

**Recent Trends in Microfinance Industry: Regulation, Supervision and the Principles of the
Basel Committee**

Gianfranco A. Vento¹

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Abstract

In the last few years, microfinance industry changed significantly due to several drivers. First, we are witnessing an increasing degree of professionalization within the industry, often moving from local spontaneous microlending initiatives to better equipped and organized institutions, characterized for a higher sustainability compared to the past. Second, a large number of global financial intermediaries, for different reasons, are starting to be involved in microfinance, so contributing to modify the landscape of the traditional MFIs. Third, new technologies, and especially the web based platforms for channeling funds directly from households to microfinance institutions and borrowers, can represent an interesting and alternative source of funding for MFIs. These alternatives make it easier to diversify the degree of dependence of such institutions from international donors and expensive funds' providers. Finally, as a consequence of the above-mentioned drivers, it is possible to witness a very significant growth in microfinance business worldwide.

Such important progresses of the industry make the role of regulators and supervisors more and more crucial and, therefore, it becomes always more urgent to highlight the key criteria that a country has to follow in order to design an efficient and effective regulatory framework. The recent attention on microfinance industry is also demonstrated by the interest towards this segment of financial market of the Basel Committee on Banking Supervision, which

¹ Regent's College (London, U.K.) and University Guglielmo Marconi (Rome, Italy). Contacts: Regent's College, Inner Circle, Regent's Park, London, NW1 4NS; e-mail: ventog@regents.ac.uk.

in February 2010 published a consultative document on 'Microfinance activities and the Core Principles for Effective Banking Supervision'. Through such a document, the Basel Committee aims at stressing how the traditional 'Core Principles for Effective Banking Supervision', largely agreed and accepted all over the world, can be adapted and implemented in microfinance business.

Starting from the analysis of the most recent trends in microfinance business, the goal of the paper is to identify the most suitable regulatory solutions according to some key variables that may draw and characterize the microfinance industry in a country. In this framework, the paper deepens the recent Basel Committee's study, which tries to extend to microfinance a set of core principles for an effective supervision, and it also analyses the practices currently used for regulating and supervising MFIs.

1. Introduction

In the last few years, microfinance industry significantly changed its shape, due to several important factors. First of all, the degree of professionalization of the industry substantially increased worldwide, especially comparing it with simpler microcredit experiences that were predominant since the beginning of this century. Nowadays, beside a huge number of small microcredit institutions, which offer small credits on a local basis, mostly pursuing a social mission, there is an increasing number of bigger and better organized commercial microfinance institutions (MFIs), which supply a wide range of financial services to financially excluded customers, aiming at full sustainability.

Second, the development of new technologies applied to microfinance makes possible for microfinance institutions to achieve several advantages; more specifically, they can optimize their financial management, can increase the set and the quality of services offered and, ultimately, are able to reach a larger number of customers. In this framework, the two most important changes in delivery channels that the microfinance industry is facing are the development of on-line peer-to-peer lending platforms dedicated to microfinance and the development of mobile banking services. Peer-to-peer microfinance on-line platforms allow microfinance institutions to have access to a potential unlimited number of people that have a financial surplus and which could be interested to finance the customers of MFIs having viable

investment projects. At the same time, thanks to the web based microfinance platforms, the MFIs are able to diversify their sources of funding, to attract cheaper funds, if compared to the vast majority of the alternative sources of funding, and to reduce the dependence from international donors.

On the other hand, the development of mobile banking services applied to microfinance is generating important advantages in providing basic financial services through a tool – the mobile telephone – that is largely owned also by the poorest people in developing countries. The collaboration between MFIs and large mobile networks made possible to supply small loans and payment services on a larger scale and in very remote areas, also in favor of those customers that, alternatively, would not easily approach MFIs.

Third, a large number of financial intermediaries – including commercial banks, large financial groups and specialized microfinance banks – are more and more involved in microfinance, either directly providing financial services to those who used to be financially excluded or sustaining local MFIs with funds and technical assistance.

As a consequence of the above-mentioned factors of change, the size and the complexity of microfinance industry increased, especially in some countries. Therefore, also typical microfinance risks are changing, together with an increasing capability of MFIs to manage them. It is obvious that all these significant transformations have a deep impact on the regulatory framework, which must be adequately equipped to tackle the new challenges.

The increasing degree of professionalization, the wider use of new technologies in the industry and the higher involvement of banks in microfinance imply a significant rethink of the rationale of microfinance regulation as well as of the supervisory practices. Thus, it is not surprising that in February 2010 the Basel Committee on Banking Supervision (BCBS) published a consultative document on ‘Microfinance activities and the Core Principles for Effective Banking Supervision’, by which the Committee tried to verify how and to what extent the traditional ‘Core Principles for Effective Banking Supervision’ could be implemented in microfinance industry².

² The ‘Core Principles for Effective Banking Supervision’ represent a set of principles that the Basel Committee published in 2006 in order to identify a benchmark for supervisory authorities on banks worldwide.

The paper is structured as follows. Section 2 briefly reviews the rationale for regulating microfinance industry. In section 3 the most recent trends in microfinance are highlighted, whereas section 4 is dedicated to analyse some of the proposals recently presented by the Basel Committee on Banking Supervision concerning the microfinance activities and the core principles for effective banking supervision. Finally, in section 5 the main conclusions are presented.

2. The rationale for regulating microfinance

The literature concerning financial regulation affirms that a market must be regulated in the eventuality that it could not achieve an efficient equilibrium autonomously³. As known, the goals of regulators are to increase efficiency in capital allocation, to implement effective risk management procedures and to protect less informed parties that enter into a financial contract. These abstract concepts are translated, in all financial systems, in a set of rules concerning the structure of the financial industry itself, the prudential regulation of intermediaries and markets and the level of transparency and disclosure. Moreover, under this complex set of rules, lies the consciousness of the presence of informative asymmetries, due to which in some financial contracts one party has less information than the other one; therefore, in order to preserve the rights of the less informed party and to allow him to take conscious decisions, a supervision on financial system is implemented in all the countries.

As to microfinance, in order to reach effectiveness in relieving poverty by creating a safer environment for economic development, the main goal of microfinance regulators is to ensure the soundness of MFIs and the quality of the services that they provide. Beside these objectives, a peculiar consideration for microfinance institutions concerns their capability to attract donor's and public's funds for financing microfinance; in some contexts the lack of a clear regulatory structure of MFIs – based on preventive and protective instruments – as well as the inadequacy of the general legal environment, determine, *ceteris paribus*, a difficulty for MFIs located in some countries to attract funds⁴. In presence of appropriate regulatory

³ See, among others, Goodhart, et al. (1998).

⁴ In order to focus some special problems in regulating financial industry in developing countries see Goodhart et al. (1998), pp. 98-115.

schemes and of a reasonable supervision on MFIs, a greater amount of money could be addressed to those economic initiatives that, as mentioned before, produce recovery rates higher than the traditional financial sector and can rapidly improve the life conditions of a huge number of people.

The analysis of the most suitable regulation and supervision to implement for microfinance should be developed considering four main criteria (Table 1). First aspect to analyse is the assessment of systemic risk deriving from microfinance. It depends on the development of the industry in the country, on the industry's age and on the volumes intermediated by MFIs in the financial system. Second decisive factor, which orients if and how to regulate MFIs, is the typology of activity carried out by MFIs; particularly, the most sensitive distinction is between credit-only institutions, entities that collect savings, and intermediaries which provide other financial services not included in traditional intermediation. Third criterion to take into account is the origin of funds utilised in order to provide microfinance services. Under this profile, there are different interests to be preserved in case the MFIs use public's sums, donor's funds or member's savings. Last aspect to be considered is the nature of MFIs to somehow regulate, analysing institutions that have different legal structures, governance, target clients and goals (distinguished, for descriptive reasons, in NGOs, credit unions, microfinance banks and downscaling commercial banks), which must be treated according to various approaches.

As far as the first criterion is concerned, until microfinance used to be a marginal phenomenon that involved a few credit-only NGOs and a small number of beneficiaries, there was no need to think about the opportunity to regulate, because regulation and supervision are expensive public goods. Moreover, in some developing countries, it is more likely that these goods are involved in a host of principal-agent failure such as corruption, which often make vain any attempt to supervise microfinance institutions⁵. Given their nature of expensive public goods, regulation and supervision should be used in those areas with the highest payoffs in terms of systemic risk mitigation.

According to the literature and to the experiences of the past years, in the vast majority of countries microfinance does not create systemic risk, given the small amount of loans and

⁵ On cost and benefit analysis of supervising MFIs as well as on the danger of corruption see Meagher (2002).

the very limited access to the payment system of MFIs, where it exists; therefore, in all the countries where the systemic relevance of microfinance is limited, a vast number of authors agree on a soft regulation, essentially based on public registration (licensing), or suggest the implementation of self-regulation schemes and second-tier regulation (delegated regulation)⁶.

Also the development of the industry in the country and the volumes intermediated by MFIs in the financial system affect the decision about how to regulate and the instruments to adopt. Particularly, the need to design a specific regulatory framework for microfinance institutions is especially felt in the countries where those institutions are significant actors in the financial market; otherwise, the most common solution that is adopted is to regulate under Banking Law those entities which collect deposits and offer loans, whereas credit-only organisations are often in a shadow area, without any explicit regulation or supervision⁷.

According to second criterion, the choices about regulation and supervision are based on the nature of the activities that are performed by microfinance entities. All the institutions that provide credits as a unique financial service are characterised by a very low contribution to the overall systemic risk. Therefore, they are often not regulated even if some countries require from them transparency standards and the control of unfair practices (so called “conduct of business” reporting). Of course, whenever a MFI does not limit its activity to credit supply, but collects savings, and sometimes offers payment instruments, the institution is almost everywhere forced to be converted in a regulated entity (commonly a bank), or assumes the status of “microfinance bank” where a specific regulation exists. Such conversion, as obvious, implies the respect of all entry requirements, of minimum capital requirements and prudential ratios, as well as of periodical reporting. Last, for those institutions which offer other financial services, it seems appropriate to adopt a regulatory approach similar to credit-only institutions, if the only peculiarity is represented by the lending methodology; on the other hand, for those MFIs which intend to provide more complex financial service than the traditional financial intermediation, a specific regulation is strongly recommended.

⁶ See, among others, Van Greuning, H., J. Gallardo, B. Randhawa (1999) and Staschen (1999). For self-regulation and two-tier regulation here we mean respectively the adoption of codes of conduct and the presence in the market of first-tier entities (often public banks) which lend money to second-tier microfinance institutions that, conversely, are to some extent subject to first-tier entity control.

⁷ On the options regarding regulation of credit-only MFIs see Christen and Rosenberg (2000).

Third relevant criterion in order to determine regulatory policy is the origin of funds used by MFIs. Whenever this money is donated by third-party organisations, these usually have appropriate instruments for assessing the MFI they intend to finance; furthermore, in absence of specific regulations, donors can prevent unfair practices by monitoring the selected institutions and requiring from them specific reporting on the use of funds. The policy considerations can vary significantly depending on whether funds are provided by the public or by members of mutual credit entities or savings banks. In this case, the presence of asymmetric information between depositors and MFIs is often adduced as the main reason why regulation and supervision are required. In fact, depositors are exposed to moral hazard due to the risk of savings absorption in the event of MFIs' crises.

As regards the third criterion, in the light of above the most suitable approach of the ideal regulation to adopt must be diversified according to the source of funds. All MFIs, whatever is their source of funding, in order to improve their capability to attract money, should be required to be publicly registered and should produce periodic reporting (including at least credit methodologies, concentration, credit provisioning and write-offs) to be addressed to a specific regulatory body – where microfinance market is a significant portion of the financial system – or to the authority in charge of supervising the financial system in other cases. Those entities which collect public's funds should be compliant with a set of tailor-made rules concerning market entry, minimum capital ratios, organisation and deposit insurance. These regulations on one hand should impose milder capital requirements than banks, on the other hand they should delimitate the potential activity, and therefore the risk, that these entities could run.

Last criterion here approached concerns the nature of MFIs, where the distinction usually performed regards non-governmental organisations, credit unions (and other mutual credit entities), downscaling commercial banks and microfinance banks. The most significant aspects to deepen about the nature of MFIs and their regulation are legal structures, the borders of their activities and their internal organisation . As mentioned before, as long as NGOs operate as credit-only institutions they need a very limited attention from regulators; however when NGOs begin to offer savings facilities they are required to assume a different legal status, with a well defined capital in order to calculate prudential ratios and to implement internal control functions. These institutions, therefore, should then be regulated according to their new

nature. Credit unions and microfinance banks, considering their deposit-taking nature, but also their difficulties in rising capital and their goal of sustainability, have to be regulated by a specific set of rules which prescribe less stringent capital requirements and an easier organisational structure than banks. Last, downgrading commercial banks, which by definition are fully regulated banks according to the national “Banking Law”, do not seem to need particular requirements if compared to other banks, because they go on performing not only microfinance services; therefore, in most countries they continue to be supervised and regulated as usual banks.

The combination of all the above-mentioned criteria originates a peculiar picture that varies according to the country, and therefore it is not possible to imagine a single regulatory approach suitable for microfinance industries worldwide. The role of the regulator in microfinance development is still an open issue. While some are in favour of a market-directed approach, with the regulator simply setting the framework for the industry, others advocate a more government-directed stance with an active promotional role for the regulator. Still, in some countries, such as India, the role of the regulator is to integrate microfinance into the overall financial infrastructure, which usually requires a degree of promotional support in the early stages of the industry’s development; the regulator’s support to ensure the soundness of these institutions could involve lending assistance and gradually the introduction of prudential norms.

A deep regulation would contribute to make the microfinance safer (and depositors too), but it would make it too complex for small MFIs to operate in accordance with regulation; the net effect could be a reduction in microfinance supply, which is the consequence that those who support regulation want to avoid. Furthermore, a too strict regulation usually limits the capability to innovate, therefore policy makers deciding which regulation to implement must consider the overall soundness of the financial system, but also innovation.

Table 1. Four criteria for MFIs’ regulation

	I	II	III	IV
	Systemic risk	Typology of activity	Origin of funds	Nature of MFIs
Relevant factors	- Development and age of the industry; - Relative	Nature of activity carried out:	Distinction among: - donor’s funds;	Distinction among: - NGOs;

	intermediated volume.	A. credit-only; B. collecting deposits; C. other financial services.	- member's funds; - public's funds.	- credit unions; - downscaling commercial banks; - microfinance banks.
Potential scenarios	A. Young expanding microfinance market, in which a low percentage of overall funds are intermediated; B. Mature microfinance market, where MFIs intermediate a significant percentage of funds.	A. Institutions which offer credits to their members or to the public; B. Institutions which offer credits and collect deposits (time deposits or demand deposits); C. Institutions which offer microinsurance, microleasing and other financial services.	- Institutions that collect donor's funds usually offer microcredits only; - MFIs which collect member's funds usually use them to finance other members; - MFIs that offer deposits to the public use them for financial intermediation.	- NGOs are usually credit-only institutions; as far as they collect deposits, they are required to assume a different legal and organisational structure; - The other MFIs can collect deposits too.
Suggested approach to regulation	- Under A scenario, mild regulation based on self-regulation schemes and two - tiers entities; - Under B scenario, tailored regulation on microfinance concerning entry requirements, capital ratios, prudential ratios deposit insurance and reporting.	- For A institutions, transparency requirements are suggested but not always compulsory; - B institutions should be regulated from a specific agency or by the central bank, according to the nature of MFIs; - C institutions: same as A institutions if the distinction is in lending methodology, whereas a specific regulation should be developed for other financial intermediation (i.e. microinsurance).	- Public registration and periodic reporting for all MFIs, also for increasing their capability to attract funds; - MFIs that collect public's funds should be compliant with a set of tailor-made rules concerning market entry, minimum capital ratios, organisation, reporting and deposit insurance.	- Credit-only NGOs need a very limited attention from regulators; - Credit unions and microfinance banks should meet less onerous capital requirement and organisational architecture; - Downscaling commercial banks should be treated according to the "Banking Law".

Source: Vento (2004).

3. Recent Trends in Microfinance and Effects on Regulation

In the last few years, microfinance industry is registering important changes. Beside an evident improvement in the degree of professionalization on the supply side and a higher involvement of the traditional financial intermediaries – mostly banks, but also specialised investment funds, insurance companies, etc. - in the business, very important opportunities for the industry are coming from new technologies. Indeed they can increase the capability of the MFIs to raise funds among a huge public and also allow microfinance institutions to provide financial services to customers in very remote areas at reasonable and affordable costs.

The most significant application of new technologies to microfinance is represented by the use of on-line platform for channelling funds from the surplus unit all over the world to MFIs and their beneficiaries, mostly based in developing countries⁸. Through such platforms, people having access to the web may select an investment project, previously screened by a MFI, and may decide to lend a certain amount of money (usually small) to the customer that propose the investment. In order to take their investment decisions, surplus units usually have also access to much information about the past repayment history of the MFI proposing and advertising the project and the perspectives of the investment.

On the other hand, in some countries (especially in Asia) microfinance institutions recently started to supply microcredit and payment services through mobile networks, due to the fact that mobile phones are now largely used also in very remote areas as well as among very poor people. Thanks to mobile banking, customers may use the credit they have on their mobiles to make small payments as well as to transfer money to other customers almost in real time. In this way, also operational risks related to alternative methodologies used for transferring money are reduced.

Such important changes in the ways MFIs can raise funds and distribute their services have a significant impact on the regulatory and supervisory frameworks too. As far as the use of web-based platforms to attract fresh capital for microfinance projects, this methodology of interacting with households traditionally far from microfinance business may represent a huge chance for MFIs to increase their funding opportunities as well as to reduce the degree of dependence of MFIs from international donors and more expensive lenders. In fact, such technologies make possible for households in Western countries and have an interest in sustaining small and fragile producers based in developing countries, to directly finance them through the microfinance peer-to-peer platforms. Moreover, the access to funds from a wide range of savers usually represents a less expensive solution for MFIs to obtain financial resources from a wide range of supporters.

On the other hand, regulators and supervisory authorities are required to design specific tools in order to protect the suppliers of funds from frauds and too risky investments. Such

⁸ One of the most important on-line platforms used to channel funds towards microfinance projects is provided by Kiva (see www.kiva.org).

tools may range from registering the companies which provide such platforms and similar facilities up to imposing minimum capital and organisational requirement for those MFIs that raise funds through such web-based platforms.

4. The Basel Committee Proposals on Microfinance Regulation

In 2006 the Basel Committee on Banking Supervision published 'Core Principles for Effective Banking Supervision'. Through this document the Basel Committee made an effort to identify common guidelines, to be implemented at global level, in order to effectively supervise banks and non-banks that mobilise deposits. In February 2010 the Microfinance Workstream of the Basel Committee on Banking Supervision developed guidelines for the application of the above-mentioned core principles to microfinance institutions⁹. More specifically, the Microfinance Workstream tried to identify how the 25 principles originally thought for banks could be implemented in the regulatory and supervisory frameworks for the MFIs.

Therefore, the Principles cover a wide range of different areas, ranging from the requirements needed to access to the market (i.e. permissible activities, licensing criteria), capital adequacy, risk management process, typical risks in microfinance (credit risk, market risk, liquidity risk, operational risk, interest rate risk), supervisory approaches and techniques as well as corrective and remedial powers.

However, the report issued by the Basel Committee shows not only several advantages, but also some limits. Indeed, the Committee's paper represents a useful effort to systematize in one single document many ideas and stimuli on microfinance regulation which are usually mentioned in literature¹⁰. Furthermore, the Committee stresses the well known principle that regulation and supervision have to be more articulated – and therefore more similar to banks' regulatory principles – as the range and the complexity of microfinance services offered by the MFIs increases. In such a framework, some riskier and more complicated services – such as deposit collection and checking accounts offering – should be limited to the most equipped MFIs.

⁹ To deepen such principles see Basel Committee on Banking Supervision (2010).

¹⁰ See, for instance, La Torre, M. and G.A. Vento (2006), chapter 8.

Nevertheless, as the regulatory solutions promoted by the BCBS paper were originally designed for banks, it is hard to implement them among small MFIs, which mostly offer microcredit services. Furthermore, the document seems not to adequately consider the peculiarities in risk management techniques adopted by MFIs (i.e. peer monitoring, dynamic incentives), which made the fortune of microfinance industry so far. For instance, the fact that a group of people applying for a microloan belong to the same village and are part of the same community – and therefore are strongly committed to repay their loans because of the ‘social pressure’ coming from the other members of the group – represents a typical example of an intangible asset that microfinance institutions have and that regulators must somehow consider.

Last, some solutions proposed by the Committee seem to be absolutely effective in promoting a safer environment for MFIs, but they probably overestimate the conditions in which microfinance institutions operate¹¹.

5. Conclusions

Regulation and supervision represent a very controversial issue in traditional finance as well as in microfinance. On one hand, more and better designed rules would make microfinance industry safer and, consequently, would contribute to help MFIs in attracting more funds from households and increasing the MFIs’ portfolio. On the other hand, a wider set of rules could slow down the MFIs’ capability to innovate products and services – which in the past made possible to create what we now call ‘microfinance’ – and, more important, may represent a non-affordable cost for many MFIs and regulatory authorities.

Thus, although the review of the Core Principles recently proposed by the Basel Committee may surely represent a useful benchmark for supervisory and regulatory authorities, it is also important to stress that in those context where the contribution to systemic risk is limited and

¹¹ We refer here, for instance, to the proposal to raise additional capital requirements compared to banks, not only because MFIs may lack investors/owners capable to respond promptly to calls for capital and to monitor managers, but also because the management is supposed to be inexperienced. With this regard, the recent financial crisis demonstrated that the capability of banks’ shareholders to monitor banks’ managers and their capability to raise capital where necessary is quite low among banks too.

MFIs supply basic microcredit services only, simpler principles in regulation and supervision could also be effective.

However, the stimuli coming from the Basel Committee are useful for future research on the topic, given that the Committee, for the vast majority of principles, proposed simplified and diversified regulatory approaches according to the importance, size and the complexity of the microfinance industry in a given country. These variables remain the most significant drivers in order to design different regulatory and supervisory framework for MFIs, in a context where – unlike what happens with banking regulation – it is likely to continue to have a large number of country-specific regulatory approaches for microfinance institutions.

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