APEC ECONOMIC OUTLOOK SYMPOSIUM
REGULATORY AND SUPERVISORY TRENDS IN MICRO-BANKING
EXAMINING SOME EXPERIENCES IN THE PHILIPPINES AND IN LATIN AMERICA

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Resumen
Este documento provee algunas respuestas a la discusión respecto a la formulación de un adecuado marco regulatorio para las microfinanzas. Asimismo busca precisar los principios subyacentes en esta discusión, en particular los siguientes: a) Por diversas razones, las agencias gubernamentales que regulan a bancos y otras instituciones que captan depósitos encuentran difícil asumir la responsabilidad de regular las instituciones microfinancieras que no captan depósitos; b) la estrategia de “simplemente decir no” nos constituye la mejor respuesta a las presiones a favor de una regulación provenientes tanto de los donantes internacionales como de las propias instituciones microfinancieras, en cambio, lo recomendable es fomentar la transparencia para facilitar la toma de decisiones según criterios de mercado; y c) generalmente, los enfoques tradicionales ni son efectivos ni eficientes cuando se trata de regular a las instituciones captadoras de depósitos involucradas en microfinanzas; por ello, no se necesita una regulación especializada (que podría fragmentar los mercados financieros) sino la implementación gradual de un esquema de supervisión del riesgo según los estándares de Basilea. Para investigar esta realidad, este documento se sostiene en las experiencias de Filipinas y en algunos países latinoamericanos, especialmente el caso peruano. Finalmente, este trabajo busca las razones por las cuales los bancos se mantienen al margen de las microfinanzas a pesar de su potencial para convertirse en los principales proveedores de servicios microfinancieros y si además, el cambio hacia una supervisión del riesgo ayudará al desarrollo de este potencial.

Abstract
The present paper attempts to provide some answers to questions that need to be addressed in thinking about an appropriate regulatory environment for micro-finance. It also attempts to be clear in its underlying precepts, three in particular: a) regulatory agencies for banks and other deposit-taking institutions will likely find it problematic for a variety of reasons to become involved with regulating micro-finance institutions that do not take deposits; b) nonetheless, a “just say no approach” is not likely to be an optimal response to pressures for regulation from international donor agencies and micro-finance institutions themselves, and what is recommended here is the alternative of transparency to facilitate market-based decisions; and c) traditional approaches to regulation are unlikely to be either effective or efficient in dealing with deposit-taking institutions that become significantly involved in micro-finance; what is required is not specialized regulation, which will further fragment financial markets, but rather a more thorough-going implementation of risk-based supervision – something already mandated by Basel standards. To investigate this reality the paper draws heavily on regulatory experiences in the Philippines and in some Latin American countries, especially Peru. Finally, the paper asks why banks still remain largely on the margin of micro-finance, despite their potential almost everywhere to become the predominate providers of micro-financial services, and whether moving more fully to risk-based supervision might help to unlock this potential.

1 I would like to thank my IMCC colleagues who have contributed so much to my work on various projects involving micro-finance and its regulation, and especially Tom Fitzgerald with whom I have co-authored several papers on risk-based supervision and micro-finance. I would like to thank at least equally the donor agencies that have supported this work, in particular the United States Agency for International Development, the World Bank, the Asian Development Bank and the Inter-American Development Bank.
I. INTRODUCTION

The present paper attempts to provide some answers to seven questions that need to be addressed in thinking about an appropriate regulatory environment for micro-finance. It also attempts to be clear in its underlying precepts, three in particular: (1) regulatory agencies for banks and other deposit-taking institutions will likely find it problematic for a variety of reasons to become involved with regulating micro-finance institutions that do not take deposits; (2) nonetheless, a “just say no approach” is not likely to be an optimal response to pressures for regulation from international donor agencies and micro-finance institutions themselves, and what is recommended here is the alternative of transparency to facilitate market-based decisions; and (3) traditional approaches to regulation are unlikely to be either effective or efficient in dealing with deposit-taking institutions that become significantly involved in micro-finance; what is required is not specialized regulation, which will further fragment financial markets, but rather a more thorough-going implementation of risk-based supervision – something already mandated by Basle standards.

While these precepts may be relatively simple and straightforward, albeit controversial to some, in the reality of implementation there are numerous complexities. To investigate this reality the paper draws heavily on regulatory experiences in the Philippines and in some Latin American countries, especially Peru. These experiences show that even defining what it means to take deposits from the general public is not necessarily simple, especially in the case of credit cooperatives. It points out that just achieving transparency provides a challenge beginning with the implementation of standardized accounting and performance indicators, followed by the promotion of auditing and perhaps rating agencies. Other major themes include: the importance of credit bureaus, not only to reduce the costs of information for micro-lenders but also to avoid multiple borrowing such as occurred in Bolivia and affected banks as well as micro-lenders; the special challenges of micro-finance in rural areas; and the importance of basing capital requirements on the riskiness of activities and the capacities to manage these risks. Perhaps most importantly the paper asks why banks still remain largely on the margin of micro-finance, despite their potential almost everywhere to become the predominate providers of micro-financial services, and whether moving more fully to risk-based supervision might help to unlock this potential.

II. WHAT INSTITUTIONS SHOULD BE REGULATED?

Traditionally, only institutions taking deposits from the general public are subject to prudential regulation and supervision because the essential role of such regulation is to protect the stability of the financial system and, secondarily, to protect small depositors. To regulate other institutions can stretch the resources of the regulatory agency too far, so that it may not be able to do its essential job adequately. It can also involve the regulatory agency in providing de-facto guarantees of the non-deposit liabilities of financial institutions that do not take deposits. In the case of micro-finance, where donors and various government agencies are involved in promoting micro-finance institutions (MFIs), the regulatory agency can be drawn into possible conflicts of interest situations where it is expected to promote as well as to regulate. In any case, this does not imply that MFIs that do not take deposits should be freed from any regulation whatsoever, as all institutions, and financial institutions that deal with the public in particular, are appropriately subject to rules about fraud, consumer protection through transparency, and so forth.

To this point the Philippines has followed the traditional practice of subjecting only deposit-taking institutions to prudential regulation and supervision.2 Although certain entities such as lending investors and pawnshops report to the Central Bank (BSP), only the various types of banks that take deposits from the general public are subject to

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2 Among the Latin American countries discussed in this paper for comparative purposes, the bank superintendencies in Brazil and Peru regulate various types of nondeposit-taking institutions, some of which engage in micro lending, while the bank superintendencies in Guatemala and Honduras do not (or at least did not until recent changes in the laws in those two countries which are in the process of being implemented).
prudential regulation and supervision. Nonetheless, there are pressures from donor agencies, as discussed below, to regulate MFIs that do not take deposits, and there are also pressures from the MFIs themselves. These latter pressures seem to emanate from the view of many MFIs that being regulated will increase their credibility and thus allow them easier access to donor funds, and possibly also to commercial funds from lenders and investors. However, such a view may seriously underestimate the costs of regulation, not only the direct costs of compliance but also the indirect costs of being more constrained in lending and other activities and consequently less able to innovate. Moreover, as BSP staff have often pointed out, these MFIs could easily become regulated by transforming to rural banks (as some already have) which have low minimum capital requirements and allow the types of activities in which most MFIs engage.

III. WHAT SHOULD BE DONE ABOUT MFIS THAT DO NOT TAKE DEPOSITS?

As should be clear, this paper supports the position that bank regulatory agencies should regulate only deposit-taking institutions. However, the paper also recognizes that there are pressures, originating mainly from international donor organizations, to regulate non-deposit-taking institutions involved in micro-finance, so that donors can thereby delegate their “due diligence” responsibilities to the regulatory agency. These pressures must be recognized and responded to, while avoiding the pitfalls that can be associated with regulating non-deposit-taking MFIs. What is proposed in this paper is an approach focused on promoting transparency, so that the decisions of donors and commercial lenders and investors can be based on access to pertinent information that can allow appropriate market-based decisions. In addition, it should be noted that the actions of MFIs and other non-deposit-taking lenders can affect the financial health of deposit-taking institutions if deposit-takers and non-deposit-takers lend to the same borrowers. Thus, it may be important to promote credit bureaus, whether in the public or private sector, that cover the full range of borrower debts, from unregulated as well as regulated lenders, small as well as large, and on-time as well as in arrears. Credit bureaus, together with other entities that can support greater transparency in micro-finance, are discussed more fully later in this paper where alternative arrangements for non-deposit-taking MFIs are dealt with in greater detail.

In the Philippines there are at least two important initiatives that are already focused on promoting transparency for institutions involved in micro-finance that are not regulated by the BSP. The first is a National Credit Council (NCC) effort, supported by USAID funding for the Credit Policy Improvement Program (CPIP) project, to develop a standard chart of accounts for deposit-taking credit cooperatives, which are not regulated by the BSP and in fact are not effectively regulated at all. Rather than focusing initially on the thorny issues of who should regulate these cooperatives and how, the NCC has put together the interested parties (e.g., representative cooperatives, their federations, and various government agencies such as BSP, CDA, LBP, PDIC, DOF, etc.) into a technical working group that first developed a chart of accounts and then the accompanying definitions and manuals, which have now been approved by these interested parties. As of the end of 2001, a set of proposed performance indicators were in final draft form awaiting approval by these same parties. The next step would, of course, be implementation, which would likely begin with a sample of leading credit cooperatives that have participated actively in the development process. Even earlier, USAID also funded a project to develop performance standards for MFIs, but this project has not progressed as far, perhaps in large part because it did not begin with the essential first step of agreeing on a standard chart of accounts with standard definitions.

3 Regulation is also often seen by donors and by the MFIs themselves as an aid in promoting the development of MFIs, which can potentially lead to conflicts of interest within the regulatory agency between promoting and regulating.

4 CDA is the Cooperative Development Authority; LBP is the Land Bank of the Philippines; PDIC is the Philippine Deposit Insurance Corporation; and DOF is the Department of Finance.

5 As noted later, a similar process of developing standardized accounting for non-deposit-taking MFIs has been carried out in Guatemala and Honduras, the two countries that have traditionally not regulated non-deposit-taking institutions.
IV. WHAT DOES TAKING DEPOSITS FROM THE GENERAL PUBLIC REALLY MEAN?

The meaning of taking deposits from the general public must be carefully defined. Compensating balances, that is, deposits that are required to be maintained against loans, are not deposits from the general public because these deposits do not represent any risk to the depositors (who are still net debtors to the institution) or to the financial system in general. However, in many countries, including the Philippines and possibly some of the Latin American countries referred to earlier, MFIs are reported to take deposits from borrowers in excess of amounts borrowed and also sometimes to take deposits from non-borrowers. In such cases, it is clear that the laws and regulations against non-regulated financial institutions taking deposits from the general public are being violated, so that the issues become the more practical ones of how to detect such activities and what penalties should be imposed. Making the activities of MFIs transparent through standardized accounting and timely, accurate reporting, as mentioned above and elaborated later in this paper, should make detection straightforward. Available penalties should be sufficient to deter continuation, including ultimately the threat of liquidation, and also to deter other MFIs from following the same path.

The concept of the general public must also be carefully defined. In particular, whether depositors at credit cooperatives are members of the general public or not is a thorny issue that needs to be dealt with at some length. Among other things, it depends on whether the credit cooperative is closed (affinity based) or open (community based), the ease of becoming a member, and the size of the credit cooperative (what degree of internal surveillance can reasonably be expected). It can also extend to the way that share capital is defined and whether it can be withdrawn (or borrowed against) so easily that it effectively becomes a deposit substitute. The complexities of finding appropriate definitions for the various aspects of credit cooperatives that are pertinent for determining an optimal structure for their regulation is explored in detail in Annex 1: The Regulation of Credit Cooperatives in Selected Latin American Countries: Brazil, Guatemala, Honduras and Peru, with Some General Observations and Recommendations.

V. HOW SHOULD REGULATION BE CARRIED OUT IN PRACTICE?

Another issue, which is often lost sight of in focusing on whether non-deposit-taking MFIs should be regulated, and if so by whom, is the appropriate approach to carrying out regulation in practice. It is widely observed that private banks have generally been reluctant to enter the micro-finance field. However, because of their size relative to MFIs, credit cooperatives and most other non-bank financial institutions, banks have the potential to dominate the micro-finance field. In fact, in most countries if banks placed only 1 or 2 percent of their loan portfolios in micro credits, they could easily account for half the market. Some have argued that the reluctance of bankers is due to their failure to be convinced that micro-finance can be profitable, or that micro clients or micro lending techniques are too far removed from traditional banking. However, it is also possible that the supervisory approach of regulatory agencies can dissuade bankers from entering the micro-finance field. Clearly, a focus by regulatory agencies on formal guarantees and audited financial statements in evaluating loans can make micro lending more risky, as provisions against losses are more likely to be required for otherwise good micro loans. More generally, traditional approaches to regulation are likely to be biased toward requiring risk avoidance and against evaluating the ability of lenders to manage risks. Moving toward a formal and structured implementation of risk-based supervision, such as recommended by the new Basle standards, is likely to put an institution’s abilities to manage risks (e.g., to mitigate and offset risks) in a more favorable light and thereby facilitate the entry of regulated lenders into micro-finance.  

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6 MFIs may also attempt to avoid regulation by creating deposit substitutes, but transparency requirements should be able to reveal and control this.

During 1998 and 1999, CPIP carried out a study for the NCC of possible regulatory barriers to micro-finance in the Philippines, which was published at the beginning of 2000. The main finding of this study was that, while BSP requirements for documentation and guarantees for loans were flexible enough to allow banks to carry out micro-lending, certain wording in the law and the accompanying BSP circulars, together with the discretion allowed BSP examiners, made Philippine bankers fearful that micro loans could easily be adversely classified and provisions required. In fact, bank examiners worldwide have a tendency toward risk avoidance, and hence to be skeptical about loans without traditional guarantees and documentation, unless they have been well schooled in risk-based supervision and its focus on risk management capabilities including, in particular, mitigating and offsetting risks.

The new Philippine General Banking Law of 2000 (especially Sections 40, 43 and 44) and its implementation through Circular 272 of 2001 officially defines micro loans and thereby clarifies many of the ambiguities that may have been making bankers hesitant to enter the micro-lending field. In particular, the circular emphasizes that micro loans are based on cash flows and are typically unsecured and also makes clear that borrowers’ financial statements (including tax returns) are not required for micro loans. Moreover, such loans are exempt from Monetary Board rules on unsecured loans so long as the lender can demonstrate competence in micro-lending (e.g., policies and procedures in conformity with micro-finance best practices, measures to ensure loan collection and an adequate monitoring system for loans). The extent to which the new law and the accompanying circular, as well as other aspects of risk-based supervision, have been effectively implemented by BSP examiners deserves to be closely monitored—as well as the ultimate impact of these changes on micro lending by banks.

VI. CAN RISK-BASED SUPERVISION OVERCOME OTHER CHALLENGES FACING MICRO-FINANCE REGULATION?

In addition to the obvious challenges to regulating institutions making large numbers of small loans for which there are neither formal guarantees nor traditional documentation, there are other challenges. Some of these challenges are important to meet whether or not risk-based supervision is effectively implemented. One example already mentioned is the important potential benefit from extending the coverage of credit bureaus to all types of lenders and to loan of all sizes. Another is that micro-finance and its regulation can likely be facilitated by improving the legal infrastructure and registries for moveable (personal) property mortgages. The frequent confusion between micro and consumer lending stemming from the similarity of the loan products (i.e., small loans for short periods of time) also needs to be overcome, which can be facilitated by understanding that the nature of the cash flows supporting repayment is totally different (irregular and uncertain revenues generated by micro-enterprise sales versus stable and relatively secure salary payments). Regulators must consequently be alert to the extent to which lenders are in reality sufficiently focused on understanding cash flows in evaluating potential loans and, in particular, the dangers from inappropriately using for micro-finance credit scoring models designed for consumer lending.

Another major challenge is that much of micro-finance is rural and consequently takes place in relatively isolated small towns and villages. Doing such lending efficiently requires the ability to open small offices that may not require the same standards of physical security as large urban branches, nor have the same times of operation. In the Philippines additional capital is required for banks to open branches, which varies both by type of bank and by

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9 See Annex 2: A Banking System under Pressure: Banking Decline in Rural Peru, which shows the relative fragility of banking in rural areas, as well as the importance of regulated banks compared to other types of financial institutions in both micro and rural finance.
location of the branch. In addition, there are security requirements with respect to illumination, locks, alarm systems, and cash vaults and their timing devices, as well as the need for other security devices that may be determined by the bank’s security officer. The extent to which such requirements may add significantly to the fixed costs of establishing a bank branch, and thereby make it prohibitively costly to establish small branches, is a constraint on rural microfinance potentially worth investigating in many countries. Furthermore, in the Philippines bank branches must be open for at least six hours per day during the five-day banking week, which may not be consistent with the expected volume of business. Also, to be open on Saturday or Sunday or before 8:00 am or after 8:00 pm, which may coincide with the needs of potential rural customers (e.g., due to market days), requires approval of the BSP. Risk-based supervision, with its focus on the capacity to manage risks, rather than on imposing arbitrary rules based on risk avoidance, is more likely to have the flexibility to deal with these challenges than are traditional approaches to regulation.

Capital adequacy, along with ownership and governance, are also seen to be important issues for microfinance regulation. Some argue that the ownership and governance structures represented by MFIs and credit cooperatives are ideal for reaching micro clients, while others argue that the structures of these institutions lack the required incentives for efficiency and sustainability compared to private banks and other for-profit institutions. While risk-based supervision does not ignore these issues, its orientation is less philosophical and more practical by focusing on risks and their management. Specifically, in the Philippines as in many other countries, there are different types of institutions with different permitted activities and different capital requirements (e.g., rural banks, thrift banks, commercial banks, etc.). Risk-based supervision does not ignore possible differences in risk stemming from ownership and governance arrangements, but rather focuses on the different levels of risk associated with the various permitted activities and thus on the amount of capital required to cover these risks. Risk-based supervision thus has the potential to be both more efficient and more flexible than traditional approaches as it begins by analyzing the risks associated with permitted activities in order to establish appropriate minimum capital requirements and capital adequacy ratios.

As noted above, in the Philippines additional capital is required when a bank opens a branch, which varies according to the type of bank and the location (and is zero for smaller types of banks in less populated locations). Moreover, there is a complex system of minimum capital requirements for different types of banks and for different locations, in addition to that for opening new branches, which is explained in detail in Annex 3: Types of Banks, Capital Requirements and Branching in the Philippines. To some extent these differences in minimum capital requirements are consistent with requiring more capital for permitted banking activities that are potentially more risky, as would be recommended by risk-based supervision. However, these differences appear to be motivated primarily by the desire to give smaller types of banks a competitive advantage and to create incentives for locating in less populated areas. While these are certainly worthy objectives, it is not clear if such variations in minimum capital requirements are the most appropriate way to attempt to achieve these objectives, especially if they are not consistent with the capacity to handle risks, as would be emphasized by the tenets of risk-based supervision. In particular, banks with limited area coverage are more likely to be exposed to systemic risks arising from the lack of possibilities for adequate diversification (e.g., taking care not to lend excessively to rice farmers in an area dominated by rice farming does not avoid the risks stemming from the impact of problems in rice farming on the rest of the local economy). In fact, an important difference between risk-based supervision and traditional approaches is that the former explicitly incorporates consideration of systemic risks.

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10 See Annex 3: Types of Banks, Capital Requirements and Branching in the Philippines, which details capital requirements in the Philippines for various types of banks and their branches.

11 Like traditional approaches, risk-based supervision covers ownership and governance by considering the moral character and technical knowledge and professional experience of prospective owners and high-level managers before granting charters for new banks and other deposit-taking institutions and, for institutions in operation, is concerned about how owners and managers are performing in fulfilling their responsibilities.
The costs of micro-finance regulation and the adequacy of its financing is another potential challenge, one about which there is relatively little specific evidence available. In the Philippines, it has often been stated that the costs to the BSP of regulating rural banks is far out of proportion to their importance in banking system deposits. However, this is a statement about the costs of regulating small institutions and not directly about the costs of regulating institutions with numerous small loans, although the two may largely coincide for Philippine rural banks, especially due to single borrower loan limits relative to capital that tend to confine most rural banks to relatively small loans. In the case of the SBS in Peru, with its regulation of most types of MFIs within a single SBS unit, it has been possible to compare the micro-finance regulatory costs incurred with the revenues received. Payments by MFIs to the SBS for their regulation totaled US$148,000 in 1999 and US$195,000 in 2000. Costs to the SBS of regulating MFIs were estimated to be US$3,246,000 in 1999 and US$3,022,000 in 2000, so that there was a deficit for MFI regulation of US$3,098,000 in 1999 and US$2,827,000 in 2000. For the SBS as a whole, the income received from regulated institutions was US$25.2 million in 1999 and US$25.1 million in 2000. Expenditures were US$22.8 million in 1999 and US$27.6 million in 2000, resulting in a surplus for 1999 of US$2.4 million and a deficit of US$2.5 million for 2000, which was covered by surpluses from prior years. It is thus clear that the regulation of MFIs by the SBS is heavily subsidized. The heavy subsidy for the regulation of MFIs may not be sustainable in times of major budgetary pressures and suggests, moreover, that major changes in the approach to regulation, possibly a movement toward risk-based supervision, are required for efficiency as well as for effectiveness.

VII. WHAT INSTITUTION SHOULD REGULATE MICRO-FINANCE?

According to the arguments presented in this paper, there should not be a specific regulatory agency for micro-finance. Rather, micro-finance should be regulated or not according to whether or not the institution doing micro-finance takes deposits from the general public or not. If it is a deposit-taking institution, then it should fall under the regulatory agency for all such institutions, the BSP in the case of the Philippines, and be regulated according to the best practices of risk-based supervision as discussed above. The situation is more complex for credit cooperatives, as already mentioned, depending primarily on the precise nature of the relationship of depositors to the credit cooperative and, furthermore, on the willingness of the regulatory agency for deposit-taking institutions to undertake this task given the other demands on its resources. Non-deposits-taking MFIs should not be regulated, but, as argued above, cannot be ignored either.

With respect to improving the regulation of deposit-taking credit cooperatives in the Philippines, the first steps, as already mentioned, have been to adopt a standard chart of accounts with standard definitions and manuals for all credit cooperative and then to agree on performance indicators. The difficult task of categorizing which credit cooperatives take deposits from the general public and which take deposits only from a well-defined set of members still remains. Moreover, the question currently under consideration must ultimately be answered: which institution should regulate the categories of credit cooperatives deemed to take deposits from the general public, noting that for implementation in the Philippines this will likely require changes in the cooperative law and possibly also in the general banking law, followed by technical assistance for the chosen regulatory institution(s).

The CDA, the Philippine government entity currently responsible for the regulation of all types of cooperatives (and for their promotion as well), is unlikely to be an appropriate candidate to be the regulatory agency for deposit-taking credit cooperatives. By institutional orientation and by the characteristics of its staff, the CDA is basically too

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12 Bank regulatory agencies can also be significantly constrained by whatever approach to cooperative regulation may already have developed in the country, including the tradition in many countries to have a single government agency that is responsible for all types of cooperatives and for their promotion as well as their regulation.

13 As mentioned earlier, variations in credit cooperative definitions and operations that are relevant for determining an optimal structure for their regulation is explored in detail in Annex 1: The Regulation of Credit Cooperatives in Selected Latin American Countries: Brazil, Guatemala, Honduras and Peru, with some General Observations and Recommendations.
devoted to promotion as compared to regulation and too burdened by its responsibilities for the entire cooperative sector. Moreover, even if the relevant laws were changed to make the CDA responsible solely for the regulation of deposit-taking credit cooperatives, the requirements for technical assistance and staff training would be daunting. Furthermore, even at the end of a long and costly process, the evidence from such attempts at reform in other countries suggests that the exercise would not be successful in strengthening the CDA sufficiently to allow it to regulate deposit-taking credit cooperatives effectively.  

What are the realistic alternatives for the agency to regulate deposit-taking credit cooperatives in the Philippines? Although the BSP has been adamantly opposed to taking on this responsibility, perhaps it could be convinced to do so for the largest credit cooperatives that define their membership requirements so loosely that they are effectively taking deposits from the general public. The BSP could thereby better position itself to avoid the failures of large credit cooperatives that effectively take deposits from the general public – failures that could potentially have significant negative repercussions on the overall financial system, not just on other credit cooperatives.  

Another alternative could be to rely on the LBP to become the regulatory agency for deposit-taking credit cooperatives because of its long-standing close relationship to rural credit cooperatives and its consequent interest in their financial health. However, it must be recognized that there would be a potential conflict of interest in such an arrangement because the LBP’s primary objective is to move its funds through these cooperatives to cooperative members and only secondarily to protect cooperatives’ financial health. Moreover, in the case of a failing credit cooperative, the LBP would logically be more interested in recovering the funds that it had lent to the cooperative than in protecting the cooperative’s depositors. Yet another alternative would be to create an entirely new regulatory agency, perhaps patterned on the NCUA in the United States. Finally, there is some support, mainly in the credit cooperative movements themselves, for self-regulation, usually by the country’s credit cooperative federation or some closely-allied entity, but as yet there are few if any examples of success with this approach in developing countries.

VIII. WHAT EXACTLY IS THE ALTERNATIVE FOR NON-DEPOSIT-TAKING MFIS?

As emphasized earlier, an environment for non-deposit-taking MFIs should be provided that encourages the provision of transparent information so that potential donors, lenders and investors can make well-informed market-based decisions. As with Philippine credit cooperatives, the recommended starting point is the chart of accounts required for a country’s deposit-taking institutions (e.g., banks), adjusted as necessary to international best practice standards (e.g., Basle or GAAP), and also taking into account possible simplifications stemming from the lack of deposit-taking and other more complex banking activities in the typical MFI. Using the standard chart of accounts for a country’s banks as the basis for non-regulated MFIs allows for more effective comparisons among all types of institutions, economizes on audit costs, allows MFIs to transform themselves more easily into regulated deposit-taking institutions should the desire and the possibility arise, etc. The standard chart of accounts of course includes standardized definitions as given in detail in the accounting manual(s) that accompany the chart of accounts.  

A non-regulated MFI wanting to access funds from donors or commercial lenders or investors would need to report its financial statements to a specific agency that has the responsibility for collecting and disseminating such information. While this could be the bank regulatory agency, the BSP in the case of the Philippines, this would

14 This certainly has been the case for any such efforts undertaken in the Latin American countries under consideration.

15 In both Guatemala and Honduras, which traditionally have not regulated institutions that do not take deposits, USAID-funded projects are promoting the adoption and implementation of standardized accounting for MFIs. It is interesting to note that implementation is proceeding more rapidly in Guatemala where added incentives for implementation have been created by linking the new accounting to MIS and IT support for participating MFIs. Adoption and implementation have been slower in Honduras, even though standardized accounting based on what is required for the banking system is required for MFIs under the new Honduran law.
probably not be the best option because the bank regulatory agency is likely already overburdened. Moreover, this might give the incorrect impression that MFIs are being regulated and not simply being transparent. In fact, the Microfinance Council has already been declared to be the preferred candidate to be the Philippine institution responsible for the collection and dissemination of uniform and transparent information on non-regulated MFIs, and possibly for other non-deposit-taking institutions as well. Failure of an MFI to make timely and accurate reports available could be disciplined by having the agency responsible for receiving these reports (e.g., the Microfinance Council) report this fact to the agency responsible for issuing the MFI’s license or permit to operate, with the recommendation that this license or permit be revoked. Another option would be to follow a more market-based approach and simply have the Microfinance Council report to any party requesting information that the required information had not been made available by the MFI.

External audits by qualified auditors could also contribute to the transparency of non-regulated MFIs, but it would need to be determined if these should be required or voluntary (possibly differentiated according to the size of the MFIs because of cost, even after the introduction of standardized accounting). Regulatory agencies typically provide a list of approved auditors, but for MFIs in the Philippines the BSP might find it convenient to do this in conjunction with the Microfinance Council. Moreover, to be as efficient and effective as possible, auditors would need to be familiar with micro-finance, which can be facilitated through the use of micro-finance audit manuals that have recently been developed by CGAP (the Consultative Group to Assist the Poorest, located at the World Bank). These micro-finance audit manuals might also be used to develop a standard scope of work for the external audits of non-regulated MFIs, as such MFIs may not always be “educated consumers” of external audit services.

Ratings by risk-rating agencies might also help to enhance the transparency of non-regulated MFIs and the role of markets in providing discipline. Currently USAID, CGAP and the Inter-American Development Bank are supporting the use of private risk-rating agencies by MFIs in various countries. In the Philippines, ratings by approved risk-rating agencies could be required for non-regulated MFIs, or they could be voluntary, relying on market discipline in the latter case. The Microfinance Council might itself evolve into such a rating agency. The Microfinance Council might also expand to provide comparable data on credit cooperatives (and on rural banks and thrift banks with the cooperation of the BSP) in order to facilitate comparisons among all the main providers of micro-finance services. In any case, the promotion of transparency would not be expected to substitute for “due diligence” efforts by funding agencies, whether donors or private lenders or investors.

Credit bureaus (either in the narrow sense of a database or in a broader sense that includes an evaluation or rating function) can provide an important means for reducing the information costs involved in granting loans. Credit bureaus can be particularly useful in the case of small-scale borrowers where obtaining information directly from potential borrowers is likely to be especially costly relative to loan size. Moreover, when such potential borrowers (and their lenders) operate in the informal (unregulated) sector where guarantees and formal documentation are largely unavailable, the potential usefulness of other forms and sources of information is increased further. However, there is another reason to promote all-encompassing credit bureaus that may be even more important

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16 In Peru, risk-ratings by approved risk-rating agencies are required for banks and certain other regulated institutions. However, while this requirement has greatly expanded the market for risk-rating agencies, it appears to have led to a focus on the banking sector and possibly to the neglect of the MFI market.

17 It is important to clarify the difference between a credit bureau and a “Central de Riesgos.” Whereas a credit bureau often provides some evaluation of borrowers, a Central de Riesgos is simply a database to which creditors supply information and from which entities allowed access to the database can obtain information on the outstanding debts and repayment histories of the debtors covered by the Central de Riesgos. A Central de Riesgos may be either government or privately owned, but in most Latin American countries they are within the central bank or the superintendent of banks. Participation may include just regulated financial intermediaries or all types of lenders, reporting may be either compulsory or voluntary, coverage may include just loans above a certain size or all loans, and may be all loans or only loans with repayment problems. As far as access, it may be limited just to participating institutions or anyone may request information on a particular potential borrower, and fees may be charged for participation and/or according to requests for information.

18 See Annex 4: The Development of Credit Bureaus in Peru, which emphasizes the key elements that have made Peru’s credit bureaus probably the most advanced in Latin America if not among all developing economies.
because it affects the entire financial system and not just the efficiency and effectiveness of MFIs. As mentioned early in this paper, there can be important feedbacks between regulated deposit-taking financial institutions and unregulated MFIs when borrowers access loans from both types of sources. Indeed, the failure to take the importance of this into account in Bolivia (clearly the leading Latin American country in micro-finance and its regulation) and to have debtor databases that included both types of lenders, left the regulatory agency there unable to foresee a major element in the Bolivian financial crisis that has spread across both MFIs and banks.

To be as useful as possible, information in credit bureau databases needs to cover the total exposures of potential borrowers, that is, to include loans of all sizes from all types of lenders, regulated or not, to include loans without problems as well as those with repayment problems and, in so far as possible, to cover other types of financial obligations (e.g., guarantees for others, trade credit, utility bills, tax obligations, etc.). Given adequate computerized information systems, which are now widely available, and that timeliness and accuracy of reporting can be assured, there are no significant technical constraints to including obligations of all sizes no matter how numerous. However, there has been resistance in many Latin American countries to mixing regulated and non-regulated lenders in the same database, based ostensibly on an interpretation of the so-called “secreto bancario” as applying to loans as well as deposits (in spite of the original intent of banking secrecy to provide protection for depositors).

It has been even more problematic in some countries to include all loans, good as well as bad, in the credit bureau database. Lenders have no reason to fear sharing information on bad borrowers, but providing information on the outstanding loans of good borrowers to the database can be inhibited by lack of confidence in the security of the database, specifically the fear that credit bureau employees could be bribed to supply information on good borrowers to competing lenders. Thus, the effectiveness of a credit bureau is more limited by coverage, and especially by the need to adopt policies that promote credibility, and hence participation, than by any technical constraints. A poor rural area of Guatemala provides striking evidence of this, as a group of MFIs using simple computer software set up a private credit database that has come to encompass virtually all lenders and all types of debt because of the credibility that the founding group was able to establish.

IX. MAIN CONCLUSIONS AND RECOMMENDATIONS

Although institutional realities may vary widely from country to country, there are nonetheless some guiding principles that can be widely applicable. From the basic precepts of prudential regulation it is already clear that MFIs that do not take deposits from the general public should not be formally regulated by the superintendency for banks and similar institutions. However, it may not always be easy to define deposits from the general public, specifically in the case credit cooperatives that ostensibly take deposits only from members but in reality members can often include anyone from the general public. In fact, care must be taken not only in categorizing credit cooperatives but also in selecting an appropriate regulatory institution, if necessary, given that there is no recognized “best practice,” or even a consensus, to recommend for implementation worldwide.

In carrying out regulation and supervision, traditional practices appear to be biased toward risk avoidance and hence against micro-finance. In addition, because good MFIs have very large numbers of very small loans, traditional practices that rely on reviewing significant proportions of loan portfolios tend to be costly. Rather than turning to specialized supervision for MFIs, which is likely to increase fragmentation in financial markets, a more thoroughgoing adoption of risk-based supervision, as recommended by Basel standards, would seem to be a more promising approach. In addition, risk-based supervision is more likely to deal flexibly with the establishment and operation of small branches, essential for significant outreach of micro-finance into rural areas. At the same time, it

19 Those requesting information from a credit bureau database are supposed to supply the name(s) of the potential borrower(s) for whom they want information and not to request lists of unnamed borrowers and their outstanding loans.
is more likely to be sensitive to the potentially greater importance of systemic risks in rural areas where adequate diversification can be difficult. Moreover, in focusing on risks and the capacity to manage them, risk-based supervision can relate capital requirements to the risks of permitted activities rather than to potentially arbitrary standards.

The alternative proposed for MFIs that do not take deposits is transparency so that potential funding agencies, public or private, local or international, can make their own decisions based on accurately, timely and comparable information. Transparency, however, is easier said that done, as implementation requires standardized accounting consistent with what is required for regulated institutions and complemented by appropriate performance indicators. Increasing transparency can also require support to strengthen financial infrastructure, including better auditing services and perhaps rating agencies. Especially important can be credit bureaus that reduce the information costs of micro lending, while also protecting regulated institutions from non-transparent over-lending by institutions, including MFIs, that are not regulated.
ANNEX
THE REGULATION OF CREDIT COOPERATIVES IN SELECTED LATIN AMERICAN COUNTRIES:
BRAZIL, GUATEMALA, HONDURAS AND PERU,
WITH SOME GENERAL OBSERVATIONS AND RECOMMENDATIONS

The issues of whether credit cooperatives take deposits from the general public or only from a restricted group of members and, for those that do take deposits from the general public, what could be the most appropriate approach to regulation, are not unique to one particular country. In fact, these issues seem to confront credit cooperatives and government policymakers in countries around the world and have become more pressing in recent years with the increasing role that credit cooperatives can play in the field of micro-finance. This annex focuses on the credit cooperative movements in four Latin American countries and the current status of regulatory efforts in each country. Brazil, Guatemala and Honduras are discussed briefly, while Peru is analyzed in much greater detail because donor agencies and government policymakers are currently involved in a major effort to sort out many of the regulatory issues. The annex concludes with some observations and recommendations on the characteristics of credit cooperatives that should be given priority when making decisions about their regulation.

A. Brazil

In Brazil credit cooperatives are only permitted to exist in the “closed” form, that is, they must be affinity based, which means that all members must have the same employer. The Superintendency Department of the Central Bank estimates that there are 1200 to 1300 credit cooperatives in Brazil. As of mid-2001, their total assets amounted to about US$2 billion, perhaps 1 percent of the assets of Brazilian banks. All credit cooperatives are required to use a standard chart of accounts, to have external audits and to send figures regularly to the Superintendency, which then deals with credit cooperatives through off-site supervision. If the figures sent appear problematic, the credit cooperative is summoned to appear before the Superintendency to explain the situation firsthand in greater detail. If members complain about the operations of their credit cooperative, the problem is referred to the “central” of credit cooperatives in that region for investigation. Formerly the Superintendency worked in conjunction with these “centrals” to carry out regulatory functions, which included the regional “central” visiting affiliated credit cooperatives at least twice per year.

Under the constraint that only affinity-based credit cooperatives are legally allowed to exist, it is understandable why Brazilian credit cooperatives have contributed little to access to financial services for micro-enterprises or in general for individuals of modest means. Because membership in any Brazilian credit cooperative is limited to employees of a specific entity, self-employed micro-entrepreneurs are by definition excluded from membership in credit cooperatives, although micro-enterprises may be financed indirectly by family members who are employed by entities served by credit cooperatives. Furthermore, the existence of even 1,200 or 1,300 credit cooperatives provides no technical basis for the expansion of Brazil’s credit cooperative system to include “open” or community-based credit cooperatives. Specifically, the skills required for extending credit to the employees of an enterprise are rudimentary, even more basic than consumer lending in general, as all that a loan officer need do is verify the salary and employment status of the credit cooperative member, together with the ability to deduct loan payments from the member’s salary. Lending to members of an open or community-based credit cooperative requires far more sophisticated technical skills, whether or not the member happens to be a micro-entrepreneur. Consequently, a more broadly-based credit cooperative system filling an important gap in access to financial services in Brazil could not be expected to emerge quickly even if current regulations were relaxed.

By definition, closed or affinity-based credit cooperatives cannot take deposits from the general public and thus would not fall into the category of financial institutions that generally would be subject to prudential regulation. The way such regulation is carried out in Brazil in practice suggests that the Superintendency is aware of the problematic aspects of the responsibility that it has undertaken with respect to credit cooperatives. To economize on the resources that could be required for full-scale regulation of such a large number of small institutions, supervision is all off-site, with credit cooperatives in fact coming to the Superintendency to deal with any problems identified. Furthermore, a standard chart of accounts and external audits are required to promote transparency, which further reduces the burden on the Superintendency. It should also be noted that the Superintendency has abandoned the practice of delegating supervision partially to the centrals in the region. At the same time, it has continued to delegate member complaints to these centrals to avoid being drawn into responsibilities of that type. Nonetheless, officially regulating credit cooperatives, rather than simply having them report, can make the Superintendency responsible in some sense to those owed money in case of a credit cooperative failure.

B. Guatemala and Honduras

The credit cooperative movements in both Guatemala and Honduras suffered through difficult times in the 1970s and into the 1980s. In Guatemala, civil unrest afflicted much of the country for many years with serious negative implications for credit cooperatives, especially those in rural areas with significant indigenous populations. In Honduras, the problems were more within the credit cooperative movement itself, as the management of the federation used external funding from donors to manipulate individual credit cooperatives and thereby maintain control for its own benefit. For similar reasons in both countries, the situation was also characterized by a lack of effective credit cooperative regulation. In both Guatemala and Honduras, there was a single government agency responsible for the development and regulation of the overall cooperative sector, but given the specialized technical nature of financial intermediation carried out by credit cooperatives and the inherent conflict between regulatory and developmental objectives, the responsible agency could not fulfill its obligations. Moreover, in both countries the regulatory agency for the banking sector was totally unwilling to take on the responsibility for regulating credit cooperatives.

Efforts began in the mid-1980s to rehabilitate the credit cooperative systems in both countries, with financial support from the United States Agency for International Development (USAID) and with the technical collaboration of the World Council of Credit Unions (WOCCU). The approaches were different in the two countries, as the Honduras project focused on strengthening individual credit cooperatives and reforming the federation through the efforts of the credit cooperatives that had been successfully rehabilitated, while the Guatemala project focused on strengthening the federation and, through the federation, the individual credit cooperatives. While both projects were highly successful in strengthening the federation and a significant number of individual credit cooperatives, the result in Guatemala was a relatively centralized, top-down system, while in Honduras the individual credit cooperatives that had been successfully rehabilitated shared leadership with federation management. Nonetheless, little progress was made on the regulatory side, as efforts to strengthen the government agency responsible for credit cooperative regulation in each country proved totally unsuccessful. Resources provided to these agencies failed to strengthen their regulatory capacities, while legal changes were not forthcoming in either country to refocus the cooperative agency on the credit cooperative system rather than cooperatives in general and on regulation rather than promotion and development. However, the credit cooperative federations in both countries have implemented standard charts of accounts with standard definitions and performance indicators for affiliated credit cooperatives that should ultimately make whatever option is selected with respect to regulation more effective and efficient.

Delegation to such bodies has typically performed poorly in Latin American countries, not only because such bodies usually lack adequate resources and expertise to carry out the supervisory function effectively but also because they suffer from a basic conflict of interest in that they are supposed to promote credit cooperatives while regulating them at the same time.

Information has been taken primarily from work by IMCC and by the author on USAID-funded projects in Guatemala and Honduras.
Unable to rehabilitate the government agency responsible for cooperatives and unable to persuade the regulatory agency for banks that it should also attend to the regulatory needs of credit cooperatives, credit cooperative leadership in both countries decided that the only option was to create their own regulatory agency. This effort was initiated first in Honduras through the creation of a private regulatory agency with voluntary participation. The main problem was that the regulatory agency was owned by the credit cooperatives to be regulated and had no legal means to discipline credit cooperatives that did not live up to regulatory standards beyond adverse publicity. In addition, some of the directors of the regulatory agency did not come from the most financially sound credit cooperatives. The Guatemalan regulatory agency is also private and a creation of the credit cooperative federation, but was initiated more recently so that it chances for success are less clear at this point. Nonetheless, it has three potential advantages: (1) it was begun as a rating agency so that collecting and providing transparent information, rather than imposing penalties, is its primary mandate; (2) it has strong financial and technical support from CGAP and also from WOCCU, neither of which was actively involved in the Honduran effort; and (3) the Guatemalan federation has much greater power over its affiliated credit cooperatives, especially because it controls a credit cooperative liquidity fund and a network through which the better (participating) credit cooperatives can clear inter-system financial transactions.

C. Peru

Credit cooperatives are divided into two groups according to the current law governing the Peruvian financial system, those that take deposits from the general public and those that take deposits only from members. Those that take deposits from the general public are regulated under this law, but in fact there are none as no credit cooperative has opted to state that it takes deposits from the general public, presumably to avoid the regulation that would be involved. Those that take deposits only from members are under the purview of the cooperative law and, consequently, are regulated by FENACREP (the Credit Cooperative Federation) under delegation from the SBS (Superintendency of Banks and Insurance). Because an “open” credit cooperative (one that is not affinity based) can make it very easy for anyone to become a member, any individual from the general public can readily become a member of such a credit cooperative, and hence a depositor. Based of this fact, current law notwithstanding, some of the more aggressive Peruvian credit cooperatives, three in particular, have become as large as small banks. This blurring of the line between “deposits from the general public” and “deposits not from the general public,” is at the heart of the need to reform how credit cooperative regulation is structured in Peru.

The following table provides a breakdown of Peru’s 193 credit cooperatives by type of credit cooperative and by type of loan, according to loan amounts outstanding.24 As of mid 2000, there were 70 credit cooperatives not taking deposits, and another 67 small “open” credit cooperatives (assets less than US$0.9 million) that together accounted for less than 10 percent of the total value of loans outstanding for the system. Both these categories of credit cooperatives are oriented heavily toward consumer lending, as are the 15 medium size “open” credit cooperatives (assets between US$0.9 and US$5.7 million) and the 9 affinity-based credit cooperatives connected with the military. These two latter categories together accounted for slightly more than 20 percent of the total value of loans outstanding from the system. By far the most important category are the three large “open” credit cooperatives, accounting for more than 40 percent of the total value of loans outstanding and responsible for the

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24 Commercial and micro loans represent 55 percent of overall credit cooperative loan portfolios, while consumer loans are 38 percent and housing loans are 7 percent. This lending pattern is heavily weighted toward micro and small business finance compared to credit cooperatives in most other Latin American countries. Another important aspect of the Peruvian credit cooperative system is its high concentration on, as only three credit cooperatives account for 78 percent of deposits and 53 percent of loans.
The overall predominance of commercial loans in credit cooperative portfolios. The last category, the twenty-nine affinity-based credit cooperatives with deposits, account for slightly less than 30 percent of the total value of loans outstanding from the system, and these are the second most important commercial lenders after the large open credit cooperatives.

Table 1

<table>
<thead>
<tr>
<th>Credit Cooperative Type</th>
<th>Loan Type</th>
<th>Non-Deposit Taking</th>
<th>Deposit Taking</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Affinity Based</td>
<td>Large</td>
<td>Medium</td>
</tr>
<tr>
<td>No. of Credit Cooperatives</td>
<td>70</td>
<td>29</td>
<td>3</td>
<td>15</td>
</tr>
<tr>
<td>Loan Type</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial</td>
<td></td>
<td>655</td>
<td>18.021</td>
<td>57.577</td>
</tr>
<tr>
<td>SME</td>
<td></td>
<td>50</td>
<td>1.496</td>
<td>2.449</td>
</tr>
<tr>
<td>Mortgage</td>
<td></td>
<td>101</td>
<td>7.22</td>
<td>2.538</td>
</tr>
<tr>
<td>Consumption</td>
<td></td>
<td>7,015</td>
<td>19.055</td>
<td>7.456</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>7.82</td>
<td>45.792</td>
<td>67.571</td>
</tr>
</tbody>
</table>

1/ As of June 30, 2000

Source: FENACREP

For Peruvian credit cooperatives, overdue loans have risen from 4 percent in 1995 to over 10 percent in the years since 1997. However, the overdue loan situation has worsened even more for the Peruvian banking system, although the credit cooperative figures may not be entirely accurate since, as detailed below, effective supervision is lacking under FENACREP. Overdue loans are lowest for affinity-based credit cooperatives, are somewhat higher for large “open” credit cooperatives, substantially higher for medium size “open” credit cooperatives, and by far the highest of all for small “open” credit cooperatives. The three largest credit cooperatives have much higher average loan size, US$3486, compared to the small ones with an average size of only about US$100. Likewise, the average deposit is US$4807 compared to US$50. This re-enforces the point that these three credit cooperatives are in fact more like small banks and thus need serious regulation like any deposit-taking entity. Nonetheless, the smaller “open” credit cooperatives are more in need of attention given their problematic loan portfolios, but with the simultaneous need to recognize the disproportionately high costs of supervising all these small institutions or even requiring them to have external audits. Most obvious is the lack of a need to regulate affinity-based credit cooperatives heavily, given the effective common bond among members and thus the ease of obtaining pertinent information for lending and collecting loan payments, which is clearly reflected in the low overdue rates for loans from such credit cooperatives.

Until 1992 Peruvian credit cooperatives were covered by the LGC (General Law for Cooperatives) and regulated by INCOOP (National Institute for Cooperatives), which was located in Lima and which regulated only the credit cooperatives in Lima. Regulation was poor with no site visits, and information was deemed unreliable since there were few accountants, no standard chart of accounts and no requirements for internal or external auditing. In addition, INCOOP was supposed to regulate 4,500 cooperatives of all types, and it delegated regulation outside of Lima to “regional INCOOPs” that depended on the state governments. INCOOP was liquidated by government decree in 1992, a year of crisis in Peru, and responsibility for credit cooperative supervision passed to the SBS.

25 The importance of commercial loans in the portfolios of affinity-based credit cooperatives, where members would be expected to have salaried employment, suggests that other members of members’ immediate families may have micro or small businesses that are financed indirectly through these credit cooperative loans. The difficulty of distinguishing between commercial and consumer loans is important to note, together with the twin difficulty that, within the household-enterprise unit, micro-enterprise loans may support consumption, and vice versa, given the fungibility of money and credit.

26 The three largest credit cooperatives also reportedly make loans to non-members, another reason to subject them to bank-like regulation.
The LGSFS (General Law for the Financial System), passed in 1996, is now the basic law that covers credit cooperatives that take deposit from the general public (see article 282), but, as explained above, no credit cooperatives have opted to state that they take deposits from the general public. Supervision of credit cooperatives not taking deposits from the general public was delegated to FENACREP\textsuperscript{27} in 1993 by government decree, which was updated in 1996 by the LGSFS, with SBS Resolution No. 0540-99 now covering the regulation of credit cooperatives that do not take deposits from the general public. In spite of these refinements, a number of discrepancies remain between the LGC and the LGSFS, and in particular credit cooperatives that do not officially take deposits from the public do not need a license from either the SBS or FENACREP, but, according to the LGC, simply to be inscribed in the public registry.

FENACREP has neither the human nor the financial resources to undertake credit cooperative supervision effectively. Moreover, even with adequate funding and human resource development, FENACREP would not be an appropriate regulatory entity for credit cooperatives because of the inherent conflict between regulating and promoting. Not only is FENACREP charged with promoting the development of the credit cooperative system, but is also owned and effectively controlled (at least to a significant extent) by the affiliated credit cooperatives that it is expected to regulate.

With respect to human resources, FENACREP has only 16 employees, of whom only six are dedicated to supervision. In the area of control (off-site supervision) there is one senior person formerly at the SBS and two young economists. In the area of inspections (on-site supervision) there are three accountants, with the lead position vacant. The area of control was only created recently in 1996 and, with only three staff, cannot handle information from 193 credit cooperatives, especially since it has no standardized approach, lacking an effective manual. Moreover, much of the information submitted is said to be incomplete and of poor quality. FENACREP requires the seventy largest credit cooperatives, comprising 95 percent of system assets, to submit external audits annually, but it is not clear if this is in fact enforced. About forty on-site inspections are carried out per year, with a focus on the three largest credit cooperatives and 26 others, which are seen to have serious problems and represent 12 percent of system assets. In the case of on-site inspections, there appears to be an adequate manual derived from the one used by the SBS, but nonetheless in need of updating.

Under its arrangement with the SBS, FENACREP is to charge between 0.58 and 2.0 per thousand of assets for regulation, with a minimum charge of US$142 per credit cooperative. Projected revenues for the year 2000 were US$372,000, of which about US$330,000 was to come from fees for regulation, which is consistent with FENACREP’s arrangement with the SBS. FENACREP’s expenditures for 2000 were projected to be US$385,000, the majority for salaries, but not broken down according to activities such as regulation. This would have resulted in a small deficit, but as of the end of August 2000 revenues exceeded projections, while expenditures were lower, leaving a surplus rather than a deficit. Before drawing any conclusions about the costs of credit cooperative regulation and the adequacy of its financing, it is useful to compare this with the costs incurred by the SBS in regulating MFIs. As stated in the body of the paper, costs to the SBS of regulating MFIs were estimated to be US$3,246,000 in 1999 and US$3,022,000 in 2000. It is thus clear that the amount spent by FENACREP on regulating credit cooperatives must be totally inadequate. FENACREP is spending less than US$400,000 per year to supervise 193 credit cooperatives, while the SBS spends over US$3 million to supervise a far smaller number of MFIs, which have approximately the same amount of assets in total as the 193 credit cooperatives.

\textsuperscript{27} FENACREP was founded in 1959 and officially recognized in 1965 under resolution No. 264 of INCOOP. Currently it has 134 affiliates and supervises 193 credit cooperatives.
D. Some General Observations and Recommendations

Perceived problems of ownership and governance in credit cooperatives, especially the failure of members to participate actively or even to be informed about the affairs of their credit cooperatives, are often cited as their most important weakness.\textsuperscript{28} In the present analysis the basic starting point is the definition of capital and especially the operational aspects of different types of capital. First, institutional capital, which consists (at least in healthy credit cooperatives) mainly in retained “earnings” plus various reserve accounts built up for special purposes, needs to be separated from share capital that has been contributed by, and effectively belongs to, individual members. Institutional capital is available for the special purposes indicated and, more importantly, to cover losses that might occur in bad years and would only be distributed among members (after satisfying prior claims) if the credit cooperative were to be liquidated. On the other hand, the share capital that an individual member has contributed can be withdrawn when that member leaves the credit cooperative. Since credit cooperatives, especially those with financial problems, typically make it difficult (or at least time consuming) for a member to resign and to withdraw contributed share capital, members wanting to resign often resort to taking “automatic loans,” which normally can be disbursed in just one day and can be up to 90 percent of a member’s share capital. The purpose of automatic loans is, of course, to give liquidity to members’ share capital, which is rightly seen as a highly attractive attribute of share capital, and not to circumvent transparency by allowing members to resign effectively without resigning officially through the designated procedures.

The analysis of credit cooperative capital has two important implications for regulatory purposes. First, unless it is made impossible for credit cooperative members to withdraw their share capital expeditiously (undesirable because of the importance of liquidity and of the right to disassociate that comes with the right to associate), it is only institutional capital that stands fully behind the obligations of the credit cooperative and thus can be counted fully for fulfilling minimum capital requirements and capital adequacy ratios. Second, because members’ share capital can be made effectively as liquid as deposits, an arbitrary regulatory distinction between credit cooperatives that operate with member deposits and those that operate only with share capital will likely be no more effective in dealing with highly aggressive credit cooperatives than the distinction between taking deposits only from members and taking deposits from the general public. Given the ability to blur the distinction not only between deposits from members and deposits from the general public, but also between deposits and share capital, some reliance has to be placed on the concept of a “club” whereby freely-associating members are expected to know and police each other effectively (aided, of course, by a government’s commitment to deal with fraud) in order for credit cooperatives to be distinguished effectively from banks. Otherwise, if all credit cooperatives, even the smallest, are treated as if they were deposit-taking banks, and thereby required to comply with what is required for even the simplest category of bank, small groups of individuals of modest means will be thwarted in their efforts to join together to help each other, and related innovations in the delivery of financial services will likewise be thwarted.

Because of the importance of effectively taking deposits from the general public in determining the appropriate regulatory category, differentiating “open” or “community-based” credit cooperatives from “closed” or “affinity-based” credit cooperatives is essential. By their nature, the latter cannot take deposits from the general public and thus would never fall into the category of being regulated like banks. Moreover, the management of risk is entirely different, such that “closed” or “affinity-based” credit cooperatives can be given much greater leeway.\textsuperscript{29} Lending limited to employees of a single enterprise, given that the enterprise itself does not have serious economic problems, requires little more than verifying employment status and prospects and having arrangements that permit loan payments to be taken out of salaries. In effect, it is consumer lending with highly simplified credit scoring models rather than lending to micro-entrepreneurs with variable and uncertain incomes.

\textsuperscript{28} Many experts concerned about the state of credit cooperative regulation in Latin America have also focused on perceived ownership and governance problems. The view here on possible inherent weaknesses in credit cooperative ownership and governance is more agnostic, based in part on the fact that private for-profit banks have likewise failed in significant numbers, typically imposing losses that are far greater than those imposed by failing credit cooperatives.

\textsuperscript{29} In Peru, as shown above, affinity-based credit cooperatives are the category with the lowest proportions of loan amounts overdue.
Credit cooperative size -- in number of members, in assets and in branches -- becomes important not only because of the more likely presence of club-type relationships in smaller groups but also because of costs. The costs of just maintaining accounting records according to even a simplified version of the chart of accounts required for regulated financial intermediaries could be unrealistically high for credit cooperatives that are very small in size. Such requirements could effectively stop the initiation of new credit cooperatives, especially if it is true, as supposed, that credit cooperatives can (even should) emerge from the voluntary cooperation of individuals of modest means. To this must be added the costs of external audits and then the costs of supervision itself, divided somehow between the regulatory agency and the regulated institution. To balance the goal of openness to permit cooperation and innovation with the importance of protecting depositors and especially the stability of the financial system, size must clearly be taken into account -- it would be both uneconomical and repressive to regulate credit cooperatives that do not have branches and have only a small number of members and a small amount of assets.

The basic recommendations are that, taking into account the way membership is defined (affinity based or open) and the way shares and deposits are defined, size would also be an important factor in putting a credit cooperative for regulatory purposes into one of three groups:

Larger open deposit-taking credit cooperatives with flexible membership requirements that allow the general public effectively to be depositors and that exceed a certain size would be regulated, basically like banks.

All affinity-based credit cooperatives and some intermediate range of open credit cooperatives (depending on size, flexibility of membership requirements and characteristics of deposits and shares) would be required to report their financial statements, using standardized accounting and supported by external audits as deemed appropriate.

The very smallest credit cooperatives would receive no regulatory attention unless membership requirements and share and deposit characteristics were defined in ways that effectively allowed the general public to be depositors.