

# **Regulatory Requirements for Microfinance**

**A Comparison of Legal Frameworks in 11 Countries Worldwide**



Deutsche Gesellschaft für  
Technische Zusammenarbeit (GTZ) GmbH



**Division 41  
Economic Development  
and Employment Promotion**

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## List of Abbreviations and Acronyms

ARB	Association of Rural Banks
BI	Bank Indonesia
BKD	Badan Kredit Desa (Village Credit Institutions)
BoU	Bank of Uganda
BPR	Bank Perkreditan Rakyat (People's Credit Bank)
CAC	Cooperativo de Ahorro y Crédito Abiertas (Open Savings and Loan Cooperative)
CAMEL	Capital, Assets, Management, Earnings, Liquidity
CAR	Capital adequacy ratio
CEO	Chief Executive Officer
CGAP	Consultative Group to Assist the Poorest
CNBS	Comisión Nacional de Banca y Seguros (National Commission for Banks and Insurance Companies)
CONAPE	Consejo Nacional de Política Económica (National Economic Policy Council)
FFP	Fondos Financieros Privados (Private Financial Funds)
FPDO	Financial Private Development Organisation
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (German Technical Cooperation)
IFC	International Finance Corporation
IRIS	Center for Institutional Reform and the Informal Sector
LDKP	Lembaga Dana dan Kredit Pedesaan (Rural Fund and Credit Institution)
MCO	Microcredit Organisation
MDI	Micro Deposit-Taking Institution
MFB	Microfinance Bank
MFI	Microfinance institution
MFRC	Micro Finance Regulatory Council
NBFI	Non-banking financial institution
NGO	Non-governmental organisation
SBEF	Superintendencia de Bancos y Entidades Financieras (Superintendence of Banks and Financial Entities)



## 1. Objective, Methodology and Scope

Microfinance regulation is no longer a new field. Much has been written about it and even more has been done in terms of actually implementing these new ideas.<sup>1</sup> In a number of countries throughout the world, legal frameworks for microfinance have been amended or, in some cases, completely revised. In the current environment, it is becoming difficult to stay abreast of new initiatives to regulate microfinance institutions (MFIs).<sup>2</sup>

The drafting of legal texts is an important step when setting up an appropriate legal framework for microfinance. It is neither the first step nor the last, but it is a crucial one. Three elements of establishing a legal regime for microfinance can be distinguished. On the legal side, some kind of assessment of existing legislation should be conducted first. On the political side, new or amended legislation is only possible when sufficient political support exists. And, perhaps most importantly, on the institutional side, regulation will only be effective when institutional capacity and will are sufficiently strong.

The objective of this study is rather humble. It is to provide those involved in drafting legal texts for microfinance with a **commented inventory of regulatory requirements for MFIs**. The study does not offer a template for a microfinance law or for the amendment for current legislation so that it becomes more “microfinance-friendly”. But it may help some countries in drafting regulations so that they neither have to reinvent the wheel, nor find themselves limited to referring to microfinance legislation from only a few other countries as a reference point. Each country is different, from which it follows that each legal system for microfinance must be different. But having a good overview of the various options at hand allows policymakers to focus on country-specific issues, such as the selection of the most appropriate regulatory approach in the context of the particular country.

This study deliberately omits some important aspects of microfinance regulation and supervision. The analysis is almost exclusively based on the evaluation of **available legal texts for microfinance** in eleven countries worldwide. We did not visit any of these countries ourselves to contrast legal theory with practical reality.<sup>3</sup> The study does not look at supervisory practice, e.g. aspects such as supervisory capacity and regulatory enforcement or forbearance. Neither does it provide a general overview of the microfinance industry in these countries. This would go beyond the scope of this short paper.

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<sup>1</sup> The following publications offer a good introduction into the field: Berenbach and Churchill (1997); Rock and Otero (1997); van Greuning, Gallardo and Randhawa (1998); Staschen (1999); Christen and Rosenberg (2000); Vogel, Gomez and Fitzgerald (2000)

<sup>2</sup> In the course of conducting this study, we learned of more than 30 countries where specific legislation for microfinance has either been introduced or is being discussed.

<sup>3</sup> The only exception is Uganda, where the author has worked as a long-term expert in this field and therefore possesses a good degree of insider knowledge.

Only those countries with an existing legal system specifically for MFIs or those relatively advanced in establishing such a system have been included in this study. The legal system for microfinance may be specified in a law catering exclusively or foremost for MFIs (Bosnia and Herzegovina, Ethiopia, Ghana, Honduras, Kyrgyz Republic, Nepal, Pakistan, Uganda), in a decree or regulations under the Banking Law (Bolivia, Indonesia), or, in the unique case of South Africa, in an Exemption Notice under the Usury Act. The selection claims to be neither representative, nor comprehensive, nor geographically balanced.<sup>4</sup> But, as mentioned above, this need not be regarded as a shortcoming, given the objectives of this study.

Yet one point in particular should be stressed, as the reader might get the impression that we favour the approach of introducing a separate legal framework for microfinance. Microfinance services can be provided under a wide range of institutional models, which are regulated under laws as different as a banking law, a cooperative law, a specific microfinance law, or any other law defining a lower ‘tier’ of financial institutions. On the contrary, we believe that it is often easier to adapt existing legislation than to promulgate a new law. It is only that the characterisation of microfinance-specific requirements can be done more easily by looking at separate laws than by looking at exemptions from or adaptations to existing laws, which made us choose the current sample.

Our method of analysis is first and foremost descriptive. We do not assume that everything we came across is effective simply because it exists. Assessing the success of a regulatory framework is a difficult task and one which we did not attempt to complete, which is not to say that the study desists from making any judgments.

We went through the following steps to come up with this final, condensed version of a summary paper. Firstly, a country template was developed in the form of a table including the most important quantitative and qualitative regulatory requirements for MFIs. After collecting all the relevant legal texts, this table was filled out for each of our eleven country cases. This left us with eleven tables of eight to twelve pages in length, which have been used to draft the analysis. They will not be published, but will be merged into a soon to be launched database on microfinance regulations on the Microfinance Gateway ([www.microfinancegateway.org](http://www.microfinancegateway.org)).<sup>5</sup> This database will also include all legislation in their full text versions. Instead of the long tables, short summary versions are included as Annex 1 to this paper.

This study has been a joint effort of a number of people. First and foremost, I would like to thank Saliya Kanathigoda, who assisted me throughout the process with collecting legal texts, developing the format of the country tables, and analysing the material. I am

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<sup>4</sup> We are particularly aware that we did not include any of the African Francophone countries, which is simply due to the fact that we were not able to get the relevant legal texts. The same applies for the Philippines.

<sup>5</sup> We shared our long tables with IRIS for further elaboration, which is setting up a “Regulation and Supervision Resource Center” on behalf of CGAP.

thankful to Thierry van Bastelaer and Patrick Meagher from IRIS for giving us unrestricted access to their huge collection of legal texts for microfinance. Heike Fiedler and her team, GTZ Bolivia, Christian Königspurger and Gabriela Rosales, GTZ Honduras and Dominique Gallmann and Hendrik Prins, GTZ Indonesia, gave us invaluable support by providing us with summary tables for their respective countries. Finally, many experts in the field - too many to name here - provided us with relevant information, contacts and comments on earlier drafts.<sup>6</sup>

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<sup>6</sup> Special thanks go to Wolfgang Heupel, Roshan Shakya, Saleemullah, Teshome Yohannes, and Timothy Lyman. The author alone bears responsibility for any errors made.

## 2. Comparison of Countries

In this study, interesting aspects of legal frameworks for microfinance are explored by looking at experiences in 11 countries. By doing so, none of these countries' frameworks will be assessed in its entirety. Rather, we will develop criteria according to how countries can be categorised. The focus of the study is on pointing out regulatory options and, if possible, indicating the benefits and drawbacks of these different options.

It is not possible to determine the effectiveness of a regulatory framework without conducting in-depth country studies. Yet in some cases, single regulatory measures or methods can be evaluated by referring to well-documented experiences in other countries<sup>7</sup>, by referring to current practices in the traditional banking sector,<sup>8</sup> or by looking at available documents in the field of microfinance regulation.<sup>9</sup>

The eleven countries in our sample are analysed according to three different sets of criteria. The first section looks at different ways to stipulate rules, at the delegation of rule-making power, and at responsibilities for supervision and follow-up. In Ch. 2.2, we look at different ways of distinguishing the microfinance window from mainstream banking and the unregulated microfinance sector. By doing this, a number of microfinance-specific regulatory provisions are exemplified. Finally, Ch. 2.3 elaborates on the most important quantitative and qualitative regulatory requirements. By looking at our country cases, different options for dealing with specific problems of MFIs are identified.

### 2.1 Rules and Roles:

#### Who Is Making the Rules and Who Enforces Them?

At the beginning of the law-making process, the legislator must decide which regulatory requirements are to be stipulated on which 'level'. One can distinguish between several levels of legal commands, which differ in terms of democratic accountability, legal bindingness, and flexibility to be altered.

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<sup>7</sup> The study of Shiferaw and Amha (2001) is an example for this.

<sup>8</sup> The World Bank has conducted a study on 'Bank Regulation and Supervision' in 2001, cf. <http://tinyurl.com/c23v>.

<sup>9</sup> The CGAP 'Consensus Microfinance Policy Guidance: Regulation and Supervision' is probably the most important document in this regard. It was officially approved by CGAP's member donors in 2002: Consultative Group to Assist the Poorest (2002a).

A typical pattern (here, the British model) of regulatory rule-making power can be described as follows:

'Regulatory policy is formulated by the government; legislative principles incorporating the policy are passed by Parliament; to flesh out the principles, powers are conferred on a Minister to promulgate rules, generally by means of a statutory instrument; those rules are subject to enforcement by a specialized agency; the courts are responsible for the adjudication of disputes and the imposition of sanctions.' (Ogus 1994: 104)

Primary legislation, i.e. laws and acts, generally define the broad framework under which financial institutions conduct business. The main focus at this level is on standards rather than rules, i.e. that it is more important to give general guidance than to prescribe specific target levels.<sup>10</sup> The general standards under which microfinance business is conducted remain relatively stable over time. Furthermore, political theory tells us that they should be subject to parliamentary scrutiny, as the setting up of a regulatory framework for microfinance is a genuinely political decision.

Rules, often also referred to as benchmarks, must usually be adapted to the changing environment much more often than general standards. Most rules are therefore specified in secondary or subordinate legislation, which can be changed without going through an onerous and time-consuming legislative process. Rules can take on different forms and different names. In general, we will use the term 'statutory regulations' when referring to secondary legislation.<sup>11</sup>

The government can delegate its rule-making power to a third party. There are strong arguments for the delegation of rule-making power. Firstly, the executive or, to an even greater extent, the supervisory authority usually has much more expertise in the field of financial regulation and supervision than the legislature. Secondly, delegation can reduce direct political interference and the abuse of financial regulation for other political aims.<sup>12</sup> An important drawback of too much delegation is the loss of political accountability and the reduced separation of power between the executive and legislature.

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<sup>10</sup> To give an example, a standard might require financial institutions "to hold adequate levels of liquidity at all times" while a rule would specify a certain liquidity level, e.g. a liquidity ratio of 20%; cf. Kaplow (1992).

<sup>11</sup> Cf. the Basel Core Principles: "A framework of banking law that sets out minimum standards that banks must meet; allows supervisors sufficient flexibility to set prudential rules administratively, where necessary, to achieve the objectives set as well as to utilise qualitative judgement"; Basel Committee on Banking Supervision (1997).

<sup>12</sup> The optimal degree of delegation certainly depends on the country context. In some countries, the central bank has a bad track record with regard to interventions in rural financial markets or might not be seen as a politically independent institution.

In addition to primary and secondary legislation, the supervisory authority may publish guidelines, which have the main function of further explaining existing laws and regulations. They have much less legal clout, but can be adapted more easily.<sup>13</sup>

The choice of a supervisory authority is a related, but not identical decision to the one of delegating rule-making power. As will be seen by elaborating on the example of minimum capital requirements, the legislature often retains important rule-making powers, while at the same time delegating the task of ongoing supervision to a much greater extent.

The following subchapters will analyse the eleven countries under consideration with respect to three aspects: the distinction between primary and secondary legislation, the delegation of rule-making power, and the choice of the supervisory authority.

### 2.1.1 Primary vs. Secondary Legislation

Table 1 gives an overview of primary and secondary legislation existing within the eleven countries covered in this study. As one can see, the majority of these countries offer a separate legal window exclusively or predominantly for MFIs. This is, as mentioned earlier, mainly due to our ‘selection bias’: in countries with a special legal framework for microfinance it is easiest to determine what typical, microfinance-specific requirements look like.

Table 1 mentions only the main microfinance window. Yet in some countries, a number of MFIs is also regulated under the general banking law as, for example, CERUDEB in Uganda or BancoSol in Bolivia. We are aware that most of the countries in this study have separate legislation for cooperatives. Cooperative laws have generally not been included, as this type of institution is distinct from other MFIs and would therefore justify a study on its own. Nepal is an exceptional case, as will become clear in chapter 2.1.2.

Some countries use different terms for regulated MFIs, e.g. Honduras calls them *financial private development organisations* (FPDOs), and Uganda *micro deposit-taking institutions* (MDIs). But the decisive criterion for including a legal framework was whether the main business of institutions under this tier is microfinance.<sup>14</sup>

In **Nepal**, three different legal windows for microfinance exist. The Financial Intermediaries Societies Act is clearly targeted at microfinance NGOs, while the Cooperative Act caters for different kinds of *cooperative societies*, amongst other savings

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<sup>13</sup> Again, terms are not uniform across countries. In Pakistan, for example, three levels of legislation exist called law, rules and regulations. The degree to which rule-making power is delegated differs on each level.

<sup>14</sup> For this study, microfinance shall be used in its broad sense. It “is about diverse institutions providing massive, permanent access to a broad range of financial services for a broad range of clients”, most of them being poor. Cf. Consultative Group to Assist the Poorest (2002b: 4).

and credit cooperatives. Finally, the third institutional type is *development banks*, of which four are specialised in microfinance.

In **Ethiopia**, laws enacted by Parliament are called Proclamations, i.e. the microfinance law is called the Micro Financing Institutions Proclamation. In **Pakistan**, the President can single-handedly promulgate Ordinances under the Proclamation of Emergency. **Ghana's** Non-Banking Financial Institution (NBFI) Law caters for nine different types of financial institutions, of which only a few offer microfinance services.

**Table 1: Legal Texts for Conducting Microfinance<sup>15</sup>**

Separate Law for Microfinance		
Country	Primary Legislation	Secondary Legislation
Bosnia-Herzegovina	Law on Microcredit Organisations	Rules
Ethiopia	Micro Financing Institutions Proclamation <sup>16</sup>	Directives
Ghana	NBFI Law	Business Rules
Honduras	Law on Financial Private Development Organisations	Resolutions
Kyrgyz Republic	Law on Microfinance Organisations	Normative Acts (not yet available)
Nepal	Financial Intermediary Societies Act, Cooperative Act and Development Banks Act	Directives
Pakistan	Microfinance Institutions Ordinance	Prudential Regulations
Uganda	Micro Deposit-Taking Institutions Act	Regulations
Only Secondary Legislation Microfinance-Specific		
Country	Primary Legislation	Secondary Legislation
Bolivia	Law on Banks and Financial Entities	Supreme Decree
Ghana	Banking Law	Regulations
Indonesia	Banking Law	Regulations
South Africa	Usury Act	Exemption Notice

In Latin America, it is much more common for MFIs not to be regulated under a separate law, but under the general banking law. Microfinance-specific provisions, referred to as decrees, are only part of secondary legislation. In **Bolivia**, for example, the Law on Banks and Financial Entities created a type of financial institution called *fondos financieros privados* (FFPs) without specifying what this might be. At a later stage, the Superintendency defined specific regulations by issuing a Decree without needing the

<sup>15</sup> It has to be stressed that in the cases of Uganda and Indonesia, statutory regulations are still in draft form.

<sup>16</sup> In some fields (e.g. ownership restrictions), the banking law (the 'Licensing and Supervision of Banking Business Proclamation') is also relevant, as it is referred to for all matters not covered under the microfinance law.

approval of Parliament (Rhyne 2001: 119).<sup>17</sup> **Indonesia**'s banking law regulates two types of banks - commercial and people's credit banks (Bank Perkreditan Rakyat, BPRs). Statutory regulations by the Bank Indonesia (BI) define microfinance-specific regulatory requirements for BPRs.<sup>18</sup>

**Honduras** recently enacted a separate law for FPDOs, which was developed by a congressional committee with the support of consultants and then passed by Congress. Both the central bank and the National Commission for Banks and Insurance Companies (CNBS) can issue statutory regulations, which are called 'resoluciones'.

**Ghana** not only has a separate law for NBFIs, but also has a huge number of *rural banks* offering microfinance services under the general Banking Law. This is why it is mentioned under both categories in the table below. As subordinate legislation, Ghana defined specific regulations, directives and guidelines for *rural banks*.

**South Africa** is a unique case as its MFIs are only indirectly regulated. Unless MFIs or, to be more precise, microcredit institutions comply with the regulatory requirements of the Exemption Notice under the Usury Act, they are subject to the very strict interest rate ceilings of the Usury Act. One of these regulatory requirements is registration with an approved regulatory institution, the Micro Finance Regulatory Council (MFRC) – currently being the only regulatory institution in place.

### 2.1.2 Rule-Making and Supervisory Authority

Two separate, but interrelated issues are the delegation of rule-making power and the choice of the supervisory authority. In most of the eleven countries, the parliament has conferred the power to make statutory regulations to the supervisory authority, even if it has retained some authority in specific fields. Typically, rules such as provisioning requirements and loan classification are made by the supervisory authority. The case is not so clear when it comes to minimum capital requirements (see Box 1). Yet in all eleven cases discussed here, the task of day-to-day surveillance of MFIs has been delegated to a specialised supervisory authority.

In the majority of the countries, the central bank is both the supervisory authority and the rule-making power for subordinate legislation. This is true for **Ethiopia**, **Indonesia**, the

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<sup>17</sup> Shugart and Haggard (2001) note that "Latin American presidents appear to employ decree powers extensively in making policy", while these decrees often have the force of law. One has to see this in the context of the legal tradition of Latin American countries.

<sup>18</sup> Apart from the banking law, a number of other legal provisions open legal windows for MFIs, yet which are not part of this study. Of note are the government regulations of the early 1930s that created BKDs (Badan Kredit Desa), i.e. small village banks (around 4,500 still in existence), and provincial regulations of the 1980's and 1990s, that enabled the establishment of LDKP (Rural Fund and Credit Institution), in essence village banks or small sub-district-based banks, of which there are over 1,600. The Ministry of Finance is currently drafting a Microfinance Law to regulate deposit-taking non-bank and non-cooperative microfinance institutions.

**Kyrgyz Republic**, and **Uganda**, for **Bosnia-Herzegovina** with regard to banks and for **Ghana** as far as NBFIs are concerned.<sup>19</sup>

Equally, the central bank has the power to make rules and is the supervisory authority in **Nepal** (with respect to *development banks* and *financial intermediary societies*) and in **Pakistan**. Yet in both these cases, the government has retained some of its rule-making power. In both countries, rules made by the central bank must be approved by the government.

An interesting case is the *cooperatives with a limited banking transaction license* in **Nepal**. As cooperatives, they are under the supervision of the Registrar of Cooperative Societies. Yet in 2002, the central bank issued a directive stipulating regulatory requirements for obtaining a limited banking transaction license. This directive brings all financial cooperatives under the purview of the central bank without curtailing the responsibilities of the Registrar of Cooperative Societies. The central bank now has the authority to issue directives for all *cooperatives with a limited banking transaction license* and to supervise these institutions. This procedure might be an interesting approach for other countries, where financial cooperatives are subject to the general regulatory system for all types of cooperatives, which leaves them without sufficient financial oversight.

In **Ghana**, the division of power between the executive and the central bank is different for banks and for NBFIs. The Minister of Finance (formerly called the Provisional National Defence Council Secretary, as still stated in the law) is in charge of issuing banking regulations. The only restriction is that he or she must consult the central bank before doing so. Yet supervisory authority remains with the central bank. According to a Bill for an ARB Apex Bank Law, which is currently pending before Parliament, on-site inspections of *rural banks* will be delegated to the recently established ARB (Association of Rural Banks) Apex Bank.<sup>20</sup>

The two Latin American countries in our sample have a supervisory authority separate from the central bank, as is characteristic for the region. In **Honduras**, the central bank is the highest authority for the financial sector, yet the National Commission for Banks and Insurance Companies (CNBS), as regulator for the banking and insurance industry, has been delegated the power to supervise FPDOS according to the FDPO law.<sup>21</sup>

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<sup>19</sup> In Indonesia, the Ministry of Finance is currently drafting a law, which will create a Financial Services Authority with responsibility for oversight of the whole financial sector (banks, pension funds, insurance, money markets, finance companies). It is expected that the law will be enacted in 2003. Microfinance would theoretically also fall under the purview of this authority. The option to create a special Microfinance Supervisory Institution, which will be in charge of supervising and regulating banks, cooperative and non-bank MFIs is currently being discussed within the Ministry of Finance, which is also in charge to draft the Microfinance Law.

<sup>20</sup> A potential conflict of interest is that the ARB Apex Bank inspects its own shareholders since all *rural banks* are also shareholders of the Bank. Yet the aggregate shareholding of all *rural banks* is below 3%.

<sup>21</sup> The international trend goes in a similar direction, as more and more countries merge their existing regulatory authorities into a single, all-embracing regulator. Recent examples are the Financial Services Authority in UK and the Bundesanstalt für Finanzdienstleistungsaufsicht in Germany.

**Bolivia** has separated the tasks of rule making and supervision institutionally. The National Economic Policy Council (CONAPE) is the principal body setting the standards governing economic policy. Amongst other powers, CONAPE can propose and prescribe statutory regulations for banks, securities firms and insurance companies. The Superintendence of Banks and Financial Entities (SBEF) is the supervisory authority in Bolivia.

**Bosnia-Herzegovina's** legislature has delegated the authority to promulgate secondary legislation for *microcredit organisations* to two different ministries in its two constituent parts (referred to as entities). In the Federation, the Ministry of Social Policy, Displaced Persons and Refugees defines the rules, which does not have any specific financial sector expertise. In the Serb Republic, the same task is located in the Ministry of Finance. Neither of the ministries actually supervises microcredit organisations.<sup>22</sup> Both laws are not identical, but there are intentions to harmonise them in the future.<sup>23</sup>

Finally, **South Africa's** Minister of Trade and Industry appointed the MFRC to regulate and supervise micro-lending institutions. The MFRC issued its own rules, yet its accreditation criteria required approval from the Minister.

### Box 1: Minimum Capital Requirement

To illustrate different ways of delegating or retaining rule-making power, the case of minimum capital requirements is very informative. The definition of an absolute amount of capital to be held at all times is usually seen as a very important regulatory measure, and duly receives a great deal of attention.<sup>24</sup> All the countries in the study which have introduced a framework for the prudential regulation of microfinance set an absolute amount of capital as one of the entry criteria.<sup>25</sup> In most cases, the legislature sees this particular regulatory requirement as too important to delegate to any other authority.

The downside of defining a nominal value in the law is that the real value of capital depletes over time, especially if countries suffer from high inflation rates. This effect might be even more pronounced with respect to the external value of the minimum capital amount if inflation is not accompanied by depreciation. To give an example, in **Ghana** the continuous devaluation of the minimum capital requirement was counteracted by a nominal increase in minimum capital requirements in 1998, 2000 and 2001. As one can see from Figure 1 above, without increases in the nominal value, both the real value and the external value of minimum capital would have constantly declined. But over time, increases in the minimum capital requirement, especially the sharp rise in 2002 from 1 to 15 billion Ghanaian Cedis, led to a considerable increase in the real and the external value. Variations of the real and external value are only minimal, which indicates that the real exchange rate of the Ghanaian Cedit to the US Dollar has been held relatively constant. This might be different in countries with a less liberalised foreign exchange market.<sup>26</sup>

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<sup>22</sup> This is because MCOs are not prudentially regulated; cf. 2.2.1.

<sup>23</sup> I am indebted to Timothy Lyman for the observation of the following differences between both laws: In the law of the Serb Republic, the Ministry has more rule-making powers and the clear responsibility to monitor compliance, which is not the case for the Federation law.

<sup>24</sup> In Uganda, for example, this figure was one of the most disputed issues at all. When the MDI Bill was discussed in Parliament, the amount was subject to intense debates among the lawmakers.

<sup>25</sup> Bosnia-Herzegovina's and South Africa's regulatory frameworks for microcredit institutions are exceptions in this regard, as they are not concerned with prudential regulation of deposit-taking institutions.

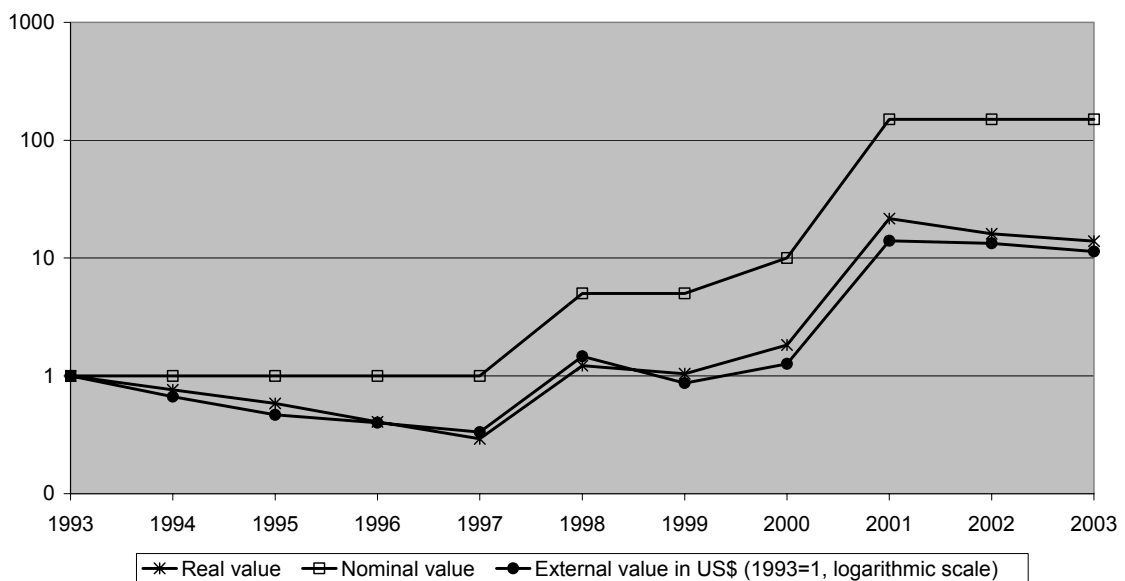
<sup>26</sup> Currently, only 1 of the 8 *savings and loan companies* and non of the rural banks comply with the minimum capital requirements.

Interestingly, both the Ghanaian Banking Law and NBFIL Law define minimum capital in local currency in the law, but then allow the central bank to adjust the figure after consultation with the Minister of Finance.<sup>27</sup> This has led to a situation where much lower figures appear in the law than are actually presently required.

In **Pakistan** and **Indonesia**, minimum capitalisation is defined according to the area of operation of the institution. In both cases, there are three different categories for this. Pakistan distinguishes between MFIs operating in a specified district, in a specified province and nationwide, with the last category requiring the highest capital amount. In Indonesia, the distinction is not based on geographical size, but on the scale of urban agglomeration. Jakarta-based MFIs must hold the highest amount of capital. Although the figures are mentioned in the law (the Ordinance), the central bank can also prescribe a higher amount (in Pakistan with approval of the Federal Government).

Uganda solved the problem of the decreasing real value of capital more elegantly. It uses currency points instead of local currency amounts throughout the Micro Deposit-Taking Institutions (MDI) Act. These currency points are applied both for defining the minimum capital amount and maximum fines for various offences. A schedule accompanying the Act defines the equivalent of a currency point expressed in Ugandan Shillings. The Minister of Finance can amend the schedule with approval of the Parliament. The advantage of this is that one can easily adjust all monetary figures in the law simply by amending the schedule. However, the power to change minimum capital requirements has not been delegated, as other rule-making powers have been, but ultimately still rests with the Parliament.<sup>28</sup>

**Figure 1: Minimum Capital Requirements for Deposit-Taking NBFIs in Ghana**



Source: Data from an unpublished paper of William F. Steel and David O. Andah. Logarithmic scale used on axis of ordinates for better visibility.

<sup>27</sup> It seems rather inconsistent that, in general, the Minister has the rule-making authority for banks (Section 43 Banking Law), while it is the central bank which may alter capital requirements by executive instrument (Section 3.3).

<sup>28</sup> The initial MDI Bill, firstly, authorised the central bank to change the minimum capital requirement as expressed in currency points and, secondly, authorised the Minister of Finance, with the approval of Cabinet, to change the definition of currency points. Both provisions were tightened in the course of the parliamentary process.

In the **Kyrgyz Republic**, **Indonesia** and in **Ethiopia**, the authority to define minimum capital requirements has been completely delegated to the respective central bank. The Kyrgyz Law on Microfinance Organisations simply defines minimum standards for charter capital, e.g. that it should only be formed in national currency. This practice holds the danger that central banks use minimum capital as a rationing tool rather than a prudential requirement. Central banks have a strong incentive to restrict the number of MFIs under their supervision, as they assume some responsibility for the soundness of these MFIs and can do this more easily for a smaller number of institutions (cf. Consultative Group to Assist the Poorest 2002a: 14).

**Bolivia** defines its minimum capital requirement in terms of Special Drawing Rights, which are valued on a basket of key national currencies (US\$, €, Yen and £). This makes the figure less susceptible to changes in exchange rates vis-à-vis single currencies. The National Economic Policy Council (CONAPE) is the rule making authority for minimum capital requirements, as it is for all other prudential norms.

In **Honduras**, minimum capital is specified in the law. Interestingly, the Congress, the central bank and the CNBS can change the stipulated amounts. The Congress is able to change the law by issuing a special decree. Alternatively, the central bank and the CNBS can change minimum capital requirements by promulgating secondary legislation (Resolución in Spanish), which does not need approval from the legislature.

### 2.2 Microfinance vs. Mainstream Banking: What Is the Difference and What Does This Mean for Regulation?

A consensus has emerged among experts in the field that all MFIs mobilising deposits from the public should definitely be regulated.<sup>29</sup> An equally strong consensus says that credit-only MFIs should not be subject to prudential regulation - defined as a regulatory system where the financial authority assumes responsibility for the soundness of financial institutions.<sup>30</sup>

Even if these guidelines sound straightforward, their implementation raises a number of questions. Firstly, there is no clear-cut distinction between prudential and non-prudential regulation. South Africa is a good example of the increasing blurring of boundaries. Secondly, how exactly do you draw the line between regulated and unregulated MFIs (the lower boundary) and between MFIs and commercial banks (the upper boundary)?

If the delineation of regulatory windows - or 'tiers', as they are often called - is not done in a clear and concise way, regulatory arbitrage, overlap or ambiguity might be the result. MFIs might choose a regulatory window, which they were not supposed to choose, or other institutions such as consumer lenders might come under the roof of the microfinance window (regulatory arbitrage). A single institution might be subject to the provisions of different legal frameworks, which may even contradict each other (regulatory overlap). And finally, unclear lines might leave some institutions with uncertainty as to whether they actually have to apply for a license or not (regulatory ambiguity). A look at the eleven countries of our sample might shed some light on these questions.

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<sup>29</sup> Cf., for example, Berenbach and Churchill (1997: 26); Staschen (1999: 43); Valenzuela and Young (1999: 7); Hannig and Omar (2000: 179) There is still no clear consensus regarding the treatment of members' savings by cooperative institutions. However, these institutions are not the focus of our study.

<sup>30</sup> Cf., for example, van Greuning, Gallardo and Randhawa (1998: 11); Christen and Rosenberg (2000: 10); Hannig and Omar (2000: 180); Vogel, Gomez and Fitzgerald (2000: 3).

### 2.2.1 Prudential vs. Non-Prudential Regulation

In three countries of our sample, the government or regulatory authority is to varying degrees involved in regulating credit-only MFIs. The most pronounced case is **Bosnia-Herzegovina**, which introduced a Law on Microcredit Organisations (MCOs) in both its entities.<sup>31</sup> The crucial question is whether these MCOs are prudentially regulated or merely subject to non-prudential reporting requirements.

A close look at the laws and decisions (secondary legislation) reveals that the legislation is silent on important prudential requirements, such as capital standards, limitations on risk concentration and insider lending, loan portfolio classification and corrective actions. On-site inspections of MCOs do not take place and MCOs are subject to only minimal reporting requirements. The main provisions of the laws are the restrictions on permissible activities (see chapter 2.2.2) and the prohibition of distributing profits. In conclusion, only banks are prudentially regulated in Bosnia-Herzegovina, while MCOs must comply with limited reporting requirements (more so in the Serb Republic than in the Federation) and some restrictions on their business activities.<sup>32</sup>

The **Kyrgyz Republic** recently promulgated a 'hybrid' law, which defines three different types of MFIs, of which two types are credit-only. A *microcredit agency* is a non-profit organisation, while a *microcredit company* is a commercial institution. Both types are not subject to prudential regulation - they only require a certificate issued by the central bank.<sup>33</sup> The third type is a *microfinance company*, which needs a license from the central bank. This type of institution is subject to the prudential requirements stipulated in the law. In return, microfinance companies are authorised to accept time deposits after two years of operation.

Based on the analysis of the Law on Microfinance Organisations, the Kyrgyz approach follows the rationale of the two points of consensus mentioned earlier. It does not subject credit-only MFIs to prudential regulation, but it has devised a credible regulatory framework for deposit-taking MFIs. A potential danger is that the subjection of all types of MFIs to the same law might lead to confusion or even to blurring of the delineation of these very different types of institutions and thus create regulatory ambiguity. Yet this would only become apparent after the law had been fully implemented.

**South Africa** is a third case of direct government involvement in the regulation of credit-only MFIs, albeit a very special one. As mentioned earlier, the strict interest rate limit

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<sup>31</sup> Separate, but similar legislation was passed for the Federation of Bosnia and Herzegovina and for the Serb Republic.

<sup>32</sup> It is of course a different question as to whether it is good practice to charge a Ministry with the tasks of registration and performance monitoring of credit-only MFIs. There are indications that a regulatory system such as this lacks effectiveness.

<sup>33</sup> Apart than microcredit agencies, microcredit companies must deposit minimum charter capital with a commercial bank. The amount will be determined by the central bank in normative acts, which are yet to be promulgated.

under the Usury Act was the driving force in setting up a regulatory framework for *entities concluding the category of money lending transactions*, as they are called officially. In 1999, a new Usury Act Exemption Notice was enacted, replacing the earlier one from 1992, which had the main purpose of setting size and term limits for loans to be exempted from the interest rate ceiling.

This new exemption notice links the possibility of charging cost-covering interest rates - which would not be possible for MFIs under the tight regulations of the Usury Act - to a number of conditions. The most important condition is registration with a regulatory institution approved by the Minister of Trade and Industry. The only such institution existing to date is the Micro Finance Regulatory Council (MFRC). MFRC is called a 'hybrid institution' as its board members stem from the microfinance and banking industry and from public institutions such as the central bank, the Department of Trade and Industry and state-owned wholesale financial institutions.

South Africa has a very strong **non-prudential** regulatory framework. Although the MFRC regulates only non deposit-taking MFIs, it does have the right to inspect lenders with or without previous notice. Furthermore, the registration criteria include fit and proper criteria for participants in the industry, e.g. that directors should not have criminal records involving dishonesty. On-site inspections are rare under a non-prudential regulatory regime. However, other important elements of a prudential framework are neither covered under the Exemption Notice, nor under the Rules of the MFRC. There are no provisions with regard to capital, asset quality, corporate governance or ownership.<sup>34</sup> In summary, there is a clear focus on performance monitoring rather than prudential regulation, as we would expect from a regulatory framework for non deposit-taking institutions.<sup>35</sup>

### 2.2.2 Specification of the Microfinance Window

The 'line-drawing' or, as it is also called, the definition of tiers, is one of the most delicate issues in setting up a regulatory system for microfinance. CGAP states several criteria that could be used for drawing the line between prudential and non-prudential regulation (Cf. Consultative Group to Assist the Poorest 2002a: Ch. IV. B.). This study will not discuss these normative approaches, but rather look at the evidence provided by our eleven countries.

Defining a regulatory window distinct from other legal frameworks is a multidimensional undertaking. As we will see, none of the countries uses a single measure to delineate tiers. Microfinance regulation differs in a number of ways from traditional banking

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<sup>34</sup> Ownership regulations may be stipulated in the law governing the respective legal form of the institution. Possible legal forms are private or public company, NGO, cooperative, bank, mutual bank, or trust.

<sup>35</sup> Ethiopia might be mentioned here as a fourth example of government regulation of credit-only MFIs. According to the Micro Financing Institutions Proclamation, **all** kinds of MFIs are covered under the law. In practice, however, most MFIs seem to offer deposit facilities as well.

regulation, just as microfinance differs from other financial services. At least in theory, these differences in regulatory requirements for microfinance should make it unattractive for other kinds of institutions to use the regulatory window, which is solely reserved for MFIs. The clear definition of microfinance-specific provisions, which renders the regulatory framework unattractive for other types of financial institutions, leads MFIs to filter themselves into the most appropriate regulatory window.<sup>36</sup>

At this point, it is useful to introduce the terms **institutional and functional regulation**. In most of our eleven countries, MFIs are regarded as a specific institutional type, regulated under a separate MFI Law. This approach is called institutional regulation. The functional approach, however, regulates market participants according to the economic function they perform, regardless of their institutional structure. Thus, microfinance is seen as a financial activity rather than a specific institutional type.

It is interesting to note that only the South African approach, which is a non-prudential regulatory framework, can be described as functional regulation. In South Africa, all *entities concluding the category of money lending transactions*, be they companies, NGOs, cooperatives, banks or mutual banks, can register with the MFRC. This is different for prudential regulatory frameworks, “which must necessarily focus on institutions because, after all, it is institutions and not functions that become insolvent” (Goodhart et al. 1998: 144). No country in our sample has defined prudential regulations for microfinance irrespective of the type of institution that conducts microfinance business. It is therefore appropriate to look at MFIs as a distinct institutional type, even though the institutions themselves might operate under a different name.

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<sup>36</sup> In practice, this does not always happen. To give an example, there are reports that some microfinance NGOs in Uganda, which do accept deposits from the public, have now applied for a license under the Cooperatives Statute. Deposit-taking was always illegal for unregulated institutions under the banking law, but the regulatory forbearance of the central bank is expected to end with the introduction of the new MDI Act. These NGOs are taking advantage of much less onerous regulatory requirements under the Cooperative Statute while essentially remaining credit-driven institutions.

### Box 2: Distinguishing Different Institutional Types in Ghana

The case of Ghana illustrates how difficult it can be to clearly separate regulatory tiers. Ghana does not offer a legal window for MFIs per se, but rather defines a number of institutional types, which could potentially provide microfinance services. Many *rural banks* could be regarded as microfinance institutions and are subject to the same law as all other banks, viz. the Banking Law 1989. The main difference between rural and commercial banks is the much lower capital requirement (USD 62,000 as compared to between USD 3.1m and USD 6.2m for commercial banks). It is only the licensing practices of the Bank of Ghana that prevent traditional banks from taking advantage of the lower capital requirements for *rural banks*. *Rural banks* are supposed to be embedded in the local area in which they operate, a criterion that the central bank monitors carefully when issuing licenses.

In addition, there is a separate legal framework for Non-Banking Financial Institutions (NBFIs) under the Financial Institutions (Non-Banking) Law, 1993. The schedule to this law lists nine different institutional types covered under the law. NBFIs are subdivided into four groups, viz. deposit-taking (other than discount houses) and non deposit-taking NBFIs, *discount houses* and *venture capital fund companies*. Four different institutional types are subsumed under non deposit-taking institutions. The category of deposit-taking NBFIs is further broken down into *savings and loan companies*, *building societies* and *credit unions*. For both deposit-taking and non deposit-taking NBFIs, the Bank of Ghana has published a separate set of rules. For this study, the NBFIs Rules for Deposit-Taking NBFIs are most relevant. They are not applicable to *credit unions*, for which a Credit Union Bill, recently drafted by the central bank, is now before Parliament. Currently, eight MFIs are registered as *savings and loan companies*.

Ghana's delineation of tiers follows neither the institutional, nor the functional approach consequently. Although the law distinguishes between a number of institutional types, for some of which the central bank has even issued exclusive operating guidelines (e.g. for *discount houses* and *venture capital fund companies*), the main categorisation is functional, i.e. between deposit-taking and non deposit-taking NBFIs. Yet this overlapping of functional and institutional regulation gives rise to a number of problems. The rules for deposit-taking NBFIs introduce another term, namely *savings institutions*, for all those NBFIs mobilising retail savings from the public or from members. Yet the same rules are not applicable to all savings institutions, but only to *savings and loan companies* and *building societies* (as *credit unions* are excluded). The central bank issues three types of licenses, of which Type I is the license for *savings institutions*. This is rather confusing, as one would expect the central bank to issue licenses according to institutional type, e.g. a license as a *savings and loan company*. To make things even more complicated, the rules for non deposit-taking NBFIs can also be applied to any other NBFIs specifically authorised to take public deposits. Furthermore, some sections of these rules apply to all "institutions in credit business (ICBs)" – another term, which is not further specified – regardless of whether they are deposit-taking or not. As there is a second set of rules for non-deposit-taking NBFIs, it is not quite clear why these sections have been included under the rules for deposit-taking NBFIs.

In summary, the proliferation of different terms and the overlapping applicability of different rules under the same law make the legal framework for NBFIs look rather complex. The main reason for this might be the attempt to combine elements of functional regulation with the existing distinction between different institutional types.

A good way to look at the problem of differentiation between the microfinance tier and other tiers is to ask the question: what could be the incentive for an institution to prefer one regulatory window to another? With regard to the upper boundary, there might be a strong incentive for commercial banks to take advantage of the (generally) much lower minimum capital requirements in the microfinance tier. Yet there are a number of forces, listed below, which counteract this. The lower boundary is of importance for the question of whether small, community-based and credit-only MFIs also come under the purview of the supervisory authority (cf. Christen and Rosenberg 2000: 11).

### ***Permissible and Prohibited Business Activities***

The most obvious distinction between tiers is the specification of permissible and prohibited activities. It would be too much to list all the activities for the eleven countries of our sample. **Bolivian** FFPs, for instance, may perform 18 activities and operations. More interesting is the general approach - some countries operate with positive lists, some with negative lists and some with both. The legal tradition of the relevant country is an important determinant in this regard. In some countries, particularly in Central and Eastern Europe and the Newly Independent States, everything not explicitly allowed is forbidden. In others, everything not explicitly forbidden is allowed.<sup>37</sup>

In the **Kyrgyz Republic**, only time deposits are listed under 'transactions carried out by microfinance company' implying that demand deposits and even current accounts are not permitted. **Pakistan** is more explicit about this, as the microfinance law states that an MFI shall not undertake any kind of business other than that which is explicitly authorised. **Uganda's** MDI Act, on the other hand, includes a long list of 'prohibited transactions'.

In **Bosnia-Herzegovina** it is not allowed for *microcredit organisations* to go into the savings business. As a result, banks are unlikely to be interested in a license that does not allow them to tap deposits as an important source of funds. The same is true for **South Africa**, where only banks are allowed to mobilise deposits. On the other hand, no lower boundary exists in Bosnia-Herzegovina. According to the legal provisions in the law, even the smallest MFIs are included under this regulatory window. Yet one must keep in mind that this is a non-prudential regulatory framework.

Other prohibited business activities of MFIs are the following:

- Current accounts (e.g. NBFIs in Ghana; BPRs in Indonesia; MDIs in Uganda);
- Dealing in foreign exchange (BPRs in Indonesia; MDIs in Uganda);
- Selling and buying real estate unless it is for the institution's own operations (*development banks* in Nepal; *microfinance banks/microfinance institutions* in Pakistan<sup>38</sup>);
- Insurance products (BPRs in Indonesia; MDIs in Uganda);<sup>39</sup>
- Equity participation (BPRs in Indonesia)<sup>40</sup>; and

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<sup>37</sup> This is, of course, a crude simplification. But policymakers should always keep the legal tradition of their country in mind when drafting legislation, and be careful when using other countries' laws as template.

<sup>38</sup> Interestingly, Pakistan allows the use of the name *microfinance bank*. In most other countries, the use of the name bank is explicitly prohibited in the microfinance law to clearly distinguish between banks and MFIs.

<sup>39</sup> This provision can be potentially quite restrictive as the insurance business is a growing market for MFIs. The cross-selling of insurance products together with other financial products can put MFIs in a unique position in this market. The Authorities in Indonesia are likely to change the banking law, to allow BPRs to provide insurance-related services on an agency basis, provided that they do not take the underwriting risk. See [www.microfinancegateway.org/microinsurance](http://www.microfinancegateway.org/microinsurance) for more information on this.

- Guarantees and other off balance sheet transactions (MFIs in Kyrgyz Republic; *cooperative societies* in Nepal).

A number of other measures exist which defend the upper boundary against unwanted 'free riders'. Certainly many of these measures were introduced with other objectives in mind, such as limiting risks taken by MFIs. But one of the side effects is that they act as a disincentive for commercial banks to take advantage of lower capital requirements for MFIs.

To name but a few, the following three measures are relatively common:

- **Commercial vs. non-profit institutions:** In a number of the countries studied, MFIs must be non-profit institutions (MCOs in Bosnia-Herzegovina; FPDOs in Honduras). In the Kyrgyz Republic, *microcredit companies* (for profit) and *microcredit agencies* (non-profit) are distinguished between according to this criterion. Except for the FPDOs in Honduras, all these institutions are non deposit-taking institutions and are not prudentially regulated. The restriction of the microfinance category in any one country to non-profit institutions certainly has far-reaching consequences for the ownership and governance structure of these institutions.<sup>41</sup>
- **Branching:** BPRs in Indonesia may only operate within a specific province. In Ethiopia, MFIs can get a license for nationwide operation or for a specific area. In the latter case, they are required to get prior approval to do business outside of this area.
- **Cheque Clearing:** In Ghana, neither *rural banks* nor NBFIs are participants in the clearing system of the central bank. Yet since early 2003, *rural banks* can do cheque clearing through a recently established ARB Apex Bank. In Uganda, this is one of the major differences between a *credit* institution and a *commercial bank*, both being regulated under the same law, the Financial Institutions Statute.

### ***Restricting Product Characteristics***

Almost all legal frameworks for microfinance restrict certain characteristics of products in one or the other way, thus separating the microfinance tier from other tiers. Most common are limitations on the type of deposit facilities that may be offered. NBFIs in Ghana other than savings institutions and credit unions are only allowed to take term deposits. Other countries permit deposit-taking by cooperative institutions from members only (*cooperatives with a limited banking transaction license* in Nepal, credit unions in Ghana).<sup>42</sup>

While in Nepal the duration of savings and time deposits for *cooperative societies* has been restricted to three years, Uganda allows any duration for term deposits, while permitting the mobilising of savings deposits, defined as deposits repayable at specified

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<sup>40</sup> The Authorities in Indonesia are likely to change the banking laws to allow BPRs to make equity investments (up to a maximum percentage of capital) in BPR industry associations, or other bodies that are concerned with the stability or financing of the industry as a whole.

<sup>41</sup> Interestingly, FPDOs in Honduras must pay taxes, although they are non-profit organisations.

<sup>42</sup> In Uganda, this is actually the lower boundary of the MDI window; see the detailed description of Uganda in Box 3.

notice, only for MDIs with considerable experience in deposit-taking. The rationale for this is that term deposits with clearly specified repayment dates are much easier to manage than savings deposits.

Ghana's NBFIs, except for the savings institutions, are subject to a lower (6 months) and upper limit (24 months) regarding the duration of term deposits. While a minimum duration might be desirable to enable a steadier funding source, setting maximum durations can limit interest rate risk, which increases with duration (assuming that deposit interest rates are fixed). Furthermore, the size of term deposits must be at least USD 120. Presumably this provision also aims at assuring a good funding base.

For lending business, some countries stipulate a maximum loan size, expressed as a percentage rate of capital or as an absolute amount.<sup>43</sup>

- The two extreme cases are Ethiopia and Indonesia. **Ethiopia's** MFIs are only allowed to lend up to a fixed amount of USD 600 to a single borrower, whilst the same limit for **Indonesia's** BPRs is currently 20% of total capital (which is likely to be reduced to 10% in the future). In addition, BI is considering placing an aggregate limit on the largest borrowers, such as a limit of 25% of total capital for the five largest borrowers or 25% of total loans outstanding for the 20 largest loans.
- In some countries, the limit depends on the kind of security available. **Honduras'** FPDOs may grant loans of up to 2% of equity capital if secured by a surety, and up to 5% of capital if secured by other means. In **Ghana**, *rural banks* can lend up to a limit of 25% and 10% of capital in the case of secured and unsecured loans, respectively.<sup>44</sup>
- In **Uganda**, the loan size limit for MDIs depends on whether the loan is granted to an individual (1% of core capital) or to a group of borrowers (5%). The rationale is that group loans are typically larger and that the regulatory framework should not favour one lending technology over the other.
- **Nepal** allows for larger consecutive loans with the second loan being double the amount of the first, and the third and all following loans being again double the size of the second. Even though such a requirement takes the graduation principle of many MFIs into account, it might be difficult to control for the supervisor.
- Finally, **Pakistan** limits the size of loans to a single borrower to a fixed amount of USD 1,725 irrespective of the size of the *microfinance institution/bank*.<sup>45</sup>

Table 2 includes the respective limits of some other countries from our study. Assuming that MFIs do not hold more capital than prescribed as a minimum, maximum loan amounts can be expressed in monetary terms (third column in the Table). There is a vast range of maximum loan amounts from USD 600 in Ethiopia to USD 190,000 for deposit-

<sup>43</sup> As always, comparisons should be done with great care. One would have to look at the precise definition of total capital and equity capital.

<sup>44</sup> An important point raised by Wolfgang Heupel is that the severe undercapitalisation of many *rural banks* reduces the scope for the lending business, as the ceiling is extremely low.

<sup>45</sup> In addition, total exposure of MFI/MFB clients from MFIs/MFBs, banks, NGOs and other financial institutions is also restricted to USD 1,725. For this purpose, clients receive a certificate for borrowing.

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taking NBFIs in Ghana. The very low amount in Ethiopia means that MFIs have a strong incentive to increase their capital beyond the amount of USD 120,000, which would relax the loan size limit of USD 600. The last column in the table takes into account income differentials between the countries. Using Gross National Incomes as a measure for income, Ethiopia's lending limit is less strict than, for example, Pakistan's or Honduras'.

**Table 2: Limits for Loan Amounts**

Country	Maximum loan amount as percentage of capital	Maximum loan amount in USD*	Maximum loan amount as a multiple of GNI per capita <sup>46</sup>
Bolivia	1 % for CACs category 1 to 4 (unsec. loans)	2,050 – 76,000	2.2 - 81
Ethiopia	Fixed amount	600	6.0
Ghana	10% for Rural Banks (for unsecured loans) 10% for deposit-taking NBFIs (unsec. Loans)	6,200 190,000	21.4 655
Honduras	2 % - 5% depending on kind of security	1,200 – 3,000	1.3 – 3.3
Indonesia	BPRs: 10 % (proposal)	5,500 – 22,000 (depending on area)	8.1 – 32.4
Nepal	Cooperatives with limited banking license: 5%, 10% and 20% for first, second and following loans, respectively	650 – 2,600 (rural coop.) 6,500 – 26,000 (urban cooperative)	2.6 – 10.4 26 – 104
Pakistan	Fixed amount	1,725	4.1
Uganda	1 % and 5 % for individual loans and group loans, respectively	2,700 and 13,500	9.6 – 48.2

\* Assuming that institutions hold exactly the minimum prescribed amount of capital

The main rationale for limiting loan sizes is to contain risk concentration. A few large loans that turn bad can pose a great risk to the soundness of an MFI. Yet an important side effect of these limits is that they make it very unattractive for larger banks to apply for a license under this window.

Ethiopia is an interesting case, which deserves some closer examination. The Ethiopian Microfinance Law orders all MFIs to reapply for a license as soon as the savings amount mobilised equals USD 120,000. The central bank has recently issued directives prescribing different prudential norms for re-registered MFIs (in the fields of provisioning, capital adequacy, liquidity and reporting), and has thereby introduced a second tier. Yet, as at 2001, the requirement to re-register had not yet been enforced. MFIs had mobilised more than USD 10m in savings without having been asked to re-register (Shiferaw and Amha 2001).

<sup>46</sup> GNI is Gross National Income per capita according to the atlas method. Data is taken from the World Development Indicators, year 2001.

The loan limit has been relaxed for re-registered MFIs as they are allowed to extend up to 0.5% of total capital to a single borrower. Yet unless MFIs hold more than five times the prescribed minimum capital amount, the fixed amount of USD 600 is still the binding limit.

Another provision restricts the aggregate amount of loans extended in any one year to 20% of the total disbursement of the previous year. Such a limit can potentially be very restrictive for young MFIs, which in many countries experience growth rates of their loan portfolio of 100% or more.

Finally, in addition to the size of loans, the term of loans has also been restricted. The period to maturity must not be longer than two years. Loans of re-registered MFIs can have a repayment period of up to five years. In Uganda, the term of loans advanced by MDIs is also restricted to two years.

### ***Definition of Target Group***

Specifying the particularities of microfinance clients is another way of drawing a line between MFIs and traditional financial institutions. Most microfinance laws include a more or less precise definition of the target group. From a legal point of view, such a definition is much more difficult to enforce than other criteria, which are easily verifiable. For example, when exactly has an MFI drifted away from the target group as defined in the law?

The following are a number of quotations from microfinance laws, which clearly show that these microfinance windows were set-up to benefit the poor:

“Microcredit organisation in the sense of this law is a non-deposit and non-profit organisation whose basic activity is the provision of microcredits to socially jeopardised with a view to the development of entrepreneurship” (Law on Microcredit Organisations, Bosnia-Herzegovina Federation)

“A microfinance institution shall [...] render assistance to micro-enterprises and provide microfinance services in a sustainable manner to poor persons, preferably poor women, with a view to alleviating poverty” (Microfinance Ordinance, Pakistan)

“Financial Private Development Organisations are private companies, which are founded with the purpose to offer financial services in support of the economic activities carried out by micro and small enterprises.” (Law for FPDOs, Honduras)

“Development banks [are] connected [sic!] with the development of specific sectors in order to make available financial resources and technology needed for the establishment, development, expansion and increase in the capacity and productivity of agricultural, industrial, services, trade and other commercially viable and productive enterprises, and thus impart dynamism to

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the development of the nation's industrial, trade and agricultural sectors and mobilize available skills, labour and capital for the development of rural and urban areas" (Preamble to the Development Banks Act, Nepal)

It should be noted that, although the objectives for establishing a regulatory framework should be stated in the law, it is actually much more important for the impact on poverty alleviation that regulatory requirements suit the specific needs for conducting microfinance business.

### Box 3: Defining the MDI Window in Uganda

Uganda can serve as an interesting case to illustrate the complex task of separating the microfinance tier from other financial tiers. In 1999, the central bank, Bank of Uganda (BoU), drafted as a first step a clear policy on regulating microfinance: the "BoU Policy Statement on Microfinance Regulation". The policy distinguishes between four tiers, of which tier three is for "Micro Deposit-Taking Institutions", MDIs. MDIs are allowed to take deposits from the public and on-lend these, while tier four is not regulated and supervised by BoU. According to the policy, tier four comprises of two types of institutions, namely non deposit-taking institutions and very small member-based organisations.

The second step was then to draft the MDI Bill, which was passed by Parliament with only slight amendments in November 2002.

The upper boundary seems to be sufficiently protected against tier one and tier two institutions that might want to take advantage of the much lower capital requirements in tier three. The following is a list of prohibited activities, some of which belong to the core activities of commercial banks:

- a) Opening and operating demand cheque accounts;
- b) Engaging directly or indirectly, for its own account or on a commission basis, in trade, commerce, industry, insurance or agriculture, except in the course of the satisfaction of debts due to it for the purpose of conducting its business;
- c) Acquiring or holding, directly or indirectly, in the aggregate, any part of share capital of, or making any capital investment or otherwise having any interest in enterprises engaged in trade, commerce, industry or agriculture in excess of twenty-five per cent of its core capital, except in the course of the satisfaction of debts due to it; but in such a case all shares and interests shall be disposed of at the earliest reasonable opportunity;
- d) Underwriting and placement of securities;
- e) Transacting in computer networks or electronic commerce;
- f) Engaging in trust operations;
- g) Taking deposits and lending in foreign exchange;
- h) Intermediating loan insurance funds;<sup>47</sup>
- i) Lending where its liquid assets are insufficient;
- j) Purchasing a non-performing or low quality loan from any of the directors, officers or affiliates of the institution or their related interests;
- k) Dealing in derivatives.

Furthermore, "microfinance business" has been defined as a distinct activity:

- l) Acceptance of deposits;
- m) Employing such deposits wholly or partly by lending or extending credit for the account of and at the risk of the person accepting these deposits, including the provision of short term loans to small or micro enterprises and low-income households, usually characterized by the use of collateral substitutes, such as group guarantees or compulsory savings;
- n) Transacting other such activities as may be prescribed by the Central Bank.

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<sup>47</sup> The 'loan insurance fund' is compulsory savings, which are to be paid as a condition to receiving a loan.

As mentioned earlier, small loans are defined as less than 1% of core capital for individual and less than 5% for group borrowers, whereas short-term loans have a maximum term of two years.

The definition of deposit excludes “a sum of money which is paid by way of security for performing a contract”. This means that MFIs only using compulsory savings as a collateral substitute need not apply for a license.

An earlier proposal to include larger financial cooperatives under tier three has been dropped as they are regulated under a different Ministry, the Ministry of Trade, Tourism and Industry. The MDI Act is not very clear about member-based institutions. They are not excluded from the definition of microfinance business and, according to Section 4(1) of the Act, only companies possessing a valid MDI licence can conduct microfinance business in Uganda.<sup>48</sup> Yet Section 10 defines the main activities of MDIs as the taking of time deposits or savings from the public and their employment in lending, which can be and is interpreted as the exemption of deposits from members.

To summarise, Uganda uses both a positive definition of microfinance business with specifications regarding size and term of loans and kinds of deposits, and a negative list of all kind of activities that are not permitted for MDIs.

Another interesting aspect of Uganda’s approach is that microfinance is regarded “as a line of business”, i.e. as an activity that can also be undertaken by banks (tier one) and credit institutions (tier two). Nevertheless, tier three follows the approach of institutional regulation, since it is exclusively reserved for deposit-taking MFIs. It is envisaged that the central bank will issue statutory regulations for banks and credit institutions with microfinance portfolios.

### 2.3 Quantitative vs. Qualitative Requirements: What Are the Major Regulatory Instruments?

The selection of regulatory instruments and tools for MFIs is not much different from that of traditional financial institutions. Legal provisions usually legislate for entry into the market, smooth operation and an orderly exit, either voluntarily or by order of the regulatory authority. Yet even when the instruments are the same, the specifications for MFIs are different. The best-known example of this is the capital requirement for MFIs, which is generally much lower than for commercial banks.

Most countries use a combination of quantitative and qualitative indicators to assess the soundness of MFIs. It is only Indonesia, which has introduced a strict rating system to assess BPR’s soundness levels. Currently, this system follows the CAMEL approach looking at the CAR (capital), non-performing loans to total loans (assets), a subjective assessment of management quality based on the last on-site inspection, the ratio of expenses to earnings (earnings) and at the ratio of liquid assets to current liabilities (liquidity). The five components are weighted and used to create a composite rating. BI plans to reduce the system to a CAEL approach, as the assessment of management is seen as too subjective.

The scope of this study does not allow us to provide a comprehensive overview of all regulatory requirements in the eleven countries we looked at.<sup>49</sup> Instead, we will pick those regulatory provisions that are at the core of risk control in an MFI.<sup>50</sup>

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<sup>48</sup> An earlier version of the MDI Bill defined the activity (a) of “microfinance business” as “acceptance of deposits and other repayable funds from the public”, which would have been much clearer.

<sup>49</sup> Please refer to the detailed country tables, which will shortly be published as part of the “Regulation and Supervision Resource Center” on the Microfinance Gateway.

### 2.3.1 Minimum Capital Requirement

Table 3 gives an overview of minimum capital requirements for MFIs. This table should be read with great care, as it includes very different types of MFIs operating in vastly different environments. Using the gross national income as a crude measure of economic development of the country, the variations between countries change. For example, in terms of multiples of Gross National Income, FFPs in Bolivia have only slightly higher values than MDIs in Uganda, whereas the relatively low capital requirement of rural BPRs in Indonesia becomes even more evident. Pakistan is clearly an exceptional case, as it asks for banking-like capital endowments. According to an official from the central bank, one reason for this is that *microfinance banks* in Pakistan are allowed to offer almost all the financial services of banks, including current accounts. Another reason is that the central bank does not want a mushrooming of MFIs, but rather the controlled and sustainable growth of this sector.<sup>51</sup>

**Table 3: Minimum Capital Requirements**

Country	Type of Institution	Absolute amount in USD	As a multiple of GNI per capita <sup>52</sup>
Bolivia	Private Financial Fund (FFP)	870,000	1,280
	Open Savings and Loan Cooperative (CAC) Category 1 to 4	From 207,000 to 7,600,000	From 300 to 11,180
Ethiopia	Micro Financing Institution	24,000	240
Ghana	Rural Bank	62,000	210
	Deposit-taking NBFI	1,900,000	6,550
Honduras	First Tier Financial Private Development Organisation (FDPO)	60,000	70
	Second Tier FDPO	600,000	670
Indonesia	BPR in rural areas	56,000	80
	BPR in provincial capitals	112,000	160
	BPR in Greater Jakarta	224,000	320
Nepal	Cooperative Society with a Limited Banking License	From 13,000 to 130,000	From 50 to 520
Pakistan	MFI operating district-wide	1,700,000	4,050
	MFI operating province-wide	4,300,000	10,240
	MFI operating country-wide	8,600,000	20,240
Uganda	Micro Deposit-Taking Institution	270,000	960

<sup>50</sup> It has to be stressed again that if a country within our sample is not mentioned below, this does not necessarily mean that such a requirement does not exist in this country. It might simply be that we were not able to collect the relevant information.

<sup>51</sup> The above-mentioned World Bank database provides some figures on commercial banks, which are interesting to compare with MFI data: <http://tinyurl.com/b32g>.

<sup>52</sup> Gross National Income per capita, Atlas method. Data taken from World Development Indicators, year 2001.

### 2.3.2 Capital Adequacy Requirements

In 1988, the first Basel Capital Accord was published, recommending a risk-weighted capital adequacy ratio (CAR) of 8% for all internationally active banks (Basel Committee on Banking Supervision 1988). Since then, this ratio has gained worldwide acceptance as a minimum standard for all financial institutions. For MFIs, it is generally recommended to impose stricter capital adequacy requirements than for traditional banks.<sup>53</sup> The CAR is a more sophisticated measure than the minimum capital requirement since it actually correlates capital with different degrees of risks on the asset side.

Table 4 summarises the capital adequacy requirements for a number of countries. Again, this table must be read with great care. Although we have tried to include some information on the definition of capital and assets, one would still have to look deeper into the exact definition of terms. Furthermore, the definition of risk weights for different asset categories varies from country to country. For example, Ghana's Banking Law uses only two weights - assets that are not included in the computation of capital requirements and those that have to be fully backed by the prescribed ratio of 6% capital. Uganda's MDIs and Nepal's *cooperative societies* are subject to weights of 0%, 20% and 100%, while Pakistan and Ghana's NBFIs and Indonesia's BPR regulations use a fourth weight of 50% for loans secured by mortgage and, in the case of Pakistan only, investments in government shares. In general, the categorisation of assets seems to follow the 1988 Capital Accord, although usually in a simplified version.

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<sup>53</sup> CGAP lists a number of arguments both for and against imposing tighter capital adequacy requirements; Consultative Group to Assist the Poorest (2002a: 16f.).

**Table 4: Capital Adequacy Requirements**

Country	Risk-Weighted Capital Adequacy Ratio for Type of Institution	Remarks
Bolivia	8% Private Financial Fund (FFP) From 10% Open Savings & Loan Coop To 20% (CAC) Category 1 to 4	Net equity as percent of risk-weighted total assets and contingencies
Ethiopia	12% Micro Financing Institution	Minimum capital adequacy ratio; applicable to re-registered MFIs
Ghana	6% Rural Bank 10% Deposit-taking NBFi	Primary and secondary capital to adjusted asset base Supplementary and core capital to risk-weighted assets
Indonesia	8% BPR	Primary capital and supplementary capital, with the latter not being larger than the former
Nepal	5% Cooperative Society with a and 10% Limited Banking License	For core capital and total capital, respectively
Pakistan	15% Institutions providing MF services under MFI Ordinance	Equity (paid-up capital, share premium, reserves and unappropriated profits) to risk-weighted assets.
Uganda	15% Micro Deposit-Taking Institution and 20%	For core capital and total capital, respectively

In all the countries except Ethiopia, MFIs must hold at least the recommended 8% capital. Uganda clearly has the tightest requirement with 15% for core capital (the Basel Committee recommends 4% for this) and 20% for total capital.

An interesting case is Nepal, which uses both a leverage ratio and a capital adequacy ratio. The aggregate amount of all deposits and advances from members of *cooperative societies* has been limited to ten times the amount of core capital. Such a ratio does not rule out the possibility of increasing leverage by borrowing money, as it does not include debt. This ratio is a more crude measure than the capital adequacy ratio, as it does not use risk-weights to reflect the differences in risk associated with different kinds of assets. Thus it does not make much sense that a core capital adequacy ratio (CAR) of 5% has been stipulated.<sup>54</sup>

Indonesia's BPRs are subject to a rather low CAR of 8%. To give BPRs an incentive to hold more capital, a current proposal is to reward a higher CAR of, say, 12 to 15% with a better overall soundness rating and permission to open new branches.

<sup>54</sup> The following calculations illustrate the relationship between both ratios: assuming that all assets are weighted with 100% and that the *cooperative society* does not do any borrowing, a debt to equity ratio of 1:10 would imply a CAR of 9.1%. Having an equally large amount of borrowed funds than mobilised savings would lead to a CAR of 4.7%. Thus it can be assumed that the debt to equity ratio is the binding measure.

### 2.3.3 Asset Quality

For MFIs, the most important asset is their loan portfolio. Thus the classification of loans and the specification of provisioning requirements serve as important regulatory instruments. In general, provisioning requirements should be more conservative than for traditional banks, as microloans have more frequent payment instalments than traditional loans. Figure 2 illustrates different provisioning schedules. In many countries, a general provision on the whole outstanding loan portfolio has to be made. Special provisions are made depending on the number of days payments are overdue. The provisioning schedules vary considerably, Uganda being the strictest and Ethiopia the least so.

Three countries' provisioning systems are of particular interest. In the case of MDIs in **Uganda**, provisioning is stricter for restructured credit facilities than for regular loans, with 50% provisioning required after payments have been overdue for more than 30 days. In addition, there are a number of restrictions regarding under which circumstances it is permitted to restructure loans. This approach supposedly takes into account the higher risk of non-repayment for loans which have already not been served regularly.

**Bolivia's** FFPs are also subject to stricter provisioning requirements for restructured loans. According to this system, loans restructured once, twice or three times are automatically classified as higher risk grades even without payments being overdue. For example, a loan that has been restructured three times is automatically categorised as a loss, i.e as a loan with payments overdue for more than 90 days.

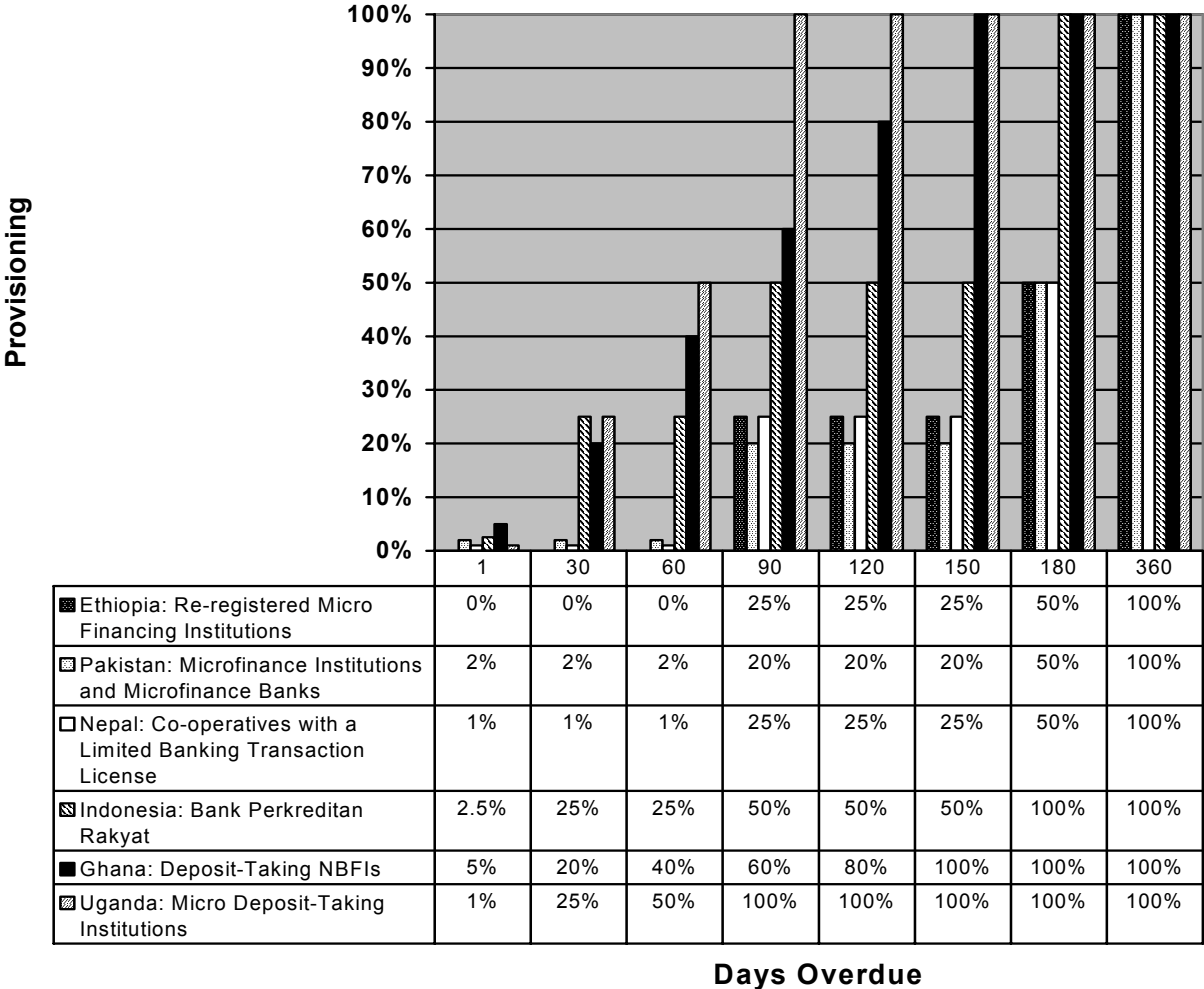
In **Ghana**, provisioning for deposit-taking NBFIs is done on a 'basket basis' and not on an individual loan basis. This means that provisions are calculated for the total outstanding loan amounts at each risk grade (sub-standard, doubtful and loss). Such a procedure simplifies provisioning. Provisioning for *rural banks* is the same as for any other bank regulated under the Banking Law, and therefore too lenient as it does not take the more frequent instalment payments into account.<sup>55</sup>

**Indonesia's** provisioning system for BPRs is about to be changed. According to the proposal, provisioning might not be based on the number of days or months payments are overdue, but on the number of instalments, of which either interest or principal has not been fully paid. This is an interesting approach, as the number of instalments missed might be a better indicator of risk than the number of days or months payments are overdue. According to this proposal, provisioning requirements would be stricter for loans with instalments of less than one month.

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<sup>55</sup> General provisions are 1%. Special provisions must be built according to the following schedule: 10% (1 to 3 months), 25% (<6 m), 50% (<18 m) and 100% (>18 m).

Figure 2: Provisioning Schedule



2.3.4 Risk Concentration

Diversification of assets can reduce the overall risk of a financial institution. The most risky asset of an MFI is usually the loan portfolio. Restricting the loan exposure to single borrowers is a typical regulatory requirement for both traditional financial institutions and MFIs. Whereas a number of traditional banks in developing countries suffer from a high dependence on a small number of big borrowers, this is usually not the case for MFIs with a portfolio of many small loans.<sup>56</sup>

<sup>56</sup> This does not mean that risk concentration is not a problem for MFIs. The high correlation of risks due to the fact that clients work in the same geographical area, belong to homogenous groups and/or work in the same sector (e.g. in trade) is more of a problem than large exposures to single borrowers.

One way for a regulator to prevent risk concentration is to prescribe a risk-weighted capital adequacy ratio (cf. 2.3.2). Different weights for different asset categories create an incentive to use some of the available resources for activities other than lending and thereby reduce the amount of capital held. To give an example, according to the Basel Capital Accord 1988, no capital has to be held against investments in treasury bills, while loans count 100 percent in terms of the capital requirement.

Another obvious way is to limit loan size, which has already been introduced as a measure for distinguishing the microfinance tier from other tiers in Table 2. In **Bolivia**, this provision has been relaxed for loans to other financial institutions. CACs may lend up to 20% of their net worth instead of the general limit of 3%. In addition, the aggregate outstanding loan portfolio may not be more than twice the net worth of a CAC.

Apart from loan portfolio, investments in other companies or fixed assets also play a role in the degree of risk diversification of a financial institution.<sup>57</sup>

- **Ethiopia** restricts investments in any single enterprise to 3% of capital, while investments in other financial institutions may reach up to 10% of capital.
- In **Ghana**, single investments for *rural banks* are limited to 15% of capital and 35% on aggregate.
- The same figures for **Nepal's cooperative societies** are 5% and 15%, respectively. *Cooperative societies* are only allowed to invest in listed companies.
- **Pakistan** only allows investments of up to 15% of capital in companies providing microfinance services to the poor.
- **Uganda** restricts investments by MDIs in firms engaged in a number of areas (but not in financial firms) to 25% of core capital.

Finally, **Ghana's** deposit-taking NBFIs may not hold more than the equivalent of 50% of their equity as fixed assets. Such a requirement does not primarily reduce the risk in a financial institution, but rather ensures that a large share of available funds is invested in earning assets such as the loan portfolio.

### 2.3.5 Insider Lending

According to the Glossary of the Microfinance Gateway, insider loans are “loans made to a person who is in a position of influence within the lending institution, or to someone else connected with such a person”. Insider lending has been a serious problem among many financial institutions in developing countries. Due to the inherent conflict of interest of such loans, they usually belong to the least-earning assets. In some cases, loan conditions are much more favourable than for external loans, in other cases it is simply much easier for borrowers to have their loans rescheduled or even forgiven.

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<sup>57</sup> Another reason for limiting investments in other companies is to prevent the creation of conglomerates through cross-shareholdings. This is not as relevant for MFIs as it is for banks.

One would think that insider lending is less of a problem in MFIs than in traditional banks, as the small loan size – especially when there is a strict ceiling on loan sizes – makes borrowing for the relatively better off insiders less attractive. Yet we do not have any clear evidence of this.

The first question that arises is: who is an insider? Definitions and terms vary considerably. The following is a list of the most commonly used terms, but one would have to look into the exact definition to get a clear picture of the wide spectrum of definitions: Directors, officials, employees, affiliated persons, founders, management level officials, and in each case possibly also their spouses and relatives. In some countries, connected firms are also treated as insiders. In **Indonesia**, these are defined as firms of which insiders own more than 35%; in **Uganda** the same applies for ownership of more than 50%.

In our sample countries, two main ways of dealing with insider loans can be distinguished. The first one is the outright ban on insider loans, which is the case in **Bolivia** for FFPs, cooperatives and banks, in **Nepal** for cooperatives and in **Honduras** for FPDOs. This is certainly the most effective way to prevent conflicts of interest, and is also quite easy to control.

A second way is to restrict the volume of insider loans to a certain percentage of capital. This approach has been taken in **Ghana**, the **Kyrgyz Republic**, **Uganda** and **Indonesia**.<sup>58</sup> In Ghana, the ceiling is lower when loans are unsecured. In Uganda, the ceiling is not binding when loans are fully secured and/or when loan terms are “non-preferential in all respects, including creditworthiness, term, interest rate and the value of the collateral.”

During the financial crisis in 1997, the capital of many BPRs in Indonesia was rapidly depleted. As a consequence, it was difficult for them to comply with legal lending limits (both for regular loans and insider loans) with respect to loans made before the crisis (legal lending limits are defined as a percentage of total capital). BI therefore now distinguishes between a violation of legal lending limits which occurs at the date the loan is made, and a transgression of these limits due to reduction in capital later on. Transgressions are subject to less serious sanctions than violations. The reasoning is that transgressions for BPR directors are more difficult to control.

In some cases, a different ceiling is used for loans to employees. In **Ghana**, these loans are limited to 200% of an employee’s annual wage, in **Uganda** to 100% of the annual emolument. It seems reasonable not to prohibit the payment of advances to staff members, as these loans are relatively secure.

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<sup>58</sup> Available figures are the following: loans to connected firms of deposit-taking NBFIs in Ghana are limited to 10% (secured) and 5% (unsecured) of the net worth. In Uganda, the limit is 1% of core capital (unsecured). In Indonesia, the limit for loans by BPRs to insiders and connected parties is 10% of total capital. All figures are aggregate figures.

In the **Kyrgyz Republic**, the Board of Directors must approve any loan to insiders (in addition to a still to be stipulated ceiling). If insider loans are granted to Directors, such an approval might not make much sense.

### 2.3.6 Reserve and Liquidity Requirements

It is not only insolvency (negative net worth), which may lead to a financial institution going under, but also illiquidity. Liquidity management becomes much more demanding when an MFI takes on savings business. A standard way of dealing with the liquidity risk of banks or MFIs is to prescribe a reserve or liquidity ratio. Yet high liquidity requirements come at a cost, as financial institutions are forced to hold available resources as idle funds instead of investing them in earning assets. If the liquidity or reserve ratio is linked to the volume of deposits, this means that, the higher the ratio, the less the incentive an MFI has to mobilise deposits instead of accessing other sources of funds such as commercial borrowings (cf. Consultative Group to Assist the Poorest 2002a: D.8.)

- In **Pakistan**, microfinance banks must hold at least 10% of time and demand deposits in liquid assets, defined as cash, gold and unencumbered approved securities.
- **Ghana** has comparatively high reserve requirements. *Rural banks* must hold 5% of total deposit liabilities with the ARB Apex Bank, 8% as primary (cash and balances with other banks) and 20% to 30% as secondary (Government and Bank of Ghana bills, bonds and stocks) reserve requirements. The percentage rate for the secondary reserve requirement depends on the loan recovery rate.<sup>59</sup> This means that only between 57 and 67 cents of every dollar mobilised from savers can be used for on-lending. Deposit-taking NBFIs are subject to a 10% and 15% liquidity ratio for primary and secondary reserves, respectively.
- In **Nepal**, cooperatives must keep 7% of total deposit liabilities in liquid assets, defined as cash, balances with financial institutions licensed by the central bank, and government and central bank bonds. 2% of this amount must be held in cash. The liquidity requirement is less strict for term deposits, as only 90% of these are taken into account when computing the liquidity requirement.
- **Uganda's** MDIs are subject to a liquidity requirement of 15% of total deposit liabilities. Notes and coins, balances with the central bank and with licensed financial institutions in Uganda, money at call, and treasury bills are acknowledged as liquid assets.
- In **Ethiopia**, the minimum liquidity ratio is 20% for re-registered MFIs.<sup>60</sup>
- **Indonesia** has an interesting approach to BPR liquidity. A regulation of 2001 requires a BPR to be placed under special surveillance status if its liquidity (liquid assets to current liabilities) for the previous 6 months was less than 3%. The present CAMEL-based soundness rating system awards the maximum of 100 points for a liquidity ratio

<sup>59</sup> The rate is 20% for loan recovery of 90% and above, 25% for recovery rate 75% to 90% and 30% for a recovery rate below 75%. Due to a lack of data on loan recovery, in many cases bank inspectors still ask for a secondary reserve of 52 % as it was in effect until April 2002.

<sup>60</sup> For comparison, some liquidity ratios for commercial banks can be found at <http://tinyurl.com/aw8u>.

of 5%; the proposed new soundness regulation will increase the benchmark liquidity ratio to 10%.<sup>61</sup>

In addition to the reserve requirement as a percentage of deposits, some countries require their financial institutions to build an accumulating reserve fund from their profits. This fund must usually also be held in liquid assets. An advantage of this is that MFIs are given time to build up their reserves. This fund, however, can become a burden as it accumulates over time and eventually becomes very large.<sup>62</sup>

- In **Ghana**, both *rural banks* and NBFIs must use part of their net profit to build an internal reserve fund. Depending on the size of the reserve fund already created, between 12,5% and 100% of net profits of *rural banks* and between 15% and 50% of net profits of NBFIs are paid into this fund.
- *Cooperative societies with a limited banking license* in **Nepal** must contribute 25% of annual profits to a general reserve fund. *Development banks* pay annually 20% of their net profits to a reserve fund until this fund amounts to 200% of paid-up capital. Thereafter, they pay in only 10% of profits. The fund can only be used for safe investments.

Finally, some countries require their MFIs to deposit reserves into an account with the central bank. Such a reserve requirement is a familiar instrument of monetary policy. As MFIs are small in comparison to traditional banks, a reserve requirement for MFIs is of minor importance for stabilising money market interest rates. If these funds are not earning any interest, such a provision again reduces the profitability of MFIs.

- *Microfinance banks* in **Pakistan** must maintain a cash reserve of at least 5% of time and demand deposits in an account with the State Bank of Pakistan.
- **Nepal's** cooperatives must contribute 1% of total deposits and advances to an NRB fund as statutory reserve.

### 2.3.7 Ownership Concentration

Another standard regulatory provision for all types of financial institutions is the stipulation of a maximum percentage of capital that can be held by a single owner.<sup>63</sup> The rationale for such a requirement is to prevent a concentration of ownership, which could enable a single owner to take major policy decisions in his/her own interest without having to consult anyone else. Furthermore, the presence of a minimum number of owners facilitates a balanced representation of interests, which is particularly important for MFIs

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<sup>61</sup> BI is considering the introduction of a kind or a reserve requirement. In the past, many BPRs in Indonesia refused to pay monetary penalties. A possible alternative being considered by BI is to require BPRs to hold compulsory interest-bearing savings deposits at commercial banks. BI would have a power of attorney over these accounts. Penalties would then be debited against these accounts.

<sup>62</sup> It would be interesting to look deeper into this issue.

<sup>63</sup> Again, the World Bank database on Bank Regulation and Supervision is a good reference point for bank regulations in a number of countries: <http://tinyurl.com/azjz>.

who face the potentially conflicting objectives of poverty alleviation and profit maximisation.

- For *microfinance banks* in **Pakistan**, the statutory regulations do not allow an Executive Director (except for the Chief Executive) and his/her affiliated persons or connected firms to jointly hold more than 5% of paid-up capital. There is no such limit mentioned for the shareholding of the Chief Executive. According to the IFC, this regulation is designed to separate ownership and management of a *microfinance bank*.<sup>64</sup>
- In the **Kyrgyz Republic**, shareholding restrictions are defined as a percentage of voting shares, taking into account the fact that large ownership stakes are only critical if they at the same time give controlling power over the institution. Legal entities may in general not hold more than 20% of voting shares of *microfinance companies*. Statutory regulations - yet to be stipulated - will define criteria for the ownership of legal entities of up to 100% of voting shares. For physical entities, no ownership restrictions have been formulated. In **Ethiopia**, ownership in MFIs (as for any other financial institution) is equally restricted to 20% of voting shares.
- In Uganda, a similar provision exists for MDIs. Ownership in MDIs is restricted to 30% of shares. There are two exceptions to this rule, both requiring prior approval from the central bank. Wholly owned subsidiaries of banks licensed by the central bank, and, reputable financial institutions or, in exceptional cases, reputable public companies (defined as financially strong companies, whose ownership is widely distributed and who are of good public standing) may hold up to 100% of the shares. The rationale behind this is to allow commercial banks to set up a microfinance subsidiary and to facilitate shareholding by international microfinance networks, which have been promoting the original microfinance NGO.

In a number of countries, the transfer of shares is subject to approval by the central bank. This is the case for share transfers of more than 10% for MDIs in Uganda and for all transfers of Indonesia's BPRs.

### 2.3.8 Sanctions and Corrective Actions

Sanctions and corrective actions have two main functions. Firstly, they should deter institutions from contravening regulatory requirements. Secondly, and this is where corrective actions are more important than sanctions, they should help to cure the problem which has been created by the violation of regulations. A serious problem with both sanctions and corrective actions is regulatory forbearance: as soon as deterrence has not worked, the regulator might choose not to make problems public, but to sweep them under the carpet. One way to preclude forbearance is to clearly spell out prompt corrective actions that must be taken as a response to clearly verifiable events (cf. Goodhart et al. 1998: 52ff.).

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<sup>64</sup> According to information from the IFC (cf. <http://tinyurl.com/azoe>), the principal sponsors of the First Microfinance Bank are the Aga Khan Fund for Economic Development (20%), the Aga Khan Rural Support Program (60%), and the IFC (20%). They are represented on the Board through their nominees, which are non-executive directors and do not personally benefit from the shareholding.

## 2. Comparison of Countries

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It is difficult to say much about sanctions without looking deeper into supervisory practices. The following is a list of sanctions that are used in the countries we looked at:

- Fines, either up to a certain amount or depending on certain indicators (e.g. as a percentage of the level of deficiency regarding the liquidity reserve requirement or depending on the number of days late reports have been submitted). An interesting proposal presently being considered in Indonesia is that monetary sanctions for certain violations be based on a percentage (e.g. 0.1%) of total assets. This is to remedy a deficiency whereby very large BPRs were unconcerned by small monetary penalties, so effective “punishment” was completely absent;
- Imprisonment, sometimes as an alternative to fines, specified by a maximum number of years or a range of years;
- Suspension or removal of individual directors or the whole board;
- Issuing of warnings and, as a next step, policy directives with specific instructions (e.g. ban on paying dividends, veto on new lending, orders to write-off bad debts or maintain sufficient reserves, ban on new branches, etc.);
- Taking over of management;
- Putting the institution under receivership;
- Revoking the license; and
- Liquidation of the institution.

Uganda and Indonesia are the only countries in our sample, which have introduced prompt corrective actions. These actions are binding for the regulator, the respective central bank, as they take precedence over any discretionary corrective actions. In Uganda, the main trigger for the actions is large losses and the depletion of capital. In Indonesia, a liquidity level over the past 6 months of less than 3% or a CAR of less than 4% triggers prompt corrective actions.

In some countries, the supervisory authority cannot impose all sanctions on its own, but needs an order from a court. In Ghana, for example, a petition to the High Court is required in order to liquidate a bank.

Another interesting question is who will be sanctioned. This could either be the institution (paying a fine, following specific instructions, etc.) or individuals. In Indonesia, it is common practice for owners of BPRs to require management and/or staff to reimburse the BPR for some or all of any penalties imposed by the supervisor.

For some offences such as concealing the real status of an institution, managers or directors are held personally liable (e.g. in Honduras).

### 3. Outlook: Some Recommendations for in-Depth Country Studies

Given the dynamic nature of its subject matter, a study like this can never be fully up to date or fully complete. As mentioned in the introductory chapter, our approach was to restrict ourselves to the analysis of already existing legislation, without looking too deeply at the practical applications of the legislation. In the final chapter, we will briefly indicate how more in-depth assessments of legal frameworks for microfinance could appear. In the course of our work, a clearer picture of the main elements of legal frameworks for microfinance has emerged. Yet to conduct comprehensive assessments of microfinance regulation in specific countries, one has to go a few steps further.

First, the appropriateness of regulatory requirements in the relevant country context must be assessed. The table in Annex 2 can assist in doing this. It lists the most important regulatory requirements and indicates why each requirement is of interest for regulating MFIs and what the rationale is for including such a provision.<sup>65</sup>

The result of this first step should provide the analyst with a comprehensive overview of the existing legislation affecting the conducting of microfinance business. This is not sufficient in itself to explain the strengths and weaknesses of a legal framework.

The second step is to look at the enforcement of legal provisions, i.e. at the supervisory practices. Here, a number of crucial elements for an effective regulatory requirement would have to be analysed. The following list only mentions some broad categories; it would need to be broken down much further.

- **Capacity:** What is the capacity of the supervisory authority to enforce legal provisions? A detailed analysis of supervisory practice can shed some light on this. Questions to be answered would be, for example: how many people work in the supervision department; what is their background; which documents (e.g. supervision manuals) do they use and what is the quality of these documents; how do they follow up on identified problems; etc. On the other hand, do supervised institutions have sufficient capacity to comply with all relevant legal provisions? Is the microfinance industry mature enough and is there a critical mass of institutions to introduce a specific legal framework for microfinance?
- **Incentives:** Capacity alone is not sufficient, if the will is lacking. There must be strong incentives both for the regulator and for the regulated to enforce and to comply with legal requirements. The main incentive for the supervisory authority should be that it is accountable to the government for the soundness of the financial sector. A look at the historic performance of the regulator could give some indication of the appropriateness of incentives. A main incentive for the compliance of regulated

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<sup>65</sup> It would be advisable not only to look at financial legislation, but also at supporting legislation such as laws on property rights, land ownership, contract enforcement, etc. Cf. Funk and Lyman (2001).

institutions is that there is a high probability that a breach of law will be detected, followed-up and sanctioned.

- **Autonomy vs. Accountability:** It is essential that the regulatory and supervisory authority is not subject to direct political intervention in its day-to-day operations. On the other hand, the regulator must be accountable for what it is doing. A mechanism must be in place to challenge regulatory decisions.

The third step is to develop clear recommendations for improving the regulatory framework for microfinance. An analysis of all influential stakeholder groups is a prerequisite, as only then can realistic proposals for the amendment of the current legal environment be devised. In most cases, part of the recommendation will be an advocacy strategy to explain the fundamentals of microfinance regulation to those stakeholders not yet concerned with this topic, but which are important for the implementation of any changes in the legal framework.

## **Annexes**

**Annex 1: Summaries of Country Cases**

**Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance**

**Annex 3: List of Major Legal Texts**

## Annex 1: Summaries of Country Cases

### COUNTRY: Bolivia

(Exchange Rate used: 1 Special Drawing Right (SDR) = 1.38 USD)

TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS	
Names of legal frameworks	Several laws cover institutions providing microfinance services in Bolivia. Private Financial Funds (FFPs), Open Savings & Loan Coops (CACs) and commercial banks are regulated by the Law on Banks and Financial Entities (1993), Central Bank of Bolivia Law (1995), Property & Popular Credit Law (1998), Law for Normative Strengthening & Financial Supervision (2001), and the Solidary Bond Law (2002). The FFPs window was defined by the Supreme Decree #24000 (1995). For CACs, there also exists a General Law for Cooperative Associations (1958) and a Supreme Decree #24439 (1996).
Thresholds/benchmarks used as demarcation of legal frameworks	Any institutions which provide financial intermediation activities or ancillary financial services are required to comply with the above laws.
Number of MFIs regulated under different legal frameworks	Currently there are 8 FFPs, 24 CACs and 13 commercial banks regulated under the above-mentioned laws (of which the Banco Solidario is the only one involved in microfinance activities)

INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION	
Regulatory and supervisory authority, responsibilities	The National Economic Policy Council (CONAPE) is responsible for the approval of prudential norms for the national financial system (except for the Bolivian Central Bank - BCB) and coordinator of Superintendence of Banks and Financial Entities (SBEF) and Superintendence of Stocks, Superintendence of Pensions, Stocks and Insurances (SPVS). The SBEF is responsible for supervision of all financial institutions in Bolivia and has complete, unmitigated access to these institutions.

ENTRY REQUIREMENTS	
Minimum capital requirement	SDR 630,000 (USD 870,000) for FFPs and SDR 5.5m (USD 7.6m) for banks. For CACs there are different requirements depending on their category – SDR 150,000 (USD 207,000) for Category 1, SDR 250,000 (USD 345,000) for Category 2, SDR 630,000 (USD 869,000) for Category 3 and SDR 5.5m (USD 7.6m) for Category 4.
Legal form	FFPs and banks are all corporations, while CACs are limited liability companies.
Other key criteria	Documents required for licensing of any institution include economic and financial feasibility studies, proof of staff suitability and financial information. Applications must also be announced in a newspaper with national circulation.

ONGOING REGULATORY REQUIREMENTS	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	Banks are permitted to conduct all financial intermediation and ancillary services activities. FFPs are permitted to carry out almost all the financial intermediation and ancillary service activities of banks with the exception of factoring, foreign trade operations, capital investment activities in securities enterprises, deposits in check books, and credit cards; these last two will be possible with special permission from the SBEF. Open Savings & Loan Coops are permitted to carry out several financial intermediation and ancillary services activities, depending upon their category. The Open Savings & Loan Coops classified as categories 1 or 2 can collect deposits, grant loans, payments and money transfer services inside the country, conduct certain payment services and trade foreign currency for their own operations. Coops that are classified as category 3 are permitted to carry out similar operations to those carried by FFPs, except those involving financial leasing. Coops that are classified as category 4 are permitted to carry out passive, active, contingent and financial service operations in local and foreign currency, with the exception of those referred to traveller cheques and credit cards, operations with forwards and futures of foreign exchange, giving endorsement, caution and other collateral operation, open, give notice, confirm and negotiate letters of credit.

Establishment of branches	All financial institutions are permitted to operate on a national level.
Other key restrictions	Business hours are regulated for all financial institutions: specific timeframes from Mon-Fri, with optional opening on Saturdays.
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	FFPs require minimum net equity 8% of total assets/risk-weighted contingencies. Banks require 10% minimum net equity. For CACs the minimum net equity is 20% for category 1, 15% for category 2 and 10% for categories 3 & 4 Risk weightings are as follows: 0% for cash, deposits with BCB and investments in securities issued by the BCB/Treasury, credits granted by Central Banks of other countries, pre-paid contingent credits and credits guaranteed with cash deposits in the bank itself 10% for credits guaranteed by Treasury; 20% for credits guaranteed by banks rated "first-class", and credits granted by the financial entity to these banks and those cash items on collection; 50% for housing mortgage loans granted by financial intermediation entities to individuals, exclusively destined for acquisition, construction, remodelling and improvement of the presently occupied/rented house; 100% for all assets, operations and services that represent a risk, or any type of financial liability for the financial entity.
Requirements with regard to ownership	Fit and proper test is required for shareholders of banks and FFPs. Transfers of these shares must be reported to SBEF. For CACs, age and contribution requirements are stipulated for members.
Governance	For FFPs and banks, minimum and maximum board size is stipulated. A fit and proper test is conducted for all management level officials and the Superintendency must be notified of any changes. For CACs, as well as General Assembly, an Administration Council and manager(s), Vigilance Councils (derived from the "Comités de Vigilancia" are also responsible for the governance of the institution. Documentation is required proving the aptitude of the members of the Administration and Vigilance Councils, Internal Audit Unit and management level officials.
Auditing	All institutions must be subjected to both internal and external audits. For all financial institutions (except the BCB), there is an External Auditor's Registry, established by the SBEF. External audits must be conducted at least once a year and at the end of every financial year.
Other criteria (if applicable):	For CACs, the Administration Council is responsible for executing the objectives agreed by the General Assembly.
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	Different classifications have been established for commercial credits, housing mortgage credits, consumer credits and micro credits. Bad loans are written off after one year.
Limitations on insider lending/lending to connected parties/risk concentration	Financial institutions may not lend to any related parties. CACs and banks are limited to lending up to 200% of their net worth. For CACs, loans to individual borrowers/groups are limited to 3% of net worth (secured), or only 1% if the borrower(s) has only personal guarantees. CACs may lend up to 20% of their net worth to other financial institutions.
Requirements regarding investments	
Other quantitative benchmarks stipulated in primary or secondary legislation	None
Reporting requirements	To be set
Other criteria (if applicable)	Financial institutions have to pay at least the LIBOR rate of interest on fixed time deposits. Fixed interest rates are determinable between lender and client. For lending activities with variable interest rates, financial institutions are obliged to use the "reference rates of interest" set by the BCB in line with specifically pre-defined adjustment methods.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	The license of any financial institution can be revoked if it does not comply with all regulatory requirements. The SBEF also has the authority to initiate a management takeover. The SBEF can put any financial institution (except the BCB) into receivership.
Corrective actions	
Liquidation	Voluntary liquidation for FFPs or banks is only possible with SBEF authorisation after all deposits have been refunded. CACs may be dissolved with the agreement of the General Assembly only with authorization from the SBEF.
Other criteria (if applicable):	Bolivia is attempting to transform its current deposit insurance system, which guarantees 100% of deposits, into a system of explicit limited guarantees in order to reduce moral hazard. The SBEF also provides information to private financial institutions and credit reference bureaus.

**COUNTRY: Bosnia-Herzegovina** (Exchange Rate used: 1 USD = 1.90 Konvertible Mark = 0.97 Euro)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Microcredit Organisations (MCOs) in both the Federation of Bosnia and Herzegovina (the Federation) and the Serb Republic (RS) are regulated under the respective Laws on Microcredit Organisations of each country (passed in 2000), which are very similar. Banks are covered under the Law on Banks for the Serb Republic, which is still to be passed by the RS Parliament, and under the Law on Banks for the Federation in its amended form (which are identical)
Thresholds/benchmarks used as demarcation of legal frameworks	Microloans extended by non deposit-taking and non-profit institutions are not explicitly covered under the Law on Banks. They are governed by the Law on Microcredit Organisations. The term microcredit has been defined in the RS as a credit exclusively used for financing a business activity which yields a certain income. In the federation, the term is not clearly defined. Limits on loan size apply. All deposit-taking institutions must apply for a banking license.
Number of MFIs regulated under different legal frameworks	1 Microfinance Bank; number of MFOs approximately 18 (in both entities)

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	For MCOs from the Federation, the Ministry of Social Policy, Displaced Persons and Refugees is responsible for registration and performance monitoring, yet not for prudential regulation. Rules and reporting requirements are set by the Ministry in the RS, yet in the Federation no reporting is required. In RS, the Ministry of Finance fulfils the same role. The Banking Agencies of the Federation and the RS are responsible for regulation and supervision of banks, including issuing licenses, setting performance standards, reporting requirements and criteria for risk management.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	For MCOs, initial capital must be reported in the application for a license, but there are no set criteria. For banks, minimum capital of KM 15m (USD 7.9m) is required.
Legal form	All institutions have to be legal entities enrolled in the Court Register.
Other key criteria	The MCO statute must be submitted to the Ministry containing information (amongst other points) about the main management and leadership bodies and the use of funds. Banks are required to submit a founding contract, information about board, management and shareholders and financial data.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	MCOs may provide microloans to "socially jeopardised categories" and provide other related services such as consulting. First loans should not exceed USD 2.600, consecutive loans USD 15.800 and the term must not be longer than 36 months. MCOs in the Federation are also permitted to use their assets (incl. loan portfolio) as security against their borrowing. Banks may provide loans, mobilise deposits and conduct a range of other financial activities usually undertaken by banks.
Establishment of branches	MCOs based outside the Federation may establish branches in the RS with the approval of the Ministry and vice versa. Banks in a similar situation may open representative offices with the permission of the Banking Agency.
Other key restrictions	For MCOs, any surpluses must be capitalised.
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	Banks require a minimum net capital of 12% of their risk-weighted assets, half of which should consist of core capital. For MCOs there is no such requirement.

Requirements with regard to ownership	MCOs in both the Federation and RS require three natural persons (irrespective of nationality) as founders, with MCOs in RS requiring one extra legal person. Banks require at least two owners, with changes in voting rights over set percentages necessitating the approval of the Banking Agency.
Governance	MCOs do not need to have a general assembly, but must at least have a management body, which has the authority to decide on mergers with other MCOs or on self-liquidation. Bank directors need to have appropriate education and experience. The governance structure for banks follows the German model of a two-tier board. Responsibilities for the Supervisory Board, Management Board and the Audit Board are set out. Banks are also required to have an AGM for shareholders.
Auditing	There are no auditing requirements for MCOs. Banks are subject to both internal and external audits. The internal auditor reports directly to the Audit Board. The Banking Agency has the authority to appoint an external auditor.
Other criteria (if applicable):	
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	Provisioning and write-off procedures are clearly spelt out in the decisions (rules adopted by the banking agency) for banks; they are not only based on days overdue, but also on the quality of collateral
Limitations on insider lending/lending to connected parties/risk concentration	Banks must offer related persons the same terms as are available for non-related persons. A limit exists of 40% of core capital to a single borrower or group of borrowers or 5% if unsecured. Collateral quality requirements come into play when lending exceeds 25% of core capital. Total credit risk exposure is restricted to 300% of core capital, with a maximum deposit size from single sources of 20% of total daily deposits.
Requirements regarding investments	Several restrictions exist for banks. They may not own more than 49% of a non-financial entity and are forbidden from investing in certain businesses. Banks may also not invest more than 5% (individually) or 20% (in total) of their core capital in legal entities without authorisation from the Agency. The absolute limits for investments in non-financial entities are 10% of core capital (25% in total), and, for financial entities, these figures are 15% and 50%.
Other quantitative benchmarks stipulated in primary or secondary legislation	Other quantitative prudential requirements for banks are stipulated in decisions and rules by the Agencies.
Reporting requirements	Banks are required to keep accurate accounts and prepare annual financial statements
Other criteria (if applicable)	A deposit insurance law is pending in BH. There are no requirements regarding the operations of MCOs.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	For MCOs, the Ministry has the authority to impose fines for non-compliance with the relevant conditions. The fines vary between USD 520-5,200 in the Federation and USD 900-9,000 in RS. If a bank violates any condition, the Banking Agency can impose fines, appoint a provisional administrator, suspend the bank's governing boards and ultimately revoke the bank's license. The Agency may also appoint a Provisional Administrator to take over management or a Receiver to sell, merge, or liquidate the bank. Fines between USD 2,600 and 8,800 can be imposed on banks.
Corrective actions	
Liquidation	Priorities for claims have been set for banks in the event of liquidation.
Other criteria (if applicable):	

**COUNTRY: Ethiopia**

(Exchange Rate used: 1 USD = 8.3 Ethiopian Birr)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Micro Financing Institutions (MFIs) regulated under the Micro Financing Institutions Proclamation (No. 40/1996) and various Directives. There are separate prudential norms for re-registered MFIs, viz. all MFIs having mobilised more than USD 120,000 in savings
Thresholds/benchmarks used as demarcation of legal frameworks	In theory, all MFIs are regulated under this legal framework except for cooperatives. "Micro financing business" is defined as "an activity of extending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs", the loan size is limited to USD 600 and the loan term to 2 years. The same limits for re-registered MFIs are 0.5% of total capital and a maximum duration of 5 years
Number of MFIs regulated under different legal frameworks	18 (as of January 2001), all carrying out savings and lending business, two MFIs with as many as 190,000 clients each

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The National Bank of Ethiopia (Central Bank) is the licensing, regulatory and supervisory authority; it "may issue directives necessary for the proper implementation of the proclamation"; in addition, the Central Bank should promote the industry by, amongst other activities, providing technical assistance, offering or facilitating training for MFIs and promoting investment in microfinance business; actual supervision is weak (particularly on-site inspections) due to a lack of capacity

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	USD 24,000 (prescribed in Directive)
Legal form	Share company wholly owned by Ethiopian nationals
Other key criteria	If mobilised savings reach USD 120,000, MFIs are required to re-register. For re-registered MFIs, different prudential norms have been prescribed by the Central Bank; the requirements to re-register has not yet been enforced, as some MFIs have mobilised more than USD 10m in savings without having being asked to re-register

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	Permitted activities: credit, savings, time and demand deposits, and other activities customarily undertaken by MFIs; "Every micro financing institution shall devise and execute a policy whereby the low-income section of society especially in rural areas, get access to credit and to this end it shall implement such means of substituting group guarantee for property collateral requirement" (this article is generally interpreted as a prohibition of individual lending even if it does not explicitly decree group lending)
Establishment of branches	The Central Bank must only be notified about the opening of branch offices, whereas it must approve the closure of branches at least three months in advance
Other key restrictions	The minimum rate on savings and time deposits is set at 3% (previously 6%), ceilings on credit rates were lifted in 1998 (prescribed in Directives)
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	12% of risk-weighted assets (for re-registered MFIs, prescribed in Directives)
Requirements with regard to ownership	Maximum ownership of 20% of voting shares. The capital shall be "owned fully by Ethiopian nationals and/or organisations wholly owned by Ethiopian Nationals and registered under the laws of, and having its head office in, Ethiopia"; shareholders must be investors who buy shares from their own resources; in reality, most MFIs are still funded by donor capital
Governance	Board with between three and twelve directors; minimum requirements regarding education and practical experience for board members and CEO (prescribed in Directives); bankrupt and convicted persons need special approval from the Central Bank

Auditing	No provisions for internal audits; annual external audit should be done prior to the payment of dividends; external auditor must be acceptable to the Central Bank; in practice, external audits are rarely undertaken annually - only about four MFIs have ever conducted an external audit
Other criteria (if applicable):	
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	Provisioning requirements are linked to asset classification; doubtful loans (180 days overdue) shall be provisioned at 50%, bad loans (360 days overdue) at 100%; loans are deemed a loss when they are 360 days overdue and the borrower does not have the capacity to make further repayments
Limitations on insider lending/lending to connected parties/risk concentration	
Requirements regarding investments	Investments in "allied activities" such as financial institutions, agricultural input distribution and transportation of agricultural products is limited to 10% of equity capital; investments in any single enterprise are limited to 3% of net worth
Other quantitative benchmarks stipulated in primary or secondary legislation	The liquidity ratio for re-registered MFIs is 20%
Reporting requirements	Quarterly reports of profit and loss statement, balance sheet, credit and savings performance and provisioning; external audit report latest 6 months after the end of the financial year
Other criteria (if applicable)	

<b>ENFORCEMENT</b>	
Sanctions/Penalties	Penalty of USD 360 for MFIs violating requirements of the Proclamation or any of the Directives
Corrective actions	MFIs conducting business without a license may be ordered by the High Court to return all payments (on application by the Central Bank); the removal of the CEO may be ordered by the Central Bank when an MFI has been penalised three times
Liquidation	
Other criteria (if applicable):	

**COUNTRY: Ghana**

(Exchange Rate used: 1 USD = 8200 Ghanaian Cedi)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	There is no legal framework explicitly and exclusively catering to microfinance. Rural Banks are regulated under the Banking Law (1989) and offer the majority of formal microfinance services in Ghana. They are regulated as any other bank is, except that their minimum capital requirement is much lower and that they only have access to cheque clearing through the ARB Apex Bank. In general, they are local institutions owned by the community. The Financial Institutions (Non-Banking) Law (1993), specified by the Non-Bank Financial Institutions Business Rules (2000), defines the legal framework for both deposit-taking and non-deposit-taking Non-Banking Financial Institutions (NBFIs).
Thresholds/benchmarks used as demarcation of legal frameworks	Ghana's regulatory system follows the institutional approach. In theory, all institutions involved in banking - defined as either deposit taking or lending - are registered under the Banking Law. Yet several different types of NBFIs operate under the NBFIs Law and the Business Rules thereunder. Under the NBFIs Law, Savings and Loan Companies and Credit Unions are most important for microfinance (the latter not being part of this study).
Number of MFIs regulated under different legal frameworks	115 Rural Banks, 8 Savings and Loan Companies

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The Bank of Ghana (BoG) is responsible for issuing licenses to all institutions. For banks, the Minister of Finance must approve new licenses and make regulations after consultation with BoG. BoG has the authority to make rules for NBFIs as long as they are "not inconsistent with the law" and is responsible for the supervision of all formal financial institutions.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	USD 62,000 for rural banks (to compare: USD 3.1m for Ghanaian commercial banks, USD 6.2m for foreign commercial banks; USD 8.6m for development banks). Initial paid-up capital of about USD 1.9m and USD 1.2m is required for deposit-taking NBFIs and non deposit-taking NBFIs, respectively. Lower amounts are mentioned in the laws and rules, but these have been altered by BoG.
Legal form	A bank is a "body corporate incorporated in Ghana". NBFIs take on different legal forms; all current MFIs licensed under the NBFIs Law are savings and loan companies.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	Rural Banks can undertake both credit and savings activities. There are three types of license issued for deposit-taking NBFIs: Type I for savings institutions (NBFIs taking retail deposits such as Savings and Loan Companies) which can operate savings accounts, fixed and recurring deposits, and 'in-house checking' facilities in savings accounts, but not current or checking accounts. Type II is for discount houses and Type III for other institutions not taking public deposits. Type II and III institutions need additional deposit-taking authorisation from the Bank of Ghana and can then take term deposits of limited size and term. Non-deposit-taking NBFIs receive specific licenses based on the category of their 'core business'. Cheque clearing of NBFIs can only be conducted through the larger commercial banks.
Establishment of branches	Banks are only allowed to open branches with the approval of Bank of Ghana.

## Annex 1: Summaries of Country Cases

<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	Banks require 6% paid-up capital and reserves to risk-adjusted assets including off-balance sheet items. Type 1 deposit-taking NBFIs require min. 10% of risk-weighted assets as unimpaired own funds; supplementary capital shall not exceed core capital; risk weightings are as follows: 0% for cash, investments in Govt./BoG Securities, balances and deposits with well-rated banks; 20% placements with discount houses; 50% home mortgage loans; 100% all other assets (including off-balance sheet exposures). For non deposit-taking NBFIs there is a 10:1 gearing ratio.
Requirements with regard to ownership	No provisions in laws
Governance	The board for Type I deposit-taking NBFIs must have at least 5 members, two or more of whom must have relevant experience.
Auditing	External audits are required from banks and deposit-taking NBFIs and must be conducted by members of the Institute of Chartered Accountants (unless otherwise approved by BoG). Banks and deposit-taking NBFIs must annually submit audited accounts with an audit report to BoG.
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	Provisioning for micro and small business loans of deposit-taking NBFIs is made using the following weightings: 1% (general provisions); 5% (1-30 days); 20% (< 60 days); 40% (<90 days); 60% (<120 days); 80% (<150 days); 100% (>150 days) There are other provisioning schedules for other types of loans. All provisioning is made on a 'basket basis' rather than for each individual loan. Provisioning for rural banks according to the following schedule: 1% (general); 10% (30-90 days); 25% (<180 d); 50% (<540 d); 100% (> 540d)
Limitations on insider lending/lending to connected parties/risk concentration	Risk concentration: Banks may lend a maximum of 25% or 10% of their net worth for secured and unsecured loans, respectively (to single or group borrowers). For deposit-taking NBFIs, the levels are 15% (if secured) and 10% (if unsecured). Insider lending: Banks are limited to loans of 2% and 1/3 % of net worth for secured and unsecured loans to connected firms, respectively. BoG determines the maximum level of unsecured lending which can be made to Directors. Deposit-taking NBFIs are limited to loans to connected firms of 10% or 5% of the institution's net worth (for secured and unsecured exposures, respectively). Directors may receive a maximum of 2% of unsecured advances. Officials and employees can receive 200% of their annual wage (same limit for banks and deposit-taking NBFIs).
Requirements regarding investments	Banks may not engage in commercial, agricultural or individual activities or in real estate investments, unless this is undertaken by a subsidiary. There is a limit on equity investment of 15% of net worth in a single subsidiary and 35% for all subsidiaries. The fixed assets of Type I deposit-taking NBFIs may not exceed 50% of their own funds.
Other quantitative benchmarks stipulated in primary or secondary legislation	Liquidity ratio (to be fixed by BoG after consultation with the Minister): for Rural Banks 5% placement with ARB Apex Bank, 8% primary (cash and balances with other banks) and 20-30% secondary (Government and BOG bills, bonds and stocks) reserve requirement, for Type I NBFIs 10% and 15% for primary and secondary reserves, respectively. 12,5%-100% (for Banks) and 15%-50% (for NBFIs) of net profit must be paid into an internal reserve fund (depending on size of fund). BoG has the authority to issue regulations regarding borrowing and lending rates, commissions and other charges of Rural Banks.
Reporting requirements	Rural Banks: weekly - liquidity; monthly - statement of assets and liabilities, large exposures, forex net open position; as necessary - analysis of loans, overdrafts and other advances, capital adequacy, maturity analysis of assets and liabilities, consolidated balance sheet (quarterly); opening, closure and relocation of bank branches and agencies. Type 1 NBFIs may be asked to report lending and deposit rates.
Other criteria (if applicable)	Banks and deposit-taking NBFIs must maintain proper accounts. Any agreements concerning potential sales, mergers or restructuring of banks must be submitted to BoG for approval.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	BoG has the authority to fine banks and deposit-taking NBFIs. Contravention of any provision in the Laws is a criminal offence.
Corrective actions	Banks and NBFIs may not be permitted to pay dividends if capital adequacy requirements have not been met. BoG may also issue policy directives to banks and is able to take control of a bank or delegate its control to an appointed agent. BoG may also veto new lending of deposit-taking NBFIs. BoG has authority to dismiss individual directors as well as the whole board.
Liquidation	BoG may present a petition to the High Court in order to liquidate a bank
Other criteria (if applicable):	NBFIs: Penalty of 0.05% of the amount deficient from the liquidity reserve requirement (per week)

**COUNTRY: Honduras**

(Exchange Rate used: 1 USD = 17 Honduras Lempira)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Financial Private Development Organisations, FPDOs (basically synonymous with transformed financial NGOs) are regulated under the Law for FPDOs (2001). First and second tier FPDOs are distinguished between. First tier FPDOs directly lend to microfinance clients, while second tier FPDOs are wholesale lenders for first tier FPDOs. They are not allowed to do retail lending.
Thresholds/benchmarks used as demarcation of legal frameworks	Unlike banks, FPDOs are non-profit institutions. Clients should be microentrepreneurs and small business owners engaged in productive activities such as commerce, service and production. Microentrepreneurs must have a maximum of five employees
Number of MFIs regulated under different legal frameworks	Approximately 12 first tier and 2 second tier institutions. In the medium term, a maximum of 20 first tier institutions are expected.

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	Conducted by a specialised department of the National Commission for Banks and Insurance Companies (CNBS), which originates from a Central Bank department, but is now an independent body. The Justice Department must approve the licensing of FPDOs and can specify a period within which an FPDO must start its operations. On-site inspections are delegated to audit firms or consultants approved by CNBS.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	USD 60,000 for first tier FPDOs and USD 600,000 for second tier FPDOs
Legal form	FPDOs must be private non-profit institutions. Former NGOs must transform into shareholding companies. Profits are capitalised annually, but may not be distributed
Other key criteria	The following, amongst other information, must be submitted with the application: certificate of establishment and statutes approved by the General Assembly, certification of equity capital, details of founders, board members and executives, feasibility study, financial projections and audited accounts

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	First tier FPDOs are allowed to lend in local and foreign currency, accept savings deposits and time deposits, on-lend donor and other funds to SMEs, engage in financial leasing, invest in stocks and securities and discount bills of exchange and promissory notes from their borrowers. Second tier FPDOs can undertake the same activities except that they must be performed with MFIs as customers, and not with individuals.
Establishment of branches	The opening of branches must be reported to CNBS and can be denied if FPDO is considered weak or financially unstable
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	Debt-equity ratio of up to five for first tier and seven for second tier FPDOs (equivalent to 16.7% and 12.5% capital to assets ratio, respectively). A ratio of capital to risk-adjusted assets is yet to be specified by CNBS
Requirements with regard to ownership	Min. five shareholders; either natural or legal persons. Legal persons must have the explicit objective of providing finance for the SME sector; natural persons must be fit and proper. Transfers of shares must be approved by the General Assembly
Governance	Shareholders have voting rights in the General Assembly. Two board structure: The Board of Directors must have at least five members (and have an uneven number of members); it is elected by the General Assembly. In addition, there is a Supervisory Board, which is likewise elected by the General Assembly. Responsibilities of these different organs are specified in the law and regulations.

Auditing	FPDOs with more than USD 600,000 equity capital must establish an internal audit facility, i.e. all second tier FPDOs and the larger first tier FPDOs. CNBS publishes a positive list of approved audit firms, from which FPDOs can choose their audit company. This can be the same company that undertakes on-site inspections on behalf of CNBS.
Other criteria (if applicable):	The general manager must provide a guarantee amounting to USD 3,000-30,000 for first tier institutions and USD 60,000-600,000 for second tier institutions (e.g. in the form of property, bonds, shares). Clear rules as to when this guarantee can be used do not yet exist.
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	Discussion on specifications is ongoing.
Limitations on insider lending/lending to connected parties/risk concentration	The maximum loan size is 2% or 5% of equity capital for loans guaranteed by a surety or by other types of collateral, respectively. Loans to founders, shareholders, directors, managers, employees as well as to spouses or other relatives of these persons are not permitted for first tier institutions (second tier FPDOs do not lend to individuals anyway)
Requirements regarding investments	
Other quantitative benchmarks stipulated in primary or secondary legislation	The annual interest rate on loans of FPDOs may not be more than three percentage points above the prevailing maximum interest rate of the national banking system
Reporting requirements	
Other criteria (if applicable)	The Financial Indicators Manual is not yet finalised. It will eventually include quantitative and qualitative benchmarks on liquidity, credit rating, portfolio at risk, profitability and management performance

<b>ENFORCEMENT</b>	
Sanctions/Penalties	Submitting false information or conducting/approving operations which conceal the real status of an FPDO by directors, managers or other staff is subject to sanctions under the Penal Code, i.e. 6 to 9 years of imprisonment. Directors or managers granting loans or performing other operations for their own benefit can be penalised with 4 to 7 years imprisonment. For penalties, the FDPO law refers to the general Law on Institutions of the Financial System, where penalties for institutions and for individuals such as managers, employees and directors are further specified
Corrective actions	Not specified
Liquidation	Either voluntarily by majority vote of the General Assembly and with approval of CNBS, or mandatory in case of insolvency or the risk of losing clients' deposits and under the conditions specified by CNBS
Other criteria (if applicable):	Credit information must be submitted to the Credit Reference Bureau in CNBS

**COUNTRY: Indonesia**

(Exchange Rate used: 1 USD = 9,000 Indonesian Rupiah)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	BPRs (people's credit banks, which operate in rural and urban areas) are regulated by the Banking Law (1992) and central bank regulations on BPRs (current version and drafts as of May 2003) There are other types of MFIs such as BKDs (over 5,000) and LDKPs (about 1,600) which are not part of this study.
Thresholds/benchmarks used as demarcation of legal frameworks	Only licensed financial institutions are permitted to mobilise deposits from the public. At present, this comprises of commercial banks and BPRs. In addition, a Microfinance Law is currently being developed, which would allow limited deposit-taking by non-bank and non-cooperative MFIs.
Number of MFIs regulated under different legal frameworks	Approximately 2,200 BPRs. Bank Rakyat Indonesia (BRI) with approximately 3,900 Units has the largest <b>outreach</b> in terms of volume of deposits. BRI, one of the largest commercial banks in Indonesia, is not included in this study.

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The Bank of Indonesia (the central bank) is responsible for regulation and supervision of BPRs. Within the next few years, BI's role as regulator and supervisor of banks will be taken over by a new Financial Services Supervisory Institution

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirements	Rp500m (US\$56,000) in areas outside provincial capitals; Rp1 billion (\$112,000) in provincial capitals; Rp2 billion (\$224,000) in the Greater Jakarta region (Rp3 trillion - \$330m - for commercial banks.)
Legal form	BPRs can be limited companies, cooperatives or companies owned by provincial government. Most are limited liability companies.
Other key criteria	Documentation on owners, key staff, organisational structure and economic feasibility are required to be submitted to Bank Indonesia when applying for license.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	Savings accounts, time deposits, loans; place surplus funds with other banks. Prohibited: current accounts, foreign exchange activities, equity participation, insurance business. Note that both equity participation and insurance business might be allowed under certain conditions in the future.
Establishment of branches	Branches can only be established in the specific province in which the BPR is established.
Other key restrictions	The present operational regulation for BPRs (of May 1999) requires any new branch to have the same capital as the head office. BI recognises that this constrains rural outreach, and is likely to remove this restriction during 2003.
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	CAR: 8% of risk-weighted assets (primary and supplementary capital). Four different risk weights are distinguished between: 0% for cash, Sertifikat Bank Indonesia, and loans secured by deposits from borrowers of the BPR concerned; 20% for claims on other banks with maturities less than one year; 50% for housing loans and 100% for all other assets. A CAR greater than 8% might (a) be rewarded by a better overall soundness level and (b) facilitate the establishment of new branches (still under discussion).
Requirements with regard to ownership	There is no limit to shares in ownership, but foreign shareholders are not permitted. Share transfers must be authorised by Bank Indonesia. BI is likely to change the banking law to allow minority foreign-ownership in BPRs by approved international institutions.
Governance	Min. 2 directors on the board, one with operational banking experience. Minimum of one commissioner (kind of internal supervisor). Directors and commissioners are subject to BI's fit and proper tests.

Annex 1: Summaries of Country Cases

Auditing	No internal audit is required as most BPRs are very small (average total assets Rp4 billion, US\$450,000). An annual external audit (by a registered, BI-approved auditor) becomes necessary once total assets exceed Rp10 billion.
Other criteria (if applicable):	
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	<p>The proposed new loan-classification and provisioning system will be much stricter than the present one, which is based on commercial bank practises. Loans are classified as standard, sub-standard, doubtful and loss. Current and proposed (in brackets) provisioning is as follows: standard 0.5% (2.5%); substandard 10% (25%); doubtful 50% (50%), loss 100% (100%).</p> <p>The loan classification system for instalment loans with monthly or more repayments (in brackets the proposed new system) is as follows: standard &lt;=3 months (&lt;=1 inst.); substandard &gt;3mth, &lt;=6mth (&gt;1, &lt;=3 inst.), doubtful &gt;6mth, &lt;=27mth (&gt;3, &lt;-6 inst), loss &gt;27 mth (&gt;6 inst.). A significant feature of the proposed new system is that collateral (unless in the form of deposits at the BPR) cannot be taken into account when calculating the amount of the provisions.</p> <p>Note that the new system is based on the number of instalments overdue, and not on the number of days or months payments are overdue.</p>
Limitations on insider lending/lending to connected parties/risk concentration	<p>Under the proposed new regulations, the following legal lending limits will apply: max. 10% of total capital to single borrower (presently 20%). BI is still considering placing an aggregate limit on the largest borrowers, e.g. 5 largest borrowers limited to 25% of total capital, or 20 largest loans &lt;=25% of total loans outstanding. Loans to private commercial banks are restricted to 50% and loans to other BPRs to 20% (25% on aggregate) of BPR's total capital.</p> <p>Loans to related parties (including companies in which insiders hold more than 25% of shares) are restricted to 10% of capital in the aggregate.</p> <p>A violation of the set limits due to a depletion of capital after the disbursement of loans is regarded as a "transgression" and is subject to less serious sanctions than for violations. No lending limits apply for loans fully secured by cash or savings and time deposits pledged to the BPR and held by the BPR.</p>
Requirements regarding investments	At this stage, BPRs are not allowed to make investments. This is likely to change in the future.
Other quantitative benchmarks stipulated in primary or secondary legislation	<p>At present, a BPR soundness rating is computed using the CAMEL system. Weights and benchmarks are as follows: CAR 30% (&gt;=8%), non-performing loans to total loans 30% (&lt;10%), management 20% (subjective rating, based on last on-site inspection), earnings 10% (expenses to earnings &lt;92%), and liquid assets to current liabilities 10% (&gt;7.5%). The proposed new system will be totally based on objective factors (CAEL), and will comprise of the following:</p> <p>CAR 30% (&gt;=8%), non-performing loans to total loans 40% (&lt;10%), earnings 20% (expenses to earnings &lt;92%), and liquidity 10% (&gt;7.5%). BI is considering a regime that will reward a BPR with a higher soundness level if its CAR substantially exceeds the minimum limit of 8%.</p>
Reporting requirements	BPRs prepare a detailed monthly report of some 20 pages, with full details of financial statements, loans, funding, non-performing loans, loan and deposit sizes, loans by industry, kind of borrower, etc. This overly detailed report is based on commercial banking practises, which BI is considering amending and simplifying.
Other criteria (if applicable)	<p>Interest rates are fully liberalised.</p> <p>Benchmarks exist for portfolio at risk (&lt;10%), liquidity ratio (&gt;5%, but this is likely to increase to 10%) and operating expense ratio (&lt;92%).</p> <p>A blanket depositor protection scheme currently guarantees all bank deposits, but excludes insider deposits.</p>

<b>ENFORCEMENT</b>	
Sanctions/Penalties	Bank Indonesia can restrict the activities, change the management or withdraw the license of a BPR for violating banking law or regulations. Sanctions for violations of certain regulations may in the future be based on a percentage of total assets (still under discussion)
Corrective actions	Bank Indonesia can issue warnings to a BPR and put it under surveillance, giving it time to rectify the situation. The composite rating for the overall soundness level can trigger prompt corrective actions, when it falls below the pre-defined levels of <i>sound</i> or <i>fairly sound</i>
Liquidation	Bank Indonesia cannot liquidate a BPR, but can put it under special surveillance and can revoke its operating licence. The latter will, in effect, trigger the BPR's liquidation under the company or cooperative laws.
Other criteria (if applicable):	BI is assessing the merits of requiring BPRs to make compulsory deposits at commercial banks, over which BI will have control. BI could then debit these deposit accounts as payment for financial penalties.

**COUNTRY: Kyrgyz Republic**

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Microfinance companies (MFCs), Microcredit companies (MCCs) and Microcredit agencies (MCAs) are regulated under the Law on Microfinance Organisations in the Kyrgyz Republic (2002). Extra provisions under the Law apply to MFCs, as they are the only type of microfinance organisation (MFO, used as generic term) eventually allowed to take deposits and are thus prudentially regulated. The activities of other finance and credit institutions (including credit unions) are regulated by the 'Law on Credit Unions' and other legal acts.
Thresholds/benchmarks used as demarcation of legal frameworks	MCAs and MCCs require certification from the Central Bank to carry out microcredit activities. MFCs conduct both credit and deposit-taking activities and require both a certificate and a license from the Central Bank.
Number of MFIs regulated under different legal frameworks	None yet, as normative acts (secondary legislation) have not yet been devised

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The National Bank of the Kyrgyz Republic (the central bank) is the licensing, regulatory and supervisory authority in the Kyrgyz Republic, authorised to issue normative acts for MFOs, define financial standards, impose sanctions and penalties and request reports and documents. The drafting of normative acts can be delegated to an authorised person.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	Still to be determined by the Central Bank. For all MFOs: minimum charter capital must be placed in an account at a commercial bank.
Legal form	MCAs are any legal form of non-commercial organisation with a certificate from the Central Bank, except political parties, professional unions or religious organisations. MCCs are any legal form of commercial organisation with a certificate from the Central Bank. MFCs are joint stock companies.
Other key criteria	Only MFCs must submit a feasibility study and business plan. The focus for MCAs and MCCs is on a list of members of the management body. MFCs pay a license issuance fee. All MFOs were obliged to comply with the Law within six months of its enactment.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	All MFOs may conduct general microcredit activities, have settlement accounts with commercial banks and borrow funds from international donor organisations, banks and financial and credit institutions. MCCs may also conduct factoring and leasing with approval from the Central Bank, although this may lead to additional regulatory requirements in the future. Furthermore, MFCs may conduct both secured and unsecured lending, accept time deposits (two years after granting of license), conduct factoring & leasing and issue shares and debt securities. MFCs are not allowed to accept savings deposits.
Establishment of branches	The Central Bank must be notified of the establishment of branches and representative offices
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	Only MFCs must comply with a capital adequacy standard (still to be determined by the Central Bank)
Requirements with regard to ownership	No restrictions on MCCs and MCAs. For MFCs, legal entities may hold a maximum of 20% of voting share (presumably ownership of physical entities is unrestricted). Legal entities meeting the criteria defined in the normative acts may own up to 100% of voting share. Investors owning more than 5% of stock can be examined for their reputation and financial condition. Should the acquisition of shares lead to the right to control the MFC, an announcement to the Central Bank for approval must be made 30 days in advance.

Governance	No restrictions on MCCs and MCAs. MFCs: Board members cannot simultaneously be board members or employees of any other affiliated company or MFC and cannot be executive officers or employees in any state body. The Central Bank can define necessary qualifications for board members, managers of large structural divisions and the chief accountant.
Auditing	MFOs are internally and externally audited. An internal audit department should confirm authenticity of accounts and appraise adequacy and effectiveness of internal control systems. The results of the annual external audit by independent auditors must be submitted to the Central Bank. The Central Bank can delegate the authority to conduct on-site inspections of MFCs to professional independent auditors.
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	The creation of loan loss reserves and write-offs are carried out in accordance with the normative acts of the Central Bank. In the case of MFCs, external auditors have the right to prepare instructions for write-offs.
Limitations on insider lending/lending to connected parties/risk concentration	The Law defines the term 'affiliated person'. In the case of MFCs, transactions with any affiliated person are subject to approval by the Board of Directors. Percentage ratios for transactions with individual affiliated people and for the gross amount of all these transactions (in relation to capital and reserves) are still to be stipulated by the Central Bank
Requirements regarding investments	Requirements with regard to the utilisation of deposit funds, amount of investments, etc. are still to be stipulated
Other quantitative benchmarks stipulated in primary or secondary legislation	Not yet stipulated
Reporting requirements	Central Bank may request any information they see fit. This is to be specified in normative acts.
Other criteria (if applicable)	MFOs have freedom to set their own interest rates. The Central Bank will set a limit for the amount of credit to be disbursed to any one entity.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	Not yet stipulated.
Corrective actions	The Central Bank may suspend/restrict transactions or suspend/withdraw the license of an MFO if the MFO violates any laws or normative acts or does not submit the necessary information. The Central Bank has the authority to reorganise MFOs and may give MFCs specific instructions (such as writing-off bad debts, maintaining sufficient reserves, refusing approval for new branches etc.) in order to ensure their compliance with the normative acts.
Liquidation	An MFO is subject to liquidation when the Central Bank has withdrawn the license and/or when it is bankrupt.

**COUNTRY: Nepal**

(Exchange Rate used: 1 USD = 77 Nepalese Rupee)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Three different legal frameworks exist for institutions conducting microfinance activities. Cooperative Societies with a Limited Banking Transaction License (CS) were initially regulated under the Cooperatives Act (1992) and have now been regulated by a further, much more detailed Directive (2002). Development Banks (DBs) are regulated under the Development Bank Act (1996) and Financial Intermediary Societies (FIS) are regulated under the Financial Intermediary Societies Act (1999).
Thresholds/benchmarks used as demarcation of legal frameworks	Cooperatives accepting deposits (from members only) and providing credit facilities for productive activities are subject to regulation under Tier 1. For DBs no clear definition yet exists. Any intermediary institutions supplying microcredit fall under the FIS Act.
Number of MFIs regulated under different legal frameworks	There are currently 34 CS and 4 DBs under the Cooperatives Act and the Development Bank Act respectively.

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The Nepal Rastra Bank (the central bank) is the licensing, regulatory and supervisory authority for all financial institutions in Nepal and is allowed full access to any such institution. The Registrar of Cooperative Societies also has responsibility for the regulation and supervision of CS (including those without the limited banking transaction license).

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	For CS, the minimum capital requirement varies from USD 13,000 (rural) to USD 130,000 (urban), depending on the district in which the institution operates. The requirement for DBs is to be set by the NRB according to the scope of the banks' functions and outreach. There is no requirement for FIS.
Legal form	DBs are public limited companies. FIS can apply to any institution providing microcredit.
Other key criteria	CS have to submit a work plan and information on their share subscriptions and are to have a minimum of 25 members. DBs are required to submit a feasibility study. FIS are required to submit a certificate of registration as well as information on their officials, members and assets and the area in which they plan to operate. A licensing fee has been prescribed for FIS by the NRB.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	CS may accept savings and offer deposits to members, and also engage in banking business with the approval of the NRB. Amongst their prohibited activities are providing credit with insufficient credit and collateral restrictions. DBs may grant credits, mobilise deposits and deal in financial instruments as well as conducting a range of other banking activities. FIS are permitted to provide microloans to groups or group members and generally promote employment-oriented enterprise.
Establishment of branches	CS are limited to operating within specific districts. For both CS and DBs establishing new branches requires NRB approval.
Other key restrictions	The FIS license must be renewed annually.
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	CS require a minimum core capital of 5% of their risk-weighted assets (10% including supplementary capital). For DBs and FIS there are no such requirements.
Requirements with regard to ownership	CS members must be Nepalis who live in the specific district of operation. NRB is still to specify shareholding restrictions for DBs. DB shares may not be transferred without NRB's prior approval.
Governance	Both CS and DBs have to have at least 7 members on their board. For CS, minimum education and experience requirements are stipulated for a proportion of the directors, with fit and proper test for the CEO. For DBs, a fit and proper test is conducted for directors.

Auditing	CS have to undergo internal audits, but are allowed to be audited in groups of three. All financial institutions must be externally audited by NRB-approved auditors and the report duly submitted to the NRB.
Other criteria (if applicable):	Provisions exist with regards to compulsory AGMs for DB shareholders, stipulating attendance and procedure.
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	For FIS, write-offs must be approved by the NRB. They must also pay a set ratio of their total outstanding loans into a risk-bearing fund. No write-off policy exists for CS or DBs. A loan classification system only exists for CS (see laws for provisioning percentages).
Limitations on insider lending/lending to connected parties/risk concentration	For CS and DBs, no loans are permitted to directors or their relations and any such loans previously made must be repaid before taking office. CS credit size to individuals and their families is limited to 5% of core capital for the first credit, 10% for the second and 20% thereafter.
Requirements regarding investments	CS are limited to investing in companies listed on the Nepal stock exchange. Up to 5% of core capital may be invested in a single institution and 15% on aggregate. No such restrictions yet exist for DBs.
Other quantitative benchmarks stipulated in primary or secondary legislation	Reserve requirements exist for both CS and DBs, with an annual percentage of net profits being placed in a reserve fund (up to a pre-defined level). CS must also comply with liquidity requirements. NRB can place a ceiling on administrative expenses for societies.
Reporting requirements	CS are obliged to periodically send financial and performance-related information to the NRB, as well as information on the board. The level of reporting for DBs is still to be specified by the NRB. For FIS, the NRB may request any information relating to their microcredit operations and must receive an annual report of the FIS' functions and a statement of income and expenditure.
Other criteria (if applicable)	Interest rates are liberalised for all institutions, subject to certain conditions. CS must submit a whole range of operational policies to the NRB for their approval. Borrowing members must finance 20% of their own projects. FIS must hold a separate microcredit fund in a commercial bank from which to pay their expenses.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	NRB may issue directives and sanctions on financial institutions in the case of non-compliance with set requirements, such as fines, suspensions and imprisonment. NRB may also revoke the license of an FIS for repeated violations. NRB can prevent dividends being paid in a CS with an inadequate capital fund.
Corrective actions	NRB is authorised to take over the management of DBs and FIS
Liquidation	All financial institutions require NRB approval for liquidation.
Other criteria (if applicable):	

**COUNTRY: Pakistan**

(Exchange Rate used: 1 USD = 58 Pakistani Rupee (Rp))

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Khushhali Bank (KB) regulated under the Khushhali Banking Ordinance (2000). Microfinance Banks (MFBs)/Microfinance Institutions (MFIs) regulated under Microfinance Institutions Ordinance (2001) (there are plans to merge both laws in the future); NGOs/Projects involved in MF sector may also apply for license. Prudential Regulations are the same for Khushhali Bank and MFBs/MFIs.
Thresholds/benchmarks used as demarcation of legal frameworks	Khushhali Banking Ordinance created specifically for Khushhali Bank. Microfinance Institutions Ordinance covers <u>all</u> institutions providing microfinance services wishing to mobilise deposits from the public.
Number of MFIs regulated under different legal frameworks	2 (Khushhali Bank and First Microfinance Bank), 2-3 more expected later in 2003

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The State Bank of Pakistan (SBP) has power to make rules to implement the existing ordinances (amongst other things, setting terms and conditions for MF services provided by MFIs, setting operational criteria and principles for good governance, setting auditing and accounting needs). For the Khushhali Bank, its Board of Directors can issue regulations with approval of the SBP. The SBP is also responsible for supervision of all licensed institutions and may inspect accounts/records and investigate their affairs at any time.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	Rs.500 million (USD 8.6m), Rs.250 million (USD 4.3m) and Rs.100 million (USD 1.7m) respectively for countrywide, specific province-wide and specific district-wide operations (for comparison: USD 17.2m for commercial banks). A founding microfinance NGO can contribute up to 50% in the form of its microcredit portfolio subject to a due diligence
Legal form	Incorporated company
Other key criteria	

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	Permitted activities: MFIs may both grant credits and mobilise deposits, as well as performing a wide range of other activities including offering checking accounts. Dealings in foreign exchange and foreign trade are prohibited. The mandate of such institutions is very much poverty-based, with institutions also permitted to undertake a number of financial and advisory activities to aid "poor persons" and generally contribute to economic development.
Establishment of branches	MFIs licensed to operate in specific areas (districts, provinces or whole of Pakistan). Require authorisation from SBP to change location of principal office and establish new branches within its specified area of operation. MFIs must submit annual plan to SBP indicating future branches/agents with at least 30 days' notice. Licensed mobile banking is the only permitted form of conducting business in unauthorised locations.
Other key restrictions	Records/documents may not be moved without permission from SBP Operational policies covering all areas must be submitted to SBP within 6 months of commencement of operations
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	15% equity (paid-up capital, share premium, reserves and unappropriated profits) to risk-weighted assets
Requirements with regard to ownership	KB – Sale/transfer of shares subject to approval of SBP Promoters/sponsor members must provide min. 51% of paid-up capital of MFI, to be held by SBP Max. 5% of capital to be held by Executive Directors (including ownership stakes of affiliated persons/companies) except for the Chief Executive

## Annex 1: Summaries of Country Cases

Governance	KB - Min. 7 directors, of which min. 2 women; requirements regarding education and experience. Max. 6 years directorship. For MFIs there are some qualitative provisions with regard to governance, e.g. that the board must run the MFI "in accordance with principles of good governance" and that the CEO should "work full time and be responsible for the day-to-day administration of a microfinance institution"
Auditing	KB - Accounts audited by one or more chartered accountants from panel of approved auditors maintained by SBP Each MFI must have internal audit department, with access to all pertinent documents; audits must be published in newspaper. Annual report/audit must be submitted to SBP.
Other criteria (if applicable):	
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	MFIs must maintain general provision equivalent to 2% of the net outstanding advances, plus: 0% - 30 to 89 days; 20% - 90 to 179 days; 50% - 180 to 364 days; 100% - 365+ days (all non-performing loans to be written off after one year)
Limitations on insider lending/lending to connected parties/risk concentration	The maximum loan to a single borrower is Rs.100,000 (USD 1,725). The maximum exposure of a borrower from all financial institutions (MFIs, banks and NGOs) should not be more than Rs.100,000 (USD 1,725)
Requirements regarding investments	MFI may invest up to 15% of equity in any company providing MF services to the poor.
Other quantitative benchmarks stipulated in primary or secondary legislation	KB must maintain general reserve fund to which every year a minimum of 20% of its annual post-tax profits is credited, until fund equals its paid-up capital, thereafter min. 5% of profits. It must also maintain a cash reserve of at least 5% of its time/demand liabilities. MFIs must maintain cash reserve of at least 5% of time and demand deposits held on account with SBP. In addition, at least 10% of time/demand liabilities must be held in liquid assets (cash, gold and unencumbered approved securities)
Reporting requirements	MFIs must submit a 'Statement of Affairs' (balance sheet) bi-weekly and a 'Statement of Condition' (more detailed) quarterly. Liquidity must be proven by submitting monthly return to SBP showing assets and time/demand liabilities at close of business on each Saturday of month.
Other criteria (if applicable)	MFIs are required (within 5 years of date of first annual balance sheet) to establish and maintain a depositors' protection fund or scheme to mitigate depositors' risk, to which they should credit 5% of their annual post-tax profits. Contingent liabilities limited to 3 times equity for the first 3 years of its operations (and 5 times thereafter).

<b>ENFORCEMENT</b>	
Sanctions/Penalties	SBP has the authority to fine or dismiss staff (who may also be imprisoned) and fine MFIs for improper conduct and not complying with requirements of the MFI Ordinance. Ultimately, SBP has authority to revoke an MFI's license.
Corrective actions	
Liquidation	
Other criteria (if applicable):	

**COUNTRY: South Africa**

(Exchange Rate used: 1 USD = 10 Rand)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	All institutions conducting money-lending transactions (consumer lending and microenterprise lending) and falling within the scope of the Usury Act Exemption Notice 713 of 1999 (Usury Act of 1968).
Thresholds/benchmarks used as demarcation of legal frameworks	All institutions taking deposits from members or the public must either be licensed or exempted under the Banks Act, 1990, or Mutual Banks Act, 1993. Most banks do not specialise in microfinance. All MFIs must comply with the strict interest rate restrictions of the Usury Act unless they act in accordance with the requirements of the Usury Act Exemption Notice. One of these requirements is to be registered with the Micro Finance Regulatory Council (MFRC).
Number of MFIs regulated under different legal frameworks	1304 money-lending institutions (05/2002)

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The Micro Finance Regulatory Council (MFRC) is the only approved regulatory institution under the Usury Act Exemption Notice. It is not a prudential regulator, but it does monitor compliance with the Exemption Notice and with its own Rules and Circulars. It has the authority to inspect lenders at its own discretion and to deregister lenders. MFRC is a hybrid institution as its board members stem from the industry (microfinance and banking associations), public institutions (the Central Bank, the Department of Trade and Industry and wholesale financial institutions) and consumer representatives. The Minister of Trade and industry can repeal the MFRC's mandate. In addition, the Department of Trade and Industry can inspect non-registered lenders to verify their compliance with the Usury Act.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	None
Legal form	Micro lending institutions may be private or public companies, close corporations (some 80% of registered lenders), NGOs, co-operatives, banks or mutual banks, or trusts. Co-operatives also are incorporated under the Co-operative Act.
Other key criteria	There is a formal registration criteria that has been approved by the minister which is designed to ensure that participants in the industry are "fit and proper" to conduct business (e.g. directors should not have criminal records involving dishonesty). Micro lending institutions pay annual registration and branch fees to MFRC. These fees vary according to the size of the lender. Accreditation must be renewed annually.

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	All micro lending institutions are permitted to conduct lending activities. Although registration with the MFRC is voluntary, there is a strong incentive to do so as it allows money-lending institutions to charge higher interest rates. Maximum loan amount is USD1,000 with a maximum term of 36 months.
Establishment of branches	
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	None
Requirements with regard to ownership	Determined by the law governing the respective legal form
Governance	Directors, trustees or members and executive staff may not have criminal records involving dishonesty.
Auditing	Determined by the law governing the respective legal form
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	
Limitations on insider lending/lending to connected parties/risk concentration	

Requirements regarding investments	
Other quantitative benchmarks stipulated in primary or secondary legislation	
Reporting requirements	Lenders must keep records of all loans. Quarterly reports containing information on loans and borrowers and consolidated annual return must be submitted to MFRC. Loan data must also be submitted to a national loans register. The MFRC can prescribe the manner in which interest rates are calculated.
Other criteria (if applicable)	MFRC must approve standard written loan agreements for each lender, which clearly determine repayment schedules. MFRC has set-up a National Loans Register where all loans are registered and which lenders have to check before extending credit. There must be a cooling-off period of 3 business days after an agreement has been signed, during which all money lending agreements can be terminated and all money is paid back.

<b>ENFORCEMENT</b>	
Sanctions/Penalties	Micro lending institutions can have their accreditation annulled and would then have to comply with interest rate ceilings under the Usury Act (currently 29% for loans below USD 1,000 and 26% for larger loans). Violating the Usury Act can result in the imposition of fines or imprisonment. Clearly defined fines must be paid for late submission of reports to MFRC.
Corrective actions	
Liquidation	
Other criteria (if applicable):	Consumers can lodge complaints about lenders (e.g. regarding undisclosed terms and conditions, unscrupulous methods of loan collection, etc.) to the MFRC, which must then follow them up.

**COUNTRY: Uganda**

(Exchange Rate used: 1 USD = 1,800 Ugandan Shilling)

<b>TYPES OF LEGAL FRAMEWORKS FOR MICROFINANCE INSTITUTIONS</b>	
Names of legal frameworks	Micro Deposit-Taking Institutions (MDIs) regulated under the Micro Deposit-Taking Institutions Act (enacted on April 30, 2003, and referred to as tier 3) and Banks (tier 1) and Credit Institutions (tier 2) regulated under the Financial Institutions Statute (1993, revised Statute expected in 2003); a number of Regulations under each law
Thresholds/benchmarks used as demarcation of legal frameworks	Deposit-taking from the public is only allowed for regulated institutions; MDIs are institutions carrying out microfinance business, i.e. accepting deposits and employing such deposits by lending or extending credit, "including the provision of short term loans to small or micro enterprises and low-income households, usually characterised by the use of collateral substitutes, such as group guarantees or compulsory savings"; short-term is defined as less than 2 years, a small loan as less than 1% of core capital for individuals or 5% for group borrowers, respectively; member-based institutions accepting deposits from members only are not covered under either law
Number of MFIs regulated under different legal frameworks	One Bank, one Credit Institution, and 2 - 4 MDIs (MDIs expected to be licensed in 2003), in the medium term up to 5 additional MDIs

<b>INSTITUTIONAL ORGANISATION OF REGULATION AND SUPERVISION</b>	
Regulatory and supervisory authority, responsibilities	The Bank of Uganda (Central Bank) is the licensing, regulatory and supervisory authority; it may make regulations and issue notices; for MDIs, the minimum capital requirement can only be changed by the Minister of Finance with the approval of Parliament, the definition of fit and proper criteria by the Minister alone, viz. without parliamentary approval.

<b>ENTRY REQUIREMENTS</b>	
Minimum capital requirement	USD 2.2m for a bank, USD 555,000 for a credit institution, and USD 270,000 for an MDI
Legal form	Banks and Credit Institutions must be companies (without further specification), whereas MDIs shall be companies limited by shares
Other key criteria	MDI regulation: The framework follows the risk-based approach with a strong focus on licensing; comprehensive feasibility study with business strategy and financial analysis as licensing requirement

<b>ONGOING REGULATORY REQUIREMENTS</b>	
<b>Restrictions on Business Activities and Definition of Permissible Activities</b>	
Legally permitted and prohibited activities	MDIs: Prohibited activities or products are cheque accounts, foreign exchange business, intermediation of compulsory savings, e-commerce, derivatives dealing
Establishment of branches	MDIs: Approval by the Central Bank required for opening and closing branches, agencies and offices
Other key restrictions	MDIs: Approval required for changes in opening hours
<b>Ownership and Corporate Governance</b>	
Ongoing capital adequacy or leverage requirements	MDIs: 20% (15%) total capital and 15% (8%) core capital (fully paid-up shares plus retained reserves) to risk-weighted assets (figures in brackets for Banks and Credit Institutions), the Central Bank may prescribe any other ratio for individual MDIs
Requirements with regard to ownership	Ownership restrictions: Max. 49% of shares to person or group of related persons for Banks and Credit Institutions, max. 30% for MDIs, but up to 100% for wholly owned subsidiaries of a bank or reputable financial institutions (with approval of Central Bank); approval of Central Bank needed for transfer of shares (from 5% for Banks/Credit Institutions and 10% for MDIs)
Governance	MDIs: min. five directors (approved by Central Bank), chairperson must be non-executive; fit and proper test for CEO, senior/top management and directors
Auditing	MDIs: Internal and external auditor to be approved by Central Bank; internal auditor reports to the Board; external auditor avails Central Bank with audit report and has certain duties towards the Central Bank

Other criteria (if applicable):	
<b>Provisions with regard to the operation of the institution</b>	
Provisioning and write-offs	MDIs: 1% general provisions, 25% (31-60 days), 50% (61-90 d) and 100% (91 days and more) special provisions; stricter provisioning for rescheduled loans: 5% (8-30 d), 50% (31-60 d), 75% (61-90 d), 100% (>91 d); loans must be written off 6 months after having been classified as a loss
Limitations on insider lending/lending to connected parties/risk concentration	MDIs: Insider lending (directors/staff members/connected firms) restricted to 1% of core capital on aggregate except when it is done on terms which are non-preferential and the loan is fully secured; lending to individuals or groups of people restricted to 1% of core capital for individuals or 5% for groups of borrowers, respectively
Requirements regarding investments	MDIs: Investments in firms engaged in trade, commerce, industry or agriculture restricted to 25% of core capital
Other quantitative benchmarks stipulated in primary or secondary legislation	MDIs: 15% liquidity ratio (liquid assets/total deposit liabilities)
Reporting requirements	MDIs: annually - audited balance sheet and income statement; monthly - statement on assets and liabilities, capital adequacy, income and expense, schedule of provisions, insider loans; weekly - liquidity report
Other criteria (if applicable)	

<b>ENFORCEMENT</b>	
Sanctions/Penalties	A number of penalties, specified as maximum fees to be paid (in currency points) and/or imprisonment
Corrective actions	Prompt mandatory corrective actions take precedence over any discretionary corrective actions, main triggers for corrective actions are large losses or depletion of capital; Central Bank may take over management, revoke the license and close the institution, put the financial institution into receivership and liquidate the financial institution; MDIs: CEO and Finance Manager are held personally accountable for a number of problems which might occur
Liquidation	Order of payments is stipulated in the laws; duties and powers of liquidator are specified
Other criteria (if applicable):	

## Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance

Issue to be looked at	Description	Why is this issue of interest?
<p>Each regulatory window or regulatory ‘tier’ should be described separately. Some countries have introduced a specific legal framework for microfinance, others have adapted existing ones to cater for microfinance or might not have microfinance-specific provisions at all</p>		
<b>1. The main characteristics of the legal framework?</b>		
2. Names of primary and secondary legislation, dates of enactment and amendment	In general, primary legislation are laws passed by Parliament, while secondary legislation are statutory regulations and guidelines issued by a specialised regulatory agency	There might not yet be much experience regarding a relatively new law. Old laws, which have not been amended, might be outdated
2.1. Number of MFIs licensed under this law	Both institutions exclusively doing microfinance and those serving (amongst others) the microfinance market should be included. In the case of a new law, give an indication how many licenses are expected in the near future	A very high number is an indication of high costs for the supervisory authority or lack of enforcement
2.2. Supervisory authority	In most countries, this is either the central bank or a specialised supervisory institution.	The capacity, political independence and knowledge of the microfinance sector are important determinants for the effectiveness of the regulatory system
2.3. Degree of delegation of rule-making power	In most cases, the power to make statutory regulations has been delegated to the supervisory authority. Yet for some prudential requirements, the government or a government agency might have retained some rule-making power	The degree of delegation of rule-making power determines the flexibility and accountability of a regulatory system
2.4. Delineation of regulatory tiers/windows	A typical way to delineate tiers is to define specific characteristics of microfinance business as opposed to traditional banking business. A soft criterion is to describe the main target group of MFIs. In addition, lower minimum capital and higher capital adequacy requirements might clearly separate the microfinance tier from the commercial banking tier	Fuzzy lines between tiers can lead to regulatory arbitrage or ambiguity. A level playing field requires different regulatory requirements for different types of institutions

Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance

Issue to be looked at	Description	Why is this issue of interest?
<b>3. Entry requirements for new MFIs</b>		
3.1. Absolute amount of minimum capital	Look at the details: how is minimum capital defined? In which assets can it be held? For transforming NGOs: can existing loan portfolio count towards this? Compare the amount to minimum capital requirements for other tiers and to the capitalisation of the market leaders in microfinance. Look at ways to change minimum capital amounts	There is a danger that minimum capital is used as a rationing tool. On the other hand, too low a minimum capital leads to a proliferation of weak MFIs.
3.2. Main documents to be submitted with the license application	Typical documents are a business plan including financial projections, geographical expansion and type of financial products to be offered; evidence on qualifications of staff; audited accounts of previous years; etc.	A thorough licensing process can reduce the need for ongoing supervision. In many countries, it is difficult to close down institutions once they have been licensed. The quality of the license application tells much about the qualification of the future executives in the institution
3.3. Requirements for a specific legal form	In order to get a license, MFIs might be required to acquire a specific legal form such as a company limited by shares or another kind of for-profit organisation	The prescribed legal form should be appropriate for microfinance, yet flexible enough to allow for different business models
<b>4. Main sources of information for the supervisory authority</b>		
4.1. Content and frequency of off-site reports	Usually a number of different reports with different frequencies must be submitted. Important are the due date, potential penalties for late submission, and the appropriateness of frequencies. For example, daily liquidity reports might be difficult to submit without a sufficiently developed telecommunication infrastructure	The content of the reports must provide the supervisory authority with accurate and timely information about the financial performance of supervised institutions
4.2. Provisions with regard to on-site inspections	Important is the frequency of inspections, whether there is the option of extraordinary inspections at the instigation of the supervisory authority, whether inspections are unannounced and inspectors have unrestricted access to important documents	Effective prudential regulation relies on the verification and confirmation of off-site reports through on-site inspections

## Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance

Issue to be looked at	Description	Why is this issue of interest?
<b>5. Restrictions on business activities and permitted activities of MFIs?</b>		
5.1. Permitted or prohibited financial products	Depending on the legal tradition of the country, this is either a positive list of all permitted products or a negative list of prohibited products. It is important to include all specifications of products in terms of type (e.g. type of savings products), size, duration etc.	These specifications should be in line with the main characteristics of MFIs. They clearly separate the microfinance tier from other financial tiers
5.2. Branching restrictions	Look at licensing requirements for branches, provisions with regard to security, opening hours, and similar things. Are mobile branches allowed?	Provisions regarding branching can potentially be very restrictive for MFIs as they operate in rural and/or insecure areas
<b>6. Ownership and corporate governance requirements</b>		
6.1. Ongoing capital adequacy or leverage ratio	Most legal frameworks prescribe a ratio of capital to risk weighted assets. If possible, include risk weights for different asset categories. Some legal frameworks might simply prescribe a debt-to-equity ratio	This is one of the most important prudential requirements. Capital serves as a risk cushion. The weights must reflect risk differentials of assets
6.2. Limitations on ownership acquisition and transfer of shares	In some countries, foreigners are excluded from ownership. In others, ownership by legal persons and natural persons is distinguished between. Limits might be set for maximum ownership stakes. Owners can be subject to fit and proper tests. Transfer of shares might need the approval of the supervisory authority	Faced with restrictive ownership rules (e.g. low maximum ownership stake, exclusion of foreign owners), MFIs might find it difficult to comply. If there are no restrictions on ownership stakes, corporate control might be weak
6.3. Rules regarding the composition of the board of directors and committees	Look at provisions such as minimum number of board members; voting rights of executive and non-executive board members; representation of owners on the board; mandatory committees (including composition and responsibility)	The division of labour between management and owners is important for the internal control of an MFI. Committees must have clear responsibilities and should be independent (e.g. no voting right of CEO on audit committee). Some countries use the German model with two boards (supervisory and management board)
6.4. Provisions for internal and external audits	Interesting aspects to look for are the frequency of external auditors; the responsibility for the appointment of auditors (many countries use a positive list); and disclosure requirements for audit reports. For internal audits, the most important questions are whether there is a separate, independent audit function and whether this is reported to the board or to management	Good internal and external audits can support (but not substitute) the work of the external regulator. One constraint in many countries is the limited availability of auditors with experience in microfinance

## Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance

Issue to be looked at	Description	Why is this issue of interest?
<b>7. Main regulations regarding the operations of an MFI</b>		
7.1. Provisioning and write-off requirements	Describe general provisions and schedule for special provisions depending on the number of days payments are overdue. Is there a different schedule for rescheduled loans? Can provisions be built on a basket basis instead of a single loan basis? Has the write off policy for overdue loans been specified?	Provisioning requirements must take the higher frequency of payment instalments of microloans into account. Rescheduling of loans should not be rewarded by lower provisioning requirements.
7.2. Limitations on insider lending	Look at definition of insider and (maybe) connected firms and limits for lending to insiders. Check whether special rules apply for advances to employees	Insider lending can become a serious problem in MFIs as loans are chiefly not issued according to economic terms
7.3. Limitations on risk concentration	Ways to limit risk concentration are to limit loan sizes or require stricter reporting for large loans, to restrict investments (amounts, kind of firms or assets to be invested in)	Risk concentration leads to dependence on the performance of a few assets (e.g. loans to large borrowers, large investments in other enterprises)
7.4. Reserve and liquidity requirements	In some countries, a specific ratio of deposits must be held in liquid assets. It is important to determine the definition of deposits and liquid assets, i.e. where the money is to be held (e.g. cash, account with the central bank, other liquid assets). Another option is the build-up of a reserve fund out of profits (is the size of this fund limited?).	A minimum amount of liquidity is essential to be able to serve demands for withdrawals at all times. On the other hand, too high a liquidity ratio reduces earnings of an MFI. If linked to the amount of deposits mobilised, it reduces the incentive for an MFI to mobilise deposits.
7.5. Potential interest rate regulations	Limitations could take the form of minimum rates for deposits or maximum rates for loans	If minimum rates for deposits are higher than market rates, there is a disincentive to mobilise deposits. Lending rates lower than market rates lead to rationing of loan amounts and make it impossible for an MFI to cover its costs.
7.6. Any other benchmark for the performance of an MFI	Some countries might stipulate quantitative benchmarks for operating/financial self-sufficiency, portfolio at risk, operating expenses etc.	It is important to assess these benchmarks in the relevant country context. As for the self-sufficiency ratio, only profitable institutions should be allowed to mobilise savings
<b>8. Sanctions and corrective actions</b>		
8.1. Sanctions for breaches of law	Most laws include sanctions for a number of misdeeds. Look at the kind of sanction (fee, imprisonment, dismissal etc.), the legal basis (civil laws vs. criminal law), the definition of personal liability for different groups of persons (e.g. auditors, senior management etc.) and triggers for prosecution	Effectiveness of sanctions depends to a large degree on the effectiveness of the legal system (access to courts, costs of using the legal system, speed of judgements). One would have to check whether sanctions are effective enough to prevent misdoings

## Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance

Issue to be looked at	Description	Why is this issue of interest?
8.2. Corrective actions for non-compliance with prudential requirements (e.g. minimum capital requirements)	Potential corrective actions are capital calls, dismissal of board members or management, management take-over by an appointed agent, receivership and ultimately liquidation.	Corrective actions should deter and protect. They must cure the symptoms (vetoing new lending, for example, might make the situation worse).
<b>9. Other Support institutions/systems</b>		
9.1. Deposit insurance system	Is there a legal provision for a (mandatory) deposit insurance system for MFIs separate from that for banks? If there is no such system, has the government bailed out savers during previous bankruptcies?	There is not yet much experience with this issue. Deposits of small borrowers should at least partially be refunded when regulated MFIs must be closed. Full coverage leads to problems of moral hazard.
9.2. Credit information service	Is there a private or public credit information system such as a credit reference bureau?	Such a system can help to prevent over-indebtedness through double lending and increases incentives for repayment
9.3. Lender of last resort or other measures of short-term liquidity support	Banks usually have access to an open discount window at the central bank. MFIs might have other systems of short-term liquidity support such as a liquidity pool, or short-term support from an apex organisation	Ensures adequate liquidity at all times

### Annex 3: List of Major Legal Texts

Country	Title of document	Year
Bolivia	General Law for Cooperative Associations	1958
	Law on Banks and Financial Entities No. 1488	1993
	Central Bank of Bolivia Law No. 1670	1995
	Supreme Decree No. 24000 (Fondos Financieros Privados)	1995
	Supreme Decree No. 24439 (Savings and Loan Cooperatives)	1996
	Property and Popular Credit Law No. 1864	1998
	Law for Normative Strengthening and Financial Supervision No. 2297	2001
Bosnia and Herzegovina	Law on microcredit organisations (Federation)	2000
	Law on microcredit organisations (Serb Republic)	2000
	Rule book on the contents and the manner of keeping the register of the microcredit organisations (Federation)	2000
	Decision on documentation necessary for the issuing of approval for founding of the microcredit organisation, for opening the micro-credit organization office with the seat in the BIH federation, and decision on definition of the micro-credit (Serb Republic)	2001
	Law on Banks (identical for the Serb Republic and the Federation)	2001
Ethiopia	Licensing and Supervision of Microfinancing Institutions Proclamation	1996
	Licensing and Supervision of the Business of Microfinancing Institutions, Directives No. MFI 01 to 06	1996
	IFAD Aide-Memoire with reference to new regulations of revised directives	2002
Ghana	Banking Law	1989
	Financial Institutions (Non-Banking) Law	1993
	Deposit-Taking NBFIs Business Rules	2000
	Non Deposit-Taking NBFIs Business Rules	2000
Honduras	Law for Financial Private Development Organisations (FPDOs), Decree No. 229	2000
	Regulations under the FDPO Law	
	Accounting, Supervision and Indicator Manuals	
Indonesia	Banking Act	1992, revised 1998
	Regulation Concerning the Method of Assessing Soundness Levels of Bank Perkreditan Rakyat	Draft 2003
	Regulation Concerning Legal Lending Limit for Bank Perkreditan Rakyat	Draft 2003
	Regulation Concerning Quality of Productive Assets and Formation of Productive Asset Reserve by Bank Perkreditan Rakyat	Draft 2003
	Regulation Concerning the Requirement to Maintain Minimum Capital (Capital Adequacy Ratio) by Bank Perkreditan Rakyat	Draft 2003
Kyrgyz Republic	Law on Micro-Finance Organisations in the Kyrgyz Republic	2002

### Annex 3: List of Major Legal Texts

Country	Title of document	Year
Nepal	Agricultural Development Bank Act	1967
	Commercial Banking Act	1974
	Finance Company Act	1985
	Cooperatives Act	1992
	Development Bank Act	1996
	Financial Intermediary Societies Act	1999
	Nepal Rastra Bank Act	2002
Pakistan	Khushhali Bank Ordinance	2000
	Application for establishing microfinance bank/institution under MFIs Ordinance 2001	2001
	Microfinance Ordinance	2001
	Annex: Risk-weighted assets on balance sheet items	2002
	Annex: Penalty Scale for Microfinance Banks/Institutions	2002
	Prudential Regulations for Microfinance Banks/Institutions	2002
	Guidelines for Mobile Banking Operations of MFBS/Is	2003
	Criteria and conditions for grant of licence for establishing microfinance banks/institutions	
South Africa	Usury Act	1968
	Banks Act	1990
	Mutual Banks Act	1993
	Usury Act Exemption Notice No. 713	1999
	Designation of Institution of which the activities do not fall within the meaning of "The Business of a Bank"("Financial service Co-operative") Notice No. 1422	2000
	Rules of the MFRC	2002
Uganda	Financial Institutions Bill (gazetted version)	2002
	Bank of Uganda (BoU) MDI Regulations: Policies and Guidelines Governing the Licensing of MDIs	Draft 2002
	BoU MDI Regulations – Reporting Requirements from MDIs to the Bank of Uganda	Draft 2002
	BoU MDI Regulations - Capital Adequacy Requirements for MDIs	Draft 2002
	BoU MDI Regulations – Prudential Requirements and Aspects of MDIs - Liquidity	Draft 2002
	BoU MDI Regulations – Prudential Norms on Asset Quality for MDIs	Draft 2002

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