

Principles and Practice: Myths of Regulation and Supervision

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"The primary reason for ... covering microdebt institutions with regulation and supervision is to allow them to mobilize deposits. Now I'm all in favour of expanding the opportunities for more poor people to increase deposits, but I continue to be uneasy about an industry that is dominated by altruistic motives getting into deposit-taking. ... Allowing many NGOs to start mobilizing deposits may delay the collapse of many of these organisations, but it will also augment the costs of the ultimate collapse, especially the costs imposed on poor depositors" (Dale Adams on the on-line *DevFin* Discussion Group at Ohio State University 1998).

Introduction

Increasing numbers of MicroFinance Institutions (MFIs) are seeking to offer savings services – both in response to demands from their clients and also as part of their strategy to raise capital for on-lending. This phenomenon has led to expressions of concern amongst central bankers, microfinance gurus and donor organisations. The result has been an attempt to regulate and supervise MFIs within a traditional central bank-driven framework – an approach that overlooks several key issues including:

- the inadequate capacity, capability and indeed (as often as not) interest of central bankers to supervise MFIs;
- the remarkable diversity of institutional types, capacities and environmental settings of MFIs;
- the relative risks faced by poor people having to save in the informal sector; and
- the possibility of alternative, less conventional, approaches towards protecting poor people's savings.

In the first section, the paper seeks to define some of the terms associated with regulation and supervision before examining the more conventional approaches to trying to regulate and supervise the MicroFinance industry. The paper then moves on to examine the options for regulation and supervision. The second section outlines the theoretical framework within which regulation and supervision has traditionally been conceptualised. The third section examines the short-comings of conventional approaches to regulation and supervision and looks at what happens when theory collides with practice. The fourth section looks at some of the alternatives that have been proposed by MicroFinance specialists thinking beyond the conventional approaches, and why these approaches are important for poor people all over the world. The paper concludes with a personal view on how different types of MFIs might be supervised.

Definition of Terms

"*Prudential financial regulation* refers to the set of general principles or legal rules that aim to contribute to the stable and efficient performance of financial institutions and markets. These rules represent constraints placed on the actions of financial intermediaries to ensure the safety and soundness of the system" (Chaves and Gonzalez-Vega, 1994).

Thus financial regulation should serve macroeconomic goals by ensuring the solvency and financial soundness of all financial institutions. In addition regulation should provide the client (in particular those making deposits) protection against excessive risks that may arise from failure, fraud, or opportunistic behaviour on the part of the financial service institution. Finally, regulation should also promote efficient performance of financial intermediaries and competitive markets.

"*Financial intermediary supervision* consists of the examination and monitoring mechanisms through which authorities verify compliance with and enforce either financial repression or prudential financial regulation. Supervision includes the specific procedures adopted in order to determine the risks faced by an intermediary and to review regulatory compliance" (Chaves and Gonzalez-Vega, 1994).

Financial intermediaries could put deposits at risk by, for example, investing in excessively risky loans at high interest rates. Savings deposits usually offer fixed interest rates, and so the owners of the financial institution would benefit and take the profits if the risky loans turn out well, but have only a limited exposure to the potential losses from the risky loans. The institution would simply go bankrupt and the owners would be able to walk away from the losses. This is referred to as *moral hazard*. Moral hazard is the incentive for someone who holds an asset belonging to another person to risk the value of that asset because the person holding the asset does not bear the full consequence of any loss.

In the case of MFIs, particularly those where neither the Executive Committees nor the Board of Directors have any substantial investment in the institution, there is clear moral hazard. In the event of poor repayment rates, it is the savings of the depositors (be they compulsory and locked-in or voluntary open-access) that are at risk. Indeed arguably, the risk to depositor's savings is greater when they do not have access to withdraw those savings when they perceive that they are at risk.

Options for Regulation and Supervision – The Theoretical Framework

External regulation is but one of several important elements to create well-managed and permanent financial institutions. Elements of “self-regulation” are probably even more important as they are permanently imbedded within the institution's systems. Supervision should be undertaken by several different parties representing the interests of either shareholders, management, or the clients.

Typically the main instruments of regulation and supervision are:

1. The *Executive Committee/Board of Trustees* (or in the case of publicly owned institutions, the Annual General Meeting) which meet to review the progress of the institution and its strategic planning;
2. The *Board of Directors* that establishes good business, financial, and risk management policies and procedures, and holds management accountable for the effective implementation of those policies;
3. The *internal controls and internal audit* department which operate to ensure that policies and procedures are implemented promptly and effectively;
4. *External auditors* who are knowledgeable and competent in MicroFinance as an objective check on institution's policies, procedures and systems of control and audit to protect against fraud and mismanagement; and
5. *External supervision* by a central bank or its agent to ensure that management does not misuse its power to use depositors' funds for its benefit and maintains industry standards (usually in terms of “CAMEL”, Capital adequacy, Asset quality, Management capability/systems, Earnings ratios and Liquidity).

In this context, Carpenter (1997), in her case study of Bangladesh, laid out the options for regulation:

“Designing an appropriate regulatory framework requires consideration of several factors; the financial condition and structure of local micro-finance institutions; their roles within the financial services industry; and the capacity of the regulating entities to administer external regulation and supervision effectively.

With those factors in mind, the five main options for regulation include:

1. **No external regulation:** This is the current environment for most MFIs (and effectively for the Grameen Bank) and it has produced an innovative and strong micro credit industry in Bangladesh. However, some regulatory oversight is needed now that MFIs are putting member's savings at greater risk.
2. **Self -regulation:** This would require individual MFIs to strengthen their institutions and share financial information on a consistent basis. For an MFI to regulate itself, it requires three elements: 1) an independent board with the technical expertise and authority to hold management accountable; 2) well-formulated and

properly implemented internal control and risk management policies; and 3) high quality auditors who are educated about micro finance. Self-regulation is only possible if these three elements are combined with transparent disclosure.

3. **Hybrid approach of part self-regulation, part supervision by a third party:** Under this blended approach, MFIs would be held responsible for meeting higher standards of financial reporting and performance analysis, and the regulatory authorities would contract to a third party to monitor their compliance with those standards. For example, to ensure consistently presented financial information, the regulating entity could contact with an accounting or consulting firm to conduct routine financial audits of MFIs, including standardised financial presentation and ratio and trend analysis. Full disclosure would allow investors and depositors to make rational choices, however this presumes that they have choices of financial services providers.
4. **Regulation through the existing legal and regulatory framework:** MFIs could apply for a standard banking license if they met all requirements for a commercial bank, such as BRAC has now done. To date, the Bangladesh Bank has resisted granting bank charters to MFIs. Since some development financial institutions in other countries have thrived under the regulatory oversight imposed by commercial bank status, this option should be given greater consideration.
5. **Regulation through MFI-specific regulation:** Some countries have created a distinct legal status and regulation for non-bank MFIs, such as Bolivia and Peru ... In some cases, these institutions are supervised through a separate unit within the central bank or delegated supervisory authority. In Bangladesh, this mechanism was used to create the Grameen Bank charter, but the central bank does not currently plan to use this approach again.

In general, the greater the financial risk and the more money at risk by depositors, the more important external regulations becomes to avoid what economists call “moral hazard” by management and owners. This suggests the need for separate tiers of regulation and supervision based on quantitative measures.”

A Conventional Option: A Liability-Based Continuum of Mandatory Regulation

Van Greuning et al. (1998) of the World Bank’s Financial Sector Development Department use an analysis of MFIs’ liabilities to highlight distinguishing features of different types of MFIs and focus on risk-taking activities that need to be managed and regulated. A continuum of MFIs, these experts argue, can be classified into three categories. The authors propose thresholds of financial intermediation activities that would trigger a requirement for an MFI to satisfy external or mandatory regulatory guidelines.

1. MFIs that depend on other people’s money (donor grants, small scale compulsory savings as loan collateral) to be self-regulated; and those that depend on other people’s money (commercial paper and large certificates of deposit) to be regulated by Companies’ Registry Agency, Bank Supervisory Authority or Securities and Exchange Agency.
2. MFIs that depend on (common bond) members’ money to be regulated by the Cooperatives’ Authority or Bank Supervisory Authority.
3. MFIs that leverage the public’s money (savings deposits) to be regulated by Bank Supervisory Authority.

The authors argue that the regulatory environments in most countries need to be changed to transform their fragmented financial markets into cohesive continuums thus making it easier for MFIs to pursue a process of progressive institutional transformation.

The Problems with the Theoretical Framework ...

“Enhanced prudential regulation and supervision must accompany deposit mobilization. It is irresponsible to encourage individuals – especially those who are poor – to deposit savings in institutions without outside surveillance. Thieves everywhere are attracted to piles of money, especially in financial institutions.

In most low-income countries the capacity of the authority in charge of bank supervision and regulation is often limited. I remember visiting one central bank that was responsible for supervising commercial banks. The office in charge was undermanned and the employees poorly trained. To make matters worse, the central bank had been unable to reconcile its own books and publish an audited annual report for several years.” Dale Adams, 1998.

Increasingly MicroFinance Institutions (MFIs) have come to recognise the need to provide savings services – both as a much valued service to their clients, and as a long-term source of capital that is more dependable (if a little more costly) than donor grants. In recognition of this significant shift from microcredit to microfinance, donors, microfinance gurus and increasingly central banks are expending a great deal of time and energy trying to dream up systems of regulation and supervision that will protect depositors’ savings while allowing MFIs to take (and intermediate) deposits.

While recognising the need for some basic rules designed to maximise the security of deposits, on the face of it, it appears to be naively optimistic to think that a system of central bank regulation and supervision will *de facto* secure poor people’s deposits². In developing countries, central banks often struggle to regulate and supervise the urban-based commercial banking sector. In Kenya, Tanzania and Uganda, for example, the central banks each have typically little more than two dozen formal sector commercial banks to supervise, and despite this apparently limited task, there has been a series of bank collapses, often due to corrupt practices or mismanagement. The record in the developed world is marginally better, but hardly the model of security. The Bank of Credit for Commerce and Industry collapsed despite being under the strict regulations and supervision of the Bank of England, the Japanese banking sector is currently in turmoil despite the best efforts of the central bank, and few need reminding of the Savings and Loan scandal in the USA. This latter case is particularly instructive since the Savings and Loan institutions were subject to central bank regulation and supervision in one of the world’s most technologically developed societies with one of the most sophisticated and comprehensive regulation and supervision systems, backed in turn by first class auditing companies. Some claim that the Savings and Loan scandal occurred because the savers’ deposits were guaranteed by the government, and thus the owners of the Savings and Loan institutions were less-risk averse and more willing to take on high-risk and high return investments – a case study in moral hazard³. And one that cost each and every US tax payer about \$2,000.

Despite this sub-optimal record, the donors and developed country-based microfinance gurus seem intent on developing central bank-driven systems of regulation and supervision. It is ironic to think that central banks struggling to supervise a handful of commercial banks should be expected to supervise dozens of small-scale MFIs. One cannot help but worry that the central banks, lacking the resources and capability to supervise the formal commercial banking sector, might be stretched beyond reasonable limits if required to supervise large numbers of MFIs running a business for which central bankers usually have scant regard, and of which they have less understanding. But conversations with many central bankers reveal that they view it as their sacred mandate to protect depositors and avoid systemic risk ... and so they believe, the central bank must be involved⁴.

² Realistically, only an effective, fully functional deposit guarantee scheme can do this – and many central bankers seem unwilling to offer this facility to microfinance clients even when they propose to supervise the MFIs that serve them.

³ Bert Ely, a US-based banking consultant, notes that it is moral hazard and information problems that make it impossible for government regulators to price deposit insurance efficiently (J.D. Von Pishke- personal communication).

⁴ Given the relatively small size of MFIs in most countries in the world, the concerns about systemic risk seem strangely surreal. At present, such concerns are probably only remotely realistic and rational in Bangladesh, Indonesia, one or two Latin American countries and possibly a few countries in West Africa.

Bangladesh Bank: A Notable Exception

The central bank in Bangladesh is an important and illuminating exception to central bankers' entrenched obsession with regulating and supervising all financial institutions. The Bangladesh Bank has the vision and understanding to be extremely reticent about getting into regulation/supervision of the MFIs. The Bangladesh Bank has recognised three important issues that prohibit it (and indeed most) central banks from getting involved in the regulation/supervision of MFIs:

1. the poor state of the formal financial sector and the role the Bangladesh Bank is playing in the reform process leave little institutional capacity free to support this rapidly growing sector;
2. microfinance is radically different to the financial sector which Bangladesh Bank supervises and would require considerable resources to devise a supervisory framework; and
3. the sheer size of the microfinance sector in terms of number of institutions poses logistical problems for supervision.

In short, the Bangladesh Bank wants to focus on its central mandate and strengthening the formal financial sector – no small task.

Donors, defensive and risk averse by nature, would hate to be associated with poor people losing their savings, and therefore seek the most conservative approach – usually some form of government deposit guarantee which in turn “necessitates” central bank regulation and supervision. For some strange reason the gurus of microfinance have chosen to support this in this approach⁵. One cannot believe that the fact that they are (generally) based in developed countries blinds them to the short-comings of developing countries' central banks, and even if it did, the history of supervision by central banks in their own countries scarcely inspires confidence.

The result of the coalition of control-concerned central bankers, risk-averse donors and sophisticated-system gurus has been a strange paralysis ... for few, if any, central banks have been able to develop appropriate regulations and systems of supervision – they remain a dream⁶. Endless research has been conducted, study-tours and participatory workshops have been held and earnest papers have been produced, but progress has been limited. And the poor have been left hanging, waiting for the day when they might be allowed to access to formalised savings services.

But it is time to recognise that central bank regulation and supervision systems are only attempts at oversight of the issues at the core of deposit-security: ownership, governance and management. Perhaps we should seek to define a regulatory framework that sets very basic requirements in terms of capital adequacy, asset quality, management systems, earnings and liquidity (CAMEL). If these basic standards are met, and the MFI has a clear ownership and effective governance structure, it should be entitled to offer savings services to its clients – without the backing of a deposit guarantee scheme or the supervision of central banks.

⁵ Although, fortunately, this is now beginning to change – see for example “The Rush to Regulate: Legal Frameworks for Microfinance” (Christen and Rosenberg, 1999).

⁶ One that in some cases become a nightmare. One African central bank is poised to pass a Policy Statement that may well close all rural finance institutions in the country and thus deny formal/semi-formal financial services to the vast majority of people. The final draft of the Policy Statement insists that 1) loan insurance funds/compulsory savings should be deemed deposits and therefore that it is not legal for inadequately capitalised MFIs to take them and 2) that any user-owned and managed organisation with over 60 members should not be allowed to take deposits. This is likely to shut 99% of the MFIs operating in the country and to drive the rural finance industry under-ground – out of reach of the very training and technical assistance programmes that might have strengthened the institutions and protected the deposits these institutions are going to take anyway.

Ownership and Governance (from Carpenter, J., 1997)

There are several key components of clear and effective ownership and governance systems.

Involved **outside investors** and a for-profit structure creates an important group of stakeholders: shareholders. This group complements management and staff, the board, and the clients by focusing on the bottom line and the health of their capital investment in the organisation. For NGOs an “equity-equivalent” investment for an NGO might be a long-term subordinated debt instrument with equity-like terms, or other instruments that might attract private investors. The right “investors” will probably bring value to the organisation through access to financial resources, some protection from government interference, and management experience from a like-minded financial institution.

Although NGO-MFIs often have weak boards and dominant executive directors, a strong **Board of Directors**, with appropriate representation of the investors, is a central component of an effective governance system. Boards should identify competent managers, approve strategies and policies for business activities, risk management and internal controls, and should hold management accountable for implementing those policies. Boards should set clear and measurable goals, monitor the progress towards these, and confront weaknesses or short-comings where and when they are detected. Finally, Boards must also be able to regulate themselves, to maintain continuity while ensuring renewal and a constant process of self-evaluation. Boards should focus on the big picture, yet be aware of details so they can identify potential problems. Board members should be drawn primarily from the private sector, including resource people who complement management’s skills. By thinking of themselves as the stewards of the MFIs capital, board members can assume greater responsibility to identify organisational development and strategic priorities. Board representation by clients may keep the organisation focused on the end-customer, but those representatives are unlikely to push the MFI to address financial and organisational issues. (See also Rock, Otero and Salzman, 1998 for an excellent discussion of the role of Boards).

A frequent criticism of MFIs is the questionable accuracy or completeness of their financial statements and reporting. Preparing **consistent, transparent and high-quality financial statements**, following generally accepted accounting principles and with transparent recording of transactions among and between subsidiaries will enhance the credibility of MFIs with clients, investors and funders. In support of this and to protect the institution, its assets and the interests of its clients, MFIs should invest in high-quality annual audits from a reputable firm with microfinance experience. While many organizations view audits as an annual review of the numbers and a rubber stamp on accounting practices, a good auditor and accountant can add significant value to MFIs with appropriate performance measures and tracking systems.

It is often argued that outside investors and private ownership will result in improved governance since shareholders with a stake in the long-term survival and profitability of the MFI will make interested, involved and high-quality board members (see for example Hannig and Braun, 999). Similarly, outside investors are credited with insisting on higher quality financial statements, transparency and audits so that they can gauge how the MFI is progressing. These factors taken together, it is argued, will result in increased security of savers’ deposits in privately owned MFIs.

Nice theory, but as practice has shown us external investors are no guarantee that savings will be safe ... indeed there are too many examples of unscrupulous external investors and private sector owners performing the opposite function and indulging in insider-lending. Private ownership as a panacea for safeguarding deposits is optimistic and naïve at best ... and it may well also be simply impractical.

Private Ownership As A Panacea

“The inclusion of private owners with an interest in the performance of a microfinance institution would enhance the internal control significantly” Hannig and Braun (1999).

There is a clear preference in many central banks, often at the behest of international advisors, for private ownership of MFIs. This, it is believed, will lead to:

1. Clarity of ownership (allowing the central bank to decide if the owners are “fit and proper” to run a bank and to seek additional capital from the owners in the event of the failure of the bank); and
2. Improved governance and involvement on the Board by private owners and thus strengthened internal controls.

Practitioners have raised several issues in response to these beliefs:

1. At present, there may not be adequate interest from potential owners/investors for the majority of MFIs, few of which have yet achieved financial self-sufficiency.
2. The investors that are mostly likely to come forward are from developed countries and are often poorly placed to understand the realities of the business in individual developing countries on the basis of a few periodic visits to the countries concerned (if indeed they attend Board meetings at all). In addition, it is also questionable whether the expatriation of ownership is necessarily desirable or indeed can work on an industry-wide basis (it is likely that international investors will seek one or two “winners” in each country).
3. Attracting international institutional investors may simply defer the issue to a later date: in Latin America, despite the profitability of the MFIs involved, international institutional investors are now struggling with their “exit strategy” and to find local investors to buy their shares.
4. Private ownership has not proved a panacea in many developing countries – for example in East Africa (as elsewhere) most of the recent collapses of privately owned banks resulted from insider lending.
5. NGO owned MFIs have often enjoyed high quality governance – examples in East Africa being FINCA (which is rigorously appraised/audited on an on-going basis by its head office) and Uganda Women’s Finance Trust (which was greatly assisted in its renaissance by its dedicated local board and assistance from World Women’s Banking). In Latin America, ACCION has played a central role in maintaining the quality of its affiliates, including saving FinanSol (when the *Superbancaria* – the supervising authority – had not seen the crisis).
6. NGO Board members may have important “intangible” investments in the organisation – in particular their reputations.
7. NGO MFIs (with no private ownership) are not necessarily intrinsically flawed: two of the largest MFIs in the world, BRAC and ASA (with a total of over 4 million clients) in Bangladesh remain NGOs to this day (although BRAC is now looking to transform into a bank).
8. There remains confusion amongst some Central Bankers over the concept of the private ownership of co-operatives in this context ... the co-operative ownership system is seen as not as effective in promoting good governance since co-operatives do not usually aim at maximising profits.

Seeking the Answers Outside Convention ...

“This leads me to think that perhaps we are placing a bit too much emphasis on the importance of external prudential regulation and supervision when it comes to credit unions. For me, at least, it is far more important to emphasize making these organizations serious businesses first and then later stressing some external regulation. After all, there are millions of unregulated RoSCAs and ASCRAs out there that operate nicely without external regulation” (Dale Adams on the on-line DevFin Discussion Group at Ohio State University 1998).

The need, desire and capability of the poor to save is increasingly well documented (e.g. Miracle and Cohen, 1980; Adams and Fitchett, 1992; Steel and Aryeetey, 1994; Rutherford, 1998; Wright et al., 1997; and Rutherford, 1999). The need for MFIs to offer credit and savings services is also well documented (e.g. Robinson, 1994; Otero and Rhyne, 1994; Wright et al. 1997; Hannig and Wisniski, 1999). But the quest for perfect security of deposits prevents these two complimentary needs from meeting and resolving. And so the poor are forced to rely on

(unregulated) cost-ineffective, often insecure and unreliable, systems to save. These include roving savings collectors who often charge 3% a month to provide the service; livestock that must be fed, housed and protected from illness; jewellery and hidden stores of money held in the home that must be secreted from thieves and marauding family members; and RoSCAs that provide an efficient but inflexible and limited savings mechanism.

Informal Self Regulation: RoSCAs and Other Savings Clubs

The informal sector is, by definition unregulated ... at least in the formal sense. However, it is important and possibly even instructive, to note that RoSCAs and many other types of savings clubs (for example Christmas clubs) have a built-in and extremely efficient system of self-regulation. These savings and loans systems are time-bound and self-liquidating. That is to say that people (usually informally) contract to participate in the association or club for a specified cycle, and on completion of that cycle they are free to join the next cycle or to opt out. Successful, well-managed RoSCAs and savings clubs generally continue and start a follow-on cycle, but members are unlikely to re-join poorly-managed associations and clubs, and particularly not those from which they did not recover their savings.

Perhaps the time is to learn from the anarchy of benign neglect in Bangladesh where hundreds of unregulated and unsupervised NGOs are offering savings services with impunity. In this environment many poor people have lost their savings either to incompetence or fraud (as they have in many regulated and supervised environments) ... but they still keep looking for safe MFIs, which will offer them savings services. Now the poor of Bangladesh are increasingly coming to recognise MFIs which have been operating in the area for a long time, or who are well known in the country, and are entrusting their savings to these institutions in preference to the small lesser known NGOs. The market, information exchange and brand recognition are working ... as in the informal market, the clients are conducting their own supervision!

One Alternative: A Savings Guarantee Foundation

In the light of the Bangladesh Bank's enlightened reticence to get involved in supervising MFIs, Henry Jackelen has suggested an innovative approach. He proposes a "Savings Guarantee Foundation" with the central purpose of to certify organisations and provide financial backing to guarantee client deposits. To obtain this guarantee organisations would pass through an intrusive review of their operations and would also have to be continually monitored. Certified organisations would be required to pay an insurance premium for this service. Two basic types of guarantees would be provided: i) certifying that NGOs place the amounts raised from clients in identifiable accounts in banks and are not used for on lending and ii) for NGOs deemed to have appropriate capacity--certifying that financial condition, lending policies, procedures and management are of a quality acceptable to use member savings in on-lending activities.

In the absence of a deposit guarantee scheme covering their savings, there should be at least two additional requirements to ensure that clients are fully aware of risk they are facing while minimising that risk. Firstly the MFI must be required to "declare the risk", to inform its clients, with clarity and regularity, that their savings are not secured by government guarantee and that the security of their deposits depends on the strength of the institution: its governance, management and the quality of its loan portfolio. These are issues over which, particularly in the case of user-owned and managed organisations, clients have some degree of control. Indeed, in their review of six MFIs of 19th century Europe, Hollis and Sweetman, (1998) argue that "MO [microcredit organisations] with depositors benefited from having interested parties overseeing their operations and withdrawing their deposits when problems began to emerge. Depositors provided information on, and monitored, borrowers, and performed administrative tasks in some instances" [p.1888]. Secondly, accounting companies need to be trained to audit MFIs and their systems, to review their ownership and governance structures, and to verify the MFIs' compliance with the basic CAMEL requirements. These accounting companies could then be required by law to report on the individual MFIs' compliance with the CAMEL standards to an MFI apex organisation responsible for co-ordinating and overseeing MFIs' activities. Working together with the member MFIs, this apex

authority could then publicise MFIs' annual compliance/non-compliance in a very simplified format (perhaps with a system of zero-five star accreditation plaques) – not only at a national level, but also at a local level in the areas where the individual MFIs are working.

Another Alternative: Guatemala Credit Union Rating Agency

The Guatemala Credit Union movement is working with the World Council of Credit Unions (WOCCU) and the Consultative Group to Assist the Poorest to develop a private organisation to act as a rating or certification agency. This agency will train, qualify and monitor auditors to review participating Credit Unions (who will pay for the service *but have no control over it*) to ensure that they comply with standards based on the existing PEARLS system (WOCCU's equivalent of the CAMEL system). In addition, the agency will maintain a watch list of Credit Unions showing signs of problems and will expect the management of these Credit Unions to prepare and negotiate remedial action plans. Credit Unions who pass certification will be permitted to display the agency's logo of certification (which will be heavily marketed as part of the system). Credit Unions who fail to maintain the standards will have their certification and the right to display the logo withdrawn.

This type of system would not be perfect, but nor would any. This type of system would not ensure that no poor people lose their savings, but the system recognises that central banks have neither the capacity nor, as often as not, the will to supervise MFIs. That recognition might just allow the microfinance industry to wake from its dream of finding the perfect system of regulation and supervision, and the resulting inertia⁷. For it is this inertia that is, on balance, more likely to hurt the poor, by depriving them of relatively low-risk savings services and offering only loans that put them into debt. In the long run this inertia will also hurt the MFIs since they lose the opportunity to provide high-quality financial services to their clients and to raise capital by doing so. As Hollis and Sweetman (1998) observe, “depositor-based MOs [microcredit organisations] tend to last longer and serve *many* more borrowers than MOs financed by donations or government loans” [p1888].

Yet Another Alternative: Market-Driven Deposit Insurance

Those in quest of a system that does indeed provide deposit insurance for the poor might be attracted by J.D. Von Pishke's proposal (based on a decade of work by Bert Ely). Von Pishke (forthcoming) proposes a system that requires:

1. that all deposits to be insured
2. that any suitably insured institution be allowed offer deposit services
3. that the insurer must be a bank doing business in the country concerned
4. that the insurer have extensive reinsurance
5. that some of the reinsurance be off-shore and in hard currency
6. the role of the state is to define the minimum acceptable insurance contract, to ensure that the parties concerned have the capacity to undertake the obligations, and to ascertain that the parties have appropriate legal standing for enforcement against them.

This market driven insurance scheme is expected to result in a variety of contracts, market-based premiums reflecting insurers' views of risk, and a dispersion of risk. And private insurance would concentrate more on leading indicators (policies, standards and systems) and less on traditional lagging indicators (reviewing financial statements and returns and concluding “My God! They're broke. Let's close 'em”).

For many MFIs another option may be more appropriate, and it is one that may well also appeal to enlightened regulators. Under this approach MFIs can provide savings services to their clients but must place the deposits mobilised in designated accounts in supervised commercial banks – the MFIs are not permitted to intermediate them into loans. This approach has several advantages: firstly it allows MFIs truly committed to providing their

⁷ An inertia that is often manifested in principle-based, super-prudential norms being imposed on MFIs seeking to offer savings services ... thus prohibiting most from doing so and – thus driving clients into the high-risk informal sector.

clients savings services (and not just looking for additional loan capital funds) to do so at relatively low risk. Secondly, it allows those MFIs to gain some experience of the complexity of delivering savings services. Thirdly, it provides a relatively straightforward opportunity for the authorities to supervise these deposits while beginning to get to know the MFI involved ... perhaps in preparation for it achieving status that allows it to conduct full scale intermediation.

There is another sector of the market that is even more difficult to supervise – that of small user owned and managed organisations. These organisations are often the only way of serving remote rural areas outside the informal sector, and cannot just be legislated away by risk-averse central banks. Saving in the informal sector is very risky indeed – probably relatively more so than many high risk, community-based, semi formal institutions (see Appendix 1 for a case study of the types of issues facing poor people forced to resort to informal sector saving mechanisms and also Wright and Mutesasira *forthcoming*). Attempts to reduce risk to members’ deposits held by small user owned and managed organisations will probably have to depend on a combination of:

- declaration of risk (and the fact that members’ savings are not covered by a deposit guarantee scheme);
- requirements that officers have undergone some basic training; and
- some basic, simple and clear reporting requirements.

The declaration of risk has been discussed above. Options for operationalising some form of required training for officers⁸ by trainers (ideally certified by an appropriate agency) have not been adequately explored but are worthy of consideration⁹. In this context options for regular “refresher training” must also be considered.

The reporting requirements should encompass regular (say quarterly) simplified financial statements that must be presented to the members at general meetings and posted on the main public notice board of the financial institution. These simple financial statements/accounts must be explained to the members, and some form of member education programme might be needed to assist them in understanding these statements and their implications for the institution. In addition, (certainly for the larger user-owned and managed organisations), annual accounts should be audited by reputable (ideally certified by some appropriate agency) accountants.

⁸ As a minimum in 1) basic book-keeping, 2) basic business planning, 3) basic loan portfolio management and 4) transparency and accountability

⁹ In Indonesia, a diploma for the managers of “People’s Credit Banks” (BPRs) is envisaged as part of the “fit and proper test” for future managers.

And Another: A Voluntary Register

Stuart Rutherford has proposed an ingenious scheme for helping the poor better assess the risks they face as they choose to entrust their precious savings to MFIs. The scheme centres round a voluntary register, backed by rule of law. It would work like this:

1. An institution would open a register of MFIs wishing to mobilise deposits. However, the institution would have absolutely no say in whether or not any particular MFI is allowed to register, and absolutely no say whatsoever in what the MFIs chooses to write in its registration document.
2. In the registration document the MFI will give details about itself. Its name, its address, the names of its owners and of its backers, its area of operation, and its resources, its financial products, and so on.
3. It will also have to state on what basis aggrieved parties could make a case against the MFI in the eventuality that it failed to honour deposits that it had accepted. For example, it might give the name and address of some immovable property that it would be willing to be confiscated.
4. The MFI would then be obliged to hand out a copy of its registration document, in easy local language, to every single one of its clients. It would also be obliged to distribute copies of the document to any member of the general public who wanted one. There would also be copies displayed at the local government offices.
5. In this way, clients would be able to compare one MFI with another, and to estimate the balance of risk and benefit represented by 'their' MFI. Unregistered MFIs would, it is hoped, lose business.

As Rutherford notes, to be effective and useful, the voluntary register must be **accurate, up-to-date, simple, clear, and accessible**.

Approaches offering accreditation plaques/certificates or a voluntary register could further empower poor people with some basic information on which to make their own decisions – on whether, where and how to save, and with a chance of understanding the associated risk. They are then in a position to evaluate the risks and compare them with those that imperil savings held in the home.

Finally, it is worth noting that the argument that savings services that are not backed by deposit guarantees and central bank supervision are dangerous for the poor and therefore should be discouraged is akin to arguing that cars are dangerous and therefore should be banned. We are all willing to take risks when we believe that the potential benefits make the risk-taking worthwhile – this is a decision that the poor need to be allowed to make for themselves.

Conclusion

“Savings are important to all of us - more important than loans. Before I used to try to save a few paisa in the house, but we always spent it - a guest came, the children begged for an ice-cream, or something else important came up - the money always went. Then when you really needed the money you had saved it was not there. We need a secure place to put savings - somewhere outside the house, but where we can get access to them quickly when emergency strikes.” Morsheda Ahktar, BURO, Tangail member in Bangladesh.

MFIs can indeed be usefully analysed on the basis of their liability structures, but considerations of their ownership and governance structures and their management systems are of central importance, as are careful consideration of the nature of the savings services they provide.

A tiered approach is necessary, one that provides opportunities and incentives for MFIs to learn, grow and graduate between tiers. The incentive to graduate between tiers would be contingent on the prestige and reputation for security of deposits associated with each tier. Those MFIs seeking to access the government-backed deposit guarantee scheme (and to market their savings products as secured in this way) will probably of necessity be required to submit to central bank determined prudential norms and supervision. These MFIs are likely to be the

largest operators in the market, but will be a minority of all the many MFIs operating ... and thus should be manageable in number for over-stretched central bank supervision departments.

To date few MicroFinance gurus have given serious thought to how best to improve the security of poor people's deposits held in smaller MFIs – most seek to simply prohibit these MFIs from providing savings services at all. This ignores the needs and demands of the MFIs' clients. Furthermore, particularly in remote rural areas, community-based, user-owned and managed systems are likely to be the only sustainable way of delivering financial services to the poor living there.

In view of the highly risky nature of saving in the informal sector it is probably necessary to think more about helping clients understand the relative risk of saving in these institutions, and to improve internal supervision (accounting systems, internal control, governance, transparency etc.) than in terms of external supervision¹⁰.

Concluding Suggestion: A Mixture
(A Personal View)

Although apparently complex, I believe that probably about six tiers are necessary – only one of which involves the central bank. These are as follows:

Gold Standard MFIs: Supervised by the central bank, covered by the government deposit guarantee scheme and encouraged to market their services as such.

Premium MFIs (possibly including larger user owned and managed organisations): Supervised by a rating agency, possibly covered by a pooled deposit guarantee scheme, and marketed as such.

Ordinary Savings and Credit MFIs: Offering loans (from equity or borrowed capital) and savings services under which deposits mobilised are taken and deposited in a formal sector bank that is subject to supervision by the central bank. Ordinary Savings and Credit MFIs would not be permitted to intermediate the savings they mobilise into loans.

Ordinary Credit-Only MFIs: Offering only loans, and depositing compulsory savings/loan insurance funds generated by the lending methodology in a formal sector bank that is subject to supervision by the central bank.

Larger User Owned and Managed MFIs: Required declaration of risk, training of officers by certified trainers, required reporting and subject to annual audit/CAMEL assessment by certified auditors. Simplified formats of the auditors' reports would then be reviewed by the MFIs' members at their annual general meetings. In addition the auditors' reports could be reviewed by an umbrella organisation that could periodically publish very simple tables of performance indicators for these larger user owned and managed MFIs in national/local newspapers.

Smaller User Owned and Managed MFIs: Required declaration of risk, training of officers by certified trainers, required reporting and subject to annual audit by certified auditors. Simplified formats of the auditors reports would then be reviewed by the MFIs' members at their annual general meetings.

Whichever system, or combination of systems is used, it is clearly time to embrace pragmatism over principle and practice over theory. It is time to wake from the dream that perfect prudential norms will safeguard people's savings ... the poor demand that we do.

¹⁰ There is almost no example in the world of a Co-operative Development Agency/Department that has managed to supervise co-operatives effectively.

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Appendix 1

Relative Risk in Mount Elgon

Like most people in remote rural Uganda, the people of the villages on the foothills of Mount Elgon had (and indeed still have) no access to a formal sector bank. Prior to 1998, they saved whatever they could in kind, cash hidden in the home or through “merry-go-rounds” (Rotating Savings and Credit Associations). But all of these presented risks to the people involved. But such was the demand for financial services that poor people even saved through unregistered and fraudulent schemes such as “Bangoma” which took Ush. 20,000 from prospective clients and then disappeared. Such schemes thrive in circumstances where poor people have no other option.

Savings In Kind

Savings in kind are subject to loss through fluctuations in commodity prices, theft, insects, illness etc.

Coffee: Saving by hoarding coffee is one of the most common forms of saving in kind, but has been characterised by high losses in recent years as the price has fallen from Ush. 3,000 per kilo in 1997 to Ush. 1,500 per kilo last year and Ush. 1,000 per kilo this year. In addition, going down to the lowlands to sell the coffee was a perilous business: bandits marked who was going to sell coffee and awaited their cash-laden return. As many as two people were killed every month by bandits lying in ambush on the cliff road up to Kamu.

Maize: For example, last year the people who had been saving by hoarding maize also lost out as the bumper harvest in Busoga flooded the market and depressed the prices to below those at harvest time in Elgon. Similar problems beset those trying to save in beans.

Livestock: Recently, in addition to the perennial problems of disease and feeding/housing livestock, recent years have seen an upsurge in incidents of livestock being stolen, particularly by the Karamajong.

The Chairman’s Woes

The Chairman of Kaselemu told us of his attempts to save in kind – and his losses to insects, commodity price fluctuations and thieves.

“In 1995 I went to Kamanguru, a nearby village, and bought 100 bags of half dried maize packed in bags of 100 kgs each. I transferred the bags to my home and kept them for three months. When the price of maize went up I hurried to Mbale and hired a vehicle to transport the maize to market. However, upon opening the bags, I couldn’t believe my eyes: all of the maize had been eaten up by weevils. It was by then too late: not only had I lost my savings, I had also incurred an additional expenditure for hiring the lorry.

In 1996 I did better, but in the 1997 season, I bought beans at Ush. 200 a kilo during the harvest period. Unfortunately there was a bumper harvest of beans in Bulegeni sub county during that season, so I was forced to keep the beans for four months before I sold them again ... at Shs. 200 per kilo. This was at a loss to me because the beans had dried out and so there were fewer kilos to sell by then, and I had put in a lot of effort to preserve the beans over those four months.

Last year, I kept coffee against the wall in one of the corners of the house. Whenever I could buy more coffee I would do so and add to the heap of the coffee. After a while I noticed that the volume of coffee was not increasing as I had expected it to; however, this didn’t bother me since the room was always locked. After two months, not wanting to repeat the experience with the maize, I decided to take out all the coffee for re-drying. It was then that I realised that someone had made a hole through the mud wall of the house and used to come at night to steal the coffee. When I re-weighed the coffee I found I had lost 270 kilos of coffee valued at over Ush. 350,000.

Now I sell produce immediately and put money in Elgon Village Bank ...” As he finished there was a sudden commotion: shouting and people running off brandishing sticks and machetes. “There are two rabid dogs on the loose”, the Chairman explained, “They killed four goats last night – one family’s entire savings.”

Savings At Home

Keeping savings at home is also an extremely risky option. In addition to all the normal risks of thieves breaking into the house in search of the money, insects eating it and trivial spending prompted by visitors or small-scale celebrations; relatives present a serious risk to savings held at home. Many of the retrenched soldiers received their severance pay packet and tried to keep it at home. Relatives came with pleas, camped outside their houses and

within a few weeks, almost all of the soldiers had spent most of the money addressing their friends and relatives' problems.

There is another significant risk in saving in kind or indeed in the home. The Bagisu tribe's culture dictates that if someone is killed (whether accidentally or on purpose) the family of the dead person will not rest until they have destroyed the homestead and all the property of the clan from which the "killer" comes.

Missing: Secret Hordes

Kyamala passed away in 1992. However at the beginning of 1999 one of the big trees in Kyamala's compound was cut down and inside one of the holes they found many torn old currency notes. When he died, nobody knew where old Kyamala was keeping his money - if they had known, the money would have been used to pay school fees for his grandson who dropped out of school soon after his death – for lack of money.

William Matabi, a farmer in Sisiyi village, had kept Ush. 200,000 inside the back of his radio. One night, a thief stole the radio as he was sleeping. William says, "This was a very big lesson – I will never keep money at home again as long as Elgon Village Bank is open."

Merry-Go-Rounds or RoSCAs

RoSCAs are common in Mount Elgon as elsewhere in East Africa – and as throughout the region, many have lost money through RoSCAs. The result is that, in common with other countries in East Africa, as a function of the limited level of trust within the community, RoSCAs are usually small in scope: both in terms of the number of participants and the amounts of money rotated. RoSCAs are excellent systems for disciplined saving for a specific goal, particularly if that goal is cyclical or recurrent. It is however, the rigid, cyclical and self-liquidating nature of typical shorter-term RoSCAs that is also their draw back, for they are poorly equipped to respond to:

1. unpredicted emergency needs, or
2. the need build-up larger lump sums over time, or
3. changes in the ability to the member save (either a reduction due to problems or an increased ability due to a windfall), and
4. to store money for the short term (if for example the pay out comes a month before school fees are due).

Elgon Village Bank

Clearly, the level of risk to poor people's savings under each of these traditional options is high. It was for this reason that when the "Elgon Village Bank" was established, the people jumped at the opportunity. Now 18 months after it formally opened its doors for business, the EVB has 1,700 members who have bought Ush. 19.3 million shares, and deposited Ush. 515 million and withdrawn Ush. 502 million in savings¹¹ ... and all this despite the negative publicity surrounding "Village Banks" and having the EVB's account in the Co-operative Bank frozen.

The EVB is not perfect¹², nor is it perfectly safe as a financial institution, but it offers a client-responsive savings service at a relatively low-risk by comparison to the alternatives open to the people of Kamu and the surrounding villages. In their position, which option would you chose¹³?

¹¹ Indicating a remarkable level of demand on the part of the clients and an outstanding service on the part of EVB.

¹² A fact recognised by the Board and the staff alike, indeed the fact that it is operating legally and above ground allows it to seek technical assistance and training to strengthen the institution. If EVB and other such institutions were to be made illegal, they would continue in some form or other as informal savings and credit associations, but be unable to solicit assistance for fear of incurring the wrath of the law.

¹³ Many people in the villages of Elgon, of course, continue to diversify and hold a little savings in each system – some at home, some in-kind, and some at Elgon Village Bank while also participating in RoSCAs.