

REACHING THE HARD TO REACH:

Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas

THEMATIC PAPER

Regulation and Supervision of Member-Owned Institutions in Remote Rural Areas

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COADY

INTERNATIONAL INSTITUTE
ST. FRANCIS XAVIER UNIVERSITY

with funding by **FORD FOUNDATION**

Antigonish, Nova Scotia, Canada • June 2008

**Reaching the Hard to Reach:
Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas**

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ISBN: 978-0-9680725-7-8

Published by the Coady International Institute, June 2008

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Abbreviations

AMC2	Association des MC2 (second tier apex)
BANSEFI	Apex Bank for MOIs in Mexico
BCEAO	Banque Centrale des Etats d’Afrique de l’Ouest
BEAC	Banque des Etats d’Afrique Centrale
BPD	Regional Development in Indonesia
BPR	“People Credit Bank” in Indonesia
CamCCUL	Cameroon Cooperative Credit Union League
CNBV	National Commission of Banks and Values
COBAC	Commission Bancaire d’Afrique Centrale
CVECA	Caisse Villageoise d’Epargne et de Credit Autogeree
DINACOOOP	<i>Dirección Nacional de Cooperativas</i>
LPSC	Law of Popular Saving and Credit (LACP in Spanish)
MACS	Mutually Aided Cooperative Society
MC2	Mutuelle Communautaire de Croissance
MMD	Mata Masu Dubara (VSLA in Niger)
MOI	Member-owned institution
NGO	Non-governmental Organisation
OHADA	Law for harmonizing business regulations in Western and Central Africa
PACS	Primary Agriculture Credit Society
PARMEC	Projet d’Appui à la Réglementation des Mutuelles d’Epargne et de Credit
SACCO	Saving and Credit Cooperative
SBS	Superintendency of Banking and Insurance, <i>Superintendencia de Bancos y Seguros</i>
SHG	Self-Help Group
UNISAP	Federation of rural and urban SACCOs in Mexico
VSLA	Village Saving and Loan Association
WOCCU	World Organisation for Credit Cooperative Union

Regulation and Supervision of Member-Owned Institutions in Remote Rural Areas¹

As the microfinance sector develops, more and more countries are coming up with specific regulations to formalize, oversee and integrate this sector into the overall financial sector. In some countries, integration may take the form of one law governing the activities of the various types of institutions which deliver financial services to this segment of market. In other countries, laws may regulate financial institutions based on legal status. Typically one law governs companies guaranteed by shares and one governs financial cooperatives (i.e. Savings and Credit Cooperative, SACCO). In many countries where cooperative or SACCO laws pre-exist, reforms have been engaged.

Regulation and supervision of Member-Owned Institutions (MOIs) which deliver financial services to their members can protect small depositors, the financial sector, and the MOIs. Effective, prudential supervision can provide incentives for good governance, thus helping MOIs to maintain the “financial discipline and prudent management” so often lacking in unregulated financial institutions. Regulation and supervision does not substitute for good governance and developing strong institutional capacity is the best means of ensuring institutional sustainability and long-term growth in outreach.

In reality, regulation and supervision of MOIs have largely been ineffective. In many parts of the developing world, they still operate under outdated cooperative laws that are designed for multipurpose cooperatives. Supervising entities often lack the technical expertise needed to supervise MOIs and, in many cases, do not do so either by regulation or because they do not have enough resources. Without effective supervision, most representative MOIs have limited outreach and mismanagement is common. In fact, developing effective regulation and supervision may be an important means of increasing MOI outreach, if some of the constraints and limitation could find appropriate solutions.

Supervising MOIs should be seen as being quite relevant. As MOIs are often the only service providers in rural areas, they represent substantial numbers of poor depositors but a lack of governance places the savings of these poor depositors at risk. The MOI sector, however, typically includes a large number of institutions that represent a small fraction of a country’s financial assets. Because supervising the sector is relatively costly, resource-poor regulatory authorities are often unable or unwilling to do so. Indeed, MOIs are known as “the conundrum” of microfinance supervision (Lyman, 2006).

Despite these issues, reaching consensus about core principles is crucial if the sector is to move forward. A process needs to be developed to build such consensus and the following fundamental questions should be at the heart of what must be resolved:

- What types of MOIs should be regulated? Or, what MOI activities should be regulated?

¹ The author would like to acknowledge the assistance of the research team, Nanci Lee, Malcolm Harper and Madeline Hirschland, for their valuable insight and advice. A special thank you to Jennifer Isern (CGAP), peer reviewer, who brought to this paper her global and in-depth experience of working with various institutions (MOIs in particular).

- Are tiered licensing standards appropriate or should standards be uniform? If tiers are appropriate, how should they be defined and what should be required of each?
- What entity should supervise? Is delegated supervision or self-regulation acceptable and, if so, under what conditions? Under what conditions might it be appropriate for different authorities to supervise different classes of MOIs?
- What are the costs of regulation and supervision? How should these costs be covered? By whom?

The Cases, Their Regulatory Environment and the Options Made

A Comparative Study on Member-Owned Institutions Offering Financial Services in Remote Rural Areas was commissioned by the Ford Foundation. This study is based on seven selected cases of MOIs, three of which operate in Asia: The PACS-Self Help Group (SHG) linkage in Andhra Pradesh, India, the Self-Help Group Federation in India, as well as LPDs in Bali, Indonesia were studied. In Latin America, Mixtlan SACCO within the UNISAP Federation in Mexico and the Jardín Azuayo Rural Credit Union in Ecuador were studied. In Africa, the Village Savings and Loan Associations (VSLA) in Niger and Mutuelle Communautaire de Croissances (MC2) in Cameroon were studied.

These cases represent the variety of legal and regulatory frameworks within which MOIs operate and integrate. Some key features of these environments are presented below together with an analysis of how conducive or detrimental these features are to the outreach function and the governance of these MOIs. In such circumstances, how did each organization adjust and decide on its own institutional options?

This article draws on individual case studies which were analysed against a literature review that provides the framework against which MOI regulation and supervision can be assessed. This article also reflects the experience and knowledge the author has gained in this area.

MOIs in Asia

India: the SHG Federation and the SHG-PACS linkages under the new MACS Act

The SHG bank linkage model has become the predominant microfinance model in India. As of March 31, 2005, 1.6 million self-help groups (SHGs) have been linked to formal financial institutions. India has a massive branching structure with over 41,082 branches of commercial, regional and rural banks and cooperatives that cover 31 states and 572 districts. The SHG bank linkage program grew by 50% in 2003 alone reaching over 24 million households. With the branch structure reaching out and the SHGs forming federations reaching back, a more inclusive sector has been created here, one that has led to increased access to financial services for remote rural populations.

One case study examines Ankuram Sanghamam Poram (ASP), a federation of SHGs with nearly 6,000 SHGs at its base. This system grew out of a local Dalit ('Dappu' Dalitbahujan) movement and the trade union, and has deep roots in social activism. The ASP is a three tier system federated at the

state and sub-district levels, with the apex serving as a wholesale financier and supervisor for the system.

In India, cooperatives fall under state rather than central bank jurisdiction. Over their century-long history, cooperatives have seen state governments adopt a number of controls on their governance and management. In some states, co-operative dependence on state governments has led to changes in state cooperative laws. In these states, government capital is prohibited, the management of cooperative societies is vested in a Board of Directors and policies are decided by the General Body subject to limited regulatory powers exercised by the Registrar by way of society registration or through registration of bylaws. The Andhra Pradesh Mutually Aided Cooperative Societies Act (APMACS), 1995, for example, was the first such legislation in India and this act has since been implemented in nine other states.

In many cases, SHGs promoted under a government program or by an NGO cluster into federations representing a number of villages in one area, typically villages within a 10-25 km radius. These cluster federations can register under the APMACS Act, 1995 and to do so, all the members of the SHGs must individually become members of the federal body, the Mutually Aided Cooperative Societies (MACS). ASP falls under this law. Registered under the MACS Act, it is legally a cooperative and structurally a federation. In fact, both the apex and the member federations are registered under the same act. In this case, SHG federations are cooperatives whose individuals (not groups) are members.

The MACS Act allows the federations to be transformed into regulated cooperatives reporting to the Registrar of Cooperatives. By registering under this Act, federations must give up government subsidies, must be subject to stricter regulation and can legally become primary cooperatives with a much higher level of autonomy. As of June 1998, a total of 1,150 co-ops fell under the Act, 31% being financial co-ops and 729 choosing to convert, demonstrating that regulation can lead to graduation within the system.

Most SHG federations differ from classic credit unions in that they largely lend using external commercial liabilities rather than member deposits which are, in some cases, limited to compulsory savings. Member deposits are retained at the base tier level or placed with banks directly by SHGs. As such, base tier clients have little financial stake in apex federations which may represent just one of many financial linkages, including linkages SHGs have with banks and microfinance institutions (MFIs). SHGs which are part of one federation system may well borrow from multiple sources at any given point of time and even be members of more than one federation.

Each level of the cooperative federation is envisioned to be financially, administratively and legally autonomous. The ASP's state level federation or apex operates as a wholesaler and its relationship with member MACS remains loosely defined. This relationship is captured in the strategic plan of the organisation which states, "The standardisation of systems and procedures that are required for taking advantage of economies of scale will be realised through processes of consensus building."

For small and remote organizations, a model of self regulation is envisaged: The apex provides supervision and guidance for cluster MACS and cluster MACS rate base tier SHGs.

In practice, this nascent-stage model presents many challenges including: Lack of good bookkeeping, lack of effective on-site supervision, lack of stringent standards, no internal reporting

on loan repayment, highly risky cash transactions by staff members without random checks on cash amounts or without any other checks and balances, weak staff capacity, and the high cost of on-site supervision and training of staff of the cluster level federation. In the absence of operational control, apex institutions, even as refinanciers, cannot always maintain strong regulatory and supervisory control over lower tiers and it is often not their role to do so.

West Bengal is one of only three states in India that allow groups to be considered clients of financial institutions. The linkage between Primary Agricultural Societies (PACS) and SHGs in West Bengal is therefore an interesting case to study to understand how this kind of linkage—in which groups are allowed to be members of cooperatives—performs in a conducive regulatory environment.

The cooperatives are not the strongest financial institutions themselves but outreach could still be stronger with them than with other institutional set ups. The potential for cooperative linkages to significantly broaden outreach is large. In India, according to NABARD, over 120,000 PACS hold 69% of the market share in rural areas. While SHGs form only a small part of most PACS' business and membership the linkage to SHGs has already encouraged PACS to include more remote villages, groups and women where once they focused on producers and males.

Nevertheless, the systemic weaknesses of PACS as cooperative societies limits the scope of products and services they can provide to SHGs. Due to weak compliance with prudential norms, for example, the Registrar of Cooperatives does not encourage PACS to actively increase deposit taking.

LPDs in Bali, Indonesia

The Village Credit Organizations or Lembaga Perkreditan Desas (LPD) were first established in 1985 but their current form and regulatory and supervisory framework was formalised with a decree issued in 2002 by the Balinese Provincial Government. As per this decree, LPD refers to a village-owned financial business entity. While any village can have one LPD it is important to state up front that in Bali a village is in fact a traditional law community unit (also called *desa pakraman* or *desa adat*) and that the LPD receives its legitimacy from the *awig awig* or the 'written traditional law' of such a community unit. (Source: Bali Province Regulation No. 8 of 2002). Other village-level savings and loan associations in Indonesia are for the most part, owned and managed by administrative bodies rather than by communities bound together by customary law.

Much of the success of the LPDs has been attributed to the balance that has been established between local ownership and management, provincial government regulation and customary regulation and external supervision and internal governance. The internal ownership and governance structure of the LPD is defined by the Provincial Decree of 2002 but LPDs are founded on age old Balinese customary law—embodied by the *awig awig*, a structure that ensures that a balance is established between consistency and individuality across the LPD sector. Local customary law has a complex hold on community life. In earlier times, the *awig awig* once passed orally from generation to generation, now it exists in written form. When interlaced with the religious and ceremonial elements of society, the *awig awig* comprises a formidable code, diversion from which has serious consequences such as banishment from the village or loss of the right to burial in the place of birth. Holloh (2001) has shown that LPDs in general perform poorly where the social bonds and adherence to customary law is weak.

LPDs are subject to both internal and external supervision. A supervisory committee supports internal supervision of an LPD while external supervision is the responsibility of the Governor and is implemented by the principal refinance agency, the Regional Development Bank (BPD) together with the training and technical support arm of the provincial government, the PLPDK. In fact, LPDs receive regular external on-site supervision from sub-district PLPDK centres and, less regularly, from BPD staff. The BPD has also relied on PLPDK staff for a number of sub-functions including loan recommendations. The supervision system here is a complex one with multiple stakeholders as no single agency has the best (or right) combination of resources, location, skills and interest to make the supervisory system work.

“Guidance Boards”, made up of representatives from provincial, district and sub-district government, also design and implement policies and support LPDs. These Guidance Boards ensure that the same standards are applied for small and large LPDs alike. LPDs are mandated by decree to cover guidance and training costs with funds derived from 5% of profits. In one sense this could be a good contribution to cost recovery for supervision but could be a constraint if the funds went to an inappropriate supervisory authority.

In general, LPDs have resisted transformation into BRPs, a more institutional form, if not for accessing more external funding. Some LPDs tried to refinance from the cooperative apex and are also considering transformation into cooperatives, but with much member reluctance. In reality, the possibilities are quite limited within the Indonesian regulatory framework.

Some LPDs have grown to become as large as some small banks. At this size, there are many good arguments made to bring these LPDs under banking laws as the start up capital of a BPR is only US\$5000. This type of transition could distract LPDs from their work in remote local areas as had been experienced in other places (Central Java, BKK) where such a transformation has led to mission/clientele drift. A clearly defined graduation path and supervisory support structure for LPDs has yet to be developed.

Box 1

In South Asia and Indonesia, SHGs and village financial organizations are well known and recognized by local and national governments which issue legally-binding acts to validate their existence and sustain them. Despite official acceptance, these institutions cannot grow or transform into larger legal entities. Transformation into cooperatives has therefore become either an option (for LPDs in Indonesia) or a compulsory graduation path (MACS in India).

In these two cases, existing supervisory bodies are not appropriate. The Registrar of Cooperatives and State authorities in India and local governments in Indonesia are non-financial authorities. The accounting system and internal control at SHG, PACS, and MACS levels are weak or nonexistent, the standards, guidance and supervision provided by the regulating authorities are weak and inappropriate for financial institutions and therefore put the MOIs at risk instead of strengthening and protecting them.

In both regulations, the standards and supervision apply to all MOIs independent of their size. Therefore, small MOIs operating in remote rural areas with no qualified staff must report in the same way as do larger MOIs which operate like banks or even higher level tiers.

Indonesia has taken an interesting approach to this problem by decreeing that MOIs must establish reserves to cover guidance and supervision costs.

The Cooperatives in Latin America

Jardín Azuayo in Ecuador

Jardín Azuayo in Ecuador is a savings and loan cooperative. Ecuador has a growing cooperative savings and loan sector but is expanding without clear regulatory systems. According to the Superintendency of Banking and Insurance (SBS) in December 2006, the cooperative sector's share of GDP was increasing. Of the 37 supervised savings and loan cooperatives, 20 have a normal risk rating, 10 have a moderate risk rating, 7 have potential risk and none is classified as unsatisfactory. The banking system also represents a growing segment of GDP, but its growth rate is more moderate than that of the cooperatives. Seventeen banks have normal risk, one shows moderate risk and two have potential risk. Between the cooperative sector and the formal banking system, the national financial system is currently quite strong.

In Ecuador, regulated entities fall under the control and supervision of the SBS. This category currently includes 17 banks, 37 savings and loan cooperatives (including Jardín Azuayo), 5 mutual savings associations and 12 financial societies.

Because complete information about the unregulated sector is unavailable, the size of Ecuador's microfinance sector is difficult to estimate. The Rural Finance Network (representing 39 institutions) with information provided by the SBS (controlling 59 regulated entities) and other finance networks has analysed financial information from about 160 financial structures or institutions. Combined with the 59 entities in the regulated sector, it is estimated that the total loan portfolio as of December, 2005 was US\$841, representing about 955,000 loan operations. In 2004, the National Director of Cooperatives (DINACOOOP) reported that there were more than 400 unregulated cooperatives operating in Ecuador. Alternative supervision systems have been proposed for these organizations but a consensus has yet to be reached.

The rural finance sector in Ecuador is quite organized and coordinated under the Rural Finance Network. This network supports 46 regulated and non-regulated rural finance organizations. The network has developed a financial monitoring system using internationally recognized benchmarks and supports non-regulated members (under the SBS) with a system of self-regulation.

Regulation is nevertheless complicated for savings and loan cooperatives because there is no specific law governing them. They fall under and report to the Ministry of Social Welfare (*Ministerio de Bienestar Social*), specifically the National Office for Cooperatives (*Dirección Nacional de Cooperativas*, DINACOOOP). However, following a resolution issued on July 27, 2006, by the Banking Board (*Junta Bancaria*), active savings and loan cooperatives with assets exceeding US\$10 million fall under the supervision of the SBS. New entities must have equity equal to or greater than US\$788,682 to achieve this classification. These resolutions, issued without the backing of a specific law, have created a dual system of control and supervision which is shared between DINACOOOP and the SBS.

While DINACOOOP's control and supervision is fairly relaxed, SBS requirements are strict and, in some cases, inappropriate for these types of entities. In order for a cooperative to move to SBS control it must incur costs related to staffing requirements, committee formation, auditing, provision of information that must be compiled and submitted, acquisition of equipment and software. There is also an adjustment period that distracts staff from regular operations. What most affects these entities, however, is the lack of understanding among the SBS, DINACOOOP and the cooperative

system itself. Misunderstanding has also led to delays in creating appropriate legislation for savings and loan cooperatives.

Mixtlan Savings and Loan and the UNISAP Federation, Mexico

Mixtlan Savings and Loan is a rural savings and credit cooperative (SACCO) which is part of the UNISAP Federation, a large and highly rated urban-rural federation of over 350,000 members in Mexico. Mixtlan works in a rural and remote area where the population density is 6 persons per km² with a rate of local outreach approaching 90%. Legislative confusion combined with a high incidence of fraud has created a high risk operating environment in Mexico. In response to this high risk, Congress approved the new Law of Popular Saving and Credit (LPSC) and the Statutory Law of the National Bank of Financial Services (BANSEFI) in 2001. The National Commission of Bank and Values (CNBV) authorizes, regulates, supervises and audits the federations. BANSEFI operates like a central financing facility and a third-tier federation. It has a secondary objective to promote the member-owned or popular finance sector, as it is known in Mexico. BANSEFI has 554 branches which provide retail financing to its own federation members or wholesale finance to local MOIs provided they comply with the law. BANSEFI supports compliance to legislation and regulation but does not directly supervise participating organizations. The long-term strategy is for BANSEFI to be self-financed by MOIs and their federations. Acting as a financial intermediary for them, BANSEFI could collect deposits, provide remittances and liquidity exchange and distribute loans and grants from governmental programs.

Of the twelve federations of MOIs in Mexico, UNISAP is one of the strongest in terms of governance and financial management. UNISAP's governance structure, unlike some others in the country, allows the local MOI a certain amount of autonomy. There is no second-tier office or staff in each MOI thus each MOI can determine its own product mix, even out-sourcing to its own local suppliers.

Membership in a strong, largely urban-based cooperative has its advantages. UNISAP offers a stable growing asset base and with it, economies of scale combined with low unit costs. This is important for Mixtlan (the MOI selected for in depth analysis in this study) in particular and the remote areas of its operations. UNISAP also provides sophistication in terms of standards, products and information systems. It also makes important market linkages with private suppliers of remittances and provides liquidity management and technical support.

The UNISAP Federation in particular is highlighted here for its high rate of "integration." The Integration Index developed by Mexican financial federated institutions is used to rate federations against benchmarks of a theoretically ideal federation. The rating index includes five dimensions considered essential in a strong network:

1. Effective economies of scale. This refers to the effort made to operate economies of scale in the production and acquisition of inputs. This includes the handling of financial intermediation and control of contractual risks associated with the acquisition of those inputs;
2. Standardization within financial operations;
3. Separation of strategic and operational functions. This refers to the development of clear division of roles and responsibilities;
4. Presence of a Governance structure which assures the protection of the interests of the contracting parties, specifically the ability to avoid opportunism or domination by the members;
5. Contractual solidarity (including control on the opening of branches, the constitution of a contingency fund and crossed subsidies, among others) (Desrochers, Fischer, & Gueyie, 2004).

Mixtlan belongs to the UNISAP federation (second tier) under the LPSC. Federations are authorized by the National Commission of Banks and Values (CNBV), which is an institution of the Mexican Federal Government which controls and regulates this sector.

Being part of a large and broad-based regulated federation has many benefits. As noted above, the economies of scale available in a federated system have allowed the MOI to have a greater rate of growth and to take care of the most remote populations. UNISAP audits the MOI on behalf of the Superintendency. UNISAP also helps its affiliated MOIs with liquidity, credit, outsourcing, and connections with other companies for hiring computer system maintenance services, stationery and a corporative image.

To belong to a system that is federated and regulated new Law of Popular Savings and Loans (LPSC) and the CNBV has given MOI members security about the safe management of their resources with the existence of Federal mechanisms and regulations that integrate and control remote MOIs. Members value the fact that they can rely on a legal endorsement in case of fraud. Security is seen to be an important factor in membership growth.

The LPSC forces the integration of the popular saving and loan sector generating economies of scale and bind cooperatives to be part of a federation. This type of regulation that encourages scale, viability and formalization has important implications for remote outreach.

Currently, organisations of popular savings and loans can only be transformed into one of two legal entities: Popular financial associations or SACCOs. As noted, Mixtlan is a SACCO. The LPSC has proposed a yet to be approved auxiliary supervision method comprised of on-site and off-site supervision to promote and to regulate the Popular Savings and Loan Sector. Under this system MOIs will have to fulfil certain requirements, for example, to maintain a capital adequacy that will allow them to endorse the members' deposits.

While strictness, standardisation and professionalisation are needed to ensure safety of deposits, flexibility and adaptation are crucial for remote MOIs. For example, the legal frame does not require greater provisioning of the portfolio when loans are taken with a solidarity guarantee, that is to say, without collateral.

Box 2

In Ecuador and Mexico, new laws have been passed to address the regulation and supervision of financial cooperatives.

The regulatory framework in these two countries encourages networking. In Mexico, the new law of LACP forces the cooperatives to be part of a federation of support, scale, viability and formalization; in Ecuador, cooperatives formed a self-regulation system that operates through the Rural Financial Network to support benchmarking and to promote graduation to external supervision.

In both countries, the supervisory role is provided by banking authorities: the SBS operates in Ecuador while the National Banking and Security Commission supervises Mexican federations or larger cooperatives with assets greater than ten million dollars or equity greater than US\$788,000. That central banks have taken on this supervisory role shows that the cooperative sector and government have learned from past failure and are now putting in place authorities with the appropriate skills to supervise financial institutions. In this Latin American environment, a rudimentary tier system allows for delegation of authority to second tier federations who can audit or rate their MOI members. Delegation of authority like this improves the effectiveness and efficiency of supervision especially for MOIs operating in remote rural areas.

In Mexico, several initiatives have been put in place to improve supervision. Mexican Financial Federated Institutions have developed a federation rating system called the "Integration Index" which is used to assess five major dimensions of control: efficiencies, standardisation, management, governance and contractual solidarity (cross subsidies, constitution of a contingent fund). It is possible, in Mexico, to use "solidarity" as collateral without making provision for "unsecured loans." This approach clearly acknowledges the value of social guarantees, at least up to a certain loan size or percentage of the portfolio.

Nevertheless, since the new laws have been enacted only recently, dual systems of control and supervision between the Ministry of Social Welfare, National Office for Cooperatives and Banking Superintendencies still coexist. Regulation that strongly encourages MOIs to integrate into federations or which forces MOIs to merge could certainly be more effective for supervision but such regulation would exclude small MOIs that serve remote rural communities and ultimately works against the deepening of outreach.

Decentralised Village Based MOIs in Western and Central Africa under the BCEAO and BEAC Laws for Microfinance

VSLA in Niger

The membership of a VSLA is typically comprised of 20 to 25 women, petty traders, vendors or farmers, who use their loans both for working capital and for consumption. VSLAs are time-bound in that savings are rotated regularly, perhaps weekly or bi-monthly as the members decide. Attendance is compulsory and each meeting acts as a form of audit where members recite by memory the transactions of a meeting and the last meetings' balance. The VSLA charges interest, distributes loans periodically and, at the end of the term, distributes a lump sum evenly among members. Members decide on all aspects of their organization together including the amount of savings, the frequency of contributions, by-laws, interest rates to be charged, the nature of loan distribution and cash out terms. The cash-out is considered to be an effective mechanism for controlling fraud and mismanagement as the loan fund remains small enough to be managed orally by the members.

CARE Niger provides VSLAs with technical training and assistance for twelve months. Theoretically after twelve months the association graduates to manage their activities independently of CARE. This is done by hiring a village agent that the VSLA finances with its own earnings. The most significant innovation to this system is the notion of networking that was introduced by CARE Niger in 2003/2004. Through their networks, savings from member associations are pooled to create a loan capital fund from which VSLA groups may borrow on behalf of individual members. The networks provide VSLAs with a number of supports such as: Wholesale loans relative to savings; training by village agents; and non-financial training. The activities of the association and of the network are managed by leaders elected by members who are also residents of the same village. CARE initially reasoned that networking would make available larger, enterprise-oriented loans that would give VSLAs the ability to finance collective income generation projects such as cereal banks and oil pressing. What CARE could not envision was how quickly VSLAs would use their networks to form linkages with larger financial institutions. CARE's policy was neither to support nor deter VSLA networks and associations from forming their own linkages. The result has been that a growing number of VSLAs and networks have accessed loans from MFIs and cooperatives, and then on-lend these funds to individual members.

Niger is part of the West African Monetary Union whose eight member states (Benin, Burkina Faso, Ivory Coast, Mali, Niger, Senegal, Togo and Guinea Bissau) share a common central bank (BCEAO), monetary policy, currency and trading regulations. These countries also share the same

Banking Law and Microfinance Law, the commonly called PARMEC law which covers the period 1996 to 2006. The Niger MFI sector, for example, is regulated under the PARMEC law. National BCEAOs are responsible for implementing this law while the Ministry of Finance's Micro Finance Monitoring Unit is in charge of enforcement, licensing, supervision and monitoring of licensed MFIs. Mutualist and cooperative MFIs providing financial services to members are governed by the PARMEC law and are required to obtain a license from the Ministry of Finance prior to starting business and opening offices (even in remote rural areas).

The PARMEC law does not cover *asusus*, *tontines* or other informal associations (in which the VSLAs could be classified) but these "associations are free to apply for recognition under the law." To do so, associations must register as formal associations (this is a simple procedure, done locally) and apply for a "Convention-Cadre" under the PARMEC law (for non-mutualist institutions). This gives the association the legal authority to engage in financial activities such as savings mobilisation and lending. These legal entities must adhere to reporting requirements and supervision as determined by the Microfinance Unit of the Ministry of Finance. Both the PARMEC license and the Convention-Cadre define several standards including a chart of account, a reporting format for financial statements, prudential and non-prudential regulations, and other norms and financial standards. The Convention-Cadre is signed for five years and may be renewed upon submission of a proposal which includes a performance evaluation and a business plan detailing the organization's level of self-sufficiency and strategy for sustainability.

In 2007, the Council of the eight member countries approved a new law that, on one hand, is more open to a variety of legal entities such as associations, mutuals and share companies: all organizations would be eligible for a non-time bound license. On the other hand, the law is quite strict about reporting and financial performance and proposes a new chart of account. This new law has yet to be approved by member nation parliaments.

Microfinance stakeholders in the sub-region have criticised the PARMEC for being too biased towards cooperatives and for attempting to supervise uniformly both very small decentralised mutuals (primary cooperative societies) in remote rural areas (and failing to do so by lack of capacity) and very large mutualist federations (second and third tiers) which represent much larger systemic risks for the sector. Microfinance stakeholders do recognise, nevertheless, that this early PARMEC law has strengthened the mutualist sector technically, financially and institutionally and has enabled steady growth.

The Niger VSLA associations and VSLA networks have been below the regulatory screens of MFIs under the PARMEC law. The Niger VSLA networks are registered, however, under the Cooperatives Act Ordinance No. 84-06 of March 1984 and should receive support and supervision from the Ministry of Community Development. This particular Cooperative Act was designed for multipurpose cooperatives so does not cover financial cooperatives that are regulated by the PARMEC law. The form of registration for financial cooperatives stipulated in the Act is not in line with the PARMEC law but changes to the OHADA law (now being discussed with BCEAO, BEAC and OHADA) on cooperatives would mandate that VSLAs follow requirements laid out for financial cooperatives. In practice, the VSLA networks are largely self-regulated with the support of CARE.

While VSLA groups and their networks appear to be operating in a grey area, the Ministry of Finance is likely to pay more attention to their operation as they become more widespread. For

example, the BCEAO effective interest rate ceiling of 27% per annum for microfinance institutions (the ceiling is 18% for banks) is much lower than the 10% per month charged by the VSLAs to their members so strict enforcement could pose some problems for the profitability of the VSLAs.

The most potential for realising the benefits of external regulation and supervision exists in the Mata Masu Dubara (MMD) network. Protection of members' savings and stability of MMD networks will be critical in the context of increasing savings transactions, increasing demand for larger loans, improving tracking of transactions and improving access to external funds from commercial banks or MFIs.

MC2 in Cameroon

In 2003, the Bank of Central African States (BEAC) and the Banking Commission (COBAC) issued a new regulation for financial institutions which deliver microfinance services in the six member countries (Cameroon, Chad, RCA, Gabon, Congo, Equatorial Guinea). With this regulation, microfinance establishments are required to obtain one of three categories of license as described in the regulation. These categories or tiers are defined according to the type of person served by the microfinance institution, as detailed below:

Categories	Characteristics	Requirements	Institutions	Market Share
1 st category	Savings collected from members and credit operations conducted only with members	No caution requirement but a minimum capital adequacy is needed. Required to retain reserves totalling at least 20% of yearly results to cover losses.	Village banks, CVECAs, CamCCUL Network Credit Unions, MC2s.	About 65% of the total sector and 85% of the volume of activities.
2 nd category	Savings collection and provision of credit to members and non-members	Bank required to hold a US\$100,000 guarantee.	Independent MFIs	About 30% of the sector, 10% of the volume of activities
3 rd category	Institutions which only provide credit services to the general public	Bank required to hold a US\$50,000 guarantee.	Projects, institutions of credit.	5% of the sectors

This regulation differs and innovates from other microfinance regulations in the sub-region by opting to regulate according to financial activity rather than by legal status. Under this regulation, “Microfinance Establishments” are free to choose to operate various legal forms: Associations, cooperative societies, or share companies. Reporting requirements also vary along with asset size: The smallest organisations must be audited by qualified accountants while larger ones must be audited by external audit firms.

While innovative, the policies, norms and standards for management of MFIs stipulated by the COBAC regulation could inhibit the development of small rural entities which cannot afford costs associated with registration, adherence to capital adequacy requirements, retention of qualified staff. Creating regulations for institutions of the first category does however provide some flexibility by lowering initial capital adequacy requirements for institutions that transact with members only. Category 1 MFIs are encouraged to generate funds from their own activities to avoid dependency on subsidies and donations, and to ensure sustainability. Institutions are also required to put in place adequate measures to cover their high-risk portfolios.

Staffing limitations at COBAC restrict its potential to supervise and control MFIs. The wide geographic dispersion of MFIs reduces the potential number of on-site supervisions per institution

to once a year at best. Internal controls must therefore exist and function effectively. COBAC has also, by law, obliged organisations to hire external auditors. As of June 2007, MFIs were required to hire external auditors even when they are affiliated to a network.

The AMC2 network is supposed to contract external auditors for MC2s regionally and will cover auditing costs for primary institutions. Each institution must also provide specific documents to obtain a licence including: The General Assembly of Members report that indicates the form of organization; proof of the guarantee deposit for second and third category institutions; the minimum capital adequacy requirement for first category organisations; and the names and qualifications of the promoters. A minimum infrastructure requirement has also been written into the law so that a secure office with appropriate safety procedures to protect the loan loss reserve fund is put in place.

All member-owned microfinance establishments are required to be linked in a network with a headquarters that centralises the liquidities and provides support services. The size of network and the economies of scale are reviewed by COBAC before issuing approval. In order to fulfil this requirement, the AMC2 (Association of MC2s) was created to act as a supra-MC2. Its role will be to centralise the liquidities of the network and to supervise member's activities. AMC2 will be assisted in this task by ADAF (the promoting NGO).

This new regulatory environment, if strictly enforced and effectively supervised, will bring more confidence to rural savers and hopefully reduce deliberate mismanagement and the bankruptcies that have undermined the sector for many decades in the past.

Box 3

In Western and Central Africa, two cases look at MOIs built on local values, endogenous mutual help practices (ROSCAs) and funds built on culture and geographic proximity, trust and, in the case, of Cameroon, the authorities of the chiefs. Though the laws now allow all legal forms of MFI to operate (associations, cooperatives and share companies) both cases considered here have been transformed into cooperatives even though the cooperative structure does not correspond to their real natures and ways of operating. These examples (and many others in the sub-region) show how the cooperative tradition (promoted by the states) is still conditioning the mindsets of all stakeholders including NGOs, banks and regulatory authorities. In the neighbouring country of Ghana, Rural and Community Banks share companies licensed as banks under the Banking Law.

Microfinance Regulations in the two sub-regions are now based on activities and not on legal status; this is true for the BEAC and also soon for the BCEAO, though not yet fully. These two Central Banks are trying to apply international best practice and are also drawing lessons from experiences and practises in the ground. A variety of methodologies, organisations and product delivery mechanisms are being developed by diverse types of institutions, addressing the needs of a larger and larger segment of the market neglected by traditional Financial Intermediaries.

The BEAC-COBAC regulation supports a tiered system with progressive requirements that are more affordable for the COBAC and adjusted to rural MOIs. Small, member-centred MOIs that are less risky for the sector must form networks that are large enough to lever economies of scale. These efficient professional organisations should foster financial solidarity that could diversify and mitigate risks: external supervision will concentrate on the network and its capacity to report and to produce credible on-site internal control. Larger MFIs that are more likely to function as small banks must provide a guarantee fund to prove solvency. These larger organisations will be easier to supervise as they will be based in the capital cities with branches in major towns.

Both BCEAO and BEAC are paying more and more attention to the role and responsibility of “promoters”, the NGOs, consulting firms, donors or governmental projects—especially for new Greenfield operations. This is being done to ensure that a credible strategy for sustainability

is being implemented. These organizations must develop a clear institutional and business model as well as an exit strategy that will care for systemic risk for the sector or in a specific territory. “Projects” and promoters must apply for licenses before setting up a system or implementing a scheme: they are accountable (supposedly) for the performance (and the losses) of schemes they have initiated. This approach may be too stringent for small action-research operations, especially for banking superintendencies which typically do not have the human resource required to do the work. Nevertheless, if the authorities intend to secure the sector and to secure depositors, in particular the most vulnerable depositors such as poor, rural, illiterate women, this type of strict approach is worth considering. Promoters could be required to establish a “security deposit” (such as has been done in BEAC for EMF, second and third category institutions) that would be used to protect savers’ money in case of failure. This would also address the issue of unfair competition from subsidised schemes that are not supposed to operate any longer under the new regulations.

Lessons Learned From the Cases Showing How Regulation Positively and Negatively Impacts the Development of MOIs in Remote Rural Areas

Which MOIs should be regulated and supervised taking into account, size, services, maturity, nature of membership, risk-balancing and supervision capacity

Two compelling arguments for not regulating all MOIs have been proposed, despite the potential benefits regulation can bring for depositors, MOIs and the financial sector. First, shutting down—despite being quite challenging to enforce, closing down MOIs that do not meet licensing requirements could cut off the rural poor from financial services, especially in remote areas. Second, regulating a large number of institutions can overburden a supervisory body and lower the quality of supervision.

It seems that the most commonly-proposed and reasonable trigger for regulation is size. Size might be measured by the number of members, financial assets or capital or the number of branches. Most of the literature agrees that large bank-like MOIs should be prudentially regulated and supervised, while small MOIs should not. Small MOIs might still be required to register and to fully disclose their unregulated status.

Small MOIs pose less risk for depositors because members can more effectively monitor their organisation’s operations. At the same time, supervising small MOIs costs more per depositor or size of financial asset.

Governments, nevertheless, should not regulate what they are unable to supervise. Regulators should set reasonable entry standards and foster professionalism but should not restrict the development of the sector. The BCEAO Law demonstrates how easily supervisory requirements can be underestimated and how un-enforced regulation could be worse than no regulation at all. Supervisory capability and cost are important factors to consider before deciding on the regulation.

The different regulations governing MOIs described in this study shows that encouraging (or even forcing, though forcing is probably less effective) small or medium size MOIs to form networks or to federate could effectively sustain growth while maintaining sound management, portfolio quality and avoiding massive losses due to fraud or defaults. Forming networks seems to reduce the major constraints associated with size, helps organisations realise economies of scale and improves reporting, internal control and liquidity management. It is also more cost effective for regulatory authorities to supervise networks, especially if they operate in remote rural areas. Regulatory authorities could delegate to the networks, collection of data for reporting as well as internal control

for higher level tiers. This would free them to concentrate on supervising for compliance, random checking of reliability of reporting and enforcement of prudential requirements.

Networks, provided that they have developed a sustainable business model for cost recovery, could also play an effective role in liquidity management and cross subsidisation (urban-rural, small and large, remote and better-served communities). Networking can also help organisations to avoid isolation and the routine and dysfunctional behaviours related to isolation. For remote rural MOIs such as the Rural Finance Network in Ecuador, the UNISAP Federation in Mexico, the ASP in India and the AMC2 in Cameroon, integrating a network could enhance sustainability and growth and be the first step on the path towards being formally regulated and gaining membership in the formal financial sector.

However, from the remote outreach perspective, small decentralised associations such as SHGs or VSLAs remain the only service providers for many rural poor in places where no other financial intermediaries operate. Regulators may consider a size under which these types of groups need not be regulated provided that they are linked with and perhaps overseen by a regulated financial intermediary such as a bank or a SACCO. The commonly considered size trigger for regulation of voluntary deposit-taking, on-lending of deposits, or for offering current accounts may appear as less relevant in the case of MOIs dealing only with their own members especially in remote rural areas, when they are the only organisations offering these services.

Innovations in microfinance delivery such as electronic banking (e.g. Mobile Phone Banking, ATM) which carry the hope of reducing the costs associated with serving poor under-served clients have also been regulated recently as part of electronic banking services. A MFI which aims to develop electronic banking services will have to obtain the proper license from monetary authorities and will probably need to prove its capacity to manage these services directly or in linkage with a bank or specialized institution that has the appropriate platform to track information such as authenticated identity of sender and receiver, to adhere to anti-money laundering requirements and to prove adequate risk management.

What about the Tiered Approach?

Tiering recognizes that different types of MOIs pose different levels of risk and have different record-keeping and reporting capacities. Tiered regulation and supervision however, poses some risks; among others, the tiered approach gives some MOIs the incentive to change their legal status or their structure in order to take advantage of more lenient regulation and supervision.

In the frame of this study, the only regulation using a tiered approach is the COBAC regulation in Central Africa. The tiers in this case are determined by the nature of the relation with clients (members only–category 1; members and non members–category 2), the nature of services offered (savings and loans or credit alone) and the size of the operation, as determined by asset base. Requirements for reporting, auditing and capital adequacy also progress from tier 1 to tier 3. This type of tiered approach appears to be enabling for smaller rural MOIs, provided that they form regional or national networks. The MC2s, for example, came together to form the AMC2 that organises internal and external audits on their behalf.

In Ecuador, a new law seems to move the sector in this direction. In 2006, the Banking Board (Junta Bancaria) issued a resolution to bring active savings and loan cooperatives with assets exceeding US\$10 million under the supervision of the SBS. In Indonesia, large LPDs are encouraged to

operate under Banking Laws as BPRs at the risk of mission or clientele drift *vis a vis* their presence in remote rural areas.

Standardised regulation and supervision for all types of financial institutions or all types of MOIs could result in either overburdening the less riskier ones in remote rural areas or, more likely, in being lax or ineffective for large, country-wide cooperatives operating small banks but with weak governance.

Who should Supervise? Direct, delegated, indirect, self-regulation, private or external regulation

In the past, regulation and supervision of MOIs have been systematically entrusted by governments to Cooperative departments within various types of Ministries (Social Welfare, Rural Development, Community Development). The problem is that government entities responsible for supervising all cooperatives normally lack the skills required to supervise financial institutions.

This study shows that, globally, lessons have been learned from the past, at least partially. New laws are emerging everywhere witnessed by the MACS Act in India, the LPSC Law in Mexico, the BEAC COBAC Regulation in Central Africa and in 2007, the revised BCEAO law for West Africa. In the majority of these new laws, the regulation is made consistent with banking laws (though adapted to a specific type of clientele) and supervision is as WOCCU suggests, “implemented by a specialized supervisory agency with appropriate skills, powers of examination, regulation and enforcement, and the ability to devote sufficient resources to MFIs including MOIs, despite their relatively small size.” This is done in Ecuador, by the SBS, in Mexico by the Superintendencia de Bancos y Seguros, and in West and Central Africa by the CNBV, National Commission of Banks and Values, Banking Commission and Microfinance Unit at Ministry of Finance. The only region where financial MOIs are still regulated and supervised by non-specialised entities is Asia. In India, this function is performed by the Cooperative Registrar and local government offices. In Indonesia, self regulation is being encouraged at the federation or second tier levels with supervision by higher level refinancing bodies—BPD supervises LPDs in Indonesia. Supervision by refinancing banks is rarely efficient because of conflicts of interest.

Sometimes new laws duplicate existing laws, creating dual systems of control as has happened in Mexico between the SBS and DINACOOOP. In other cases, such as in Ecuador, regulated and unregulated cooperatives continue to coexist and are allowed to compete in distorted terms.

As mentioned above, authorities could delegate certain functions to networks and then supervise networks instead of directly supervising every tiny MOI in remote rural areas. This has been proven effective in terms of controlling risks and efficient considering the lack of human resource and high costs associated with supervision, especially in vast, sparsely populated regions.

Delegating supervisory functions should not be confused with self-regulation and self-supervision. Self-regulation by federations or networks has proven to be unreliable for many reasons as discussed in numerous studies (Hirschland, et al., 2007). Self-regulation should be disregarded as a possibility for external supervision for MOIs forming the same system with their network or federation. It has been shown repeatedly that many very large federations of mutuals in West Africa are incapable of regulating and supervising their first tier members.

Delegation to private external oversight, to specialised audit firms or refinancing banks for example, is a domain that has been widely envisaged by stakeholders and authorities alike. While prudential regulation could be audited by private bodies, authorities are reluctant to delegate compliance supervision arguing that legally, this function cannot be subcontracted. Therefore in West Africa, under the PARMEC law, the microfinance unit of the Ministry of Finance in charge of supervision was not allowed to commission external auditors for supervision missions. The unit could only integrate private auditors in their supervision team under the authority of a Chief of Mission from the Ministry. The cost aspect of delegation to private auditors is also a serious issue that must be taken into consideration.

The study describes cases where some aspects of supervision were entrusted to refinancing banks such as the BPD in Indonesia, BANSEFI in Mexico and, in a different arrangement, First Afriland Bank for the MC2 in Cameroon. For various reasons, these cases suggest that this has not been very effective. Distance is one factor as these banks are usually located in the capital cities far from the primary MOIs they are intended to supervise. Human resource scarcity and lack of human resource capacity are other factors as well as the fact that refinancing banks take a different approach when assessing credit risks, which is more their role. If MOIs are shareholders of the bank, as many of these banks are designed, then supervision by refinancing banks would be even less appropriate as there would be pressure to pursue refinancing and to avoid disclosure of failures.

If regulation and supervision are clearly recognised as being tailored to the financial character of the activities of all institutions, it would be sound and consistent to designate one financially-specialised supervision agency to regulate and enforce, equitably, all institutions, regardless of legal status. Central Banks and Banking Commissions are usually the most appropriate entities for carrying out such a mandate and they should propose to the stakeholders of the sector whether licensing and supervision should be undertaken by a special unit within the institution or by the same team of inspectors that deal with the banks.

What to Supervise?

Regulatory standards should be designed to fit the size and complexity of the institution under regulation: Standards should be easily understood and implementing them should be financially manageable for the both the MOI and the regulatory authority. Reporting that is manageable, comprehensible and valuable to both parties may be the most powerful solution to the conundrum of MOI supervision.

For example, Vogel recommends that a large number of MOIs—those that are too small to merit bank-like supervision but too big to rely on peer monitoring—should simply be required to use standard accounts and submit standard financial statements that have been certified by an external auditor. Many large MOIs do not use a standard chart of accounts and do not undergo standard external audits so these low-cost measures alone could significantly improve their management.

In the microfinance sector, performance standards and benchmarking have been shown to drive improved performance and professionalism. For MOIs, establishment of simple, appropriate standards may be the key to improved outreach and governance so the challenge is to arrive at a few appropriate indicators that MOIs can understand and track.

The greatest risk MOIs face is the weak control that members exert over their boards and managers. MOI regulation should, therefore, focus on governance as has been done in Mexico and in Cameroon.

In summary, MOI regulations should include or require the following elements:

- **Member Representation:** Members should have the right to elect new directors and to attend annual membership meetings.
- **The Board or Management Committee:** Directors should have a profile in the community and bring a minimum set of qualifications to the position. It should be noted that, in remote rural areas, this requirement may concentrate decision making power in the hands of elites and lower community ownership. Time limits should be set for terms held and compensation guidelines should be clearly specified. Clarity is also required to establish a board's functions, limits, and responsibilities. Items such as fiduciary responsibilities and penalties and the distinction between board and management responsibilities should be clearly stated. The case describing LPDs in Indonesia shows the limits of such requirements.
- **Supervisory Committee Functions:** Clear guidelines for the functioning of a supervisory committee must be established. A supervisory committee could be validly replaced by external auditors and/or private service providers appointed for this purpose especially for MOIs operating in remote rural areas with high illiteracy levels. Networks or federations should contract external auditors and/or private service providers to ensure quality of service and to monitor application of all recommendations.
- **Credit Analysis:** Credit decisions must be based on risk analysis once an MOI (or the size of a loan) is so large that personal knowledge of applicants does not provide enough information for decision making;
- **Conflicts of Interest:** Conflicts of interest should be prohibited. These would include but are not limited to insider lending, nepotism, directors taking on contractual working relationships with an MOI or loan payment delinquency.
- **External Audits:** Annual external audits should be conducted with a standard scope of work but a special focus on portfolio control and internal control. External audits could also be tiered so that small, lower-risk MOIs would be audited with greatly-simplified terms of reference. Networks and federations should also have their internal control systems audited using a representative sampling of member MOIs each year.
- **Internal Controls:** A professional internal auditor, someone who is free to carry out his or her work and who reports to the supervision committee and the General Assembly, should be put in place. Internal control reports should also be included with documents sent to Superintendency for off-site supervision.

As governance presents the most risk for MOIs, regulation should not be overly detailed such as it is in some laws which regulate according to legal status. MOIs should be left to define their own day-

to-day management rules, operational procedures, methodologies and products. A more appropriate approach would be to provide MOIs with core principles for good governance.

In most other respects, large MOIs require prudential regulation like that established for commercial banks. This was recognised in the BCEAO Law in West Africa. MOIs, however, also face certain distinct risks that call for somewhat different regulations and supervision. It is recommended that the following regulations, unique to MOI operations, would be useful:

- **Capital Adequacy Ratios:** Large MOIs should be expected to maintain higher capital adequacy ratios than banks because of the volatility of the loan portfolio. In rural areas, for example, MOIs are subject to co-variant risk.
- **Liquidity Ratios:** Similarly, MOIs should be subject to higher liquidity ratios because they have no access or more limited access to liquidity facilities than banks.
- **Loan Documentation and Provisioning:** MOI loans are assessed on the basis of character and current cash flow and are supported by social guarantees. Allowing solidarity mechanisms to secure loans without requiring additional provisioning up to a certain loan size (or a percentage of the portfolio) is essential for the sustainability and the growth of MOIs. Applying this condition for MOIs, and for banks refinancing MOIs, reduces costs significantly.
- **Limits on External Credit:** The BCEAO law limits an external loan amount to twice the amount of savings held by an MOI. Unlimited access to external credit could be damaging to MOIs as it could reduce the MOIs' efforts to mobilise internal savings and equity, both of which promote ownership and provide incentive for savers to oversee their operations effectively. Stringent rules about external credit could limit outreach, adaptation of products to the needs of members and sustainability.
- **Minimum Capital Requirements:** Minimum capital requirements can restrict remote-rural access to financial services. These requirements should therefore be much lower than those set for commercial banks. In the COBAC regulation, minimum capital requirements are very accessible for MOIs and are higher for institutions dealing with both members and non members.
- **Operational Restrictions:** Regulations that require branches to be open a certain number of days and hours may prevent outreach to less densely-populated areas where such long hours are neither warranted nor cost-effective.
- **Portfolio Diversification:** To offset MOIs' high covariant risk, regulations should address the concentration of loans by sector and geographic area. These norms would encourage MOIs to form networks and federations to mitigate the risk.
- **Fixed Assets:** Fixed assets should be limited to a proportion of total assets to prevent managers and directors from spending large amounts on unproductive but showy assets. These limits might be relaxed for small or start-up MOIs.

- **Nonfinancial Businesses:** The BCEAO Law stipulates that MOIs cannot have more than 5% of their business in activities other than savings and credit. For rural MOIs, this restriction probably makes good sense, as marketing of crops, a very popular activity requested by members, could put savings at risk because crop marketing requires a different set of skills than does the managing of saving and loan activities.

Setting an interest rate cap could be detrimental to MOIs, especially remote rural MOIs. Operating as they do in sparsely-populated, infrastructure-deficient environments, MOIs have the freedom to charge sufficient interest rates to cover their own costs (some of which are minimal, as several functions are performed by volunteers) and the costs of higher-level tiers or service providers. Interest caps reduce the ability of an MOI to attain self-sufficiency.

Costs of Supervision and Ways of Covering Them (Cost of being regulated and benefit)

The most frequently cited reason government does not supervise MOIs is the lack of government resources. Shifting responsibility for supervision to another entity may not solve the issue of cost recovery. High cost is perhaps the biggest constraint to effective MOI supervision.

For this reason, some suggest that MOIs should cover the costs of their own supervision. They argue that supervision is crucial, that governments cannot be expected to cover the costs of supervising many small institutions and that these costs could be covered through a relatively small increase in interest rates. In Indonesia, the LPDs pay 5% to an LPD guidance fund to cover the cost of support teams and centres. Furthermore, these costs might quickly be offset by the benefits of supervision, benefits which could include significant efficiency gains, access to commercial resources and increased deposits from those attracted by the increased security and the regulated status.

One must distinguish between the regulation costs the MOI bears and direct costs such as capital adequacy, reporting requirements, staff qualification, extra staff, MIS, more frequent control and provisioning requirements.

One key to controlling costs is to keep obligatory reports simple so that reporting requirements can be met by small and medium-sized MOIs. Evaluation of direct costs will certainly determine which size of MOI could absorb such investment and cover them in a recurrent way.

The other type of cost is the one involved for the authorities to supervise (off-site and on-site) all the regulated institutions, including MOIs in remote rural areas. Mechanisms combining delegation of certain functions to networks, involving external audit firms and effective off-site and on-site supervision of the networks should be able to keep the costs for supervision reasonably low for the authorities to bear them in the long run, even if they have to request the donors' assistance to support the initial set up phase (develop procedures, train inspectors, software for data processing).

Nonetheless, the costs of supervising are still very high. Cost remains a significant issue that is not fully addressed here.

Conclusions and Ways Forward

Several lessons can be drawn from this study of member-owned institutions in India, Indonesia, Mexico, Ecuador, Niger and Cameroon. Although the legal and regulatory environments are quite different, both for microfinance and for MOIs in these countries, it is clear that regulation and supervision can affect the outreach capabilities of MOIs particularly with regard to their capacity to deliver sustainable financial services to address the needs of remote rural populations.

There is a growing awareness among policy makers and governmental stakeholders that MOIs provide the best access to remote rural areas, and therefore, MOIs should be strengthened and encouraged to do so on a larger scale than they currently operate.

The study did not identify a legal or regulatory environment that is explicitly hostile to MOIs: In all the cases documented MOIs have emerged and grown without many constraints (perhaps by avoiding being regulated at early stage). In fact, MOIs have attained such a size and visibility that MOIs are seeking more formalization and authorities are seeking accountability and transparency.

Clearly, this study shows that grassroots initiatives and innovations are not threatened by the regulatory environment. Regulation, in fact, should be considered as grassroots initiatives develop and as the financial sector in a geographic area is placed at risk.

- Small MOIs which cash out and are time bound should not be regulated considering the lack of capacities and resources common to most specialised supervisory authorities. Other small to medium MOIs operating in sparsely-populated rural areas should be encouraged to form or to join networks or federations which can perform some functions delegated by the authorities (i.e. organising off-site and on-site supervision). If the market allows, these larger organizations could be transformed into banks (i.e. BPR in Indonesia)
- MOIs are still identified or associated with cooperatives and the path of graduation is almost always transformation into cooperatives, within the traditional credit union set up of primary societies, second and third tiers (federation, confederation). In the field there are innovations going on showing other approaches to participation by the local communities. Change in paradigm may be needed in this area.
- In different parts of the world, lessons on past errors in supervision of financial cooperatives have been drawn: New laws are emerging which are typically designating specialised supervision authorities such as Central Banks and Banking Commissions to oversee financial institutions like MOIs. Importantly, these laws recognise the nature of MOI activities as being the most essential aspect for regulation rather than legal status.
- Establishing dual control by a Cooperative Registrar and a Banking Superintendency should be avoided as it creates confusion, distorts the market and ultimately weakens an MOI's capacities.
- A good regulation is one that both parties can understand and implement. The regulation should be simple and yet strict on some core principles, progressive in regards to a tier system and affordable so as to encourage rural outreach. Regulation of microfinance activities using the tiered approach seems to be helping MOIs and regulators to achieve this goal.

To direct the way forward, we join other key stakeholders in the microfinance sector to propose the following recommendations:

- A Basel Accord-like process should be put in place to develop international guidelines for MOI regulation as proposed by Cuevas and Fischer (2006).
- More pragmatically, a good first step towards development of appropriate regulation and supervision methods would be to commission an international multi-stakeholder task force comprised of experts, promoters and practitioners. The task force would build consensus on good practice for MOIs which operate in rural areas and identify norms, standards and related risks.
- An in-depth analysis of key regulation and supervision frameworks should be undertaken to assess their impact on the MOIs, especially with regard to sustainability, capacity for rural outreach and safety and soundness of member savings. This analysis should provide the evidence necessary to support the initiation of an advocacy campaign that would raise awareness at governmental and central bank levels globally. This analysis should ideally include the participation of national associations such as the Rural Finance Network in Ecuador which has begun to document this issue.

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Appendix A: Methodology and Summary of Case Studies

Study Objective

To illustrate how varied member-owned models in different contexts have been able to achieve significant outreach in remote, rural areas.

Defining Member-owned

- Clients are both owners and users of the institution
- Member equity is tied to ownership and decision-making (shares; savings; rotating/internal capital)
- Member equity is a key source of funds
- Legal entity is based on member-owned (i.e. association)

In order to cut across models definition needs to account for a variety of forms of equity and decision-making. Even what legal entities are possible will vary from context to context.

Defining Remote

Unserved in its own market. This can be due to several factors:

- Geographical distance from nearest service or input provider
- Population density
- Socio-cultural aspects of access such as gender or ethnic background as in the case of lower castes in Asia or indigenous groups in Latin America

Study Methodology

The intention of the research is to help answer some questions about different types of member-owned institutions to determine what potential they have for depth, breadth, scope, length, worth and cost of remote outreach, using Schreiner's (1998) six aspects. In-depth institutional analysis of each MOI sample examines remote outreach and demand by remote members and member groups. The second level of analysis focuses on how remote outreach is influenced by three key drivers:

- Networking and linkages
- Governance and ownership
- Regulation and supervision

The perspective of analysis is from the lowest tier association, SACCO or set of groups and their members. Selection of case MOI(s) is based on the 20% most remote MOIs within their sample universe. Selection is based on remote members/groups that are representative and mostly strong. The sample universe would be the district, sub-region or cluster of MOIs according to second-tier organizations, political boundaries or regulatory areas. Depending on size of MOI and sample, range could be a number of self-help groups to one SACCO or village association.

Case-Selection Criteria

- Remote in terms of households is proxied by one or more of the following:
 - Location of access points (decentralized and centralized level if receiving different services at each point).
 - Distance of access points to local centre and nearest road (nature of road), availability of transportation.

- Depth of outreach (varies by context but broadly a factor of population density and infrastructure, poverty level, and other indicators of social exclusion).
- Member-owned (not managed externally; members involved in decision-making)
- Strong breadth of outreach relative to the context
- Informative in terms of one or more of our key research questions (governance and member-participation; external resources; regulation and supervision; type of MOI)
- Not so unique or idiosyncratic that it does not have lessons that can be applied to other contexts
- Relatively financially viable
- MOI is transparent, information is readily available or fairly easily collected and staff is willing to collaborate in collecting information.

Schreiner, M. (1998). Aspects of outreach: A framework for the discussion of the social benefits of microfinance. *Journal of International Development*, 14, 1-13.

Cases Selected

1. PACS (Primary Agricultural Credit Society) with self-help groups as members, Andhra Pradesh, India [linkage between SHGs and cooperative]
2. SHG (Self-Help Group) Federation, India [Federation of SHGs]
3. LPDs (Lembaga Perkreditasi Desa), Indonesia [small village-based associations]
4. VSLAs (Village Savings and Loans Associations, Niger [de-linked and networked groups]
5. MC2s (Mutuelle Communautaire de Croissance), Cameroon [federated and decentralized associations]
6. Jardín Azuayo, Ecuador [rural credit union with remote service points]
7. Mixtlan Savings and Credit Cooperative Organization (SACCO) within the UNISAP Federation, Mexico [urban-rural cooperative with some rural SACCOs]

Self-Help Group—Primary Agricultural Credit Societies Linkage, India

The self-help group (SHG) linkage model is the largest-scale and perhaps the best-known linkage model in microfinance. SHGs are informal thrift and credit groups of poor, mainly women that became recognized as bank clients under a pilot project of the rural apex bank NABARD in India in 1992. As of March 2007, there were more than 2.9 million SHGs linked to financial institutions (commercial banks, rural banks and cooperatives) representing over 40 million households. This case study examines the linkage between SHGs and cooperatives, specifically the Primary Agricultural Credit Societies (PACS) which accounts for 69% of the rural financial branch infrastructure (NABARD, 2007). West Bengal has had the highest percentage of SHG-PACS linkages in India and regulation there allows groups to be members of financial institutions rather than requiring groups to serve as conduits for individual members.

This case examines the Bararanga PACS in West Bengal linked with 85 SHGs and 1,382 members, all women. It is located within Purulia Manbazaar II a border block with a population density of 405 persons per km². This PACS was locally described as the most remote since more than 75% of the SHGs live in the most remote areas of the block and over 80% are from a tribal group, otherwise largely excluded from finance.

SHGs Federated into Mutually Aided Cooperative Societies, India

SHG linkage models have been given much more attention than SHG federated models. This case examines an SHG federation in the Tribal Belt of Andhra Pradesh (AP). AP is the most concentrated state of SHG activity, so it is interesting to understand how inclusive it actually is of people living in remote areas. AP also passed a new law called the AP Mutually Aided Cooperative Societies Act to govern the new generation cooperatives (including SHG federations) to allow them to move from charitable status and forgo government subsidy to become regulated in a new act free of the challenges and bureaucracy of the Cooperative Act.

This case study examines ASP (Ankuram Sanghamam Poram), a federation of SHG federations with nearly 6,000 SHGs and 65,520 members at its base. This system grew out of a local Dalit (Dappu' Dalitbahujan) movement and trade union, and has deep roots in social activism. It is a three-tier system federated at the state and sub-district levels, with the apex serving as the system's wholesale financier and supervisor. Each sub-district MACS has an office as does the state level MACS, and in addition there is some minimal infrastructure for the district level teams. The infrastructure and staff are largely subsidized by the apex MACS, which, through a business planning process, is attempting to wean member MACS away from subsidies. However significant levels of grant support are still required in the system.

This case examines Jeevan MACS, a sub-district level MACS, one of 108 within the ASP federation. Jeevan MACS has 1020 members and 68 SHGs. The population density is 190 persons per km². The remote nature of this case is also more socio-cultural than geographical. The federation is largely comprised of lower-caste women who have taken on leadership at each tier. The case allows an interesting contrast to the PACS-SHG linkage model.

LPD, Indonesia

The LPDs (Lembaga Perkreditan Desas) are village-based financial institutions in Indonesia that have been encouraged by the provincial government. LPDs have grafted their governance and management onto local customary institutions as one way to ensure local ownership and accessibility. Basing the financial institution in each village has enabled LPDs to achieve broad and remote outreach through lowered costs and local ownership, as well as a high level of acceptance and trust among local people. Since LPDs are owned by the traditional council and managed in part with traditional laws, member accountability to the MOI is high.

LPDs were chosen because they have high penetration in Bali, Indonesia where over 90% of the households are members of one of more than 1,200 LPDs. Even islands have their remote contexts. In this case, the Muntigunung LPD is one of 156 LPDs in Karangasem Regency/District. Muntigunung was identified by local officials as the most remote and poorest settlement in the hills, with poor irrigation and poor access to drinking water and located at least 45 km from another financial source. The population density is 400 persons per km² and the population is largely dependent on agriculture, as it is distant from the flows of tourism. This LPD reaches out to 1,020 members (all households in the *desa adat*) with 249 borrowers and 88 savers.

Village Savings and Loans Associations, Niger

Niger is the oldest, largest and one of the most remote CARE programs for village savings and credit associations (VSLAs) in Africa. Similar programs with a similar though adapted methodology exist in thirteen other African countries. Through the methodology, CARE has encouraged the formation of village loan funds composed of members' savings, using a simple time-bound savings

and lending methodology. CARE tries to limit external involvement to one year of training and follow-up. The number of members in Niger VSLAs is currently about 50,000. While some of these savings and credit associations are entirely self-managing and cash out at the end of their one- to three-month cycles, others have come to network and link to financial institutions including cooperatives. CARE is also using the networks as a springboard for non-financial activities such as cereal banks. For this case, 25 VSLAs were chosen in Tahoua Region including both networked and non-networked VSLAs. The population density in this area is between 10-25 persons per km².

MC2s, Cameroon

Mutual associations have a strong reputation in West Africa for their rural outreach. This case study examines two Mutuelle Communautaire de Croissances (MC2s) in Cameroon, part of a larger network covering 62,744 members through 64 MC2s. The two MC2s, Njinikom and Bambilang, are located in two rural localities in the Northwest province of Cameroon situated 65 km and 85 km respectively from Bamenda, the main city of the province. The population density in the area of study is 107 persons per km². The two MC2s have 3,512 members, more than half of the members found in the province. Overall the MC2 network has 62,744 members. They present a good contrast between a strong and weak MC2 in terms of governance and financial performance.

The case examines the MC2s' complex set of relationships including its own emerging apex structure, government subsidy, support from a promoting non-government organization and linkages with market suppliers. The MC2s offer a variety of savings and loan products, training and other non-financial services to both individuals and groups. Groups include 'tontines'—informal savings and loan groups affiliated with local agricultural and women's associations—that are common throughout Cameroon. Of particular interest for remote outreach is their use of migrant relatives as a key source of funds and other ways that they have managed to secure market linkages.

Jardín Azuayo Cooperative, Ecuador

One way for larger cooperatives to reach rural and remote areas is to provide urban-based services that can provide liquidity balancing and cross-subsidize smaller, costlier service points. The Jardín Azuayo Cooperative case presented here runs contrary to this logic. It is a largely rural cooperative (80,378 members) with twenty of its twenty-three offices in rural areas.

This case examines five rural offices with 29,260 members in the south-east spanning three provinces. The population density averages 39 persons per km² across the offices. Jardín Azuayo uses a model of decentralized representative governance in each office complemented by member education to support member participation. This case also demonstrates a reversal in the trend of rural siphoning (taking savings from rural areas to finance urban lending) common in Ecuador and elsewhere. It is a self-financed cooperative that has successfully moved from a system of self-regulation to prudential supervision by the Superintendency of Banks and Insurance.

Mixtlan SACCO, Mexico

Large cooperatives or federations with economies of scale, an urban and rural presence and a stable asset-base may be one solution to the challenges of decentralized MOIs. In part, Mexico's policy and regulatory regime have encouraged consolidation and scale in both microfinance institutions and MOIs.

This case examines Mixtlan, a rural SACCO. It is part of UNISAP Federation, a large and highly-rated urban-rural federation. UNISAP has over 350,000 members in Mexico. Of those, 19,155 are rural. Mixtlan cooperative, with 3,452 members, covers over 40 localities in the north mountain range of Jalisco State. Mixtlan works in a rural and remote area with a population density of six persons per km². The nearest input supplier is 257 km. away and remote collectors are used in some rural localities. Mixtlan is one of few rural cooperatives within UNISAP (Cooperative Federation), which is a largely urban federation (more than 70% of its members are in urban areas). Within the rural MOIs, Mixtlan showed one of the highest rates of local penetration, nearly 90%. The federation's scale has provided important efficiencies and the urban presence is crucial for market linkages including remittances, a highly demanded service for remote members.

Appendix B: Regulation and Supervision Survey

Key research questions: What are the conditions that warrant external supervision? In the absence of government regulation and supervision, what works best? How can specific regulations enhance or inhibit MOIs' ability to achieve broader or deeper outreach?

Hypotheses:

- Regulatory frameworks typically are not appropriate to the compliance capacity of small MOIs.
- For small MOIs that offer simple services that do not require complex asset liability management and in which members participate directly, self-regulation – internal governance and control - can be adequate if these controls are free from undue influence.
- External supervision cannot compensate for internal governance deficiencies.
- Remote SACCOs cannot pay for the full costs of external supervision. Therefore creative solutions are necessary.
- Delegated supervision is more financially feasible and effective than direct supervision. However, the regulatory framework under which it takes place must take into account the compliance capacity of MOIs.
- The regulatory framework can support graduation, branching, networking, or other linkages. Alternatively, it may limit an MOI's choice of linkages, forcing it to choose a sub-optimal arrangement.

Description:

Legal

- What is the legal framework governing MOIs?
- How are MOIs registered?

Regulation

- What are the regulatory guidelines or restrictions for deposit mobilization?
- What are the reporting requirements? Frequency? How demanding and time-consuming?
- Does the MOI have technical capacity to comply?
- What is the overall framework (incentives and disincentives) for MOI entry and graduation and closure? Restrictions (branching/products; Requirements—capital, reporting; sanctions..... Unclear what's meant here.
- How can the MOIs be organized into logical quartiles/tiers? What factors divide them into categories? Relates to above....

Supervision:

- By whom is the MOI supervised? (Self, network, apex, federation, government body? Internal, external or by a second-tier organization? Private or public)?
- What triggers prudential regulation for this type of MOI? At what point is this type of MOI externally supervised?
- What is the nature of external supervision? (i.e. frequency of visits, foci of the visits, follow-up and consequences of poor performance)
- Is supervisory capacity (skills, time, costs) an issue for the supervisory authorities?
- Does the MOI have a regular internal and/or external audit? How frequently? By whom? How has this influenced operation?

- Does the MOI submit to rating, standards, or benchmarking? How frequently? By whom? How effective at influencing operations?
- What has been most effective at promoting vigilant and secure management of funds?
- Does the MOI pay for supervision? If so, how much does supervision cost the MOI?
- How is the MOI covering the cost of supervision?
- How many like MOIs have failed and been closed? Why?
- What is the incidence of fraud/embezzlement?
- To what extent is the regulatory and supervisory environment supportive or constraining of the linkages and networking?
- To what extent is the regulatory and supervisory environment encouraging certain paths of formalization?

Methods: staff and management interviews; audit reports; central bank guidelines, interview; reports of any supervisory body, rating agency, network.