NEW CHALLENGES IN MICROFINANCE: THE IMPORTANCE OF REGULATION

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ABSTRACT

In the last years microfinance emerged as an important instrument to relieve poverty in the developing countries, as well as in Western economies. The set of microfinance services provided by microfinance institutions (MFIs) rapidly increased, the sustainability of microfinance programmes received a great deal of attention, and therefore the complexity in managing MFIs increased too. At the same time, the typology of institutions that offer microfinance services became wider, including NGOs, but also commercial banks and specialised microfinance banks.

Since at present MFIs begin to offer a more complex set of services and the sustainability becomes an important variable also for donors, in order to assess the microfinance institutions to finance, a need for some kind of regulation is arising.

This paper analyses the different approaches in supervision and regulation of microfinance institutions, pointing out the most significant pros and cons in regulating those MFIs not yet regulated and highlighting the possible alternatives about how to regulate.

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1. INTRODUCTION

In the last years microfinance has become a very important instrument for facing poverty worldwide and promoting the growth of small and very small enterprises. The vast majority of International Organisations involved in fighting poverty are now conscious of the usefulness of microfinance in rapidly improving life conditions of the beneficiaries of microcredits and other financial services. Therefore, the number of microfinance projects increased quickly in developing countries as well as in more developed Western countries and the intermediaries involved in these projects has become increasingly diversified.

In the light of above, microfinance is ceasing to be a sort of informal "movement" and it is more and more becoming a segment of the financial industry, which in some countries includes formal financial intermediaries too. The enlargement of the set of services provided by different kind of actors involved in microfinance is highlighting the importance of regulating microfinance industry; at the same time, the process of expansion of microfinance services and the capability of microfinance institutions (MFIs) to reach as many people as possible, which is a fundamental feature of microfinance, is threatened in some contexts by the lack of an adequate regulation on microfinance. As a consequence, in some cases MFIs operate in a shadow area, in absence of a clear legal and regulatory framework.

On the other hand, the environment in which some microfinance projects are based and the countries where some MFIs are located are sometimes so precarious that the weakness or the absence of microfinance regulation could appear as a secondary aspect in limiting the microfinance expansion.

Despite it is not possible to imagine a single microfinance regulatory framework suitable for deeply different countries located in all the continents, this paper tries to focus on the possible guidelines that could animate a debate about the opportunity to regulate microfinance as well as how to perform such regulation, in order to foster the expansion and the sustainability of this new financial approach to poverty.

The relevance of the issue of regulating microfinance is highlighted in the paper using the example of Argentina, where the mix of a diffuse mistrust towards banking system after 2001 crisis and the lack of an adequate microfinance regulation reduce the capability of saving agents to finance investment in local enterprises.

As regards methodological aspects, this paper does not describe the different approaches of microfinance regulation adopted worldwide – with the exception of Argentinean case study – neither analyses the wide set of regulatory instruments already introduced, which cannot be properly understood leaving out of consideration a wider analysis of different domestic legal environments, to be conducted in further studies.

The paper is structured as follows. In section 2 we describe the evolution of microfinance industry in last years, highlighting the distinctive features of those who supply and demand microfinance services. Section 3 analyses the technical features of microfinance, especially focusing on microcredit, while section 4 is dedicated to studying the source of funding for MFIs. Section 5 extends the analysis to the typical risk in microfinance. Section 6 focuses on the role of regulation in microfinance development, pointing out the different criteria to consider in order to decide how to regulate. Section 7 deals with the importance of an adequate regulatory framework presenting Argentinean case study. Finally, section 8 offers some concluding remarks on the regulatory hypothesis of microfinance.

2. MICROFINANCE INDUSTRY: AN OVERVIEW

The expression "microfinance" identifies the supply of financial services – often "microcredits" - to poor people in order to finance very small businesses that produce a return by which the life quality of the producer and of its family is improved. Microfinance is an essential part of the overall financial system in a large number of countries, providing crucial services to thousands of communities lacking access to the formal financial sector. Even if there are no official features regarding microfinance and microcredit, it is estimated that there are about 7,000 MFIs in the world, which offer financial services to millions of people[1]. Due to the importance of microfinance as an instrument that can rapidly improve the life conditions of poor people, The United Nations fixed the objective to reach with microfinance services 100 million of families in 2005.

The definition of microfinance is not unique, because the borders of this activity depend on the different geographic areas in which these services are provided - given a relative geographically different concept of poverty - as well as on a different interest of traditional financial intermediaries to do business with marginal producers. Sometimes the distinction between

[1] For a general overview see Calderon (2002), p. 23. More recent data about microfinance in a sample of countries are collected from World Bank and made available by Meagher (2002), p. 45; particularly, microfinance clientele vary from 8-9 million in Bangladesh to 23 million in Indonesia, while total microfinance portfolio reached $ 1.6 billion in South Africa and $ 1.04 billion in Philippines.

microfinance and "traditional" finance is used as a synonym of "finance to informal sector" and "finance to formal firms"; even if a significant number of micro-firms financed by MFIs are part of the informal sector, nevertheless there is the case of registered companies that incur in difficulties to access to traditional financial intermediaries, while they are accepted as clients of MFIs only. Vice versa, the case of formal financial intermediaries that provide financial services to informal firms is surely unusual.

The supply of financial services to micro-firms is performed by 4 kind of institutions usually classified as MFIs. These are: non-governmental organisations (NGOs), which offer microfinance services; credit unions and similar mutual banks, which provide credit and other financial services to their members; microfinance banks, specialised in working with micro-firms; commercial banks that have designed specific downscaled services[2]. The above-mentioned typologies of MFIs are often distinguished according to their goals; therefore, beside institutions having philanthropic or mutual objectives, such as NGOs or credit unions, there are other more profit-oriented organisations that have decided to enter into microfinance business after a risk and return analysis. These entities, despite having different goals, are attracted towards microfinance market due to the unwillingness of traditional financial intermediaries to lend to marginal producers, often working in informal fields.

Following another taxonomy based on the structure of the liability side of their balance sheets, microfinance institutions are also distinguished among entities which depend on other people's money to finance their lending

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[2] In order to deepen the MFIs' classification criteria see Foster, S., S. Greene and J. Pytkowska (2003).

business, institutions that use member's money and MFIs that utilise the public's money in order to finance microloans[3].

The main reasons why formal financial institutions are not interested in working with informal producers could be identified in the supposed higher risk of these producers, in the lack of any form of guarantees, in the higher level of administrative cost per loan compared to the lent amount and, more generally, in the inadequacy of their procedures and models which are used for formal firms. Whatever is the reason why a MFI decides to offer microfinance services, all the authors agree on the necessity of a microfinance programme to be financially sustainable in the medium and long term. In other words, it means that even if the start-up of a microfinance project could be subsidised by donors (i.e. International Organisations or governments), the economic and financial equilibrium of the projects themselves and of MFIs that perform these projects has to be guaranteed by cash flow, as it happens for traditional intermediaries.

Due to the good financial performance of some MFIs and the rapid wealth improvement of some beneficiaries of microfinance initiatives, during the Eighties and Nineties several International Organisations preferred to finance the start-up of some microcredit programmes instead of pure aid programmes to be addressed to the governments. One of the reason underlying this choice was the higher commitment of the programmes beneficiaries to implement more productive activities in order to repay the

[3] This taxonomy is presented in Van Greuning, H., J. Gallardo, B. Randhawa (1999) and in Staschen (1999).

microloans. It has been proved that the commitment to repay the microcredits pushes the borrowers towards higher return investments[4].

On the demand side, the typical beneficiary of a microcredit project is an informal producer - often located in a developing country and unable to access the formal financial system - in need of a small amount of money in order to buy raw materials that would be transformed in marketable goods. Even if these kind of producers adopt obsolete technology in order to perform their products, they would be able to produce items that could significantly ameliorate their living standards, both by selling them or by using them for own consumption. Nevertheless, the difficulties in funding their activities seriously limit their ability to make sellable goods and, sometimes, these micro-producers are forced to demand funds to usurers (Table 1).

Table 1. Distinctive features of microfinance

Microfinance suppliers	**Source of funds**	**Services offered**	**Microfinance demanders' characteristics**
- NGOs	- Other people's money	- Microcredit	- Small "unbankable" producers
- Credit Unions	- Member's money	- Microleasing	- Lack of guarantees
- Microfinance banks	- Public's money	- Microinsurance	- Low income
- Commercial banks		- Deposits	

Source: Own compilation.

[4] On the importance of repayment as a commitment to better economic and financial performance see Yunus (2003) and Calderon (2002).

Due to the often unsatisfied demand of funding, in different periods the vast majority of countries tried to expand the borders of the financial industry in order to contact those people and firms so far “unbanked”; accordingly, in a significant number of developing countries microfinance business has achieved a quite large outreach, that poses questions concerning the overall financial stability and suggests the regulators to somehow include these activities in the regulatory framework.

Moreover, beside microcredits, in the last years some MFIs started to offer a more diversified set of services. The direction towards which microfinance is expanding is the supply of microleasing and microinsurance services, as well as time deposits and demand deposits. It goes without saying that as far as a MFI provides such services, several risks arise and it appears necessary that authorities should control this portion of financial market.

However, microfinance is a peculiar activity according to client’s characteristics, lending methodology and institutional structure; therefore, it is not always useful to extend to MFIs the rules that are designed for traditional financial intermediaries and, in some circumstances, microfinance requires a specific regulation and supervision. The direction that should also be taken into consideration in order to develop a specific regulation for microfinance in developing countries regards the increasing attention, especially of international donors, to self sustainability of microfinance projects and institutions; at the same time, the introduction of a regulation should not constitute a limit to microfinance industry innovation and development, and should be designed considering costs and benefits of regulating and supervising.

3. THE TECHNICAL FEATURES OF MICROFINANCE

In order to identify the most suitable options about how to regulate MFIs, first it is advisable to focus on the distinctive features of microfinance, highlighting the peculiarities compared to formal financial sector. In this section the analysis is mostly developed by concentrating the attention on microcredit, which is, to date, the most significant microfinance activity. Despite microfinance presents different geographical characteristics, as well as different lending technologies according to the nature of the institutions that do so, it is useful to identify the most typical aspect of microfinance business.

Microfinance services usually consist in small amount loans with short – term maturity, mostly oriented to finance working capital (but also longer-term plants), repaid in very short-term instalments (weekly, monthly, but also daily), to poor people with lack of collateral to offer (Table 2). These microcredits are characterised, in many developing countries, by a higher repayment rate than the one in formal financial sector.

Due to the scarce financial culture of borrowers, it is always the MFI that contacts them locally, mainly through a net of credit officers which go to their customers in rural or urban areas. The capability of credit officers to identify those producers that have the ability to use microloans in order to improve their micro-firms, which are therefore more likely to reimburse the credit, is a fundamental issue in the success of any microfinance project. Sometimes, representatives of MFIs provide for borrowers training sessions and offer technical assistance regarding how to increase the productivity of their investments by using the assigned sums.

In the light of above, the operational costs for MFIs concerning these ancillary activities are higher, if compared to traditional financial intermediaries, as higher are the average operational costs per loan or per deposit amount. Nevertheless, the strong presence on the territory of credit officers, the familiarity with their clients and the training sessions represent a crucial aspect to be implemented for the success of a microfinance programme and of a MFI. Such approach originates a highly decentralised organisational structure, with credit officers that have a wide discretional power about who to finance; it makes it also difficult to implement effective internal auditing procedures.

Another peculiar feature in deciding to whom money can be lent is probably that qualitative evaluations concerning the borrowers are more important than quantitative ones in order to assess their credit worthiness[5]. In fact, the usual analysis tools based on cash flow of the borrower and on its assets are useless in case of informal producers or in the case that the eligible firm has a very simplified accountancy. Therefore, it could appear more useful for regulators to evaluate the overall credit methodology.

Due to the lack of collateral, the most common instruments of credit risk mitigation are solidary groups. These are self selected groups of about 4-5 borrowers that are jointly obliged to reimburse all members' microcredits; in case one of the members of the group does not repay his loan, the others member of the solidary group are called to pay it[6]. The past experience regarding implementation of microfinance programmes has demonstrated that solidary groups work better as a commitment to repay the microcredits in

[5] On the trade-off between quantitative and qualitative analysis as well as on regulatory tools see Staschen (2003).

those countries or areas where the "social pressure" deriving from the membership of a group is deeper. It usually happens in rural areas, in which the local communities are closer.

The vast majority of microfinance programmes allow borrowers that have punctually reimbursed their loans in the past to have access to higher amounts of microcredits; in this way, people that are not used to have relationships with financial intermediaries become accustomed to respect the maturity of their duties and to schedule their cash flow coherently with their liabilities.

Given the high level of operational costs of screening, monitoring and sometimes training the borrowers, MFIs are forced to fix a higher level of interest rates, in order to make the microfinance programme sustainable in the medium and long period. Some policymakers are concerned that the necessarily high interest rates for microfinance would politically be considered unreasonable, but international experience has shown that interest rates are secondary to microborrowers compared to the assured access to repeat loans.

[6] On the functioning of solidary groups see Yunus (2003).

2. Technical features of microcredits

Features	*Commonly chosen solutions*
Amount lent	Small sums, but increasing amounts when the previous credits has been repaid punctually.
Maturity	Short-term maturity.
Repayment	Monthly, weekly or daily instalments.
Screening	Based on the nature of the borrowers' activity as well as on the knowledge of them.
Monitoring	Performed by credit officers which usually follow the community of the borrowers.
Guarantees	Lack of usual collateral; solidary groups.
Interest rates	Higher or similar to the formal sector.

Source: own compilation.

4. THE SOURCE OF FUNDING FOR MICROFINANCE INSTITUTIONS

Microfinance institutions are usually financed in different ways, according to their nature. While NGOs mostly use donors' funds (basically provided by International Institutions, governments or foundations) in order to set up microfinance initiatives, other typologies of institutions offer microcredits and other microfinance services by utilising member's funds and public's money.

However, for the purpose to reach a vast number of clients, to improve the set of services provided and to better manage the risk, MFIs are now conscious of the importance to go beyond donors' funds, attracting private capital and collecting savings. In fact, several studies have also demonstrated how poor people are able to save, but then they prefer to keep their money outside financial intermediaries or to buy goods which could be consumed in the future[7]. Such approach deducts potentially useful resources from the financial intermediation circuit, which alternatively could be addressed to more productive initiatives.

The opportunity to take deposits is for MFIs one of the most debated issues at the moment. In case MFIs would collect savings, it is possible to identify some pros and cons. As to the danger of collecting deposits, there is the risk that depositors could loose their savings in case of default of the MFIs; more generally, it is possible to identify a typical agency problem, where depositors are the principal and the MFI is the agent that could venture on riskier businesses. Furthermore, the low diversification of microloans on MFIs' asset side increases the concentration risk for depositors. On the other hand, in some countries the risk related to agency problem is mitigated by deposit insurance schemes and lender-of-last-resort facilities. Anyhow, it is opportune to remember that alternatively micro-depositors would invest their savings in a very concentrate business, that is their own micro enterprise, if they would not deposit their savings in a MFI.

If commercially well mobilised, savings guarantee a greater potential for the institutional and services expansion with less dependency on the vagaries of donor funding; by collecting savings MFIs could dispose of funds for providing services more continuously, so it would be important to facilitate the collection of savings from these institutions. Moreover, several studies

[7] See Calderon (2002), p.60.

proved that the institutions which provide saving facilities to their customers have to face less frauds than those that do not offer these services[8]. Also for this reason the role of regulators could be very useful in order to create a suitable environment to develop this function.

However, once a MFI begins to collect savings, among its members or the public, under the vast majority of jurisdictions it is obliged to assume the formal structure of a financial intermediary, also being regulated by banking laws. In a few cases, a specific regulation designed for MFIs that also collect deposit has recently been implemented[9]. Although the collection of deposits represents a frontier for the sustainability of microfinance Institutions and it is a further useful instrument for the poor people that are the beneficiaries of the microfinance initiatives, it is opportune to highlight that offering both deposits and credits increases the complexity of managing MFIs, imposes a review of the organisational scheme of these institutions due to the need of deeper internal and external controls, and expose the financial system to higher risks.

Therefore, the regulators' interest in financial intermediation is not only limited to depositor protection, but should also consider the institutional sustainability and the overall risk of the system. On the other hand, an effective regulation has to maintain a valuable service quality, but also ensure the implementation of internal mechanisms for an efficient risk management of MFIs.

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[8] See Calderon (2002), p. 62.

[9] It is, for instance, the case of Ethiopia and Uganda. For an overview on a selected sample of countries see, among others, Meagher (2002) and Staschen (2003).

5. THE TYPICAL RISK IN MICROFINANCE

Similarly to traditional financial intermediaries, MFIs are exposed to several risks too[10]. First of all, the most typical risk faced by any entity that offers credit under different technical forms is credit risk. Under credit risk profile, MFIs are characterised by a high concentration towards a relatively homogeneous clientele, given that customers are usually concentrated in the same geographic areas or run similar businesses. Moreover, the cost of debt collection per loan amount is, on average, higher than in formal intermediation. Last, in the vast majority of developing countries lending moratoria are very difficult, so MFIs had to identify other alternatives in order to maintain a satisfactory portfolio quality.

As mentioned before, the most used techniques for mitigating credit risk are represented by the social pressure of solidary groups and by the incentives from the promise to access to subsequent loans; as far as the overall portfolio concerns, a higher degree of diversification can be reached by financing small firms located in different geographical areas or involved in different economic activities. Nevertheless, due to the importance for MFIs to be very close to their customers, the achievement of a higher portfolio diversification implies a wide net of credit officers and branches on the territory, that also biggest institutions can have. In the light of above, it is possible to identify a spur to market concentration, sustained by the research of a better risk diversification, that incentives the entering into microfinance market of commercial banks or the constitution of specialised microfinance

[10] For an overview on the risk profile of MFIs see Staschen (1999), p. 9 and Hanning, A., E. Katimbo-Mugwanya (1999), p. 7.

banks[11]. It is the case to underline again how, despite the lack of collateral and the endogenous fragility of micro-firms that are customers of microfinance projects, repayment rate is usually higher than those of formal financial institutions operating in the same geographic area.

A second source of risk for MFIs is represented by interest rate risk; it can be significant in the case of MFIs that collect deposits too, due to the average higher interest rate volatility in most of developing countries; for credit-only microfinance institutions, which do not pay any interest on their funding, this risk appears to be more limited. In those countries where an interest ceiling is legally specified MFIs are forced to consider this further variable in their credit policy.

Similarly to interest rate risk, also liquidity risk appears more significant for deposit-taking MFIs; in fact, since small savers tend to make frequent withdrawals and deposits, managing liquidity could become more difficult. For credit-only institutions liquidity management seems easier, because the overwhelming majority of microcredits are offered according to a pre-scheduled repayment plan. Nevertheless, also this kind of institutions can incur in liquidity shortage in the eventuality of donors' funds delayed payment[12]. Strictly related to this issue, a further source of risk for MFIs is the high dependency on donors' funds as well as the lack of diversification both in funding and in lending.

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[11] An incentive to market concentration is motivated also from economies of scale in collecting and processing information. On this point see Diamond (1984).

[12] As underlined by Staschen (1999), liquidity difficulties on a MFI can affect also its credit risk profile because the access to subsequent loan represents a crucial incentive for borrowers to repay their instalments on time.

In all those cases where MFIs are not profit-oriented institutions, but pursue a mutual goal, also ownership and governance risk is particularly significant. This risk concerns the weakness in internal control systems, which play a particular role especially in case of lack of external regulation. Given the decentralised nature of microfinance, an effective information system for the management is crucial in order to prevent crises and misuse of funds[13]; internal controls are important because badly managed microfinance portfolios can deteriorate rapidly. Moreover, given the lending technology used by a significant number of MFIs, based on the personal ability of credit officers, the quality, the motivation and the training of these people can make the difference in credit portfolio risk.

No external supervision can compensate the absence of "real" owners with strong interests in the long-term sustainability and profitability of their MFIs. The culture of controls is often absent in MFIs, especially in NGOs. When owners in the customary sense are absent, incentives to achieve a solid financial performance may be weak, while socially motivated objectives may orient operations. However, in the last years an incentive to implement effective internal control mechanisms is coming more and more from donors, which usually assess also this profile in order to decide which MFI to finance.

For those institutions that also collect savings, there is a risk for depositors to loose their savings in case of difficulties of the MFI; the nature of depositors as the less informed agent usually induces authorities to impose to those institutions which offer deposits to implement the organisation of a formal financial intermediary, also respecting minimum capital requirements

[13] The role of information systems and financial transparency in microfinance industry is deepened by the Consultive Group to Assist the Poorest in several papers and notes

and solvency ratios imposed on commercial banks. Strictly related to the issue of deposits, another source of risk may arise from the participation of MFIs in the payment system, due to higher systemic risk. Those institutions that can collect savings and time deposit only (not demand deposits) appear less risky, because they mismatch to a lower extent and have limited connections to other formal institutions through payment system.

In order to reduce the systemic risk, in some contexts limitations of the geographic areas in which a MFI can operate has been considered viable, as to reduce the dimension of the institution and therefore its relative dimension compare to the whole financial system.

6. THE ROLE OF REGULATION IN MICROFINANCE DEVELOPMENT

According to the literature concerning financial regulation, it is often stated that a market or its segment has to be regulated in the eventuality that it could not achieve an efficient equilibrium autonomously[14]. The goals of regulators are to increase efficiency in capital allocation, to implement effective risk management procedures and to protect less informed parties that enter into a financial contract. These abstract concepts are translated, in all the financial systems, in a set of rules concerning the structure of the financial industry itself, the prudential regulation of intermediaries and markets and the level of transparency and disclosure. Moreover, under this complex set of rules, lies the consciousness of the presence of informative asymmetries, due to which in some financial contracts one party has less

available on CGAP web site (www.cgap.org).

[14] See, among others, Goodhart, et al. (1998).

information than the other one; therefore, in order to preserve the rights of the less informed party and to allow him to take conscious decisions, a supervision on financial system is implemented in all the countries.

As to microfinance, in order to reach effectiveness in relieving poverty by creating a safer environment for economic development, the main goal of microfinance regulators is to ensure the soundness of MFIs and the quality of the services that they provide. Beside these objectives, a peculiar consideration for microfinance institutions concerns their capability to attract donor's and public's funds for financing microfinance; in some contexts the lack of a clear regulatory structure of MFIs – based on preventive and protective instruments – as well as the inadequacy of the general legal environment, determine, *ceteris paribus*, a difficulty for MFIs located in some countries to attract funds[15]. In presence of appropriate regulatory schemes and of a reasonable supervision on MFIs, a greater amount of money could be addressed to those economic initiatives that, as mentioned before, produce recovery rates higher than the traditional financial sector and can rapidly improve the life conditions of a huge number of people.

The analysis of the most suitable regulation and supervision to implement for microfinance should be developed considering four main criteria (Table 3). First aspect to analyse is the assessment of systemic risk deriving from microfinance. It depends on the development of the industry in the country, on the industry's age and on the volumes intermediated by MFIs in the financial system. Second decisive factor which orients if and how to regulate MFIs is the typology of activity carried out by MFIs; particularly, the most

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

sensitive distinction is among credit-only institutions, entities that collect savings and intermediaries which provide other financial services not included in traditional intermediation. Third criterion to take into account is the origin of funds utilised in order to provide microfinance services. Under this profile, there are different interests to be preserved in case the MFIs use public's sums, donor's funds or member's savings. Last aspect to consider is the nature of MFIs to somehow regulate, analysing institutions that have different legal structures, governance, target clients and goals (distinguished, for descriptive reasons, in NGOs, credit unions, microfinance banks and downscaling commercial banks), which must be treated according to the various approaches.

As far as the first criterion is concerned, until microfinance used to be a marginal phenomenon that involved a few credit-only NGOs and a small number of beneficiaries, there was no need to think about the opportunity to regulate, because regulation and supervision are expensive public goods. Moreover, in some developing countries, it is more likely that these goods are involved in a host of principal-agent failure such as corruption, which often make vain any attempt to supervise microfinance institutions[16]. Given their nature of expensive public goods, regulation and supervision should be used in the areas with the highest payoffs in terms of systemic risk mitigation.

According to the literature and to the experiences of the past years, in the vast majority of countries microfinance does not create systemic risk, given the small amount of loans and the very limited access to the payment system of MFIs, where it exists; therefore, in all the countries where the systemic

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

relevance of microfinance is limited, a vast number of authors agree on a soft regulation, essentially based on public registration (licensing), or suggest the implementation of self-regulation schemes and second-tier regulation (delegated regulation)[17].

Also the development of the industry in the country and the volumes intermediated by MFIs in the financial system affect the decision about how to regulate and the instruments to adopt. Particularly, the need to design a specific regulatory framework for microfinance institutions is especially felt in the countries where those institutions are significant actors in the financial market; otherwise, the most common solution that is adopted is to regulate under Banking Law those entities which collect deposits and offer loans, whereas credit-only organisations are often in a shadow area, without any explicit regulation or supervision[18].

According to second criterion, the choices about regulation and supervision are based on the nature of the activities that are performed by microfinance entities. All the institutions that provide credits as a unique financial service are characterised by a very low contribution to the overall systemic risk. Therefore, they are often not regulated even if some countries require from them transparency standards and the control of unfair practices (so called "conduct of business" reporting). Of course, whenever a MFI does not limit its activity to credit supply, but collects savings, and sometimes offers payment instruments, the institution is almost everywhere forced to be

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

converted in a regulated entity (commonly a bank), or assumes the status of "microfinance bank" where a specific regulation exists. Such conversion, as obvious, implies the respect of all entry requirements, of minimum capital requirements and prudential ratios, as well as of periodical reporting. Last, for those institutions which offer other financial services, it seems opportune to adopt a regulatory approach similar to credit-only institutions, if the only peculiarity is represented by the lending methodology; on the other hand, the MFIs which intend to provide more complex financial service than the traditional financial intermediation, a specific regulation is strongly recommended.

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

As regards the third criterion, in the light of above the most suitable approach of the ideal regulation to adopt must be diversified according to the

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

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

Last criterion here approached concerns the nature of MFIs, where the distinction usually performed regards non-governmental organisations, credit unions (and other mutual credit entities), downscaling commercial banks and microfinance banks. The most significant aspects to deepen of the nature of MFIs and their regulation are legal structures, the borders of their activities and their internal organisation. As mentioned before, as far as NGOs operate as credit-only institutions they need a very limited attention from regulators; in all the cases where NGOs begin to offer savings facilities they are required to assume a different legal status, with a well defined capital in order to calculate prudential ratios and to implement internal control functions. These institutions, therefore, should then be regulated coherently with their new nature. Credit unions and microfinance banks, considering their deposit-taking nature, but also their difficulties in rising capital and their goal of sustainability, have to be regulated by a specific set of rules which prescribe less stringent capital requirements and an easier organisational structure than banks. Last, downgrading commercial banks, which by definition are fully regulated banks according to the national “Banking Law”, do not seem to need particular requirements if compared to other banks, because they go on performing not only microfinance services; therefore, in most countries they continue to be supervised and regulated as usual banks.

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

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

Table 3. Four criteria for MFIs' regulation

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

Source: Own compilation.

7. THE SHAPE OF MICROFINANCE INDUSTRY AND THE REGULATORY ENVIRONMENT: THE CASE OF ARGENTINA

Argentina discovered microfinance quite recently. Due to its economic weakness during the Nineties, which culminated with a financial crisis, currency devaluation and bank run in 2001, a significant number of people lost their bank deposits and suddenly become "unbankable" in order to apply for a loan. As a consequence, millions of people ceased to deposit their savings in commercial banks, taking away from formal financial circuits a considerable percentage of the national wealth[19].

Given the rapid increase of poverty after 2001 crisis, the use of microfinance as an instrument for fostering the economy augmented rapidly, as well as microfinance initiatives all over the country. In last years, small and informal producers, often without any collateral, could obtain funds only from NGOs and other associations – both not regulated - involved in microfinance, whereas formal banking system reduced its lending business. In Argentina, however, NGOs and mutual associations are not allowed to collect deposits according to "Banking Law", therefore the credits they can supply to smaller firms are insufficient, while a significant percentage of domestic savings does not contribute practically to finance investments[20]. This evident market failure was, to some extent, caused by the presence of too strict capital requirements demanded by "Banking Law" for constituting a regular financial entity.

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[19] Despite there are no official features on the amount of money maintained outside Argentinean banking system it seems that several US$ billions are still hoarded in different forms. For an overview on Argentinean crisis see Gervasoni (2002).

[20] We indicate as "Banking Law" the Law n. 21,526 which regulates banking system.

The credit crunch for smaller producers is also motivated by the absence of local cooperative banks (that we can here define “credit societies”), which have been cancelled from military dictatorship in the late Seventies. In order to facilitate the access to funding for marginal producers and to aid microfinance development, Argentinean Parliament in October 2003 approved a law (Law 25,782) which reintroduces credit societies; on 6th August 2004 Argentinean Central Bank communicated the regulation for actuating the above-mentioned Law. These credit societies are cooperative banks which can operate with one office only, without branches, so that they can only lend in the same geographical area where people save.

The minimum capital required to these societies varies from 100,000 to 1 million pesos, according to the region where are located; at the same time, banks can operate with a minimum capital of 15 million pesos[21]. Associated people of credit societies, which have to subscribe a minimum capital of 200 pesos, cannot own individually more than 5% of the capital. These credit societies, supervised by the central bank, must respect solvency ratios as well as limits on credit concentration and make opportune credit provisioning and write-offs; they can also collect small deposits (not higher than 12,000 pesos each), which are subject to deposit insurance regulation, and provide short-term microcredits (maximum 50,000 pesos each).

Despite these microfinance banks have been designed for a target of clients that are not “the poorest of the poor”, the above described is a typical example of how a specific regulation for MFIs, which impose less severe

[21] Given an exchange rate of 3 to 1 between peso and US dollar, 100,000 pesos are about 33,000 USD. The regulation that carries into effect the Law 25,782 (called “Comunication “A” 4183” of Argentinean Central Bank) is available on central bank’s web site (www.bcra.gov.ar).

requirements compared to commercial banks, can concretely aid the marginal producers and savers to have again a role in the financial system.

At the same time, Argentinean government is working on a project of implementation of non-banks financial entities, which could only operate in their own geographic region and would be regulated by a specific section of the Treasury Department.

8. CONCLUSIONS

Due to the significant differences existing at international level in microfinance industry, it is not possible to imagine a single regulatory environment suitable for various countries. Among others, four peculiar aspects – contribution to systemic risk, typology of activity, origin of funds and nature of MFIs - arise as more significant in order to select regulatory options. The analysis of the above-mentioned criteria first highlights the risks that affect MFIs and their clients, then proposes how regulators and authorities in charge of financial stability could face these potential risks.

Moreover, given the youth of microfinance market, there are no consolidated best practices tested during financial crises. Therefore, the decision about how to build an effective regulatory environment does not only depend on the authorities' interpretation of supposed commonly used practices, but also on the wider set of priorities in the economical and legal fields, as well as on the peculiar nature of microfinance service providers in the country.

However, in recent years the regulation of microfinance has become more and more an issue not only related to financial stability and to customer protection, but also a feature to consider for microfinance market growth. In fact, on one hand donors are always more careful to finance those institutions which can better achieve the goal of sustaining economic initiatives in a safer environment. On the other hand, it has been highlighted that a significant foster to microfinance can derive from the capability of MFIs to collect public's fund; in order to do that, a regulation that contributes to assure depositors can represent an indispensable instrument.

Also for these reasons, the designing of microfinance regulation in many countries has been conducted with the aid of the biggest International Organisations which usually address money to microfinance.

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