Policy Brief
ELLA Area: Economic Development
ELLA Theme: Microfinance

ELLA
Evidence and lessons from Latin America

Before the 1980s, the microfinance sector was virtually non-existent in Latin America, but now it grows at two-digit rates. How have institutional innovations played a role in this expansion?

LATIN AMERICA'S INSTITUTIONAL AND REGULATORY INNOVATIONS FOR MICROFINANCE GROWTH

SUMMARY

Current microfinance sector performance is associated with the reforms of Latin American countries' financial sectors, starting at the end of the 1980s. Before the reforms, development of microfinance was constrained by an overly regulated financial industry that was primarily based on state participation. Streamlining regulation and implementing practices to supervise the sector provided microfinance institutions (MFIs) with the right environment to expand, innovate and become worldwide leaders in their field. This Brief provides an overview to the Latin American experience in regulating MFIs, covering the history of microfinance regulation in the region and the positive effects it has had on the sector's current performance. It also highlights good practices in regulations, risk management and oversight, and concludes with lessons learned that might prove useful for other regions.

THE CHALLENGE OF MICROFINANCE REGULATIONS

Developing countries around the world struggle with supplying resources to the poor. Social assistance programmes are one option, though they depend on continued government resources. In contrast, microfinance offers a mechanism to channel resources to the poor but in a way that generates a declining need for assistance in the future. As in Asia and Africa, the adoption of microfinance in Latin America was neither fast nor easy: before the late 1980s, the poor regulatory system discouraged both private investment and consumer confidence. Controlled interest rates and exchange transactions, high reserve requirements, and a myriad of controls on credit were just some of the obstacles the sector faced.[1] In addition, the microfinance sector was dominated by NGOs dependent on donor money, with low coverage, poor management standards and little sustainability. It seemed to be sufficient to make money available to poor people; recovering principal, and consequently sustainability, were not high on the agenda. It was not until the financial reforms of the 1980s and 1990s that financial intermediation and allocation of credit improved, promoting healthy competition and boosting the sector's rapid development.[2]

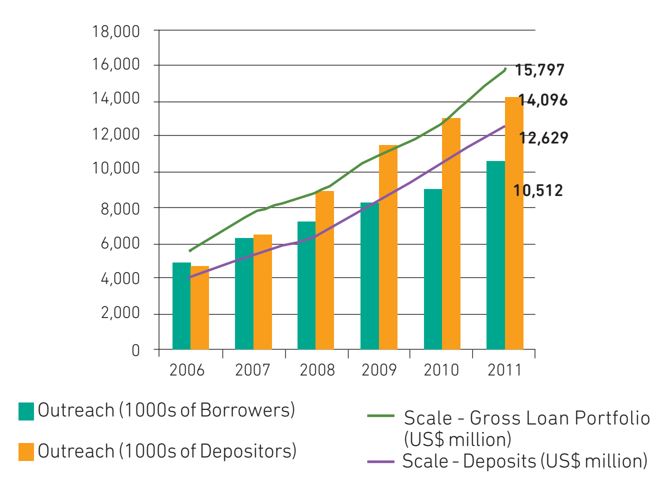
[1] Lora, E. 1997. *A Decade of Structural Reforms in Latin America: What Has Been Reformed and How to Measure It*. Working Paper Green Series #348. Inter-American Development Bank (IDB), Washington, DC.
[2] Rennhack, R. *et al.* 2009. *Global Financial Regulatory Reform: Implications for Latin America and the Caribbean (LAC)*. International Monetary Fund (IMF), Washington, DC.

Nowadays, eight of the top dozen countries that rank in the Global Microscope on the Microfinance Business Environment 2011[3] are in Latin America, with Peru and Bolivia in first and second place, respectively. The assessment ranks institutions according to a weighted index where the two key factors are the regulatory framework and oversight practices, and the supporting institutional setting. Though microfinance is expanding worldwide, the success some Latin American countries have had, particularly in terms of their regulatory framework, means lessons from the region may prove useful in other areas of the world.[4]

THE INSTITUTIONAL FACTOR AND PERFORMANCE

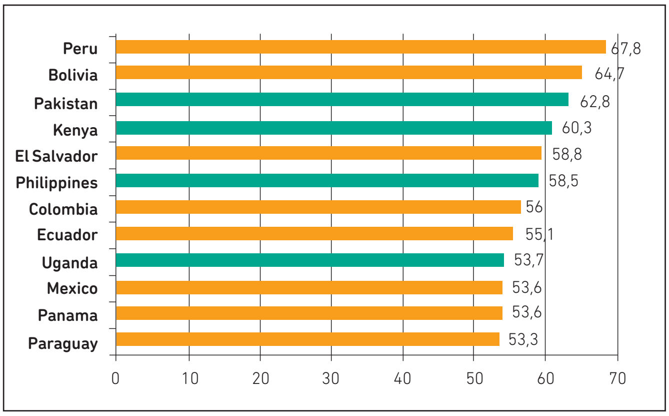
Definitively, a favourable regulatory environment for MFIs is what Latin America needed. Miller (2000) argues that as long as there is a large microenterprise sector, an appropriate regulatory framework and a stable environment, there will be viable MFIs.[5] The Latin American experience in the last two decades validates his argument, with proof coming from the fast growth of the sector since the reforms of the late 1980s. Figure 1 below illustrates growth in the microfinance sector in recent years. Note that even the international financial crisis did not affect the dynamism of the sector.

Figure 1: Evolution of Credit in 48 MFIs from LAC



Own elaboration. Source: Martínez, R., 2012. *Latin American and the Caribbean Microfinance Market Trends 2006 – 2011*. MIX Market (www.themix.org). Note: Outreach is understood as the amount of people with access to the service.

Figure 2: Microscope on the Microfinance Business Environment: Top 12 Country Rankings (8 from Latin America), 2011



Own elaboration. Note: Countries are scored from 0 to 100, with 100 being the highest score.
Source: Economist Intelligence Unit. 2011. *Global Microscope on the Microfinance Business Environment 2011*. Economist Intelligence Unit, London.

Some may assume that the positive evolution of microfinance in Latin America has been caused by the region's strong overall economic growth performance. But research and evidence from the region highlight that institutional factors, such as regulatory framework and supervision, do matter. Data from the Global Microscope on the Microfinance Business Environment 2011 are important in demonstrating this link, with the instrument specifically focusing on institutional factors.[6]

Coupled with the growth and performance data for the sector presented in Figure 1, it provides meaningful evidence of the association between institutional factors and performance.

Although the literature is not abundant and additional research is needed, some authors have attempted to more formally test the causal hypothesis of the impact of regulation on sector performance. Using the Microscope rating, Olsen (2010) tested the effect of regulation on number of borrowers using firm-level data of MFIs in Latin America, and found that strong regulation had a positive and significant effect on the sector's ability to attract borrowers.[7]

[3] Commissioned by the Multilateral Investment Fund of the Inter-American Development Bank (IDB), the Andean Finance Corporation (CAF) and the International Finance Corporation (IFC), the study is carried out by the Economist's Intelligence Unit to provide policymakers with useful information to monitor and evaluate the microfinance market in 55 countries worldwide.
[4] Research for this Brief was based on a review of recent literature and surveys of the sector, which is cited throughout, and the author's research expertise in Latin American microfinance. As discussed later, research evidence on the links between regulation and microfinance performance is scarce, though expert consensus points to the importance of Latin America's regulatory innovations in spurring the growth of the sector.
[5] Miller, T. 2000. *Microfinance: Lessons Learned in Latin America*. Inter-American Development Bank, Washington, DC.
[6] The full rankings can be found in the complete report: Economist Intelligence Unit. 2011. *Global Microscope on the Microfinance Business Environment 2011*. Economist Intelligence Unit, London.
[7] Olsen, T. 2010. New Actors in Microfinance Lending: The Role of Regulation and Competition in Latin America. Perspectives on Global Development and Technology 9 500-519.

FINANCIAL REGULATION REFORMS IN LATIN AMERICA

This section presents an overview of Latin America's experience with regulatory reform. During the last years of the 1980s and the beginning of the 1990s, most Latin American countries underwent an overall reform of their financial systems. For some countries, the overwhelming interest was to strengthen their traditional banking sector, which had been weakened by the long crisis of the 1980s. However, other countries, such as Bolivia and Peru, took advantage of the opportunity to specifically address the goal of providing an adequate environment for a sustainable microfinance sector. Even among those countries that did not reform the microfinance sector at that point, their overall financial sector reforms established a foundation for future reforms specific to the microfinance sector. Table 1 summarises some of the features of these broad-ranging reforms.

One key feature of the reform was the liberalisation of interest rate setting. This was key in order to generate sustainability in a context of lending with no real guarantees. Almost all countries liberalised deposit rates while only a few countries kept some lending rates under the control of either the central bank or the financial regulating agency. Elimination of targeted credits, such as earmarking a percentage of total credit to a certain sector, was also uniform across the region, except for in two small countries, Jamaica and Paraguay. Reduction of legal reserves was also widespread, though the degree varied significantly from country to country. Finally, two out of three countries modernised banking legislation while more than half of them also modernised regulation of capital markets. As can be observed in Table 1, countries such as Peru and Bolivia, as well as others like Colombia, Ecuador, El Salvador and Mexico, implemented most of the full package of reforms.

Table 1: Financial Reforms Implemented in Selected Latin American Countries

Country	Initial Year of Reform	Liberalisation of interest Rates		Reduction of Legal Reserves (3)	Elimination of Targeted Credits (at least by half)	Modernisation of Capital Market Legislation	Modernisation of Banking Legislation
		Deposit Rates	Lending Rates				
Argentina	1992	*	**	Much	Yes	Yes	Yes
Bolivia	1990	Yes	Yes	Some	Yes	No	Yes
Brazil	1988	Yes	Yes **	No	Yes	Yes	No
Chile	1989	*	**	No	there were none	Yes	No (2)
Colombia	1990	Yes	*	Much	Yes	Yes	Yes
Costa Rica	1988	Yes	Yes **	No	Yes	No	Yes
Dominican Republic	1991	Yes	Yes	Some	Yes	No	Yes
Ecuador	1992	Yes	Yes	Some	No	Yes	Yes
El Salvador	1990	Yes	Yes	Some	Yes	Yes	Yes
Guatemala	1991	Yes	Yes	Some	Yes	No	Yes
Haiti	1995	*	Yes	No	Never	No	No
Honduras	1991	*	Yes	No	Yes	No	Yes
Jamaica	1992	**	**	Some	Yes	Yes	No
Mexico	1989	*	Yes	Much	Yes	Yes	No
Paraguay	1988	Yes	Yes	Some	No	Yes, but (1)	No
Peru	1990	Yes	Yes	Much	Yes	Yes	Yes
Trinidad & Tobago	1990	*	*	No	Yes	Yes	Yes
Uruguay	1985	*	*	Much	Totally	No	Yes
Venezuela	1989	Yes	Yes	Much	Yes	No	No

Own Elaboration.
Notes: * They were already liberalised ** A few rates are controlled *** Controls are widespread
(1) There is a law, but no actual capital market. No equity transactions were recorded, only money market instruments.
(2) A modern capital market or banking legislation (or a set of regulations) already regulated the market prior to the financial reform period
(3) 'Much' refers to 20 points or more. 'Some' refers to between 0 and 20 points.
Source: Lora, E. 1997. *A Decade of Structural Reforms in Latin America: What Has Been Reformed and How to Measure It*. Working Paper Green Series #348. Inter-American Development Bank (IDB), Washington, DC.

Though not included in the table, the emergence of universal banking was also important for microfinance growth, since prior to reforms financial institutions were not allowed to engage in different operations outside of their specialisation. In effect, commercial banks could only offer short-term commercial loans while mortgage banks could only offer services related to mortgage operations. Thanks to the reform, commercial banks, among other institutions, could engage in microfinance activities. This reform was appealing to investors as well, because it opened up the possibility of diversification of services. Combined with the increase of available resources due to the diminished level of legal reserves, this provided additional incentives for other institutions to get involved in microfinance.[8]

Some countries went even further in their reforms. In the case of Peru, for instance, bankrupted state development banks were altogether eliminated and the financial regulatory agency, the Superintendence of Banking and Insurance (SBS), was strengthened. The new legislation also established the framework for implementation of credit bureaus that assisted in evaluating risks for all financial institutions. Also, NGOs that were already providing microcredit to small producers were given a specific path for moving into the regulated sector. To achieve this, the law created a new category of institution called Development Entity for Small and Medium Enterprises (*Entidad de Desarrollo para la Pequeña y Mediana Empresa - EDPYME*), with special tax and leverage incentives to encourage them to formalise.

TYPES OF INSTITUTIONS AND DEVELOPMENT OF MICROCREDIT

The microfinance institutions that emerged in Latin America varied depending on each country´s circumstance. Between 1980 and 1995, MFIs in Bolivia and Peru could grant small loans and take deposits. In the mid-1990s, microcredit was included in their regulatory framework so that these institutions could, along with banks, serve the unmet demand for credit. Most countries included microfinance in general banking regulation, while others, such as Colombia, Ecuador and Nicaragua, regulated microcredit as a lending activity itself.[9]

All of the various types of MFIs are regulated by a superintendent's office or an equivalent. Table 2 shows the size and distribution of the different types of institutions in 2006. Almost 70% of the total microfinance portfolio in 2006 was in the hands of regulated MFIs, who served more than half of all borrowers.[10] This is quite a change from two decades prior, when most MFIs were managed by NGOs and were not regulated.

Latin American MFIs are classified into three types: greenfields, upgrades and downscales. Greenfields are new, specialised institutions that were started from scratch. Upgrades are regulated financial institutions that emerged from microcredit NGOs that operated through banks. These institutions are characterized as moving up-market to increase profitability in countries where there are still challenges with the regulatory environment. For instance, in Guatemala, finance companies cannot mobilise savings deposits and can only grant medium- to long-term loans which do not adapt to the needs of entrepreneurs. Some examples of upgrades are Banco los Andres ProCredit in Bolivia, Banco Caja Social and Bancolombia in Colombia, Compartamos in Mexico and MiBanco in Peru.

Downscales are commercial anks or Non-Bank Financial Institutions (NBFI) that desire to deepen their services to take advantage of the current profitability in the microfinance sector. In Latin America, regulators have aimed to make sure new organisational models are developed to avoid over-indebtedness of clients. Examples of downscales from the region include Banco Solidario in Ecuador and Banco Agrícola in El Salvador.

[8] Trigo, J., Devaney, P., Rhyne, E. 2004. *Supervisión y Regulación de las Microfinanzas en el Contexto de la Liberalización del Sector Financiero: Las Experiencias de Bolivia, Colombia y Mexico (Supervision and Regulation of Microfinance in the Context of Financial Sector Liberalisation: The Experiences of Bolivia, Colombia and Mexico)*. Report to the Tinker Foundation. Online publication.
[9] The question of which regulatory strategy works better - general regulation or a specific microfinance law - has yet to be addressed in the literature. In part this is because regulation is a complex, multi-element variable. But it is also because there exist good examples of success with both of the two approaches, as in the cases of Peru and Bolivia, highlighted in this Brief. For more information, see this paper outlining differences in legal frameworks for microfinance worldwide, including cases from Latin America such as Bolivia and Honduras: Staschen, S. 2003. *Regulatory Requirements for Microfinance: A Comparison of Legal Frameworks in 11 Countries Worldwide*. Division 41, Economic Development and Employment Promotion. GTZ, Bonn.
[10] Source: Bate, P., Navajas S., Pedroza, P. 2008. *Microfinance in Latin America and the Caribbean: 2008 Data Update*. Inter-American Development Bank (IDB), Washington, DC.

Table 2: Microfinance Portfolio and Borrowers in Latin America by Type of Institution, 2006

Type of Institution	Number of Institutions	Outstanding Portfolio (US$ billions)	Borrowers	Average Outstanding Loan (US$)
Data from 2006 (25 Latin American Countries)				
Regulated	217	**5.152**	**3,854,704**	**1,337**
Downscales	58	1.734	1,225,711	1,415
Greenfield	57	1.018	644,030	1,580
Upgrades	33	1.795	1,710,545	1,050
Credit Unions	69	605	274,418	2,204
Nonregulated	449	**2.332**	**3,115,931**	**748**
NGOs	391	1.457	267,484	554
Credit Unions	58	875	488,447	1,792

Source: Navajas S., Bate, P., Pedroza, P. 2008. *Microfinance in Latin America and the Caribbean: 2008* Data Update. Inter-American Development Bank (IDB), Washington, DC.

Finally, credit unions, or member-owned financial cooperatives, are also important in the region. Since they are operated by members, profits are also shared among members. According to MIX market, in 2008 12% of MFIs in Latin America were credit unions, and by 2011 their gross loan portfolio was about USD$ 4.3 billion and deposits were about USD$ 3.3 billion.

MICROFINANCE-SPECIFIC REGULATIONS

The problem MFIs face is that their potential clients typically lack two essential elements in traditional lending operations: formal information regarding their ability to repay and real collateral that would serve as a guarantee. In addition, self-employed individuals are likely to be more vulnerable to adverse shocks than formal employees or entrepreneurs because of their limited productivity. For this reason, regulators have the task of reducing risk through promoting diversification while making sure every credit-worthy individual has access to credit. In this context, whether as part of a single law for the banking system or as a specific regulation for MFIs only, effective microfinance regulation requires specific rules that consider the characteristics of microcredit and the targeted market of such loans. In this section we review microfinance regulatory practices in Latin America, focusing first on rules orientated to protect depositors and creditors through adequate risk management, and second, on supporting institutions, such as credit rating agencies and credit bureaus.

Protecting Depositors and Creditors

Banking regulations establish minimum conditions necessary to promote risk diversification. Authorising the operation of microfinance institutions requires establishing precise guidelines to be satisfied. A lax approach may make supervision a difficult task. Text Box 1 presents general principles and practices for regulating microenterprise in Latin America.[11]

Text Box 1 General Principles and Practices for Regulating Microfinance Lending in Latin America

- Need for an internal lending process for the variety of institutions: written manuals and institutional policies should explicitly identify oversight mechanisms
- Freedom to set interest rates, but no ability to unilaterally modify them
- Contractual transparency: high standards of fairness for loans to ensure entrepreneurs are constantly informed
- No predefined collateral and minimal client documentation
- Loan contracts in local currency if clients are not engaged in producing traded outputs
- Non-performing loans should be recorded as past due
- Risk classification of loans, risk weighting and legal recovery (not always a common practice)
- Recognise rescheduled or restructured loans
- Loan loss provisions to cover the portfolio at risk
- Loan write-offs (loans that have been 100% provisioned for a 360-day period) should be deducted from assets

Source: Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC

[11] See also: Association of Supervisors of Banks of the Americas (ASBA). 2010. *Guidelines and Principles for Effective Regulation and Supervision of Microfinance Operations*. ASBA, Washington, DC.

This section highlights some best practices for regulating MFIs specialising in microcredit, from a range of experiences in Latin America:[12]

- Minimum capital of about US$ 1 million to safeguard against potential losses. The capital base also makes it possible to reach a sustainable scale of operations. In Latin America, it has been considered important to protect depositors against shareholders engaging in risky activities from the beginning without having the capital to support them. Table 3 shows minimum capital levels for three Latin American countries.[13] It should be noted that countries with lower minimum levels tend to constrain the ability of institutions to take deposits from the public.

Table 3: Minimum Capital Requirements for Microlending Institutions in three LAC countries

Country	Institution	Minimum Capital (US$)
El Salvador	Savings and loan institutions	2,850,000 1,140,000*
Panama	Microfinance banks	3,000,000
Venezuela	Specialised microcredit development banks	2,370,000

*This lower requirement is applicable if the institution lends only to micro and small enterprises and accepts savings only from its borrowers (according to the definition of microenterprises stated).
Own elaboration. Source: Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC.

- Strict standards to keep related-party lending, meaning loans to the institution's shareholders, management staff or their relatives, to a minimum. This is because related-party lending concentrates risk, can lead to relaxation of procedures for evaluation and recovery, and can also increase the risk of institutional governance problems.[14] Some countries strictly prohibit related-party lending, such as Bolivia, where Article 32 of the Banks and Financial Institutions Law establishes that financial institutions may not grant related-party loans. Other countries, such as Peru and Paraguay, establish specific limits in terms of proportions of net worth or capital. In the case of Paraguay, directors, managers, controllers and employees may not receive loans exceeding 1% of the net worth of the financial institution, while in the aggregate this type of loan may not exceed 10% of net worth (20% is possible only with accepted collateral). Major shareholders are allowed to receive up to 20% of net worth in the aggregate. Credit unions may make exceptions since members are shareholders as well.[15]
- A graduation system that allows MFIs to access more complex or risky operations and offers a broader range of services subject to fulfilling specific requirements. One of the most important innovations that the reform of the financial sector introduced in the mid-1990s was the creation of 'modules', making specific operations available to MFIs provided that some requisites concerning social capital, administrative systems and internal controls are fulfilled. For instance, accepting saving deposits from the public requires a higher level of social capital; engaging in foreign trade finance operations requires enhanced administrative and control systems. This graduation system was intended to promote competition among banking and non-banking institutions; and thus enabled the expansion of services provided by MFIs.[16]
- Operations at the national or at least regional level in order to achieve efficiency and offer competitive rates to clients. An MFI that concentrates its operations in a town or a very small region not only faces difficulties in achieving high levels of efficiency, but also engages in a dangerous concentration of geographic and sector risk. This has been supplemented by lifting restrictions

[12] Based on author's own expertise and review of the literature, including: Rosales, R. 2006. Regulation and Supervision of Microcredit in Latin America. In: Berger, M., Goldmark, L., Miller-Sanabria, T. (eds). 2006. *An Inside View on Latin American Microfinance*. Inter-American Development Bank (IDB), Washington, DC.
[13] See also Table 1.
[14] Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC.
[15] Paraguay's General Law Governing Banks, Finance Companies and Other Credit Institutions (Law No. 861/69).
[16] Jaramillo, M., Valdivia, N. 2005. *Las Políticas Para el Financiamiento de las Pymes en el Perú (Policies for Financing Small and Medium-sized Enterprises in Peru)*. Grupo de Análisis para el Desarrollo (GRADE), Lima.

Text Box 2 Regulatory practices and institutions that work: Peru and Bolivia

Bolivia and Peru are recognised worldwide as having the most advanced regulatory frameworks in the region.[17] Table 4 shows the different regulatory standards applied in both countries. As can be seen, there is no homogeneous set of practices in the field of microfinance, largely because of the need for a prudential regulation that adapts to circumstances and an adequate monitoring of institutions. Each country defines its own parameters. In Peru, for instance, legislation allows a graduation system for expanding MFI activities. Pre-requisites are more stringent, for example, if the MFI wants to offer savings accounts.

In Bolivia, the supply of microcredit is through specialised banks, private financial funds (called *Fondos Financieros Privados* – FFPs), credit unions that had to adjust to new regulatory reforms, and unregulated NGOs who channel government funds. On the other hand, in Peru the most important entities are municipal savings banks (*Cajas Municipales de Ahorro y Crédito* - CMAC),[18] that are initially restricted to a given geographic area, but may apply for authorisation to operate in other regions. There is also one specialised bank with national coverage (*Mi Banco*), specialised units in commercial banks, private finance companies, rural credit unions and EDPYMES. Credit unions and unregulated NGOs, which are allowed to self-regulate to gain access to government funds, have a relatively small presence.

Table 4. Regulatory Standards for Microfinance Institutions

Characteristics	Bolivia	Peru
Geographic coverage	National	Provincial
Minimum Capital Level	$900,000	$283,000
Individual Credit Limit	1% of net worth	10 % of net worth
Related-Party Lending	No	Within limits
Loan-loss recognition	90 days	120 days
Capital Adequacy	10%	9%

Although capital levels in Bolivia require a higher degree of financial strength, they still enable non-profit entities to become financial institutions. Capital requirements are lower to start with in Peru, but increase with access to more complex operations. For instance, EDPYMES cannot take deposits.

Source: Rosales, R. 2006. *An Inside View on Latin American Microfinance, Chapter 4: Regulation and Supervision of Microcredit in Latin America*. Inter-American Development Bank (IDB), Washington, DC.

for MFIs to open new offices, again subject to certain requirements. In Peru, for instance, the Office of the Superintendent of Banking and Insurance (SBS) only requires institutions of risk rating C or D to ask for authorisation to open or close offices. A notification is the only requisite if the institution belongs to the risk rating categories A or B. This practice is not applicable for credit unions, however, since members are also owners and need to be able to handle operations more easily.

Risk Management and Supporting Institutions

In addition to strengthening the role of the supervising entity, one important set of institutional reforms for improving risk management in Latin America is related to the creation or promotion of supporting institutions, such as credit rating agencies and credit bureaus. These types of institutions make monitoring more effective in that access to information can ensure adequate size of loans, debt status and portfolio composition, thus promoting lower information costs, preventing over-indebtedness and monitoring delinquency. To be effective, the Latin American experience demonstrates that it is important that legislation find a balance between promoting the use of credit information and guaranteeing respect for privacy rights while supervising the accuracy of data.[19]

In Peru, the public bureau system received an important push in the late 1990s when it moved away from its focus on only large loans from regulated commercial banks. In 1998, digitalisation and inclusion of records on smaller loans was implemented, including those generated by MFIs, such as *Cajas Municipales* and EDPYMES, among those of other institutions. The 1996 law states that the activities of private credit bureaus (CEPIRS) must be regulated and that anyone could access the public credit bureau by paying a fee.

Two private institutions emerged at that moment, CERTICOM and Infocorp, that still remain in the market today. This 'credit reporting revolution' has increased competition among MFIs, as reliable information about the client's reputation is now publicly available.

[17] For an in-depth analysis of the two cases, see: Vogel, R. 2012. *Microfinance Regulation: Lessons from Bolivia, Peru and the Philippines*. Multilateral Investment Fund (FOMIN), Inter-American Development Bank (IDB), Washington, DC.
[18] To learn more about Peru's system of *Cajas Municipales*, see the ELLA Brief: Peru's Microfinance Sector and the *Caja Municipal* Model.
[19] Bauchet, J. *et al.* 2003. *Credit Bureaus and the Rural Microfinance Sector: Peru, Guatemala, and Bolivia*. University of California - Berkeley, FAO Office for Latin America, Santiago de Chile.

ENABLING FACTORS

LATIN AMERICA'S MICROFINANCE REFORMS

Institutional reforms are decided within the political sphere and require a level of dissatisfaction with the current state of affairs. Although country-specific circumstances differed across Latin America, the 1980s were generally an unsatisfactory period in terms of economic progress. At least three areas of the economic structure were viewed as problematic: limited state capacity to regulate markets; inadequate and often outdated regulatory frameworks; and a weak financial sector that was sensitive to external shocks. Specifically, the external debt crisis and poor macroeconomic management, with large fiscal deficits, runaway inflation and dysfunctional public enterprises being some of the most visible symptoms, left Latin American financial markets in a weak position, putting financial reform high on the political agenda.

Inadequate regulatory frameworks, that were too restrictive and prescriptive, rightly took part of the blame for financial systems' problems. Interest rates caps, high legal reserves ratios and targeted credits, among other regulations, were seen as factors obstructing efficiency and preventing markets from functioning well.

Citizen trust in state intervention had waned as bankrupted institutions and poor efficiency came to characterise the economic landscape.

Many state-owned banks had to be restructured or eliminated with large social costs. Thus, the content of the reforms was orientated to leave greater room for markets to allocate resources.

Lack of access to credit markets was seen as a factor constraining growth for the micro, small and medium enterprise sector. Unleashing the potential of this sector was associated with facilitating access to formal credit.

LESSONS LEARNED

1. Underinvestment in microfinance before the 1990s was associated with institutional obstacles to private investment. When a sound regulatory framework was established in the 1990s, it provided an adequate environment for greater investment, which, in turn, spurred growth in the sector.

2. Regulators have the task of reducing risk through promoting diversification while making sure every credit-worthy individual has access to credit. Banking regulation in Latin America has aimed to establish minimum conditions necessary to promote risk diversification.

3. Although specific policies and requirements vary from country to country, a set of good practice from the Latin American context emerges, including: minimum capital requirements, strict standards for related-party lending, increased access by MFIs to more complex or risky operations subject to fulfilling more demanding requirements, ensuring adequate scale for efficiency, and promoting competition.

4. Prudential regulation is key to speeding up the development process of the microfinance sector. Latin American experience shows that stability of policies, transparency and the establishment of guidelines that highlight differences between types of institutions are desirable qualities of the institutional framework.

5. It is also critical to have a strong supervising entity and adequate supporting institutions, such as independent and credible credit-ratings institutions and a well-regulated system of credit bureaus.

CONTACT GRADE

To learn more about institutional and regulatory innovations in Latin America's microfinance sector, contact the author, Miguel Jaramillo, PhD, Principal Researcher – GRADE, at mjaramillo@grade.org.pe.

FIND OUT MORE FROM ELLA

To learn more about microfinance in Latin America, read the ELLA Guide, which has a full list of knowledge materials available on this topic. To learn more about other development issues, browse other ELLA Themes.

GRADE Grupo de Análisis para el Desarrollo

ELLA is supported by: UKaid from the British people

PRACTICAL ACTION Consulting