

# **International Conference on Microfinance Microfinance Regulations: Who benefits?**

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## **Regulation of Microcredit in Bolivia**

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## 1. Introduction

The regulation of microfinance entities is directly related to the government's policy of extending the rulings to financial Non Government Organizations (NGOs,) that grant credit to the poor and to the informal sectors. These entities were hitherto unregulated.

In the mid 90s, four NGOs chose voluntarily to be regulated and hence adopted the norms established in the banking law of 1993. The Superintendence of Banks and Financial Institutions - that became later the Financial System Supervisory Authority (FSSA) - in the framework of the banking law promulgated the norms to regulate microfinance institutions (MFIs) in 1995. One of the most important stipulations was that for financial NGOs to become Regulated Microfinancial Institutions (MFIs) they had to become public corporations, with shareholding ownership. They received the heading of Private Financial Funds (PFFs). However, most financial NGOs remained as unregulated non-profit entities, called Development Finance Institutions (DFI).

The decision to adhere or not to the regulated system, crucially depended on the obligation to become a public corporation. The benefits of becoming regulated institutions came at the cost of losing their essential purpose as financial NGOs. Some entities therefore chose not to adhere to the new regime in order to retain their purpose, namely to support with microfinance services those sectors excluded from the financial system, due to their poverty and the informal nature of their activity.

Currently many financial institutions, either regulated or unregulated, have to cope with changes in financial policy. The FSSA has proposed regulation for the DFIs while allowing them to keep their legal status as non-profit entities. Also, it is fostering their institutional strengthening by setting general and specific requirements.

This document describes the current and the previous regulation, emphasizing the steps taken by the authorities to make it more inclusive. The process started with the MFI that most closely resembled to banks but it went beyond incorporating also the DFIs that desire to maintain their status of ONGs. The presentation highlights the challenges DFIs will have to face in their future activities and in their efforts to serve their target clientele.

## **2. Description of the financial environment**

### **2.1 Characteristics of the country**

Microcredit in Bolivia has gained international prestige because of its innovation, efficiency, and competitive activities in serving poor clients from informal sectors. Also, because microcredit institutions have achieved economic sustainability, while having great social impact.

Bolivia has 10.4 million inhabitants spread in 1.1 million km<sup>2</sup>; sixty six % live in the urban areas and the rest in the rural areas. The official language is Spanish but about 50% of the population has a native language as mother tongue<sup>1</sup>. Bolivian GDP is close to 17,300 million US\$, and growth in 2009 is

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<sup>1</sup> Aymara, Quechua, Guaraní, and other American Indian languages.

<sup>2</sup> Source: National Statistic Institute INE

estimated to be about 3.5%. Per capita GDP is 1,670 US\$. Extreme poverty affects 37% of the population. The 2009 inflation rate is projected to be about 1%<sup>3</sup>.

Microcredit is closely related to the informal sector. Estimates indicate that 2.0 million people work in the informal sector of the economy and contribute with a value added of 15%-20% to Bolivian GDP.<sup>4</sup> According to specialised studies, the informal sector of the economy currently constitutes about 60% of the total employment of the country.

## **2.2 Participants in the bolivian financial system**

There are many types of regulated entities, authorised to provide financial intermediation services<sup>5</sup>. Banks are corporations with a very broad range of services: corporate credit, housing credit, commercial credit, consumer credit, foreign trade credit, and microcredit. Savings and loan associations are no-profit institutions that also offer multiple banking services although they specialize in mortgages. Savings and credit cooperatives or credit unions are institutions that primarily lend to their members. Private Financial Funds (PFF) are organized as corporations like the banks, but they specialize completely in providing microcredit and other financial services to small and micro clients.

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<sup>3</sup> Source: *Central Bank*.

<sup>4</sup> The labor Force or Economically Active Population—EAP— is of 4.5 million people (Economy and Finance)

<sup>5</sup> The Regulated Financial System comprises 12 private banks, 6 private financial funds, 8 savings and loan Associations, 24 cooperatives (Credit Unions), a second floor bank, 7 firms of auxiliary financial services (2 of financial leasing, 2 warrants, 2 credit information bureaus, and a clearing house).

In 2008, the DFIs were allowed to offer financial services within the reach of the regulations of the FSSA. They are however awaiting authorisation for their operations in order to be considered regulated entities.

## **2.3 Role of the Supervision Authority and the Central Bank**

The authorities that rule and supervise the financial system are: the Financial System Supervision Authority(FSSA) in charge of the system that controls the gathering of deposits from the public and, more generally, the country's financial intermediation – and the Central Bank of Bolivia who in charge of the monetary and foreign exchange policies and of the payments system. The FSSA is independent of the Central Bank, unlike many countries. The FSSA and the Central Bank do however coordinate policies under the aegis of the Minister of Economy.

The Law of Banks and Financial Entities regulates the activities of financial intermediation.<sup>6</sup> This law determines and established FSSA as the body in charge of granting licenses to operate with financial services. The objective of the FSSA is to support a healthy, efficient, financial system and to safeguard its solvency and transparency. Regulation and supervision must seek to protect the savings of the public, defend consumer financial rights, and ensure that services rendered are of the best possible quality. As a regulator, FSSA sets the requirements for the establishment, capital replenishment, liquidation, administration and operation of depository financial institutions of all types. It also sets prudential norms like limits and prohibitions for certain types

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<sup>6</sup> Law 1488 of April 14, 1993. In a nutshell, the law regulates the customary reception of deposits of the public, under any modality, and their placement in risk assets.

of loans and rules for internal control. As a supervisor, it conducts on site examinations and verifications of compliance with the regulations. FSSA also manages a bureau of credit risks and periodically publishes financial data of supervised entities. With regard to the latter, FSSA bulletins are highly regarded for their candid assessments of the institutions that it supervises.

The objective of the Central Bank is to procure the stability of the domestic purchasing power of the national currency. Its specific duties to the financial system are of being a depository of the liquid reserves of the financial institutions, including the minimum legal reserve requirements and the reserves needed for the payments system, and of acting as a lender of last resort to meet liquidity needs of the financial institutions.<sup>7</sup>

The Central Bank has a crucial role in the payments system. Interbank settlements and operations with the government are done on its books. Its weekly publication of the effective interest rates of each financial entity provides essential information to the market.

### **3. Transformation of NGOs to Private Financial Funds (PFF)**

Financial NGOs were very instrumental in the expansion of microcredit and they directed their efforts to attend to the needs for credit of the informal sector: micro enterprises, small traders, self-employed service workers, artisans, and small agricultural producers in rural and marginal urban areas. The void left in Bolivian rural areas by the divestiture of state banking was gradually filled with microcredit from financial NGOs.

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<sup>7</sup> The Central Bank rules its activity by Law 1670 of December 31, 1995

The financial NGOs with their funding constraints could not grow despite the demand of the market. There was an excess demand for microcredit. Regulators as well as the financial NGOs themselves felt that there was room for expansion. The challenge was then to include financial NGOs in the regulated financial system to extend the geographic and demographic ambits and attain greater depth. By transforming their legal capacity to that of public corporations, they would acquire legal stability and ensure their participation in risk capital with a view of long-term profitability and feasibility. The liberalisation of financial markets in 1985, in the aftermath of a stabilization program, created the need to bring up to date the regulatory framework. The Law of Banks and Financial Entities was promulgated.<sup>8</sup> It was later modified by other laws<sup>9</sup>.

The progress of NGOs and the experience of “Banco Sol” encouraged a specific regulatory framework for microcredit.<sup>10</sup> In 1995, regulations were set for the creation and operation of PFFs as regulated public corporations with the main purpose of channelling resources to the activities of small and micro borrowers, both in urban and in rural areas.<sup>11</sup>

PFFs are required to have a minimum capital of 630,000 Special Drawing Rights (SDRs). They can receive deposits in passbooks as well as term deposits,

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<sup>8</sup> Law N° 1488 of April 14, 1993

<sup>9</sup> Among the most important laws: *Ley del Banco Central de Bolivia* (1995), *Ley de Pensiones* (1996), *Ley de Propiedad y Crédito Popular* (1998), *Ley Modificatoria de Disposiciones Legales del Sistema Financiero* (1999), *Ley de Reactivación Económica* (2000), and *Ley del Fondo Especial de Reactivación Económica y Fortalecimiento de la Normativa y Supervisión Financiera* (2001).

<sup>10</sup> The PRODEM Foundation along with other investors created Banco Solidario S.A (Banco Sol) in 1992.

<sup>11</sup> Supreme Decree N° 24000. Public corporation is a fitting figure for financial intermediation, both for the juridical stability that this legal figure embodies to the eyes of civil society and for granting the flexibility needed to call for more capital from the shareholders, should solvency problems arise, for instance when the capital to risk-weighted assets falls below the statutory limit.

place the funds in loans and other authorized assets and carry out placement, capture, and auxiliary financial services. However, their operations with checking accounts and foreign trade are restricted.

As said above, the new entities<sup>12</sup> adopted the legal form of public corporations. In the shareholding structure the founding NGOs kept a percentage of the shares and the rest was divided among international development organisations and private investors. The NGOs loan portfolios were transferred to PFFs in two modalities: 1) NGOs transferred clients and credit portfolios definitively to the PFFs, or 2) they delegated the management of their loan portfolio to the PFFs and transferred their clients to them gradually.

The new dimension of microcredit, with its attendant supply increase, and the easiness of access led to a very substantial increase in the number of the beneficiaries, to better financial services and to strengthened competition. Moreover, the whole financial sector benefited from the growth of the microfinancial institutions. The MFIs taught to traditional banks that mass banking could be profitable and safe if adequate technologies were used. Because of the lessons learned from the MFIs, the established banks ceased to be “exclusive” institutions, of the country-club type, and went beyond their traditional clients.

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<sup>12</sup> In July 1995, ProCredit, the first NGO to become a PFF, founded Los Andes Savings and Loan (today, Los Andes ProCredit S.A. Bank). In March 1998, the NGO FIE became the PFF FIE, and in June 1999, five NGOs founded the PFF EcoFuturo.

### 3.1 Specific regulation for Microfinance Institutions MFIs<sup>13</sup>

The specificities of microcredit institutions make their activities diverge from the credit activities of commercial banking.<sup>14</sup> Thus, FSSA issued a specific regulation that allows entities working with microcredit to operate and assess operations according to the activity in which they take place but obliges them to track credit and operational risk more closely than in the banks.

To approve a microloan, the financial situation, payment capacity and collateral of borrowers must be verified and analysed. Additionally, the Central Bureau of Risk Information must be consulted. Also, internal control mechanisms need to be set up. This is not very different from what is required from traditional banks.

#### **Portfolio rules**

Credit risk regulation for the MFI sector requires a) specific and b) generic provisions against bad loans due to:

a) Specific risk of unpaid credit.- As a microcredit has a very short economic cycle, it is fundamental to record the length of delay in payment (in days) to

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<sup>13</sup> MFIs are formed by regulated entities: Private Financial Funds PFF and the Banks specialized in microcredit: Sol and Los Andes.

<sup>14</sup> Microcredit is defined as the credit granted to an individual or corporate borrower or to a group of borrowers, with joint or supportive collateral, in order to fund small scale activities in production, commercialisation, or services, and where the source of payment is the income generated by such activities or the sale of produce.

assess the credit risk of each operation, and to determine the specific provisions.<sup>15</sup>

b) Additional risk of default.- Considers compliance with credit policies. The latter comprises an appropriate credit technology that includes practices and procedures in credit granting, management, and risk control as well as policies on re-programming; information systems; and risk assessment of the more indebted clients in other entities. The entity must set a generic provision of 3% of its total microcredit portfolio if found not complying with its own credit policies.<sup>16</sup>

### **Rules for financial services**

To extend the geographic reach of financial services, the procedures for branch and office openings have been simplified. Mobile services have been included. Likewise, the assignment of correspondent auxiliary financial services was regulated. The regulated financial intermediation institutions were authorized to correspond among themselves and with non-regulated entities to carry out financial services such as payments and transfers.

A Credit Information Bureau (CIB) has allowed regulated MFIs to access the credit information of non-regulated micro finance entities. In this way, it helps them evaluate over indebtedness more fully.

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<sup>15</sup> According to the length of delay in the payment (in days) of microcredit, provisions range from 1% for delays of 1 to 5 days ; 5% for delays of 6 to 30 days; 20% for delays of 31 to 60 days; 50% for delays of 61 to 90 days; and 100% for delays of more than 90 days.

<sup>16</sup> The frequency of cases that deviate from or do not comply with credit policies is determined on the basis of a statistical representative sample of borrowers; for every 10% of deviation or non-compliance found, 1% is set as a generic provision.

Market transparency and consumer protection were strengthened with the regulation on interest rates. There are no ceilings on interest rates but this regulation states the characteristics and minimum contents of credit contracts as well as basis for the determination of interest rates.<sup>17</sup>

The Service to Attend Customer Complaints (*SARC*) allows clients to express their dissatisfaction or query directly to financial entities. If client's complaints are unattended, they can appeal to FSSA. The *SARC* makes preventive and corrective actions possible.

Corporate governance was stimulated to follow best practices, with guidelines for relations and behavior of members of the board of directors, managers, shareholders, and third parties. As a component of corporate governance, financial institutions need to state their strategic objectives as well as the means, resources, and processes to attain these objectives. Control systems of decisions or operations are established to duly follow-up compliance with the guidelines at each level.

Regulations were set up for trustee roles and duties, as well as for control and internal auditing. Guidelines for internal control and risk-based auditing support a proper risk management.

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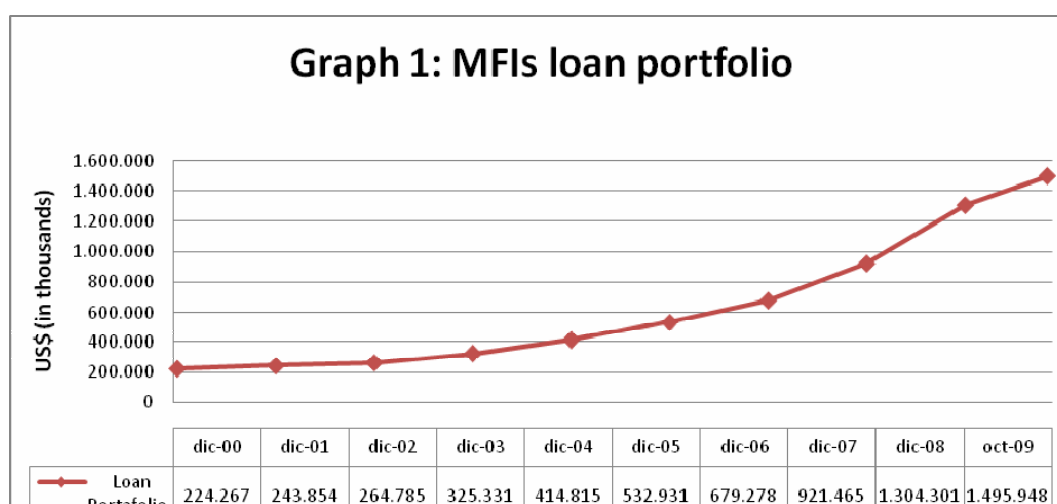
<sup>17</sup> The main characteristics required in contracts are:

- a) The amount contracted, specifying additional charges at the time of disbursement,
- b) All applicable fees and charges, be they periodical or not, at the beginning or end of the operation,
- c) The modality (fixed or variable) of the nominal interest rate agreed on,
- d) The frequency and manner in which the Reference Rate (RR) will be applied for readjustment when rates are variable.
- e) Entities are under the obligation to publish the interest rate and all commissions and surcharges.

The implementation of internal control systems in each financial entity involves risk evaluation, activities in control and segregation of tasks, information and communication, and activities in monitoring and correcting deficiencies. All the board members, managers, and staff of financial intermediation entities are asked to participate with clearly defined roles and duties.

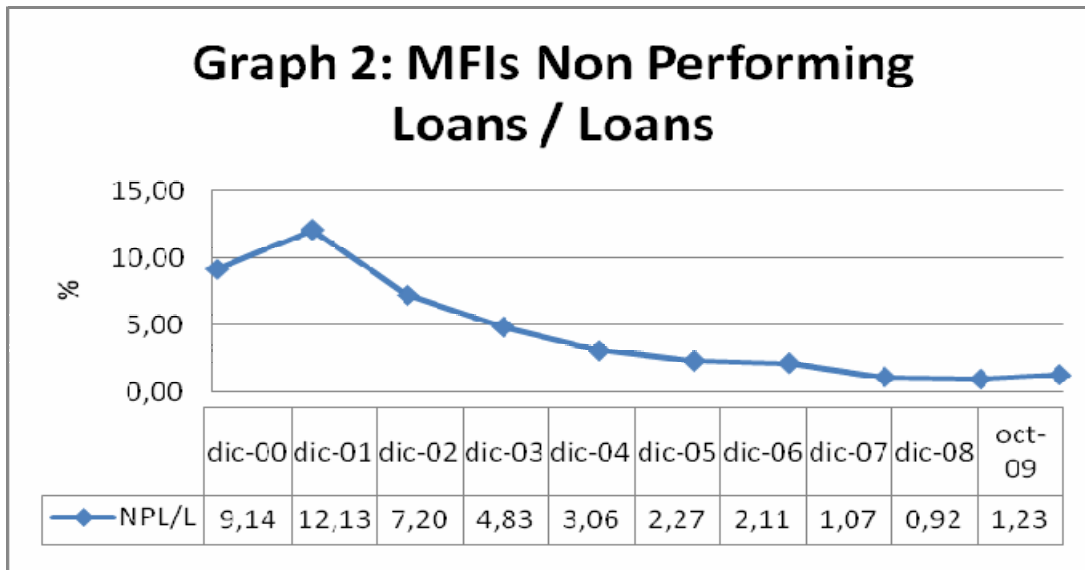
### 3.2 Evolution of MFIs

In terms of intermediation volume, portfolio quality, provisions, and number of clients serviced, indicators for the regulated system MFIs are significantly better than those for commercial banking. The numbers in the tables below clearly show this.



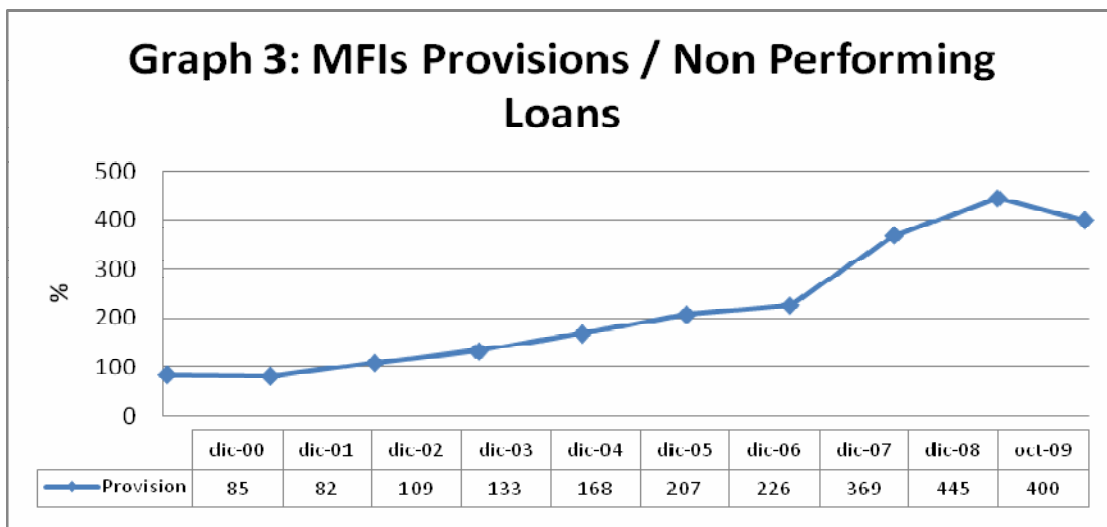
Source: ASOFIN

The current loan portfolio level is US\$ 1.496 millions. The MFI portfolio in the last five years shows an average growth of 30%. Growth was over 40% in 2008, but barely 15% in 2009 (October).



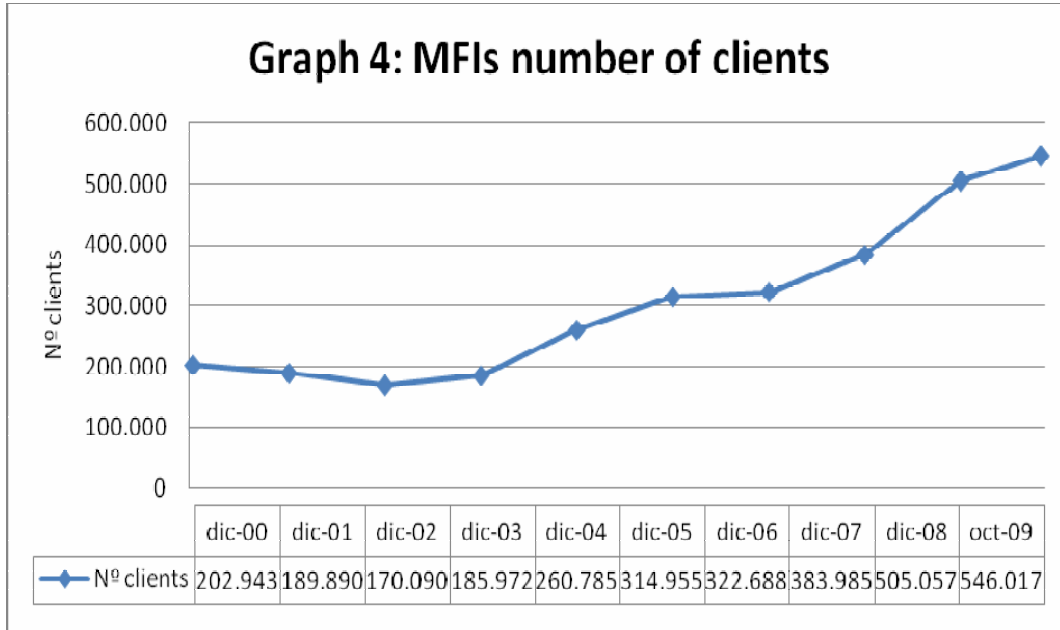
Source: Asofin

The quality of loans shows a good stable behavior, although in 2009 there was a slight deterioration. The current ratio of non performing loans is 1.23%.



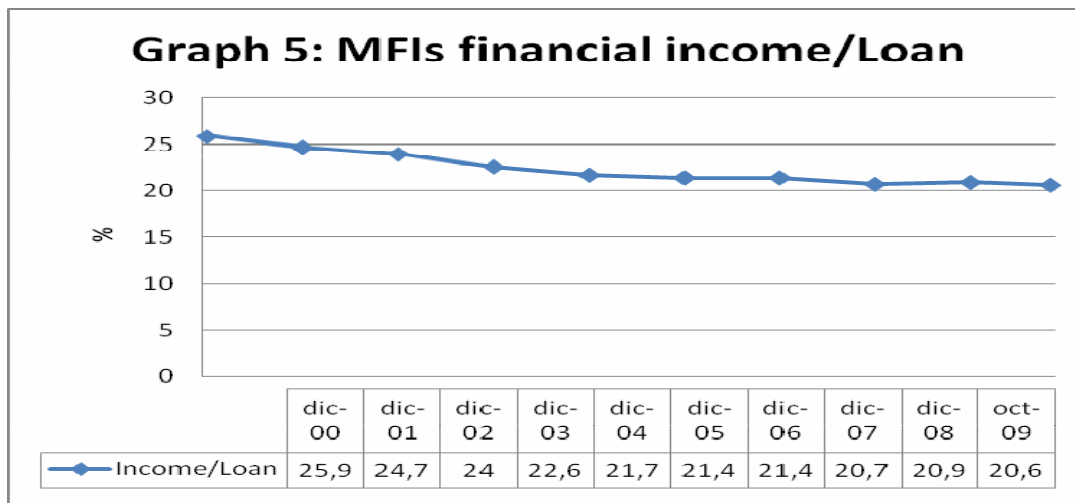
Source: Asofin

The level of provisions for non performing loans taken by MFIs is four times higher than the portfolio level, reflecting prudence before a portfolio with volatile characteristics.



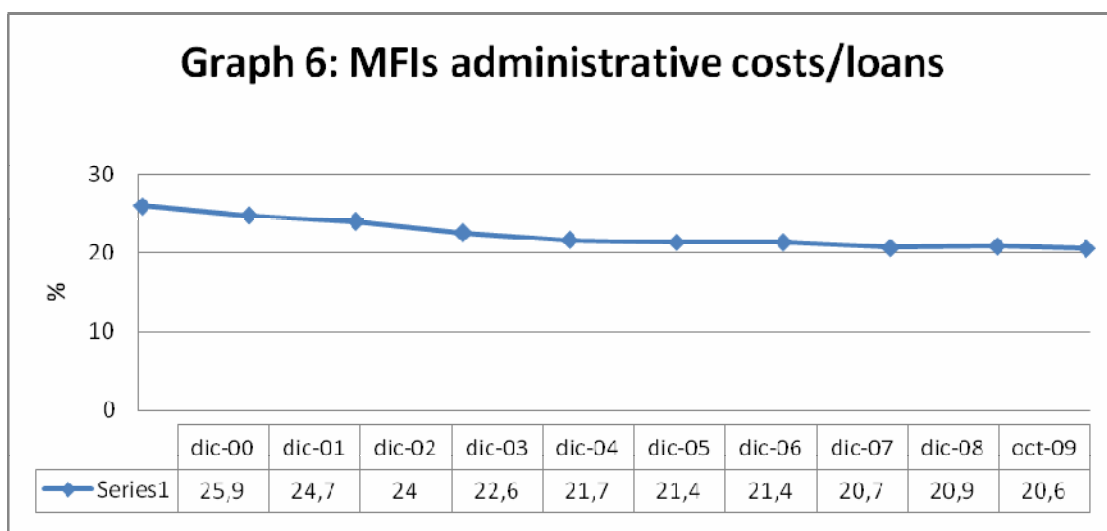
Source: Asofin

The number of clients has almost doubled since 2005. Today, MFIs have 546 thousand clients recorded.



Source: Asofin

Profitability was high in all the periods, with a decreasing ratio of financial income to loans, result of increases in the size of the portfolio. Additionally, it shows a slightly decreasing trend, with 19.9% in October 2009. This indicator shows the interest rate behavior.



Source: Asofin

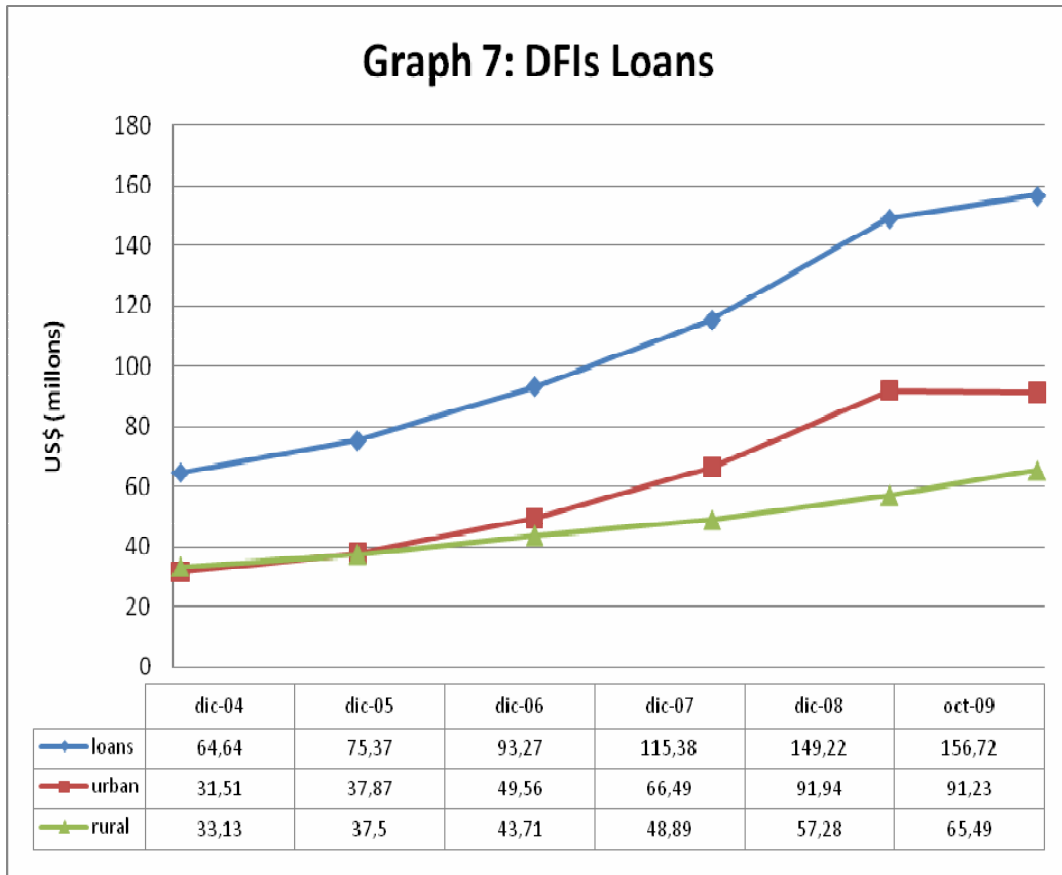
Administrative costs show a decreasing trend, the result of both administrative improvements and significant increases in the size of the portfolio.

#### 4. Characteristics of Development Finance Institutions (DFIs)

Development Finance Institutions, DFIs, are non-profit entities or financial NGOs<sup>18</sup>. They are to be distinguished from the regulated MFIs described above.

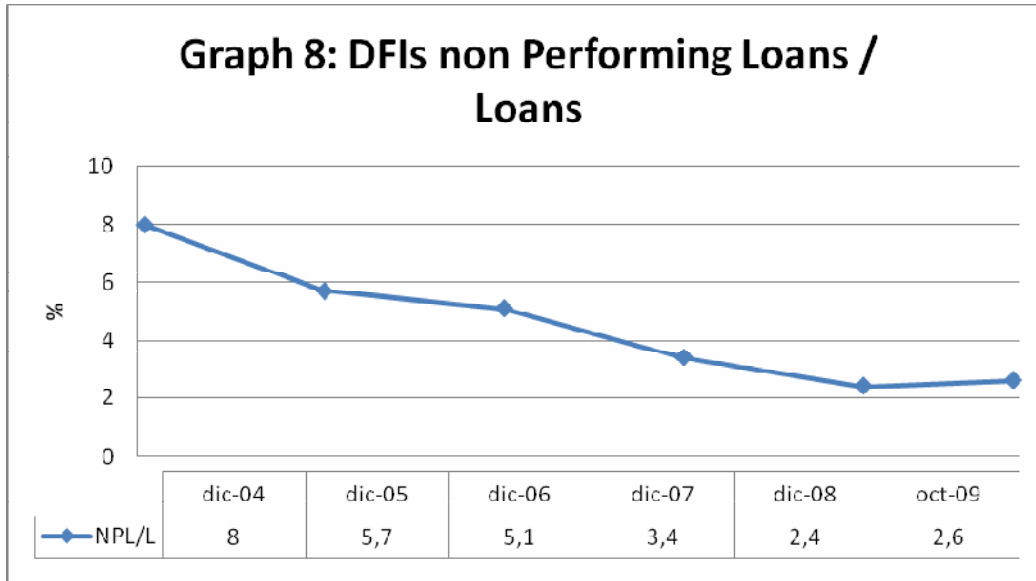
<sup>18</sup> The DFIs ANED, Pro Mujer, FONDECO, IDEPRO, Diaconía FRIP, CRECER, CIDRE, FONCRESOL, FUNBODEM, Sartawi, FUBODE, IMPRO, and EMPRENDER joined among themselves to establish the Association of Financial Institutions for Rural Development, FINRURAL (*Asociación de Instituciones Financieras para el Desarrollo Rural*), in 1993.

They were funded with international cooperation grants and still resort to foreign loans. Their actions target sectors of the population of scarce resources to offer them microcredit as well as non-financial services (health, education, etc.). DFIs are still largely unregulated entities, but they are in the process of becoming regulated.



Source: Finrural

The current loan portfolio level is US\$157 million. The DFI loan portfolio in the last five years shows an average growth of 19%. Growth was over 23% in 2006, but barely 5% in 2009 (October). It is important the increasing of the urban loan portfolio.



Source: Finrural

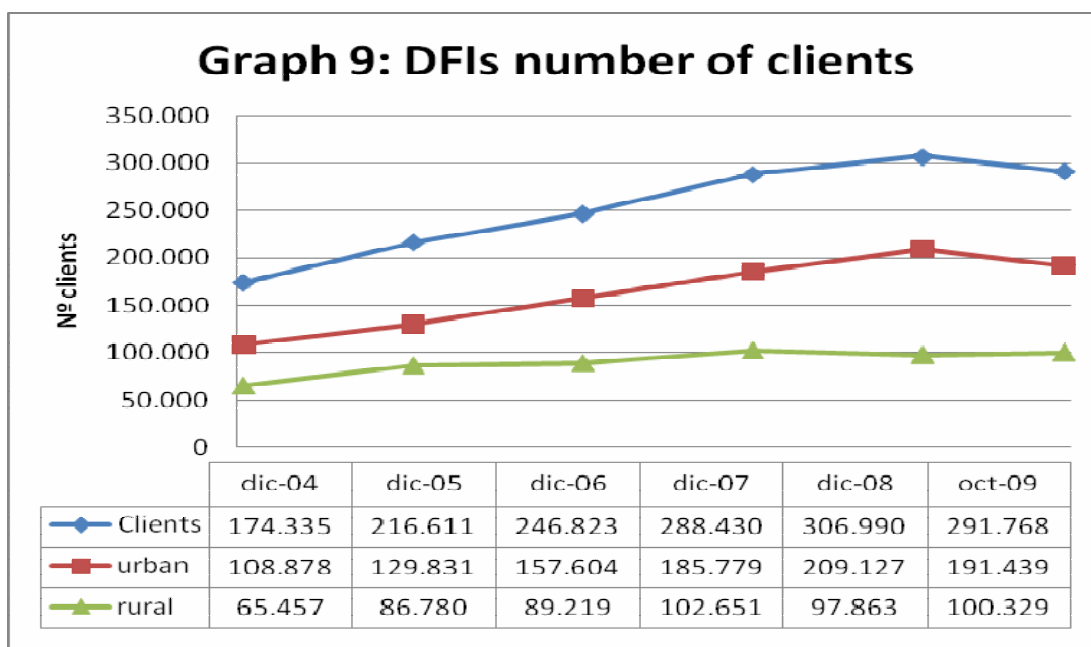
The quality of loans shows a good behavior, although in 2009 there was a slight deterioration. The ratio of non performing loans is 2.6%.

#### 4.1 Target clients

DFI clients are people normally excluded from financial services due to their lack of payment capacity or of collateral. In general, their scarce economic resources place them under the poverty line. The average loan that they receive is very small in comparison with the loans of clients served by commercial banking. The clients of the DFIs work in small scale informal activities in the rural and marginal urban areas: micro entrepreneurs, small traders, artisans, and small agriculture producers.

The business of these clients is highly volatile, influenced by several commercial opportunities and by the easiness with which they change activities to adapt themselves to changing market conditions. Moreover, their household economy is inextricably tied to their activities, as their business is family owned and their labor comes from their households. .

The array of credit services that the DFIs provide is varied. The main common characteristics of these services are versatility and adaptation to local conditions. Modalities may differ among DFIs and even within the same DFI . They may vary from one place to another. The services are very client oriented with special attention given to the poorest clients, who often lack not only regular income and assets that could serve as collateral but also, and as important, information. Some of the credit modalities are described below. The description is by no means complete.



Source: Finrural

The number of clients has increased 67% since 2004. Today, DFIs have 292 thousand clients recorded

## **4.2 Types of credit offered**

### **Communal Banking:**

This modality uses groups of 15 to 20 people, mostly poor women. The credit beneficiaries associate themselves to jointly guarantee the repayment of the total amount, which is the sum of the small loans that each member of the association receives as working capital. The group chooses a board of directors to manage and recover the credit. Communal banking starts with very small loans and gradually increases the amounts. Payments are done in association's meetings, where the attendants receive in addition non-financial services, such as education and health.

In some cases, this modality includes managing a savings fund in a regulated entity, where a percentage of the loan has been deposited. The group uses this fund and the interest earned to grant loans to each member and distribute the profits.

### **Microcredit to Solidary Groups:**

This microcredit is given to people working in the production of goods and services but who lack real collateral. Members of the group join to guarantee and support the credit that each one received for working capital and/or for fixed investments.

**Associative Credit:**

The credit is granted to an organisation already established. In many cases, these resources are used to improve the activities of its members –mostly producers-, and generally as investment capital.

**Individual microcredit:**

Clients who graduate from communitarian or solidary credit technologies and need larger amounts for working capital or investment capital resort to this type of credit. Individual microcredit is granted after assessing the client's capacity and willingness to pay. The assessment is based on information from her or his social and economic milieu and after consulting the Credit Bureau to learn about the said client's credit behaviour and indebtedness. Personal guarantees are usually required.

**4.3 Microcredit conditions****Evaluation of the payment capacity of borrowers**

The information provided by the borrowers – required to evaluate the loan applications – is initially scarce or null. This assertion is especially true when dealing with communal or solidary banking technologies. To overcome this shortcoming demands numerous credit officers experienced in building up the necessary information with visits to homes and worksites.

The basic financial information needed to determine the borrower's capacity for payment and indebtedness comes from a formal survey of the borrower's activity or business. In most cases, documents such as financial statements, valuations, and inventories are unavailable; therefore, the loan officer must crosscheck references in the client's home and worksite and then complement with other reference sources. The information problems are compounded by the fact that the turn over of microcredit operations is high: DFI portfolios can pass in short time from a solvent to a high-risk position and even to bankruptcy.

### **Interest rates**

Interest rates charged by DFIs for microcredit are much higher than those offered by regulated entities. However, in the past years, because of competition among entities, of improvements in administration and advances in technology, an important reduction has been observed. The decline in interest rates, that initially were very high, is one of the most remarkable features of the bolivian DFIs.

The following factors have influenced interest rates and their fall.

### **Administrative costs**

The administrative costs of credit management are high when administrating a large number of small operations. More clients imply greater additional costs in database maintenance, number of branches and tellers and so on.

Although micro finance entities have invested heavily in technologies of information, the industry is still labour intensive. Staff expenses are comparatively higher than those of the more traditional financial system. Given the type of clients and the credit technology used in each evaluation before disbursement and for the follow-up stage, the loan officer visits the client's home and business. This is a costly process.

The level of credit at which microcredit entities started to operate allowed for very few scale economies. As a result, the costs had to be distributed among a small portfolio volume. Over time, the volume of operations augmented considerably. This brought down the administrative costs and hence the interest rates.

### **Collateral**

Micro finance is characterised by the lack of traditional collateral (securities, real estate and so on). In most cases the physical collateral that the DFI's clients can offer presents problems of property registration. Also, there are high costs of verification of their existence and holding. Therefore, DFIs developed other means to ensure loan reimbursement, like the collateral supplied by groups. Nonetheless, the DFIs on occasions sidestep real collateral because they consider it difficult to assess. Mobile collateral, which may be more pertinent for micro finances, is affected by deficient property registration, shortcomings in the legislation, and a wanting judicial system. Receivables could be used as collateral, especially for food producers that sell their produce to large food

distributors, but this type of documentation is very rare, moreover with clients that are mostly in the informal sector. The fuzziness of the collateral has to be substituted, in many cases, by an intensive loan evaluation and a thorough follow up of the credit. This is costly and falls on the interest rates.

## **5. Self Regulation System**

The strategy of entering a self-regulation system, voluntarily assumed by DFIs associated in FINRURAL, was a transitory process (2004-2007) of institutional preparation and strengthening for an eventual formal regulation, while keeping their legal status as non-profit institutions and complying with their social mandate to attend the very poor.

The main objectives of the self-regulation process were: a) to increase DFI credibility with evaluations that gave proof of their solvency and sustainability over time; b) to improve the quality of administration, enhancing efficiency and preventing risks; and c) to consolidate their mission of supporting excluded sectors.

The implementation of self-regulation included the adoption of: a) accounting norms with an account plan similar to that of the Financial Supervision Authority, FSSA; b) the same credit portfolio regulation parameters of the supervising authority; c) a specific regulation for the agricultural loan portfolio and reports to FINRURAL were made mandatory; d) financial evaluation studies or ratings, including independent auditing reports with opinion about compliance with the self-regulation system dispositions; e) process monitoring through financial evaluations; and f) transparency, by

divulging and publishing newsletters with financial information from DFIs as well as outstanding administrative aspects and regulation updates.

## **6. Incorporation of Development Finance Institutions into the regulated ambit**

In accordance with the Banking Laws, FSSA incorporated DFIs or Non-Governmental Organisations, NGOs, in the category of “non-banking entities”.<sup>19</sup> Hence they are in the ambit of the Law of Banks and Financial Entities so they can function as financial intermediaries.<sup>20</sup>

Existing DFIs, operating on the day the FSSA Resolution was issued had to go through two stages for regulation: 1) obtain an Adequation Certificate, and 2) obtain an Operating License.

### **6.1 Diagnosis**

The first stage, i.e. to obtain the Adequation Certificate, begins with a diagnosis done by an external specialised entity that confirms the capacity of the DFI to comply with the following operative and documentary requisites:<sup>21</sup>

- A minimum capital of 300,000 SDRs and a capital-to-risk weighted assets ratio of 10%.

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<sup>19</sup> Article 4 of Law 144 allows the supervision authority to include other extant or future entities in the legal area.

<sup>20</sup> Resolution SB 034/2008 of March 10, 2008

<sup>21</sup> The DFI had to hire an external auditing firm within 30 days of the issuance of the regulation.

- Premises for a main office and branches with minimum operations and customer service conditions.<sup>22</sup>
- Security conditions like vigilance systems, alarms, and security staff to handle money. A critical aspect is security related information: developing procedures to assign user profiles and specific areas for systems.
- A filing system to safeguard operational documents.
- Information and telecommunication technology is priority; the DFI management must ensure ongoing information processing and safeguard such processing.<sup>23</sup>
- Information systems with auditing capabilities for the following applications:
  - Clients. Client information and control of client data
  - Credits. Records of credit operations and collateral. Portfolio and collateral assessments and provisions according to days of delay. Rescheduled loans. Interest rates applied to each loan.
  - Deposits. Processes of savings operations. Capitalisation of interests. Behavior of the legal minimum reserve requirements.
  - Accounting. Records of information on operations, in accordance with the accounts manual of FSSA.

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<sup>22</sup> Furniture, proper areas for cashiers and for customer service, and an area for systems and telecommunications.

<sup>23</sup> The entity must have policies, processes, and procedures to evaluate the systems and applications.

The regulation emphasizes internal controls. They must be structured to promote effective, reliable, and transparent operations that will be verified later by internal auditing.

Documentation requisites refer to the documentation accrediting the organisation and its legal status as a non-profit organization. The list of founding partners or associates and of the board of directors is to be included in the documentation.

## **6.2 Building up the Action Plan**

The Action Plan must include a schedule for the reclassification of items of non-financial operations as off-balance. It must also include the steps to be taken to fully comply with the recommendations of the diagnostic done by the external evaluator.<sup>24</sup>

## **6.3 Evaluation and issuance of the adequation certificate**

FSSA will assess the action plan and, in the absence of observations, issue the adequation certificate; otherwise, the DFI needs to correct the points observed

## **6.4 Obtain its operating license**

The DFI will have 12 months (Adequation period) to obtain its operating license by the FSSA

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<sup>24</sup> The action plan approved by the Board of Directors must be submitted to FSSA within 90 days after receiving the diagnosis

## **7. Challenges for the regulation process**

Microcredit differs from commercial or consumer credit in the characteristics of its clients and in the credit technologies it applies. Also, FSSA must adapt its supervising procedures to the high volatility of the business, the little formality in client information, and the diverse credit technologies applied by each entity. The aim of the regulation must be to facilitate expansion, prevent risks, eliminate redundant requirements for activities, and promote transparency.

Microcredit needs flexibility and versatility to achieve its objectives. Adjusting to standardised requirements that are not flexible enough and with great demands in terms of information and documentation may restrict the supply and the capacity for innovation, and may raise the cost of financial intermediation, without reducing risks for DFIs as a trade-off. On the other hand, an openly indulgent legal frame may weaken institutions, in detriment of customers' trust. The appropriate balance must be sought and found.

By keeping their legal nature as non-profit entities, DFIs run the risk of being more vulnerable to solvency problems. If because of non performing assets a capital replenishment is called for by the FSSA, the DFI cannot ask easily the founding partners to put the missing capital. It is unlikely that they will be willing to add more capital, which is non-refundable and with no possibility of recovery.

When attracting deposits from the public DFIs will be obliged by prudential regulations to protect savers and the stability of the entire financial system. DFIs have no experience with methodologies to attract the savings of

their clients and even less to manage them as a source of funding. .The lack in experience may generate high operative, and even liquidity, risks. In addition, the estimation of the legal minimum reserve requirements on deposits demands timely, precise information systems.

The costs of regulation that DFIs will face are high. They must improve and adjust their information systems, develop new systems, organise the documentation, and adapt their infrastructure. These aspects may impinge on interest rates, make credits more costly and ultimately affect their financial sustainability.

## **8. Concluding Remarks**

Finally, a comparison of both processes to incorporate NGOs into the regulated setting shows that, PFFs, now public corporations, have managed to position microcredit well in financial markets. They operate with a large number of clients in areas formerly unattended. Their extraordinary growth in terms of the number of clients, their high quality portfolio, their deposit taking, and their improvements in management have resulted in high profits and have made them in sustainable entities. In the social area, the profile of the clients of PFFs has gradually been transformed to customers of greater payment capacity. It seems that PFFs have chosen financial viability over service to the very poor. The demands of stakeholders (shareholders and supervisors) may have been the driving force behind the changes in their credit policies. The PFF portfolio of credits for trade, services, and transportation represents 74% of total credits. The average amount per client has increased from \$us 1,638 (December 2004) to \$us 2,740 (October 2009)

In contrast with PFF, DFIs remain as non-profit entities. Financial viability is subordinated to the mandate to serve the poor and the very poor. Yet DFIs can show good performance indicators while their portfolio growth has been smaller, due to more limited funding sources (they are still unauthorised to receive deposits until they receive the license of the FSSA), they have good results in loan quality and financial performance. Also they can show the transparency and management improvements that self-regulation has brought in. In the social aspect, 40% of the portfolio is communal banking and serves 76.5% of the clients. Individual credit is 59% of the portfolio and serves 22.6% of the clients. The average credit of DFI communal banking is below \$us 500. DFIs serve poorer sectors of society and provide non-financial services like education and health, a feature duly acknowledged in social impact reports.

When passing the directive that made DFIs regulated entities, the supervision authority considered the request of DFIs to maintain their legal status as non-profit entities. DFIs have the challenge now to preserve over all other considerations the mission, for which they were created, i.e., reducing the poverty conditions in sectors excluded from financial services. This burgeoning process must sustain their mission and at the same time grant them long-term economic viability. To meet this objective, DFIs must continue with their main mandate of serving the poor while seeking more efficiency with the introduction of new credit technologies, and with more reliance on information technology. More efficiency based on technological progress will allow meeting the dual objectives of service and sustainability. Carefully drafted policies that pay due

attention to the particularities of microfinance, that avoid overregulation and excessive paperwork and yet are sufficiently stringent to keep the system safe and sound will be needed. The process is still in the making.

**Disclaimer:** The views expressed in this Working Paper are those of the Author.