then, the environment has become increasingly unfavorable to the FAs operations. Along with economic prosperity, Chinese Taipei's industrial structure has become more industry- and services-based. As a result, agriculture's share of GNP has fallen from 32.22 percent in 1952 to only 1.91 percent in 2001, agricultural investment has narrowed to 0.7 percent of the gross fixed capital formation in 2000, and the agricultural employment has also shrunk by about 7.5 percent in 2001. Furthermore, with the vigorous promotion of financial liberalization and globalization, and Chinese Taipei's accession to the World Trade Organization (WTO), the agricultural sector's economic significance is expected to recede further.

In the interim, several unfavorable events have occurred that particularly affected the operation of the credit departments of the FAs. In 1987, the government amended the Banking Law to allow banks to increase types of services offered and opened the market to the entry of new banks. This move resulted in intense competition on the financial market, hence implying higher risks for businesses. Such a situation was more noticeable at the end of 1991 when 16 new banks began operations and the banking market was further segmented. The business environment for financial service providers started to deteriorate, from farmers' and fishermen's associations, and credit cooperatives, to provincially-owned banks. Their market shares plunged; return on assets (ROA) and return on equity (ROE) shrank; and their non-performing loan (NPL) ratios increased. In August 1995, Chungli City's FAs was involved in a corruption scandal, triggering a series of runs on deposits of FAs credit departments and bringing to light problematic FAs. The condition of FAs worsened further with a powerful earthquake on 21 September 1999, which caused severe damage in agricultural regions.

The 1997 Asian financial crisis forced Southeast Asian economies to rethink their financial sector. Although largely spared from the effects of the crisis, Chinese Taipei had to face financial crises and problems in finance companies that were aggravated by financial problems at various levels in the second half of 1998. The government, in February 1999, proposed a resolution to strengthen Chinese Taipei's economic health. Among the core suggestions was restructuring the financial sector. In 2000, the Financial Institution Merger Law was passed, and six financial reform laws also passed in 2001. Subsequently, financial reform took place across the board in Chinese Taipei. How such a reform will affect and restructure the credit departments of the FAs is the focus of this study.

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The rest of this paper is organized as following. In Section 2, we sketch the organization and function of Chinese Taipei's FAs. A detailed description of the agricultural finance system is provided in Section 3. In Section 4, we focus on the credit departments of the FAs, and discuss in detail their function, supervision, existing problems, and potential challenges. Following that, we discuss the reform of credit departments of FAs in Section 5. In Section 6, we explore the prospects for FAs in Chinese Taipei and conclude the paper.

## **2. The Farmers' Association in Chinese Taipei**

The FAs in Chinese Taipei are general purpose farmers' cooperatives and are multi-service. The establishment of FAs dates back to the period of Japanese colonial rule. As regional cooperative organizations, they were charged with the mission of providing services at the grassroots level. Taking advantage of their geographic and cultural familiarity with the communities they served, they were able to build up close relations with the local people. Before Chinese Taipei embarked on a course of aggressive liberalization, these agricultural community institutions enjoyed a well-defined, protected, and specialized market niche within the regulatory framework, and played a vital role in the supply of, and demand for, credit funds. Their categorization as non-profit organizations means that their operations are tax-exempt, while their status as agricultural cooperatives renders them exempt from deposit reserve requirements.

Chinese Taipei's FAs is the most prevalent farmers' organization, having the most farmers as members. The FAs history is also the longest and has the most influence on agricultural development. The original reason for establishing Chinese Taipei's FAs was that it was essentially a cooperative organization composed of the economically disadvantaged and a non-profit entity that emphasizes character as establishing credit worthiness. Thus, FAs adopted a membership system. The present federated system of the farmers' associations is a result of the amalgamation of the many farms and rural organizations that had been developed in Chinese Taipei since 1900.<sup>69</sup> The main functions include the provisions of agricultural marketing, promotion services, credit services, and insurance services.

The agricultural marketing functions of FAs can be classified into two major categories: self initiated economic services and government-entrusted economic services. The former are conducted by the FAs to serve their member-farmers with such activities as cooperative purchasing and marketing, warehousing, and processing, while the latter includes the collection and purchasing of rice and other agricultural products on behalf of the governments.

The work to promote agriculture by the FAs is mainly educational. It provides training programs to increase agricultural production and to improve living conditions in the rural areas. Generally, the promotion department works closely with the other departments of the associations.

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<sup>69</sup> The first farmers' association dates back to September 1900 when the Sanhsia Farmers' Association in Taipei County was set up. Subsequently, other farmers' associations were established all over the island, so that these associations have a history of more than a hundred years. In the early years, farmers' associations in Chinese Taipei were primarily concerned with providing technical assistance. However, in September 1941, they started to supplement this assistance with financial services, with the result that, in July 1949 when the government promulgated the Regulations Governing the Merging of Farmers' Associations and Credit Cooperatives in Taiwan Province, the farmers' associations in each township set up a credit department to handle agricultural credit. In addition, in January 1972, the government promulgated the Regulations Governing the Management of the Credit Department of Farmers' Association in the Taiwan Area, whereby these credit departments became a part of the financial system. In June 1974, the government revised the Statute Governing Farmers' Associations. From this time on, the legal status of the credit department of these farmers' associations began to be formally established.

The credit services of the farmers' associations aim to encourage farmers to deposit their money in the credit departments, and to supply farmers with loans for farming operations and daily needs.

Presently, the FAs are organized at three administrative levels: (1) 281 township FAs (in year 2001); (2) 21 county FAs, which are the federations of the township FAs at the county level; and (3) one Provincial FAs, which is organized as the federation of the county FAs at the Provincial level. The organizational or business area of an FAs coincides with the administrative boundary at the respective levels. The number of township FAs is less than the number of townships. Not all FAs have credit services, only township FAs are engaged in the credit business. County and provincial federations do not have credit facilities.

Since credit departments of FAs are scattered all over the townships and villages, the FAs thus have a very important role to play in the agricultural loan market. In line with government specialized agricultural loans, FAs directly disburse government-delegated loans, while providing some matching funds from the FAs own capital for policy-based agricultural loans the interest on which is subsidized. For example, the "Agricultural development fund loans" lists some loan categories and shows that FAs credit department account for more than half the number; among them loans for "Accelerating Farming Development Loans" make up 77 percent.

It is generally recognized that complementary relationships exist among services of FAs, because of its organizational elements and geographical distribution. Also, profits from the credit department's loan activities are used for improving cooperative marketing, supply, and sales and promotion activities. The activities of other departments also attract savings to the credit department. The close linkage among services offered by the FAs have made FA credit departments the most important financing institution in financing rural Chinese Taipei. FAs at city level have been growing remarkably with economic development and urbanization, while the role of FAs at other levels is diminishing.

### **3. The Agricultural Finance System**

Chinese Taipei's agricultural financial system can be discussed in three main areas. First there are the state-run agricultural banking systems that include the Farmers Banks of China, the Land Bank of Taiwan and Taiwan Cooperative Banks. Secondly, there are FA credit departments whose business operations are designed to fulfill a wide range of objectives and to provide comprehensive banking services. Lastly are government and state-run systems that include the Council of Agriculture (COA), the Provincial Food Bureau, the Provincial Supply Bureau, the Provincial Tobacco and the Wine Monopoly Bureau and Taiwan Sugar Corporation. The organizational structure is shown in **Figure 1**. In addition, the government set up the Agricultural Credit Guarantee Fund in 1983 to improve the operations of the current agricultural finance system. Under contracts with agricultural banks and FAs, the Agricultural Credit Guarantee Fund provides farmers with credit guarantee services.

The original structure and design of the three agricultural banks was intended to support agricultural development. The Farmers Bank of China is responsible for strategic and project-based farm and fishery loans as well as getting involved in foreign exchange business for agricultural imports and exports. The Taiwan Land Bank takes care of real estate and agricultural credit. The Taiwan Cooperative Bank is involved in adjusting supply and demand for credit funding, and financing and advising the credit cooperatives in the credit departments of farmers' and fishermen's associations.

In 1990, privatization of the three banks was targeted as part of the active promotion of financial liberalization. As a result, the Farmers Bank of China was fully privatized in 1999; and the Taiwan Cooperative Bank became a limited company in 2000, and is still in the process

of privatization. Although the Taiwan Land Bank remains a state-owned bank, plans are being drawn up for its merger with other banks to improve competitiveness. Recently, these three banks have become just like commercial banks since agricultural specialties were of no more advantage to them. Their roles in the agricultural sector have grown vague.

The credit departments of FAs are spread out in townships, forming a closely linked financial network that attracts farming capital and regulates farmers' economic needs. With specialization in villages, these credit departments are the main source of loans for production and livelihood capital in farms. As shown in **Table 1**, in 2000 44.94 percent of agricultural loans were provided by FAs. This made FAs Chinese Taipei's most important financial organizations in the agricultural finance system. Other government and state-run institutions do not play as important a role. Except for strategic agricultural loans mandated by the COA, agricultural loans provided by other state-run enterprises are relatively small.

#### **4. Function, Supervision and Problems of Credit Departments**

##### **4.1 The Function of the Credit Departments of Farmers' Associations**

The credit departments are authorized to perform services including: deposits and loans for members, and remittances; and provide an agency for agricultural banks and other government departments in the supply of farm credits. They frequently make collections, keep custody, and maintain accounts on behalf of the township treasury. The credit department is also allowed to provide short-term credit to supplies and marketing departments within the same FAs. By the end of 2001, Chinese Taipei had 260 FAs credit departments with 883 branches scattered all over the townships and villages. The assets of credit departments of FAs amounted to NT\$1,477.7 billion, deposits NT\$1,273.6 billion, and loans NT\$664.2 billion (see table 2 and table 3).

As shown in **table 4**, FAs credit departments remain the only financial services providers (apart from the postal savings system) in 31.4 percent of the 309 townships in Chinese Taipei. Although many scholars think that Chinese Taipei is over-banked, it cannot be denied that FAs credit departments have played a vital role in providing financial services in remote towns. Furthermore, they have helped to promote savings, maintain social stability in rural areas, and boost agricultural investments.

As shown in **table 5**, from a 1975 survey, 55.1 percent of farm loans were from informal financial institutions. This share decreased in subsequent years. In contrast, loans from credit departments increased to 83.4 percent in 1993, indicating the growing importance of FAs as financial institutions. As the capital provider, FAs credit departments managed to lower the high level of interest rates imposed on poor farming communities. In 1999, the share of farm loans from informal financial institutions dropped to a mere 0.83 percent. Nevertheless, the share of farm loans from FAs credit departments fell to 66.2 percent in 1999, due to intensifying competition in the financial sector.

##### **4.2 The Supervision and Management of the Credit Department**

At present, the central supervisory body of agricultural financial institutions is the Ministry of Finance. Responsibility for supervising and disciplining these institutions lies, however, with the finance departments of the county and municipal governments (see figure 2).

The financial examination of FAs credit departments is delegated to the Taiwan Cooperative Bank, according to the 1970 ruling of Article 38 of the Central Bank of China Act. Since the FAs is a shareholder of the Taiwan Cooperative Bank, the examination has been much criticized. When the Central Deposit Insurance Corporation (CDIC) was established in September 1985, the government drafted the Program for the Division of Duties in Bank Examination among the

Competent Authorities in April 1986. This allowed the newly established CDIC to examine the operations of insured credit departments of FAs. Examinations were divided between the CDIC and the Taiwan Cooperative Bank. However, beginning in July 1996, in accordance with the government's New Plan Governing the Reform of Financial Supervision and Regulation, all community financial institutions that had formerly been examined by the Taiwan Cooperative Bank were now to be examined by the CDIC.

The financial supervision of FAs credit departments is entrusted to the CDIC, that applies the US-based CAMELS system to evaluate the credit risk standard and establish an early warning system. This gives the government an effective tool for supervising and managing financial institutions. In July 1999, participation in deposit insurance became compulsory, and the credit departments of FAs became part of the deposit insurance system.

### **4.3 Problems of Credit Departments of Farmers' Associations**

Even through FAs made great contributions to the agricultural industry, farm villages, and farmers, changes in the economy and financial environment have caused an extremely difficult bottleneck to the development of the FAs credit departments. This study will discuss the problem from three perspectives: organization, macro environment, and business.

#### **4.3.1 Organizational Aspect**

The FAs' development and its related services stand out as an excellent example of a cooperative organizational business structure. Since Chinese Taipei lawmakers considered FAs to be a farmers' union, the Farmers' Association Law was amended to replace the paid-in capital system with working capital in 1974. This law not only did away with the cooperative nature of FAs but also changed FAs ownership to a collective (or non-individual) type. Previously, members were the shareholders and liability bearers of FAs. Now, the ownership and accountability have become vague.<sup>70</sup> The move eroded the effectiveness of FAs credit departments, and depressed their earnings and growth.<sup>71</sup>

#### **4.3.2 Macro Environment**

##### **A. Challenges to FAs from joining the WTO**

Being a member of the WTO, Chinese Taipei will accelerate agricultural restructuring towards capital and technology-intensive agricultural production or recreational farms. Structural changes are expected to affect agricultural capital needs. In addition, reclassification of farm lands or emphasis on non-farm industries will dampen growth since capital will be diverted to areas other than towns or villages. This may also lead to a loss of control of supply and demand for capital.

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<sup>70</sup> Doing away with the paid-in capital system made it into a collective, non-individual system that resulted in rent-seeking and inadequacy of the supervisory system.

<sup>71</sup> The credit departments could not increase their capital and had to rely on small increments of retained earnings to strengthen its financial structure.

## B. Increasing Competition

Since the late 1980s, Chinese Taipei has vigorously pushed forward with financial liberalization. Restrictions on bank activities, the establishment of new banks and foreign banks, and branch expansion have all been substantially eased. In 1991 alone, 16 new banks entered the market, greatly intensifying market competition in the financial sector. While commercial banks are now allowed to conduct more types of financial business, credit departments of FAs are still restricted to basic services related to savings and loans. As they have gradually lost their monopolistic position in serving the agricultural market, and as interest rate spreads have narrowed due to increasing competition, their earning position has deteriorated quite severely. In 1991, commercial banks had a 24.1 percent share of branch numbers, FAs credit departments had 24.7 percent. But by 2001, commercial banks' share reached 47.0 percent while FAs credit departments dropped to 18.6 percent. As shown in figure 3 and table 6, the growth rate of assets, deposits and loans has declined; and as the returns on assets and equity also shrank, the outlook for the performance of FAs credit departments is widely considered to be pessimistic.

### 4.3.3 Businesses and Management

#### A. Principle Agency Problems

Since the business policymaker seeks the growth of business or an increase to his advantage, he usually looks for high-risk, high-return investments. Failure, however, or mismatched prediction of macro-economic trends implies big losses. Another significant problem is that local interest factions have often interfered in the operations of the FAs. As a result, business policymaking has frequently been based on non-economic factors. For example, many problematic FAs credit departments, in seeking high returns, have resorted to accepting collateral from outside their district, failing to assure collateral quality resulting in the poor loan quality.<sup>72</sup>

#### B. Internal Structural Problems

With FAs credit departments business activities restricted to local districts, and limited to savings and loans, the credit departments have far less operational flexibility than other financial institutions. Moreover, because of their low capital adequacy ratios, their risk-bearing capability is poor.

Within credit departments, management has generally failed to keep abreast of modernization and new trends, and has fallen progressively behind in standards of efficiency and governance. The high concentration of decision-making power in the hands of the general manager, and the failure of internal controls and the audit system, has allowed corrupt practices to take root. At the same time, the small scale of these community agencies has made it difficult for them to develop professional expertise in their staff.

## 5. The Reform of Farmers' Associations

Between 1995 and 2000, more than 30 FAs credit departments were hit by runs on deposits. Meanwhile, as NPL ratios climbed persistently year by year, a systemic crisis seemed to be approaching. Aside from internal reforms, government intervention in external reform has been helpful. The main reforms are: strictly terminating the operation of the worst performing FA credit departments; and encouraging the others to consolidate and reorganize into regional agricultural banks.

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<sup>72</sup> The most common problem of credit departments of FAs is accepting as collateral, land outside one's area and the associate member using the loan for non-productive use or as opportunistic investment to artificially shore up land prices instead of being used for agricultural production.

## **5.1 Structural reform**

Structural reform can be done in the following manner:

### **5.1.1 Special Project**

According to the rules governing the operation of the FAs' credit departments, small committees can be formed at county level to give regular guidance to poorly performing FAs credit departments. Members of these committees are, aside from the county government and FAs members, drawn from the CDIC and Taiwan Cooperative Bank's supervisory managers.

### **5.1.2 Restructuring**

Based on Farmers' Associations Law, the supervisory authorities shall appoint between five and nine members to organize the restructuring committee to exercise powers on behalf of member representatives, directors and supervisors during the restructuring period.

### **5.1.3 Mergers**

The government had a hand in dealing with runs on deposits of Chungli City FAs (1996) and of Yen-Pu FAs (1997). The central bank was asked to finance the merger of Taiwan Provincial FA with Chungli City FAs, and that of Pingtung FAs with Yen-Pu FAs. Although this seems to have temporarily solved the problem, Taiwan Provincial FA and Pingtung FAs still do not have credit departments and have no expertise in that area. In addition, they do not have enough personnel in finance. Consequently, the harm has become more severe.

## **5.2 Retreat from the Market**

Since 1995, the worsening situation of FAs credit departments has forced their governing bodies to initiate internal reforms. However, results are quite limited and the situation has grown worse. Thus, in 2000, the Financial Institution Merger Law was enacted to effectively solve problematic financial institutions by reorganizing them into banks. In other words, the credit departments of farmers' and fishermen's associations must merge with banks if they are unable to pay off debts or have negative net worth.

In 2001, the Financial Restructuring Fund (quasi-RTC mechanism), a resolution trust fund, was established with funding from a business tax on the financial sector and the incremental premiums paid to the semi-official CDIC. With a 'war chest' of about US\$4 billion, the fund is designed to run for three years. It targets problematic financial institutions, primarily at the community level, which are unable to pay debts or have financial problems so severe it is inappropriate for them to continue in operation. In the clean up's initial sweep, 7 credit cooperatives, 27 FAs credit departments and 2 Fishermen's Associations credit departments ceased operation and were placed under government control in preparation for takeover by large commercial banks.

To prevent runs on deposits that might threaten the whole system whenever the above measures are taken, the government has amended the Deposit Insurance Act. The amendment guarantees that both deposit and non-deposit debts will be paid in full, and not be subject to the maximum amount payable limit. The only restriction is that the administrative cost of paying back debts should be less than the cash repayment. Moreover, the Financial Institution Merger Law allows the formation of asset management companies (AMC) to handle bad debts. In May 2001, the Taiwan Asset Management Company (TAMCO) and the Taiwan Financial Asset Service Company (TFASC) were created to speed up processing of bad assets in the financial system, improve liquidity, and lower the overdrawn amount, thus improving the overall asset quality of the financial system.

For FAs without credit departments and having undergone restructuring, the government first makes sure that employees' annuity accounts are cleared, and then delegates the Ministry of Finance to coordinate with the merging bank and keep at least 30 percent of employee. Those who are not employed will be taken care of by the COA, including guidance and assistance of training and employment. The COA will take care of the promotion of services other than that provided by the credit departments through projects and of payment of salaries and provision for administrative needs. Each FA will present a stabilization proposal to the COA. The FAs will face the pain of restructuring.

### **5.3 Reorganization into Agricultural Banks**

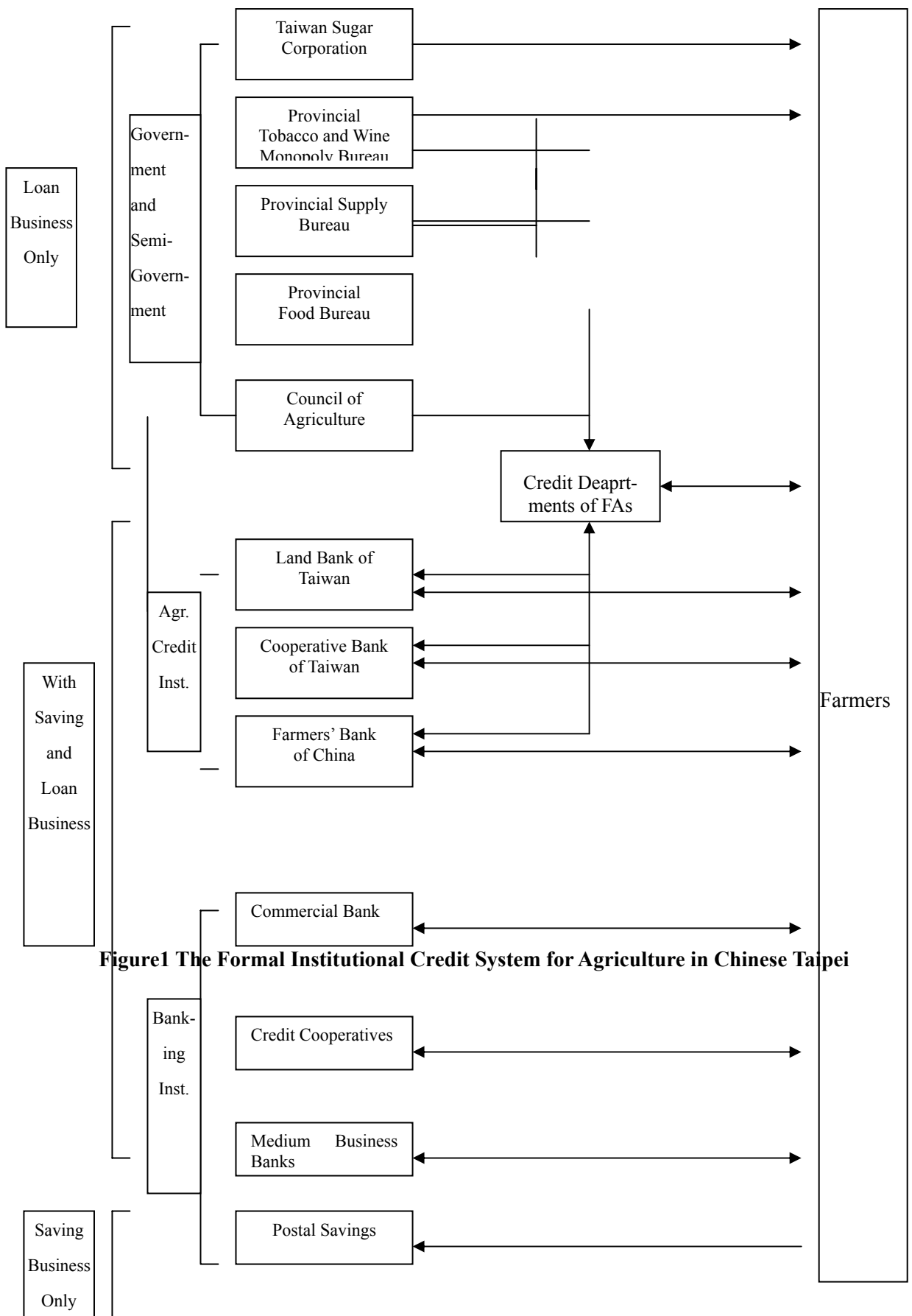
In 2000, legislation was passed to pave the way for FAs credit departments to restructure into regional or national banks, either individually or collectively. Some FAs may become nationwide agricultural banks, while the government favors multi-dimensional policies, including investment in the wider banking sector by credit departments, and their merging with commercial banks. These policies are presently being promoted.

## **6. Prospects for the Credit Departments of Farmer Associations**

The FAs' credit departments have played an active role in serving the financial needs of farm communities in the course of Chinese Taipei's economic development. However, the FAs business environment has evolved from a closed system into an open one. Services that were once monopolistic have become more competitive. FAs competitiveness has declined in recent years due to internal management problems and fierce competition from commercial banks. Non-performing loans increased threats of a systemic crisis. Reform has become painful yet necessary for the FAs' credit departments. Several conclusions, drawn from the reform process of the reform are listed as follows:

1. So far, exit mechanisms for problematic institutions have been setup and laws relevant to financial reform have been more or less put in place. Thanks to prior guarantees by CDIC to pay deposits in full, and the financial restructuring fund, the poor-quality assets were liquidated and the government was able to coordinate the assumption of assets and liabilities of 27 FAs by participating banks. Although the absorption process has encountered some opposition, solving this Herculean problem has not caused any widespread runs on deposits and has led to the successful exit of credit departments with negative net worth.
2. Although quasi-RTC and AMC mechanisms have been established, the next issue to be addressed are: the prevention of moral hazard; smooth clearance of non-performing loans; and further reform of FAs.
3. It is anticipated that implementation of the internal restructuring and unitary reform policy will meet many difficulties. In contrast, diverse reform policies, including reorganization of the FAs' credit departments into agricultural banks, mergers between FAs for greater economies of scale, and mergers with commercial banks, are good options. Nevertheless, the restructuring process will continue to present great challenges.
4. In any case, once the market exit mechanism is in place, the most important issue is to promote the sound development of FAs' credit departments. A number of issues need to be addressed: capital adequacy for strengthening financial structure, modern management, and internal control. The authorities should effectively strengthen the supervision and regulatory system, and problematic FAs credit departments should be dealt with properly and in a timely fashion.





**Figure1 The Formal Institutional Credit System for Agriculture in Chinese Taipei**

**Table 1: Outstanding Balance of Agricultural Loans in Chinese Taipei by Lending Agencies**

Unit: NT\$ Million

Year	Farmers Bank of China	Land Bank of Taiwan	Cooperative Bank of Taiwan	Subtotal	Credit Dept. of FAs	Banking Agencies	Government and Semi-Government	Total	Total Loans in Financial Institutions
1970	2,219	5,395	4,532	12,146 (71.34%)	1,401 (8.23%)	632 (0.75%)	2,846 (16.72%)	17,025 (100%)	84,145 (20.23%)
1975	11,573	6,332	12,586	30,491 (69.95%)	8,383 (19.23%)	1,683 (0.49%)	3,030 (6.95%)	43,587 (100%)	341,478 (12.76%)
1980	19,751	16,713	19,480	55,944 (55.63%)	38,207 (38.00%)	3,637 (0.36%)	2,768 (2.75%)	100,556 (100%)	1,022,756 (9.83%)
1985	36,773	41,693	54,908	133,374 (60.05%)	80,119 (36.07%)	6,325 (0.34%)	2,281 (1.03%)	222,099 (100%)	1,839,602 (12.07%)
1990	97,099	51,539	97,003	245,641 (55.85%)	173,354 (39.42%)	9,402 (0.19%)	11,401 (2.59%)	439,798 (100%)	4,985,586 (8.82%)
1995	177,905	95,017	163,506	436,428 (48.56%)	445,740 (49.60%)	6,769 (0.06%)	9,801 (1.09%)	898,738 (100%)	11,423,717 (7.87%)
1996	185,123	103,229	165,850	454,202 (50.47%)	424,806 (47.20%)	7,955 (0.07%)	12,996 (1.44%)	899,959 (100%)	11,867,307 (7.58%)
1997	203,856	108,870	175,609	488,335 (53.81%)	402,353 (44.33%)	7,554 (0.06%)	9,322 (1.03%)	907,564 (100%)	13,341,573 (6.80%)
1998	206,626	107,860	164,056	478,542 (52.78%)	413,098 (45.57%)	6,933 (0.05%)	8,026 (0.89%)	906,599 (100%)	14,078,509 (6.44%)
1999	201,851	107,764	160,206	469,821 (53.21%)	400,593 (45.37%)	5,020 (0.03%)	7,518 (0.85%)	882,952 (100%)	14,708,798 (6.00%)
2000	181,603	108,216	165,266	455,085 (53.68%)	380,985 (44.94%)	4,657 (0.03%)	7,009 (0.83%)	847,736 (100%)	15,444,133 (5.49%)

Source: Farmers Bank of China, Information of Farmers Bank of China, Unpublished Statistics.

**Table 2: Number of Financial Institutions**

unit: number

End of Period	Head office								Branches							
	Domestic Banks	Local Branches of Foreign Banks	Community Financial Institutions					Trust and Investment Companies	Bills Finance Companies	Domestic Banks	Local Branches of Foreign Banks	Community Financial Institutions			Trust and Investment Companies	Bills Finance Companies
			Credit Cooperatives	Credit Departments of Farmer's Associations	Credit Departments of Fishermen's Associations	Credit Cooperatives	Credit Departments of Farmer's Associations					Credit Departments of Fishermen's Associations				
1989	24	33	381	74	285	22	8	3	953	38	1,043	358	665	20	44	17
1990	24	35	383	74	285	24	8	3	996	43	1,143	399	713	31	46	17
1991	25	36	385	74	285	26	8	3	1,046	47	1,210	425	754	31	62	20
1992	40	36	386	74	285	27	7	3	1,212	50	1,242	439	770	33	54	21
1993	41	37	386	74	285	27	7	3	1,382	55	1,304	482	788	34	60	21
1994	42	37	386	74	285	27	6	3	1,577	57	1,395	530	827	38	53	22
1995	42	38	385	73	285	27	5	10	1,807	58	1,486	556	886	44	49	29
1996	42	41	385	73	285	27	5	12	1,936	65	1,567	595	925	47	55	31
1997	47	46	378	64	287	27	5	14	2,176	69	1,496	505	943	48	61	34
1998	48	46	368	54	287	27	4	16	2,404	72	1,453	446	958	49	43	39
1999	52	41	364	50	287	27	3	16	2,576	71	1,436	416	971	49	36	46
2000	53	39	362	48	287	27	3	16	2,693	70	1,416	394	973	49	36	52
2001	53	38	324	39	260	25	3	15	3,005	69	1,300	373	883	44	33	48

Note: Refers to the number of institutions which formally open for business.

**Table 3: Assets, Net Worth, Deposits and Loans Outstanding of Credit Department of FAs**

Unit: NT\$ Million

<b>Year</b>	<b>Assets</b>	<b>Net Worth</b>	<b>Deposit</b>	<b>Loan</b>
1970	8,945	966	5,139	4,427
1975	27,914	2,245	18,844	13,739
1980	91,973	4,934	70,003	53,435
1985	303,912	11,557	253,688	135,538
1990	632,079	24,858	552,427	335,398
1991	781,025	29,516	692,657	385,343
1992	955,994	35,761	841,533	538,734
1993	1,137,052	43,851	996,588	688,483
1994	1,312,247	51,977	1,147,767	802,015
1995	1,357,202	58,167	1,228,691	882,479
1996	1,368,987	64,146	1,247,140	843,729
1997	1,494,928	69,531	1,270,728	822,260
1998	1,538,405	72,816	1,315,043	802,002
1999	1,610,061	73,069	1,380,802	775,891
2000	1,586,400	709,00	1,355,725	753,151
2001	1,477,700	792,00	1,273,612	664,159

*Source: Taiwan Cooperative Bank, Analysis on Credit Business of the Town/Township Farmers' Association in Taiwan.*

**Table 4: Distributions of Financial Institutions in 16 County**

County	Townships (A)	Townships Having Only Credit Departments (B)	Townships Having No Financial Institutions (C)	(B)/(A)	(C)/(A)
TAIPEI HSIEN	29	7	0	24.1%	0.0%
YILAN HSIEN	12	6	1	50.0%	8.3%
TAOYUAN HSIEN	13	1	0	7.7%	0.0%
HSINGHU HSIEN	13	7	0	53.8%	0.0%
MIAOLI HSIEN	18	7	0	38.9%	0.0%
TAICHUNG HSEN	21	4	0	19.0%	0.0%
CHANGHWA HSEN	26	5	0	19.2%	0.0%
NANTOU HSIEN	13	7	0	53.8%	0.0%
YUNLIN HSIEN	20	9	0	45.0%	0.0%
CHIAYI HSIEN	18	8	0	44.4%	0.0%
TAINAN HSIEN	31	11	0	35.5%	0.0%
KAOHSIONG HSEN	27	6	1	22.2%	3.7%
PINGTUNG HSEN	33	7	8	21.2%	24.2%
TAITUNG HSIEN	16	5	3	31.3%	18.8%
HUALIEN HSIEN	13	3	2	23.1%	15.4%
PENGHUH SIEN	6	1	0	16.7%	0.0%
Total / Average Rate	309	94	15	30.4%	4.9%

Source: The Central Bank of China, List of Financial Institutions (2001/05/31).

**Table 5: Percentage Distribution of Farm Loan by Various Institutions**

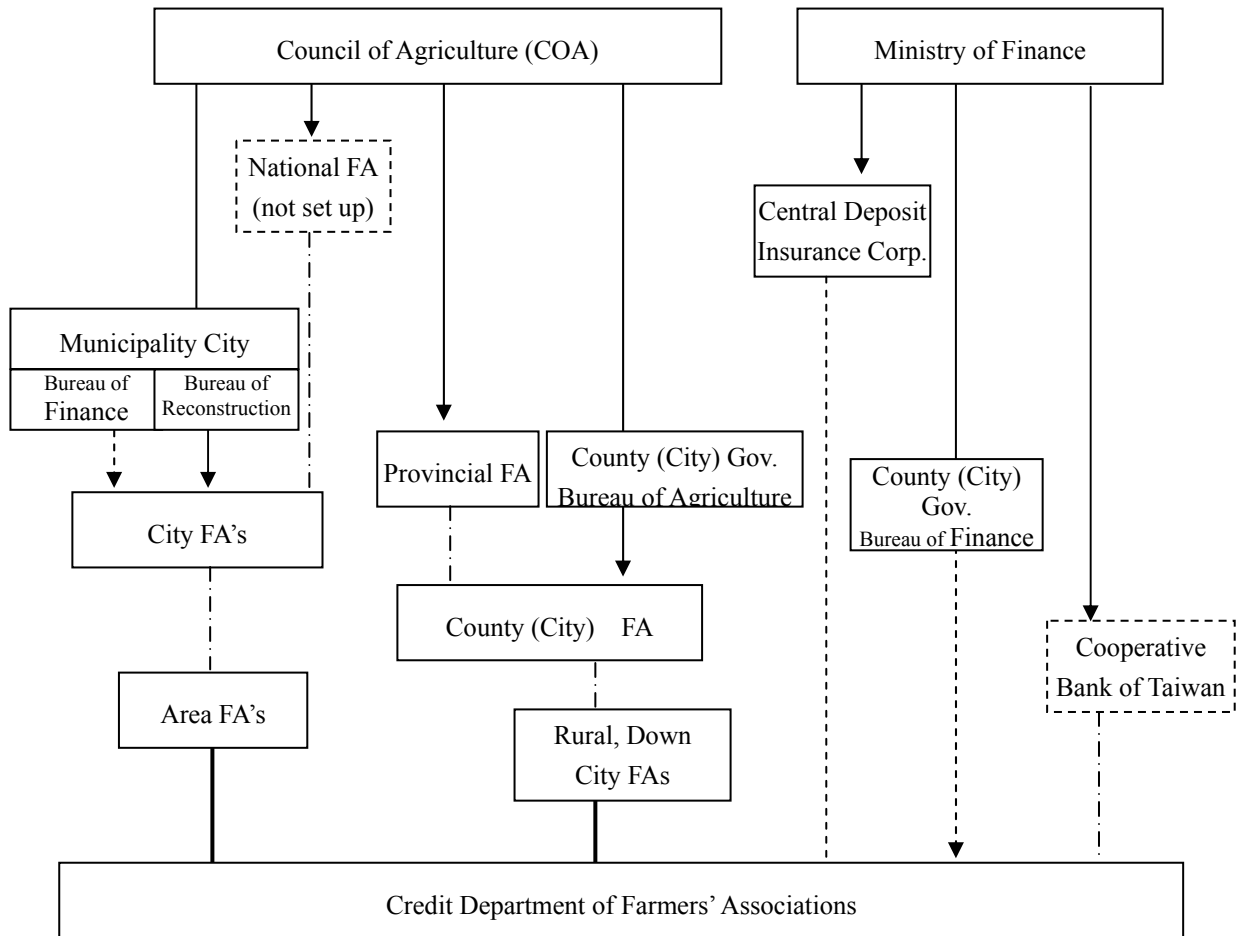
Institutions	1975	1985	1989	1991	1993	1995	1999
<b>Credit Departments of FAs</b>	<b>33.5%</b>	<b>65.3%</b>	<b>72.7%</b>	<b>70.4%</b>	<b>83.36%</b>	<b>81.13%</b>	<b>66.24%</b>
<b>Agricultural Banks</b>	<b>8.3%</b>	<b>18.7%</b>	<b>17.2%</b>	<b>9.6%</b>	<b>6.4%</b>	<b>12.01%</b>	<b>4.01%</b>
<b>Semi-Government and other Banks</b>	<b>3.1%</b>	<b>4.7%</b>	<b>8.3%</b>	<b>8.35%</b>	<b>8.05%</b>	<b>3.94%</b>	<b>28.93%</b>
<b>Informal Financial Institutions</b>	<b>55.1%</b>	<b>11.3%</b>	<b>1.8%</b>	<b>11.7%</b>	<b>2.19%</b>	<b>2.92%</b>	<b>0.83%</b>
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: *Surveys on Farm Loan Opinions Regarding Farm Loan*

Notes: 1. Semi-Government refers to the Taiwan Sugar Corporation, Provincial Tobacco and Wine Monopoly Bureau.

2. Agricultural Banks include the Farmers Bank of China, the Land Bank of Taiwan and the Cooperative Bank of Taiwan.

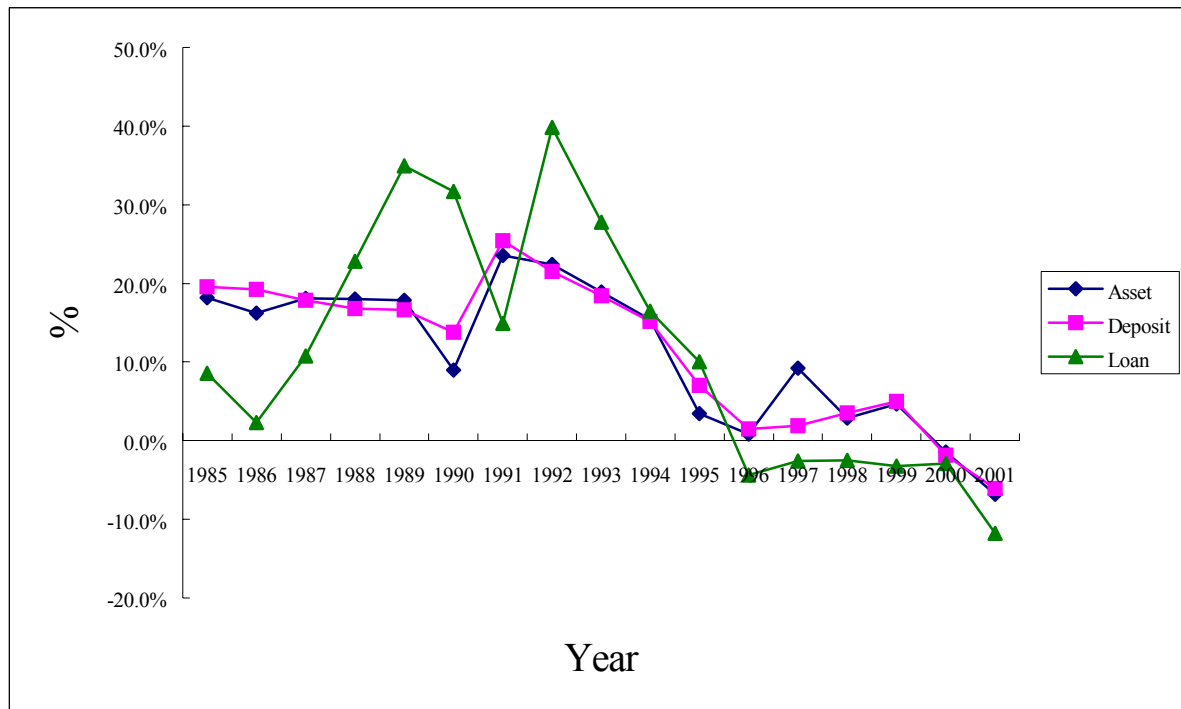
**Figure 2: The Supervisory System of Farmers' Associations' Credit Department**



Footnote:

- |    |                          |         |                                       |
|----|--------------------------|---------|---------------------------------------|
| —  | Subordinating            | ----->  | Target Business Competent Authorities |
| —> | Competent Authorities    | -.-.-.- | Business Counseling                   |
| —  | System of Administration | -----   | Financial Examination                 |

**Figure 3: The Growth Rate of Assets, Deposits and Loans of FAs Credit Department**



**Table 6: The Performance Ratio of FAs Credit Departments**

Unit: percent

Year	Net Worth / Deposit	Loans / Deposits	ROA	ROE
1990	4.3%	56.68	1.0%	26.5%
1991	4.1%	51.69	0.9%	25.7%
1992	4.1%	59.89	0.9%	24.5%
1993	4.2%	64.73	0.8%	23.3%
1994	4.3%	65.46	0.8%	22.6%
1995	4.7%	70.27	0.7%	16.7%
1996	5.1%	65.99	0.8%	16.9%
1997	5.5%	62.76	0.6%	13.2%
1998	5.5%	58.99	0.4%	9.5%
1999	5.4%	54.24	0.2%	5.2%
2000	5.2%	52.80	0.1%	1.3%
2001	6.2%	52.80	0.01%	0.2%

Note: ROA means Return on Assets; ROE means Return on Equity.

Source: Taiwan Cooperative Bank, *Analysis on Credit Business of the Township Farmers' Association in Taiwan*.

## MICROCREDIT/MICROBANKING FOR ECONOMIC DEVELOPMENT: THAILAND'S EXPERIENCE

**Krisda Udyanin**  
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The first type of microbanking intermediary in Thailand was a cooperative founded in 1916. However, since then microbanking institutions (MBIs) have developed to include specialized financial institutions, public and private institutions, and government agencies.

**Table 1: Total Assets of the Overall Microbanking System in Thailand:**

Categories of existing intermediaries	Institutions	Total Assets (US\$ Million)	Total Credit (US\$ Million)
Specialized Financial Institutions (SFI)	Bank of Agriculture and Agricultural Cooperatives (BAAC)	7,021.14	6,077.28
	Government Savings Bank (GSB): "People's Bank Program"	10,852.86	3,380.34
Cooperatives	Cooperatives	10,674.60	7,630.07
	Credit Unions	133.45	93.18
Public Institutions	Community Organization Development Institution (CODI)	38.50	12.15
Government Agencies	Community Development Department (CCD) Poverty Reduction Program	186.05	186.05
	Saving groups for Production	153.14	71.81
	Office of the National Village and Urban Community Fund	1,502.20	928.64
Private Institutions	Saving Societies	2.18	N.A.
<b>TOTAL</b>		<b>29,193.28</b>	<b>17,441.24</b>

Note: Approximate exchange rate 43.08 baht/US\$ (July 2002)

The recent world economic slowdown resulted in a sharp decline of external demand. This has become a significant obstacle for economic growth in Thailand, given the slowdown in export value and malfunction of the regular credit system.

Policies are mainly aimed at stimulating domestic demand and emphasizing grassroot level. In this regard, the two major microbanking programs launched in 2001 were the People's Bank Program and the National Village and Urban Community Fund.

### **The People's Bank Program**

This program targets retail customers and small credit entrepreneurs that are unable to get access to services in commercial banks. The services provided are a) savings, b) credit and c) training and development. Credit is provided as follows:

- first loan: up to a maximum of 30,000 baht (approx. US\$682) for the and
- second loan: 50,000 baht (approx. US\$1,136). If the loan exceeds the limit of 50,000 bath, then a collateral is required)

A flat interest rate is charged, equal to 1 percent a month, with monthly loan repayments (no more than 25 months with a one month grace period).

**Table 2: Members Region of Thailand**

Central Region	40%
Northern Region	18%
Northeaster Region	29%
Southern Region	13%

### **The National Village and Urban Community Fund**

This fund, established in 2001, provides funding of approximately one million baht (US\$22,730) for each of the 74,000 villages and poor inner-city communities, and seeks to ameliorate occupation development, employment creation and income generation.

Through this program the government channels 1 million baht through the National Village and Urban Community Fund Committee to the Village and Urban Community Funds Committees (composed of 15 to 19 persons each), which in turn distribute amounts ranging from 20,000 to 50,000 baht to members of villages and urban communities.

**Table 3: Trade Balance and Domestic Consumption (% of GDP)**

<b>Year</b>	<b>Trade Balance</b>	<b>Domestic Consumption</b>
1997	1.42	64.74
1998	15.89	65.21
1999	12.59	67.46
2000	8.71	67.54
2001	6.06	68.57

*Source: NESDB*



**Table 4: Unemployment Rate of Thailand vs. Region (%)**

<b>Year</b>	<b>Thailand</b>	<b>Region</b>
1996	1.10	3.70
1997	0.90	3.92
1998	4.36	5.50
1999	4.18	5.82
2000	3.60	5.29
2001	3.36	5.12

*Source: Bank of Thailand, ARIC*

**Table 5: Thailand's Annual GDP Growth (%)**

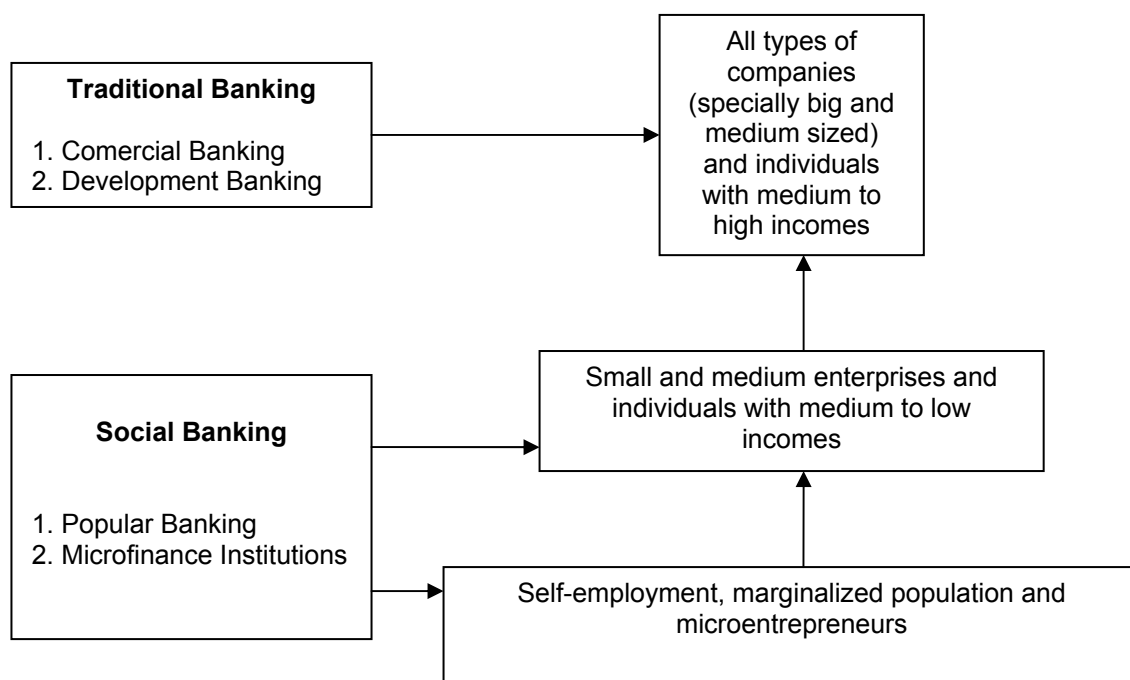
<b>Year</b>	<b>Rate</b>
1991	8.60
1992	8.10
1993	8.40
1994	9.00
1995	8.90
1996	5.90
1997	-1.80
1998	-10.40
1999	4.20
2000	4.40
2001	1.80
2002	3.60

*Source: Bank of Thailand*

## THE CASE OF MEXICO

**Julio César López Marín**  
**Consejo Mexicano de Ahorro y Crédito Popular**

In Mexico, financial services are offered by a wide array of intermediaries. Characteristics, ways of financing and market niches differ among them but they can all be divided in the following manner:



In the medium and long term, social banking will increase its scale of operations reaching commercial banks, and thus creating greater competition and increasing financial system deepening.

Social banking is conformed by popular banking and microfinance institutions. The former includes financial entities, such as cooperatives, that receive savings and award loans. The Mexican Ministry of Finance promotes the strengthening of these institutions through the Popular Credit and Savings Law and The Bank of National Savings and Financial Services (BANSEFI) acts as a coordinator and promoter of the sector. Microfinance institutions, on the other hand, are entities that serve the marginalized population (those in poverty and extreme poverty) and do not receive savings. The Mexican Ministry of Economy coordinates these institutions through the National Program for Entrepreneurs Financing (PRONAFIM).

Both popular banking and microfinance institutions have an increasing importance, since, although the resources they hold represent only 0.5 percent of commercial banking deposits, they serve close to 2.6 million people. Potential demand is estimated to be more than 20 million users. The Mexican Council of Popular Savings and Credit (Compacrep) promotes and integrates popular banking.

## Popular Banking

In Europe, the cooperative movement began in Rochdale, England in 1844. In 1850, Schulse-Delitzsch established the first popular banks in Germany and four years later Raiffeisen created the rural credit cooperatives. In 1900, Desjardins established the *caisses populaires* in Canada and a few years later, credit unions emerged in the United States.

In Mexico, the *cajas populares* have been the entity with the greater presence, precedence and experience in this sector.

They began in the pre-hispanic period with the establishment of Orizaba's credit cooperative in 1639. In 1879 the Mexican *Caja Popular* was created; in 1910, the rural savings and loans cooperatives; in 1951, *cajas populares*; in 1991 *cajas populares* legislation was enacted; and in 2001 the Popular Credit and Savings Law was enacted. By 2002, the *cajas populares* had been in existence for more than 50 years.

From 1951 to 1991, the popular banking sector worked based on self-regulatory and supervisory schemes and through their own integration organisms, without any government participation. In 1991, the first regulatory and supervisory experience for the popular credit and savings sector took place in Mexico when the legal entity of the Savings and Loans Society emerged. However, various mistakes were made by not taking into consideration the experience of the cooperative movement and not acknowledging the integration structures of the federations and the confederation.

In 1994 the legal existence of Savings and Loans Cooperatives was formally recognized, although the regulatory schemes were weak. In 2001, new legal, regulatory and supervisory conditions were established for the popular financial sector, which became fully incorporated to the national financial system. In June 2001, the Popular Savings and Credit Law was enacted.

Currently, there are different and various expressions of popular savings and credit entities in Mexico, such as credit unions, savings and loans societies, limited object societies, savings and loans cooperatives, civil associations, private assistance institutions, and non-governmental organizations.

The new Popular Savings and Credit Law only considers two legal forms: popular financial societies which are anonymous entities and savings and loan cooperatives.

**Table 1: General Statistical Data for the Sector**

Total assets	20,000 million
Deposits	15,000 million
Credit portfolio	12,000 million
Members and users	2.5 million
Entities	600
Offices	1,200

Popular savings and credit entities have developed a wide experience and methodologies to serve the popular sector, through receiving and allocating resources. The characteristics include linkages between savings and credit; promotion of a savings culture; combating usury; education, formation and personal training.

The process of transition to the new legislation entails the support of the Comacrep to most of the popular financial sector.

## Comacrep

Comacrep is a national body established with the aim of developing popular finances through the creation of operation nets and the promotion of favorable public policies. The Comacrep project began by in mid 2000 in parallel with the discussion on enacting the Popular Savings and Credit Law, thus responding to the need for an organization with ample representation of the sector and with managerial strength before governmental authorities.

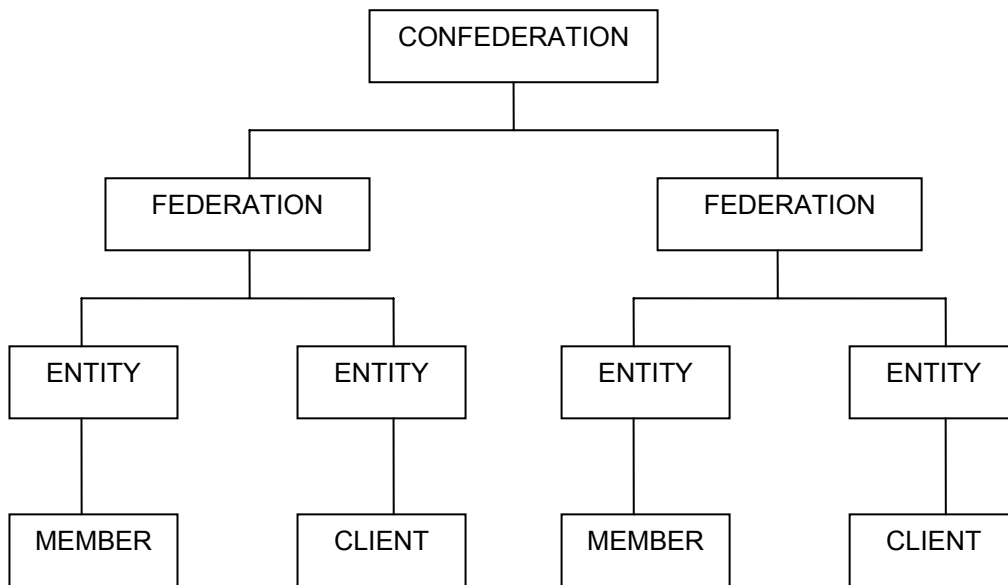
In October 2000, a Linkage Commission was established with seven representatives of the main national organizations in order to advance the project. In February 2001, the results of efforts materialized with the constitution of a national organization with wide representation and a strategic vision.

The Comacrep is formed by the Federation of *Cajas Alianza* (in the city of León, Guanajuato); the South-Center Federation (in Cuernavaca, Morelos); the System *Coopera* Federation (Mérida, Yucatán); the North-East Federation (Monterrey, Nuevo León); the Federation *UNISAP de Occidente* (Guadalajara, Jalisco); the Mexican *Caja Popular* (León, Guanajuato); the Mexican Association of Savings and Loans Societies (AMSAP, in Querétaro, Querétaro); Pro development, Finances and Microenterprises (Mexico City); the Mexican Association of Social Sector Credit Unions (AMUCSS, Mexico City); and the National Coordination Council of *Cajas Solidarias* (Mexico City).

**Table 2: Statistical Data of the Organizations Associated to Comacrep**

<b>Federation</b>	<b>Entities</b>	<b>Members</b>	<b>Subnational States</b>
Cajas Solidarias	217	213,447	25
Pro Development	18	50,000	10
AMSAP	6	696,370	25
Coopera	10	57,894	3
UNISAP	32	123,325	4
Alianza	24	130,099	3
North-East	14	76,385	3
Center-South	17	24,982	5
AMUCSS	34	43,053	11

## Comacrep Integration Model



### Strategic Projects of Comacrep

Comacrep's main projects are to become a confederation; structure the Protection Fund and the National Auxiliary Supervision System; promote prudential regulation, a fiscal regime and diverse supports to develop the sector in a comprehensive manner; strengthen and structure the federations; professionalize the sector at every level; and make the entities more sound.

So far, Comacrep's activities have included: participating actively since the beginning of the Popular Savings and Credit Law, keeping contact with federal legislators from different political factions; participating actively with the National Banking and Securities Commission to define secondary regulation, by incorporating flexible and gradual processes and protecting the smaller entities; managing governmental supports; managing international financial aid; structuring and integrating the sector; managing solutions to the historical fiscal problems of the sector and defining an adequate and transparent fiscal framework; and managing an ordered transition.

### Conclusions

We are confident that the popular financial sector's future will be successful, although we will require openness, vision and disposition to change from all popular financial entities, as well as much support from every level of government.

Success will greatly depend on the integration we can achieve in the popular financial sector and on the trust that we will be able to win from savings depositors and society as a whole.

# THE CASE OF PERU

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## 1. Introduction

Over the last decades, microbanking development in Peru has been significant from the point of view of the creation and performance of specialized microbanking institutions and the adequacy of the regulatory and supervisory environment for microbanking activities. Nevertheless, the existing supply of financial services is still far from satisfying the demand from low-income segments of the population, and the regulatory and supervisory framework can be enhanced.

The aim of this paper is to substantiate the claim made above. For this purpose, we will review the participation and performance of Peruvian banking institutions, and the approach Peru has taken to the regulation and supervision microbanking. The performance assessment will emphasize the outreach, depth and sustainability obtained by financial institutions doing microbanking.<sup>73</sup>

However, we will not be able to analyze all financial services (credit, deposits, insurance) that may be available for low-income segments of the population, as microbanking is defined for this symposium. Given the information available to us, we will refer fundamentally to the **micro lending** activity, and more precisely to loans offered to **micro-enterprises**. In addition, we will analyze deposit services offered only by specialized institutions in micro lending. Finally, we do not have information on micro insurance.

Therefore, the demand side of microbanking for this paper is the micro-enterprise sector, whose dimension is important to highlight in order to assess the outreach achieved by micro lenders.

As in all Latin American economies, the micro-enterprise sector in Peru has a major significance independently from the definition assumed.<sup>74</sup> The Third Peruvian Economic Census of 1994, which defines micro-enterprise as those units with fewer than nine employees and annual volume 3 of sales less than 12 tax units (currently about US\$10,000), reports that 95.8 percent of the total enterprises censused in Peru were micro-enterprises. Furthermore, they explained forty two percent of the GDP and provided employment to 75 percent of the working age population (INEI, 1995). This discrepancy between micro-enterprise's share of GDP and in the total employment suggests the sectors low productivity compared to that of medium and large firms.

However, the economic and financial reforms started in early nineties in Peru, under the spirit of a free market economy, have defined a more competitive environment for micro-enterprises, compelling them to make productivity and product quality improvements. Higher capital requirements to finance new investments and to make improvements in their installed capacity are the result. However, lending to micro-enterprises is not an easy task and requires an understanding of the risks associated to them, and designing or acquiring a lending technology

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<sup>73</sup> An indicator of outreach is the volume of operations, and the number of clients reached. An indicator of depth is the average size of operations, where a small size indicates the ability of the institutions to serve targeted clients.

<sup>74</sup> Micro-enterprise is usually defined in Peru and elsewhere based on parameters such as: number of employees, value of assets, volume of sales, and volume of debts. Therefore, there are several definitions for micro-enterprise. The implications of assuming a particular definition are beyond the scope of this presentation.

with the correct incentives to overcome or ameliorate informational problems and high administrative costs relative to the small size of individual transactions.

## 2. Development of Microbanking Activity in Peru

The liberalization of the financial sector was accompanied by positive changes in the regulatory framework and the economic situation, which created a favorable environment for the development of microbanking. Government-owned development banks were liquidated, interest rate controls slashed, credit targets were eliminated, and incentives were provided for the creation of financial institutions serving the rural sector and for the transformation of financial non-governmental organizations (NGOs) into regulated institutions serving micro-enterprises.

Currently, most of the existent financial intermediaries in Peru do microbanking activity to some extent. However, there are financial institutions operating under different types of licenses, serving predominantly micro- and small enterprises. We will next document the participation in microbanking of the diverse intermediaries, reviewing their performance in terms of outreach, depth and sustainability.

Table 1 shows the structure of microcredit in the regulated Peruvian financial system, by type of financial institutions, as of 31 March 2002. In this table, and in the remainder of this presentation, we will be using the definition of microcredit as assumed by the Peruvian Superintendency of Banking and Insurance (*Superintendencia de Banca y Seguros: SBS*). **Microcredit** is defined by the SBS as any credit granted to an individual or to a firm with total 4 assets or total debts in the financial system worth less than US\$20,000, to finance the production, commercialization or services activities.

**Table 1: Structure of Micro Credit by Type of Institution.**

	<b>Number of micro borrowers (thousand)</b>	<b>Share on total micro borrowers (%)</b>	<b>Total Credit Portfolio (1) (\$ million)</b>	<b>Micro Credit Portfolio (2) (\$ million)</b>	<b>(2)/(1) (%)</b>	<b>Share on the total volume of microcredit (%)</b>
Commercial Banks	78	19.3	12544	216	1.7	39.4
MiBanco	68	16.9	65	47	72.7	8.6
Finance Companies	40	9.9	247	62	25.0	11.2
Cajas Municipales	132	32.9	250	129	51.7	23.6
Cajas Rurales	18	4.5	71	33	46.0	6.0
EDPYMEs	42	10.4	53	41	76.9	7.5
Credit Unions	24	6.0	183	21	11.5	3.8
<b>TOTAL</b>	<b>401</b>	<b>100.0</b>	<b>13413</b>	<b>549</b>	<b>4.1</b>	<b>100.0</b>

*Source: Superintendency of Banking and Insurance*

As shown in table 1, the regulated financial system serves to almost 400,000 microborrowers, and provide loans in the amount of almost US\$550 million. However, this amount represents only about four percent of the system's portfolio, which contrasts with the significance of the small and micro-enterprise sector. Moreover, the presence of micro loans in the commercial banks' portfolio, which account for 94 percent of the total credit portfolio in the economy, is insignificant.

### **Commercial Banks**

Although microcredit is a very small part (1.7 percent) of the commercial banks' lending portfolio, commercial banks account for almost 40 percent of the total amount of micro lending, and about 19 percent of microborrowers. This implies that commercial banks efforts in following a "downgrading strategy" may have a high impact in terms of outreach, although not much in terms of the depth of outreach, since they select the largest clients of the micro- and small enterprise community.<sup>75</sup>

In general, commercial banks seem not to be interested in providing microloans, because they lack information about micro-entrepreneurs, credit technology and the organizational structures to serve them. Nevertheless, as a consequence of the financial liberalization process of the nineties and when the economy was in a period of expansion, two commercial banks (Banco Wiese, Banco de Crédito del Perú) made an attempt to approach the micro-enterprise sector using NGOs as their agents (although assigning only a very small part of their loan portfolio around two percent). However, agency problems, and the fact that the benefits of the relationship were not clear to banks, (partly because the know-how was not being transferred to them), resulted in the decision to discontinue the relation with NGOs and to lend directly to the clients or through its subsidiaries, or invest in specialized institutions, as will be documented later.

Among commercial banks, the Banco del Trabajo, that started operations in 1994, is an unusual case. It started growing, aggressively targeting consumption loans. However, by the late nineties after facing high delinquency rates, over-indebtedness of low and medium income clients, and a slow down of the economy, the Banco del Trabajo has progressively entered at the micro and small enterprise niche. Currently, with an equity of US\$17 million, about US\$122 million of total lending portfolio, it holds more than one third of its loan portfolio in micro- and small loans.

However, commercial banks seem to have a comparative advantage in deposit mobilization. As shown in table 2, almost 86 percent of deposit accounts are smaller than US\$ 1,917, with an average of US\$188. Although these deposits account only for 12 percent of the total savings and term deposits mobilized by commercial banks, these numbers suggest that commercial banks are also serving small clients.<sup>76</sup>

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<sup>75</sup> Downgrading strategy refers to the willingness of a public or private-sector bank, which so far has not served low-income segments of the population, to provide financial services, especially credit, to the target group.

<sup>76</sup> The size categories defined in Table 2 are a function of the maximum amount covered by the Deposit Insurance Fund. The first category is 10% the maximum deposit amount covered.



**Table 2: Commercial Banks: Savings and Term Deposits**

Size (in US\$)	No of accounts	Share of accounts	Total amount (\$ million)	Average deposit (\$)
Up to 1,917	3,983,339	85.9	748	188
1,917 - 4,792	326,809	7.1	926	2,833
4,792 - 9,585	169,543	3.7	1,044	6,159
9,585 - 19,170	101,685	2.2	1,237	12,168
More than 19,170	53,937	1.2	2,205	40,879
<b>TOTAL</b>	<b>4,635,313</b>	<b>100.0</b>	<b>6,160</b>	<b>1,329</b>

Source: SBS

**MiBanco** is also a commercial bank, and the first one in Peru specialized in serving micro- and small enterprises. MiBanco is the result of the transformation of the Peruvian NGO *Acción Comunitaria del Perú* (ACP) into a commercial bank. It started its operations in April 1998. Rapid growth and a supportive political and economic environment encouraged ACP to transform into a regulated financial institution.<sup>77</sup> ACP retained about 60 percent of the shares, and was very successful in its search for investors. Current investors are ProFund, Accion International, Banco de Crédito y Banco Wiese Sudameris, CAF, among others.

As of 31 May 2002, MiBanco has 27 branches and a presence in four (out of 23) departments of Peru. Having as assets expertise in lending to micro and small entrepreneurs and the portfolio of ACP, MiBanco has expanded its activity maintaining a good quality of loans. It initially used credit groups and non-traditional individual credit technology, but it currently uses basically the latter.<sup>78</sup> MiBanco has an equity of almost US\$20 million, US\$81 millions in total assets, and US\$61 million in its loan portfolio, 72 percent of which is granted to microborrowers.

Although MiBanco accounts for less than nine percent of the total volume of microloans it provides credit to 17 percent of total micro borrowers. Thus, with average loans of less than US\$700, MiBanco achieves a very good depth of outreach, serving the lower segment of its target clientele. Furthermore, by having a three percent portfolio in arrears, MiBanco shows that credit risk can be controlled with the appropriate technology.

Table 3 presents some performance indicators for institutions strongly oriented to the small and micro-enterprise sector. There, it is shown that deposit services are also oriented to low-income segments of the population, as suggested by the low average deposit account of less than US\$900. However, this orientation partly explains the high administrative costs observed. Despite high costs the profitability indicators of MiBanco are very high, which is explained by the good portfolio quality and the large financial spreads.

<sup>77</sup> Champion, A. and V. White (1999). "Institutional Metamorphosis. Transformation of Micro finance NGOs into Regulated Financial Institutions". The Micro finance Network. Occasional Paper No. 4.

<sup>78</sup> Some aspect in which a non-traditional individual credit differs from the conventional banking technology are: lenders make efforts to acquire information about potential borrowers by direct inspections rather than relying on documentation and lenders are more flexible defining acceptable collateral.

**Table 3: Performance Indicators for Some Institutions Involved in Microbanking Credit Unions (31 March 2002)**

	Cajas Municipales	Cajas Rurales	EDPYME	MIBANCO	Solución Financiera	Banco del Trabajo	Credit Unions
<b>BASIC INDICATORS</b>							
Total equity (\$ million)	58.8	14.6	26.2	19.7	90.8	17.4	103.0
Total assets (\$ million)	390.8	99.6	63.7	81.1	319.7	160.9	279.5
Total loan portfolio (\$ million)	250.0	71.3	53.0	65.1	69.4	122.5	182.7
<b>OUTREACH</b>							
Volume of micro credit (\$ million)	129.3	32.8	40.7	47.3	51.7	43.5	21.0 a
No. of borrowers of micro credit (thousand)	132.2	18.1	41.7	67.8	37.6	51.6	24.0 a
Deposits from the public (\$ million)	228.7	48.7	1.2	26.1	97.5	102.0	155.9 b
<b>DEPTH</b>							
Average credit (\$)	608.7	1614.6	1248.0	760.2	446.5	464.7	878.2
Average credit to micro-enterprise (\$)	977.8	1812.5	976.4	697.8	1376.6	843.2	874.1
Average deposit of individuals (\$)	650.9	341.5	c	887.1	660578.8	3045.1	460.5
<b>CREDIT WORTHINESS</b>							
Capital adequacy (N° of times)d	5.5	5.9	2.2	3.8	4.1	8.3	
Liability/social capital + reserves (N° of times)	8.4	6.3	1.6	3.3	4.5	8.7	
<b>ASSET QUALITY</b>							
Portfolio in arrears / Direct loans (%)	6.0	13.3	9.3	3.0	1.7	5.3	13.1
Provision reserves / Portfolio in arrears (%)	129.3	105.2	92.3	150.0	162.3	107.2	99.4
Earning assets / total assets (%)	86.5	78.0	85.4	89.6	93.9	87.2	
<b>EFFICIENCY AND MANAGEMENT</b>							
Administration costs/ Direct & Indirect credit (%)	13.4	13.6	16.7	17.5			
Credit portfolio / No of employees (\$ thousand)	173.1	193.2	116.3	102.9	46.2	52.8	128.7
Credit portfolio / No of branches (\$ million)	3.2	1.4	1.4	2.4	2.2	2.1	
Deposits/ Direct loans (%)	102.0	68.6	-	41.4	72.7	81.4	0.9
<b>PROFITABILITY</b>							
R O E (%)	29.1	10.1	6.1	18.9	33.7	8.2	8.1
R O A (%)	4.4	1.4	2.5	4.6	6.7	0.9	
Gross financial margin/ Financial income (%)	71.6	74.6	83.6	85.7	77.5	75.2	
Financial Income / Earning assets (%)	27.9	26.3	32.2	35.1	38.7	40.9	

Source: Based on information of the SBS.

(a) Preliminary information

(b) These are deposits from credit unions' members.

(c) By Law, EDPYME are not allowed to mobilize deposits from the public.

(d) Total assets and contingencies weighted by risk over capital.

## **Finance Companies:**

Solución Financiera de Crédito, a subsidiary of the Banco de Crédito (the largest commercial bank in Peru) and Daewoo are the only finance companies providing microloans, with Solución Financiera accounting for more than 97 percent of the microcredit portfolio of the finance companies. This is the result of a change of strategy from Banco de Crédito in 1997, which switched the leasing operations from Solución to another subsidiary, and targeted the lending activity of Solución to low and medium income segments of the population.

After a period of rapid growth and an undesirable deterioration of its credit portfolio, Solución has moved more cautiously. Nevertheless, it has 31 branches and a presence in 18 departments of Peru. As of March 2002, the balance of its total loan portfolio was almost US\$70 million, 70 percent of which is composed of microloans. As shown in Table 3, Solución Financiera presents the lowest rate of portfolio in arrears of micro loans. The average micro credit is among the highest for specialized institutions, but total average credit is the lowest because of the presence in its portfolio of small consumption loans. Although total deposits appear significant in volume, they are concentrated in only a few institutional accounts, thus the average account is large. (See table 3)

## **Municipal Non-Bank Institutions**

The system of Municipal non-Bank Institutions is composed of:

- The Metropolitan Area Popular Credit Institution (*Caja Popular de Lima*), and
- The Municipal Savings and Credit Institutions (*Cajas Municipales*) that operate outside the metropolitan area of Lima.

These institutions are the oldest specialized microfinance institutions. In terms of outreach and performance, the *Cajas Municipales* are relatively more important than the *Caja Popular de Lima*. The first *Caja Municipal* emerged in 1982 in Northern Peru, and currently there are 13 *Cajas Municipales* with 88 branches outside the Lima Metropolitan area, and a presence in 20 (out of the 23) departments of Peru. They account for more than a quarter of total microlending and lend to more than one third of total microborrowers.

Although municipalities own the *Cajas Municipales*, their influence in their operations is very limited and, by maintaining economic and administrative autonomy, the *Cajas Municipales* are managed under technical criteria. From the beginning, these institutions benefited from the advisory services provided by the German Technical Cooperation (GTZ), who helped them in the development of adequate financial technology to serve their target group, in the generation of information systems and with the constant training of their employees.

The growth of the *Cajas Municipales* has always been oriented to the objective of financial sustainability, the generation of profits, and an emphasis on deposit mobilization. This approach together with financial technology adequate to serve their small clients, explains the *Cajas Municipales* consistent growth. In the last decade they have shown rates of increase of around 30 to 40 percent in the volume of deposits, loan portfolio, assets and equity. Furthermore, in the 1999–2000 period, while the economy as a whole was experiencing recession and the banking system was stagnant, deposits and loans of the *Cajas Municipales* maintained their sustainable growth. Credit allocations are largely financed by deposit mobilizations, as shown in table 3.

The performance of the *Cajas Municipales* in terms of outreach, depth and sustainability in micro-enterprise finance in Peru is also outstanding. As of 31 March 2002, the *Cajas Municipales* as a system had a total equity of almost US\$59 million, total assets of US\$391 million and a total loan portfolio of US\$167 million, 52 percent of which is micro credit. They serve 33 percent of total micro borrowers and grant almost a quarter of total microcredit (see

Table 1). Deposits from the public reached US\$148 million. The average loan of US\$608 and average deposit of US\$651 confirm the Cajas Municipales ability to reach its target clientele. Notwithstanding, the rates of profitability reached as measured by rate of equity (ROE) of 29.1 percent and return on assets (ROA) of 4.4 percent are very high, mainly explained by the good quality of their lending portfolio and large financial spreads.

Currently, the Cajas Municipales are in the process of privatization. The fact that their municipalities own them constitutes a constant threat of political interference. Moreover, being a public institution, the Cajas Municipales lack the management flexibility needed to make investment decisions and to create incentives for their trained employees and avoid losing them to the competition.

### **The Rural Savings and Loans Institutions (Cajas Rurales de Ahorro y Crédito)**

The Supreme Decree 25612 enacted in 1994, created the Cajas Rurales, as private entities, with the purpose of providing financial intermediation in rural areas, and to fill in the gap left by the liquidation of the government's agricultural bank. To date, there are 12 Cajas Rurales, with 52 branches and a presence in 16 departments. The Cajas Rurales are owned by individuals or firms involved directly or indirectly in agricultural activities, handicrafts, manufacturing, commerce or services. They have received support from the government through a revolving fund to support the agricultural sector (*Fondo de Revolvante de Apoyo al Sector Agropecuario: FRASA*), and some other promotional credit lines from the Development Financial Corporation (*Corporacion Financiera de Desarrollo: COFIDE*)—a second tier development bank—created to finance micro-, small and medium firms in the rural sector.

The performance of the Cajas Rurales has not been satisfactory. Five of these institutions were or are being liquidated, and four Cajas Rurales are still in a consolidation process. Management and internal control problems, poor credit technology, together with the low profitability, high risk and lack of insurance mechanisms for agriculture—the activity where the Cajas Rurales have more than 50 percent of their loan portfolio—make the system weak and vulnerable.

As of 31 March 2002, they have close to US\$15 million equity and US\$100 million of total assets. From a total loan portfolio of US\$71 million, about 47 percent is microcredit. However, although the portfolio in arrears has recently decreased, it is still 13.3 percent, and the portfolio at risk defined as the portfolio in arrears plus the refinanced loans over total portfolio is 30.4 percent. Eleven Cajas Rurales entered the *Programa de Rescate Financiero (RFA)*, a government program designed to reduce the burden of overdue agricultural loans through the reduction and refinancing of contracts, postponing the agricultural producers' debt payment by offering government bonuses to participant financial institutions.

The Cajas Rurales have, with a few exceptions, not been very successful in deposit mobilization. Overall, deposits are 53 percent of their total liabilities, and debts 43 percent, largely explained by loans from COFIDE.

### **The Entities for the Development of Micro and Small Enterprises: EDPYMEs.**

By December 1994, the government had created a mechanism to allow the transformation of nongovernmental organizations into regulated credit-only institutions, Entities for the Development of Micro and Small Enterprises (EDPYME). The purpose of creating this mechanism was to help NGOs to gradually grow into regulated full financial intermediaries. The main incentives provided for that transformation were the access to government's credit lines and the exemption of the sales tax payments enjoyed by regulated financial institutions. The credit operations of NGOs used to be exempted of the sales tax payment, but that privilege was cancelled in 1998.

The first EDPYME (Credinpet) was established in 1996, and couple of years later six more NGOs became regulated institutions. During the last five years the total assets and equity of EDPYMEs grew faster than those of other institutions because of the emergence of new EDPYMEs and the fact that large NGOs progressively transferred their loan portfolio to the EDPYME. As of 31 March 2002, there were 13 EDPYMEs, with 40 branches and a presence in 15 (out of the 23) departments. Since the EDPYMEs are not allowed to receive deposits from the public, their lending activity is been financed mostly with credit lines from the public sector, international cooperation, donors and capital inflows from their stakeholders.

As of 31 March 2002, the system of EDPYME has a total equity of US\$26 million, total assets of US\$64 millions, and total loan portfolio of US\$53 million, 77 percent of which are micro loans. As shown in table 3, the average loan is higher than that in other specialized intermediaries, but still low, and the quality of the portfolio has deteriorated. As is the case for the other financial intermediaries, the EDPYMEs face high administrations cost in relation to its total volume of credits and low productivity of their employees, as measured by the indicator 'volume of credit per employee'. Profitability indicators are high but lower than those of its competitors.

### **Credit Unions**

Credit unions, with deposits and credit services, emerged in Peru in the fifties, as a response to the limited access of low and medium income individuals to financial services. After periods of rapid growth and downturns, the system appeared to be stabilizing. However, in 1992, as a consequence of poor administration and macroeconomic problems, 40 credit unions, accounting for 78 percent of the total deposits of the credit union system went bankrupt, producing losses estimated at US\$120 million.<sup>79</sup> In the same year, the SBS assumed responsibility for the regulation of credit unions, but the supervision is delegated, as we will explained later.

As of March 2002, there were 172 cooperatives with overall net equity of US\$101 million, total assets of US\$279.5 million, total loans of US\$182.6 million, and total deposits US\$155.9 million. However, according to the current financial system law, these deposits are not considered deposits from the public because they come from credit unions members.

The Credit Union System is heterogeneous and extremely concentrated. The three largest cooperatives account for almost 47.6 percent of total assets, 45.6 percent of the total loan portfolio, 72 percent of total deposits and 15.5 percent of net equity. The share of micro-enterprise loans is about 12 percent. Moreover, both the average credit and the average credit to micro-enterprise were less than US\$900, and the average deposit per member was US\$460.5. However, these numbers hide enormous differences. For instance, the average credit for the largest credit union was about US\$3,500 while that for the small cooperatives is US\$100. The same diversity is found when analyzing the quality of the portfolio and other financial indicators.<sup>80</sup> Although the small cooperatives showed larger delinquency rates, credit unions, overall, have to improve the incentive mechanisms for their borrowers in order to reduce loan delinquency.

In summary, the overall performance of the institutions involved in microbanking over the last five years has been satisfactory in terms of outreach, depth, and sustainability, although the

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<sup>79</sup> Morris, Felipe (2000). "Diagnóstico de Situación y Perspectivas de las Cooperativas de Ahorro y Crédito en el Perú". Report presented for IADB Project "Reforma de Políticas y del Marco Regulatorio para las Microfinanzas", manuscript.

<sup>80</sup> A detailed analysis of the performance of credit unions controlling for their heterogeneity can be found in Morris (2000).

pace of growth among institutions has been diverse. However, the total volume of credit granted to the micro-enterprise sector that contains most of firms in Peru (about 96 percent), is only four percent of the total volume granted in the economy. Moreover, high operational costs likely explained by the small size of the transactions, the quality of credit risk involved in serving the low income segments of the population, and the still low volume of transactions, imply high costs of money for low income segments of the population.

Table 4 shows the effective annual interest rates for microcredit for some financial institutions. MiBanco shows the highest lending interest rates, followed by EDPYMEs, and the Cajas Municipales. The Cajas Rurales have the lowest interest rates. However, we have to recall that the average loan of the Cajas Rurales is about twice the size of that of the Cajas Municipales. In fact, the Cajas Municipales have had important efficiency gains during the last decade. However, apparently the efficiency gains were not totally shared with their customers.

**Table 4: Annual Effective Interest Rates for Specialized Institutions, as of 31 March 2002.**

	90 days		180 days		360 days	
	Domestic currency	Foreign currency	Domestic currency	Foreign currency	Domestic currency	Foreign currency
<b>MiBanco</b>	90	45	90	45	70	40
<b>Cajas Municipales</b>	74.9	32.5	74.9	32.7	71.2	32.9
<b>Cajas Rurales</b>	58.4	25.9	61.1	26.2	62.4	28.4
<b>EDPYMEs</b>	79.4	43.4	79.7	43.4	77.3	43.6

Source: SBS.

### 3. The Regulatory and Supervisory Framework

The General Law of the Financial and Insurance Systems and The Organic Law of the Superintendency of Banking and Insurance, Law No. 26702 (the General Law), and the SBS Resolution No.572-97 are the most important documents for understanding the regulation of the financial system in Peru. The main purpose of the General Law was to legislate for competitive, sound and reliable financial and insurance systems with the objective of promoting Peru's development. The SBS is an autonomous institution with the responsibility of looking for the compliance of the licensed institutions with the law and other norms that govern them. Its main purpose is to protect the interest of the public in dealings with the financial and insurance systems.

Provided that risk factors for specialized institutions in microbanking are no different from those of commercial banks, in Peru most of the regulation is common to all financial institutions. Nevertheless, it is also recognized that the risk profile of specialized institutions in serving the low-income population is different than that of commercial banks. That is, the mix and weight of different risk factors are different and result in different risk profiles.<sup>81</sup> Most of them are young institutions, in the process of strengthening their internal controls, some "owned" by non-profit NGOs that may not respond quickly to capital calls from the regulator, are most likely limited in their access to capital sources, and are lending to low income clients with a limited ability to signal credit-worthiness. However, it is also a fact that any financial

<sup>81</sup> Vogel, Robert, Arelis Gomez and Thomas Fitzgerald (1999), "Regulations and Supervision of Microfinance: A conceptual Framework".

institution can provide microlending, which although it may not generally entail a large amount of credit risk (because of the small size of loans) it does involve a high probability of not recovering the loans, because of the riskiness of client's activity and the absence of collateral.<sup>82</sup>

To face these problems, the response of the Peruvian regulation scheme for financial institutions can be summarized in two elements:

- Entry capital requirement and the modular operations scheme
- The regulation of microcredit as an activity

### **Entry Requirements and the Modular Operations Scheme:**

For institutions specializing in microlending the required minimum subscribed capital is lower than for commercial banks, but the number of permissible operations is also lower. Cajas Municipales, Cajas Rurales, EDPYMEs and those Credit Unions authorized to mobilize deposits from the public<sup>83</sup> currently require the lowest entry capital of S/825,930 (approximately US\$236,000). Finance companies are required to have S/ 9.1 million (approximately US\$2.6 million) and commercial banks are required to have S/ 18.2 million (approximately US\$5.2 million). The operations allowed for specialized micro finance institutions are shown in Table 5.

Article 290 of the General Law defines a modular scheme of operation, which creates the opportunity for specialized institutions to develop themselves into full intermediaries, performing more complex and riskier operations as they augment their capital and build adequate organization and internal control, in the judgment of the SBS and risk rating institutions. For instance, institutions that progress to module 1 are allowed to receive savings and term deposits, to discount and grant advances over bills of exchange, promissory notes and other debt instruments, to issue and negotiate letters of credit, to issue credit and debit cards, to carry out factoring operations, and to issue payment tickets, among other operations. The minimum capital required to advance to module 1 is S/ 4.57 million (approximately US\$1.3 million). Module 2 adds to the set of operations permitted in module 1 the ability to sight deposits without granting overdrafts and without possibility of conversion by the Central Bank, and grant mortgage and secured loans, and in relation to them issue credit instruments, mortgage and pawned securities, both in domestic and foreign currency, among others. The required minimum capital is the same as that of finance companies (US\$2.6 million). Finally, Module 3 defines the operations of a full financial intermediary, for which the required capital is that of a commercial bank (US\$5.2 million). Additional requirements in each module are: rating of A or B during the last year, and adequate organization and internal control.

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<sup>82</sup> For specialized institutions the amount of credit risk is also important given the concentrations of their credit portfolio in microloans.

<sup>83</sup> Currently there are no credit unions authorized to mobilize deposits from the public. The existent credit unions mobilize deposits only from their members only, which are not considered deposits from the public.

**Table 5: Permitted Operations for Specialized Institutions.**

Type of operation	Cajas Municipales	Cajas Rurales	EDPYMEs
Deposit mobilization	Savings and term deposits	Saving and term deposits	Not allowed
Lines of credit	Authorized from internal and external sources	Authorized from internal and external sources	Authorized from internal and external sources
Credit activity	Commercial, micro credit, consumption, pawned credits	Commercial, micro credit, consumption, pawned credits	Commercial, micro credit, consumption, pawned credits
Other financial services	Expert appraisal of pawned objects, act as trustees when trust is involved	Negotiate credit letters, act as guarantors for credits, and as trustees when trust is involved	Discount letters of credit, act as guarantors for credits, and as trustees when trust is involved

*Source: Table taken from Portocarrero, Felipe (2001). "Marco Regulatorio y de Supervision de las Microfinanzas en Peru". Report presented for the IADB, Programa Reforma de Políticas y del Marco Regulatorio para las Microfinanzas.*

Pertaining to entry capital requirements of specialized institutions, most professionals that have reviewed the Peruvian regulation (including myself) agree that the entry capital requirements for specialized institutions need to be raised to some extent, particularly for those authorized to mobilize deposits. Moreover, we know that entry requirements are a signal of the regulator about the desired structure for the financial system. High barriers point to larger financial institutions while low barriers facilitate the entry of new institutions to the regulated system, and may induce the proliferation of small institutions, resulting in excessive supervision costs.

#### **The Regulation of Micro Credit as an Activity:**

According to the SBS Resolution No.572-97, four types of loans are defined: commercial loans, microcredit, consumption loans, and mortgage loans. As mentioned before, microcredit is defined as the credit granted for production, commercialization and services activities to individuals or firms with total assets or total debt in the system worth less than US\$20,000.

In an effort to control credit risk, regulators usually require that the institution gather some minimum information both at the time of evaluating the riskiness of a potential borrower, and during the loan period. The Peruvian regulation is flexible on this issue, allowing institutions to agree with their clients on some credit worthiness and loan compliance indicators, to the satisfaction of the SBS. However, microlenders are required to make explicit their lending technology. This approach is adequate except that microborrowers are usually unable to present a credit history, collateral or formal income statements.

For the purpose of establishing the criteria to evaluate the borrower and then define the required loan loss provision, microcredit is treated as a consumption credit, and microborrowers are evaluated based only upon the number of days their loan is past due. Table 6 summarizes the risk categories for borrowers and the corresponding provisions required.



**Table 6: Micro Borrower Evaluation and Required Loan Loss Provision**

<b>Risk category</b>	<b>Period the loan is past due</b>	<b>Required provision (%)</b>
Normal	Less than 8 days	1
Special mention	Between 9 to 30 days	5
Substandard	Between 31 to 60 days	25
Doubtful	Between 61 to 120 days	60
Loss	More than 120 days	100

Given the lack of formal documentation for microborrowers, and the costs involved in verifying cash flows during the loan period, the advantage of this approach is its simplicity.

Pertaining to capital adequacy (an indicator intended to measure the institutions ability to afford losses and a powerful instrument of regulation), the minimum requirement is the same for all financial institutions. The General Law rules that the assets and contingencies weighted by risk should not exceeded 11 times the capital of the financial institution. The inverse of this factor (9.1 percent) is slightly more severe that the 8 percent of capital over risk weighted assets recommended by the Basle Capital Accord.

It is usually argued that capital adequacy requirements should be more severe for specialized microlending financial institutions. However, in practice, this concern is not critical since most Peruvian specialized institutions are far below the limit.

#### **Supervision of Institutions Involved in Microbanking:**

The SBS applies a modern risk-based supervision that emphasizes the identification, measurement and monitoring of main risk factors faced by financial institutions: credit, liquidity, market and operational risks. Consistently, the SBS counts with specialized units in the supervision of credit, market and operational risks.

Supervision is performed on-site and off-site. However, on-site and off-site supervisions have been integrated since 2001, which makes the supervision more dynamic, allowing for better feedback and coordination between those who make the analysis (based on the reports submitted by financial institutions), and the on-site examiners who visits the regulated institutions. Without prior notice, inspections are performed at least once a year, and more often if there are aspects of specific concern of the SBS. For this purpose, examiners may request the support of one or more specialized risk units, if it is deemed necessary.

There are two areas in the SBS in charge of the supervision of non-bank institutions. MiBanco is also supervised by one of those areas, because of its specialization in microbanking. The review of credit risks, internal controls, risk management systems and the quality of management are considered priorities in the supervision of institutions strongly oriented to micro lending.

An important ingredient of credit risk supervision is the information provided by credit bureaus, which is reviewed before on-site examinations in order to test whether the institution to be examined has satisfactory evaluated the riskiness of its borrowers. The SBS manages an

improved system called the Credit Report of Borrowers (*Reporte Crediticio de Deudores RCD*), which allows the bank to capture debt balances associated to the account that originated the debt, the type of credit, and the number of days the individual's account has been delinquent, among other information. This information is available for debts of S/1 and above.

In general, supervision is carried out in three different ways:

- Direct supervision,
- Collaborative supervision, and
- Delegated supervision.

The SBS does direct supervision of all commercial banks, finance companies, Cajas Rurales and EDPYMEs. The Cajas Municipales are also directly supervised by the SBS; however, the National Federation of Cajas Municipales, (*Federación Peruana de Cajas Municipales: FEPMAC*) an organization that integrates Cajas Municipales, represents, promotes and audits them, submits its audit reports to the SBS. It is important to highlight that this effort does not substitute for the direct supervision of the SBS. Finally, the supervision of Credit Unions is delegated to the National Federation of Credit Unions (*Federación Nacional de Cooperativas de Ahorro y Crédito: FEPMAC*), which in turn is supervised by the SBS. Delegation is possible provided that existing credit unions do not mobilize deposits from the public, but only from their members.<sup>84</sup> However, given the fact that the FEPMAC has, at the same time, the role of promoting and supervising credit unions, the SBS still needs to take appropriate measures to solve/ameliorate the problem of the conflict of interests inherent in this delegated supervision.

#### **4. Conclusions**

Peru has made a considerable progress in the provision of financial services to the poor, particularly credit and, to a lesser extent, deposit services. Insurance services to the target population are still absent. There are new specialized micro lending institutions in the market, and their overall performance over the last five years has been satisfactory in terms of outreach, depth, and sustainability, although the pace of growth among institutions has been diverse. Nevertheless, the existent supply of financial services is still far from satisfying the demand from low-income segments of the population. However, the system is relatively new and the trend appears to be in the right direction.

The regulatory and the supervisory framework provide a sound environment for the development of microbanking. However, as the microbanking activity grows, there is still room for improvement in some aspects of its regulation and supervision. For instance, capital entry requirements need to be raised to encourage the development of solid institutions in a competitive framework, and the efficiency in their supervision of needs to be enhanced. In addition, the SBS needs to design mechanisms to cope with the problem of conflict of interests inherent in the delegated supervision of cooperatives.

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<sup>84</sup> According to the General Law, credit unions that mobilize deposits from the public have to be supervised directly by the SBS.

# THE CHILEAN MICROCREDIT EXPERIENCE

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## 1. Microbanking Economic and Institutional Framework

The macroeconomic importance that the micro-entrepreneurial sector has unveiled in the last years is mainly associated with two variables: employment and poverty.

In Chile, a significant percentage of productive units are micro-enterprises (according to CASEN–1996, 82 percent of national enterprises are in the micro-enterprise category). These absorb an important volume of the work force (according to CORFO–1997, 38 percent of workers belong to this sector).

Even though there are no studies that relate poverty with participation in micro-entrepreneurial sector activities, it is possible to relate workers in the sector to low socio-economic levels. Available data shows that in spite of the high number of enterprises and workers in them, their participation in national sales is very limited (according to CORFO–1997, only 4 percent of national sales are associated to this sector).

Chile's economic scenario, characterized by an increase in unemployment rates and the government's compromise regarding the creation of institutions that promote and facilitate the development and financing of small productive initiatives, are elements that have strongly induced both a questioning of the problems affecting the sector and a particular concern about public policies.

**Table 1: Classification of Enterprises According to Associated Employment**

<b>Strata</b>	<b>Number of Employees</b>	<b>Annual Income (US\$)</b>
Micro-enterprise	1 to 4	0 to 74,393
Small enterprise	5 to 49	74,393 to 774,922
Medium enterprise	50 to 199	774,992 to 3,099,688
Large enterprise	More than 200	Above 3,099,688

\* Conversion from UF (14.685) and US Dollar (474) on 31/12/98

- **High Absorption of the Labor Force**

<b>NÚMERO DE TRABAJADORES OCUPADOS, SEGÚN TAMAÑO DE EMPRESA, POR REGIÓN, 1996</b>						
(cifras en miles)						
<b>Región</b>	<b>Micro</b>	<b>Pequeña</b>	<b>Mediana</b>	<b>Grande</b>	<b>Sin Información</b>	<b>Total</b>
	1 a 4	4 a 49	50 a 199	mas de 200		
I	53,0	45,1	14,3	10,5	7,3	<b>130,2</b>
II	60,7	60,9	7,5	4,3	12,5	<b>145,9</b>
III	30,9	25,6	9,0	12,6	4,0	<b>82,1</b>
IV	79,7	62,1	26,4	12,9	10,0	<b>191,1</b>
V	205,1	194,4	60,7	42,1	24,4	<b>526,7</b>
VI	101,4	94,5	30,8	19,5	8,5	<b>254,7</b>
VII	130,3	130,7	34,9	15,4	5,5	<b>316,8</b>
VIII	236,4	194,2	74,5	59,3	33,6	<b>598,0</b>
IX	165,5	78,8	15,1	6,4	7,3	<b>273,1</b>
X	172,0	131,1	21,5	5,6	4,8	<b>335,0</b>
XI	15,4	11,8	2,4	2,0	0,6	<b>32,2</b>
XII	25,4	22,6	6,3	5,2	1,6	<b>61,1</b>
RM	748,5	782,1	349,4	309,5	73,8	<b>2.263,3</b>
<b>TOTAL</b>	<b>2.024,3</b>	<b>1.833,9</b>	<b>652,8</b>	<b>505,3</b>	<b>193,9</b>	<b>5.210,2</b>
<b>%</b>	<b>38,9%</b>	<b>35,2%</b>	<b>12,5%</b>	<b>9,7%</b>	<b>3,7%</b>	<b>100,0%</b>

**Table 2: Number of Occupied Workers According to the Size of Enterprises, by Region, 1996, (in thousands)**

<b>Region</b>	<b>Micro (1 to 4)</b>	<b>Small (4 to 49)</b>	<b>Medium (50 to 199)</b>	<b>Large (more than 200)</b>	<b>No information</b>	<b>Total</b>
I	53.0	45.1	14.3	10.5	7.3	<b>130.2</b>
II	60.7	60.9	7.5	4.3	12.5	<b>145.9</b>
III	30.9	25.6	9.0	12.6	4.0	<b>82.1</b>
IV	79.7	62.1	26.4	12.9	10.0	<b>191.1</b>
V	205.1	194.4	60.7	42.1	24.4	<b>526.7</b>
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VII	130.3	130.7	34.9	15.4	5.5	<b>316.8</b>
VIII	236.4	194.2	74.5	59.3	33.6	<b>598.0</b>
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<b>Total</b>	<b>2,024.3</b>	<b>1,833.9</b>	<b>652.8</b>	<b>505.3</b>	<b>193.9</b>	<b>5,210.2</b>
<b>%</b>	<b>38.9</b>	<b>35.2</b>	<b>12.5</b>	<b>9.7</b>	<b>3.7</b>	<b>100</b>

- **Importance in the Entrepreneurial Sector**

<b>NÚMERO DE EMPRESAS, SEGÚN TAMAÑO, POR REGIÓN, 1997</b>				
<b>Región</b>	<b>Micro</b>	<b>Pyme</b>	<b>Grande</b>	<b>Total</b>
I	14.776	2.047	67	16.890
II	12.650	2.564	103	15.317
III	7.619	1.250	33	8.902
IV	17.647	2.609	70	20.326
V	43.528	8.136	245	51.909
VI	23.864	3.928	91	27.883
VII	35.250	4.372	116	39.738
VIII	48.672	8.205	254	57.131
IX	24.723	3.878	90	28.691
X	31.447	5.545	197	37.189
XI	3.256	486	15	3.757
XII	5.014	1.162	28	6.204
RM	150.001	45.198	3.500	198.699
Sin Información	13.984	295	5	14.284
<b>TOTAL</b>	<b>432.431</b>	<b>89.675</b>	<b>4.814</b>	<b>526.920</b>
<b>%</b>	<b>82,1%</b>	<b>17,0%</b>	<b>0,9%</b>	<b>100,0%</b>

Fuente: CORFO, sobre la base de información del SII. No se tiene información respecto de la localización geográfica de 4.945 empresas, por ello el total nacional es superior a la suma de todas las regiones.

**Table 3: Number of Enterprises by Size and Region, 1997**

<b>Region</b>	<b>Micro</b>	<b>Small and Medium</b>	<b>Large</b>	<b>Total</b>
I	14,774	2,047	67	16,890
II	12,650	2,564	103	15,317
III	7,619	1,250	33	8,902
IV	17,647	2,609	70	20,326
V	43,528	8,136	245	51,909
VI	23,864	3,928	91	27,883
VII	35,250	4,372	116	39,738
VIII	48,672	8,205	254	57,131
IX	24,723	3,878	90	28,691
X	31,447	5,545	197	37,189
XI	3,256	486	15	3,757
XII	5,014	1,162	28	6,204
RM	150,001	45,198	3,500	198,699
No information	13,984	295	5	14,284
<b>Total</b>	<b>432,431</b>	<b>89,675</b>	<b>4,814</b>	<b>526,920</b>
<b>%</b>	<b>82.1</b>	<b>17.0</b>	<b>0.9</b>	<b>100.0</b>

Source: CORFO with information from SII. There is no information available on the geographical location of 4,945 enterprises, for which the national total is superior to the sum of all the regions.

- **Social Relevance**

**Table 4: Number of Enterprises by Size and Economic Activity, 1997**

Sector	Size of Enterprise			Total
	Micro	Small and Medium	Large	
Farming Production	54,174	8,672	121	62,967
Hunting and Agricultural Services	1,444	479	18	1,941
Forestry	2,380	965	41	3,386
Fishing	1,223	427	74	1,724
Mining, Oil and Quarry	966	476	97	1,539
Manufacturing Industry	26,605	11,577	1,211	39,393
Electricity, Gas, Water	530	116	72	718
Construction	15,407	6,618	587	22,612
Commerce	179,320	32,462	1,765	213,547
Restaurants	22,355	3,480	62	25,897
Transport	33,727	7,956	234	41,917
Financial Services	7,329	2,956	166	10,451
Technical and Professional Services	21,954	6,654	230	28,838
State Social and Institutional Services	4,830	978	49	5,857
Leisure and Entertainment Services	3,640	651	26	4,317
Personal and Housing Services	33,407	3,626	41	37,074
Other Activities	18,347	1,435	15	19,797
No Information	4,793	147	5	4,945
<b>Total</b>	<b>432,431</b>	<b>89,675</b>	<b>4,814</b>	<b>526,920</b>

NÚMERO DE EMPRESAS POR TAMAÑO Y ACTIVIDAD ECONÓMICA, 1997				
Sector	Tamaño de Empresa			Total
	Micro	Pyme	Grande	
Producción Agropecuaria	54.174	8.672	121	62.967
Servicios Agrícolas y de Caza	1.444	479	18	1.941
Silvicultura	2.380	965	41	3.386
Pesca	1.223	427	74	1.724
Minería, Petróleo y Canteras	966	476	97	1.539
Industria Manufacturera	26.605	11.577	1.211	39.393
Electricidad, Gas, Agua	530	116	72	718
Construcción	15.407	6.618	587	22.612
Comercio	179.320	32.462	1.765	213.547
Restaurantes y Similares	22.355	3.480	62	25.897
Transporte	33.727	7.956	234	41.917
Servicios Financieros	7.329	2.956	166	10.451
Servicios Técnicos y Profesionales	21.954	6.654	230	28.838
Servicios Estatales Sociales e institucionales	4.830	978	49	5.857
Servicios de Diversión y Esparcimiento	3.640	651	26	4.317
Servicios Personales y del Hogar	33.407	3.626	41	37.074
Otras Actividades	18.347	1.435	15	19.797
Sin Información	4.793	147	5	4.945
<b>TOTAL GENERAL</b>	<b>432.431</b>	<b>89.675</b>	<b>4.814</b>	<b>526.920</b>

Fuente: CORFO, sobre la base de información del S.I.I.  
Source: CORFO with information from SII.

- **Sector Development in the New Environment**

**Table 5: Characterization of Micro-enterprises in Chile**

	Micro-enterprises
Participation in the Entrepreneurial Universe	82%
Participation in Total Employment	39%
Participation in Total Sales	4%
Concentration at the Metropolitan Level	35%
Concentration at the Trade Sector Level	41%
Participation in Exports	0,1%

Source: Based on background from CORFO.

**Main Microcredit Actors**

The main microcredit operators are banks, savings and credit cooperatives (CACs) and some NGOs.

**Table 6: Main Microcredit Services Suppliers in Chile**

Type of Supplier	Agents
Banks	Bancoestado, Bandesarrollo and Banefe
CACs	Coopeuch, Oriencoop and Cocretal
NGOs	TPH, PROPESA, Fundación Contigo and Red Cresol, among others.

Separately, the public categories that participate actively in financing microcredit are:

Institution	Main Types of Instruments	Types of Financing
CORFO FOSIS INDAP SENCE BANCOESTADO	a) Subsidy to Credit Assessment b) Financing Lines for Operators c) Credit Guarantee	Mainly short term with some medium term

**Table 7: Financing Instruments for Micro, Small and Medium Enterprise**

INSTITUTION	PROGRAM
<b>FOSIS</b>	<ul style="list-style-type: none"> <li>• IFIS, Cost Subsidy in Credit Operation Transactions</li> <li>• Pilot Program of Microcredit for Women</li> </ul>
<b>SENCE</b>	<ul style="list-style-type: none"> <li>• Direct Subsidy for Micro and Small Enterprises</li> </ul>
<b>CORFO</b>	<ul style="list-style-type: none"> <li>• Credit Line: Financing of Investments for Small and Medium Sized Enterprises</li> <li>• Credit Line: Financing of Small Industries, Credit Corfo-Germany</li> <li>• Credit Line 2000: Reprogramming of Small Enterprises' Liabilities</li> <li>• Environmental Credit Line Corfo-KFW</li> <li>• Financing Line of Leasing Operations for Small Enterprises</li> <li>• Credit Line for Non Banking Financial Intermediaries (IFNB)</li> <li>• Credit Line: Financing the Foreign Purchaser of Chilean Products and Services</li> <li>• Credit Line: Financing Production Inputs and Foreign Trading</li> <li>• Special Benefits Program for Reprogramming Micro, Small and Medium Sized Enterprises Financial Debts</li> <li>• Coverage of Banking Loans to Exporters (COBEX)</li> <li>• Agricultural Insurance</li> <li>• Small and Medium Sized Enterprises Insurance. Export Credit Insurance</li> <li>• Credit Line: Financing Program for Investment Funds that Foster Risk Capital</li> <li>• Credit Line D.1. Line to Finance Factoring Operations</li> </ul>
<b>BANCOESTADO</b>	<ul style="list-style-type: none"> <li>• PC-Internet Credit</li> <li>• Micro entrepreneurs Credit</li> <li>• Training Credit</li> <li>• Guarantee Fund for Small Enterprises, FOGAPE</li> <li>• Electronic Checkbook for Banking MYPE</li> <li>• Forestal Credit Line</li> <li>• Credit Line for Risky Works</li> <li>• Agricultural Insurance</li> <li>• Seasonal Agricultural Credit</li> <li>• Agreement with FONASA</li> <li>• Financing for Purchasing Land for Schools</li> <li>• Financing Lines for Small Entrepreneurs</li> <li>• Leasing</li> </ul>



### *International Agencies*

There is a series of international institutions that support the development of the micro entrepreneurial sector, by financing studies, promoting the development of financing instruments, acting as a second tier bank, etc. These institutions include: the Ford Foundation, the IADB, the World Council of Savings Cooperatives, and the German Confederation of Savings and Credit Cooperatives, among others.

### *Intermediaries Fond of Specialized Supervision*

Without a doubt, the main credit supply is provided by banks' financing, which generally holds the following characteristics and conditions:

Bank Financing:

- *It is not their targeted market.* It cannot be overlooked that this market segment is not the most attractive to banks. With the exception of some institutions that define small and medium-sized enterprises within their targeted market, it is difficult to find a clear statement that includes micro- and small enterprises in the interest area of these institutions. This situation can be explained by the following factors:

#### Conventional Maximum Rate.

This norm aims to protect debtors by determining the maximum interest that can be charged by financial institutions. However, in some cases it does not turn out to be so protectionist since it transforms into an artificial ceiling for charging interests that leaves more risky sectors outside the formal banking sector, sometimes falling into the hands of unscrupulous lenders. This encourages a lack of transparency in the system since the most creative institutions can charge more than the maximum through other legal means, such as commissions, insurances, credit assessments, etc.

#### Risk versus Return

It is believed that small enterprises face a higher than average risk. Evidence confirms this observation, although it is important to note that risk does not constitute a loss. In finance, risk is the probability of real returns to be less than expected returns. Financial institutions can manage this situation perfectly. There are sophisticated techniques that have been designed precisely for such situations. Risks can be diversified, particularly when we are talking about small enterprise financing, this is, many transactions of relatively small amounts.

#### Operational Costs (assessment, granting, management)

Financing these enterprises presents special characteristics that must be taken into account. It requires a different approach from the one used for large enterprises. The key is knowledge of the client and his business. Analysis of these enterprises cannot be reduced to an examination of numbers and balances. This is why the process of granting credit to small and medium-sized enterprises becomes difficult and there are both successful experiences and failures of institutions that wanting to reach that market, have done it using traditional granting rules. The management of many loans, all of small amounts, requires a greater proportion of resources (human and technological).

- *Creation of Specialized Subsidiaries.* Traditional banking has tried to serve this specific segment. It is important to consider that in some cases financial institutions have created specialized divisions for this market, while others have created subsidiaries or companies that can cover it.

#### Leasing Companies

Currently in Chile, almost all leasing companies pertaining to banks are incorporated to the main bank; only 2 of 16 leasings are constituted as subsidiaries. Data available as of September 2001 shows that these leasing contracts amounted to US\$1,228 billion. In Chile there are also leasing companies that do not belong to the financial system, and for which there is no data available.

#### Factoring Companies

Like leasing companies, factoring companies are agents interested in satisfying the financing needs of small and medium-sized enterprises. The situation in banks for these companies is slightly different to the leasing, as their development is more recent. Only two of the bank factorings are incorporated to the main bank, leaving three as subsidiaries. Data available as of September 2001 shows that documents to be collected by these factorings amounted to US\$138 billion. As in the previous case, in Chile there are also factoring companies that do not belong to the financial system, and for which there is no data available.

#### Subsidiaries Specialized in Microcredit

The last alternative considered by financial institutions is the creation of subsidiaries specializing in microcredit. Currently there are only two.

#### *Structure of Banking Credits*

The composition of commercial placements granted by banks, as of September 2001, for micro and small enterprises was of approximately 616,443 debtors. If we were to add medium-sized enterprises it would reach 703,663 debtors, comparable to a credit demand of 790,000 debtors related to small and medium-sized enterprises. We see that not all financing needs of the sector are covered by the traditional banking system. To these data we must add the amounts of financing granted by leasing, factoring and specialized subsidiaries.

#### *Supervision of Bank by the Superintendence of Banks and Financial Institutions*

The concept of microcredit in the national financial legislation is not particularly mentioned and thus there are no specific regulations applicable. Consequently, such operations are regulated by general regulations that govern all credit operations of banks and financial institutions. In this context, the main applicable regulations are:

- Chapter 1-13 of the Updated Compilation of Norms, regarding the Classification of Management and Solvency.
- Chapter 8-16 of the Updated Compilation of Norms, regarding Non Performing Loans.
- Chapter 8-28 of the Updated Compilation of Norms, regarding Asset Assessment and Classification.
- Chapter 8-29 of the Updated Compilation of Norms, regarding the Provision and Punishment of Placements.
- Chapter 7-1 of the Updated Compilation of Norms, regarding Interests and Adjustments.

### *Supervision of Savings and Credit Cooperatives by the Superintendence of Banks and Financial Institutions*

Currently, the Superintendence has the responsibility of supervising two CACs (and shortly another one), as a result of legislative changes. Traditionally, these cooperatives were in practice regulated by the same supervision and regulation criteria as banks. This situation has recently changed and actions are being taken to adopt a specialized supervisory model.

### *Supervision of Savings and Credit Cooperatives by the Department of Cooperatives*

Even though the activities of savings and credit cooperatives are not exclusively microfinancial, Chile is rapidly tending to adopt international orientations regarding a regulation similar to that applicable to specialized financial institutions. In the case of CACs, which do not undergo specialized banking supervision, the Ministry of Economy has a Cooperatives Department that is in charge of their regulation and supervision.

Along with the recent enactment of the new General Banking Law (LGC), the Cooperatives Department of the Ministry of Economy has restructured its operations and even signed an agreement of auxiliary supervision with the Federation of Savings and Credit Cooperatives (FECRECOOP). In this process, the Department has received the collaboration and technical assistance of the SBIF, impelling the establishment of a homogeneous accounts manual and plan for the sector.

In regard to savings and credit cooperatives, we can state the following:

#### Characteristics

Chile has developed approximately 80 CACs with total assets amounting to US\$322 billion and a joint portfolio of US\$300 billion. Of this total only two cooperatives are registered under fiscal policy implemented by the Superintendence, since the 1980s when a strong crisis hit the sector and the sounder cooperatives were incorporated to the regulators' supervision.

#### Types of Credit

In Chile, cooperatives serve micro-, small and medium-sized enterprises, with the exception of the largest cooperative, which represents 59 percent of the sector's total assets. A large number of them are located in regions where their presence exceeds that of banks. The type of credit granted is for an average amount of US\$700 with an average installment plan of 14 months, in contrast to banks where these indicators amount to US\$1,200 and 12 months. In sum, CACs' patrimony over the patrimony of the financial system is 2.8 percent and total assets are 0.7 percent.

**Table 8: Savings and Credit Cooperatives**

Name	Total Patrimony			Total Assets		
	UF	UF accrued	% accrued	UF	UF accrued	% accrued
COOPEUCH	2.809.672	2.809.672	45,1%	6.982.851	6.982.851	59,2%
ORIENCOOP	1.133.550	3.943.222	63,3%	1.717.637	8.700.488	73,8%
COOCRETAL	337.554	4.280.776	68,7%	454.587	9.155.075	77,6%
UNION AEREA	289.911	4.570.687	73,4%	426.440	9.581.515	81,3%
UNION Y PATRIA	139.805	4.710.493	75,6%	148.535	9.730.050	82,5%
LOS ANDES	111.272	4.821.765	77,4%	149.496	9.879.547	83,8%
DETACOOOP	104.227	4.925.991	79,1%	193.721	10.073.268	85,4%
Norte Grande	103.849	5.029.841	80,8%	169.718	10.242.986	86,9%
O'HIGGINS	99.303	5.129.143	82,4%	124.332	10.367.318	87,9%
MANTENCION CAP	92.315	5.221.458	83,8%	96.991	10.464.309	88,8%
CREDUMONTT	89.199	5.310.657	85,3%	117.609	10.581.918	89,8%
Santa Inés	84.128	5.394.785	86,6%	102.512	10.684.430	90,6%
ISLA DE MAIPO	74.739	5.469.525	87,8%	90.121	10.774.551	91,4%
Cooperlacar	61.157	5.530.682	88,8%	65.754	10.840.305	91,9%
SAN FELIPE	55.713	5.586.395	89,7%	71.756	10.912.061	92,6%
Others	641.063	6.227.457	100,0%	878.233	11.790.294	100,0%

Source: FECRECOOP. Information as of December 2000.

#### *Considerations on Other Financing Options*

Currently, the small and medium-sized enterprises that cannot obtain formal sector financing (through banks, CACs, factoring, leasing, NGOs) have a behavior similar to that of people searching for financing. This is endorsed by empirical evidence that these enterprises are confused with their owners. This way, we can state that suppliers' credits, uncollected accounts, state lines, commercial houses (construction), other personal loans (by family members), informal financing sources, and lenders have a presence in the financing options of small and medium-sized enterprises, the list transforming itself in a more to less wanted chain of financiers.

In these situations, we can observe that when we face the expansive part of the economic cycle, the agents at the beginning of the previous list grant greater financing than the latter. But when we are in the contracting phase of the economic cycle, the situation reverses itself and those at the end of the list have greater relevance and presence than the former, with consequent costs and losses.

The aim is to remove the greatest quantity of small and medium-sized enterprises from the above financing circuit, thus tending to a more "bankarized" economy. This banking tendency can also have stages; for example, the micro-enterprises join the cooperatives first and then, depending on their development and operational size, they can access formal banking.

## 2. Regulatory Framework

### *Legislation and Main Legal Bodies*

- General Cooperatives Law  
<http://www.fecrecoop.cl/cgi-bin/tsearch.cgi>
- General Banking Law  
<http://www.sbif.cl/documentos/LGB.doc>
- Law Decree 1.638 LOC of the BCCH  
<http://www.bcentral.cl>

**Table 9: Prudential Regulation and Supervision**

	<b>Banks</b>	<b>CACs</b>
Evaluation Prospects and Managers	Prospective exhaustive assessment and solvency and ideality requisites, authentication	Legal assessment of the prospect without solvency and ideality requisites
Minimum Capital	US\$10 million	Established in the statutes
Capital Adequacy	≥ 8%	≥ 10% for the ones of relevant size
Insertion	Affects deposits and in sight payments, national and foreign currency	Affects requirements similar to those of banks
Documentation and Authentication	Information objectives are specified	Information objectives are specified
Portfolio Classification	Permanent and according to the financing objective	Permanent and according to the financing objective
Provisions	Moratoria and other variables	Moratoria and other variables
Concentration	5% of effective patrimony	5% of effective patrimony
Liquidity	Take-off limit	Partial application limit
Inflation	Take-off limit	Partial application limit
Interest Rate	Take-off limit	Partial application limit
Maximum Interest Rate	Maximum Rate: Law 18.010	Maximum Rate: Law 18.010
State Deposit Guarantee	Depending on guarantee	Not depending on guarantee
Mechanisms for Unstable Situations	Special dispositions, considered in the LGB, apply	Generally, dispositions considered in the Code Of Commerce (LGC) or LGB apply

### *Supervision Scheme*

Regarding supervision, the regulatory and supervisory scheme of microcredit debtors is basically subject to general banking regulation. The LBG states in Title V, Article 62, that banks will be classified in three levels according to their management:

Level A: Institutions not classified in levels B and C.

Level B: Institutions that reflect certain weaknesses in internal controls, information systems for decision making in the timely follow-up of risks, private classification of risks and capacity to face contingency scenarios, which will be corrected by the own institution during the period preceding the next classification in order to avoid deterioration in the institution's soundness. Sanctions applicable to enterprises will also be considered, except those with pending complaints.

Level C: Institutions that show significant deficiencies in some of the factors mentioned in Level B, which should be corrected promptly to avoid reducing their stability.

An institution's assessment of its management includes analysis of:

- a) Credit risk management and global management of the credit process
- b) Financial risk management and treasury operations
- c) Operational and technological risk management
- d) Resources compromised abroad
- e) Control over subsidiaries and domestic support companies
- f) Process of strategic planning, and
- g) Information systems on risk management

In all, financial institutions are currently assessed according to the solvency and management. Regarding solvency, Basil indicators have been adopted, demanding a minimum 8 percent of patrimony over risk weighted assets. In any case, the supervision model is considered preemptive and comprehensive, with the development of *extra situ* and *in situ* activities, and with an associative supervision.

As mentioned before, the legislation observed by microcredit debtors is the same than the one applicable to debtors from all financial institutions. Given the nature of the operation, productive microcredit, these debtors are generally classified as commercial credits too, but as a minority they are classified as consumer credits. Regulation on portfolio classification is stated in Chapter 8-28 of the Updated Compilation of Norms of the SBIF.

When assessing the placement portfolio, commercial credits, consumer credits and mortgage housing loans are treated separately.

Commercial credits. In order to establish the classification process, commercial credit portfolio is composed all credits granted by the institution, independently of the particular objective, with the exception of consumer credit and mortgage loans for housing. Financial entities must classify the results of current and due placements, including the respective adjustments and due interests in local and foreign currency, contracted by the 400 largest debtors of the company or the necessary number to reach 75 percent of the commercial credit portfolio, whichever is bigger. Additionally, financial entities can willingly classify a greater portion, or all, of their placements. Most institutions assess a percentage greater than 75 percent, which on average amounts to 93 percent of the placements portfolio.

To assess the commercial credit portfolio five classification categories must be used. The basic factors for the evaluation are, at least, the debtor's payment behavior, his payment capacity and the availability of guarantees that can back his debt. Considering the average amount of microcredit granted by financial institutions, these debtors are classified as commercial credits, although most of them pertain to the segment of non-assessed debtors (meaning without an assigned risk category, and thus called "risk of the non-assessed minority"). The risk of this portfolio is recognized by deducing the entity's global risk to this segment (meaning, the risk of the sum of commercial, consumer and mortgage credits).

Through the information collected on the behavior of these debtors, it has been estimated that the global risk percentage is not sufficient to capture the risk of the non-assessed minority, for which supervision has translated into financial institutions applying additional methodologies of risk recognition. Normally, risk matrices involving variables such as internal payment behavior, external payment behavior (financial system), commercial background (Dicom), and coverage of guarantees are used. According to the characteristics of the portfolio, each institution has developed a risk matrix for unassessed debtors, which is revised during the *in*

*situ* visits. The Superintendence has a standard methodology for comparison, which is used to verify the sufficiency of provisions of the institutions' methodology.

The results of this practice are translated into a global amount of provisions that accounted is in the demanded provisions (as additions to the global provisions) not being reflected as one on one provisions per debtor, as is the case with larger debtors (75 percent of portfolio or 400 large debtors).

Consumer credits. In order to establish the classification process and the evaluation of risks in the placement portfolio, consumer credits are understood as direct, current or due liabilities, contracted only by individuals with the aim of financing the acquisition of consumer goods or the payment of services, and their payment will be done in quotas which are normally equal and successive. Consumer credits will be classified according to the timely payment of the debtor's obligations, considering methodologies of recognition of additional risks not covered by untimely payments.

### **Legal Scheme of CACs**

- No different than the banking scheme, in the essential aspects
- Sound management principles

Revision of non banking financial entities (EFNB)—in the case of Chile this only includes savings and credit cooperatives—are carried out through *extra situ* monitoring and *in situ* direct supervision.

As mentioned earlier, supervision is done under a framework of prudential management practices and application criteria. In this context, the following can be stated:

#### *Internal control assessment*

- Observance of the processes associated with the formation and functioning of the Management Council.
- Functional segregation: evaluation of the organizational structure and verification of full independence between the areas that perform the commercial function and those that perform the risk management and control functions.
- Establishment of policies and procedures: definition of general policies to guide cooperatives' behavior and of specific procedures for critical functions. Ensure that they are properly formalized.
- Presence of internal and external audits.
- Accounting revisions, such as provisions, tax exemptions and readjustments, and balance accounts, among others.

#### *Timely follow-up of risks (recognition of risk, processes, policies and procedures)*

- Recognition and limitation of risks, either credit, financial, operational or technological risk.
- Global management of the credit process, especially management of the portfolio classification process.

What is relevant is the observance of the portfolio classification process and of Chapters 8-28 and 8-29 of the RAN. So far, cooperatives have been subject to revisions of their portfolios as are any other formal financial entities.

#### *Management information systems*

#### *Planning (operational and strategic)*

### 3. Progress in Regulation and Supervision

#### *Amendments to the LGB*

In Chile, the minimum capital necessary for the opening and functioning of a bank was recently halved. The idea is to facilitate the establishment of smaller institutions that could operate as specialized banks or banks for a certain niche market. These banks will have to operate with minimum capital adequacy levels greater than larger banks. This capital reduction is part of a policy to ease financing management for micro- and small enterprises and is coupled by the strengthening of the markets of other actors, such as CACs.

#### *Amendments to the General Cooperatives Law (LGC)*

New authorizes activities

**Table 10: Activities Authorized for CACs**

<b>Operations permitted</b>	<b>Operations for all</b>	<b>Operations supervised by SBIF</b>	<b>Operations authorized by SBIF</b>	<b>Operations authorized by the Ministry of Economy</b>	<b>New Operations</b>
Receive deposits from members and third parties	X				
Issue bonds and securities for public offerings		X			X
Borrow from national or international financial institutions	X				
Acquire, conserve and alienate debt from the Government or public institutions	X				
Perform credit operations to members, with or without guarantees, readjustable or not	X				X
Discount to members documents that represent payment obligations	X				X
Grant loans with mortgage guarantees to members	X				
Issue payment orders, and letters against their own offices		X			
Grant to their members, loans in national currency through the issuance of credit letters		X	X		X
Acquire, give and transfer commercial effects	X				
Perform collections, payments and transfers between members		X			
Acquire, conserve, construct and alienate the necessary real estate for their functioning	X				
Acquire, conserve and alienate the necessary physical goods for servicing	X				



<b>Operations permitted</b>	<b>Operations for all</b>	<b>Operations supervised by SBIF</b>	<b>Operations authorized by SBIF</b>	<b>Operations authorized by the Ministry of Economy</b>	<b>New Operations</b>
or keeping investments					
Issue and operate credit cards for their members		X			X
Be a stockholder or have a participation in a cooperative that supports remittances.	X	X	X	X	X
Offer to clients financial services in the account of a third party.	X	X	X	X	X

### *New Fiscal Scheme*

The fiscal process as a result of the amendment of the LGC is based on the strengthening of the Cooperatives Department of the Ministry of Economy and in the adoption of a specific supervision model. In order to do so, the SBIF has given its collaboration and technical support.

### *Auxiliary Supervision*

One of the most important elements that has to be stressed in the new legislation on CACs is the possibility that the Cooperatives Department delegates the supervision of these cooperatives. Considering the progress in self regulation that this sector experiences, mainly as a result of the efforts made by the FECRECOOP and indirect support by the DGRV, the department has signed a supervision agreement with the FECRECOOP.

Similarly, and as a result of the above mentioned, an accounting plan and manual for CACs was recently established, allowing a better information control and homogenization.

### *Legal Amendments to the SBIF*

#### Capital Adequacy

The already mentioned reduction in minimum capital.

#### Asset Classification

New legislation for the classification of assets will be enacted soon. Such regulation will allow better management of credit risk on behalf of financial institutions, through the instruction of their own models and group credit classification. These legal changes will facilitate a better identification of risk from knowing the behavior of the portfolio they manage, thus facilitating the specialization in the microcredit sector.

#### Model of Specific Supervision for CACs

The SBIF is developing a specific supervision model for CACs based on sound management principles and an adequate control of risks, particularly credit. Considering a specific model is based on the recognition of the specificities of the sector and the need to conduct significant changes regarding the general legislation applied to banks.

#### Accounts Plan

The SBIF is also developing an adjustment to the account plan for CACs under its supervision in order to better collect their operations and new activities allowed.

### Information Systems

Accordingly, all information systems and archives related to CACs have been reviewed, aiming to improve the quality of the information to perform better controls on them.

### Sector Statistics

As a result of the above mentioned the possibility of creating a comprehensive statistical synthesis of the cooperative sector is clear. The linkage with the Cooperative Department will allow the collection of aggregate information on the sector, thus facilitating the adoption of more effective sector policies.

## THE ROLE OF RISK RATING AGENCIES IN MICROFINANCE

**Ursula Wilhelm**  
**Standard & Poor's, Mexico**

A rating is not an audit, a consultancy or a recommendation on buying, selling or keeping a certain asset, but an opinion regarding the credit quality of an entity and is based on the following scale:

<b>International Ratings</b>	<b>National Ratings (Mexico)</b>
AAA	Mx AAA
AA	Mx AA
A	Mx A
BBB	Mx BBB
BB	Mx BB
B	Mx B
CCC	Mx CCC
CC	Mx CC
D	Mx D

Ratings are established in order to deliver impartial information to the market, define the level of risk, the financing cost, and access to the market and to investors.

Regarding risk, CCC ratings have historically reached a default rate of 45 (on a scale from 0 to 50) after 10 years, while B ratings have reached 30, BB ratings reached 19, and BBB, A, AA and AAA have reached between 5 and 3 in the same period of time.

Ratings follow a specific methodology that focuses on economic risk, industry risk, diversification, management and strategy, market and credit risks, liquidity and financing, profitability, capital, risk management, and financial flexibility.

The basic operational requirements include clear credit policies, effective controls to manage portfolios, efficient information systems, and an adequate capital level to support risks.

Microfinance and traditional banking face different risks as far as competition goes. While microfinance has low entry barriers and a more specific expertise regarding a certain product or market, traditional banks face high to moderate entry barriers and their expertise can be more flexible depending on the product and market.

When considering risk related to the stockholders, traditional banking also differs from microfinance activities. In microfinance, the stockholder base is diverse which is better since there is more flexibility to attract new stockholders, and participation of international institutions is also positive, particularly when the participation constitutes a majority in which case microfinance institutions receive the benefit of "parent support". On the other hand, traditional banks have a mixed stockholder base and normally have a greater flexibility to attract new stockholders, control is often held by families although sometimes it can be neutral, and they can only receive "parent support" benefits if international participation has both control and a background of support to their subsidiaries.

Another criterion that differs for both banks is the risk of their legal structure. Microfinance institutions have a legal structure that can limit their growth, stockholder base and activities

they can perform, while traditional banks have different structures according to the activities that they pursue.

Likewise, concentrations risks are different. Whereas traditional banking has generally a greater risk due to individual exposures, geographic areas, the economic sector and related credits, as well as a greater flexibility to restructure portfolios, microfinance activities normally do not share that risk (except in geographic areas and the economic sector), and have less flexibility to restructure their portfolios.

Credit risk is also dissimilar. For traditional banks, risk management is a key element and the assessment of asset quality includes qualitative and quantitative criteria for each institution. For microbanking entities, credit performance depends on the culture that supports the payment incentives and assessment of asset quality is based on quantitative processes.

Finally, it is also important to evaluate the differences in liquidity and financing risks. In microbanking, the access to financing sources depends on the legal structure of the institution, and market financing sources can be limited given the lack of sufficient information in the sector, less recognition in the market and the size of the institutions. In traditional banking, access to financing sources is according to the legal nature of the institution and financing sources are likely to be less limited due to greater information in the sector, greater recognition in the market and the bigger size of the institutions.

## THE ROLE AND EXPERIENCE OF A RATING AGENCY

Sanjay Sinha<sup>85</sup>

Micro-Credit Ratings International Ltd

### **The Context: Why Microfinance Institutions Need to be Rated**

Asia is well known to be a study in contrasts. Economic performance in the region ranges from the phenomenal success of the “tiger” economies through the substantial achievements of some of the ASEAN economies to the grinding poverty of significant parts of South Asia. Yet, as the current global recession has shown, it is possible to buck the economic trend. India’s improved performance in recent years—in spite of the global recession—has shown how growth can be sustained if domestic economic factors are favorable. Thus, the continuing growth of Indian agriculture has boosted demand for construction and services as well as certain types of goods to maintain economic growth.

In relation to the economics of poverty the experience of Indonesia is even more instructive. The regional economic crisis of 1997 resulted in a huge recession in Indonesia’s formal economy leading to substantial job losses in the organized sector and a decline in income of the average urban family. Yet, the unorganized sector with its focus on basic needs not only suffered no recession it actually flourished as demand for its goods and services expanded with a decline in the demand for high quality consumer goods. It is well known that recourse to the informal economy was a major savior for many families individually affected by the crisis.

Inevitably, in a situation where informal sector demand grows strongly the demand for capital to finance the supply of goods and services grows in tandem. Yet, as is well known, the economics of formal sector banking and finance are such that it is virtually impossible, and certainly unrealistic, to expect that the informal economy’s demand for funds will be met by it. The microfinance sector, on the other hand, provides a relatively semi-formal, usually cheaper and more transparent alternative source of finance to the moneylenders, pawnshops and savings and loan associations that have, traditionally, met the financial needs of the poor.

It is against this background that a significant microfinance sector has developed in the region over the past three decades in particular, but even more strongly in recent years. As a result, there is a vibrant network of micro-banks in Indonesia, extensive coverage of NGO-based microfinance institutions (MFIs) in Bangladesh and strongly growing microfinance sectors in the Philippines, Cambodia, India, Nepal and Sri Lanka. However, with the exception of Indonesia much of this growth has been based on subsidized development funds. Studies<sup>86</sup> have shown that this dependence on subsidized funds has had the perverse impact of limiting the growth of the sector by promoting “poverty lending” which has spawned unsustainable MFIs rather than a sustainable “financial services approach”.

It was the realization that promoting the “financial services approach” was the only way to facilitate the development of sustainable institutions that led to the idea of an agency to rate MFIs. It is only dependence on commercial funds that can impose the discipline of the market on MFIs. Yet, commercial lenders—the formal banks—have traditionally shied away from the poor as customers on account of the cost entailed in lending small amounts of money to large numbers of people. The problem of assessing the credit-worthiness of the poor and, thereby, determining the risk premium on such loans has been a major issue for commercial bankers.

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<sup>85</sup> With inputs from Team Leaders Niraj Verma, Tanmay Chetan and members of the M-CRIL team.

<sup>86</sup> In particular The M-CRIL Report, 2000 and Robinson, MS, 2001. *The Microfinance Revolution: Sustainable Finance for the Poor*. Washington DC: The World Bank.

By extension, as the MFIs have grown with the support of development funds, for the commercial banking world these institutions have become a shadowy group of “do gooders” with little understanding of the principles of good financial practice. Yet, there are MFIs that have adopted good financial practices and that are capable of providing sustainable financial services to the poor. There are also others that could and would do so if commercial finance became more easily available to them. Bridging the gap between the MFIs and commercial finance, therefore, represents one of the major challenges of development.

It is in bridging the information and perceptual gap between MFIs and the commercial finance sector that a rating agency can play a key role. Essentially, a rating agency with a specialized knowledge of microfinance and that is able to earn the confidence of commercial lenders is required for this purpose. The existing mechanisms used for the assessment of microfinance institutions were unable to fulfill this need because individual/freelance consultants, academic institutions or consultancy companies based in developed economies dominate the field. Such consultants use a mix of financial and development assessment tools to appraise the performance of MFIs. The problem here is that the financial assessment is not only diluted by development considerations, but the level of competence is variable, regional experience is often inadequate (in the case of developed economy consultancy firms) and when, both conditions are met, the commitment to make a contribution to Asian development is lacking.

The **hypothesis behind the creation of a rating agency** in Asia was that an organization that could make an informed and trustworthy judgment of the performance and creditworthiness of MFIs would be able to promote the flow of commercial funds into microfinance. This would lead, in the long run, to the promotion of professionalism in microfinance generating further confidence in MFIs as borrowers and would, thereby, strengthen the growth of the sector. A strongly growing microfinance sector would provide increasing financial services to the large numbers of poor families in Asia, facilitating their economic lives and reinforcing the proven strengths of the informal economy as an engine of growth and development.

### **The Roots of M-CRIL**

M-CRIL—now Micro-Credit Ratings International Limited—was established by EDA Rural Systems, a development consultancy company that has been undertaking research and management support of development programmes since 1983. Since its inception, EDA has focused its work on the livelihoods of the poor. More recently, the organization has been engaged specifically in supporting microfinance promotion and business development services (BDS) for micro-enterprises in the South and South East Asian region.

Working with a large number of lenders, donors and MFIs, EDA found that access to reliable information and an adequate understanding of the functioning of MFIs was a constraint for all institutions engaged in the development of microfinance in the region—but particularly so for banks. This led to an environment characterized by limited levels of confidence between bulk lenders and MFIs and thereby to high levels of risk aversion. Not surprisingly the demand by MFIs for microfinance funds far exceeds supply. The idea of M-CRIL was conceived out of this observation and based on the above hypothesis.

EDA felt confident of its ability to establish this service because it had:

- The requisite research orientation and methodological sophistication through its research on appraisal methodologies,
- Considerable experience and knowledge of development finance and microfinance programmes,
- An established reputation for rigour, diligence, competence and professional integrity, and

- A locational advantage combined with its well known commitment to make a contribution to Asian development.

M-CRIL, a separate company, was launched for this purpose because it was felt that the rating agency should have an identity that was distinct and clearly transparent relative to EDA's many management support roles and commitments. The issue of transparency in this context has always been a primary consideration for M-CRIL's promoters and it is for this reason that the organization has gone to some lengths to establish a board of directors consisting of eminent academics and professionals from the field of microfinance. It is a highly functional board that is consulted regularly not only on policy matters but also, often, on operational issues that could have a bearing on the image of the organization. M-CRIL further ensures the objectivity of its rating reports by subjecting them to thorough scrutiny by a rating committee consisting of independent professionals.

The second concern in the establishment of M-CRIL was to assemble a dedicated team of executives who not only had a knowledge of microfinance but, over time, would develop a specialization in aspects such as risk assessment which are of particular relevance to rating.

### **Developing the Tool—The Road Less Traveled**

In the course of developing the expertise for this service, M-CRIL formulated and tested the rating instrument and methodology through consultations with experts, extensive literature survey of rating and appraisal experiences (both commercial and microfinance-related) and consultative visits to organizations using similar instruments. The tools considered included appraisal tools of the Donor Committee on Small Enterprises, ACCION, the SEEP Network, the Philippine Coalition on Microfinance Standards and those of various bilateral/international donors as well as the rating tools of both a major international and an Indian commercial rating agency. Discussions and exchange of information was also undertaken in this process with a number of these agencies and with the Seed Capital Development Foundation—then working on the development of MicroRate's methodology.

This process was followed by trial ratings with 14 MFIs of varying sizes, following different savings and credit models and based in different parts of India. Intensive re-formulation of the tool was carried out after each of the seven rounds of trial rating and intensive meetings of M-CRIL's informal advisory group.

The rating service was launched commercially with the first assignment being undertaken in Bangladesh in September 1998.

### **M-CRIL – Who We Are**

**Micro-Credit Ratings International Ltd (M-CRIL)** is a specialized rating and microfinance research agency that has pioneered and successfully introduced the rating of microfinance institutions (MFIs) in Asia. It is dedicated to bridging the information gap between MFIs and the formal financial sector in Asia.

The **mission** of M-CRIL is to facilitate the flow of commercial capital into microfinance through minimizing the information asymmetry between the formal financial sector and microfinance practitioners.

Started in 1998, M-CRIL's activities are based on the belief that with a greater flow of reliable information between the microfinance and the formal financial sectors, MFIs would be better

placed to access wholesale/bulk finance for onlending to the poor. In line with this mission of facilitating the flow of commercial funds into microfinance, M-CRIL also undertakes sectoral research for clients to enable the setting of professional benchmarks and standards. M-CRIL sees its work as an important component in the process of mainstreaming microfinance institutions.

M-CRIL was the pioneer in microfinance ratings in Asia. The organization has set itself very high standards and, partly in recognition of this, was **one of the first five credit rating agencies globally to be certified by the Consultative Group to Assist the Poorest (CGAP) for rating MFIs through the IDB/CGAP Rating Fund.**

### **M-CRIL's Services–Credit rating**

Credit rating of MFIs, M-CRIL's main product, was the first service of its kind in Asia and continues to be the most widely accepted. Developed after intensive research of various micro-credit initiatives in India and elsewhere, the product incorporates the assessment of critical features of microfinance and standard credit rating principles into a comprehensive rating tool.

To maintain its design superiority, and in response to an evolving microfinance environment, the instrument is continuously reviewed and adapted to reflect the risk exposure of MFIs in the region. In a short span of three and a half years, M-CRIL has completed more than 120 credit ratings in 10 South and South East Asian economies.

Donors who have used this service have found that the rating report is a good way of encouraging MFIs to adopt best practices through benchmarking and improving their financial and operational systems and strategies.

### **M-CRIL's Rating Methodology**

M-CRIL's rating is based on the following **working hypothesis**

The risk profile and creditworthiness of an MFI depends critically on its financial performance, but is also affected by its managerial capabilities and governance.

The rating tool contains some 30 indicators subdivided into these three assessment areas. Thus, there are indicators of the MFI's governance, its management systems and its financial performance. These indicators are weighted according to M-CRIL's perception of their importance to the overall performance of the organization. The MFI's rating for each indicator multiplied by the weight for that indicator contributes to the organisation's overall score. This score largely (but not completely) determines M-CRIL's assessment of the MFI's creditworthiness.

The methodology for undertaking a rating involves the following basic steps:

- 1 Request for rating
- 2 Discussions with the organization and data collection
- 3 Analysis and scoring based on M-CRIL's rating tool
- 4 Draft report preparation
- 5 Submission of the draft report to the rated MFI for feedback
- 6 Presentation of the rating and MFI's comments to an external expert committee (Rating Committee)
- 7 Presentation of final rating/creditworthiness report to the client after revision of the draft report.



Each *draft rating report* contains a detailed description of the organization's operations, its products and services as well as analysis of its performance and a justification for the risk grades assigned. Comments on the strengths and weaknesses of the rated institution's operations are also an important component of the report. The draft report is sent to the rated institution for comment/correction of any factual errors before being taken up for finalization.

The rating team presents this draft to the Rating Committee along with the comments of the rated MFI. The committee critically examines the rating, the rationale for grades assigned under each of the three assessment areas against set benchmarks and analysis norms particularly in the context of the rated organization's comments. If the committee does not agree with the report, suitable changes are made and only after the endorsement of the committee is the report finalized and submitted to the client.

### **M-CRIL's Sectoral Research and Advisory Services**

Focused microfinance **research services** ranging from macro-level sectoral studies to operational assessments and detailing for specific programmes are also an important service provided by M-CRIL. Some of the important assignments that have been undertaken in the recent past are:

- A study of innovations in microfinance products and delivery systems in India, in collaboration with the South Asian Network for Microfinance Initiatives, 1999–2000.
- Analysis of the Swarnajayanti Gram Swarozgar Yojana (a Government of India poverty reduction programme)—identification of intervention needs of DRDAs, the implementing agency for the programme—for CARE India, 2001.
- A study of the microfinance regulatory environment and the role of central banks in India, Nepal and Bangladesh for the Asian Development Bank, 1999–2000.
- Assessment of the commitment of Regional Rural Banks to low-end market products and the mapping of constraints that exist or may arise in the future in achieving a sustainable focus on low income clients (*ongoing*).

An integral part of M-CRIL's endeavor to build capacity in the microfinance sector is through its **advisory services**. M-CRIL undertakes a range of advisory services for support institutions, providing specific insights on issues like credit demand, product design, delivery systems and due diligence of processes and accounts.

Some of the recent advisory assignments undertaken by M-CRIL are:

- South Africa: Development of a rating system for housing finance (1999)
- Development of a client scoring/risk rating system for a leading Indian microfinance institution (2000)
- Mahila Abhivruddhi Society, Andhra Pradesh: Development of an SHG rating tool
- Programme support in the selection of ideas, development of projects and preparation of proposals for CARE India's Innovations Fund, 2001–02
- A study of the demand and supply of rural credit amongst low income clients for determining the potential for utilizing CARE India's microfinance loan fund, 2001–02
- Due diligence of an MFI for potential investors—a group of Non-Resident Indians supported by the Rockefeller Foundation.

### **Achievements—The Clients' and MFIs' Perspective**

The process of making lending decisions is facilitated by the use of M-CRIL's services. The rating process and reports have led to quicker decision making by lenders. Significant instances of this are:

- Blue Orchard Finance, manager of the Dexia Micro-Fund of Luxembourg, has requested a number of MFIs in the Asian region to obtain ratings from M-CRIL as part of the process of establishing a financial relationship between them. MFIs rated as part of this process so far include EMT of Cambodia, and TSKI and NWTF of the Philippines.
- Hivos of the Netherlands has obtained ratings by M-CRIL for guiding its decisions in capitalizing Moris Rasik of East Timor and KCLF of Kazakhstan.
- Bank Dagang Bali has also recently been rated by M-CRIL as part of the bank's efforts at obtaining additional capital from international lenders.
- UNDP used a capitalization review by M-CRIL to determine the extent and nature of its support to three microfinance projects in Myanmar.
- The Swiss Agency for Development and Cooperation, Dhaka guaranteed a loan by Sonali Bank (the largest commercial bank in the country) to a large urban MFI (Shakti Foundation).
- Following M-CRIL credit ratings, other MFIs in Bangladesh—BURO, Tangail, VARD and BEES—have obtained loans from Sonali Bank.
- In India, the housing finance company, HDFC has used M-CRIL ratings as part of its decision making process in lending to MFIs.
- Finally, most importantly, SFMC (SIDBI Foundation for Micro-Credit)—a major bulk lender to MFIs in India—has made rating an integral part of its loan appraisal process.

Access to financial services can improve through the use of the rating service, since clients—particularly commercial banks and development banks—now have a scientific, professional and tested means to assess and invest in microfinance. This service, therefore, provides the crucial missing link—to both the borrowers (MFIs) and lenders—of access to adequate and detailed information, thereby, facilitating the flow of funds to MFIs.

In their feedback to the rating reports, several MFIs have indicated that the comments in the report on the **strengths and weaknesses** of their programmes were instrumental in enabling them to improve their operations. The changes brought about as a result of the rating exercise are varied—while some MFIs have altered their strategy for microfinance operations, others have adopted better and more transparent financial monitoring and accounting systems or modified and improved their MIS.

The demand for the service has developed well though, in the initial stages, the growth of this new service was relatively slow. M-CRIL's work has gained momentum in the region in recent months with some interest having been shown in Indonesia in the development of a rating system for village banks/BPRs. In Bangladesh, M-CRIL has negotiated with the Swiss Agency for Development Cooperation (SDC) an agreement for the latter to part-sponsor requests from commercial banks to undertake ratings of MFIs.

Donors who have used this service have found that the rating report is a good way of enabling leading MFIs to adopt best practices and improve their financial and operational systems and development strategies. SIDBI in India has specifically requested the M-CRIL provide a separate capacity building report on each MFI rated to enable it to design its capacity building inputs to the microfinance sector. Similarly, both SDC and DFID in Bangladesh and HIVOS in East Timor and Kazakhstan have used M-CRIL's ratings to establish performance targets for rated MFIs.

### **The Experience – M-CRIL's Perspective**

Given the early stage of development of many MFIs in Asia and the lack of a sufficiently strong emphasis on reporting and monitoring systems development, data gathering is a difficult and intensive task and requires use of various techniques and cross checking. It is the re-

worked financial statements of MFIs, generated as part of the rating report, that provide a realistic financial picture of the organization. **This re-working results in a standard format being used for all organizations and provides more information relevant for rating purposes than is generally available from audit reports.**

- The technology, instrument and methodology being used by M-CRIL have yielded consistent and appropriate results for organizations working in the Asian region.
- The experience of completing over 120 ratings so far, has increasingly led to more efficient and rigorous assessments being undertaken by M-CRIL staff.
- A significant amount of incisive and high quality data has been generated at M-CRIL and has led to the formulation of an extensive and unique database on MFIs in the Asian region (M-CRIL has developed an in-house MS-Access based software for data recording and analysis). Using this database, M-CRIL has undertaken an analysis of “The Performance of Rated MFIs in South Asia” which has been published as **The M-CRIL Report, 2000**. This report has provided a comprehensive picture of the status of microfinance in South Asia. A new edition is currently being compiled.
- After over two years of operation, M-CRIL undertook a major review of its rating instrument. This involved the study of M-CRIL’s database information, scenario analysis, and consultation with M-CRIL Board members. As a result of fine-tuning of the instrument, the rating methodology was made more stringent with the inclusion of minimum conditions—in addition to scores across all indicators—for achieving higher grades.
- M-CRIL’s Rating Committee—consisting of independent professionals with considerable experience, knowledge and understanding of microfinance—has played a significant role in emphasising and reinforcing M-CRIL’s commitment to employing rigorous yet progressive standards in assessing the creditworthiness of MFIs in the region.

### **Summary and Conclusions**

M-CRIL’s initiative in pioneering microfinance in Asia has led to a number of beneficial impacts for the development of microbanking in the region. Specifically, M-CRIL’s rating initiative has:

- **Facilitated transparency** by overcoming information asymmetries between banks and donors interested in providing capital to MFIs; in an apparently bleak scenario where MFI capabilities are questioned, it has helped lenders to understand the positive role played by many MFIs in providing financial services to the poor. It has also helped to establish that many MFIs are at or near sustainability and, therefore, do constitute good investments for either loans or equity. Public transparency is also starting to happen as a number of MFIs have placed rating reports on their websites. Indeed, the IDB/CGAP fund imposes public disclosure of the rating report as a condition for its support.
- **Generated internal accountability** by identifying the key weaknesses found in MFIs in the region as part of the process of promoting transparency, enabling such issues to be discussed between lenders and donors, on the one hand, and MFIs, on the other. A number of MFIs have undertaken specific actions to build capacity in areas of weakness either with donor support or, even, at their own initiative utilizing internal resources. When requested, M-CRIL has made specific recommendations for this purpose.

- **Strengthened links with investors** leading to lending of the order of \$8 to 9 million to around 50 MFIs by the SIDBI Fund for Micro-Credit in India and to substantial capitalization of other MFIs in Asia by the Dexia Micro-Fund, HIVOS of the Netherlands, UNDP, SDC, DFID and others.
- **Enabled the development of standards**—particularly in India where the rating of a large number of institutions has resulted in a substantive database. The statistically significant industry averages and comprehensive picture of microfinance provision emerging from this database has facilitated the development of standards for the microfinance sector in India. M-CRIL is working towards the development of a similar database and introduction of standards for different segments of the industry in the entire Asian region.

To conclude, M-CRIL's experience is that ratings as institutional assessments based on accepted standards can be a very powerful tool both in enabling capitalization of MFIs and in promoting institutional capacity building thus strengthening the provision of financial services to the large numbers of low income families in the Asian region. However, to be effective the service must be provided by a professional team that is

- dedicated to microfinance and is, thereby, able to develop the knowledge and experience that goes with specialization, and
- committed to the long term development and growth of the microfinance sector.

**BLUE ORCHARD FINANCE S.A.**  
**GROWING TOGETHER WITH THE ENTREPRENEURIAL POOR**

**Jean-Philippe De Schrevel**  
**Blue Orchard Finance**

Microfinance is defined as the provision of financial services (credit, savings, insurance, payments) to the entrepreneurial poor. The vision of microfinance is based on four facts: 1) microfinance is one more segment of global finance; 2) microfinance institutions' (MFI) profitability is key to sustainable impact delivery; 3) access to capital markets is a condition for increased outreach in the long term; and 4) profitable microfinance is compatible with poverty alleviation and socio-economic development objectives.

Microfinance targets two kinds of micro-entrepreneurs. "Survival" microfinance helps micro-entrepreneurs by allowing stability of business funding and income, while "Growth" microfinance allows poor entrepreneurs with business acumen to develop their business and pull others through job creation. Both sub-segments ought to follow the profitability rules in order to ensure sustainability of action.

**Investments vs Donations and Subsidies**

The entrepreneurial poor need consideration and trust, not compassion and paternalism. Efficiency cuts operational costs and benefits clients and is reached through professionalism and formalization. Subsidies or donations must be given as a driver toward more independence and they need to be properly targeted, either towards institutional capacity building or start-ups.

**Advantages of a Well Managed Commercial MFI**

Commercial MFIs have among other things, the capacity to attract business talent, focus on productivity and efficiency, new product development capabilities, capability to attract diversified funding, and for them pricing is market-driven.

**Advantages of Commercial Funding for MFI**

Through commercial funding, MFIs have the advantage of funding diversification, fast and reliable access to large amounts of funds, branding and reputation spill-overs, know-how build up, exposure to international investors, rigor of financial reporting, independence from donors and hidden agendas, and access to new products with flexible terms.

From an investor's perspective, microfinance is a nascent industry since there is an increasing number of professionally managed and profitable MFIs, specialized rating and evaluation companies, increased supervision from central banks and regulators, external audits by recognized international firms, and market competition and consolidation. Furthermore, microfinance is within the wave of ethical investments since it offers a concrete dimension to ethical investment, an attractive asset class with a double bottom line, and a growing investment opportunity: volume counts!

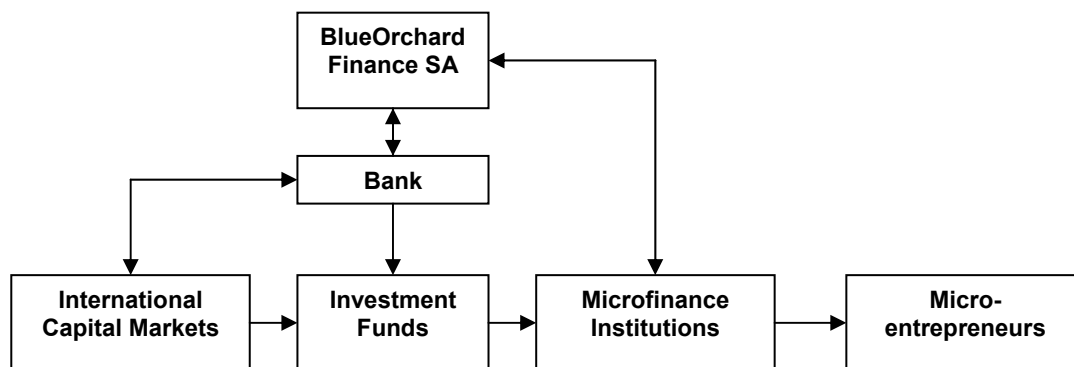
In summary, we see microfinance as a very efficient tool for poverty alleviation, one more segment of global finance, and a great opportunity for SRI.

## Blue Orchard Finance

Blue Orchard is a Swiss asset management company specializing in microfinance investments, whose mission is to channel flows of funds from international capital markets to microfinance institutions throughout the world.

Blue Orchard has a gradual approach to MFI investment since their new products strategy follows the evolving needs of the market from seed and start-ups to consolidation to maturity. Short term financing loans evolve to long term financing and equity and bonds.

## Blue Orchard Positioning



## Blue Orchard products and services

Products and services consist of the development, management and advice of microfinance investments and investment related products. In this regard, Dexia Micro-Credit Fund (DMCF) is our flagship. There is also an on-going discussion with other banks for new products development, and an international securitization project.

Blue Orchard's investment policy, DMCF, consists in short-term lending in USD to MFIs worldwide. MFIs targeted by Dexia Micro-Credit Fund must be experienced and profitable (at least with sustainable operations), have direct operators, and be externally audited as well as de rated or evaluated. In this sense, we aim to contribute to the creation of the microfinance industry.

Microfinance debt is a new asset class with double bottom line impact, since it offers an attractive risk-return financial profile and a concrete and effective social impact. The risk-return profile has a good return (levels in 2000 and 2001 were 7.8 percent and 6.8 percent, respectively) and is steady considering that there has not been a single downturn. Like wise the risk is limited given that well screened MFIs are very good credit risks, promissory notes are not quoted on financial markets, and there is a weaker correlation with macro impacts than other FI. Other advantages are that short-term lending allows fund managers to permanently reassess portfolio composition, and the de-correlation with other asset classes in our investors'

portfolios. Furthermore, there is a concrete and effective social impact: the 26 MFIs currently in our portfolio serve over half a million poor entrepreneurs in 16 countries.

The DMCF is a successful commercial fund with total assets amounting to US\$20 million and total outstanding micro-finance loans to US\$15.5 million. The distribution of the 40 loans made by 26 MFIs over 16 countries is as follows:

Bolivia	5%
Bosnia-Herzegovina	2%
Cambodia	2%
Colombia	6%
Dominican Republic	10%
Ecuador	8%
Guatemala	2%
India	4%
Indonesia	6%
Mexico	6%
Morocco	5%
Mongolia	3%
Nicaragua	19%
Peru	21%
Uganda	1%
Uruguay	1%

Likewise, the DMCF is a successful commercial fund with a good track record, when considering the net share value of the USD Compartment, the net return amounted to 7.8 percent in 2000, 6.8 percent in 2001, and 20.6 percent since inception, without any defaults.

### **Constraints for Future Development**

Firstly, cheap money and untargeted subsidies crowd out the private sector. Secondly rating capabilities in the microfinance market are somewhat limited since mainstream rating companies have only recently begun to discover microfinance and the specialized microfinance rating companies who know the sector well are not recognized by investors. Likewise, local regulations sometimes present difficulties when investment funds are not recognized as financial institutions since the reserve policy required from MFI by central banks makes loans too expensive.

Additionally, direct international lending in US dollars is forbidden when the MFI is an NGO and when the lending is short-term. Also, a cap is sometimes placed on MFI interest rates which weakens the MFI and hinders lending possibilities, while local tax levels on interest earnings are too high and make loans too expensive for MFIs. Finally, the industry's lack of centralized statistical data hinders the development of a global visibility for potential investors in the sector who consider the flow of commercial money, absorption levels, and the default history of those investments.

### **Conclusion**

In sum, microfinance is one more segment of finance where profitability is key to sustainability and access to capital markets is key for volume. Microfinance has all the elements of a nascent industry although some changes could be made to facilitate investments, such as preventing unfair competition and crowding out, improving local access to MFIs by international investors, developing recognized rating capabilities, and ensuring an attractive fiscal treatment.

## TRADITIONAL AND NEW SOURCES OF FINANCING

**Miguel A. Rivarola**  
**Chemonics International, Inc., USAID**

Currently, there is relatively little self-capitalisation. Financing sources can increase portfolios, enhance the chances for self sufficiency, increase the reach and depth of spreads, reduce transaction costs, and diversify dependence risks. There are four types of financing sources: public, private, national and international.

### **National Public Sources**

One of the ways that financing can be awarded is through government programs, such as the National Program for Micro-entrepreneur Financing in the case of Mexico, as well as funds with specific objectives, such as NAFIBO and FONDESIF in Bolivia. Likewise, governments can establish trust funds such as the agricultural trust created in Mexico, and development banks, such as “Nacional Financiera” and the National Savings Bank in Mexico, the National Financing Corporation in Ecuador, IFI in Columbia, and COFIDE in Peru.

These sources normally use the following financing instruments: 1) subsidized or commercial loans; 2) donations in the form of capital for loans, training, technical assistance, equipment, initial organization, new agencies, and information systems; 3) capital investments, a stock position with or without ousting mechanisms, short or medium term; and 4) guarantees to access public or private sources, with or without costs.

There are a number of points to be considered when addressing national public sources including, unfair competition, continued dependency on the state, imposed lending criteria, imposition of subsidized rates, little or no taxation, the fact that sometimes schemes are just mechanisms to distribute funds, and they can be unstable and be driven by political criteria.

### **International Public Sources**

There are two types of entities that can give international public financing: multilateral organizations and banks, such as the World Bank, the Inter American Development Bank, the Multilateral Investment Fund, the Asian Development Bank, the African Development Bank, the United Nations, FIDA, PNUD, FNUDC, and CFI among other, and foreign governments, such as Japan, Luxemburg, France, USA (through USAID), Canada, Switzerland, Sweden, GTZ, Australia, CIDA, Finland, and China to name a few.

International public sources award financing through direct or government loans, subordinated loans, donations, capital investments, loan guarantees or issuance of bonds and/or stocks, and deposit guarantees.

The issues to be considered here are that it can be difficult and expensive to interact with these entities, they are generally very slow and have their own national political agendas, there can be a geographical and economic concentration, they are difficult to coordinate since they can have somewhat opposing policies, and sometimes these sources are used to influence domestic policy.

### **National Private Sources**

The entities considered under this category are: 1) commercial banks (such as Citibank, Bital and Bancomer in Mexico, Pacífico in Ecuador, Mercantil and La Paz in Bolivia, Wiese in



Peru, and Banco Empresarial in Guatemala); 2) foundations (Fundapro in Bolivia, Covelo in Honduras, and Carvajal in Colombia); 3) civil associations (Chamber of Commerce and Industry and FWFB in Indonesia); 4) integration organisms (Federaciones, Uniones de Crédito and Emprender in Colombia) ; 5) individuals, through loans; 6) banks and second tier funds (Mexican Microfinance Fund, Accorde in Costa Rica, and FonfoMicro in Dominican Republic); and 7) clients and/or partners, through savings and deposits.

Among the instruments these sources use are commercial loans, loans from integration organisms, credit lines guaranteed by the portfolio, individuals' capital risk investments, subordinated loans, donations, clients and/or partners' deposits and savings, commercial debt instruments (guaranteed or not), liquidity loans, and guarantees.

In this category it is important to consider the number and capacity of MFIs, additionality, substitution, sustainability, concentration, and competitiveness.

### **Other Private Sources**

Another important private source is through remittances. In the case of Mexico, BANSEFI, NAFIN and USAID can be placed in this category. During 2001, these institutions accounted for more than US\$9 billion, representing the fourth largest source foreign currency income, after manufacturing exports, foreign direct investment, and oil exports. These funds are used for consumption, investment, savings and to promote trade and productive activity.

Deposits and savings constitute another source of financing although it is difficult to determine if they are mandatory or voluntary, expensive, unknown, risky, short or long term, or if they are designed for the market in terms of security, profitability, convenience and liquidity.

Guarantee or deposit protection funds award preventive liquidity loans, financial support in cases of mergers or sales (including the capitalisation of the entity), investments in secured entities, and investments in government bonds or letters representative of the social capital of investment funds. In Mexico the Protection Fund award loans of between US\$12,000 and US\$30,000.

Lastly, another source of private financing is insurance. In the case of insurance, reserves have to be invested in liquid or quasi-liquid instruments, medium or long term depending on the type of insurance policies sold, and must have a loan provider. The limitations are the capitalization, specialization and content requirements of the policies. An example of a Mexican insurance entity is the Social Works Fund established in Article 15 of the Savings and Popular Credit Law.

There are a number of challenges for microinsurance companies such as a restrictive regulatory scenario, limited interest from commercial insurance companies, high transaction costs, experience and knowledge about microinsurance, costs of primes, establishment of differential prices, destination of utilities and reserves, and management of reserves and primes.

### **The Advisor Syndrome**

Regardless of the sources of loans, it is advisable to consider further diversification to diminish dependency; to share a compatible vision, mission and values; to verify permanence, and finally; to compare institutional and financial benefits and costs.

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Investing in Microfinance. Several international and regional funds have been established that invest moneys in microfinance activities and institutions. These funds are managed by non profit organizations, commercial banks and investment firms. A listing of such funds is provided in the web link below. The contact person is Hari Srinivas at [hsrinivas@gdrc.org](mailto:hsrinivas@gdrc.org). The Web page is: <http://www.gdrc.org/icm/invest-mfi.html>

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## **CLOSING REMARKS**

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Ladies and gentlemen,

Experiences of APEC member economies with microbanking are rather heterogeneous, especially in terms of the complexity and outreach of existing intermediaries, the regulatory and supervisory schemes in place, and the current issues facing the industry in each economy.

However, for all economies considered, regardless of how developed they are, microbanking activities are indisputably significant, whether as part of an integral aspect of national poverty reduction and safety net strategies or as a specific mechanism to address the needs of specific economic or social sectors of the population.

Considering the different institutional paths existing in each APEC economy, there is no single approach on how to enhance the effectiveness of regulation and supervision. However, in all cases, there is agreement that government action should be geared at enabling the growth and expansion of sound microbanking intermediaries, fostering their gradual and full integration into the domestic financial system.

\* \* \*

In sum, the experience reviewed in this symposium concludes that the APEC region is at the forefront of the microbanking industry. Whether as an integral part of the financial system in the most industrialized economies, or as an incipient industry with great potential among the less developed economies, the vast array of microbanking experiences in the APEC region offers a formidable lesson of how relevant the industry has become for economic development, and particularly for the improving the welfare of our societies.

As a result of this event and the study that will be included in the Economic Outlook, future collaboration projects on the issue of microbanking could be considered in the Economic Committee, as well as in other APEC fora.

\* \* \*

I would like to thank APEC's Economic Committee and the member economies that participated in this project for their enthusiasm in contributing to the symposium and for having shared their national experiences and know-how on this matter. It is also with great thankfulness that we recall the Ministers of Finance Process for their support on this initiative.

Likewise, this symposium would not have been so enlightening without the valuable contributions from the Inter-American Development Bank, the World Bank, and the Asian Development Bank, and the assistance and encouragement from the Bank of National Savings and Financial Services, and the National Banking and Securities Commission of Mexico in conjunction with the Mexican Ministry of Finance and Public Credit.

Ladies and gentlemen, thank you all for attending this meeting and for your valuable insights on this initiative.

## ABBREVIATIONS

ADB	Asian Development Bank
ATMs	Automated Teller Machines
BANSEFI	Bank of National Savings and Financial Services <i>in Mexico</i>
BKD	Badan Kredit Desa <i>in Indonesia</i>
BPR	Bank Perkreditan Rakyat <i>in Indonesia</i>
BRI	Bank Rakyat Indonesia
BSP	Bangko Sentral ng Pilipinas
BSP	Bank of South Pacific
CAMEL	Capital, Asset Quality, Management, Earning, Liquidity
CAR	Capital Adequacy Ratio
CDA	Cooperative Development Authority <i>in Philippines</i>
CECA	Spanish Confederation of Savings Cooperatives
CGAP	Consultative Group to Assist the Poorest (located at the World Bank)
COBEX	Coverage of Banking Loans to Exporters <i>in Chile</i>
COPEME	Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises
CUs	Credit Unions
DCPs	Government-Directed Credit Programs <i>in Philippines</i>
DGRV	German Confederation of Savings and Credit Cooperatives
DMCF	Dexia Micro-Credit Fund
EACPs	Popular Credit And Savings Entities
EC	Economic Committee
ECOTECH	Economic and Technical Cooperation
EDPYME	Entities for the Development of Micro and Small Enterprises <i>in Peru</i>
EU	European Union
FAs	Farmers' Associations <i>in Chinese Taipei</i>
FECRECOOP	Federation of Savings and Credit Cooperatives <i>in Chile</i>
FENACREP	Credit Cooperative Federation in Peru
FX	Foreign Exchange
GFIs	Government Financial Institutions
HLMME	High Level Meeting on Micro-enterprise
IADB	Inter-American Development Bank
IMF	International Monetary Fund
LBP	Land Bank of the Philippines
LDKP	Lembaga Dana Kredit Pedesaan <i>in Indonesia</i>
LDR	Loan To Deposit Ratio
MBIs	Microbanking Institutions
M-CRIL	Micro-Credit Ratings International Limited
MFIs	Microfinance Institutions
NGOs	Non-Governmental Organizations
NPL	Non-Performing Loan
PNGBC	Papua New Guinea Banking Corporation
PRONAFIDE	National Program for Development Financing in Mexico
PRONAFIM	National Program for Microentrepreneurs' Financing
RCCs	Rural Credit Cooperatives <i>in China</i>
REITs	Real Estate Investment Trusts
ROA	Return On Assets
ROE	Return On Equity
RoSCAs	Rotating Savings and Credit Associations
SHGs	Self-Help Groups
SLs	Savings and Loans Societies <i>in Papua New Guinea</i>
SME	Small and Medium Enterprises
SOCBs	State-Owned Commercial Banks

SOM	Senior Officials' Meeting
TILF	Trade and Investment Liberalisation and Facilitation
USAID	United States Agency for International Development
VFL	Village Finance Limited <i>in Papua New Guinea</i>
WB	World Bank
WOCCU	World Council of Credit Unions
WTO	World Trade Organisation