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Private Capital for Microfinance: How to Turn the Faucet On

By Robert Pouliot

Latin American microfinance institutions (MFIs) are showing stellar results. The leading institutions are growing at breakneck rates and generating financial results far in excess of commercial banks in their countries. It would be reasonable to think, therefore, that MFIs constitute very attractive opportunities for private investors. In reality, however, there are less than a dozen private financial and social investors providing funds to MFIs in Latin America. Compared to the tens of millions of dollars provided yearly by multilateral and national donors, private capital is no more than a trickle. Why is that? And what would it take to "turn the faucet on"?

Viewed from the demand side, the aim and desire of many MFIs is to "climb the ladder", from dependency on donations and subsidized credit to full integration into local and international financial markets. However, even the most determined and market oriented MFI can be tempted and led astray by cheap, below-market donor funds. And in many instances such funding continues to be available, even for MFIs that have the capacity to pay commercial rates.

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By Tor Jansson

Something big has changed over the past few years. Starting in 1999, a wave of regulatory reform in the area of microfinance has swept across Latin America and the Caribbean. Until that year, the topic wasn't even on the radar screens of most bank supervisory authorities in the region. In fact, only Bolivia and Peru had at that time made efforts to create an appropriate regulatory and supervisory framework for microfinance. How things change. Today, more than 10 countries in the region have undertaken similar reforms, from Chile in the south to Mexico in the north.

What happened? What, apart from the events in Bolivia and Peru, set off this avalanche of regulatory reform and what does it mean for microfinance in Latin America?

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On the supply side, commercial investors are also affected by the flow of donations and soft loans to MFIs. They are outbid by the cheap funds and are forced to withdraw from individual transactions, sometimes after due diligence costs have been incurred. Not surprising, it is impossible for them to compete with funds provided below cost.

> "We recently lost a large client in Peru. We were offering them a USD 1 million loan at 24 months maturity for a rate of Libor USD + 4,5% (11% at the time). We were driven out by an international donor offering the same amount with a 15 year horizon, a 5 year grace period and a nominal interest of 5%. The donor also offered an additional USD 100,000 gift for technical assistance. At the time of our negotiation, this client in Peru had a return on equity of 25% and was perfectly capable of paying commercial rates for funding".
>
> *Comment by Jean-Philippe de Schrevel, Managing Director of Blue Orchard Finance (fund manager of Dexia's microfinance investment fund)*

In sum, subsidized donor funding drives a wedge between profitable MFIs and commercial investors by reducing the incentives of the former in seeking commercial funds and undercutting the latter in providing those funds. Unless a more rational approach is achieved among public actors on this basic issue, it is doubtful that a reliable capital market for MFIs can emerge any time soon. Donors need to focus on the weaker MFIs and not lend to institutions that are mature and profitable enough to access funding from commercial investors.

On their part, MFIs can only gain more effective access to financial and capital markets if they understand what investors want. This is not always an easy task because different actors have widely divergent concerns and priorities, which in turn determines their strategy towards the MFIs (see table). The differences are particularly apparent between aid agencies and for-profit investors; however, even between more closely related groups, such as social and commercial investors, the differences can be quite significant.

A good illustration is the difference between LACIF, a regional microfinance investment fund based in Peru, and Triodos Bank, a Dutch universal bank with a social investment program. Triodos fund managers have one goal: to protect capital. However, there is no incentive or a benchmark goal to achieve revenues or reach a minimum level of return. Actually, investors don't expect any return from the funds. Country and transfer risks are not taken into consideration and only the specific risk of the microfinance institution is dealt with. Although four times smaller and funded by social investors and multilateral-and bilateral agencies, LACIF is fully profit-driven and considers all forms of risk threatening its capital and fund return. Dexia, a small global microfinance investment fund based in Luxembourg, depends entirely on private institutional investors and adheres to the same rules.

While fund providers have different concerns and priorities, they do have one thing in common: they all want transparency, because it allows them to assess and understand MFIs as investment vehicles. Any MFI interested in accessing funding, particularly private capital, must therefore make disclosure a priority.

Two central elements of transparency are reporting and risk measurement. Given the history of donor involvement, however, neither one of them are naturally occurring elements in the microfinance industry. Reporting is typically done yearly or semi-annually, but not quarterly and monthly, which is the standard in established financial markets[1]. Meanwhile, risk measurement practices are still rudimentary as specialized microfinance assessment firms don't provide recognized ratings and establish rating agencies don't yet know the microfinance market.[2] The lack of standard decision-making tools and the absence of a recognized and agreed upon universal risk rating

	Who They Are	Main Concerns
Aid providers	National aid agencies and multilateral organizations such as the Inter-American Development Bank, Corporación Andina de Fomento, World Bank, etc.	Outreach. Fiduciary risk to a very limited extent as aid program trustees.
Financial operators	Institutional NGOs or foundations managing and developing equity stakes in MFIs, including Accion, Finca International, etc.	Outreach and financial performance. Credit and fiduciary risk.
Socially responsible investors	Triodos Bank, Profund (mainly on the equity side), Developpement International Desjardins, etc.	Credit, fiduciary risk and transfer risk
Pure commercial investors	Dexia*, Shorebank, LACIF**, local banks	Credit, fiduciary, country and transfer risks

* Dexia's microcredit fund is managed by Blue Orchard Finance, a Swiss investment management firm.

** The Latin American Challenge Investment Fund (LACIF) is managed by Cyrano S.A, a private investment management firm operating out of Peru.

1 One exception is the monthly reports each MFI debtor must submit to LACIF. These monthly reports have become so useful than even other institutional lenders are now asking for copies.

2 Although several local rating agencies in Latin America are entering the MFI market, none of the better known organizations, such as Moody's, Standard & Poor's and Fitch, have yet seriously moved into this area.

process keeps commercial investors away and delays the emergence of any true capital market.

The less than perfect transparency in the microfinance industry means commercial investors have yet to figure out the nature and opportunities of MFIs as investment vehicles; there is currently no consensus on what kind of asset class these institutions actually belong to or represent. Moreover, given the lack of a coherent and comprehensive track record for the industry as such, which would allow investors to establish default probabilities for the asset class, the true risk of MFIs is hard to discern. In practice, MFIs still largely belong to the family of high yield speculative investments due to their perceived overall financial fragility. However, some claim that MFIs are in fact mid-yield instruments ready to pay much higher rates and offer a much better return to investors than their level of risk would warrant[3].

A rational approach to donor funding, high standards of disclosure and standardization of information are central to the prospect of increasing private capital flows to MFIs. However, the emergence of a capital market for microfinance also crucially depends on a couple of additional factors.

Instruments, Mechanisms and Transactions

The microfinance market lacks some basic features of more established markets. For one, there are no standard instruments. Transactions between investors and MFIs are all unique with varying characteristics and conditions in terms of maturity, interest-setting method, risk pricing and legal framework. Typically, investors offer three-, six- or twelve-month rollover bullet loans, renewable up to a period of three years, but there is still too much diversity to call it a standard. The lack of standardization means that transaction costs are unnecessarily high, that instruments cannot be pooled and that transparency is, yet again, less than ideal.

However, the lack of standard instruments is just the beginning of the problem. Conditions of execution are critical and could "make or break" deals. In order to enhance credit instruments beyond risk and return considerations, the liquidity (or tradability short of straight securitization) and capital protection through safe custody of instruments must be developed. Today, investors have to initiate a lengthy process each time they wish to provide funds to MFIs and typically they employ a conventional banking approach far away from recognized fiduciary practices.

More often than not, microfinance debt instruments are held directly, or through an affiliated administrative arm, by the investment management firms themselves. Standard practice is that debt instruments should be handled only by trustees or fully independent custodians in order to protect investors, especially in the case of pooled funds such as Dexia, LACIF and Triodos. As for settlement, the act of disbursing money to the MFIs and collecting back capital and interest is essentially a linear operation involving the borrower and its lender. However, as no liquidity exists and little deal syndication is carried out, debt is neither traded nor shared.

Given these conditions, it is not surprising to find that transaction costs are very high for investors when interacting with MFIs. In addition, loan amounts are small, which puts the relative costs, and thus the required return,

Transaction Cost of a USD500K Loan

Transaction Expenses	Cost in USD
Due diligence evaluation/rating report	10,000
Legal cost	2,000 to 5,000
Custody arrangements	2,500 to 10,000
Communication (tel, courier, fax, etc)	1,000 to 1,500
Bank transfer	200 to 500
Miscellaneous (settlement, etc)	500 to 1,000
TOTAL	16,200 to 27,000 3.2% - 5.4%

Improving Conditions for Private Capital Flows

Recognition

Standards of instruments must be recognized by the domestic and regional community of banks, finance companies and credit providers to ease exchange and seed tradability. To gain recognition, standards must remain simple and easily identifiable, such as a range of limited maturities.

Clearing & Custody

In each of the more densely populated MFI countries, depository banks or trust companies should be identified and selected as prime clearers or custodians of microfinance instruments to be negotiated under standard legal conditions. Those clearers could also be market makers by trading MFI paper either from local or foreign institutions. For this, a registrar of transactions should be established on a regional basis.

Settlement

Conditions should be standardised across Latin America in order to ease in and outflows of funds and allow major funders to move swiftly from one MFI to another according to needs and market conditions. Easing settlement processes would lead to faster circulation of documents and the adoption of standard legal formats.

3 The recent public debt issues of Compartamos in Mexico (USD 10 million) and the upcoming issue of Mibanco in Peru (50 ~ USD 15 million) illustrate how attractive some MFIs are becoming.

at levels far above normal transactions. For instance, the cost of a USD 500,000 credit transaction lies in the range of USD 16,000 to 27,000, or 3.2–5.4% of the transaction. This does not include the monitoring costs borne by the investor.

The high transaction costs – and the existence of subsidized donor funding —distort the actual pricing of loans to MFIs. If a spread of say 6% p.a. over Libor is charged on a one-year loan, the 3% transaction cost only leaves a yield of some 3% to pay for management (usually ≥1.5%) and monitoring (0.5%), with precious little left to the investor, particularly when country and currency risks are taken into account. In short, in today's world, managers earn more money lending to MFIs than investors themselves.

A syndicate approach, where two or more lenders get together, could reduce the overall cost of transactions (by sharing due diligence, contractual terms, sell and purchase agreement, bank transfers, custody arrangements, etc) and provide greater leverage to investors if they can agree on arms-length commercial conditions. Still, syndicates are subject to their own transaction costs in the form of search and coordination efforts among the participants.

In sum, there is little chance that the trickle of private capital going to microfinance will turn into a steady stream unless the issues of yield, cost and risk are more effectively tackled. Until then, investors will find it more rewarding to buy high yield instruments from the shelf on the US market, which enjoy standard rules, good liquidity and reasonable returns.

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Microfinance Regulation Sweeping Latin America

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Basically, the pressure for regulatory reform had been building on several fronts in the region since 1995. At that time, several highly successful and fast-growing nonprofit microcredit foundations began to emerge. One by one they sought to “transform” themselves into licensed and supervised intermediaries, typically in the form of finance companies and, sometimes, banks. Meanwhile, established commercial banks and consumer finance companies began eying the microenterprise segment with more interest as the high growth rates and financial returns experienced among the institutions operating in this market proved that microenterprise lending could be a profitable business. In both these cases, the nonprofit foundations as well as the commercial banks saw their ability to serve their clients hampered by a regulatory environment that didn’t take into account the distinctive features of microfinance.

The pressure of these trends, and a greater awareness of microfinance in general, started to converge in 1999. In that year, Brazil took measures to create a new financial entity specializing in microfinance. Soon other countries followed and today El Salvador, Honduras, Mexico, Panama, Chile, Paraguay, Venezuela, Colombia have all undertaken significant (though not always comprehensive) regulatory reforms to facilitate microfinance.

But will these reforms have the desired effect of expanding financing to the region’s microentreprenurs? Put another way, might regulatory reform in some cases be ineffective or even detrimental to the industry?

Actually, it is quite possible to implement reforms that don’t facilitate micro-

Distinctive Features of Microfinance

Category	Consumer/Commercial Credit	Microcredit
Ownership and Governance	• Profit maximizing institutional and individual shareholders	• Shareholders are mainly nonprofit institutional shareholders
Client Characteristics	• Diverse formal businesses and salaried individuals. • Geographically dispersed clients.	• Low-income entrepreneurs with rudimentary family businesses and limited formal documentation. • Located in specific geographic area
Lending Methodology	• Collateral and formal documentation	• Character and cash flow analysis through on-site inspections.
Product characteristic	• Larger amount • Longer term • Lower interest rate • Monthly repayment	• Smaller amount • Shorter term • Higher interest rate • Weekly or bi-weekly repayment

Source: Adapted from Tor Jansson, Village to Wall Street, IDB Working Paper, 2001.

finance in the long run. A framework that doesn't adequately address the distinctive features and risks of microfinance will not serve these institutions and, consequently, neither the people who depend upon them. For instance, a very inflexible and conservative approach may unduly restrict the supply and expansion of microfinance by not allowing financial institutions to adopt appropriate lending technologies. At the other extreme, and much more likely, well-intended efforts to promote microfinance may result in overly lenient framework, that enable and permits weak institutions to operate, which in turn may lead to bankruptcies, shaken confidence in the industry and poor people losing their savings.

The issue of savings is crucial. One the one hand, it is one of the fundamental reasons why nonprofit microcredit foundations want to transform into regulated and supervised intermediaries. As these institutions have grown, so have their demand for funding. Savings is a vast and potentially inexpensive source of funding and, additionally, it's an attractive service that most microfinance institutions would like to offer their clients.

On the other hand, one of the fundamental responsibilities of bank supervisors is to make sure people don't lose their savings in failing institutions. They therefore need to make every effort to ensure that institutions that mobilize deposits from the public are appropriately regulated and supervised. By the same token, there is much less reason for bank supervisors to be involved if an institution is not allowed to mobilize deposits; supervisors have limited budgets and should focus on institutions and situations where ordinary people's money is at stake.

Regulated and Supervised Financial Entities Partially or Wholly Created for Microfinance

Year	Country	Name	Legal Form	Min. Capital (US$)	Deposits?
1980	Perú	Caja Municipal de Ahorro y Crédito – CMAC	Municipally owned	236,000	Savings
1992		Caja Rurales de Ahorro y Crédito—CRAC	Incorporated	236,000	Savings
1995		Entidad de Desarrollo a la Pequeña y Microempresa EDPYME	Incorporated	236,000	No
1995	Bolivia	Fondo Financiero Privado—FFP	Incorporated	820,000	Savings
1999	Brazil	Sociedad de Crédito para el Microempresario - SCM	Incorporated	53,000	No
2000	El Salvador	Sociedad de Ahorro y Crédito—SAC	Incorporated	2,850,000 (1,140,000*)	Savings
2001	Venezuela	Banco de Desarrollo Especializado en Microcrédito—BEM	Incorporated	2,370,000	Checking & Savings
2001	Honduras	Organización Privada de Desarrollo Financiero—OPDF	Nonprofit foundation	60,000	Savings
2001	Mexico	Sociedad Financiera Popular—SOFIPO	Incorporated	45,000	Savings
2001		Sociedades Cooperativas de Ahorro y Préstamo—SOCAP	Cooperative	45,000	Savings
2001	Panama	Bancos de Microfinanzas—BMF**	Incorporated	3,000,000	Checking & Savings

Source: Bank laws and regulations from the respective countries.
Notes:
* This lower minimum capital requirement is applicable if the institution only lends to small and microenterprises and it if only captures deposits from its borrowers. For this purpose, a microenterprise is defined as a business with less than 10 employees or US$ 5,700 in monthly sales; a small enterprise is defined as a business with 10 to 50 employees or US$ 5,700 to US$ 57,000 in monthly sales.
** The portfolio of these institutions must consist to at least 75% of loans smaller than 3% of the institutions' equity; the remaining 25% can be lent according to general bank limitations (each loan can be up to 50% of equity).

Recent Initiatives to Regulate Microfinance

The pressure for regulatory reform often manifests itself in the political arena. In particular, nonprofit foundations have taken an increasingly active role in promoting legal reforms to facilitate microfinance. Such pressure has led some countries to create new types of financial institutions, precisely for the purpose of enabling nonprofit foundations to transform into financial intermediaries. Not unlike politics as usual, it turns out that this is a high-profile response to a problem that could many times be better solved by more modest regulatory modifications.

There are two situations in which it may be appropriate to create a new type of institution to facilitate the transformation of nonprofit microcredit foundations into licensed and supervised financial intermediaries. First, if the minimum capital requirement for existing institutional forms (typically bank and finance company) is very high it could prevent, or at least delay, mature and well-managed foundations from entering the formal financial system. Second, if the existing institutional form that has the lower minimum capital requirement (typically the finance company) is severely limited in the type of operations it can carry out—particularly in the area of savings mobilization—then it may simply be an unattractive form of institution for those microcredit foundations that want to enter the formal financial system[1].

Consequently, if the minimum capital requirement for finance companies is reasonable (say US$ 1-3 million) and if they are permitted to mobilize not only time deposits but also savings, then there is really not much of a reason to create a new type of institution for microfinance. And if finance companies cannot mobilize savings, then the first alternative should be to see if it is possible to change that restriction, either for all firms or on a case-by-case basis, rather than to create a completely new type of institution. There is no value in an unnecessary proliferation of institutions—it only makes the job of supervisors that much harder[2].

The PFDO—Civil Society Participation Gone Awry?

The PFDO, or Private Financial Development Organization, was created by the Honduran Congress in February of 2001 after significant lobbying from local civil society organizations active in microenterprise development. The desire of these organizations was to expand the availability of financial services to microentrepreneurs and other low-income clients by eliminating the funding constraint faced by nonprofit foundations serving them. The solution was to create an institutional form that would permit nonprofit foundations to operate as regulated and supervised financial intermediaries, which in turn would allow them to mobilize savings from the public.

But good intentions do not make a good framework. While the regulatory framework for the PFDO has some good aspects to it (for example minimum credit diversification standards and a prohibition to lend to related parties) there are a couple of major flaws in its design.

First, since the PFDO is constituted as nonprofit foundation, it has no owners (like an incorporated entity has shareholders). Consequently, as there are no owners with money at stake, there is no one with strong and selfish interests to monitor the management of the institution. Second, the minimum capital requirement for the PFDO is only US$ 60,000, much too low to reasonably guarantee that the institution can mount a sustainable operation while complying with the standards and requirements of the supervisory authorities. Third, the loans of the PFDO are subject to an interest rate restriction equal to 3 percentage points above the maximum rates charged by banks on commercial and consumer loans. Given the high operating costs associated with microfinance, this restriction could prevent institutions operating as PFDOs from becoming financially sustainable.

These flaws should disqualify PFDOs from mobilizing deposits from the public. There's just too much risk of institutional failure.

In fact, the regulatory framework for the PFDO states that they should only be allowed to take deposits from their own "clients", which would dramatically lower the risk if it means that the PFDO can only have net borrowers. However, neither the original law nor the regulations recently issued by the supervisory authorities specifically deal with this issue. Yet, since the definition of who is a client will determine the extent of the rights of the PFDO to mobilize deposits, this is likely to become a hotly debated issue between the supervisory authorities and the nonprofit community. No doubt, should the definition of who is a client end up being very loose, the supervisory authorities will have to protect depositors by developing additional norms and standards that strengthen the stability and solvency of the nonprofit foundations that operate as PFDOs.

Source: Decree No. 229-2000, Gaceta Oficial, February 3, 2001

[1] In some Latin American countries the permitted operations for the finance companies are so limited that it is impossible to offer microfinance services through them. In Guatemala for example, finance companies cannot mobilize savings deposits and can only lend over the medium to long term. Since the ability to capture savings is one of the primary motivations in the transformation of NGOs, and microloans usually have a term of 3-12 months, the Guatemalan finance company is entirely unattractive for entities that wish to provide microfinance services.

[2] The bad reputation of finance companies in some Latin American countries has sometimes been mentioned as a reason to create a new institutional form for non-profit foundations that want to transform into formal financial intermediaries. However, if the reputation of finance companies is badly damaged, it might be better to eliminate that type of institution and create an institutional form that is flexible enough to accommodate the traditional activities of finance companies well as microfinance.

And, of course, if there are no large and mature foundations that are ready to transform into financial intermediaries, it is premature to create an institutional form to this effect.

So far, 11 different types of financial institutions have been created in Latin America wholly or partly for the purpose of facilitating microfinance, including in Bolivia, Brazil, El Salvador, Honduras, Mexico, Panama, Peru and Venezuela. On the face of it, the ones in Bolivia and El Salvador appear to be the most justified and balanced because: (a) they fill the role of both finance company and microfinance institution, thus avoiding a proliferation of institutions (as has occurred in Peru); (b) they are allowed to mobilize deposits from the public, and; (c) they have capital requirements that are low enough to enable the transformation of nonprofit foundations, but high enough to ensure sufficient financial strength to operate successfully as a regulated and supervised intermediaries, and; (d) they are created as incorporated shareholder-based companies that, while far from perfect, is still the institutional form that provides the best set of checks and balances in terms of governance.

The justification for and design of the other 9 institutions seem less convincing. In some cases, the required minimum capital requirements is too low to ensure that the institutions can mount a sustainable operation; in other cases, the institutions are not permitted to mobilize savings, which begs the question why they are supervised in the first place. For instance, the minimum capital requirements for the institutions created in Mexico[3], Honduras, Brazil and Peru are quite low, and in the cases of Brazil and Peru the institutions are not permitted to capture savings[4]. The case of Honduras also stand out for another reason: it is the only example where nonprofit foundations will be permitted to operate as deposit-taking intermediaries while retaining their legal status as foundations (see box). In Venezuela, the high capital requirements for conventional banks, coupled with the lack of an institutional form such as finance company, means that the new institution fills a significant void. However, there are few, if any, microcredit foundations in Venezuela that are mature or successful enough to actually transform into this new type of institution.

In spite of the questions surrounding these new institutions, they will likely help expand microfinance by giving

Basic Principles for Regulating and Supervising Microfinance

1. Only supervise microfinance institutions that mobilize deposits from the public. If an institution doesn't mobilize deposits, there is no compelling reason for the supervisory authorities to be involved.

2. Allow only incorporated, shareholder-based microfinance institutions (not nonprofit foundations) to mobilize deposits from the public. Nonprofit foundations have no owners with money at stake (in fact they have no owners at all) and are therefore characterized by important weaknesses in terms of governance and institutional stability.

3. Don't create a new and distinct institutional forms specialized in microfinance unless the existing institutional forms—such as bank or finance company—are unattainable (due to high minimum capital requirements, for instance) or carry important operational restrictions that cannot be easily changed (such as the inability to mobilize deposits).

4. Require the participation of private strategic investors in deposit-taking microfinance institutions that are formed through the transformation of nonprofit foundations. Deposit-taking microfinance institutions are typically dominated by the original nonprofit foundation and therefore need profit-minded investors as counterweight.

5. Define microcredit as a new form of lending, distinct from consumer, commercial and mortgage lending. This will enable the simplification of rules and requirements for microenterprise loans.

6. Create simpler rules for risk classification, client loan documentation, collateral, loan loss provisions and write-offs of operations defined as microloans. In some cases the standards need to be stricter than current practice, in others more flexible; however, they should always be simple.

7. Implement risk based supervision focused on microfinance institutions' (i) governance and ownership, (ii) lending methodology, and (iii) internal control mechanisms and procedures.

8. Encourage the development and use of credit bureaus so that microfinance institutions can more easily assess the credit worthiness of potential clients and so that microenterprise clients can more easily use their credit histories to shop around with different financial institutions.

Source: Manual for Regulating and Supervising Microfinance, IDB (forthcoming)

3 The Mexican initiative is unique in that it also deals with microfinance through the lens of financial cooperatives. In this regard, Mexico is addressing an issue that is starting to catch the attention of supervisors all over Latin America. There are approximately 5,800 financial cooperatives in Latin America that collectively have a loan portfolio of about US$ 4.1 billion, of which 30-40% is estimated to be microloans.

4 In Peru, the EDPYMES can—through more capital and good ratings—theoretically progress to a higher "module", which would allow them to capture savings. So far, however, the Bank Superintendency has not allowed the progression of any EDPYMES.

microcredit foundations something concrete to strive for and grow into. Of course, if the institutions are badly designed[5], it could lead to problems in the long run. And the stakes are high, because not only would the Latin American microfinance industry suffer a serious loss of credibility, but a very large number of low-income depositors could also lose their life savings.

Furthermore, creating new institutions for microfinance, even when well justified and designed, is not enough to provide a comprehensive regulatory framework for microfinance. The first and perhaps most important step to this end is actually to design appropriate regulations for microlending as such. These regulations, which should be based on the distinctive features of microlending as an activity and microcredit as a product, will ensure that any interested financial intermediary can provide this type of loans in an efficient manner while having to strictly recognize the revenues, expenses and risks arising from this activity.

This type of regulation should be guided by three principles: flexibility, simplicity and automaticity—flexibility in interest rates, collateral and internal credit processes; simplicity in client documentation, loan delinquency and recuperation of collateral; and automaticity in portfolio classification, loan loss provisions and write-offs. Together, these basic rules provide room for innovation, lower the regulatory costs of compliance and subject microlending to a strict recognition of revenues, expenses and risks.

Finally, although the regulatory framework is important, it is only half the story. The other half is supervision. Since most of the regulatory initiatives are still quite recent (apart from Bolivia and Peru), supervisory authorities have not yet developed effective processes, tools and practices of supervision. In fact, it would not be an exaggeration to say that supervisory authorities in several countries have been taken by surprise by the recent wave of legal and regulatory initiatives in the area of microfinance. Now, however, it is up to them to add the specifics to the regulations and figure out how to supervise this activity and the entities involved in it. Achieving the proper mix of regulations and supervisory practices that foster a competitive and sound microfinance industry will not easy, but neither is it impossible. What is certain, though, is that it will require a sustained commitment on the part of supervisory authorities.

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In Future Issues...

Leasing as a way to provide long-term financing to microenterprises

Secured transactions and microfinance

[5] The information provided in this article is not sufficient to make a conclusive statement in this regard. Whether or not an institution is well designed depends on several additional factors not examined in this article.

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The Micro, Small and Medium Enterprise Division manages the IDB's microenterprise projects with the private sector and provides training, disseminates best practices, and develops policies and strategies to guide Bank country operations and promote the growth of the microenterprise sector in Latin America and the Caribbean.

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