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| **Microfinance Regulation: Implications for the Caribbean**  |

 **Microfinance Regulation: Implications for Caribbean Microfinance**

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Her research interests are in the areas of microfinancing and its relationship with poverty eradication and micro-enterprise development. She is keen on building a microfinancing model specifically targeted to the conditions of the Caribbean economy; and to developing techniques of microfinance application that will work to measurably alleviate the conditions of the poor in this region.

 Abstract

Transforming the lagging microfinance industry in the Caribbean to financial sustainability requires the implementation of enabling regulation. This will support an expansion in the services provided under the microfinance umbrella, in line with those being offered globally. In this paper global approaches to microfinance regulation will be critically studied in order to formulate policy recommendations for the introduction of microfinance regulation in the Caribbean region. The paper seeks to emphasize the need for an appropriate regulatory framework; to support stable expansion of the industry, to protect the vulnerable client base and to deliver on expected social and economic objectives.

Key Words: Microfinance, Regulation, Caribbean

INTRODUCTION

Microfinance refers to the provision of financial services in limited amounts to low-income persons and small businesses shunned from the commercial banking sector because of their unfortunate economic status (Basel Committee 2010). Microfinance offers poor people access to basic financial services such as loans, savings, money transfers and microinsurance. The microfinance industry started in the 1970s as a philanthropic movement with a primary focus on alleviating the conditions of the poor. It did not, however, take the industry players long to realize that the marginalized and under-served poor formed a lucrative market that could be profitably served by microfinancing.

Commercial microfinance has enabled significant growth in the microfinance industry over the last two decades. This growth is evidenced in borrower outreach and expanded services such as new savings accounts. The Microcredit Summit Report of 2009 reported that to the end of December 2007, there were 3,552 microcredit institutions servicing 154.8 million clients (Daley-Harris 2009). To fund this expansion many Microfinance Institutions (MFIs) have tapped into commercial sources of finance and the Microfinance Bulletin (2008) reports that from the year 2004 to 2006, commercial financing sources on MFIs’ balance sheets almost tripled.

The expansion of microfinance services especially deposit taking during the 1990s raised concerns on the part of financial regulators, donors and microfinance gurus (Wright 2000). These interested parties saw the need to offer protection to depositors especially in instances where deposits were being used by MFIs as a source of capital for on-lending. During the 1990s many Latin American countries were among the first to begin regularizing the microfinance sector. This early experiment with regulation boasted of much success. It was found that a sound micro-financing regulatory framework acted as a key contributor to attaining financial sustainability for MFIs, which fostered further industry growth and outreach.

The success of the microfinance revolution globally has not been favourably reflected in the Caribbean. The industry described as immature when compared to Asia and Latin America, suffers from substandard financial performance and lacks outreach into the microenterprise sector (Wenner and Chalmers 2001). The microfinance industry in this region operates on a very small scale, experiencing great difficulty with loan recovery and lacking sustainability. The under-developed Caribbean microfinance sector suffers from deficiencies in basic institutional structures and policies guidelines. One such deficiency is the lack of financial regulations covering microfinancing activities.

This paper starts by examining a number of theoretical considerations in microfinance regulation. It builds the case for increased regulation for the microfinancing sector, and seeks to offer guidelines to Caribbean policy makers, for the introduction of micro-financing regulations in the region. In forming recommendations the paper draws on successful experiences of nations across the globe.

WHAT IS MICROFINANCE REGULATION?

Rhyne (2002) in a study of seven MFIs in six Latin American countries writes that:

.... Until recently regulated microfinance was so new that microfinance institutions and banking authorities barely shared a common vocabulary......today there are enough regulated microfinance institutions with some length of experience that we can begin to bring a more practical dimension into the discussion.

To aid the regulation of microfinance operations the Consultative Group to Assist the Poor (CGAP)[[1]](#footnote-1) in 2003 published guidelines on regulation and supervision of microfinance. These principles were adopted by the CGAP’s donor members, and will serve as the basis for this paper’s discussion on microfinance regulation. The following definitions taken from these guidelines will be used to further discussions (Christen et al. 2003):

* Regulation – binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations).
* Prudential Regulation or Supervision – governs the financial soundness of licensed intermediaries’ businesses, in order to prevent financial system instability and losses to small, unsophisticated depositors.
* Supervision – external oversight aimed at determining and enforcing compliance with regulation.
* Financial Intermediation – is the process of accepting repayable funds (such as deposits or other borrowing) and using these to make loans.
* Self-regulation – regulation or supervision by a body that is effectively controlled by the entities being regulated or supervised.

Prudential financial regulation thus serves the following macroeconomic goals (Wright 2000):

1. Ensuring the solvency and financial soundness of all financial institutions.
2. Providing depositors protection against excessive risks that may arise from failure, fraud or opportunistic behaviour on the part of the financial institution.
3. Promoting efficient performance of financial intermediaries and markets.

Prudential regulation must be administered by a specialized financial authority such as the Central Bank, it is complex and expensive to introduce and burdensome to administer. Non-prudential regulation and supervision does not address the financial soundness of individual financial institutions, but rather addresses regulatory issues enshrined in the conduct of business. Non-prudential regulatory requirements span a wide spectrum and include: reporting and disclosure requirements; ‘fit and proper’ requirements for directors and officers; and restrictions on interest or deposit rates, setting up of credit information services and preventing fraud and financial crimes. Unlike prudential regulation and supervision, non-prudential regulation and supervision may apply not only to licensed financial institutions but also to registered financial service providers (Microfinance Gateway 2011). In designing regulations to cover microfinancing in the Caribbean non-prudential regulation can play a major role in enabling the formation and efficient operation of MFIs. In the planning of a regulatory framework care must be taken to avoid using complex and expensive prudential regulation for non-prudential purposes (Christen et al. 2003).

Despite the phenomenal growth enjoyed by the microfinance sector globally, it can be argued that on a country basis microfinance in most cases does not form a large enough part of the financial system to threaten its overall integrity. Regulation for microfinancing is thus mainly aimed at protecting deposits and serving an enabling role to promote industry development.

In the Caribbean where MFIs are few in number and are mainly focussed on providing credit services, microfinance presents little or no risk to the stability of the financial sector. It may be as a result of this that the islands have not concentrated efforts on establishing an adequate regulatory framework or on institutional development. A 2009 study conducted by *the Economist* ranked fifty-five countries worldwide based on each country’s regulatory, investment and institutional environment for microfinance. The only two Caribbean countries in the study were Jamaica and Trinidad. Both countries ranked in the top twenty for investment climate[[2]](#footnote-2), while under institutional development Trinidad ranked forty with a score of 16.7 out of 100, and Jamaica ranked fifty-second with a score of 8.3. Under the regulatory framework dimension, Jamaica scored 25 out of 100 and ranked fifty and Trinidad came in last at fifty-five with a score of 12.5. A full listing of the study’s rankings on regulatory framework is given in Appendix I (Economist Intelligence Unit 2009)). This study highlights that in spite of the potential for favourable microfinancing business in the Caribbean region, little has been done by way of supportive or enabling policies and regulations to develop the industry. Focus must be placed on protecting the existing institutions and ensuring that the appropriate regulations are in place to promote their growth to achieve financial sustainability and expanded outreach.

WHY IS REGULATION NEEDED?

The need for regulation of the microfinance industry can be traced to trends in microfinancing over the past two decades.

The global microfinance sector has experienced phenomenal growth evidenced by rising numbers on both the demand and supply sides. According to the 2009 Microcredit Summit Report there was an 83 percent increase in MFIs reporting to them over the period 1997 to 2007; from 618 to 3,552. This trend is also reflected on the demand side with a 91 percent increase in the number of clients accessing the services of MFIs from 13.4 million clients in 1997 to 154.8 million clients in 2007. Table I reports these increases for the ten year period from 1997 to 2007. Table I also highlights the steady increase in the portion of MFI clients that came from the poorest groups. In 1997 the poorest clients accounted for 56 percent of the total clients and by 2007, 72 percent of the clients served were among the poorest[[3]](#footnote-3) (Daley-Harris 2009). Microfinance regulation is critical to safeguard the interests of these poor clients who generally have low levels of financial literacy, which impedes their judgment on the riskiness of microfinance ventures. Increased transparency is required in areas such as interest rate reporting, as in microfinance it is commonplace for the real cost of borrowing to be hidden by creative practices such as, charging interest on the original value of the loan as opposed to reducing balance, up-front fees, use of security deposits which are deducted from loan amounts and compulsory savings (Karnani 2009).

To enable sustained growth many MFIs sought to transform their legal structures and the types of institutions offering microfinance services today range from NGOs, credit unions and cooperatives, commercial banks, non-bank financial institutions (NBFIs) and rural banks. The Microfinance Information Exchange (MIX)[[4]](#footnote-4) reports on MFIs by institution type and this data is summarized for the years 2000 and 2009 in Table II. The increase of 82 percent in total MFIs as reported on the MIX from 2000 to 2009 further supports the 2009 Microcredit Summit data on industry growth presented earlier.

Figure I, highlights that while NGOs and NBFIs continue to dominate the microfinance landscape, by 2009 NGOs accounted for a smaller proportion of institution type, falling from 43 percent in 2000 to 38 percent in 2009. NBFIs have however become the more popular of the two, increasing from 30 percent in 2000 to 36 percent in 2009. This trend is an indication of the increased commercialization that is occurring in the industry, with MFIs opting to transform from their non-profit status to registered financial institutions, and start-up MFIs generally opting for regulated status. Appendix II which reports on MFIs transformed from NGOs to regulated financial institutions as at March 2006 (Hishigsuren 2006) shows that institutional transformations have occurred more in Latin America than any other region. TheMicroBanking Bulletin (2007) reports that over the period 2003 to 2005 the ‘ranks of transformed’ MFIs was expanding to Africa and Asia this is also supported by the data presented in Appendix II. This shift has contributed to a greater professionalization of the microfinance industry, with better organized MFIs, attracting the best consumer finance professionals and large scale institutional financing (Mittal 2010). Regulation for microfinance is thus necessitated and complicated by the variety of business models that are followed most times simultaneously in the same country.

The benefits to be had from operating as a regulated MFI as opposed to an un-regulated NGO are detailed by Hishigsuren (2006) as follows:

*Access to additional commercial sources of funds*: NGOs’ sources of funds are limited to donations, income from lending and subsidized loans. Regulated MFIs can access commercial sources of funds for both equity and debt (Rhyne 2002). The MicroBanking Bulletin (2007) reports that in their 2005 benchmarking exercise it was found that the median institution’s commercial funding of its loan portfolio stood at 60 percent. This trend held true for every region and type of institution reported on. It was reported that in 2005 MFIs held US$1billion more in commercial borrowings than two years prior and that regulated status helped these MFIs attract commercial funding, as nearly half of the US$1 billion went to regulated MFIs. Although the volumes of loans and borrowings being held by the MFIs may not be enough to cause instability in the financial sector, the increased use of commercial funding can have damaging spill over effects in cases of major MFI failures. The need for effective regulation over microfinance activity was confirmed when in August 2010 the Basel Committee on Banking Supervision[[5]](#footnote-5) published guidance for the application of the “Core Principles of Banking Regulations” to microfinance activities conducted by depository institutions in their jurisdictions. The Basel Committee saw the need for a coherent approach to regulating and supervising microfinance, and acknowledged the fundamental differences between the traditional banking and the microfinance sectors (Basel Committee 2010). In general, microfinance oversight, whether over banks or other deposit taking institutions, should weigh the risks posed by this line of business against supervisory costs. The publishing of these guidelines serve as an indication that the size of the microfinance market has perceived implications for the risk of financial stability.

*Wider range of financial services*: In many countries regulation prevents un-regulated, non-profit MFIs from mobilizing savings. Transforming to a regulated financial institution would enable the MFI to offer a wider range of financial services to clients including but not limited to savings. Savings mobilization gives the MFI access to a stable source of local resources, and enables expanded outreach. Depositors’ savings need to be protected from financial intermediaries who may take excessive risks in investing and loaning out these funds. Prudential regulation to protect depositors and guard against moral hazard[[6]](#footnote-6) is critical.

In delivering this diversified range of products MFIs are using technology to ensure that banks and their customers can interact remotely in a trusted way through local retail outlets (Mas 2009). In technologically advanced developing countries electronic banking technologies such as smart cards, point of service devices, automated teller machines (ATMs) and phone and internet banking are reaching rural areas and reducing costs (Nagarajan and Meyer 2006). To date a best practice in using internet technology to progress the business of microfinance is Kiva. Kiva combines microfinance with the internet to deliver on its mission to connect people, through lending, for the sake of alleviating poverty (Kiva 2011). Such innovations add complexity to MFI operations and introduce new financial risks that must be mitigated through a rigorous regulatory framework.

*Self Sustainability and Profitability*: The basic premise behind commercial microfinance is profitability and self sustainability, and transformation is viewed as the only means to achieve this. There is however an on-going debate on profit-maximisation goals benefitting MFIs and investors at the expense of financially illiterate and needy clients. Karnani (2009) cites the example of Compartamos in Mexico, which started as an NGO and went public in April 2007.

The initial investors’ stake of US$6 million was valued at US$1.5 billion – a return of roughly 100 percent a year compounded over eight years. This profitability is due to the fact that Compartamos charges interest rates that exceed 100 percent per year on loans to the poor.

Profit-maximization by MFIs and their investors, and the potentially nega­tive effect it can have on clients and the public perception of microfinance highlights the need for client protection, through increased transparency in microfinance operations. In July 2008 MFTransparency[[7]](#footnote-7) was launched to publicly demonstrate the microfinance industry’s commitment to pricing transparency, integrity and poverty alleviation. MFTransparency was born out of the need to ensure that the true price of microfinance credit products was accurately measured and reported, a critical area to be covered by any microfinance regulation (MFTransparency 2011).

Self regulation is often put forward as an alternative to prudential regulation for MFIs. In practice it has been found that self regulation does little more than improve the financial reporting and internal controls in the organization. Karnani (2009) argues that MFI responses to self-regulate have at best been naively optimistic, and highlights that the USA is on the path to greater government regulation after the failure of that country’s experiment with self-regulation. If developed economies such as America have failed at self regulation, there is little reason to expect self regulation alone to work for the microcredit industry in developing countries which face less competition, less scrutiny and more vulnerable consumers.

Microfinance regulation is thus a requirement to promote and sustain the growth of the industry. Prudential regulation is required in many regions of the world to cover issues such as lack of transparency, complexity of operations and high profits at the expense of clients. In the Caribbean region where microfinance is yet to take off the ground as a sustainable industry, regulation is equally needed. Regulation in the Caribbean region needs to focus on implementing measures to support the development of a sustainable microfinance industry. This will propel viable MFIs to operate efficiently, increase outreach and price services according to prevailing market conditions, thus enabling eventual financial self sufficiency.

The benefits from regulation has been proven and Rhyne (2002) reported that in her study of seven regulated MFIs all asserted that the benefits of being regulated outweigh the costs, and that none would even contemplate reverting to NGO status.

IMPLEMENTING REGULATIONS

Caribbean microfinance regulations must focus on promoting market efficiency and encouraging the appropriate functioning of market forces. Presently there is little distinction between the institutions providing microcredit services. Clear rules need to be established distinguishing between commercial microfinance businesses, whose aim is to profitably provide microfinance services, state funded social programs aimed at micro-lending and donor funded schemes. Operations of well-established MFIs need to be reviewed for the conferring of regulated status. Specialized risks associated with MFI operations must also be identified and ameliorated with regulation. The role of the government must also be clearly defined and understood by all parties. The creation of such a framework will rely on close co-operation between the regulators and the regulated, and if done correctly can enhance and support the dynamic nature of microfinancing by enabling MFIs to be responsive, versatile, flexible and sustainable (Counts and Sobhan 2002).

The Basel Committee (2010) in publishing the “Microfinance activities and the Core Principles for Effective Banking Supervision” acknowledged the fundamental differences between microfinancing and the traditional banking sector.

Product design, client profile and labour-intensive underwriting methodologies give microcredit a unique risk profile. Effective credit risk management thus requires different tools and analyses than for conventional retail lending (Basel Committee 2010).

Implementation of suitable microfinance regulation starts with an astute appreciation of the fundamental differences between microfinancing and the traditional banking sector. The Basel Committee’s 2010 report highlights the following distinguishing traits of microlending.

* Borrowers: a microcredit provider usually targets low-income clients, who are either underemployed or entrepreneurs with an often informal family business. Borrowers are typically concentrated in limited geographic areas, social segment or entrepreneurial undertaking. Loans are usually very small, short term, and unsecured and repayment periods are more frequent. Higher interest rates[[8]](#footnote-8) than the traditional banking sector are often required to offset higher operational costs involved in the labour-intensive microlending methodology.
* Credit risk analysis: loan documentation is generated largely by the loan officer through visits to the borrower’s business and home. Borrowers often lack formal financial statements, so loan officers help prepare documentation using expected cash flows and net worth to determine the amortization schedule and loan amount. The borrower’s character and willingness to repay is also assessed during field visits. Credit bureau data for low-income clients or for microfinance providers is also used if it exists. Credit scoring, when used, complements rather than supplants the more labour-intensive approaches to credit analysis.
* Collateral: micro-borrowers often lack the type of collateral traditionally required by banks, and what they have to pledge is of little value for the financial institution but are highly valued by the borrower (e.g. appliances and furniture). If the lender does take collateral, it is for leverage to induce payment rather than to recover losses. In the absence of collateral, underwriting depends on a labour-intensive analysis of the household’s repayment capacity and the borrower’s character. Traditional banking rules would consider most of an MFI’s loan portfolio as un-secured, resulting in over excessive reserve requirements and write off provisions.
* Credit approval and monitoring: microlending tends to be a highly decentralised process with credit approval by loan committees depending heavily on the skill and integrity of loan officers and managers for accurate and timely information.
* Controlling arrears: strict control of arrears is necessary given the short-term nature of, high frequency of payments on (eg weekly or bi-weekly), and contagion effects[[9]](#footnote-9) associated with microloans. Monitoring is primarily left in the hands of loan officers as knowledge of the client’s personal circumstances is important for effective collections.
* Progressive lending: customers who have limited access to other financing are usually dependent upon ongoing access to credit. Microlending uses incentive schemes to reward good borrowers with preferential access to future, larger loans (sometimes with favourable repayment schedules and lower interest rates), which raises the risk of over-indebtedness, particularly where credit information systems are absent or deficient. This feature also affects interest rate risk management, as microfinance customers expect rates to decline as their track record grows, regardless of changes in the general level of interest rates.
* Group lending: some microlenders use group lending methodologies, where loans are made to small groups of people who cross guarantee other members of the group. Peer pressure also helps to ensure high repayment levels, as the default of one group member could adversely affect the availability of credit to others.
* Political influences: microcredit and microfinance in general, may be seen as political tools in some countries, tempting politicians to demand forbearance or forgiveness of loans to poor customers during times of economic stress. This can impact the repayment culture of microfinance borrowers. Political influence is a severe impediment to viable microcredit growth in the Caribbean region, where governments often implement their own microcredit schemes that compete with legitimate long standing MFIs unfairly, as the former accesses state funds for on-lending.

The dynamics of microfinance assets and liabilities also differ from those of commercial banking this affects liquidity and interest rate risk management. On the asset side, loan repayment is often driven by expectations of repeat loans over time, thus transforming short-term loan portfolios into long-term, fixed-rate assets. Illiquidity of such assets is heightened by the fact that there are few established securitisation markets available for microcredit portfolios. Microfinance institutions also tend to grow rapidly, particularly in their early stages. In this situation, they may lack a cushion of unencumbered, high-quality liquid assets to enable them to withstand a range of stress events, since most funds are designated to support loan growth (Basel Committee 2010).

The differences highlighted above would imply that the application of pre-existing regulations for the formal sector cannot be successfully applied to the microfinance industry. It has been found that this approach many times serves as an impediment, restricting MFI growth (Counts and Sobhan 2002).

Wright (2000) discussed the following options for microfinance regulation

* No External Regulation: this is the current environment for many MFIs operating in the Caribbean.
* Self-Regulation: this requires a competent independent board with authority to hold management accountable, sound internal control and risk management policies and external auditors knowledgeable in the field of microfinance. These three factors must work together with transparent disclosure. NGOs styled MFIs generally tend to practice self regulation, as do informal institutions, like rotating savings plans (Sou Sou in the Caribbean).
* Blended approach: a mix of self-regulation and part supervision by a third party. Regulation and supervision generally take the form of operational standards designed and enforced by an industry umbrella body or apex organization. Apex organizations are usually government sponsored creating the potential for much government interference. In India for example the operations of the National Bank for Agriculture and Rural Development (NABARD) as an apex organization is subject to much government interference while in Bangladesh the domestic apex organization Palli Karma Shahayak Foundation (PKSF) despite being government sponsored has been able to execute its functions autonomously (Haq et al. 2008).
* Regulation through the existing legal and regulatory framework: this is achieved by amendment of the existing financial sector laws and regulations. Christen et al. (2003) suggest that this approach better promotes integration of the new license into the overall financial system and increases the likelihood that the regulatory changes are properly harmonized within the existing regulatory landscape. In Asia countries such as; Bangladesh, China, Philippine and Vietnam have all nominated their central banks as their interim MFI regulator under banking law, and so they are subject to normal prudential regulation and supervision (Haq et al. 2008). BancoSol in Bolivia was the first MFI to be registered in 1992 as a bank under existing banking regulations.
* Regulation through MFI-specific regulation: some countries such as Bolivia, Peru Mozambique and Uganda have created a distinct legal-status and regulation for non-bank MFIs. This approach can be appropriate when there is a ‘critical mass of qualifying institutions’ ready to transform from NGO MFIs to deposit-taking status (Christen et al. 2003). Developing MFI specific regulation is time-consuming, requiring much negotiation and consultation and should only be undertaken when the costs can exceed the benefits. MFI-specific regulations present low barriers to entry, and offer institutions a more favourable regulatory environment; as a result many existing institutions and new entrants contort to qualify as MFIs. This ‘regulatory arbitrage’ (Christen et al. 2003) can cause some institutions to be under-regulated. The Grameen Bank in Bangladesh was incorporated by special regulation.

The approach adopted by any nation must depend on its local conditions. In main part the risk imposed on the financial system by microfinance operations, the stage of development of the microfinance industry, the effectiveness of existing financial monitoring or regulating agencies and the supervisory skills and capabilities available.

The success of any regulatory framework depends more on its content than whether it was implemented as special regulations or within existing regulations. In determining regulatory content a number of prudential and non-prudential instruments can be used.

There are many windows in microfinance regulation that can be covered using non-prudential regulation. Some of the areas where non-prudential regulations can apply include: consumer protection, fraud and financial crime prevention, credit reference services, interest rate caps, ownership structures and tax and accounting implications. Table III provides details on the instruments that can be used to achieve these aims. The instruments discussed in Table III highlight that much non-prudential regulation can be introduced through general commercial laws, such as fiscal regulations. Regulatory goals can also be reached by modifying existing laws such as criminal laws for anti-fraud and financial crime regulations. Transforming MFIs aiming to move from NGO status to a commercial entity may face numerous regulatory obstacles such as, prohibition of not for profit NGOs holding equity in commercial entities, limits on foreign ownership and participation, prohibitive tax implications and restrictive labour laws. These obstacles can be addressed by a number of non-prudential regulations, which if harmonized can be an important enabling reform (Christen et al. 2003). A microfinance regulatory framework built on non-prudential regulations is appropriate when the goal is to enable MFIs to extend credit but not take deposits.

As MFIs seek to acquire financial autonomy by borrowing from depositors and commercial sources, they must accept permanent public supervision and comply with prudential rules and standards (Rosales 2006). In studying the implications for prudential regulations for MFIs it is useful to use the ACCION CAMELTM instrument which is based on the CAMEL methodology[[10]](#footnote-10). The CAMEL reviews and rates five areas of financial and managerial performance: Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity Management. Although the ACCION CAMELTM reviews these same five areas, the indicators and ratings used by ACCION reflect the unique challenges and conditions facing the microfinance industry (ACCION CAMELTM 2011). In Table IV Rhyne (2002) uses the ACCION CAMELTM key Indicators, to show areas where microfinance differs from conventional banking norms. This analysis highlights that special supervisory issues arise in all areas of microfinance inspection and that while the basic principles are the same for commercial banking application must be different.

Capital adequacy and minimum capital requirements are critical in protecting deposits and mitigating risks. It represents a “commitment fund” before starting the business, it serves as a cushion against MFI losses and it provides a source of long term permanent finance. Meeting capital adequacy requirements also instils a sense of confidence in the MFI on the part of depositors, investors and other lending agencies (Haq et al. 2008). In studies conducted in Asia by Haq et al. (2008) it was found that the minimum capital requirement varied significantly by country, type of institution and geographic location of MFI. In Pakistan one microfinance bank operated with a minimum capital requirement of US$27.9 million, the Grameen Bank has US$2.5 million and Indonesian MFIs vary from US$6,000 to US$0.59 million depending on their location. This study also reported that minimum capital adequacy ratios (CAR) averaged at 8 percent of risk weighted assets, with the highest being 15 percent.

The Basel Committee (2010) specifically addresses the issue of CAR requirements for MFIs with member owned shares such as credit unions and co-operatives. The recommendation is that these shares not be considered a part of high-quality regulatory capital unless withdrawal of these shares is restricted. Approaches to deal with co-operatives can be to limit members’ rights to withdraw share capital if the institution’s capital adequacy falls to a dangerous level, or to require co-operatives to build up a stipulated level of institutional capital[[11]](#footnote-11) over a period of years, after which time capital adequacy will be based solely on this source of capital (Christen et al. 2003).

Capital adequacy ratio requirements were reported by the Basel Committee (2010) to vary greatly among countries but generally to be higher for MFIs involved in deposit taking than commercial banks. This is justified by the un-secured nature of microfinance portfolios, the contagion effect of default alluded to earlier, the vulnerability of MFIs to cope with delinquency due to their high operating costs and the fact that the industry is new and most players lack an established track record (Christen et al. 2003).

MFI regulation must depart from the traditional requirement of 100 percent provision on all un-secured lending for loan loss. Loan loss provisioning should instead be based on the institution’s lending, tracking and collection procedures. Features of MFI operations should include motivation for borrowers to repay through promise of continued access to credit or other suitable methods, conservative approach to loan approval and loan size determination based on analysis of existing repayment capacity or step lending and strong delinquency management, (Rhyne 2002). Once balances become past due however these must be provided for more aggressively by the MFI than the commercial banks. In Cambodia the number one ranked institution in the 2009 *Economist* study, MFI loans are classified into four types; standard, sub-standard, doubtful and loss, depending on the financial situation of the borrowers and the timeliness of principal and interest payments. Loan categorization and days past due drive aggressive provisioning for portfolio at risk. Loan loss is provided for as follows: standard 0 percent, sub-standard 10 percent, doubtful 30 percent and loss 100 percent (Vada 2010). Banking rules in some countries may also need to updated to allow MFIs to borrow from banks even though they cannot offer qualifying collateral and do practice a 100 percent provisioning on their non-collateral lending portfolio (Christen et al. 2003).

In determining interest rate policies for MFIs it can be argued that the imposition of interest rate caps obstructs the operation of a free market and ultimately reduces the supply of microfinancing to the poor (Christen et al. 2003). In practice however there is no consensus on how regulators have treated with this issue. Many regulated MFIs are presented with either interest rate ceilings or flexibility to set interest rates within a stipulated range, while a lesser portion are given full freedom to set interest rates on microlending. A best practice policy guideline for interest rates can be drawn from Cambodia. Here the National Bank of Cambodia has issued regulation of no interest rate cap on microfinance operators; however the Bank stipulates that the method of interest rate calculation must be on a ‘declining-balance method.’ Additionally all licensed MFIs have joined the Cambodian Microfinance Association which embraces as one of its aims to not use interest rates as a completive tool to attract customers (Vada 2010). Globally however interest rates charged by the regulated MFIs are significantly lower than those charged in the informal markets by money lenders, which generally cross over 100 percent (Haq et al. 2008), but are understandably higher than that charged by traditional banks.

In determining a regulatory framework for microfinance, leniency needs to be applied in a number of areas. Loan documentation requirements for commercial loans cannot be replicated for microfinance loans. The volume of microlending transactions is too high and clients do not always have the documents required by traditional banking. Microfinancing operations cannot be restricted to fixed opening and closing hours, as most of the banking in microfinance is done on the field, at times suitable to clients. The already high operating costs of microfinancing are increased by satisfying regulatory requirements. Christen et al. (2003) estimates the cost of compliance at 5 percent of total costs during the initial year and 1 percent thereafter, sensible cost benefit analysis should be undertaken therefore in determining levels of regulation for this sector. If regulations are not customized to cater to the unique features of microfinancing, the marginalized poor for whom microfinance was developed would once again find themselves neglected.

MICROFINANCE IN THE CARIBBEAN

The Caribbean microfinance industry can be described as immature when compared to Asia and Latin America; it suffers from substandard financial performance and lacks outreach into the microenterprise sector (Wenner and Chalmers 2001).

In the Caribbean microcredit and microfinance are terms that can be used interchangeably given that the main microfinance service offered is microcredit (Knight and Farhad 2008). Delivery of services is generally undertaken by specialized financial institutions, state owned and funded companies, credit unions and donor supported NGOs. To date most programs are financially unsustainable and remain dependant on government or donor-supported funding (Westley 2005 and Wenner and Chalmers 2001). The primary focus of Caribbean MFIs is the provision of funding to small entrepreneurs and microenterprises (Lashley and Lord 2002), as only the NGO type institutions have focussed directly on reaching those disenfranchised and excluded from participation in the traditional banking sector. Many donor funded programs operate in remote geographic areas close to their target client. Such a program operates in Trinidad and Tobago as a partnership between the United Nations Development Program (UNDP) and the Ministry of Social Development. This project has established eight community-led Micro Credit Facilities in six of the fourteen regional districts in Trinidad and Tobago. The project aims to improve the living standards of economically vulnerable groups through community empowerment and entrepreneurial development. It provides on-lending funds and business development support services to facilitate direct community involvement in entrepreneurial development and the promotion of sustainable livelihood opportunities at the community level as a strategy to reduce poverty (UNDP Trinidad and Tobago 2011). It is generally accepted that growth in small and micro enterprises will have a spill over effect by creating constant employment for those lacking special skills.

The microfinance market in the region is extremely small and fragmented. Wenner and Chalmers (2001) in comparing Caribbean and Latin American MFIs associate a number of limiting factors for Caribbean microfinance.

…. the smaller and more concentrated financial markets, the greater degree of macroeconomic stability, their lower rates of poverty and superior standard of living, as well as the prevalence of inappropriate lending technologies, are crucial factors in determining the major constraints to growth of the microfinance sector...

Lashley (2004) also stresses that the highly developed financial sector in the region acts to crowd out the operation of the MFI.

 Sustainable microfinance is stifled by a number of factors; key among them is the poor re-payment culture of Caribbean borrowers. Lashley and Lord (2002) commented that clients generally take loans as handouts never to be re-paid. MFIs must tow a conservative line in providing for loan loss, Caribbean Microfinance Limited (MICROFIN)[[12]](#footnote-12), provides for 80 percent of its loans outstanding over 90 days, and 100% percent for those outstanding over 180 days. In 2008 loan loss expenses for its Trinidad operations as reported in the company’s 2008 Annual Report accounted for 13 percent of total operating income.

 Caribbean MFIs also operate in an environment of fixed interest rates. These rates are set too low to allow MFIs to profitably cover their high operating costs or to take advantage of their clients’ willingness to pay higher than market rates. This latter assertion is supported by the thriving informal money lending industry which charges significantly higher than market interest rates.

Many government initiatives designed to ease the conditions of the poor sometimes take the form of financial handouts. Such policies create a dependency syndrome that can suppress entrepreneurial spirit among those for whom microfinance is available. This limits the potential client base available to MFIs.

State owned and funded microfinance companies are also common in this region. These institutions use state funds to compete with well-established private MFIs that fund their operations from commercial sources. This perverts the operation of free market forces in the supply of microfinancing and operates to the disadvantage of the private MFIs. Wenner (2005) confirms that state funded programs in the Caribbean lend at lower interest rates and are not as aggressive in ensuring portfolio quality or enforcing debt recovery, thus benefitting from greater product demand and lower operating costs. Meagher et al. (2006) in a study of microfinance regulation in Ghana, noted that the Ghanaian government’s focus over the period 2002-3 to expand directly subsidized credit programs was not consistent with best practices in microfinance and worked to undermine the development of the microfinance industry. This problem is further complicated by the shifting priorities on policies such as microcredit funding as government regimes change.

The development of microfinance in the Caribbean region depends on capitalizing on our many naturally enhancing factors such as well developed transportation and communication networks, political and economic stability, secure financial markets and dense albeit small population sizes. Clarity needs to be established on the goals of microfinance, so as to determine appropriate enabling policies such as a supportive regulatory framework.

RECCOMENDATIONS FOR REGULATING THE CARIBBEAN MICROFINANCE SECTOR

The starting point in regulating the largely un-regulated microfinance industry in the Caribbean is a comprehensive understanding of the present state of the industry. Equally important is the need for clarity of purpose to be signalled by governments, whose commitment to the effort must remain unfaltering. Achieving these two landmarks will lay the foundation of where we are and where we want to go, so that a plan can then be worked.

 Microfinance in the Caribbean region is often misunderstood, and is generally taken to mean giving money to the poor. A clear definition of what microfinance is, what it is supposed to achieve and what activities or services fall under the microfinance umbrella must be formulated. These definitions must not be static but must leave room for continuous refinement as microfinancing itself is still evolving globally.

A careful study of all institutions that purport to offer microfinance services should be conducted to determine among other things financial sustainability, sources of funding, risk to the stability of the financial system and MFI readiness and desire to operate in a regulated environment. These findings will help to frame the priorities in the regulatory framework. Caribbean microfinance operates on a very small scale, with microcredit being the main activity; risks to either the financial system or clients are thus minimal. Considerable prudential regulation may therefore not be the best approach given its cost and complexity. State of the industry analysis will also enable policy makers to classify MFIs into key groupings either based on their activities or legal form. These groupings can then be assessed for readiness to become regulated. Unless an MFI can demonstrate an ability to operate profitably it should not be considered a candidate for regulation.

Counts and Sobhan (2002) suggest the creation of a “Microfinance Commission” which operates with a broad mandate from the government to create a suportive regulatory environment for microfinance. This Commission should consist of wide representation and members should be knowledgeable in microfinance and be representative of donors, government, NGOs, academia and the private sector. This body being involved in making intial proposals can graduate to become the regulatory body that will implement the recommendations.

Priority areas based on the situation analysis should be formed. A tiered approach as suggested by Wright (2000) can be adapted to the local conditions. This approach will result in different regulatory requirements for different tiers of institutions classified on the basis of their primary activities. In Ghana the following tiers have been developed:

* Deposit-taking institutions (other than discount houses)
* Non-Deposit-taking institutions in credit business
* Discount Houses
* Venture capital fund companies

Credit Unions were covered under a separate legal, regulatory and supervisory framework (Meagher et al. 2006).

A phased approach should be adopted in setting up the regulatory framework. Critical priority areas should be focussed on. For the Caribbean region recognition of qualifying MFIs as licenced non-financial banking institutions (NBFIs) should be a priority. Regulations should be updated to give NBFI recognition. Licensed MFIs should have higher capital adequacy ratios (CAR) and liquidity requirements than traditional banks if they are to intermediate deposits. Reserve requirements should however be less onerous than the traditional banks. In Cambodia CAR for NBFIs is 20 percent and liquidity requirements are 100 percent, whilst for commercial banks it is 15 percent and 50 percent respectively and the reserve requirement for NBFIs is 5 percent while it is 8 percent for traditional banks. Licensed NBFIs will be able to expand services and outreach, as well as attract and qualify for more sources commercial funding.

Increased transparency on interest rates charged should replace fixed interest rates. This can be achieved by stipulating a standardized manner for calculating and communicating interest rate charges to borrowers and the public (Counts and Sobhan 2002).

Setting up of regulations will only be effective with proper supervision. In framing the regulatory framework for Caribbean microfinance it must be clear how these regulations will be enforced. Gaps, such as adequately trained supervisors in the field of microfinance, must be identified and closed. Christen et al. (2003) warn that regulation that is not enforced can be worst than no regulation at all.

The following safeguards should be observed in creating the regulatory framework for Caribbean countries. For the recommendations to succeed the regulatory process should be an inclusive one. A cautious approach, resisting the temptation to copy what other nations have done should be adopted. Microfinance in all its facets has shown that local conditions must be embraced for success. Over-regulation must be guarded against as this can shut down rather than promote development in the sector. Realism must be maintained at all times, and policy framers must not lose sight of the fact that we in the Caribbean are now attempting to enter the commercial microfinance arena, one in which most players have been building their positions over the last three decades.

CONCLUSION

The introduction of microfinance regulation in the Caribbean can act as an enabling policy to trigger growth of this under-developed sector. As is written in the history of the microfinance revolution thus far, duplication is not the answer and policies need to be crafted with an extensive understanding of local conditions and needs. The goal of microfinance regulation in the Caribbean is less focussed on the protection of the vulnerable microfinance clients and stability of the financial systems, and more concentrated on building an enabling environment to encourage sector growth. The promise of microfinance to alleviate the conditions of the poor has been fulfilled in many parts of the globe. Regulation of Caribbean microfinance alone will not enable this region to enjoy similar benefits; regulation must be enacted together with other enabling policies such as institutional rationalization and development to succeed. If this is done, maybe someday soon the Caribbean can document microfinance successes similar to those being reported in the rest of the world.

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Table I: Growth in Demand and Supply of Microfinance Services from 1997 to 2007

|  |  |  |  |
| --- | --- | --- | --- |
| **Date** | **Number of Programs Reporting** | **Total Number of Clients Reached** | **Number of Poorest Clients Reported** |
| 12/31/97 | 618 institutions | 13,478,797 | 7,600,000 |
| 12/31/98 | 925 institutions  | 20,938,899 | 12,221,918 |
| 12/31/99 | 1,065 institutions | 23,555,689 | 13,779,872 |
| 12/31/00 | 1,567 institutions | 30,681,107 | 19,327,451 |
| 12/31/01 | 2,186 institutions | 54,932,235 | 26,878,332 |
| 12/31/02 | 2,572 institutions | 67,606,080 | 41,594,778 |
| 12/31/03 | 2,931 institutions | 80,868,343 | 54,785,433 |
| 12/31/04 | 3,164 institutions | 92,270,289 | 66,614,871 |
| 12/31/05 | 3,133 institutions | 113,261,390 | 81,949,036 |
| 12/31/06 | 3,316 institutions  | 133,030,913 | 92,922,574 |
| **12/31/07** | **3,552 institutions** | **154,825,825** | **106,584,679** |

Source: Daley-Harris (2009)

Table II : MFIs by Institution type as at Dec 31st 2000 and Dec 31st 2009

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Reporting Year. | Bank | Credit Union | Non-Bank Financial Institution | NGO | Rural Bank | Total Institutions Reporting |
| 2009 | 81 | 152 | 396 | 417 | 64 | 1,110  |
| 2000 | 28 | 21 | 60 | 84 | 4 | 197  |

Source: Microfinance Information Exchange (MIX) (2011)

Table III : The Instruments and Aims of Non-Prudential Regulations

|  |  |
| --- | --- |
| REGULATORY AIMS | INSTRUMENTS |
| Consumer Protection:* Protection against Abusive lending and Collection Practices
* Protect borrowers against abusive lending and collection practices
 | Truth in Lending: achieved by a requirement for lenders to effective interest rates to loan applicants using a uniform formula mandated by the government. |
| Fraud and financial crime prevention:* Concerns about securities fraud and abusive investment arrangements such as pyramid schemes
* Money-Laundering concerns
 | Existing anti-fraud and financial crime regulation will be adequate, they may need amendment only to add any new categories of institutions that need to be regulated. |
| Excessive interest rates | Interest Rate Limit / Cap: governments that set caps on interest find that practical politics makes it difficult to set an interest rate cap high enough to build sustainable microcredit. This risk is very real though not relevant in all countries. |
| Credit Reference or Credit Bureau services | Credit Bureaus and Statistical risk-scoring techniques. The government, merchant groups and or donor groups can work together or individually to develop public or private credit information systems that include micro-borrowers. This has the potential to greatly expand the availability of credit to lower-income persons. This mechanism is most suited to mature MFI markets where there is some system such as national identification cards to identify clients and an enabling legal framework that protects fairness privacy. |
| Open up citizenship, currency and foreign-investment regulations for MFIs. | Microfinance business does not as yet attract conventional commercial investors in sufficient numbers. As a result some relaxation of the rules regarding foreign-equity holders, borrowing from foreign sources and employment of non-citizens is needed for MFIs. |
| Tax and Accounting Treatment of Microfinance:* Level the playing field among all institutions with respect to tax on financial transactions and activities
* Taxation of Profits
 | Base favourable tax treatments on type of activity or transaction regardless of the nature of the institution or whether it is prudentially licensed.Of special attention to microfinancing is the tax deduction for loan loss provisioning. Licensed institutions have the loan –loss calculation defied in the prudential regulations, but un-licensed MFIs need to be policed by tax authorities to regulate the deductions being claimed. |

Source: Christen et al. (2003)

Table IV ACCION CAMELTM Key Indicators, Showing Areas Where Microfinance Differs from Conventional Banking Norms

|  |
| --- |
| **CAPITAL ADEQUACY** |
| Capital Adequacy Ratio | • Minimum capital requirement lower• Leverage ratio higher |
| Adequacy of Reserves | • Provisioning policy should fit microcredit terms |
| Ability to Raise Equity | • Unconventional owners (NGOs, donors) mayhave difficulty with this |
| **ASSET QUALITY** |
| Portfolio Quality | • No need for concern about large loanconcentration• Focus on quality of delinquency management systems |
| Write-Offs and Write-Off Policy | • Should fit microcredit terms and experience |
| Portfolio ClassificationSystem | • Treatment of loans with unconventional form ofguarantee |
| Productivity of Long TermAssets | *No change* |
| Infrastructure | • Allowance for low-cost infrastructure suitablefor reaching the poor |
| **Management** |
| Governance/Management | • Unconventional owners and sometimesmanagers |
| Human Resources | • Different staff profile, salaries• Importance of incentive systems |
| Controls, Audit | • Internal audit must take lending methodologyinto account |
| Information Technology | • Delinquency monitoring focus |
| Strategic Planning andBudgeting | *No change* |
| **Earnings** |
| Return on Assets | • May be higher than the norm |
| Return on Equity | *No change* |
| Efficiency | • Administrative costs expected to be well abovestandard commercial banking• Indicators and benchmarks specific to microfinance are needed here |
| Interest Rate Policy | • Interest rates well above standard commercialbanking |
| **Liquidity** |
| Productivity of Current Assets | *No change* |
| Liability Structure | • May differ substantially from most other banks |
| Liquidity Ratio | *No change* |
| Cash Flow Projections | *No change* |

Source: Rhyne (2002)

Figure I: Percentage Composition of MFIs by Institution type as at Dec 31st 2000 and Dec 31st 2009

Source: Microfinance Information Exchange (MIX) (2011)

APPENDIX I

The Economist Intelligence Unit Ranking of Countries on their Regulatory Framework for Microfinancing

Source: Economist Intelligence Unit (2009)

APPENDIX II

Microfinance NGOs transformed into Regulated Financial Institutions as at March 2006



Source: Hishigsuren (2006)

1. CGAP is an independent policy and research centre dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, microfinance providers, donors, and investors (CGAP 2011) [↑](#footnote-ref-1)
2. Under Investment Climate, Trinidad ranked 9, with a score of 56.1 out of 100, and Jamaica ranked 15, with a score of 51.7. [↑](#footnote-ref-2)
3. The poorest clients are defined as those living on less than US$1 a day. [↑](#footnote-ref-3)
4. The Microfinance Information Exchange (MIX) is the leading business information provider dedicated to strengthening the microfinance sector. Founded by CGAP, MIX was incorporated in 2002 as an independent organization designed to improve transparency among microfinance institutions (MFIs), provide a means of standardization, and help move the industry towards mainstream financial markets. [↑](#footnote-ref-4)
5. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located. [↑](#footnote-ref-5)
6. Moral hazard is the incentive for someone who holds an asset belonging to another person to risk the value of that asset because the person holding the asset does not bear the full consequence of any loss (Wright 2000). [↑](#footnote-ref-6)
7. MFTransparency was launched in 2008. To date 711 industry leaders, including MFIs and Apex Banks currently serving 107 million clients worldwide, have signed the endorser statement (MFTransparency 2011) [↑](#footnote-ref-7)
8. High interest rates for sustainable microcredit also result from the fact that a portfolio of very small loans is usually more costly that the same total value of lending in larger amounts, as not all cost vary in direct proportion to the amount lent. [↑](#footnote-ref-8)
9. Contagion effects occurs when borrowers who notice increasing delinquency in the institution may stop paying if they believe the institution will be less likely to offer future loans due to credit quality problems (Basel Committee 2010). [↑](#footnote-ref-9)
10. The CAMEL methodology was originally adopted by North American bank regulators to evaluate the financial and managerial soundness of U.S. commercial lending institutions. [↑](#footnote-ref-10)
11. Institutional Capital is capital built up from retained earnings. [↑](#footnote-ref-11)
12. Caribbean Microfinance Limited (MICROFIN) is one of the largest providers of microlending in the Caribbean, with operations in Trinidad, St. Lucia and Grenada. The company’s mission is to provide loan financing and business services to local communities of micro and small entrepreneurs who pursue profitable business initiatives on a permanent basis and sustain themselves as responsible citizens (MICROFIN 2011). [↑](#footnote-ref-12)