FINANCIAL REGULATION AND ITS SIGNIFICANCE FOR MICROFINANCE IN LATIN AMERICA AND THE CARIBBEAN

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With:

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ABSTRACT

This paper builds on a questionnaire sent to 23 Bank Superintendencies/Central Banks in the Latin America and the Caribbean during late spring/summer of 1997. The questionnaire, elaborated jointly by the Microenterprise Unit (SDS/MIC), the Chief Economist's Office (OCE), and the Infrastructure and Financial Markets Division (SDS/IFM), identified a number of issues within financial regulation and supervision which could potentially pose obstacles to regulated microfinance institutions.

Although there are certainly a great number of financial regulations which in one way or another affect institutions which lend to microentrepreneurs, this study is not concerned with the majority of them. Instead, the study focuses on those regulations which, while appropriate for most other institutions, may have a negative *differential* impact on microfinance institutions. As defined, these regulations impose restrictions which are particularly costly to institutions involved in microfinance, either through their inappropriateness with regards to financial service delivery methods of microfinance or through their inability to provide a decrease in risk to microfinance institutions.

The study identifies a number of areas in which such differential biases exist or could potentially exist, including--inter alia--capital adequacy requirements, provisioning, documentation, and restrictions on the operations of financial entities. The areas of potential and actual bias are summarized at the end of the paper where some recommendations are also put forward for how to deal with or eliminate them.

TABLE OF CONTENTS

1. INTRODUCTION

1.1 FINANCIAL REGULATION AND MICROFINANCE

The fundamental purpose of financial regulation is to promote effective and efficient capital accumulation and resource allocation while maintaining the safety and soundness of financial institutions that take deposits from the public. Supervisory authorities achieve these objectives by imposing various restrictions on the risk exposure, accounting and reporting practices, and operations of financial institutions. This ensures that few bankruptcies occur and that the systemic economic effects of any bankruptcy are limited.

Viewed from a different perspective, financial regulation exist to achieve a balance between shareholder and debtor/depositor interests. Without proper regulation, financial institutions would be inclined to assume excessively risky positions since expected returns to shareholders increase with increased risk while their maximum losses remain limited to their equity. Depositors and other debt-holders, on the other hand, would be opposed to such a strategy since they stand very little to gain but a lot to lose (i.e. their deposits in and loans to the institution) from increased risk. At the same time, it is not cost-effective or even reasonable to expect depositors to inform themselves about the position of shareholders and the risk profile of the financial institution. This asymmetry in pay-off to risk and the lack of information between depositors and shareholders means that there is a need for supervision in order to safeguard the interest of the general public (i.e. depositors).

Naturally, the same basic principles of supervision should apply to deposit-taking institutions which lend to small and microentrepreneurs as to all other deposit-taking institutions. They should be regulated and supervised with the same undeniable objectives in mind. This is clear. However, the assertion that applying the existing regulatory and supervisory structure to microfinance institutions always leads to these objectives is less obvious. Microfinance institutions, whether incorporated as banks or finance companies, differ in some significant ways from financial institutions with conventional client bases[1]. It is therefore not immediately evident that regulations employed to control the risk of financial institutions in general are entirely effective in doing so for microfinance institutions.

Inappropriate regulation will tend to raise the cost of financial intermediation without offering a corresponding reduction in the risk to financial institutions. Microfinance, due to its high per unit cost of credit delivery, is already expensive and can ill afford regulation which unjustifiably raise the cost of financial services to low income entrepreneurs even further. At the same time, depositors have reason to be skeptical about the banking superintendencies' interest and ability to effectively supervise microfinance institutions. Interest may be lacking because, while microfinance institutions certainly have many clients, the total value of their assets is relatively small compared to the system as a whole. Problems occurring in microfinance institutions are thus not likely to have any systemic effects. Furthermore, many superintendencies in the region appear to be unfamiliar with the concepts and technologies integral to microfinance and may also lack the training necessary to effectively supervise microfinance institutions.

[1] See section 2.1 for discussion

While there certainly exist obstacles to effective supervision of microfinance, there are also important reasons to promote this process. In order to reach any significant scale and provide adequate service to their clients, microfinance institutions need to attract private capital and mobilize savings. For this to happen, they will need to be regulated and supervised. The superintendencies, on the other hand, face a regional trend of increasing formalization of microfinance that is not likely to diminish or disappear. Given these conditions, the challenge now lies in the design and implementation of appropriate and cost-effective regulation for microfinance institutions that do not compromise the goals of long-term capital accumulation, resource allocation, and stability for the system as a whole.

1.2 OBJECTIVE

The objective of this paper is to provide a regional overview of financial regulations in Latin America and the Caribbean which have the potential of constituting important obstacles to microfinance. It is important to mention that the study does not intend to examine all regulations and requirements that may in one way or another negatively affect microfinance institutions. Rather, it attempts to identify the regulations and restrictions which may be inappropriate or inadequate for microfinance while, at the same time, be satisfactory and effective for the great majority of financial institutions. As defined, these regulations would thus impose a unjustified differential impact on institutions involved in microfinance. This study will serve as a first step to identify these issues in a region-wide perspective as well as to indicate which countries are in need of further study and/or reform.

1.3 METHODOLOGY

In order to identify potential obstacles to the effective supervision of microfinance institutions, a survey (referred to as the "MIC Survey") containing approximately 50 questions was sent out to 23 bank superintendencies in Latin America and the Caribbean[2]. The questions included in the survey were identified and elaborated through consultation between the Bank's Microenterprise Unit, The Chief Economist's Office, and the Finance and Infrastructure Division (see annex for the questions). The questions were kept as detailed and specific/technical as possible so that the superintendency staff would be able to answer the questions even if they were not experts in microfinance issues. The survey was sent to the IDB representative offices during the spring and summer of 1997 and then forwarded to the respective superintendencies. A total 22 answers were received back[3].

While a survey may provide unique insights into many aspects of financial regulation, it should be kept in mind that it will only provide referential information. Other potential weaknesses include the possibility that respondents may not have completely understood how certain questions relate to the topic investigated or may not have spent enough time on the survey to provide quality answers. To reduce the risk of misinterpretation and misinformation, considerable efforts were made to follow up and clarify the answers provided. Furthermore, other primary and secondary

[2] See annex; Haiti, Bahamas, and Suriname were not included.

[3] The response from Jamaica was not received in time for it to be included in the paper.

sources were used to add context and depth to the issues as well as to complement the survey results.

1.4 ORGANIZATION OF PAPER

The paper will first offer a brief description of the particular features of microfinance institutions and their operations. This description will serve as the basis for a discussion of financial regulation in general and how the particular characteristics of microfinance and microfinance institutions relate to several specific areas of financial regulation: entry requirements, capital adequacy, provisioning, guarantee requirements, documentation and notarization requirements[4], and usury laws and interest rate ceilings. A final section will summarize the findings and set out some recommendations for future action. Throughout the paper, the results from the survey of the superintendencies will be used to illustrate the current situation in Latin America and the Caribbean.

[4] Refers to the documentation that financial institutions are required to request from and compile on their clients.

2. BACKGROUND AND BASIC PREMISES

2.1 BACKGROUND

Most countries in Latin America have undertaken significant financial reforms during the last decade. Reforms have been made in many areas, including the adoption of new banking and capital markets laws, elimination of interest rate controls and subsidized credit programs, liquidation of inefficient public banks, and increased central bank independence. Although these reforms have certainly enhanced competition and improved resource allocation in financial markets, many aspects of regulation and supervision remain to be satisfactorily addressed (IDB 1997).

In terms of microfinance, until recently very little attention had been given to how it is influenced by financial (de)regulation and prudential norms applicable to other ("traditional") financial institutions. This relative dearth of research is not very surprising since it is only recently that microfinance organizations have started to make the transition from unregulated NGOs to regulated financial institutions. However, with the increasing pace of inclusion of microfinance institutions among the ranks of regulated financial institutions, issues and problems associated with financial regulations have taken on greater urgency.

A few recent publications have tried to take a broader view and focus on the issues rather than on particular countries (Chaves and Gonzales-Vega 1994, Rock and Otero 1996, Berenbach and Churchill 1997). To the extent that these publications use case studies, these are mainly provided to support a more general theoretical discussion regarding appropriate financial and regulatory norms for microfinance institutions. This paper continues to take a broad view of financial regulation, focusing on the technical issues related to financial supervision and regulation. It combines theory with results obtained from a survey carried out with bank superintendencies in the region. The study is not as country-specific as some of the ones just mentioned and it instead provides a regional overview of the regulatory issues that may have an unjustified differential impact on microfinance institutions[5]. It is thus an attempt to explore the issues and take broad stock of the situation in Latin America and the Caribbean, not to examine one specific country or group of countries in detail.

2.1 DISTINCTIVE FEATURES OF MICROFINANCE

It is crucial to understand and keep in mind the unique characteristics of microfinance as compared to traditional finance before examining how regulatory and prudential norms in the financial sector affect microfinance institutions. Essentially, the differences can be grouped in three areas:

1. Lending methodology
2. Composition of loan portfolio

[5] As defined, these regulations would impose restrictions which are particularly costly to institutions involved in microfinance, either through their inappropriateness with regards to the financial service delivery methods employed by microfinance institutions or through their inability to provide a decrease in risk to these institutions.

3. Institutional characteristics

These differences are ultimately a function of the non-traditional client base of microfinance institutions: low-income self-employed people with no or inadequate collateral. The lending methodology used by microfinance institutions to compensate for their clients' lack of collateral is labor and information intensive and usually rely on character references, joint liability contracts, and conditional long-term access to credit rather than on physical collateral and formal documentation. Furthermore, loan officers typically visit each client individually in order to evaluate their character and planned undertakings. Since loans are small, each loan officers has to administer a very large number of accounts, sometimes as many as 500-700. Furthermore, microenterprise loans are generally of relatively short maturity and turned over several times per year. As a result of these distinctive features, the per unit cost of microfinance is high, typically 4-5 times the costs of other loans. Consequently, microfinance institutions must charge higher interest rates than other financial institutions.

Table 1: Distinctive Features of Microfinance

AREA	Traditional Finance	Microfinance
Lending Methodology	(1) based on collateral (2) more documentation (3) less labor intensive	(1) based on character (2) less documentation (3) more labor intensive
Loan Portfolio	(1) fewer loans (2) loans larger in size (3) collateralized (4) longer maturity (5) more stable delinquency	(1) more loans (2) loans smaller in size (3) uncollateralized (4) shorter maturity (5) more volatile delinquency
Institutional Structure and Governance (of regulated financial institutions)	(1) Profit maximizing institutional and individual shareholders (2) Creation by spin-off from existing regulated institution (3) Centralized organization with branch office located in cities	(1) Mainly non-profit institutional shareholders (2) Creation by conversion from NGO (3) Decentralized set of small units in areas with weak infrastructure

Source: Rock & Otero 1996; Berenbach & Churchill 1997

While many financial institutions today are created by spin-offs from already regulated institutions and capitalized by both individuals and institutions, microfinance institutions are so far created by *conversion from unregulated Non-Governmental Organizations (NGOs)* and capitalized almost exclusively by other institutions (usually foreign NGOs). The lack of experience of NGO staff and the non-profit motives of international NGOs tend to make efficient and effective management and oversight of microfinance institutions more difficult than for normal financial institutions. Although the effect of ownership structure on governance and management is certainly very relevant to microfinance institutions, this is not primarily a regulatory issue. The reason why international NGO's tend to capitalize newly created microfinance institutions normally stems from a lack of interest on the part of private investors, not from any regulations that explicitly bias against a certain type of investor.

In conjunction with this discussion it should be mentioned that the dichotomy between microfinance institutions and other traditional financial institutions is gradually becoming less and less pronounced as the latter type of institutions are beginning to enter the microenterprise segment (Baydas et al. 1994). Increased competition in financial markets and more freedom in the provision of financial services are compelling traditionally oriented financial institutions to seek new markets, including low-income self-employed people.

3. FINANCIAL REGULATION AND ITS IMPACT ON MICROFINANCE

Financial regulation is a broad label to describe a number of different types of regulations employed to achieve a variety of purposes. In brief, financial regulations comprise the following six categories (Vittas 1992)[6]:

- **Macroeconomic controls, to maintain control of overall economic activity**
  --reserve requirements
  --interest rate controls
  --restrictions on foreign investments

- **Allocative controls, to influence the allocation of resources in the economy**
  --selective credit programs
  --compulsory investment requirements
  --preferential interest rates

- **Structural controls, to control the structure of the financial system**
  --entry and merger controls
  --geographic restrictions
  --limits on the range of activities of different types of financial institutions

- **Prudential controls, to preserve the safety and soundness of financial institutions**
  --minimum capital adequacy standards
  --limits on concentration of risk
  --reporting requirements
  --provisioning requirements

- **Organizational controls, to ensure the smooth functioning and integrity of financial markets and information exchanges**
  --rules of market making and participation
  --disclosure of market information
  --minimum technical standards

- **Protective controls, to provide protection to the users of financial services**
  --information disclosure to consumers
  --compensation funds
  --ombudsmen offices
  --interest rate ceilings

Microfinance institutions will, like any other financial institutions, be impacted by regulatory changes in all these areas and inappropriate policies will have detrimental effects on their ability to reach and serve their clients. Nevertheless, given the assumption that regulatory policies are reasonably appropriate for the financial system as a whole, there are a few areas which may hide a differential policy bias against microfinance. The areas in which this is most likely are the following: prudential controls (loan documentation, provisioning, and capital adequacy), protective controls (interest rate ceilings), and structural controls (entry requirements and limits

[6] Certain policies may fit in more than one category.

on the activities of financial institutions). (Cristen 1995). The subsequent sections of this paper will cover the following areas of regulation:

- Entry requirements
- Capital adequacy standards
- Provisioning
- Collateral and joint liability groups
- Usury laws and interest rate ceilings
- Documentation requirements
- Operational restrictions (hours and platforms of operation)

Although other regulations also impact microfinance, it is not always easy to see how their effect is different or particularly severe for microfinance institutions compared to other entities in the system. High reserve requirements, for example, raise the cost of financial intermediation, including for microfinance institutions. Reserve requirements are thus a serious concern to microfinance institutions and to the extent that they are not justified by macroeconomic conditions, they should be of course be lowered. They do not, however, impose a higher cost on microfinance institutions than on any other deposit-taking institutions.[7]

[7] It may be tempting to argue that low-income people are less able than affluent people to afford the higher interest rates brought about by high reserve requirements. This argument, however, ignores that fact that whether or not an investment decision (and, consequently, a loan) is worth taking depends on the return generated by the investment/ activity, and not on the wealth of the borrower. As long as the projected internal rate of return of the investment/ activity is positive, it makes sense to take the loan.

3.1 ENTRY REQUIREMENTS

Newly licensed banks, as any other start-up businesses, are particularly vulnerable to financial collapse. Not only that, they also use other people's money (in this case investors' and depositors'/lenders' money) to finance their activities. It is therefore imperative that bank supervisors have the ability to screen owners and management before granting an operating license. This screening usually includes an evaluation of management's' qualifications, previous experience, ethical standards, the existence of a reasonable business plan, and the financial strength of the proposed owners. In addition, there is a minimum capital requirement for each type of financial institution.

Few of the above mentioned issues can be argued to pose an a-priori unjustified differential bias against (potential) microfinance institutions. Nevertheless, there are at least four concrete regulatory issues within the scope of entry requirements that may pose significant and sometimes unique problems for microfinance:

- Minimum capital requirements
- Using the net present value of existing loan portfolios to capitalize a new institution
- Microfinance and institutional form
- Ownership restrictions in regard to financial institutions

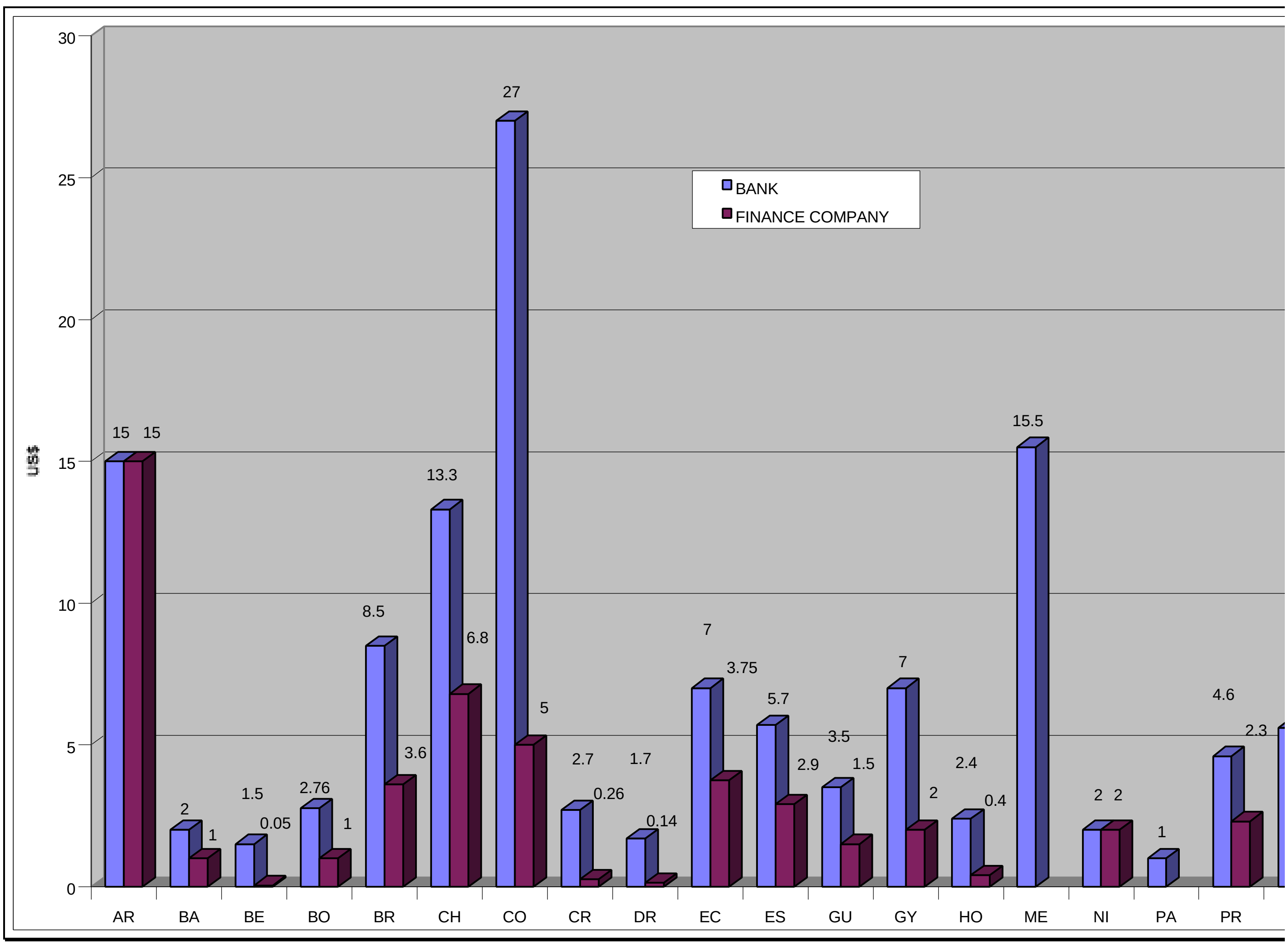
3.1.1 MINIMUM CAPITAL REQUIREMENTS

Minimum capital controls are a means to influence the structure of the financial system. A low minimum requirement may allow a large number of small institutions to become part of the supervised system. High minimum capital requirements will create a system of relatively few large institutions. While low minimum capital requirements may be an attractive point to many of the microfinance NGOs in the region, bank superintendencies will be less enthusiastic about the prospect of having a large number of new institutions which, due to their special characteristics, may require labor intensive and unorthodox supervisory methods. Furthermore, small institutions are more likely to suffer from insufficient asset diversification and therefore be more sensitive to economic fluctuations in a specific sector or region.

On the other hand, high minimum capital requirements constitute barriers to entry for potential competitors. High minimum capital requirements will also prevent microfinance NGOs from converting themselves to regulated institutions by making it difficult for them to raise the necessary funds for incorporation. Furthermore, even if the money can be raised, few microfinance institutions will be able to attain a large enough client base to fully leverage its capital within any reasonable period of time, if at all.

The survey carried out by the Microenterprise Unit shows that minimum capital requirements vary significantly in Latin America and the Caribbean (Graph 1). At one extreme, it takes US$ 27 million in Colombia to start up a bank while, at the other extreme, it takes only US$ 1.7 million in Belize. The relative difference is even greater when it comes to finance companies (an institutional form chosen by several microfinance institutions in Latin America), for which US$ 15 million is required in Argentina and only US$ 50,000 in Belize.

Graph 1: Minimum Capital Requirements in Latin America



Source: MIC Survey 1997

The minimum capital requirement for banks as compared to finance companies also vary significantly between countries. In some countries (Nicaragua, Trinidad and Tobago, Argentina) the same amount of money is required to capitalize a finance company as for a bank. In Belize, on the other hand, it costs 34 times more to capitalize a bank than a finance company (Table 2).

Table 2: Comparison of Minimum Capital Requirements

Issue	Institution	Lowest	Highest
Minimum Capital Requirement	Banks	US$ 1.7 million (Belize)	US$ 27 million (Colombia)
	Finance Companies	US$ 50,000 (Belize)	US$ 15 million (Argentina)
Ratio of required capital for banks in relation to finance companies		1:1 (Nicaragua, Trinidad & Tobago, Argentina)	34:1 (Belize)

Source: MIC Survey 1997

While recognizing that there may exist valid reasons for high minimum capital requirements, the amounts required in countries such as Colombia, Mexico, and Argentina make it very difficult for microfinance NGOs to become banks or finance companies. Furthermore, if finance companies are not permitted to accept savings deposits, their appropriateness for microfinance purposes will be severely diminished. While the ability to offer savings deposits does not address all the deposit needs of microentrepreneurs, fixed term deposit services in themselves are likely to be seriously inadequate. If finance companies are prohibited from accepting anything but fixed term deposits (as in the case of Colombia for example), microfinance institutions are effectively left without any reasonably attractive or feasible institutional form.

Finally, even if an organization succeeded in raising the necessary funds, a minimum capital requirement of US$ 27 million (as in Colombia) would imply a portfolio of approximately US$ 210 million when the capital is fully paid and the institution fully leveraged[8]. If the institution's average loan size is US$500 (as is common in many microfinance organizations), then the institution would need to have more than 420,000 clients in order to remain fully leveraged. This number is approximately 8 times the number of clients of BancoSol in Bolivia, the largest microfinance institution currently operating in Latin America.

The table below (table 3) illustrates the same calculation for most Latin American countries, assuming two scenarios with average loan sizes of US$ 500 and US$ 1,000 respectively. Using US$ 500 and US$ 1,000 as average loan sizes may not be appropriate in all cases, but between them they are probably decent approximations for the average microenterprise loan in most countries.

[8] Assuming a risk-weight of 1.00 for microenterprise loans, a capital adequacy ratio of 9% (which is what the survey indicated for Colombia), and that 70% of the institution's assets are in its loan portfolio.

Table 3: Minimum Capital Requirements and their Impact on Loan Portfolio Size

Country	Institution	Minimum Capital (US$ Million)	Capital Adequacy Ratio	Minimum No. of Clients with Average Loan of US$500	Minimum No. of Clients with Average Loan of US$1000
ARGENTINA	Bank Finance Company	15 15	11.5%	182,609 182,609	91,305 91,305
BARBADOS	Bank Finance Company	2 1	8%	35,000 17,500	17,500 8,750
BELIZE	Bank Finance Company	1.5 0.05	8%	26,250 875	13,125 438
BOLIVIA	Bank Finance Company	2.76 1	8%	48,300 17,500	24,150 8,750
BRAZIL	Bank Finance Company	8.5 3.6	10%	119,000 50,400	59,500 50,400
CHILE	Bank Finance Company	13.3 6.8	11.3%	164,779 84,248	82,390 42,124
COLOMBIA	Bank Finance Company	27 5	9%	420,000 77,778	210,000 38,889
COSTA RICA	Bank Finance Company	2.7 0.26	8%	47,250 4,550	23,625 2,275
DOM REPUBLIC	Bank Finance Company	1.7 0.14	10%	23,800 1,960	11,900 980
ECUADOR	Bank Finance Company	7 3.75	9%	108,889 58,333	54,445 58,333
EL SALVADOR	Bank Finance Company	5.7 1.5	8.6%	92,791 24,419	46,396 12,210
GUATEMALA	Bank Finance Company	3.5 1.5	8%	61,250 26,250	30,625 13,125
GUYANA	Bank Finance Company	7 2	8%	122,500 35,000	61,250 17,500
HONDURAS	Bank Finance Company	2.4 0.4	5.5%[9]	42,000 7,000	21,000 3,500
MEXICO	Bank Finance Company	15.5	8%	271,250	135,625
NICARAGUA	Bank Finance Company	2 2	8%	35,000 35,000	17,500 17,500
PANAMA	Bank Finance Company	1	5%	28,000	14,000
PARAGUAY	Bank Finance Company	4.6 2.3	10%	64,400 32,200	32,200 16,100
PERU	Bank Finance Company	5.6 2.8	9.1%	86,154 43,077	43,077 21,539
TRIN. & TOB.	Bank Finance Company	2.4 2.4	8%	42,000 42,000	21,000 21,000
URUGUAY	Bank Finance Company	6.3 3.8	8%	110,250 66,500	55,125 33,250
VENEZUELA	Bank Finance Company	2.5 1.4	8%	43,750 24,500	21,875 12,250

Source: MIC Survey 1997. **Note:** (1) It is assumed that 70% of the institution's assets are in its loan portfolio; (2) The answer from Costa Rica did not specify the percentage, so 8% is assumed.

[9] "In Honduras a 5.5% ratio is applied on net assets, something which implies a somewhat stricter requirement than the one established by the Basle Committee as risk is assigned to assets which the institution does not have" (translated quote).

3.1.2 USING THE NET PRESENT VALUE OF EXISTING LOAN PORTFOLIO TO CAPITALIZE A NEW INSTITUTION[10]

Most countries require financial institutions to be capitalized by cash contributions. In this way a new financial institution starts out with a clean slate and with no uncertainty regarding the value of its assets. This procedure does usually not pose a significant problem for most financial institutions. For microfinance institutions, however, it may pose somewhat of hurdle since they are usually formed by NGOs with existing loan portfolios. Microfinance NGOs are in these cases required to transfer cash and clients to the new institution concurrently with the repayment of individual loans to the NGO. Furthermore, since some countries require the capital to be fully paid before the institution is allowed to start operating, capitalizing an institution through continual cash transfers may not only be cumbersome, but also unfeasible.

For NGOs it would clearly be convenient if they could simply transfer their existing loan portfolio to the new institution when undertaking its capitalization. This course of action could, however, bring with it an uncertainty about the quality of the NGO's loan portfolio and a danger of transferring bad loans to the new institution. If this occurred, the new institution would not only start out in a weak position by having a possibly "contaminated" portfolio, but it would also be more difficult to gain the support of other investors if such a contamination was even a possibility[11]. However, as long as it is clearly understood that the transfer involves the *net present* value (i.e. minus provisions and discounted for future inflation) of an *independently* evaluated loan portfolio, these type of potential problems would be minimized.

Clearly, from a microfinance perspective, there is a need to have capital requirements that are flexible enough to enable even microfinance institutions to reach them. In this case, this flexibility has to be balanced against the difficulty in determining the net present value of NGO loan portfolios, especially considering that their reporting and provisioning practices are not always the best. Nevertheless, permitting the use of the net present value of loan portfolios in capitalizing a new financial institution may be an option to consider for those countries that do not wish to lower existing capitalization requirements or create a new type of financial institution.

In sum, although there are some real problems involved in permitting the practice of transferring loan portfolios, it would offer an additional option for well-managed NGOs that wish to become regulated entities. Currently this practice is legally possible in Bolivia, El Salvador, Nicaragua, Honduras, and Uruguay (table 4), but has so far not been tried.[12]

[10] It should be recognized that the question of using the net present value of a loan portfolio toward initial capitalization is part of a larger issue of how the transition from unregulated NGO to regulated financial institution can be made easier while still safeguarding the financial health of the new regulated financial institution. Consequently, the norms regulating the transfer of loan portfolios are only one among many other important issues in this area.

[11] Few investors would be willing to contribute with equity without some sort of guarantee that the NGO's portfolio is actually worth what it claims. Consequently, special arrangements would have to be worked out with other investors so they are assured that their contributions are fully matched by the NGO, even in the case the quality/value of the NGO's portfolio turns out to be less than expected.

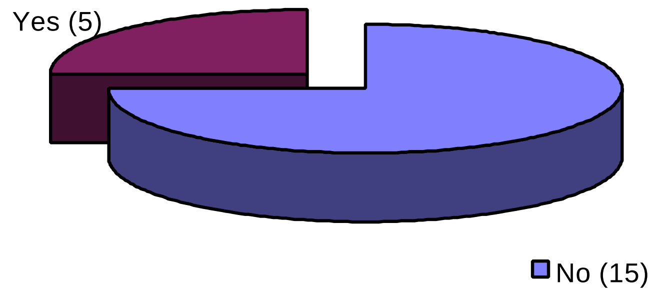
[12] Contrary to popular belief, the initial capitalization of BancoSol was carried out by a cash transfer.

Table 4: Portfolio Assets as Initial Capital?[13]

Country	Portfolio Assets as Initial Capital?
ARGENTINA	No
BARBADOS	No
BELIZE	No
BOLIVIA	Yes
BRAZIL	No
CHILE	No
DOM REPUBLIC	No
ECUADOR	No
EL SALVADOR	Yes
GUATEMALA	No
GUYANA	No
HONDURAS	Yes[14]
MEXICO	No[15]
NICARAGUA	Yes
PANAMA	No
PARAGUAY	No
PERU	No
TRIN & TOBAGO	No
URUGUAY	Yes
VENEZUELA	No

Source: MIC Survey 1997

GRAPH 2 : Portfolio Assets as Initial Capital ?



3.1.3 MICROFINANCE AND INSTITUTIONAL FORM

Traditional banks have generally been reluctant to attend to the microenterprise sector due to a number of factors, including the perception of microentrepreneurs as bad credit risks, the high cost of making small loans relative to the income generated by them, and cultural barriers vis-à-vis the microenterprise sector (Bayadas 1997). In conjunction with this discussion, the question has been raised whether existing institutional forms (commercial banks and finance companies) are appropriate and sufficient to effectively serve the microenterprise sector.

Some countries in the region have already created new types of financial institutions to facilitate the development of microfinance. The most conspicuous examples are the Bolivian Private Financial Funds (FFP) and the Peruvian Entities for the Development of Small and Microenterprises (EDPYME). This paper will point out some of the most salient features of these organizational forms but will not enter into a prolonged discussion of the matter[16].

In Peru the creation of EDPYMEs was authorized in 1994 with the intention of providing an appropriate institutional form for microfinance activities. To date, two institutions of this kind exist. The exact scope and restrictions of the EDPYME institution are not yet well defined and the institutional characteristics are continually elaborated by the superintendency (see table 5).
The Private Financial Fund form in Bolivia was created in 1995 through Decree 24,000. Since Bolivia did not previously have an institutional form equivalent of finance companies, this

[13] Colombia and Costa Rica were part of a trial-run for which the questionnaires did not include this question.
[14] Only until November 16, 1997.
[15] There are precedents (Sociedades de Ahorro y Prestamo) but in general it is not permited.
[16] See Rock and Otero (1996) and Berenbach and Churchill (1997) for more information

institution was partially meant to fill that void (see table 5). However, the FFP was also created to provide a vehicle for those institutions that want to offer financial services to the microenterprise sector in a regulated setting. It appears as if the Bolivian superintendency was successful in creating an appealing institutional form for this purpose: today there are a total of six FFPs, two of which are geared toward microfinance. Furthermore, another three NGOs are currently in the process of conversion into FFPs[17].

Table 5: Comparison of FFP and EDPYME

Areas Of Regulation	FFP	EDPYME
Minimum Capital: Capital Adequacy Ratio: Deposits: Security:	US$ 1 million 10% (10:1) Savings, but not demand deposits Recognizes solidarity groups, movables, and jewelry	US$ 265,000 10% (10:1) Savings deposits, but only after special permission from the superintendency Not defined
Maximum Loan Size:	3% of net capital (US$30,000)	5% of net capital (US$12,500)
Unsecured Credits:	1% of net capital (US$10,000)	Not defined
Foreign Exchange:	Yes	Yes
Other Operating Restrictions:	No trust and foreign trade operations, equities, underwriting, or mutual fund management	Not defined

Source: Rock and Otero 1996; Resolución SBS No. 259-95 (Peru); Decreto Supremo 24,000 (Bolivia)

While Peru and Bolivia are currently the only two countries with new institutions largely designed for microenterprise purposes, it is interesting to note that other countries are following suit in adopting laws that will allow for new types of institutions with similar objectives. Both in Nicaragua and El Salvador reform laws are currently being implemented in this regard.

Box 1: New Financial Institutions Under Way in El Salvador and Nicaragua

EL SALVADOR: "We are currently reforming the law on the Federación de las Cajas de Crédito and Bancos de los Trabajadores, which will permit a new type of financial institution that can take deposits from the public and allocate credit primarily to small businesses."

NICARAGUA: "The recent reforms of the Banking Law recognize the existence of so called Non-Profit Nonbank Financial Entities with shareholder capital, non-profit charter, and a purpose focused on the habitual and massive lending to small and medium sized enterprises." [18]

Source: MIC Survey 1997

The answers to the 1997 MIC survey indicate, however, that superintendencies in the region are generally not too interested in the possibility of creating a new type of institution primarily or

[17] Based on field research carried out in 1997 by Hege Gulli, IDB Microenterprise Unit

[18] These new institutions are permitted to capture deposits from the public and are subject to the general banking laws/norms. However, the reformed law gives the Superintendency some freedom in establishing special norms for these institutions with regard to supervision and regulation (Ley No. 244, Art. 2, 1997).

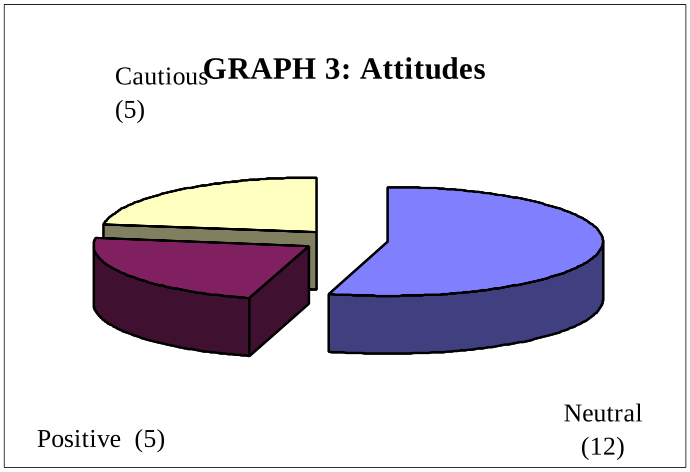
solely for microfinance. While some superintendencies are positive (5 countries), most are either neutral (12 countries), or negative/cautious (5 countries).

Table 6: Policy/Attitude Toward New Types of Financial Institutions

Country	Policy/Attitude?
ARGENTINA	Neutral / No such policy exists
BARBADOS	Neutral
BELIZE	Neutral / No such policy exists
BOLIVIA	Positive
BRAZIL	Neutral / No such policy exists
CHILE	Cautious
COLOMBIA	Neutral / No such policy exists
COSTA RICA	Neutral / No such policy exists
DOM. REP.	Neutral / No such policy exists
ECUADOR	Neutral / No such policy exists
EL SALVADOR	Positive
GUATEMALA	Neutral / No such policy exists
GUYANA	Neutral / No such policy exist
HONDURAS	Cautious
MEXICO	Cautious
NICARAGUA	Positive
PANAMA	Neutral / No such policy exists
PARAGUAY	Cautious
PERU	Positive
TRIN & TOB.	Cautious
URUGUAY	Neutral / No such policy exists
VENEZUELA	Positive, but no such policy exists

Source: MIC Survey 1997

GRAPH 3: Attitudes



3.1.4 OWNERSHIP RESTRICTIONS WITH REGARDS TO FINANCIAL INSTITUTIONS [19]

Ownership restrictions with regards to financial institutions can be a crucial obstacle to the formation of regulated microfinance entities. This is not likely to be an issue in countries which have carried out far-reaching financial reform in the last decade, but it may still pose a problem in some of the countries which have lagged behind or only implemented partial reforms.

In Honduras, for example, institutional ownership of financial institutions is not permitted; only individuals may own stock in a financial institution (Chemonics International 1997). Originally implemented to prevent the laundering of money, this law makes it virtually impossible for microfinance NGOs to become regulated entities. It is not possible, for example, for institutions such as the IDB's Multilateral Investment Fund to make an equity investment in a new incorporated financial institution. Even more serious, not even the NGO *itself* could retain any ownership in the new financial institution. These types of restrictions are obviously a major hindrance to the incorporation of microfinance institutions whose major shareholders will, because of the perceived risks involved, almost certainly be domestic and international institutions committed to the field of microfinance. A similar problem existed in El Salvador where until

[19] The MIC survey did not include questions on this topic.

recently foreign persons or institutions were not allowed to hold majority stakes in local financial institutions (Schmidt and Mommartz 1997).

3.2. CAPITAL ADEQUACY

Capital adequacy standards set limits on the extent to which a financial institution may leverage itself; that is, how high its ratio of assets (which is largely loans) to equity may be. According to the recommendations proposed by the Basle Committee in 1988, which more and more countries are adopting and abiding by, financial institutions are required to maintain a maximum risk-weighted asset-to-equity ratio of 12.5 to 1 or, alternatively stated, a minimum capital adequacy ratio of 8%. To calculate this ratio, assets are weighted in accordance with their risk. The Basle Capital Accord recommends that financial institutions classify assets in five categories and assign risk-weights to each of the categories in the following manner[20]:

Table 7: Basle Committee Recommendations for Asset Classification

Asset Category	Risk Weight
Cash; claims on central governments	0.00
Claims on domestic public sector entities, excluding central governments, and loans guaranteed by such entities	0.10
Claims on multilateral development banks, OECD banks, and non-domestic OECD public sector entities	0.20
Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented	0.50
Claims on (1) the private sector, (2) banks incorporated outside OECD, (3) non-OECD central governments (unless denominated and funded in that currency), (4) premises, plants, equipment, and other fixed assets, (5) real estate and other investments, (6) capital instruments issued by other banks, (7) commercial companies owned by the public sector, (8) all other assets.	1.00

Source: Basle Committee Recommendations, 1988

It should be recognized that the Basle Committee recommendations originally were intended for financial institutions incorporated in OECD countries and operating on an international level. As such, the recommendations may thus be insufficient or even inappropriate for, for example, smaller less diversified local or regional banks operating in Latin America and the Caribbean where the economic environment is more volatile. Furthermore, the Basle Committee recommendation of 8% capital adequacy presumes adequate provisioning practices for delinquent loans, something which is usually less certain among financial institutions in Latin America and the Caribbean.

In spite of these differences, the Basle Committee recommendations have become widely accepted standards for capital adequacy in the region[21]. In fact, many countries in Latin America and the Caribbean require higher minimum ratios of about 10% (table 3) or are in the process of raising

[20] It should be noted that the Basle Recommendations are quite incomplete since they do not consider the covariance of assets. A negative covariance allows two very risky assets, when grouped, to become a much less risky asset.

[21] Only Chile and Paraguay claim that they have not yet adopted the Basle Committee's recommendations (although they do appear to have minimum capital adequacy ratios in excess of the ones stipulated in the Basle Accord). In addition, it would seem that Jamaica has not adopted these recommendations either.

the minimum to those levels. This appears to be a prudent decision given the less stable economic environment compared to OECD countries.

Based on the categories for risk classification provided by the Basle Committee, it is quite clear that loans to microentrepreneurs should be classified in the most risky asset category, together with most other consumer and commercial loans (except those fully secured by mortgages). In this sense, capital adequacy standards are neutral in their effect on microfinance portfolios as compared to traditional portfolios with largely better secured loans.

The MIC Survey confirms that, as expected, microenterprise loans are generally to be classified in the most risky asset category. However, in Ecuador (where there are 9 asset categories from 0.00 to 1.00), and in Bolivia (where there are 6 categories from 0.00 to 2.0) microenterprise loans are not required to be classified in the most risky category. In Ecuador, the superintendency considers it appropriate to classify a microenterprise loan in the next to riskiest asset category (0.90) whereas in Bolivia the Superintendency believes that a microenterprise loan should be classified in the fourth category (1.00; Normal Risk). The effect of this asset classification practice is that microfinance institutions are able to achieve a higher leverage than they would with more conservative asset classification requirements.

In conjunction with this discussion of capital adequacy standards and their effect on microfinance institutions, the case of Argentina should also be mentioned. The Argentine system for establishing risk factors for each asset category is different from all other surveyed countries and depends primarily on two factors: the guarantees backing the loan and the interest rate at which the loan is made (see Box 2).

These two dimensions have been established as proxies for the underlying risk of a loan; nevertheless, the result is that the system de facto biases *against* microfinance. Microfinance is at the extreme end of finance in both these areas: it uses very few real guarantees and interest rates are usually very high to compensate for high lending costs (rather than only risk).

With the exception of Argentina and Mexico, the standards for capital adequacy are identical for all regulated institutions

Box 2: Capital Adequacy in Argentina

In Argentina the calculation of capital adequacy is based on (A) the guarantees and (B) the interest rate charged on the loan. The loan is ranked according to both of these factors and is classified in one of five categories regarding its guarantees and in one of 22 categories regarding its interest rate.

In terms of guarantees, the risk weight schedule goes from 0.00 (more real guarantees/more certain recuperation of loan) to 1.00 (less real guarantees/less certain recuperation of loan), while for interest rates the risk-weight schedule goes from 1.00 (lower interest rate) to 6.00 (higher interest rate). These two schedules together generate a matrix of 110 positions in which each loan is classified.

According to the superintendency, a microenterprise loan (guaranteed only by a personal guarantee) would need to be backed by 11.5%--69% capital, depending on the interest rate charged. Clearly, an overall capital adequacy requirement in anything but the lower end of this range is likely to be excessive and would severely hamper the competitiveness of microfinance institutions.

Source: MIC Survey 1997

within the same country[22].

Due to the various factors mentioned in this section, microfinance institutions in Latin America and the Caribbean should generally be required to maintain a higher capital adequacy than the 8% recommended in the Basle Accord[23]. Not only do they operate in a relatively volatile economic environment, but they are also small institutions whose portfolios have little asset diversification and therefore subject to more volatility than most other financial institutions[24]. Furthermore, higher capital adequacy for microfinance institutions is justified to the extent that they have higher average loan losses than other financial institutions. If an institution's required provisioning on bad loans is continually high relative to the size of its capital base, a bad year could wipe out a large part of the capital of an institution.

However, while it appears reasonable to require microfinance institutions to have a somewhat higher solvency than most other financial institutions, it is important that capital adequacy standards are set at appropriate levels and truly reflect the underlying risk of the assets. Although much is to be said for the importance of institutional solvency, *excessively* strict capital adequacy for microfinance institutions can create problems on other levels: from a social and macroeconomic point of view excessively strict standards will result in less than optimal quantity of financial intermediation; from the point of view of individual institutions, such standards will lower expected returns to equity and thereby reduce private investor interest. Stricter capital adequacy standards are only justified as long as the reduction in risk is equal to or greater than the reduction in expected returns.

Additionally, a practical problem of having different capital adequacy standards for different institutions is that it implicitly assumes that microfinance institutions are of a distinct institutional form, or, at the very least, that the institutions involved in microfinance are specialized enough in their activities to be classified as "microfinance institutions" As has been indicated earlier, however, very few countries have a distinct institutional form for microfinance and most other countries are either reluctant or disinterested in the possibility of creating such an institution. Furthermore, it is becoming more and more common for commercial banks to enter the microenterprise segment, something which further blurs the distinction between what is and what is not a microfinance institution.

There appears to exist three alternative ways of applying varying capital adequacy standards, all of which have their own caveats:

(a) To base capital adequacy on certain proxies of the riskiness of each loan, as is currently done in Argentina. As has been pointed out, however, these proxies may easily bias against institutions with microenterprise loan portfolios.

[22] Mexican Sociedades de Ahorro y Prestamo are required to maintain a capital adequacy ratio of 6%, as compared to 8% for all other regulated financial institutions.

[23] Recommendations on the appropriate capital asset ratio vary, but most suggestion are in the 10-20% range.

[24] It should be noted, however, that many other financial institutions in Latin America and the Caribbean are insufficiently diversified in terms of sector, borrower concentration, type of collateral, or financial product.

(b) To require more capital for all loans below a certain amount. This would implicitly assume that all small loans have identical risk profiles with regards to volatility and sensitivity to disturbances in the economy.

(c) To require small financial institutions to maintain higher capital adequacy than larger institutions. This would recognize the fact that microenterprise portfolios are small in terms of value and have less asset diversification in some or all of the relevant dimensions (sectors, geographical region, collateral forms, financial products, and borrower concentration). It would also, however, subject other small financial institutions without any microenterprise operations to the same standards.

At any rate, to the extent that microfinance institutions *can* be identified and classified as such , it is prudent to hold them to somewhat stricter capital adequacy standards than more extensively diversified financial institutions. Given all the factors mentioned above and the relatively recent appearance of microfinance in a regulated setting, the industry will need to prove itself in a couple of business cycles before capital adequacy requirements are relaxed or brought closer in line with other financial institutions. Additionally, given the transitional problems likely to be experienced in the areas of institutional culture, growth management, and management information systems, an even more conservative ratio could be justified during the initial period of operation.

3.3 PROVISIONING

By provisioning, a financial institution recognizes the losses it can reasonably expect to have in its loan portfolio. Before any provisioning is ever done for specific loans, however, financial institutions are generally required to set aside a so called general provision of 1-3% in anticipation of future loan losses[25]. The general provision is based on the assumption that even current and sound loans have some degree of credit risk. Specific provisions, on the other hand, are based on the nonpayment risk of individual loans, including considerations such as the existence of collateral, guarantees, past repayment history, and days past due (Bascom 1994). Depending on these factors, the financial institution classifies loans in one of several categories (5 in most Latin American countries). The provisioning associated with each category ranges from 0% to 100%. Provisions for specific loans are generally charged against global provision as they occur.

The provisions are registered as a cost in the financial statement of the institution. High levels of provisioning thus significantly impact the bottom line for a financial institution. Furthermore, there is also a fundamental connection between credit risk and asset/liability management in that all asset management relies upon the assets being of good quality and correctly valued (Harrington 1987). If a financial institution has consistently high loan losses/provisioning, it is important that it also have a strong capital base. As already mentioned, the financial health of the institution becomes quite precarious if its yearly provisioning is large relative to its capital base.

3.3.1 PROVISIONING AND MICROFINANCE

Microfinance is a difficult and risky business and few institutions have so far been able to become financially self-sustainable. Compared to financial institutions with traditional client bases, microfinance institutions do generally have more problems with their loan portfolios (Cristen, Rhyne, and Vogel 1994) . At the same time, however, a few microfinance institutions have shown that it is possible to be profitable and keep arrears and loan losses to a minimum.[26]

The issue of provisioning for microenterprise loans can be separated into two basic conceptual parts: (1) if/how microenterprise loans that are *not* in arrears should be provisioned for and (2) how microenterprise loans that *are* in arrears should be provisioned for.

Microenterprise portfolios should, as any other loan portfolios, be subject to global provisions. In a sense then, performing microenterprise loans *are* provisioned for, just as for any other portfolio of loans. Since it is not unreasonable to think that microenterprise loans are more susceptible to a deterioration in the economic environment than loans backed by people of greater financial means, global provisions may need to be higher for microenterprise portfolios than for other portfolios. On the other hand, regulated microfinance has hardly been around long enough to show how microenterprise portfolios are impacted by the ups and downs of a business cycle.
The results from the MIC Survey in table 8 indicate how the superintendencies in the region relate the issues of loan classification and provisioning to the existence of adequate guarantees. In most

[25] According to the MIC Survey, it appears as if only Uruguay does not require financial institutions to establish global provisions. This conclusion is, however, inferred from answers to related questions; the questionnaire did not specifically ask this question.
[26] For example BancoSol and Caja de los Andes in Bolivia

countries the amount of physical collateral is simply deducted from the amount of required provisioning. Some countries, however, have norms and regulations that directly tie the *classification* of non-performing loans to the existence of guarantees (Brazil, El Salvador, Guyana). Finally, in some Latin American and Caribbean countries, the superintendencies would like to see *performing* microenterprise loans provisioned for individually (Nicaragua, Chile, and Dominican Republic).

In principle this is not an incorrect treatment of microenterprise loans since the existence of collateral may be included as one of the factors that determine nonpayment risk. However, this policy appears to be excessively strict given the alternative collateral mechanisms employed by microfinance institutions, the more lenient treatment afforded consumer loans (which are made partly under similar circumstances), and the fact that various microfinance institutions have proven that it is possible to keep arrears and losses for microenterprise portfolios as low as for traditional portfolios.

As can be seen from table 8, only five countries would not classify a typical (performing) microenterprise loan in the highest category: Belize, Dominican Republic, Chile, Cost Rica, and Nicaragua. In the case of Belize this classification does not have any significance in terms of the necessary provisioning (0%). In the other countries, however, microenterprise loans would have to be provisioned for even when fully performing. While the superintendencies in Nicaragua and the Dominican Republic would require 1% provisions for performing microenterprise loans, the Chilean and Costa Rican superintendencies would require provisions of at least 20%. Given the arguments put forward earlier, provisions of 20% seem inappropriate and unjustified.

Table 8: How Guarantees Influence Provisioning

Country	Guarantees Determine Classification of *Performing* Loans	Guarantees Determine Classification of Non-Performing Loans	Guarantees Reduce Provisions for Non-Performing Loans	Appropriate Classification of a Performing Loan to a Microentrepreneur (without physical collateral)
ARGENTINA				A (1%)
BARBADOS				N/A
BELIZE				B (0%)
BOLIVIA				A (0%)
BRAZIL				A (0%)
CHILE				B- (20%) o C (60%)
COLOMBIA				A (0%)
COSTA RICA				C (20%)
DOM. REP.				B (1%)
ECUADOR				A (0%)
EL SALVADOR				A (0%)
GUATEMALA				A (0%)
GUYANA				A (0%)
HONDURAS				A (0%) ó B (0%)
MEXICO				A (0%)
NICARAGUA				B (1%)
PANAMA				A (0%)
PARAGUAY				A (0%)
PERU				A (0%)
TRIN & TOB				A (0%)
URUGUAY				A (0.5%)
VENEZUELA				A (0%)

Source: MIC Survey 1997; **Note:** Although countries use different coding for their categories, for convenience and comparability they are all denominated A, B, C, D and E in this paper. In most cases this renaming is not of any real significance. In Chile, however, the B- has been maintained for reasons of accuracy.

The rules for provisioning outlined in table 8 apply primarily to commercial loans and not necessarily to consumer loans. Many countries allow financial institutions to establish provisions for consumer loans solely based on the number of days past due, without consideration to physical collateral, previous payment history, etc. Furthermore, provisions for consumer loans are usually not required until the loan is at least 30 days past due. Consequently, whether or not microenterprise loans are classified as consumer or commercial loans can be of great importance to microfinance institutions.

In Latin America and the Caribbean loans are usually classified as consumer or commercial loans based either on the amount of the loan or its purpose. When the purpose of the loan determines the classification, consumer loans are those loans that are provided to individuals for the purchase of consumer goods or payment of services. When the size of the loan determines the classification, the amount below which a credit is considered as a consumer loan varies from US$ 3,825 in Honduras to US$ 200,000 in Argentina[27].

[27] In the case of Argentina, loans below US$ 200,000 may be classified as either consumer or commercial.

Table 9: Consumer-Commercial Classification of Loans in Latin America[28]

Country	Purpose	Amount	Other	Comment
ARGENTINA				Loans below US$ 200,000 may be classified either as consumer or commercial loans. The decision regarding classification must be reported to the superintendency.
BARBADOS				Depends on purpose, life of loan, repayment structure
BELIZE				It is up to each individual bank
BOLIVIA				Depends on purpose of loan and nature of end user
BRAZIL				Depends on purpose of loan and nature of end user
CHILE				Loans below US$ 18,333 to individuals for consumption[29]
COLOMBIA				Loans below 300 monthly minimum wages (US$ 51,500) are considered consumer loans. Certain forms of financing (e.g. credit cards) are always considered consumer credit.
COSTA RICA				Depends on purpose of loan and nature of end user, but for provisioning purposes there are special rules for loans below ~US$ 21,000.
DOM REP				Depends on purpose of loan and nature of end user
ECUADOR				Loans below US$ 37,500 are considered consumer loans
EL SALVADOR				Depends on purpose of loan and nature of end user
GUATEMALA				Loans below US$ 7,000 are considered consumer loans
GUYANA				This distinction does not exist.
HONDURAS				Loans below US$3,825 are classified as consumer loans
MEXICO				Microloans are considered commercial loans
NICARAGUA				Loans below US$ 10,000 to individuals for consumption
PANAMA				Depends on purpose of loan and nature of end user
PARAGUAY				Loans below 4% of the minimum capital base for banks (US$ 185,000) and 3% for other institutions are classified in a special category for provisioning purposes.
PERU				Also credit card loans are considered consumer loans
TRIN & TOB				Depends on purpose of loan and nature of end user
URUGUAY				Depends on purpose of loan and nature of end user
VENEZUELA				Depends on purpose of loan and nature of end user
TOTAL	12 (2)	6 (2)	3	

Source: MIC Survey 1997

When the size of the loan determines classification, the choice of how to classify a microenterprise loan is fairly uncomplicated. However, when the purpose and nature of the end user of the credit determines classification, the task becomes more difficult. Since it is virtually impossible to separate many microenterprises from the household economy, the distinction of what constitutes commercial or consumer credit becomes blurred. Consequently, unless there is an explicit policy by the superintendency to consider microenterprise loans as either consumer or commercial credit (which seems to be the case in Mexico; see table 9), individual institutions under the "purpose/end user" system are left with considerable freedom to determine classification, especially for loans to the smallest microenterprise units.

[28] Many countries also have a third classification category for mortgage loans.

[29] As the perceptive reader may have noted, this statement is inconsistent with the previous table where the Chilean superintendency indicated that it would want to see a 20-60% provisioning of a typical microenterprise loan. According to this table, a microenterprise loan would automatically be classified as a consumer loan, and thus only be provisioned for based on days past due.

In some countries there are additional or altogether different criteria for classifying a loan as a consumer or commercial loan; for example, credit cards are automatically considered to be consumer loans in Peru and Colombia[30]. In Belize and Trinidad and Tobago the distinction between commercial and consumer loans either does not exist or is left up to the individual institution to decide. Finally, three countries are especially interesting with regards to loan classification and provisioning: Paraguay, Costa Rica, and Bolivia.

Bolivia has arguably the most knowledgeable supervisory authorities in Latin America and the Caribbean with regards to microfinance. The provisioning schedule that it has established for all small loans (including both commercial and consumer type loans) is relatively complex and uses both the amount of the loan and its term structure to determine appropriate provisions. The smaller the loan and the shorter the term, the higher the provisions in case of delinquency.

Table 10: Provisioning for Small Loans in Bolivia

Days past due	US$5,000--US$20,000[31]	Loan < US$5,000 & loan term > = 1 month	Loan < US$5,000 & loan term < 1 month
1-15	0%	0%	0%
16-30	0%	0%	10%
31-60	10%	10%	50%
61-90	10%	50%	100%
91-120	50%	100%	
121-180	50%		
181-360	100%		

Source: Rock 1996; MIC Survey 1997;

In Paraguay, the Cantral Bank has established a special category for small *commercial* loans below 4% of the minimum capital requirement for commercial banks and 3% for other financial institutions (US$ 185,000 and US$69,000 respectively). Within these quite generous limits, provisioning is determined solely by number of days past due, without obligatory consideration of collateral or other factors as is normal with commercial loans. The provisioning schedule for small commercial loans is itself also quite generous and actually less strict than the provisioning schedule for consumer loans (see table 11).

The Costa Rican Superintendency has created a special provisioning schedule for all commercial and consumer loans below the amount of US$ 21,000[32] and all mortgage loans independent of the amount. As in the case of Bolivia and Paraguay, this provisioning schedule for small loans is based only on days past due. It is not as strict as the one applied in Bolivia, but quite a lot stricter than the one used in Paraguay.

[30] According to Peru's Superintendency, reforms will soon create a special provisioning schedule for small loans.
[31] Guarantees are taken into account for loans larger than US$20,000
[32] 5,000,000 Colones

Table 11: Provisioning for Small Loans in Costa Rica and Paraguay

	COSTA RICA	PARAGUAY	
Days past due	<US$ 21,000	<US$ 185,000 (Banks) <US$69,000 (other inst)	Consumer Loans <US$ 25,000
1-30	0.5%	0%	0%
31-60	1.0%	0%	0%
61-90	20%	1%	1%
91-120	60%	1%	20%
121-180	100%	20%	50%
181-360		50%	100%
361-		100%	

Source: Resolution No. 8, Act. 252, Art. 11 (Paraguay, 1996); Acuerdo SUGEF 1-95 (Costa Rica)

The provisioning schedules in Paraguay, Bolivia, and Costa Rica represent an attempt to deal realistically with the problem of establishing provisions for very small loans. Normally it is neither possible nor worth-while to require physical collateral for loans of this size, and the provisioning schedules have been designed to disregard this factor. Schedules based solely on days past due provide an easy and straightforward way to provision for microenterprise loans. At the same time, it is arguably reasonable to tighten these schedules to compensate for the lack of executable collateral among the borrowers.

This type of approach may represent a second-best answer to a problem that has no perfect solution. Nevertheless, a consumer loan type provisioning schedule based solely on days past due has its weakenesses. Although microenterprise loans resemble consumer loans in many respects, they are nevertheless usually given for some sort of business purpose. Applying a provisioning schedule solely based on days past due ignores this risk and does not take clients' credit history and the overall performance of the specific credit delivery technology into account. Furthermore, in the countries where a normal consumer loan provisioning schedule is applied to microenterprise loans, its generosity makes it possible for microfinance institutions to postpone dealing with a deteriorating portfolio for a considerable period of time. Given the high turnover of microenterprise portfolios, this kind of permissiveness in provisioning schedules could be very damaging to the institution.

3.3.2 AUDIT OF LOAN CLASSIFICATION AND PROVISIONS

In order to make sure that financial institutions maintain adequate provisions, bank superintendencies need to evaluate a certain number of loans in their portfolio and subsequently infer whether or not the provisions established by the institutions are adequate. In this evaluation, the superintendencies will generally use the same criteria as the financial institution in classifying and provisioning for the loans. As mentioned earlier, it is important to microfinance institutions that these criteria include clients' credit history and the performance of the credit delivery technology.

Since it would be not only inefficient but also virtually impossible for superintendencies to evaluate all loans within all financial institutions, there has to be a mechanism by which representative loans are selected and evaluated. This selection mechanism is very important because it can ultimately impact the supply of credit to small and microentrepreneurs. Essentially, superintendencies employ one of two methods when evaluating the adequacy of portfolio classification and provisioning:

1. The evaluation starts with the largest loans and proceeds towards smaller loans until a certain percentage of the value of the portfolio has been examined.

2. The evaluation is based on a sample of loans.

If the provisions calculated in the evaluation are significantly different from those established by the institution, the institution must re-evaluate its portfolio[33].

Often superintendencies selectively choose which institutions to audit based on indicators such as liquidity and solvency of the institutions as well as the perceived risk of their portfolios. Once the institutions to be audited are selected, evaluation approach number one is valuable in that it covers a large portion of the loan portfolio (in terms of value) and provides a decent estimate of the value of its overall risk exposure. According to the MIC Survey, two countries in Latin America and the Caribbean use this approach to monitor provisioning by financial institutions. In Honduras the superintendency is required to evaluate the largest borrowers whose combined assets correspond to 75% of the institution's loan portfolio. In El Salvador, the superintendency is required to examine 30% of the portfolio.

However, approach number one has some serious problems. First, it does not provide a representative sample of the portfolio. Second, this method of selecting loans is only practical as long as a significant portion of the portfolio's value can be covered by evaluating a relatively small number of loans. This does not pose a problem in traditionally oriented financial institutions whose portfolios are usually dominated by a few large borrowers. For microfinance institutions, however, it is an altogether different matter. Imagine the superintendency which, instead of perhaps 50-100 borrowers, has to examine 5,000-10,000 borrowers to reach, say, 30% of the value of a portfolio. This approach is thus clearly impractical when applied to microfinance institutions and prevents their effective supervision.

Evaluation approach number two solves this problem but creates a new one, especially for institutions which have both large and small loans in their portfolio. For sampling to work, it is important that the sample is representative of the portfolio as a whole. This usually requires a random sample[34]. If it is assumed that the number of microenterprise loans in an institution's portfolio exceeds the number of large loans, a random sample is likely to contain more microenterprise loans than large loans. At the same time, however, the value of the microenterprise loans in the sample will only constitute a fraction of the value of the larger loans. This situation can give rise to the following problem:

[33] In some countries, audited institutions are required to re-evaluate only examined loans and may otherwise apply a general provision for loans not examined.
[34] In order to more satisfactorily ensure the representativeness of the loans examined, a *stratified* random sample should be used. This procedure is quite naturally more expensive than just taking a single random sample.

- Assuming that small and large loans are accurately represented in the sample, the resulting provision may nevertheless be misstated if the superintendency uses a straight instead of a weighted average to arrive at the average percentage of provisions. As a quick example shows (see box 3), unless the size of every loan in the sample is taken into account, the superintendency runs the risk of requiring a level of provisions that is too high. Currently, at least two superintendencies in Latin America use straight averages when evaluating the adequacy of provisions (Nicaragua, Peru)[35].

BOX 3: Portfolio Sampling

Imagine that the sample of the superintendency contains 10 loans: 1 large, well-secured loan of US$100,000 and 9 small, unsecured loans of US$1,000 each. Suppose that the appropriate level of provisioning is 20% for the small loans and 0% for the large loan (this would be the case for performing loans in Costa Rica for example).

Using a weighted average, provision of this sample should be: (1*100,000*0%+9*1,000* 20%)/(1*100,000+9*1,000)=**1.65%**

However, if the superintendency used a straight average to calculate required provisions, the result would be the following: (1*0%+9*20%)/10=**18%**

In this case, the size of each loan is not taken into account and the difference with the weighted average is enormous.

This somewhat technical point of provisioning control and sampling is most important for commercial banks and other regulated institutions which are making efforts to reach smaller borrowers. These institutions will, unintentionally, be penalized for trying to expand their services to the microenterprise sector.

[35] A number of other countries also use the sampling method, but the answers to the survey did not specify whether the resulting provision is based on a straight or weighted average (Dominican Republic, Cost Rica, Bolivia)

3.4 COLLATERAL AND JOINT LIABILITY GROUPS

The lack of physical collateral is one of the defining characteristics of microfinance. To compensate for this increase in risk, microfinance institutions have devised other means to assure repayment from borrowers. For example, the use of joint liability groups (solidarity groups) is an important instrument for many microfinance institutions in achieving high repayment rates[36]. Joint liability groups substitute peer pressure for physical collateral and each one of the participants stands to lose both money and future access to credit if the group as a whole cannot meet its obligations.

For most superintendencies, however, the use of joint liability group guarantees is a new and unfamiliar concept which, even when known, is not very highly regarded. The results of the MIC Survey indicate that most superintendencies consider joint liability guarantees to be the equivalent of personal guarantees and, as such, not a very effective form of guarantee since the there are no real assets of significant value behind any of the participants (see table 12 below). Some countries do not know how to classify solidarity group guarantees at all (responding n/a) and only in Bolivia is the concept of solidarity group guarantees recognized in the law.

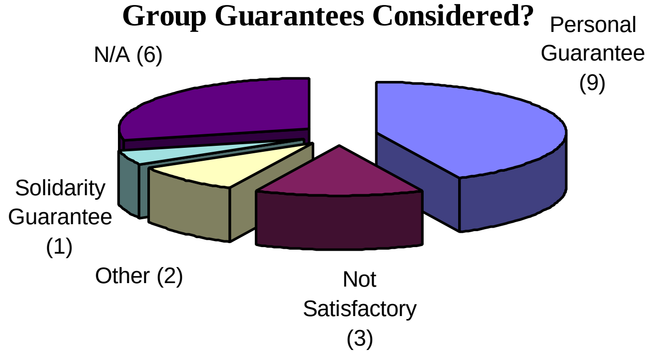
Table 12: Joint Liability Group Guarantees

Country	Type of Guarantee?	Effective Guarantee?
ARGENTINA	Personal Guarantee	The concept does not exist formally
BARBADOS	n/a	No
BELIZE	Personal Guarantee	Yes
BOLIVIA	Solidarity Guarantee (D.S. 24000)	Yes
BRAZIL	Personal Guarantee	No
CHILE	Other	No
COLOMBIA	Not Satisfactory	No
COSTA RICA	n/a	n/a
DOM REP	Not Satisfactory	No
ECUADOR	Real Guarantee[37]	n/a
EL SALVADOR	Other	Facilitates recuperation, but is not effective
GUATEMALA	Personal Guarantee	Depends on selection and follow-up
HONDURAS	Personal Guarantee	No.
MEXICO	Personal Guarantee	No
NICARAGUA	Personal Guarantee	Yes, fairly effective
PANAMA	Personal Guarantee	No
PARAGUAY	Personal Guarantee	As other personal guarantees
PERU	Personal Guarantee / Not Satisfactory	No
TRIN & TOB	n/a	n/a
URUGUAY	Personal Guarantee	No
VENEZUELA	n/a	n/a

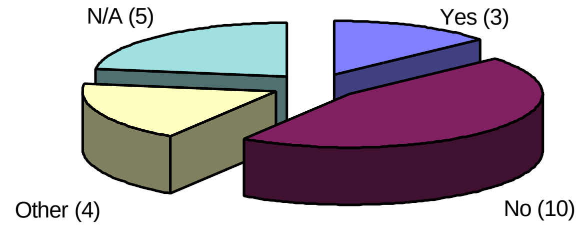
Source: MIC Survey 1997

[36] Institutional design, economic environment, loan size, are of course other relevant factors.
[37] It is likely that this response was given by mistake.

GRAPH 4: How are Joint Liability Group Guarantees Considered?



GRAPH 5: Are Joint Liability Group Guarantees Effective?



There are a number of additional issues related to guarantees and collateral that are very relevant to microfinance institutions. In Bolivia, for example, there is an overall limit on how much uncollateralized credit a regulated financial institution may have in its portfolio (2 times net equity). Clearly, this limit would severely restrict regulated microfinance institutions in Bolivia if it were not for resolution SB 228/93 which exempts bank loans below US$2,000 and loans made by Private Financial Funds below US$500 from this limit (in the case of joint liability groups, this exemption applies to each borrower in the group)[38]. Bolivia is the only country in the region with this kind of overall limit on uncollateralized loans; most countries simply have a single borrower limit for collateralized and uncollateralized loans (usually 20-30% and 10-15% respectively), something which does not affect microfinance institutions.

As mentioned in the beginning of this section, joint liability groups are created to compensate for the lack of collateral and assets among borrowers. However, often it is not lack of collateral per se that precludes its use; instead, the collateral may exist but not be considered acceptable by the financial institution. Due to badly organized and funded property registries it is difficult and expensive for financial institutions to verify the existence, ownership, and the status of collateral. Furthermore, due to inadequate and inefficient judicial systems in many Latin American and Caribbean countries it is also difficult and time-consuming to repossess property that has been offered as a guarantee.

Consequently, the value of any specific collateral must be considerable to justify the explicit and implicit costs associated with its use. For movable collateral, which may be more relevant to small and microentrepreneurs than conventional real estate guarantees, the deficiencies in the property registries and judicial systems are particularly problematic. Improving the framework for secured transactions in general would thus be very beneficial to small businesses and to the microenterprise sector (Fleisig 1994).

[38] See Loubiere, Jacques Trigo. (1995) "Supervision and Regulation of Microfinance Institutions: The Bolivian Experience" for brief discussion on financial regulation related to microfinance in Bolivia.

3.5 USURY LAWS AND INTEREST RATE RESTRICTIONS

Usury laws are usually implemented with the protection of the consumer in mind. By establishing interest rate ceilings, regulators and law makers try to protect unsophisticated clients from being exploited by unscrupulous lenders. Contrary to their intended purpose, however, usury laws often have negative effects on both the financial viability of microfinance institutions and the supply of credit to the microenterprise sector.

Not only do these laws prevent microfinance institutions from charging market clearing interest rates that are high enough to cover the relatively high per unit costs of microfinance, but they also induce financial institutions in general to screen out clients with the highest credit risk. Very often these "least attractive" borrowers are in fact small and microentrepreneurs with no assets to explicitly or implicitly back up their loans. It is also possible that financial institutions find other ways to compensate for their inability to charge market clearing interest rates; closing fees, servicing fees, and discounts from face value of the debt instruments are all common methods to circumvent a restrictive interest rate ceiling (Van Horne 1990). Although small and microentrepreneurs may in this case have access to credit, it will usually be very difficult for them to calculate the real cost of the loan.

Most Latin American and Caribbean countries have since the late 1980s carried out extensive financial reforms, including deregulation of interest rates (Glenn Westley 1995). The results from the MIC Survey indicate, however, that some kind of legal upper limit for interest rates exists in a majority of Latin American and Caribbean countries. If enforced, these usury laws could pose serious obstacles to sustainable microfinance in several countries.

Table 13: Usury Laws and Interest Rate Restrictions

COUNTRY	USURY LAWS & INTEREST RATE RESTRICTIONS
ARGENTINA	Free
BARBADOS	Free
BELIZE	Free
BOLIVIA	3% per month (nominal), applicable to persons and institutions
BRAZIL	12% per year in real terms
CHILE	150% of the average rate of commercial banks
COLOMBIA	Financial institutions: 150% of the average rate of commercial banks
DOM REP	Free
ECUADOR	There are some usury restrictions, but they do not apply to financial institutions
EL SALVADOR	Free
GUATEMALA	Free
GUYANA	Free
HONDURAS	Average rate of commercial banks + 6% (nominal)
MEXICO	Free if there is a contract/agreement; 6% (nominal) if no contract/agreement exists
NICARAGUA	Financial Institutions: Free Individuals and unregulated entities: 150% of the highest rate in the system
PANAMA	2% per month (real/nominal not defined)
PARAGUAY	Financial institutions: 150% of the average rate of commercial banks
PERU	Free
TRIN & TOB	Financial institutions: Free Individuals and unregulated entities: 24% per year (nominal; higher if licensed)
URUGUAY	175% of the Central Bank's average rediscount rate
VENEZUELA	Financial institutions: 4% per month (nominal) Individuals and unregulated entities: Free

Sources: MIC Survey 1997, Martindale Hubbell Law Digest 1996

Usury laws are particularly restrictive in five countries: Brazil, Honduras, Panama, Uruguay, and Bolivia. For the most part, these restrictions seem to originate in old commercial, civil, and penal codes which have not been kept up to date. However, also in countries where usury limits are set by financial and banking laws at 150% of the average commercial bank rate (Chile, Colombia, Paraguay), microfinance institutions may find themselves hard pressed to achieve financial sustainability. Information from Bolivia, which arguably has the most developed microfinance market in the region, shows that the interest rates of microfinance institutions are normally twice as high as those of traditionally oriented financial institutions (~4% vs. ~2% per month)[39].

Box 4: Forced Lending in Costa Rica

In october 1996 Costa Rica adopted a law which requires deposit-taking banks to lend at least the equivalent of 10% of their local currency deposits of 30 days or less to the small and microenterprise sector. Banks are free to do the lending themselves or contract other entities for this purpose. As far as the loans are concerned, however, neither banks nor contracted entities may charge effective interest rates exceeding the Central Bank's deposit rate. According to the Cost Rican Superintendency, these requirements pose a serious dilemma for banks since they cannot profitably lend to the sector at the rate required by law.

Source: MIC Survey 1997; Law No. 25480-H

From the above information it is clear the usury laws in Bolivia are not generally enforced, at least not with respect to institutional lenders. The situation is similar in Panama and Brazil where usury laws of 2% per month and 12% (real terms) per year respectively are not enforced in any significant manner; in the case of Panama it is not even defined whether the 2% are in nominal or real terms[40]. In Honduras, where the usury restriction of 6% above average was retained in the new 1997 penal code, it is not clear to what extent it applies to financial institutions. At any rate it is not enforced[41].

However, interest rate restrictions in Uruguay (175% of the Central Bank's rediscount rate) and Venezuela (4% per month in nominal terms) *are* enforced and are creating problems for financial institutions that need to charge high interest rates[42]. Consumer lending in Uruguay, for example, is currently dominated by unregulated credit card companies which are not bound by the interest rate restriction applied to regulated banks and finance companies. Under these circumstances it would naturally be extremely difficult for regulated financial institutions to serve the microenterprise sector. Although institutions may sometimes be able to get around this type of restrictions by charging higher commissions and fees than they otherwise would, interest ceilings are, if enforced, one of the most important obstacles facing microfinance.

[39] Based on field research carried out by Hege Gulli (IDB Microenterprise Unit) during August of 1997
[40] Ricardo Reyes, IDB Representation, Panama; Roberto Correia Lima, IDB Representation, Brazil
[41] Olga Patricia Falck, IDB Representation, Honduras
[42] Alfredo Echegaray, IDB Representation, Uruguay; Miguel Taborga, IDB Microenterprise Unit

3.6 LOAN DOCUMENTATION REQUIREMENTS

In traditional regulatory and supervisory practices, loan documentation requested of borrowers is designed to ensure the reliability of collateral and the financial stability of the borrower. It is thus an important component of prudent banking practice. For commercial loans, financial institutions request documentation that will verify the client's identity, the financial status of the business, its assets, and the viability of the activities to be undertaken. More concretely, the borrower may be required to submit proof of identity/bylaws of enterprise, registration with tax authorities and/or the business registry, balance sheets and financial statements, information on existing liens, and so forth. In addition, financial institutions generally try to obtain the credit history of the applicant through credit bureaus, if such institutions exist in the country.

Large formal sector companies will have few problems in complying with these loan documentation requirements; however, for small and microenterprises it will often be nearly impossible. Many microentrepreneurs do not keep books or pay taxes on a regular basis, and the enterprise may not even be formally registered. Furthermore, loan documentation requirements have many times been used to establish the *worth* of the client rather than the viability of the activities to be undertaken with the loan (Bascom 1994). In microfinance, however, the viability of the activities to be undertaken with the loan quite naturally becomes the principal basis for credit decisions since microentrepreneurs usually lack collateral. To the extent that microfinance institutions try to establish some sort of guarantee of repayment, they usually rely heavily on personal references, guarantee structures such as joint liability groups, and information about the borrower's character (rather than on collateral). Consequently, not only are microentrepreneurs unable to provide many of the aforementioned documents, but these documents are also many times of secondary importance in microfinance credit decisions.

Consumer loans normally require less documentation and analysis than commercial loans. The underlying rational for this distinction is that repayment of consumer loans is intended to be made out of existing assets or a reliable flow of income, not be dependent upon the success of some inherently uncertain business venture. As a result, in some instances it is enough to have a regular salary to receive a consumer loan; other times consumer credit decisions are based on so-called credit scoring models whereby the financial institution uses various personal and professional attributes of the borrower to estimate credit worthiness[43].

Consequently, in countries where microenterprise loans are classified as consumer loans, financial institutions are likely to have more freedom in determining what kind of documentation it should request from its small borrowers. As has been pointed out already, this flexibility is needed. In order to also make documentation requirements for commercial loans more flexible, laws and regulations should not explicitly detail the requirements but let financial institutions themselves determine what sort of documentation they should request from loan applicants (as long as repayment capacity can be satisfactorily established). Currently, financial institutions are free to do so in at least 8 Latin American countries. In the majority of Latin American countries, however, financial institutions are required to obey certain specific minimum standards in regard to loan documentation (see table 13 and graph 6 below).

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[43] Variables could include age, education, gender, home ownership, employment condition, marital status, etc

A few countries with specific mandatory minimum documentation requirements have made the requirements more flexible for small borrowers. This is the case in for example Bolivia and Paraguay (Box 5). Also in Uruguay are financial institutions allowed to be flexible in requesting documents from small borrowers as long as the institutions obtain sufficient information to evaluate the borrowers repayment capacity. In Brazil, loans under US$ 15,560 are allowed to have more flexible arrangements in terms of guarantees (i.e. it is easier to use various types of personal guarantees), which diminishes documentation requirements.

BOX 5: Loan Documentation Requirements in Bolivia and Paraguay

Bolivia
In Bolivia there are special guidelines for evaluating individuals that intend to borrow the equivalent of US$20,000 or less.

For salaried people, financial institutions may use their salary as the only indicator to determine repayment capacity. In the case where a fixed salary is not the principal source of income, the financial institution has to consider the assets, debts, and cash flow of the applicant's "socioeconomic unit" (i.e. business and/or household). However, when loan terms do not vary from those of previous loans and the borrower has a good repayment record, the financial institution is permitted to forego a new evaluation of the borrower's payment capacity.
Resolution SB No. 062/94, Art. 11, 1994

Paraguay
Small commercial loans are in Paraguay defined as those smaller than 4% of the minimum capital requirement for banks (~US$ 185,000) and 3% for other financial institutions (~US$ 69,000). For commercial loans below this amount, financial institutions need only to request/keep the following minimum information:

(1) Proof of identity
(2) The use and terms of the credit
(3) Sworn statement of assets of borrower and guarantor
(4) Source of income of borrower
(5) Proof of constitution/registration of business (*informe judicial y comercial*)
Resolution No. 8, Acta 252, Art. 11, 1996

Another potential obstacle related to documentation requirements is the need to have certain legal documents/contracts notarized. For microlending, where the usefulness of documentation is limited to begin with, notarization requirements will only add to the cost of each loan. Since notarization is used to verify the authenticity of documents, it is normally left to the banks themselves to decide whether they want to require it and for which documents. However, while this freedom appears to be the norm in the region, some countries in Latin America and the Caribbean do require by law that loan documentation be notarized.

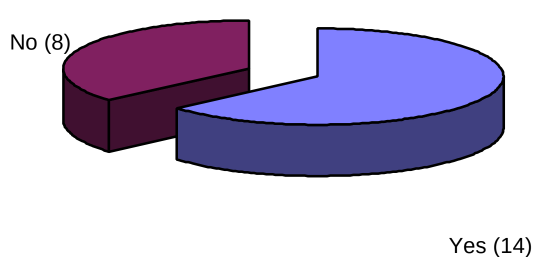
According to the MIC Survey, Bolivia, Ecuador, Guatemala, Mexico, Panama, and Trinidad and Tobago impose this type of requirement. The notary fees are high in Bolivia and Guatemala (US$ 20 and US$25-40 respectively), but even in countries such as Panama where the fee is lower (US$5.20 each for borrower and lender), the fee may constitute a significant cost since microenterprise loans are usually turned over several times per year.

Table 14: Documentation Requirements

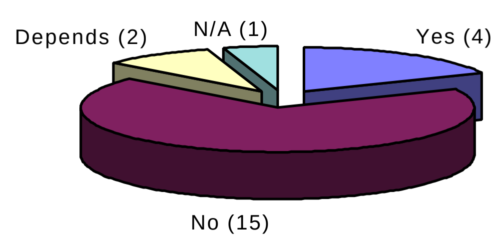
Country	Documentation specified by Law?	Special requirements for small borrowers?	Notarization of documents required?	Cost of Notarization
ARGENTINA	Yes	No	No	N/A
BARBADOS	No	N/A	No	N/A
BELIZE	No	N/A	No	N/A
BOLIVIA	Yes	Yes	Yes	US$ 20
BRAZIL	No	Yes	No	N/A
CHILE	No	N/A	No	N/A
COLOMBIA	Yes	No	N/A	N/A
COSTA RICA	Yes	No	N/A	N/A
DOM. REP	No	N/A	No	N/A
ECUADOR	Yes	No	Yes	US$ 1.25
EL SALVADOR	Yes	No	No	N/A
GUATEMALA	Yes	No	Yes, most documents	US$ 25-40[44]
GUYANA	Yes	No	No	N/A
HONDURAS	Yes	No	No	N/A
MEXICO	Yes	No	Depends on type of credit and guarantees	Depends on contract value, no. of pages, and no. of signatories
NICARAGUA	No	N/A	No	N/A
PANAMA	No	No	Yes	US$ 5.20
PARAGUAY	Yes	Yes.	No	N/A
PERU	Yes	No		
TRIN & TOB.	Yes	No	Yes, if any part of document needs to be registered as Deed[45]	US$ 0.50
URUGUAY	Yes	Yes	No	N/A
VENEZUELA	No	N/A	No	N/A

Source: MIC Survey 1997

GRAPH 6: Documentation Specified By Law?



GRAPH 7: Notarization Required By Law?



[44] Dependent upon the amount in the contract and the authorized fee schedule.

[45] In this case an Affidavit or Declaration of due execution of the document must be sworn to in the presence of a Commissioner of Affidavit.

3.7 OPERATIONAL RESTRICTIONS

Since low-income people have limited possibility to travel long distances or carry out their transactions electronically, microfinance institutions need to have branch offices within close distance of the communities they serve. At the same time as microfinance institutions are dependent upon branch offices to reach their clients (especially for purposes of savings mobilization), the client base in the community may not economically justify the presence of a branch office that is open 5 days per week, 8 hours per day, and offer a whole range of sophisticated services. An extensive branch system implies considerable fixed costs and microfinance institutions need flexibility in adapting operations and services to a level that is appropriate for the communities they serve[46].

In most Latin American countries, however, financial institutions are limited in their flexibility with regards to services and branch opening hours. There are limits on minimum and maximum hours per day, days per week, and hours of the day. Minimum limits are generally more common than maximum limits (see table 15). Additionally, in many countries institutions are restricted from opening on weekends or evenings, something which may be particularly convenient for self-employed people who work long days and often find it hard to leave their workplace during normal banking hours.

Table 15: Regulation of Opening Hours

Country	Not Regulated	Moderately Regulated	Narrowly Regulated
ARGENTINA			
BARBADOS			
BELIZE			
BOLIVIA		min 5 d/w & min 7.5 h/d	
BRAZIL		max 5 d/w & min 5 h/d	
CHILE		exactly 5 d/w & min 5 h/d	
COLOMBIA		min 28 h/w of which min 15 h/w between 8am-6pm.	
COSTA RICA			exactly 5-6 d/w & 8am-5pm
DOM. REP		Min 5 d/w & exactly 7 h/d	
ECUADOR		min 5 d/w & min 6 h/d	
EL SALVADOR		min 5 d/w & min 8 h/d only between 9am-4pm	
GUATEMALA			
GUYANA			
HONDURAS			exactly 5 d/w & 8 h/d
MEXICO		min 5d/w & min 4.5 h/d	
NICARAGUA		min 8 h/d & exactly 5 d/w	
PANAMA			exactly 5 d/w & 5 h/d
PARAGUAY			exactly 5 d/w & 3.5 h/d only between 8:45am-12:15pm
PERU			exactly 5 d/w & 6 h/d
TRIN & TOB			
URUGUAY		min 5 d/w & min 4 h/d	
VENEZUELA			exactly 5 d/w & 8h/d until 5:30

Source: 1997 MIC Survey

[46] This type of regulations posed a problem for BancoSol at the time of its incorporation as it could not justify a five day per week and eight hour per day presence in many areas with low initial demand.

In order to lower administrative costs and reach their target population, it is also important for microfinance institutions to be able to employ innovative and less expensive credit delivery methods ("platforms") than conventional branch offices. These platforms could, for example, include mobile banking units or limited service offices. As table 16 shows, most countries in Latin America do permit financial institutions to use some form of alternative platform to reach certain target populations. In some countries (Guatemala, Colombia, Belize, Nicaragua) financial institutions are entirely free to employ whatever platform they see fit in order to reach and serve their clients.

Table 16: Alternative Methods of Offering Financial Services to the Microenterprise Sector

Country	Financial Service Delivery Systems
ARGENTINA	(1) Non-operative offices (basically for marketing purposes), (2) branch offices with limited range of services, (3) small branch offices in companies, (4) ATM machines
BARBADOS	It is up to each individual bank, but will require prior approval of the Central Bank
BELIZE	It is up to each individual bank. Currently one bank is introducing mobile offices.
BOLIVIA	Yes, limited service branch offices. All such platforms much be explicitly and individually improved by the superintendency.
BRAZIL	Temporary offices which may be located in fairs and the like for no more than 90 days.
CHILE	Auxiliary offices authorized explicitly and individually by the superintendency
COLOMBIA	There are no restriction. Financial institutions are free to employ mobile units and limited branch offices as they like, as long as these are not exclusively geared to a certain group.
COSTA RICA	There are no financial institutions that use mobile units or limited service branch offices.
DOM. REP	It is permitted and there are several types of limited service offices in use.
ECUADOR	In certain instances, e.g. at fairs, financial institutions put up temporary limited service offices.
EL SALVADOR	Automated Teller Machines
GUATEMALA	Financial institutions have a lot of freedom in this area. Some banks currently use limited service offices to reach their clients.
GUYANA	Mobile deposit units
HONDURAS	Home visits
MEXICO	Only certain services and forms of operations are authorized.
NICARAGUA	There are no restrictions in this area.
PANAMA	No such platforms exist
PARAGUAY	Very rarely used and authorized only on a case by case basis.
TRIN & TOB	Mobile office and limited service branch offices are permitted.
URUGUAY	There is no specific regulation in this area.
VENEZUELA	No such platforms exist

Source: MIC Survey 1997

4. CONCLUSIONS AND RECOMMENDATIONS

As was mentioned in the introduction, the fundamental purpose of financial regulations is to promote effective and efficient capital accumulation and resource allocation while maintaining the safety and soundness of financial institutions that take deposits from the public. Furthermore, supervision must also aim to strike a balance between maintaining solvency for the protection of the system and allowing banks to adopt the innovations needed to remain competitive.

As has been pointed out in this paper, there are many instances in which generally applied financial regulation is not entirely appropriate for institutions lending to small and microentrepreneurs. While supervision should be strict in terms of capital, management controls and portfolio quality, efforts may need to be made to assure that regulators understand and take into account the differences among different classes of borrowers and the technologies employed to reach these borrowers. For example, often regulators do not allow sufficient flexibility with regard to collateral requirements, documentation, legal procedures vis-à-vis past due borrowers, branch hours, or alternative methods of offering financial services.

Recent discussions about financial regulation and microfinance have included the issue of whether countries should reform existing laws or create new forms of financial institutions in order to encourage microfinance activities. As this paper has shown, that discussion is somewhat misguided because the solution depends on the problem. The creation of a new type of institution may be an attractive alternative in countries where minimum capital requirements are high and the authorities do not wish to lower them. In other countries it is not institution-specific issues that cause problems, but rather generally applicable financial regulations (e.g. capital adequacy standards, documentation and provisioning requirements, interest rate ceilings etc.). In these cases, the creation of new institutions will not be a very effective measure to encourage microfinance.

In fact, in spite of the excitement caused by the creation of new financial entities such as Private Financial Funds in Bolivia and Entities for the Development of Small and Microenterprises in Peru, much of the potential to reach small and microentrepreneurs remain with existing banks and other regulated financial entities. Given their existing physical and institutional infrastructure as well as their access to savings, they are generally well positioned to expand into this segment of the market. In order for this to happen, however, *it must be profitable,* something which in the end can only be achieved by increasing the income or reducing the cost/risk associated with microfinance. An appropriate regulatory framework will permit regulated entities to do both.

The previous sections have shown that there are some important legal and regulatory considerations in several Latin American countries as far as microfinance is concerned. At the same time, there are few countries where regulations and norms are consistently biased against microfinance activities and institutions. However, this is far from saying that the region's legal and regulatory frameworks are conducive to or encouraging of microfinance activities. Based on the results of the MIC survey, it is possible to identify potential problem areas in almost every country in the region (see table 17). Without on-site inspections and more in-depth diagnostic studies, however, it is difficult to know how serious these obstacles/problems really are.

Table 17: Potential Problem Areas by Country

Country	Min. Capital/ Incorporation	Capital Adequacy	Loan Classification and Provisioning	Audit and Control of Loan Portfolio	Interest Rates	Documen Notarizati
ARGENTINA	High min. capital req. for banks and finance companies	Risk-weights based on interest rate and guarantee				
BARBADOS						
BELIZE						
BOLIVIA					Restrictive ceiling	Notarizatio and expens
BRAZIL					Restrictive ceiling	
CHILE			Provisioning for performing loans		Restrictive ceiling	
COLOMBIA	High min. capital req. for banks				Restrictive ceiling	
COSTA RICA			Provisioning for performing loans			
DOM. REP						
ECUADOR						Notarizatio
EL SALVADOR				Inappropriate portfolio evaluation method		
GUATEMALA						Notarizatio and expens
GUYANA						
HONDURAS	Inst. ownership not permitted			Inappropriate portfolio evaluation method	Restrictive ceiling	
JAMAICA						
MEXICO						Notarizatio
NICARAGUA				Inappropriate portfolio evaluation method		
PANAMA						Notarizatio
PARAGUAY						
PERU				Inappropriate portfolio evaluation method		
TRIN. & TOB						
URUGUAY					Restrictive ceiling	
VENEZUELA					Restrictive policy	

In spite of the complexities and country-specific features of regulation, it is nevertheless possible to set forth some basic policy recommendations based on the discussions in this paper. These recommendations, while specifically suggested to improve the regulatory environment for microfinance, should ultimately be evaluated and judged in the context of the entire financial system of the country. It is important that reforms to improve the situation of microfinance do not cause problems in other areas or destabilize the financial system as a whole.

Entry Requirements: Minimum capital requirements should not be too high and superintendencies should consider the possibility of permitting NGOs to use the net present value of a carefully evaluated and provisioned loan portfolio as part of the initial capital requirement for a new incorporated entity. Furthermore, there should be no sweeping restrictions on share-holders which prevent domestic and international organizations from taking an equity stake in financial institutions.

Capital Adequacy: The risk-weighting of assets should be based upon appropriate proxies of risk. The broad categories of asset classification set out in the Basle Accord and currently applied in most countries are imperfect approximations of underlying risk, but they do not automatically bias against microfinance. Specific proxies of risk such as interest rates and the existence of guarantees, while not unrelated to the underlying risk of a loan, are also far from perfect indicators. However, in the case of microfinance, where the interest rate is a reflection of high per unit costs as much as risk, this type of proxies create an unjustified bias against microfinance. Other possible methods of applying stricter capital adequacy standards to microenterprise loans would be to subject either all small loans or all small institutions under a certain limit to such requirements. Both of these methods have their own set of problems.

Regardless of what method is used to measure the underlying risk of assets, it is arguably appropriate to somehow hold microfinance institutions to somewhat stricter capital adequacy requirements than most other deposit-taking institutions. The limited asset diversification of microfinance institutions generally makes them more vulnerable to economic disturbances and therefore justifies a higher capital adequacy ratio. Additionally, given the challenges likely to arise in the areas of institutional culture, management information systems and growth management, it would seem appropriate to make capital adequacy requirements for microfinance institutions even more strict in the initial stages of operation. With time, the capital adequacy requirement could be brought in line with other institutions (or at least lowered) contingent upon successful evaluation(s) by the bank superintendency.

Loan Classification and Provisioning: A few countries have created special provisioning schedules for small loans that are not dependent upon the existence of physical collateral. Since it is often not feasible or cost-effective to require collateral for microenterprise loans, it would arguably be desireable to have provisioning rules that take this situation into account. A schedule based solely on days past due provides a simple and straightforward means to provision for microenterprise loans, and may represent second-best answer to a problem that has no perfect solution. At the same time, however, the lack of collateral and the short term structure of microenterprise loans would make it seem appropriate that these sort of schedules are stricter than the normal commercial and consumer loan provisioning schedules.

Auditing and Control of Loan Classification and Provisioning: Stratified random samples should be used to select which loans should be evaluated and a weighted average should be used to arrive at the appropriate level of provision for the sample as a group. The practice of evaluating the largest borrowers until their collective loan amount exceeds a certain percentage of the entire loan portfolio is not a feasible procedure for financial institutions involved in microfinance.

Guarantees/Collateral: Joint liability groups and other microfinance technologies have proven relatively effective in lowering delinquency and therefore merits recognition in the regulatory framework. Alternative methods of securing loans (other than physical collateral) and ensuring repayment should be given consideration in evaluating clients and provisioning for loans. Financial institutions should be free to base their credit decisions primarily on clients' repayment capacity rather than the existence of physical collateral. It is also important to facilitate the use of movable collateral through reforms in the property registries and the judicial systems.

Usury Laws: Usury laws that restrict the ability of microfinance institutions to charge sufficiently high interest rates to clear the market and cover their costs should be repealed, raised, or modified. At a very minimum, the applicability of usury restrictions (supervised institutions vs. unregulated entities vs. individuals) should be clarified and brought in line with financial and banking laws in the country. In general, a competitive and transparent financial sector coupled with good supervision will go a long way to prevent usury.

Loan Documentation and Notarization: Regulations regarding the loan documents to be requested of the borrower should be phrased in a manner that emphasizes their purpose (to verify payment capacity) rather than specifying in detail the documents that financial institutions need to request. Notarization should normally not be required by law but left to the discretion of each individual financial institution.

Operational Restrictions: Microfinance institutions must be able to adapt credit delivery methods to the local economic and demographic environment. Consequently, the regulatory framework must be flexible in terms of branch opening hours and alternative methods of delivering financial services (e.g. mobile units and limited service offices).

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ANNEX I:
Questions Included in Questionnaire Sent to Bank Supervisory Authorities

NOTE: In the actual questionnaire many of these question came accompanied by a short description/explanation (see question 2 for example); however, for the most part these explanations have not been included in this annex since they would add another few pages to this list.

INCORPORATION AND SUPERVISION

1. Which first-floor institutions does the Superintendency regulate and supervise? Please indicate the number of institutions supervised.

2. What criteria does the Superintendency use to chose which institutions to supervise when it does not have sufficient resources to supervise all financial institutions? *(Expl: Some Latin American countries require the Superintendency to supervise Credit Unions. However, due to the large number of such institutions it is often necessary to have some criteria for choosing which institutions should be supervised. In Ecuador, for example, the Superintendency is required to supervise credit unions with more than US$600,000 in assets.)*

3. What is your policy with regards to the possibility of creating a new financial institution especially suited for microfinance purposes? (Ex: EDPYMES in Peru and Private Financial Funds in Bolivia)

4. If a non-governmental organization wish convert itself into a regulated financial institution, can it use its loan portfolio (net of liabilities) as part of the initial capital needed to establish the new institution?

5. What are the minimum capital requirements for the various financial institutions in your country?

CAPITAL ADEQUACY

6. Does your country apply the guidelines established in the Basle Accord 1988 (the norm that financial entities should maintain a ratio between equity and risk-weighted assets of 0.08)?

7. Please indicate the risk categories for assets and the corresponding risk factors applied in your country to weight these assets.

8. What is the minimum ratio between equity and risk-weighted assets that each type of regulated entity is required to maintain?

9. According to your best estimate, in which risk category should a US1,000 loan to a microentrepreneur be classified, assuming that the loan has no real guarantees (only personal) and that the loan is <u>not</u> past due?

PROVISIONING

10. How is the distinction between commercial and consumer loans made?

11. Please detail the provisioning schedule applied to commercial and consumer loans in your country.

12. Are there any norms that regulate how the relation between the amount of real guarantees and the loan amount should determine the risk classification for provisioning purposes?

13. What other norms determine the classification and provisioning of a loan? *(e.g.: credit history, size of loan, repayment capacity etc. If there exists a formula to determine the provision, please explain how it works)*

14. According to your best estimate, in which risk category should a US1,000 loan to a microentrepreneur be classified, assuming that the loan has no real guarantees (only personal) and that the loan is <u>not</u> past due?

15. Are there any norms that facilitate the evaluation of the loan portfolio for the purpose of provisioning (e.g. use of samples instead of complete evaluation)?

16. When/if, during an audit, the Superintendency takes a sample of loans to determine the global provisions of a bank, does the Superintendency use a simple or weighted average to calculate the appropriate level of provisions?

COLLATERAL AND GUARANTEES

17. What percentage of credit through the private financial system is guaranteed by personal guarantees, real estate, and movable collateral (respectively)?

18. Are financial institutions limited in how much credit they can provide without having real guarantees to secure the loans?

19. If such a rule exist, is there any exception for small loans?

20. When/if a joint liability/solidarity group is used to guarantee a loan, how should this type of arrangement be considered?

21. According to your experience, does the Superintendency the joint liability/solidarity group arrangement to be an effective guarantee mechanism?

RESERVE REQUIREMENTS

22. Are there different reserve requirement for different institutions in your country? If so, what are they?

USURY LAWS AND INTEREST RATE CEILINGS

23. Given the usury laws in your country, what is the maximum interest rate that lenders can charge?

ADMINISTRATIVE AND OPERATING REQUIREMENTS

24. What kind of documents are financial institutions legally required to request of borrowers?

25. Are there any special norms that allow smaller loans to receive a different treatment?

26. Must loan documentation be notarized?

27. If so, how much does it cost for a typical microenterprise loan?

28. If notarization is required, is it usually complied with?

29. What are the limits in regard to the operating hours of bank branch offices?

30. Do current regulation permit a bank to limit its opening hours to two days per week?

31. What different “platforms” are financial institutions permitted to use in their intent to reach small and microentrepreneurs?

CREDIT BUREAU SYSTEM

32. How many credit bureaus exist in your country?

33. Who manages them?

34. Which institutions are not permitted to participate in these credit bureaus?

35. Are there any alternative credit bureau systems for those institutions not permitted to participate in the credit bureau(s) mentioned previously?

35. What is the minimum amount (if any) registered in the credit bureau system?

36. Are there any plans to change the access or minimum amount registered in the credit bureau system?

The United Nations Economic Commission for Latin America and the Caribbean, known as ECLAC, UNECLAC or in Spanish and Portuguese CEPAL, is a United Nations regional commission to encourage economic cooperation. ECLAC includes 46 member States (20 in Latin America, 13 in the Caribbean and 13 from outside the region), and 13 associate members which are various non-independent territories, associated island countries and a commonwealth in the Caribbean. ECLAC publishes statistics covering the countries This study presents a general overview of financial inclusion in Latin America and the Caribbean. I employ data for the three dimensions: access, use and quality, which outline a complete picture of the nature and characteristics of financial inclusion in the region.Â MarÃa JosÃ© Roa GarcÃa, 2015. "Financial Inclusion in Latin America and the Caribbean: Access, Usage and Quality," Documentos de InvestigaciÃ³n - Research Papers 19, Centro de Estudios Monetarios Latinoamericanos, CEMLA. Handle: RePEc:cml:docinv:19. as.Â "The Economics of Microfinance, Second Edition," MIT Press Books, The MIT Press, edition 2, volume 1, number 0262513986. Rajdeep Sengupta & Craig P. Aubuchon, 2008.