Focus Note

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

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In remote rural areas of many parts of the world, MOIs are often the only means by which people can access financial services. However, "reaching the hard to reach" through MOIs requires a careful balance between the provision of loans to their members (using their own savings or share capital) and the regulation of the institution to ensure that small savers are protected from losses due to fraud, defaults, or mismanagement. Regulation of MOIs is necessary to provide such sanctioning and protection, and to increase MOI outreach. And yet, current regulation and supervision of MOIs exposes several critical shortcomings. In many parts of the developing world, MOIs operate under outdated cooperative laws which were not designed for particular application to financial cooperatives. Moreover, supervising entities often lack the technical expertise, capacity, and resources to handle MOIs. To increase MOI outreach and build greater trust in this type of financial institution, appropriate solutions must be found to the conundrum of MOI supervision and regulation.

The following fundamental questions lie at the heart of what must be resolved:

- What types of MOIs and what MOI activities need to be regulated?
- Is it appropriate to have a tiered licensing system for different MOIs depending upon the size and scope of services or should the standards be uniform?
- What entity should supervise MOIs? Is delegated supervision or self-regulation acceptable and, if so, under what conditions? Should different authorities supervise different classes of MOIs?
- How should the costs of supervision of MOIs be covered?

This focus note provides a summary of the findings on regulation and supervision from "Reaching the Hard to Reach: Comparative Study on Member-Owned Institutions Offering Financial Services in Remote Rural Areas."[1] The study involved seven MOI cases. Three of these are located in Asia: The Primary Agricultural Credit Society (PACS) – Self-Help Group (SHG) linkage in Andhra Pradesh, India; the Self-Help Group Federation in India; and a cluster of village credit organizations in Bali, Indonesia. In Latin America, the Mixtlan Savings and Credit Cooperative (SACCO) within the Federación Nacional de Cooperativas Financiera (UNISAP) in Mexico and

[1] The study was published by the Coady Institute in 2008 and is available online at <http://coady.stfx.ca/moi/>.

the Jardín Azuayo Rural Credit Union in Ecuador were studied. In Africa, the cases included Village Savings and Loan Associations (VSLAs) in Niger and Mutuelles Communautaires de Croissance (MC2s) in Cameroon.

These cases illustrate the variety of legal and regulatory environments in which MOIs operate and the challenges and opportunities found there. Presented below are some key features of these environments and their influence on the outreach function and governance of the MOIs studied.

MOIs in Asia

India: The SHG Federation and the SHG–PACS Linkages under the Mutually Aided Cooperative Societies (MACS) Act

The SHG – Bank linkage has so far been the prevailing microfinance model in India. As of 31 March 2009, 4.15 million 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. With this branch structure reaching out and the SHG federations reaching back, an inclusive sector has been created, which has led to increased access to financial services for remote rural populations.

Ankuram Sanghamam Poram (ASP) is a federation with nearly 6,000 SHGs at its base. It 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 many cases, SHGs are encouraged to cluster into federations representing several villages in one area, typically within a 10-25 km radius. These federations can register under the Andhra Pradesh Mutually Aided Cooperative Societies Act of 1995. This was the first legislation in India that addressed the issue of cooperative dependence on, and control by, state governments, and it has since been enacted in nine other states. It prohibits government capital and assigns management responsibilities to a Board of Directors. ASP is registered under this act. It is legally a cooperative and structurally a federation. This is because in Andhra Pradesh, SHG federations are cooperatives made up of a number of groups in a particular geographic area, whose individual members are both members and shareholders in the federation directly; in other states, such as West Bengal, groups can only be clients of such federations.

In such small and remote organizations, a model of self-regulation can be applied where an apex organization provides the supervision for cluster MACS which, in turn, rate their base-tier SHGs. In practice, this model faces many challenges due to the lack of bookkeeping skills and efficient on-site supervision of cash management and transfers.

LPDs in Bali, Indonesia

Lembaga perkreditan desas (LPDs), or village credit associations, were first established in Bali in 1985, but their current form and regulatory and supervisory framework were formalized in 2002 by the Balinese Provincial Government. An LPD refers to a village-owned financial business entity. In Bali, a village is a community unit under traditional law which confers legitimacy on the LPD.

Much of the success of LPDs has been attributed to the balance that has been established between local ownership and regulation—through customary law on the one hand and provincial government regulation on the other. Local customary law has a complex hold on community life. Interlaced with the religious and ceremonial elements of Balinese society, it comprises a formidable code, deviation from which triggers serious consequences. Fear of these consequences—which can be as harsh as banishment from the village—provides a compelling incentive to repay loans and fulfil other obligations to LPDs. At the same time, LPDs' reliance on customary norms raises confidence in these MOIs, making them a safe place to keep one's savings in.

LPDs are subject to both internal and external control. A supervisory committee maintains internal control while external supervision is carried out by the principal refinancing agency, the Regional Development Bank (BPD), together with the training and technical support arm of the provincial government. A concern here is that this structure is a complex one with multiple supervisors as no single agency has the optimum combination of resources, location, skills, and interest to make the supervisory system work comprehensively.

Cooperatives in Latin America

Jardín Azuayo in Ecuador

Jardín Azuayo is part of Ecuador's growing cooperative savings and loan sector. Unfortunately, the pace of this sector's growth has been impeded by the lack of a streamlined regulatory system tailored to the needs of MOIs. Regulation is complicated for savings and loan cooperatives because there is no specific law governing them. They fall under the Ministry of Social Welfare (Ministerio de Bienestar Social), specifically under the purview of the National Office for Cooperatives (Dirección Nacional de Cooperativas, DINACOOP).

However, following a resolution issued in 2006, active savings and loan cooperatives with assets exceeding US$10 million fall under the supervision of the Superintendency of Banking and Insurance (SBS). In order for a cooperative to move under SBS control, it must incur costs related to staffing requirements, committee formation, auditing, compilation of information, and acquisition of equipment and software; so new entities must have sufficient equity to achieve this classification.

These regulations, issued without the backing of a specific law, have created a dual system of supervision, which is shared between DINACOOP and SBS. As of mid-2008, SBS supervised 17 banks, 37 savings and loan cooperatives (including Jardín Azuayo), 5 mutual savings associations, and 12 financial societies. While DINACOOP's supervision is fairly relaxed, SBS requirements are strict and, in some cases, too onerous and inappropriate for MOIs.

Mixtlan Savings and Loan Cooperative and the UNISAP Federation, Mexico

Mixtlan is a rural savings and credit cooperative (SACCO) which is part of UNISAP, a large and highly rated urban-rural federation of over 350,000 members in Mexico. Mixtlan works in a remote rural area where the population density averages six persons per km^2, with a rate of local outreach approaching 90%. Legislative confusion combined with a high incidence of fraud have created a high-risk operating environment in Mexico. In response to this, the Congress approved new laws requiring The National Banking and Securities Commission to authorize, regulate, supervise, and audit the federations, with the National Bank of Financial Services (BANSEFI) operating as a central financing facility and a third-tier federation, and promoting the popular finance sector, as it is known in Mexico. The long-term strategy for BANSEFI is to be self-financed by MOIs and their federations. Serving as a financial intermediary for them, BANSEFI could collect deposits, provide remittance services, act as 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, and through its high rate of "integration,"[2] UNISAP's governance structure, unlike some others in the country, allows local MOIs a certain amount of autonomy. There is no second-tier office or staff in each MOI, thus every MOI can determine its individual product mix, even outsourcing to its own local suppliers.

Being part of a large federation that operates under broadly applicable regulations has many benefits. The economies of scale available in a federated system have allowed this MOI to attain a relatively high rate of growth and reach out to the most remote populations. UNISAP audits Mixtlan on behalf of the Superintendency, and also helps its affiliated MOIs with liquidity, credit, outsourcing, and connections with other companies for obtaining computer system maintenance services, stationery, and a corporate image. Belonging to this system gives MOI members a sense of security about the safe management of their savings and resources, owing to the existence of federal mechanisms and

[2] The Integration Index is used to rate federations against benchmarks of effective economies of scale, standardization of financial operations, separation of strategic and operational functions, and contractual solidarity.

regulations that integrate and control remote MOIs. This type of regulation that encourages scale, viability, and formalization offers important lessons for remote outreach elsewhere.

Decentralized Village-Based MOIs in Western and Central Africa

VSLAs in Niger

The membership of a VSLA is typically comprised of 20 to 25 women, petty traders, vendors, or farmers, who use their loans for both working capital and consumption. 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 the previous meeting and its balance. VSLAs charge interest and, at the end of the annual term, distribute lump sum profit proportionally among their members. Members make joint decisions on all aspects of their organization, including the amount and frequency of savings contributions, by-laws, interest rates on loans, the particulars of loan distribution, and annual cash-out terms.

The model of networking that was introduced by CARE Niger in 2003/2004 has been a significant factor in the success of VSLAs. Through their networks, savings from member associations are pooled to create a loan capital fund from which VSLA groups may borrow on behalf of their individual members. The networks provide VSLAs with a number of supports such as provision of wholesale loans proportionate to savings, training by village agents, and non-financial training. VSLAs have since used their networks to form linkages with larger financial institutions, which has allowed a growing number of VSLAs and networks to get access to loans from microfinance institutions (MFI), thus becoming able to make bigger loans to individual members.

Niger belongs to the West African Economic and Monetary Union (WAEMU) whose eight members (Benin, Burkina Faso, Guinea Bissau, Ivory Coast, Mali, Niger, Senegal, and Togo) share a common central bank (BCEAO) monetary policy, currency, and trading regulations. These countries also have unified legislation regulating mutual or cooperative savings and credit institutions, known as the PARMEC Law.[3] Under this law, mutuals (primary cooperative societies) and cooperative MFIs providing financial services to members are required to obtain a license from the Ministry of Finance prior to starting business and opening offices. This regulation is applicable even in remote rural areas.

The PARMEC Law does not cover *asusus*, *tontines*, or other informal associations that typically would be classified as VSLAs, but it stipulates that such entities "are free to apply for recognition under the law." To do so, they must register as formal associations in order to have the legal authority to engage in financial activities such as savings mobilization and lending.

Microfinance stakeholders in the WAEMU zone have criticized the PARMEC Law as being biased towards cooperatives and for attempting to supervise both very small decentralized mutuals in remote rural areas and very large mutual federations without distinction. Nonetheless, these critics do recognize that this early legislation has strengthened the mutual sector and enabled its steady growth.

MC2s in Cameroon

In 2003, the Bank of Central African States (BEAC) and the Central African Banking Commission (COBAC) issued a new regulation for institutions which deliver microfinance services in six member states (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon). Under this regulation, MFIs require a particular type of license, depending on whether they are serving members only (such as MC2s), both members and non-members, or the general public. Reporting requirements vary according to asset size; the smallest organizations must be audited by qualified accountants while the larger ones must be audited by external audit firms. Albeit innovative, this regulation can

[3] The acronym PARMEC stands for *Projet d'Appui à la Réglementation sur les Mutuelles d'Epargne et de Credit*.

inhibit the development of small rural entities, which may not be able to afford the costs associated with registration, adherence to capital adequacy requirements, retention of qualified staff, and financial auditing.

In Cameroon, the Association of MC2s (AMC2) is supposed to contract external auditors for MC2s regionally and will cover auditing costs for primary-level institutions. All member-owned microfinance establishments are required to be linked in a network with a headquarters that centralizes the liquidities and provides support services. This new regulatory environment, if strictly enforced and effectively supervised, will create more confidence in rural savers and hopefully reduce the occurrence of deliberate mismanagement and bankruptcies that undermined the sector for many decades in the past.

Both the BCEAO (mentioned in the previous section) and BEAC are paying more and more attention to the role and responsibility of "promoters": NGOs, consulting firms, donors, and government agencies. These organizations must develop a clear business model as well as an exit strategy and must apply for licenses before setting up a system or implementing a scheme. Promoters could be required to establish a "security deposit" that would be used to protect savers' money in case of failure. These requirements would also address the issue of unfair competition from subsidized schemes that are not supposed to operate any longer under the new regulation.

How Regulation Impacts the Development of MOIs in Remote Areas: Lessons Learned From the Cases

What Types of MOIs, and Which of Their Activities, Should Be Regulated?

There are two compelling arguments for not regulating all MOIs, even though such regulation can bring potential benefits for depositors, MOIs themselves, and the financial sector as a whole. First, closing down MOIs that do not meet inflexible licensing requirements could cut off the rural poor from financial services, especially in remote areas, besides being difficult to enforce. Second, regulating a large number of institutions can overburden a supervisory body and lower the quality of supervision.

The most commonly proposed trigger for regulation is size. Most of the literature on the subject agrees that large bank-like MOIs should be prudentially regulated and supervised, while small MOIs should not. The principle here is that governments should not regulate what they are unable to supervise or support. In other words, regulators should set reasonable entry standards and foster professionalism in formalized banking institutions, but should not restrict the deepening of the financial sector at informal MOI levels. Supervisory requirements can easily be underestimated and unenforced regulation can be worse than no regulation at all.

The different regulations governing the MOIs considered in the study indicate that encouraging small or medium-sized MOIs to form networks or federate can effectively sustain growth while maintaining sound management and portfolio quality and avoiding losses due to fraud or defaults. MOI networks, provided that they have developed as a sustainable business model for full cost recovery, can also play an effective role in liquidity management and cross-subsidization (urban-rural, small and large, remote and better-served communities). For remote rural-based MOIs such as the Rural Finance Network in Ecuador, the UNISAP Federation in Mexico, the ASP in India, and the AMC2 in Cameroon, integrating into a network can enhance sustainability and growth and be the first step on the path towards being both self-regulated and formally regulated.

However, from the remote outreach standpoint, small decentralized associations such as SHGs or VSLAs remain the only service providers for many rural poor in areas where no other financial intermediaries operate. Given their small size (typically 5–30 members) and direct and regular oversight by all members, such MOIs tend to have low risk from a regulator's perspective, and are often left alone to operate. Some regulatory agencies recognize these small MOIs while others do not officially acknowledge their existence.

Are Tiered Licensing Standards Appropriate or Should Standards Be Uniform?

Analysis of multi-tier MOIs suggests that different types of MOIs pose different levels of risk and have different record-keeping and reporting capacities. Among the cases examined, the only regulation using a tiered approach is the COBAC regulation in Central Africa. The tiers in this case are determined by the type of the MOI's relation with clients (members only – category 1; members and non-members – category 2), the type of services offered (savings and loans or credit alone), and the size of the operation as determined by its asset base. Requirements for reporting, auditing, and capital adequacy also progress from base-tier to third-tier institutions. This type of tiered approach appears to be appropriate for smaller rural MOIs, provided that they form regional or national networks. The MC2s in Cameroon, for example, are networked into an association (AMC2) that organizes internal and external audits on their behalf.

In Ecuador, a new law seems to be moving the sector in the same direction. In 2006, Ecuador's Banking Board issued a resolution aimed 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 People Credit Banks (BPR), although this puts them at risk of compromising their mission in remote rural areas. Such standardization can be counterproductive either by overburdening the less risky MOIs in remote areas or, more likely, by being lax or ineffective in supervising large, country-wide cooperatives that operate small banks with weak governance.

Who Should Supervise?

In the past, regulation and supervision of MOIs were systematically entrusted by governments to cooperative departments within various ministries (e. g., social welfare, rural development, or community development). The major problem with this scheme was that government agencies responsible for supervising all cooperatives usually lacked the skills required to supervise financial institutions.

The study shows that, in various parts of the world, lessons have been learned from the past. New laws are emerging everywhere such as the MACS Act in India, the Popular Savings and Credit Law in Mexico, the BEAC COBAC Regulation in Central Africa, and, in 2007, the revised BCEAO law for West Africa. In most of these new laws, the regulation is harmonized with the current banking legislation (though adapted to a specific type of clientele) and supervision is delegated to a specialized agency capable of devoting sufficient resources to MOIs, despite their relatively small size. The only region among those considered in the study where financial MOIs are still regulated and supervised by non-specialized 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 LPD federation level with supervision by higher-level refinancing bodies.

The issue of supervision of MOIs remains unresolved in many places. Sometimes new legislation duplicates existing laws, creating dual systems of control as has happened in Mexico between the SBS and DINACOOP. In other cases, such as in Ecuador, regulated and unregulated cooperatives continue to coexist and are allowed to compete in what becomes a distorted market environment.

As mentioned above, authorities could delegate certain functions to networks and then supervise networks instead of directly supervising every MOI in remote rural areas. This approach has proven effective, especially in vast, sparsely populated regions. Delegation to private external oversight, such as specialized audit firms or refinancing banks, is widely considered a preferred option, except where compliance functions cannot be subcontracted by law, as in West Africa. Some aspects of supervision can be entrusted to refinancing banks, as exemplified by the BPD in Indonesia, BANSEFI in Mexico, and, in a different arrangement, First Afriland Bank for the MC2 in Cameroon. However, for various reasons, including distance and inadequate human resources and capacity, these cases suggest that, so far, supervision by refinancing banks has not been very effective.

What to Supervise?

If regulatory standards that fit the size and complexity of the institution under regulation are in place, then reporting that is manageable, comprehensible, and valuable to both parties may be the most powerful solution to the conundrum of MOI supervision. For example, those MOIs that are too small to warrant 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. The establishment of simple, appropriate standards may be the key to improved outreach, governance, and professionalism, as it has been for other types of MFIs. The challenge is to arrive at a few appropriate indicators that MOIs can understand and track.

There are specific areas in which MOI regulations for governance need to be strengthened to address the greatest risk that MOIs face, namely the weak control that members exert over their boards and managers. There exists considerable scope for improving these regulations together with regulations unique to MOI operations.[4]

How Should the Costs of Supervision Be Covered?

High cost is perhaps the biggest constraint to effective MOI supervision, especially if it is carried solely by a centralized agency. For this reason, some experts suggest that MOIs should cover the costs of their own supervision. They argue 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, for example, 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, such as significant efficiency gains, access to commercial resources, and increased deposits from savers attracted by the improved security of the MOI due to its regulated status.

The other type of cost is that incurred by supervising authorities (both off-site and on-site), 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 MOI networks should be able to keep the costs of supervision low enough for the authorities to bear them in the long run, even if they have to request donor assistance to support the initial set-up phase.

Conclusions

There is a growing awareness among policymakers that MOIs have the greatest potential to reach remote rural areas, and therefore, they should be strengthened and encouraged to do so on a larger scale than they currently operate. Since regulation and supervision can both enhance and hinder outreach capacity, it is important to ensure that they are part of the solution.

The study did not identify a legal or regulatory environment that is explicitly hostile to MOIs; in all the cases examined, MOIs have emerged and grown without many constraints and perhaps by avoiding being regulated at an early stage. In fact, MOIs have attained such a size and visibility that they are seeking more formalization at the same pace as authorities are seeking enhanced accountability and transparency.

Recommendations

- Small MOIs which are time-bound should not be regulated considering direct involvement of all their members and the lack of capacities and resources on the part of supervisory authorities. Other small and medium-sized MOIs operating in sparsely populated rural areas should be encouraged to establish or join informal networks or formal federations which could per-

[4] Detailed recommendations for these areas can be gleaned from the full report (http://www.coady.stfx.ca/tinroom/assets/file/ford/docs/Coady_ThReg_Final.pdf).

form certain supervisory functions delegated by the authorities. If the market allows, these larger organizations could eventually be transformed into formal financial institutions (such as the BPR in Indonesia).

- MOIs are still commonly identified or associated with cooperatives and their graduation path practically always involves transformation into cooperatives, within the traditional credit union made up of primary societies, second, and third tiers (e. g., federation, confederation). At the grassroots level, innovations are taking place which demonstrate the possibility of other approaches to ensure the continued participation of the local communities. A change in paradigm may be needed in this area.
- In different parts of the world, new laws are emerging which are designating specialized supervision authorities such as central banks and banking commissions to oversee MOIs. Importantly, these laws recognize the character of MOI activities as the most essential aspect for regulation rather than their legal status.
- Dual control (e. g., by a cooperative registrar and a banking superintendency) should be avoided as it creates confusion, distorts the market, and ultimately weakens the capacities of MOIs involved.
- A good regulation is one that both parties can understand and implement. Regulation of microfinance activities using the tiered approach appears to be helping MOIs and regulators to achieve this goal.

To direct the way forward, MOIs and their supporters must join other key stakeholders in the microfinance sector in promoting the development of appropriate and context specific guidelines for MOI regulation.

This focus note is an abridged version of the thematic paper “Regulation and supervision of member-owned institutions in remote rural areas” by Renée Chao-Béroff. The original paper is available on the Coady Institute’s website at <http://coady.stfx.ca/tinroom/assets/file/ford/docs/Coady_ThReg_Final.pdf>.

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