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CEE / NIS NEWS AND VIEWS

Policy Considerations for Developing Networks of Financial Co-operatives

BY NORMUNDS MIZIS, PROJECT DIRECTOR AT WOCCU

In microfinance networks that are being built in countries around CEE and NIS in many cases policy makers consider financial cooperatives as one of the key instruments for the delivery of small scale lending and savings services to the population. Today within NIS by the virtue of law or regulations financial cooperatives can be and have been established in the following countries – Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan. In CEE financial cooperatives exist in Albania, Bulgaria, Czech Republic, Former Yugoslav Republic of Macedonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia[1]. However, principles which are applied in defining financial cooperative may differ significantly from one country to another. Purpose of this paper is to discuss what are defining characteristics of the financial cooperative, what policies are crucial to build a successful system and what may be potential pitfalls in the process.

Historically financial cooperatives first appeared in Europe (Germany and England) in the middle of 19th century as a response to the growing needs of the workers to have access to financial services at the beginning of the era of industrialization. Since then cooperatives have remained a phenomenon of free market economy correcting market inefficiencies or market failures in the segments of financial markets where commercial banks, targeted government owned/supported lending programs and other institutions of for profit financial intermediation have no interest or possibility of penetrating, e.g., low income people, small and/or remote rural communities, economically depressed regions. In industrialized economies financial cooperatives have not only survived, but are thriving, often setting the standard for quality of service and pricing for financial services to consumers and small scale entrepreneurs.

Presently financial market inefficiencies in various segments are a harsh reality both in NIS and CEE. Willingness and attempts of policy makers to introduce networks of financial co-operatives in their respective countries are obvious and fully understandable. However, long-term success and effectiveness of such networks will largely depend on the underlying principles included in the laws and regulations governing licensing/registration, operations and regulation/supervision of financial cooperatives.

Definition of the (financial) cooperative is best presented by the International Co-operative Alliance (ICA). For the convenience of the reader I have attached to this paper seven co-operative principles presented by ICA[2], which must serve as a catalyst whether institutions in various countries where they

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are called financial cooperatives (also savings and credit unions or credit unions)[3] should be allowed to bear that name. While I am not going to discuss all of the principles in detail and will leave it up to the reader to examine ICA's principles, I would like to point out three key requirements that must be present in a successful and enabling legislation governing credit union networks.

Firstly, long term success of the cooperative can be reasonably ensured only if the services and establishment of the cooperative is driven by member demand. However, there are programs in the region that are donor driven, are designed to create networks of financial co-operatives, but effectively create demand only on the loan side. The downside of such approach is that life span of the credit union is going to be linked to the term of implementation of donor program unless there is a well developed strategy how to replace donor funds with member savings before donor driven program expires. While in some cases such strategies have been developed and introduced by donors, in my opinion, in order to make a conclusion on the sustainability of model of financial cooperative that is initially set up based exclusively on loan demand and is predominantly donor driven, requires more evidence and qualitative analysis of performance of such cooperatives in the post project period. Nevertheless, it is clear that long term success of the financial cooperative requires member demand for both savings and lending services and can be ensured only by providing access to permanent source of funds.

Secondly, the only known permanent source of funds in modern (transition) economy is household (member) savings. Therefore, granting by law or regulation access to savings of members is crucial for the long-term sustainability and efficiency of the financial co-operative. While this concept should not entirely exclude credit union access to sources of funds other than member savings, maximum levels of credit union borrowing from the donors and third parties, should be considered in the context of their ability to mobilize savings from their own membership. In case financial co-operative cannot demonstrate demand on savings side, it will be much more prudent to implement donor lending programs thru other entities, e.g. government owned development banks or specialized donor controlled finance corporations.

Thirdly, allowing access to savings mobilization does require prudent regulation of the financial co-operatives. Key issue, after prudential standards are set, is the enforcement mechanism. Ideally, there must be a professional regulatory agency having sufficient resources to perform off-site and on-site supervision and examination. It really is the heart of ensuring the quality of operations and safety of the system in the long term. Systems used in the CEE and NIS are government regulators (e.g. Latvia, Moldova, Uzbekistan), quazi governmental entities (e.g. planned in Romania) and self-regulatory mechanisms (e.g., Poland). Each of those mechanisms has its own strengths and weaknesses, yet the above list has been presented in the order of preference. There are some countries in the region where there are non-regulated systems (e.g. Russia, since regulator has not been specified in the law, and recently also in Kazakhstan), in which case quality of operations and safety of the system is impossible to determine, since there is no mechanism of verification of data against the prudential norms. In the latter case it would be important for credit union members to understand that it is entirely responsibility of the members themselves to control compliance with the legislation and prudential standards and that they are the only ones who are collectively liable for the success or failure of their own financial co-operative.

In summary it is important to realize that long term success of financial co-operatives in any legislative environment is dependent on member demand for both – savings and lending services, right for coops to mobilize savings and presence of some form of prudential regulation and enforcement.

However, history of development of co-operative systems in CEE and NIS indicates that there are certain pitfalls that must be avoided to allow achievement of the objective of introducing effective financial services for underserved thru the networks of financial co-operatives. Pitfalls increasing the risk of the failure of coops, are: poor or too restrictive legislation/regulations, underfunded or non-existent supervision and regulation, untrained regulators and examiners, serious flaws in licensing procedures and process, legal and operating environment allowing for development of "pocket banks" using provisions for financial cooperatives, lack of control inducing non transparent financial operations and poor accounting and financial reporting. Awareness of the policy and regulatory mistakes listed above and similar challenges should call for policy action in order to lower the risks present in any deposit taking network.

REGIONAL OUTLOOK

The Future of Microfinance

by Justyna Pytkowska, Ewa Bańkowska, MFC Researchers

As part of the mapping study carried out by the Microfinance Centre for CEE and NIS (MFC) in 2005 NGOs and non-bank microfinance institutions were asked about their vision of microfinance in the next 10 years and about their future goals.

Long-term vision

While the majority of ECA non-bank MFI have become profitable institutions, most of them operate on a not-for profit basis, that is are mission-driven and reinvest their earnings back into the operations. However, more than half of the institutions plan in the future to convert into for profit businesses as, in the long term, they see microfinance as part of mainstream financial sector.

This opinion is especially shared in the Balkans, where MFIs have evolved into strong financial institutions.

Only 16 percent of responding MFIs expect the industry to move towards increased social performance, integration of finance with other socially oriented services including wider range of non-financial services and extending outreach to the excluded groups.

The clearest social focus is present among the MFIs in CEE sub-region, while it is practically absent among Balkan MFIs. This is due to the more developed mainstream financial sector in CEE where banks already have quite wide outreach and MFIs therefore select an untapped niche of the excluded who need a broader assistance on a social level apart from the need for financial services.

continued on page 3 ▶

In conclusion, properly designed and guided development of the networks of financial co-operatives is well worth the risk, since it will create a long term access to the financial services for underserved and marginally served and will increase access and quality of financial services, particularly for small scale entrepreneurs and consumers. Other benefits for the communities/regions where there will be material presence of financial co-operatives, will include: growing number of jobs, including in rural areas, faster development of small and micro enterprises, increase in manufacturing output and consumption, increase in trading turnover, faster expansion of agricultural producers, additional state tax/budget revenues.

Attachment: ICA Co-operative Principles

1st Principle – Voluntary and Open Membership: Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2nd Principle – Democratic Member Control: Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote) and co-operatives at other levels are also organized in a democratic manner.

3rd Principle – Member Economic Participation: Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

4th Principle – Autonomy and Independence: Co-operatives are autonomous, self-help organizations controlled by their members. If they enter to agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

5th Principle – Education, Training and Information: Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of co-operation.

6th Principle – Co-operation among Co-operatives: Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures.

7th Principle – Concern for Community: Co-operatives work for the sustainable development of their communities through policies approved by their members. ■

1 List includes those countries World Council of Credit Unions, Inc. have had consulting relationships with. Other countries in CEE and NIS not included in the list may have some form of financial cooperatives as well.
2 More information on co-operative history, statement of co-operative identity and more can be found on www.coop.org. Attached to this paper are seven cooperative principles as defined by ICA.
3 In this article terms financial co-operative, credit union and savings and credit union are interchangable.

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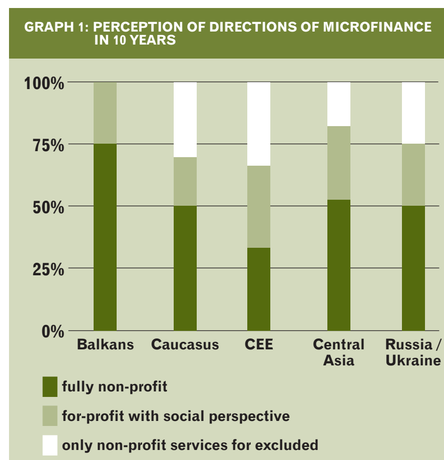


Strategic goals

MFIs are quite unanimous in stating their strategic goals. Most of them aim at increasing loan portfolio size and number of active borrowers. Maintaining or improving financial sustainability and gaining larger market share often accompany these goals. There is also a group of MFIs that focus on becoming or remaining a leader in various areas, like becoming a country or regional leader, becoming one of the top MFIs in the specified domain or range of services.

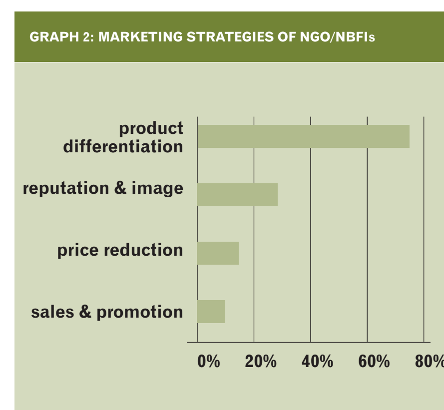
The goal of institutional growth is most often realized by geographical expansion, aiming at covering all the region or even country with a network of branches. Such undertaking is supported usually by increasing the number of employees and providing training to new and current staff, increasing staff efficiency as well as improving marketing strategies.

For most NGO/NBFIs in the ECA region the best strategy to market their products is to differentiate themselves from their competitors, in terms of customer service, product quality and product range. Most of the MFIs recognize that price reduction alone does not attract clients unless the other loan conditions meet their needs.

Innovation is perceived as the most important success factor for most MFIs. Offering innovative products, together with excellent financial and risk management, is key to ensuring good position on the market. Additionally, developed infrastructure that provides good access to services increases the chances for success.

As MFIs often mention difficult access to funding as their major constraint to growth, they often decide to transform into a for-profit organization and attract equity investors as well as local or international commercial lenders.

The third, very common way of achieving strategic goals mentioned above is develop-



ing a wider range of products. This includes introducing new, often innovative products, refining existing products and adjusting them to the clients' needs.

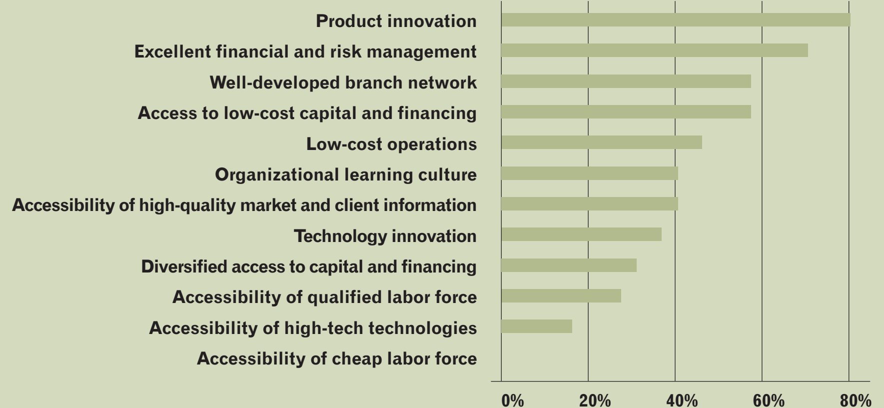
Some MFIs connect reaching strategic goals with focusing on the specified target group. Most often they mention micro and small entrepreneurs as the group with the biggest potential to contribute to general employment increase and life condition improvement. Another indicated group are rural borrowers. Only few MFIs underline focusing on excluded people, trying to attend them with efficient financial services and products.

Going deeper to socially oriented MFIs, one of the strategies to achieve greater outreach is working on improving legal framework, mainly through cooperation with government, participating in international programs or creating partnerships with other microfinance institutions.

The quality of stating strategic goals and the ways of achieving them improve among MFIs. They are more precise, distinguishing well goals from the strategy. It seems most of MFIs treat microfinance industry as a business opportunity, planning to reach well defined targets in terms of both social and financial impact.

In order to achieve the goals MFIs see the product innovation, good management as well as extended infrastructure as the most important factors. Since the majority of MFIs still use grants or subsidized funds to grow their portfolios a large share of them perceive access to such concessional funds as their competitive advantage. However, already almost half of the MFIs realize the importance of efficiency in the operations that ensures low-cost structure and therefore higher financial potential. ■

GRAPH 3: MOST IMPORTANT SUCCESS FACTORS PERCEIVED BY NGO/NBFIs



Unified Financial Sector Supervision

BY BRYAN D. STIREWALT, SENIOR MANAGER, BEARINGPOINT, INC.

Introduction

Over the past two decades, a general consensus has emerged on the broad objectives of financial sector supervision under the watchful eye of various international standard setters such as the Basle Committee on Banking Supervision. One of the key consensus points amongst all countries, developed and developing, is that central banks and financial sector supervisors should enjoy arm's-length independence from government. In emerging markets new monetary authorities and financial sector supervisors are continuously evaluating how traditional functions can be delivered more efficiently and effectively in a manner that is consistent with internationally accepted standards and best practices. This article will focus mainly on the global trend of forming unified or integrated regulatory structures. We will also discuss some of the relevant points concerning microfinance activities related to these new structures.

Global Trends in Establishing a Unified Financial Regulator

Historically, many countries developed supervisory agencies that specialize in a single sector (e.g. banking, insurance, securities, etc.) as laws often prohibited corporate affiliations between various financial sector entities. Such sectoral supervisors, or "solo" supervisors as they are sometimes called, may be unfamiliar or ill-equipped to monitor risks outside of their primary business area, particularly when financial conglomerates are involved having networks of complex and overlapping managerial and operational structures. These concerns lead to a generally recognized need for some form of consolidated risk management for supervision of conglomerates, independent of, or as a supplement to, any supervision of the individual regulated entities. The emphasis placed on consolidated supervision can been seen in the Basle Committee's Core Principles for Effective Banking Supervision[1] and in recent European Union Directives[2].

Per a recent World Bank survey[3], at least 46 countries have adopted the so-called model of unified or integrated supervision by either establishing a single supervisor for their entire financial sector or by centralizing in one agency the powers to supervise at least two of their main financial intermediaries (such as banking with insurance, banking with securities or securities with insurance). From a review of this list, one can easily say that the number

of countries adopting unified supervision has increased further since this World Bank publication, as financial conglomerates have come to dominate the financial landscape in many countries. Forming a unified supervisory body is, in essence, an attempt to match the supervisory structure with the structure of the entities being supervised.

Countries that have adopted integrated supervision believe that a single supervisor is more effective and efficient than multiple supervisors in monitoring systemic risks and in responding to real or potential threats that may undermine the stability of a financial system. By centralizing the supervision of a financial system in a single institution, a supervisor can better understand risks arising not only at a single financial intermediary, but also at a group of intermediaries as well as within the entire financial system. Furthermore, unlike a system of multiple supervisors in which accountability may be easily diffused in case of regulatory failure, a single supervisor becomes the only agency accountable for monitoring risks in the financial system.

Per a July 2000 International Monetary Fund ("IMF") MAE[4] Operational Paper, it should be stressed at the outset that changing the structure of regulation cannot of itself guarantee effective supervision. Changing the structure of regulation might appear to answer to the desire to be seen to "do something" – especially in the aftermath of a financial crisis – but it will not necessarily address the root causes of the weaknesses of supervision that may have contributed to the crisis in the first place. Likewise, changing the structure or regulation because the global trend is to take such action is also not a valid reason for this undertaking. The unification of financial sector supervision can improve the efficiency and effectiveness of regulation in certain circumstances; however, its formation in the short-run can be highly disruptive to normal workflow.

From the same IMF paper mentioned above, we can see the main arguments for unification and those against unification.

The debate on the advantages and disadvantages of integrated supervision has become increasingly more important in recent years, as a growing number of countries assess the appropriateness of its adoption.

Critical Issues and Lessons Learned in the Creation of the Unified Regulator

Outlined below are certain areas of debate in a country's transition to a unified supervisory system. As more countries form unified regulatory structures and learn from the formation process, many more "lessons learned" will be available. The literature on the pros and cons of forming a unified regulator is certainly growing. The list below is not meant to be an all-inclusive description of the arguments for or against unification of regulators.

Mission Clarity and Legal Issues

The enabling law for a unified regulator needs to define the mission, objectives, powers and scope of responsibilities of the new unified agency. This is particularly important in relation to coordination with other safety net providers such as deposit insurers and the central bank's "lender of last resort" role.

The mission statement of the unified regulator has direct relevance to microfinance activity. The general purposes of financial sector regulation are: to minimize (not to eliminate) systemic risks in the financial sector, to guard against moral hazards arising from government guarantees for financial sector participants (i.e. deposit insurance schemes), and to protect consumers. Since microfinance entities are rarely considered a systemic risk player and the vast majority of microfinance entities do not have access to government guarantees, the protection of consumers becomes the primary objective in licensing, regulation and supervision of microfinance activity.

Financial sector supervisors do not need to supervise non-deposit taking entities in the same manner as deposit takers and other entities with systemic risk possibilities because the risk of failure rests with the owners and creditors, not with depositors, and failure of one or more microfinance entities is not likely to disrupt the financial sector as a whole. However, in many emerging markets, the government wrongfully holds the supervisor responsible for the condition of any licensed entity and, therefore, it becomes difficult for the supervisor to separate a more intensive safety and soundness emphasis for systemic risk players and deposit takers from a more limited consumer protection emphasis in the case of microfinance organizations. If the government holds a supervisor responsible for the condition of all licensed entities, the supervisor often wants to limit the number of entities under its purview. This cause and effect relationship could affect hundreds of licensed microfinance organizations, and causes the supervisor to consider moving supervision of these entities to another government body or possibly not regulating them at all. All entities using a third party's money to grant consumer credit should be licensed and should be regulated, but the regulations and overall supervision should be "smart", and focused on the risk to the financial system. Regulation and supervision of microfinance entities should be basically limited to a reasonable barriers to entry (fit and proper management and minimum capital) followed by ensuring fairness and transparency to the consumer, rather than the safety and soundness of the entire organization.

Legal Issues

In most countries, the establishment of a unified supervisory agency has required the review and amendment of a large number of financial sector laws and regulations to enable the new entity to fulfill its functions effectively across the

TABLE 1: ADVANTAGES AND DISADVANTAGES OF UNIFICATION

For Unification	Against Unification
Supervision of financial conglomerates – the supervisory body should match the structure of the entities being supervised.	**Unclear objectives** – different industries are regulated and supervised with different ultimate objectives – one unified regulator can make development of common objectives less clear.
Competitive neutrality – bringing all financial sector regulators together helps avoid regulatory arbitrage.	**Diseconomies of scale** – bureaucracies tend to feed themselves, eliminating the benefits of economies of scale.
Regulatory flexibility – a larger, more diverse organization, allows for resources to be diverted to areas of greatest need.	**Limited synergies** – similar to the unclear objectives argument above, different entities require different approaches and may prevent combination synergies.
Developing a body of professional staff – the unified regulator allows development of a common culture, and allows certain economies of scale can be achieved with training.	**Moral hazard** – the "safety net", particularly for deposit insurance, may be extended too far with a unified regulator.
Improved accountability – the unified regulator adds clarity to responsibilities (this could theoretically be viewed as an argument against formation).	

financial system. New legislation will need to be drafted to address the unified regulator, particularly if this entity is contemplated to be independent (outside the central bank), and all sectoral legislation will need to be amended to refer to the new unified regulator. Along with the inherently painstaking and tedious process of amending the country's financial sector laws from a "technical standpoint", there is a danger that more substantive changes – not all of them beneficial – may creep into that process. Ordinarily, the supervisory bodies will not want to simultaneously "open" the laws for all financial sectors to the full review of parliament. The supervisory bodies need to have the support of the government, and understand the mood of parliament, before offering all laws for potential amendment. When creating the unified regulator, it is best to make only technical changes to legislation (i.e., "search and replace" name changes) rather than to incorporate any substantive amendments at this time.

Economies of Scale and Efficiency

Achieving better "economies of scale and scope" is one of the primary reasons for adopting a unified regulatory body. One area of cost savings, particularly for smaller countries, is the area of information technology and data storage systems. Proper information technology is cost prohibitive if incurred separately for each sectoral supervisor. The ability to design and purchase information technology, and design proper management reports, is a strong advantage of unification. While economies of scale are a reasonable justification for formation of a unified regulator, this should not be the driving force behind this decision with regard to staffing. As we discussed above under mission clarity, many countries are considering jettisoning certain regulated entities, including micro-finance entities, from the purview of the unified regulatory body under the rubric of economies of scale and scope as well. Smarter, more risk-focused supervision should be able to accomplish the same objective without jettisoning the microfinance entities to an inexperienced regulator, or worse, leaving them without licensing and regulation entirely.

Separation from the Central Bank

A key dimension to the arguments for and against unification is the extent to which the central bank is, or should be, directly involved in financial sector supervision. There are strong arguments for and against the separation between supervision and the central bank, and its monetary policy role. Since banks are the conduits through which changes in short-term interest rates are transmitted to the wider economy, the central bank needs to be concerned about their financial soundness as a precondition for an effective monetary policy. This argument is reinforced by a number of other arguments, including: the synergies between the information required for the conduct of monetary policy on the one hand and the supervision of the banking sector on the other; the central bank's need to assess the creditworthiness of participants in the payments system, which will inevitably involve it in forming judgments about the solvency and prudent conduct of banks; and, the central bank's need to have access to information on the solvency and liquidity of individual banks in order to exercise its lender of last resort functions.

The primary drawback to forming a unified supervisory system within the confines of the central banks is the potentially excessive concentration of power this brings. This is particularly the case in emerging economies, where governmental checks and balances are not strong and political interference is a distinct possibility. Moral hazard is also a problem when monetary policy and financial sector supervision are conducted by one entity. It may be difficult for a central bank, which also supervises a wide range of financial intermediaries, to make a sufficiently clear distinction in its priorities. Thus it may give rise to a perception that all types of financial companies – and possibly even non-financial companies – will receive the same degree of protection in the event of failures.

The primary risk of separation from the central bank is unified regulator might not have the same degrees of "independence" and "deference to judgment" from the government that the central bank enjoys. Indeed, in the early days of formation, Parliament may view an independent regulatory body as a "controlling body" with purely objective decision-making abilities, rather than a "supervisory body" with more subjective decision-making. Also, the reputation and stature of a central bank ease its recruiting possibilities, whereas a new regulatory body may have more difficulties recruiting, training and maintaining staff.

In any emerging market economy there may be a case for retaining financial sector supervision within the central bank, not only on the traditional grounds cited above, but also out of a concern to avoid the politicization of financial supervision and regulation. This must be balanced against the potentially excessive concentration of power this creates. If a unified regulator is housed within the central bank, microfinance entities might indeed be better off with regulation and supervision from an independent, external agency to bring a more focused emphasis on proper supervision and limited moral hazard of being associated with the central bank.

Disruption to Workload and Personnel Issues

The creation of the unified regulator is highly disruptive to normal workload. People's attention is diverted away from supervisory functions, and toward the unification process in drafting new legislation and new procedures for supervision. This often involves the supervisor's most talented employees. While this is good for the unified regulator in the long run, it is an added detriment to current workload.

An unintended consequence of the unification of supervisory agencies is often the departure of experienced personnel of the merging institutions and the demoralization of the staff of the merged entities during and after the unification process. Staff might view the unification process with uncertainty, not just because of the possible redundancies, but also because of the delays in configuring the definitive structure of the unified institution, appointing or ratifying the new heads of the departments and setting the overall conditions of employment. Relevant to microfinance, if staff traditionally involved in microfinance activity supervision feel their future career is threatened by the formation of the new agency, a critical amount of institutional knowledge and understanding might be lost. The management challenge of merging a number of different regulatory agencies should not be underestimated. Due to the disruptive nature of large-scale change, this process should not be attempted during a period of instability in the financial sector.

Conclusion

The following lessons learned should be considered when forming a unified financial sector regulator in any country.

- Develop an organizational structure that mirrors the industry being supervising, and focus on ease of communication within the agency and outside the agency;

- Focus on the mission statement of the unified regulator and the specific risks of the various industries being regulated – do not treat every financial sector entity the same;
- Ensure that all affected parties – executive levels of government, parliament, financial sector entities, and the personnel of regulatory bodies – understand and “buy into” the concept;
- Be patient – do not rush the creation and development process of the unified regulator;
- Do not create a unified regulator simply because it is the newest trend – carefully evaluate the conditions in your country before deciding to move down this path; and,
- Do not start this process until you have achieved a degree of stability in the financial sector.

For further information, please also see: “Unification of Financial Sector Regulators: The Case of Kazakhstan”, Central Bank Modernization (2005), pages 93-103, by Bryan D. Stirewalt.

1 Basle Committee on Effective Banking Supervision, “Core Principles Methodology”, October 1999.
2 “Directive 2002/87/EC of the European Parliament and of the Council of December 16 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.”
3 “International Survey of Integrated Financial Sector Supervision”, Jose de Luna Martinez and Thomas A. Rose, World Bank Policy Research Working Paper 3096, July 2003.
4 “Issues in the Unification of Financial Sector Supervision”, International Monetary Fund, Monetary and Exchange Affairs Department, MAE Operational Paper, MAE/oo/03, July 2000.

Anti-Money Laundering Regulation – A Threat to Access to Financial Services?

BY MARTIN OWEN
VICE PRESIDENT, PRODUCT DESIGN, HAYDRIAN CORPORATION. FORMERLY HEAD OF THE FINANCIAL CRIME POLICY UNIT, UK FINANCIAL AUTHORITY

‘The introduction of new or tightened AML/CFT regulations may have the unintended and undesirable consequence of reducing the access of low-income people to formal financial services. … The challenge is to strike a balance that promotes prudential practices at a reasonable cost for financial service providers that want to offer services to less well-off clients.’

AML/CFT Regulation: Implications for Financial Service Providers that Serve Low-Income People. CGAP Focus Note No. 29, July 2005.

Introduction

This article takes up the challenge set out in CGAP Focus Note No. 29.

AML – the new compliance challenge

The 1990s and the 2000s have seen step-changes in the regulation of financial services – stricter licensing requirements, more demanding capital adequacy regimes, the emergence of specialist supervisory authorities with strong powers, more extensive monitoring by regulators and the exemplary use of enforcement sanctions against institutions failing to meet required standards.

Compliance has become more necessary – to avoid regulatory sanctions and a damaged reputation. But also more burdensome and expensive.

Within this general picture of much increased regulation, anti-money laundering has become a priority issue.

Anti-money laundering (generally abbreviated in English to AML) has been around since the late 1980s. It started as a tool in the fight against drugs. It was recognized that drug-dealing generated large amounts of money, which must flow through the financial system. AML was developed to try and cut off the ability of drug-dealers to make use of the criminal proceeds of their dealings.

But for many years, AML was practiced in a half-hearted manner:

- it was applied only to banks, not to other kinds of financial institution;
- it was a low-priority issue for bank regulators, who were more concerned with the financial health and prudential integrity of banks;
- it was also treated as a low priority issue by banks themselves. They devoted limited resources to the issue within their overall compliance departments. It was unpopular, seen as interfering in the ease with which they could take on new customers, prejudicing their relationships with existing customers and potentially restricting their ability to maximize their income;
- it was tackled virtually exclusively through Know Your Customer procedures, and those meant little more than recording a new customer’s name and address and photocopies of documents provided to verify that information – passport, driving license, utility bill etc.

Notwithstanding the formation of the intergovernmental Financial Action Task Force (the FATF) in the early 1990s, and the issue of guidance by the Basel Committee of Bank Supervisors, AML was a compliance Cinderella.

In the late 1990s, official attitudes to AML changed dramatically:

- in the US, the UK and other countries, major banks were discovered to have been used for the channeling of vast proceeds of corruption by Pinochet of Chile, Salinas of Mexico, Abacha of Nigeria and others. This made it politically imperative that banks strengthened their AML efforts;
- the Financial Action Task Force raised its standards, through strengthening its Recommendations, peer reviews of member countries’ AML regimes, and developing the concept of Non-Cooperative Countries and Territories (NCCTs – jurisdictions regarded as having unacceptably inadequate AML regimes);

- in Europe, the EU introduced new laws to implement the FATF Recommendations;
- AML became a much higher priority for bank regulators, who included the topic more systematically in bank examinations.

In the early 2000s, AML was given a dramatic new impetus following the emergence of global terrorism, symbolized by the events of 9/11 in New York and Washington but manifest also world-wide, in Bali, Turkey, Spain, London, the Middle East, East Africa and elsewhere. AML was seen as a potent tool for Countering the Financing of Terrorism (CFT), since terrorists have to channel finance for their organizational and training activities and their day-to-day expenses as well as to effect their acts of terrorism.

Terrorism created a further impetus for strengthening AML regimes, resulting in:

- a further strengthening and extension of the FATF Recommendations;
- adoption by the IMF and the World Bank of the FATF Recommendations as standards that they would include in their assessments of countries' governance regimes;
- new laws in the U.S.A (the Patriot Act), the EU (the third Money Laundering Directive) and in many other countries throughout the world – a process still continuing;
- the extension of AML beyond banks to other financial institutions such as money service businesses, securities brokerage and insurance, and to non-financial businesses like the legal and accounting professions, real estate and casinos.

Modern AML

This revolution in official attitudes to AML in the late 1990s and the early 2000s has resulted also in a transformation in the technique of AML:

- AML is no longer seen simply as a narrow issue of compliance with the letter of laws and regulations. It is now seen also as a risk management issue, partly because institutions have seen the need to minimize the risks of being found to have lax standards and to be harbouring or channeling dirty money, and partly because institutions have needed to find a rational way of prioritizing the much-increased resources they have had to devote to AML;
- AML is no longer seen as a one-tool matter, with all the focus on Know Your Customer. Now institutions see the need to pursue a 'holistic' approach, deploying a range of tools:
    - comprehensive corporate policies and procedures, based on an assessment of the institution's AML risks
    - customer identification (name and address)
    - know your customer in a broader sense (e.g. source of income);
    - monitoring of customers' transactions, in order to identify unusual ones that may be suspicious;
    - checking customer names against lists of individuals and entities on which the UN, the EU and national governments have imposed financial sanctions, and also against 'watch lists', for example of politicians, that help institutions pick up customer providing a higher risk of laundering the proceeds of corruption;
    - making 'suspicious activity reports' to government bodies established as 'Financial Intelligence Units' (FIUs) to look for criminal activities;
    - training their staff not just in compliance procedures but in how to be alert for suspicious transactions and activities;
- AML is no longer treated by institutions as a low-priority, mundane compliance issue. It is seen as a matter that has to engage the board and top management of an institution.

So, modern AML is:

- risk-based
- holistic
- cross-sectoral
- high priority.

That sounds formidable. And it is quite right that AML should be a serious business. The fight against terrorism and the fight against drug-dealing, people-trafficking, fraud, theft, corruption, extortion and all money-driven crimes are vital to the achievement of a good society and therefore to the welfare of each of us as individuals and family members.

The challenge for the smaller institution

The large multi-national and national financial institutions, with substantial resources, can accommodate the greatly increased costs and burdens of modern AML comfortably (if not enthusiastically).

But all these developments present dangers for smaller financial institutions. How can they afford the compliance resources? How can they attract AML expertise? How will the cost implications impact on the affordability of their products and services?

These challenges face all but the biggest institutions. For micro-finance institutions they can be seen as presenting a real threat to viability. Can this threat be overcome?

There is an English saying that every cloud has a silver lining. This particular cloud over micro-finance does have a silver lining – but it requires common sense and awareness on the part of both the regulatory authorities and the micro finance institutions themselves.

The answer is NOT to treat micro finance institutions as inherently immune from money laundering or terrorist financing and to exempt them from AML requirements. Small financial institutions can present AML risks, for example:

- criminal activity such as drug dealing or fraud can involve low-scale payment flows;
- accounts that start small can grow big;
- a person or entity can open multiple small accounts to disguise substantial overall activity.

No. The silver lining lies not in exemption but in the risk-based approach to AML.

The risk-based approach to AML

The risk-based approach involves tailoring the intensity of AML effort according to the perceived AML risks so that the effort is proportionate to the risks. This is the same principle as applies in a risk-based approach to, for example, health and safety at work issues, where it is recognized that the safety of employees will be greater, and the overall costs lower, if the areas of greatest safety risk are identified and most effort is put into mitigating those risks.

The risk-based approach to AML recognizes that if every customer, every product, every transaction is treated the same, then the AML results are likely to be sub-optimal and the costs high. One size does not fit all.

The risk-based approach is officially recognized by the FATF – see box.

BOX 1: FATF RECOMMENDATION 5 (EXTRACT)

'Financial institutions should apply each of the Customer Due Diligence measures but may determine the extent of such measures on a risk sensitive basis depending on the type of customer, business relationship or transaction. For higher risk categories, financial institutions should perform enhanced due diligence. In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures.'

What does the risk-based approach to AML involve?

First and foremost, that the law and regulation recognizes the validity and indeed the desirability of a risk-based approach – institutions must have the authority and the confidence to apply it. In particular, because risk management involves judgement, the authorities must recognize that judgement is fallible and that an institution may make an honest mistake in treating a customer or a transaction as low risk.

Secondly, that institutions themselves consider their money laundering risks. In the case of large, international, complex, multi-product institutions, this risk assessment can be a substantial task. However, a micro-finance institution is likely to have a limited range of products, and a customer profile that is both homogenous and local. Many micro finance institutions are also likely to have a very similar product and customer profile, for example as cooperatives offering simple savings and/or loans products. AML risk assessment for micro finance institutions can therefore typically be a straightforward, generic task capable of being addressed with a generic model.

Assessing AML risk involves taking an institution taking a view on:

- its customers: given their income, their resources, their occupations, the services they are getting, how likely are they to be using us for the purposes of money laundering?
- its products: how likely are our various products and services to be used for money laundering?
- geographical considerations: are our customers associated with areas with high levels of crime, terrorism or corruption?

A micro finance institution may reasonably give weight to such factors as: a low level of absolute monetary balance, a low level of account activity, low customer income, a low level of transfers of funds to and from third parties (especially third parties overseas), that credit is unlikely to be used for money laundering purposes, and its local knowledge of its customers occupations and resources.

If, taking these and any other factors into account, it can reasonably consider its mix of customers, products and geographical considerations to add up to a low AML risk profile, then it can apply a correspondingly 'light' AML regime:

- it can be more flexible in the customer identification procedures it applies for customers lacking conventional ID documents such as passport or driving license or utility account in the customer's own name. It can rely more on personal recommendation, welfare or tax documents, non-official documents;
- it need not routinely take other Know Your Customer information, such as sources and amount of income, expected pattern of account activity;
- it can rely on 'manual' monitoring of accounts, by installing procedures and training staff so that it becomes aware, on an exception basis, if any account does show unusual behaviour in terms of, for example, the size of the balance, the frequency of transactions, a pattern of early repayment of loans.

By way of contrast, the large retail bank with a diverse customer base and product profile, and used for extensive third party transfers of funds within and beyond the country, will be expected to have identified customers that it should treat as potentially higher risk, to be more rigorous in its customer identification procedures, to obtain more information about higher risk customers, and to have more sophisticated – probably electronic software – monitoring tools.

Case studies

The 'risk-based approach' has become something of a mantra in AML. Two recent examples show it in action.

In South Africa, the authorities introduced a new AML regime in the early-2000s in order to help them meet the standards required for admission to membership of the Financial Action Task Force. This included the introduction of strict new customer identification requirements involving the verification of new customers' identity using income tax numbers and utility bills. But many low-income potential customers have no tax identification number and no formal address that they could corroborate from independent sources. The South African authorities recognized that the new AML regime was becoming instrumental in denying access to financial services to a large group of persons for whom a bank account would be beneficial. They issued new guidance that allowed institutions to relax the identification requirements for accounts having restrictions on the maximum account balance, the number of transactions permitted and the ability to make international transfers. In effect, the authorities had recognized a particular kind of account as inherently low risk.

In the United Kingdom, the greater emphasis on AML from the late 1990s made banks much more demanding and risk-averse so far as customer identification was concerned. Here too, organizations representing people on low incomes represented that the result was to exclude from access to banking many individuals with a low income or reliant on welfare benefits. Moreover, the government was developing a policy of paying welfare benefits directly into banks instead of by cash through post offices and it too became concerned that bank practices would frustrate this policy intention. In this case, the financial regulator, the Financial Services Authority (the FSA), took the lead. It brought together representatives of government, the banking industry, the consumer organizations, law enforcement agencies (a major stakeholder in effective AML) and other interested parties. In discussion, all the stakeholders agreed that the risk-based approach to AML did allow institutions to be much more flexible in their identification procedures than they had recognized and that they should use that flexibility to accept a more extensive range of items that verify identity.

Conclusions

- Micro finance institutions, like any other financial institutions, need to take AML seriously because AML is an important weapon in the fight against crime and terrorism and to achieve a better society.
- But modern good practice AML allows the application of a risk-based approach.
- Under a risk-based approach, institutions can take a proportionate, pragmatic approach to applying customer identification and other AML tools, whilst also ensuring that they are alert to, and take seriously, unusual activity that may be suspicious.
- Law makers and regulators need both to recognize and to practice the risk-based approach. They need to give confidence to financial institutions, including micro finance institutions, that, if they apply thoughtfully a risk-based approach, they will not be second-guessed for individual decisions that are reasonably justified under that approach. And they need to treat micro finance institutions as inherently lower risk than larger, more complex and more international financial institutions.
- The national and industry stakeholders in AML need to recognize that AML is not a competitive issue and that the best results are likely to come from a collaborative effort. This should include regulators and industry representatives working together to achieve practical, proportionate good practice that nevertheless meets adequate AML standards.

Policy Makers Aim to Expand Microfinance in CIS Region through Wise Policy Reform

by Anna Wiśniewska, Microfinance Policy Programme Coordinator at MFC;
Samer Badawi, CGAP`s Communications Officer

Faced with stubborn poverty levels and formal banking sectors that do not reach a majority of the population, financial sector policymakers and public officials from 9 Commonwealth of Independent States (CIS) countries have renewed their commitment to "microfinance-friendly" policy reform during the Krakow III Policy Forum on Law and Regulation Governing Microfinance.

The Forum was a unique gathering of high level policy makers held in Warsaw, Poland, April 6-8, 2006.

The Krakow III Policy Forum followed two previous Krakow Policy Forums (held in 2001 and 2003), which have had a marked impact on policy reform in several participating countries, stimulating increased dialogue, improved understanding, and positive changes in several countries' legal and regulatory frameworks for microfinance. Armenia, Georgia and Tajikistan are examples of countries in which the reform process was initiated after or assisted by discussions at the Krakow Policy Forum. During previous Policy Forums the participants had the opportunity to discuss and share experience on key issues related to regulating and supervising microfinance including:

- Discussing the proper role of microfinance within the financial system;
- Setting the proper scope of control over the different types of microfinance institutions;
- Addressing staffing and financial limitations in supervising microfinance.

This year the Krakow III Policy Forum brought together a limited number of carefully selected policymakers and top-ranking public officials from 9 NIS countries – Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan and Uzbekistan.

Kazakhstan delegation reporting back (Natalya Maksimova – Kazak Agency for Regulation and Supervision of Financial Markets and Organizations, Tolegen Igembaev – The Device Senate, Parliament of the Republic of Kazakhstan, Askar Zhakenov – Prime Minister Office)

The Krakow Policy Forum is designed to provide actors in positions of influence with an opportunity for a free exchange of views and experiences among peers on the key issues concerning the legal and regulatory framework for microfinance. This includes participants' plans and concerns connected with the growth of a strong and sustainable microfinance sector and discussions of its place in the broader financial sector.

Discussions during this year's Krakow III Forum were organized around the following four issues of importance to the development of the microfinance sector in the region and globally:

- policy reform measures that have the potential to increase significantly the provision of financial services to the lower income population and to micro-enterprises – the issue contained two topics: branchless banking and credit bureaus
- measures that might inadvertently constrain access to financial services for these clients, including measures aimed at combating money laundering and the financing of terrorism and interest rate ceilings
- financial cooperatives – the potential risks of over-regulation and of under-regulation, and strategies to strike a sensible balance
- issues to consider regarding government-sponsored guarantee funds established to support microfinance

"The right policies can make critical financial services – from affordable credit and money transfers to safe, reliable savings – available to more poor people," said Grzegorz Galusek of the Warsaw-based

Microfinance Centre for Central and Eastern Europe and the New Independent States (MFC), organizers of the Krakow III Policy Forum on Law and Regulation Governing Microfinance.

The event, which was co-sponsored by the World Bank-based Consultative Group to Assist the Poor (CGAP), featured expert analysis from microfinance policy specialists working in the region, including representatives of international donor agencies. Additional support to the Forum was provided by USAID and a Dutch ICCO Foundation.

Richard Rosenberg, Senior Advisor at Consultative Group to Assist the Poor (CGAP)

CGAP policy expert Timothy Lyman called the forum "an invigorating experience," citing the breadth of topics - from the promise of branchless banking to the potential pitfalls of interest rate ceilings or over-reaching measures to fight terror and money laundering. "It is also great that the topic of policy reform to facilitate greater access to financial services has gained such a high level of recognition among people really in a position to push sensible reforms," he added.

"Although there are widely accepted policy principles for microfinance, this conference was not about turn-key solutions," said Irina Evseeva, key note speaker and advisor to the Ministry of Finance of the Russian Federation, which is actively considering what regulatory direction Russia will take in its path to a more inclusive financial system. The Russian Microfinance Center, which mobilized the delegation from Russia, "has my Ministry's ear," Evseeva added.

"The experts, both from the region and abroad, really engaged the policymakers, helping them to arrive at their own solutions for boosting access to financial services," commented Olga Tomilova, manager of the Almaty, Kazakhstan-based office jointly operated by the MFC and CGAP.

"The problem is not so much shortage of capital in CIS countries; instead, the key is to get rid of the regulatory bottlenecks," says Lyman. "Increasingly, it seems there is the political will in the region to see this happen."

Regulation of financial cooperatives occupied a prominent position among the issues debated, owing to the unique prominence these types of institutions have in many countries in the region. The largest of these institutions, which in several countries in the region are not appropriately regulated, are beginning to cause concern among regulatory authorities. While all participants agreed the large cooperatives need appropriate external regulation and supervision, "the same approach is simply not going to work for regulating smaller cooperatives," according to Paula Perttunen, a former supervisor of Finish capital markets, who has most recently been working with banking sector regulation for the World Bank in Moscow.

Policymakers from participating countries that have already embarked on microfinance-related legal and regulatory reform noted the importance of dialogue with their counterparts from other CIS countries. "In Armenia, we have charted an independent path," remarked Karine Minasyan, a Board Member of the Armenian Central Bank, which has recently overhauled its regulatory scheme for non-bank credit organizations to facilitate transformation of Armenian microcredit organizations into formal financial institutions. "Nonetheless, it's also great to be able to compare notes with colleagues from neighboring countries grappling with similar concerns."

During plenary discussion (Olga Tomilova – CGAP/MFC, Irina Evseeva – Ministry of Finance of Russian Federation, Alexander Sarkisov – USAID, Mikhail Mamuta – Russian Microfinance Center)

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Towards the end of the forum, each country delegation presented its plans and ideas for policy changes or reforms coming out of the Policy Forum. These are the highlights of the next steps:

- **Armenia:** Review the existing legislation to help develop credit cooperatives; improve legal environment for guarantee funds and possibly initiate actions for developing a new guarantee fund; reconsider the issue of Anti-Money Laundering.
- **Azerbaijan:** Reconsider creating a special law on microcredit organizations and review the possibility of regulating microfinance under existing legal acts.
- **Georgia:** Consider some ideas related to unified supervision, credit bureaus and branchless banking issues while drafting the law for microfinance institutions.
- **Kazakhstan:** Additional analysis and amendment to the existing Law On Microlending Organizations in order to create more specific conditions for offering microcredit services for low income people and to create norms that would let the banks to participate more actively in microfinancing process. Review questions related to unified supervision.
- **Kyrgyzstan:** Create better legal environment for the development of branchless financial services; implement changes and amendments to the law on credit unions; work on the creation of unified financial supervision.
- **Moldova:** Consider carefully the creation of unified regulator/supervisory body; review the law on financial cooperatives; create legal base for credit bureaus and accelerate the work on the law on credit bureaus.
- **Russia:** Review the regulation of credit cooperatives; work on the development of the appropriate system of regulation of microfinance activity; implement branchless financial services.
- **Tajikistan:** Consider creation of the credit bureau in Tajikistan and see if there is a need for improving the legal and normative basis of microfinance organizations.

For more on the Forum and its outcomes, visit www.mfc.org.pl. To learn more about CGAP and its work, visit www.cgap.org. ■

Round Table with Tajik Government Officials

After the introductory meeting in 2005, in January 2006 the Ministry of Labor and Social Protection of Tajikistan approached the CA office with a request to advise them on the microfinance best practices and best practices of governments' involvement in MF. The Ministry is commissioned to implement a microcredit program, and the Vice-Minister Mr. Ashurov was appointed the chair of the cross-ministry MF development committee.

In response to the issue and the request, a 4-hour round table was prepared for Tajik government officials. The objectives of the round table were to:

- discourage the government from doing direct lending;
- make them understand that microcredit may not be suitable for all categories of the poor (i.e. that the unemployed may not be able to repay);
- educate them on the role of the government in MF and familiarize them with the main CGAP messages on regulation and supervision.

The topics of the presentations included:

- Fundamentals of MF and the new vision for MF
- Sustainability concept
- Impact of MF
- MF as one of the development strategies
- Interest rates in MF and the impact of IR caps
- Apexes in MF
- Basic concepts of regulation and supervision of MF
- Role of the government and alternative development strategies

In addition, the participants received full sets of translated CGAP Donor Briefs, MFC Policy Monitor, and a few other translated publications. The presentations were followed by discussions and question/answer time. The Vice Minister also presented the original concept and the challenges encountered.

15 participants of the Round table were representatives of the Ministry of Labor, President's Office, Ministry of Finance, Ministry of Economy and Trade, State Employment Service, Amonat Bank (former Soviet Savings Bank), and the Fund to Support Professional Education and Training.

As a result of the meeting, it was decided to form a working group on the development of the optimal mechanism for the MF development in the country; participants agreed that they should look at various mechanisms, not only at direct provision of credit; it was also decided to invite MF practitioners to the working group and to send gov't officials to the upcoming Tajik National MF conference in March and possibly to the CA Regional CAMFA conference in May.

After the round table, the Ministry of Labor and Social Protection sent an official letter of gratitude to the CA office. ■

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If you would like to send an update on any information on new legal initiatives in your country, please contact: Anna Wiśniewska (anna@mfc.org.pl), Grzegorz Kaliszuk (grzesiek@mfc.org.pl).

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