Principles of Regulation and Prudential Supervision: Should They Be Different for Microenterprise Finance Organizations?

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CFAES_ESO_1979.pdf (3.37 MB)

Date

1992-09

Authors

Chaves, Rodrigo A.
González Vega, Claudio

Publisher

Ohio State University. Department of Agricultural, Environmental, and Development Economics

Abstract

This paper offers the microenterprise development community a discussion of general principles of financial intermediary regulation and prudential supervision as well as an evaluation of how these issues are relevant for microenterprise finance organizations. Regulation, financial repression, prudential regulation, financial intermediary supervision, and internal control are defined first. A clear distinction among these concepts in critical for the analysis. The rationale for the regulation of depository financial institutions is provided next. The importance of a well-functioning payments system is not a sufficient reason for government regulation of financial markets. Opportunistic behavior on the part of depository institutions that results in excessive risks and instability, asymmetric information and moral hazard, and the associated negative externalities are at the core of the rationale for regulation. Consumer protection issues, in the presence of market failure, and conditions for the successful enforcement of financial contracts are emphasized. Regulation is desirable because, in the case of financial markets, preventive action is more cost-effective than remedial interventions. There are no standardized rules for optimum regulation. The authors propose seven regulatory "commandments," including competitive neutrality, minimum cost, specific objectives, incentive compatibility, and flexibility. Recognition of idiosyncratic risks is critical. Among frequently adopted instruments of prudential regulation described are the role of lender of last resort, deposit insurance, licensing, capital adequacy requirements, prohibition of loans to insiders, diversification rules, admissible activities, and enforcement powers. Preventive regulation is distinguished from protective regulation. Five supervision "commandments" are also proposed. Off-site and on-site methodologies for supervision are evaluated. Typical risks (credit, interest rate, liquidity, fraud) are described. Sui generis risks such as subsidy-dependence and donor-intrusion are added to traditional lists of risk. Difficulties of generalization for microenterprise finance organizations are discussed.

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