Basel Committee
on Banking Supervision

Microfinance activities and the Core Principles for Effective Banking Supervision

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Contents

Microfinance Activities and the Core Principles for Effective Banking Supervision

Executive Summary

Microfinance – the provision of financial services in limited amounts to low-income persons and small, informal businesses – is increasingly being offered by a variety of formal financial institutions, including banks and non-banks, either as their core business or part of a diversified portfolio. As recommended in the Core Principles for Effective Banking Supervision, non-banks that mobilise deposits from the public should be subject to regulation and supervision commensurate to the type and size of their transactions.[1] In general, microfinance oversight, whether over banks or other deposit taking institutions, should weigh the risks posed by this line of business against supervisory costs and the role of microfinance in fostering financial inclusion. To assist countries in developing a coherent approach to regulating and supervising microfinance, the Microfinance Workstream of the Basel Committee on Banking Supervision[2] has developed guidance for the application of the Core Principles to microfinance activities conducted by depository institutions in their jurisdictions.

Following an **Introduction** briefly describing the distinctiveness of microfinance business lines and risks, **Part I** (Guidance) of this report provides guidance on applying the Core Principles to depository microfinance – the result of an analysis of the key issues and challenges faced by supervisors of deposit taking institutions engaged in microfinance.[3] The Guidance is not a summary of best practices,[4] nor does it propose new principles or revisions to the Core Principles; it is intended to highlight the key differences between the application of each Core Principle to conventional retail banking and microfinance in banks and nonbanks, pointing out areas that may require tailoring.

The Guidance is followed by **Part II** (Range of Practice), which summarises the outcome of a survey undertaken by the Microfinance Workstream to identify the range of practice on regulating and supervising microfinance in deposit taking and non-depository institutions. The survey targeted the most significant risks in microfinance and the systems and processes used to manage and supervise these risks. Respondents comprise all geographic regions and income levels, although a few major countries were not able to participate. The survey results were supplemented by secondary research to provide an enhanced picture of current practices and incorporate experience beyond the responding countries. The Range of

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1 BCBS 2006a (Footnote 11)

2 The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

3 Several aspects of the Guidance, such as those related to customer due diligence and credit risk, may also be relevant for non-deposit taking institutions engaged in microfinance.

4 Moreover, the Workstream recognises that a variety of supervisory and regulatory practices across different jurisdictions may produce equally sound approaches that, depending on the context, may diverge somewhat from certain elements of the Guidance. The Guidance does not seek to reduce or supersede the discretion of national supervisors to act in a manner that is consistent with their unique regulatory approach and their broader policy goals.

Practice also does not constitute a summary of best practices, being no more than a portrait of regulatory and supervisory approaches being adopted at the time of the survey, conducted to provide background information to the analyses carried out in developing the Guidance.

Guidance on applying the Basel Core Principles to depository microfinance

While the Core Principles generally offer a suitable framework for supervisors of depository microfinance activities, four consistent themes with regard to their implementation emerged throughout in the analysis, indicating the need for microfinance supervisors to: i) allocate supervisory resources efficiently, especially where depository microfinance does not represent a large portion of the financial system but comprises a large number of small institutions; ii) develop specialised knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly microlending; iii) recognise proven control and managerial practices that may differ from conventional retail banking but may suit the microfinance business both in small and large institutions, specialized or not in microfinance; and iv) achieve clarity in the regulations with regard to microfinance activities, particularly the definition of microcredit,[5] and specify which activities are permitted to different institutional types, while retaining some level of flexibility to deal with individual cases.

Core Principles that apply equally to banks and <u>other deposit taking institutions</u> engaged in microfinance

Some Principles will apply equally to banks and <u>other deposit taking institutions</u> (ODTIs) engaged in microfinance regardless of the nature of microfinance activities, or complexity and size of supervised ODTIs. These are **Principle 1** (Objectives, independence, powers, transparency and cooperation), **Principle 4** (Transfer of significant ownership), and **Principle 5** (Major acquisitions). Three other Principles would also apply equally, but the present state of development of most microfinance markets render the applicability of such Principles very limited. These are **Principle 12** (Country and transfer risk); **Principle 24** (Consolidated supervision); and **Principle 25** (Home-host relationships).

Core Principles requiring a tailored approach

Most Principles, however, require some degree of tailoring in their implementation compared to conventional retail banking. This approach would incorporate the need for specialised knowledge of supervisors to identify and measure risks that are specific to microfinance, particularly to microcredit; additional effort to allocate supervisory resources efficiently; as well as a proportional regulatory and supervisory framework that does not add significant costs to microfinance activities across different institutional types, and that is also suitable for small microfinance institutions.

Principle 2 (Permissible activities) and **Principle 3** (Licensing criteria), for instance, should be tailored to ODTIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions, which may differ from banks. The types of permissible microfinance activities, including microcredit and microsavings and microinsurance, should be clearly defined in laws or regulations and tied to the size of the institution and its ability to manage risks inherent with such products and clients. Permission to engage in sophisticated

[5] The definition of microcredit for prudential purposes may differ from or not be appropriate for other purposes (eg defining the scope of permitted lending activities for non-profit tax-exempt MFIs).

activities should be substantiated by management's experience and ability to identify, control and mitigate more complex risks. Also, the supervisory or licensing authority should maintain and publish a current list of licensed/supervised ODTIs, and remain alert to and have the authority to deal with the illicit provision of financial services.

Lower initial capital requirements for ODTIs may be appropriate given the limited complexity, scope and size of their operations, especially in rural areas. However, the threshold should be high enough to discourage unviable candidates and yield a manageable number of institutions to supervise. In exchange for lower initial capital, supervisors should limit the kinds of activities permitted to ODTIs. Ongoing monitoring and surveillance may be used to identify when certain players or sectors become systemically significant or begin using new technologies (eg mobile phones and non-bank agents) that require different supervisory approaches.

A similar degree of tailoring is appropriate for applying **Principle 6** (Capital adequacy), as capital adequacy requirements should relate to (i) the nature of microfinance risks for all institutional types, and (ii) the size and constituents of capital of specialized ODTIs. Defining regulatory capital for cooperative ODTIs is particularly challenging, since capital invested by members may be generally withdrawn if the member decides to leave the cooperative. Also, where ODTIs have fewer options to raise capital compared to banks, or exhibit a more pronounced risk profile, a proportionately higher capital adequacy ratio (CAR) may be warranted.

To implement **Principle 7** (Risk management process) effectively – that is, identify, measure and manage microfinance risks – supervisors need to develop specialised knowledge and tailor supervisory techniques to risks in microloan portfolios and other products such as microsavings and microinsurance, for both banks and ODTIs. With respect to microfinance institutions, supervisors should focus on credit risk, as the loan portfolio is their main asset, although other risks can be equally significant some situations. They also need to take into consideration the relative significance of microfinance within a diversified institution; that is, where microfinance is one of many lines of business in a diversified financial institution, risks may be more easily mitigated. Supervisors must also be aware of potential differing governance weaknesses in ODTIs compared to banks and implement regulation and supervisory practices to mitigate them. Further, as microfinance is often a rapidly growing and dynamic sector, supervisors need systems to track and respond to changing risks in ODTIs and in the microfinance sector as a whole.

Given the distinctive features of microcredit products, client profile and loan underwriting methodology, managing credit risks is significantly different in the microfinance business. Implementation of **Principle 8** (Credit risk) should be carefully tailored to the particular risks of microlending. It should also take into account the context in which microlending occurs, ie as a business line within a large diversified bank versus, for example, a small microfinance organisation in which microloans comprise the main asset class. A clear regulatory definition of microcredit distinguishing it from other loan types is necessary for adequate supervisory oversight of credit risk. Further, specialised knowledge of characteristically labour-intensive microlending methodologies and an appropriate degree of flexibility from supervisors are imperative for assessing asset quality and risks. For example, supervisors should set loan documentation standards that are efficient and feasible to maintain relative to the nature of the customers and their businesses, which may differ from those of conventional retail lending.

In applying **Principle 9** (Problem assets, provisions and reserves), supervisors should adjust provisioning and classification requirements to the unique risks of microcredit compared to other loan types. To allow for specialized treatment of problem assets, provisions and reserves, the regulation should clearly define microcredit versus other loan types. The regulatory framework should also compel financial institutions to recognise the risk posed by past due microfinance loans quickly and accurately, and provide the supervisor with flexibility to deal with unique situations, as necessary. Regulatory limitations on exposures dealt with in **Principle 10** (Large exposure limits) should also be tailored to the distinctive risks in geographic or sector concentrations often observed in microloan portfolios and across different institutions, without unduly penalising otherwise sound practices.

Not only credit risk requires specific knowledge and supervisory tools. In applying **Principle 13** (Market risks) supervisors should pay particular attention to sources, risks and concentrations in ODTI foreign currency borrowings. The application of **Principle 14** (Liquidity risk) and **Principle 16** (Interest rate risk in the banking book) should take into account the unique features of microfinance assets and funding liabilities, particularly in microfinance institutions compared to those of a diversified commercial bank.

Implementation of **Principle 15** (Operational risk) should be tailored to the differing risks, practices and trends in microfinance operations – including outsourcing and the typical decentralised and labour-intensive microcredit methodology, which, although important to contain credit risk, has significant implications for operational risk management in comparison with retail banking, as well as for the evaluation of internal controls put in place by the institution, as described by **Principle 17** (Internal control and audit). The implementation of these Principles must take into account that microlending methodologies, as well as other lines of business such as microsavings, may require different organisational arrangements and controls from those of conventional retail banking. Requirements should be strict while at the same time accommodating proven practices.

The application of **Principle 11** (Exposures to related parties) should be tailored to ODTIs engaged in microfinance. Where governance of microfinance institutions is weak, supervisors may enhance restrictions or prohibitions to avoid abuse. Conversely, member-owned institutions that are very widely held may warrant a more flexible treatment for loans to non-management members.

Supervisors should adopt a risk-based approach to the implementation of **Principle 18** (Abuse of financial services), which should be tailored to the risks posed by low-value microfinance operations undertaken by banks and ODTIs. Such a risk-based approach better aligns crime prevention concerns and the rational use of supervisory resources, and is consistent with the goal of financial inclusion (which in turn serves law enforcement objectives as well by reducing informality).

Implementing **Principle 19** (Supervisory approach) and **Principle 20** (Supervisory techniques) in a microfinance context requires specialised knowledge and customised supervisory methodologies, particularly with regard to the evaluation of microcredit portfolios, ownership and funding structures, both in diversified banks and microfinance institutions. The supervisor should have the power to use a mix of off-site surveillance and on-site inspections for both banks and ODTIs. Supervisors must be trained and have comprehensive knowledge of the differences between microfinance and traditional banking and the particularities of microfinance institutions, to set up and consistently apply tailored supervisory tools and measures to identify and address weaknesses. Given the characteristics of microfinance and microfinance institutions, some techniques used to supervise conventional retail banking activities are not appropriate. Cost and feasibility considerations may allow for alternative supervisory arrangements to cover small, numerous institutions that pose low systemic risk in some jurisdictions. However, delegated/auxiliary supervision is not without its own risks and practical challenges.

The effectiveness, timeliness, quality and costs of off-site surveillance and on-site inspections will depend on the implementation of **Principle 21** (Supervisory reporting), which should be tailored to ODTIs in a manner that is commensurate with the type and size of their transactions, as well as to banks engaged in microfinance in a way that requirements do not unduly increase costs of microfinance activities in both institutional types. The content of reports and their frequency must be strictly aligned to the specialised analyses that are needed for effective supervision. Participation in credit bureaus should be required of all supervised microfinance providers, if relevant data for microfinance borrowers is available.

Principle 22 (Accounting and disclosure) should also be tailored so that disclosure requirements for small ODTIs engaged in microfinance are based on supervisory cost-benefit considerations. To fulfil their responsibilities, external auditors must have sufficient expertise in microfinance. Supervisors and accounting standard setting bodies should cooperate where possible to ensure accounting rules and principles are aligned with safety and soundness objectives in microfinance, although allowing for some discretion to whether apply international financial reporting standards to microfinance activities, in particular to specialized microfinance institutions.

Last, to implement **Principle 23** (Corrective and remedial powers of supervisors), supervisors should tailor corrective measures typically used in commercial or conventional retail banking to be effective in microfinance institutions and even for microfinance activities in banks. The supervisor should have powers, policies and procedures to address supervisory concerns in a variety of situations, including the orderly resolution of problem ODTIs, application of fines, and revocation of licenses when ODTIs engage in unsafe or unsound practices, or do not otherwise observe prudential standards.

Range of practice in regulating and supervising microfinance

The survey attempted to incorporate as many countries with significant microfinance activity by deposit taking institutions as possible, although some major countries were not able to participate and some regions rendered a higher response rate than others. As such, the Range of Practice presented in this report should not be considered exhaustive or globally representative. Notwithstanding this limitation, there were sufficiently robust trends revealed in the survey responses and the literature review to provide background information for the development of the Guidance presented in this report. For the most part, these trends centre on the need to calibrate regulation and supervision of deposit taking institutions engaged in microfinance so that this line of business is conducted in a safe and sound environment without hurting financial inclusion objectives and optimising allocation of supervisor resources. Key findings of the Range of Practice include:

Permissible activities and licensing (CP 2, 3)

Virtually all countries surveyed have ODTIs, mostly financial cooperatives although some jurisdictions also have non-bank depository institutions that are not cooperatively owned, such as specialised microfinance institutions for example. The range of permitted activities varies by country but generally is more restrictive for ODTIs compared to banks.

Most respondents that license and supervise ODTIs use similar criteria as for banks, although requirements may be streamlined for lower-risk institutions, such as small microfinance institutions.[6] Large cooperatives, those that do business with non-members, and ODTIs that are not cooperatively-owned are usually licensed by the same authority that

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[6] Not all types and sizes of ODTI are subject to licensing, regulation and supervision in all countries.

grants banking licenses. Small financial cooperatives are sometimes licensed under a special cooperatives law and supervised by an agency that also supervises non-financial cooperatives.

Some countries may create a tiered framework to encourage previously unregulated microfinance institutions to gradually upgrade the quality of their management, governance and operations to allow for participation in the formal financial sector. Such frameworks attempt to align permitted activities – for example, from lending only to deposit taking – with licensing and regulatory requirements. Tiered frameworks have had mixed results, since in some countries there are either too many or too few qualifying entities to justify the resources expended to license and oversee them.

Very few surveyed countries regulate and supervise microfinance as a business line that cuts across institutional types including banks. Where microfinance is defined by law or regulation, it usually denotes specialised microfinance institutions under different regulatory regimes, or specific features of a product (ie loan size, repayment source, target customer).

The survey and secondary research show that ODTIs are generally subject to lower initial capital requirements than banks, in some cases significantly lower. Most countries apply fit and proper requirements and other criteria during the licensing process, but only a few surveyed countries apply explicit exemptions to licensing requirements for non-bank institutions under a certain size, or with limited scope of operations.

Capital adequacy (CP 6)

Several respondents use the Basel capital framework to define and calculate CARs for ODTIs, including those that are cooperatively owned. There seems to be consensus in literature and among survey respondents that member shares should not be considered a part of high-quality regulatory capital unless withdrawal of shares is restricted. CARs applied to ODTIs vary greatly, but generally are higher than for banks in the surveyed countries and other countries described in secondary research. Cooperatives also may have a higher CAR requirement than other types of ODTIs in the same country.

Risk management process (CP 7)

Most supervisors who responded to the survey require banks and ODTIs to establish risk management processes, but ODTIs are less often subject to this requirement than banks. The emphasis is on general risk management, and credit, market and operational risks. Where risk management policies and processes are required from supervised entities, a plan for this area must be provided as part of the licensing procedures although some countries are less strict in the evaluation of these plans for small entities.

Credit risk (CP 8, 9, 10)

While most countries require regulated ODTIs and banks to adopt and maintain policies and procedures for the approval of new credit exposures or the renewal and refinancing of existing exposures, very few have differentiated requirements for microfinance loans, such as credit administration policies and loan documentation. Regulations usually outline criteria for classifying loans in banks and ODTIs, although in the vast majority of surveyed countries loan classification rules apply equally to conventional retail loans and microcredit, regardless of institution type.

The jurisdictions that have specific criteria for classifying microcredit usually use these criteria to determine provisions and credit impairment. Where there is special regulatory treatment of microcredit, provisioning usually starts earlier than conventional retail lending; the loan migrates faster to higher risk levels and is considered overdue earlier. The survey responses on exposure or concentration limits also suggest the presence of stricter rules for ODTIs than for banks.

Abuse of financial services and related party exposures (CP 11, 18)

Supervisors in the surveyed countries permit related party transactions for banks more often than ODTIs. When ODTIs are permitted related party transactions, they may be subject to lower limits per transaction. ODTIs are less frequently subject to anti-money laundering and combating the financing of terrorism (AML/CFT) rules than banks, and very few countries have undertaken a formal AML/CFT risk assessment to define low-risk operations, clients, or institutions.

Market, liquidity, and interest rate risks (CP 13, 14, 16)

Most respondents require a risk management process for market risks in banks, but about half as many require this of ODTIs. The majority of survey respondents require ODTIs to have a liquidity management strategy and contingency plan. Most apply the same standards to banks and ODTIs, and half set and review limits on the size of cash flow mismatches for foreign currencies. Few reported having regulations regarding diversification of ODTI funding sources. Most countries responding to the survey require by regulation an interest rate risk management process for banks, but fewer require this of ODTIs.

Operational risk, internal control and audit (CP 15, 17)

Most of the sampled countries have regulations requiring supervised institutions, including ODTIs, to have policies and procedures to control operational risk, and require ODTIs to comply with standards regarding internal control, segregation of duties, internal audit and compliance functions. With few exceptions these requirements and supervisory review of them were designed for commercial banking and do not consider the specificities of microfinance risks nor the size and complexity of microfinance operations.

Supervisory approaches and tools (CP 19, 20, 21, 22, 23)

In countries which responded to the survey, cooperatives that lend to and take deposits from non-members, as well as ODTIs that are not cooperatively-owned, are normally prudentially regulated and supervised by the banking supervisor. A few respondents also regulate and supervise cooperatives that lend to and take deposits only from members. Some countries in the survey have recently created new regulatory windows for specialised microfinance institutions, with the intent to attract previously unregulated entities or newly formed microfinance institutions.

The survey and secondary research suggest a need for supervisors to accumulate additional expertise in supervising microfinance. Some supervisors, even in countries with sizeable supervised deposit taking microfinance institutions may lack specialised personnel, processes and methodologies to develop and maintain a thorough understanding of the risk profile of microfinance in individual institutions and the microfinance industry as a whole. According to the survey, authority to conduct on-site inspections in ODTIs is also lacking in some jurisdictions where ODTIs are regulated and supervised.

Supervisors in the respondent countries use a range of data sources for off-site monitoring of ODTIs, but most do not have specialised techniques for analysing them. Many authorities reduce the frequency of required reports for ODTIs compared to banks, however. Most supervised ODTIs in the countries surveyed are subject to similar accounting, auditing and disclosure standards as banks, whether local or international standards.

Most supervisors in the sample have a similar range of tools and procedures to require prompt correction of problems and weaknesses in banks and ODTIs. However, the survey suggests that there is not enough legal or regulatory clarity in all countries on the circumstances in which the supervisor can impose administrative sanctions and apply for criminal sanctions with respect to ODTIs.

Introduction

Background

In many countries, microfinance – the provision of financial services in limited amounts to low-income persons and small, informal businesses – is increasingly being offered by formal financial institutions, either as their core business or as part of a diversified portfolio. Although banks dominate deposit taking activity in most countries, other types of financial institutions (eg microfinance institutions, financial cooperatives) that take deposits may be significant providers as well. According to conservative estimates, other deposit taking institutions (ODTIs), including cooperatives, hold some 5% of deposit accounts in the developing world.[7] Further, while these institutions typically take deposits in small increments, the proportion of citizens they serve may be significant in some jurisdictions. In Rwanda, for example, ODTIs hold 10% of the amount of deposits but serve nearly 40% of depositors.[8] Similarly, the number of loans from regulated non-banks may surpass those granted by banks in some markets. For example, recent figures from Bangladesh show microcredit providers hold nearly 7 million outstanding loans compared to 4.4 million in banks, while Zambian microcredit providers have three times as many borrowers as commercial banks.[9]

ODTIs should be subject to regulation and supervision commensurate to the type, complexity and size of their transactions.[10] In addition to protecting depositor funds, official oversight may enhance access to financial services by increasing public confidence in microfinance providers, improving their operational standards and setting a level playing field for both banks and non-banks. However, compliance with prudential rules and other requirements can be costly for both supervised institutions and supervisors relatively to the risks posed by this line of business. Thus, microfinance oversight, whether over banks or ODTIs, should weigh the risks posed by this line of business against supervisory efforts that are necessary to monitor and control those risks and the role of microfinance in fostering financial inclusion. This calls for a coherent regulatory and supervisory approach, tailored to the unique features of microfinance as compared with conventional retail banking, in particular the distinctiveness of microlending and microfinance institutions.

Well-established guidance has been available for banking supervisors for over a decade. The *Core Principles for Effective Banking Supervision* developed by the Basel Committee on Banking Supervision in cooperation with fellow supervisors, have become the *de facto* standard for sound prudential regulation and supervision of banks. The Core Principles, along with the *Core Principles Methodology*[11], are intended to help countries assess the quality of their supervisory systems and provide input into their reform agendas. The vast majority of countries have endorsed the Core Principles and have declared their intention to implement them. The Basel Committee believes that implementation of the Core Principles by all countries would be a significant step towards improving financial stability domestically and internationally, and provide a good basis for further development of effective supervisory systems.[12] This paper attempts to provide additional guidance for the implementation of the

[7] CGAP 2009

[8] Survey data

[9] CGAP 2009

[10] BCBS 2006a (Footnote 11)

[11] BCBS 2006a

[12] BCBS 2006

Core Principles to the supervision of microfinance activities conducted by banks and ODTIs.[13]

Distinctive features of the business of microfinance

Microcredit is at the heart of many microfinance business models, and has a number of distinctive features.[14] Product design, client profile and labour-intensive underwriting methodologies give microcredit a unique risk profile. Effective credit risk management thus requires different tools and analyses than for conventional retail lending. Some of the more distinctive features of microcredit include:[15]

(a) *Microborrowers.* A microcredit provider usually caters to low-income clients, both the underemployed and the entrepreneur with an often informal family business (eg petty traders). Borrowers are typically concentrated in a limited geographic area, social segment or entrepreneurial undertaking.[16] Loans are usually very small, short term, and unsecured, with more frequent repayments and higher interest rates than conventional bank loans. Many providers require higher interest rates to offset higher operational costs involved in the labour-intensive microlending methodology.[17]

(b) *Credit risk analysis.* Loan documentation is generated largely by the loan officer through visits to the borrower's business and home. Borrowers often lack formal financial statements, so loan officers help prepare documentation using expected cash flows and net worth to determine the amortisation schedule and loan amount. The borrower's character and willingness to repay is also assessed during field visits. Credit bureau data are not always available for low-income clients or for all types of microfinance providers, but when they exist, are used as well. Credit scoring, when used, complements rather than supplants the more labour-intensive approaches to credit analysis.

(c) *Use of collateral.* Microborrowers often lack collateral traditionally required by banks, and what they have to pledge is of little value for the financial institution but are highly valued by the borrower (eg TV, furniture). Where the lender does take some sort of collateral, it is for leverage to induce payment rather than to recover losses. In the absence of collateral, underwriting depends on a labour-intensive analysis of the household's repayment capacity and the borrower's character.

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[13] Several aspects of the Guidance, such as those related to customer due diligence and credit risk, may also be relevant for non-deposit taking institutions engaged in microfinance.

[14] Jansson et al 2004 and Christen et al 2003

[15] The regulatory definition of microcredit for prudential purposes may not include all features that characterize the microlending methodology, and may differ from definitions used for other purposes, such as defining the permitted activities of a non-profit tax-exempt MFI..

[16] Concentrations may be required by socially motivated investors that have a special interest in targeting a given region or social segment, such as women.

[17] High interest rates for sustainable microcredit are also the result of the fact that a portfolio of very small loans are usually more costly than the same total value of lending in larger amounts, as not all costs vary in direct proportion to the amount lent.

(d) *Credit approval and monitoring.* Because microlending tends to be a highly decentralised process, credit approval by loan committees depends heavily on the skill and integrity of loan officers and managers for accurate and timely information.

(e) *Controlling arrears.* Strict control of arrears is necessary given the short-term nature, lack of collateral, high frequency of payments (eg weekly or bi-weekly), and contagion effects (see h. below) of microloans. Traditionally, monitoring is primarily in the hands of loan officers as the knowledge of the client's personal circumstances is important for effective collections.

(f) *Progressively increasing lending.* Customers who have limited access to other financing are usually dependent upon ongoing access to credit.[18] Microlending uses incentive schemes to reward good borrowers with preferential access to future, larger loans (sometimes with favourable repayment schedules and lower interest rates), which raises the risk of over-indebtedness, particularly where credit information systems are absent or deficient. This feature also affects interest rate risk management, as microfinance customers expect rates to decline as the customer's track record grows, regardless of changes in the general level of interest rates.

(f) *Group lending.* Some microlenders use group lending methodologies, where loans are made to small groups of people who cross guarantee other members of the group. Peer pressure also helps to ensure high repayment levels, as the default of one group member could adversely affect the availability of credit to others.

(h) *Contagion effects.* Tight control of arrears and peer pressure has driven traditionally sound repayment rates in most jurisdictions to date. However, the quality of individual loan portfolios can deteriorate quite rapidly, due in part to the unsecured or under-secured nature of microloans as well as so-called contagion effects, where borrowers who notice increasing delinquency in the institution may stop paying if they believe the institution will be less likely to offer future loans due to credit quality problems.

(i) *Currency-related risks.* Occasionally microlenders lend in a currency other than that of a borrower's repayment source (eg sale of goods or services), so foreign currency fluctuations may affect the borrower's ability to repay. While not unique to microcredit, microborrowers may be less able to appreciate the nature of this exposure, much less take measures to mitigate it.

(j) *Political influences.* Microcredit, and microfinance in general, may be seen as a political tool in some countries, tempting politicians to demand forbearance or forgiveness of loans to poor customers during times of economic stress. This might affect repayment culture of microfinance borrowers.

The dynamics of microfinance assets and liabilities also differ from those of commercial banking, affecting liquidity and interest rate risk management. On the asset side, loan repayment is often driven by expectations of repeat loans over time, transforming short-term loan portfolios into long-term, fixed-rate assets. Illiquidity of such assets is heightened by the fact that there are few established securitisation markets available for microcredit portfolios. Microfinance institutions also tend to grow rapidly, particularly in their early stages. In this

[18] Interesting evidence that poor people have active financial lives – including significant borrowing and high savings relatively to their income – exactly because they are poor is presented by Collins et al 2009.

situation, they may lack a cushion of unencumbered, high-quality liquid assets to enable them to withstand a range of stress events, since most funds are designated to support loan growth.

On the liability side, data on the historical volatility of deposits in ODTIs may not be available to allow for meaningful gap analysis. In addition, ODTIs tend to have less certain access to backup sources of liquidity from local banks, although lack of bank liquidity lines may be mitigated by the existence of a local wholesale lender or government program set up to provide funding to the microfinance sector. ODTIs are also vulnerable to disruptions in commercial borrowings due to delays or changes in policies of public (government) and private (donors and lenders) funders. Nonetheless, borrowing from international lenders may be a stable source of liquidity depending on individual relationships and contract terms.

Purpose and structure of the report

The Basel Committee asked its Microfinance Workstream to identify the relevant Basel Committee standards for microfinance activities and develop additional guidance for supervisors. **Part I** of this report provides such **Guidance,** which is the result of an analysis of the key issues and challenges faced by supervisors of deposit taking institutions engaged in microfinance, either banks or nonbanks. The Guidance is not a summary of best practices, nor does it constitute new principles or revisions to the Core Principles; it is intended to highlight the key differences between the application of each Core Principle to conventional retail banking and microfinance, pointing out areas that may require tailoring, including for supervision of microfinance entities. Similarly, the Guidance does not seek to reduce or supersede the discretion of national supervisors to act in a manner that is consistent with their unique regulatory approach and their broader policy goals.

The analyses conducted to develop the Guidance greatly benefited from the findings of the **Range of Practice** described in **Part II** of this report, which provides background information on supervisory issues, practices and trends for the regulation and supervision of microfinance in different jurisdictions. The Range of Practice is, in its majority, the result of a survey conducted with supervisors from all geographic regions by the Microfinance Workstream (although some major countries were not able to participate). Nonetheless, it was complemented by secondary sources and a review of the existing literature.[19] The secondary sources were an important means to expand on issues of interest not covered by the primary research, and highlight practices in countries that did not respond to the survey, including significant countries with large microfinance sectors. Although a significant amount of primary and secondary data was accumulated, the Range of Practice is not intended to be considered globally representative. Also, it does not constitute a summary of best practices, being no more than a portrait of regulatory and supervisory approaches being adopted at the time of the survey, which was conducted mainly to provide background information for the development of the Guidance. The Range of Practice section of this report follows headings used in the survey instrument: Permissible Activities and Licensing, Arrangements for Ongoing Supervision and Supervisory Tools, Risk Management, and Capital Adequacy.

[19] Main secondary sources are CGAP 2009, Christen et al 2003, Jansson et al 2004, IMF 2008, the Microfinance Regulation and Supervision Resource Center, and websites of the supervisory agencies. Other relevant literature is highlighted throughout the report.

PART I - Guidance on applying the Basel Core Principles to depository microfinance

This section is designed to help supervisors tailor the Core Principles to microfinance activities conducted by deposit takers in their jurisdictions, making use of the Principles' flexibility and adaptability. Special attention is given to the supervision of deposit takers other than banks (ie ODTIs) where practices and techniques typically differ from conventional retail banking. Each Principle is cited below along with guidance as to its applicability. Where relevant, a brief discussion follows describing the distinctive features and risks of microfinance and specialised deposit taking microfinance institutions that may warrant a tailored approach. Principles not addressed in the background survey[20] are discussed as well. Although this Guidance focuses on supervision of deposit taking institutions, some aspects may also have relevance to credit-only microfinance institutions, such as Credit Risk (Principle 8) and abuse of financial services (Principle 18).

While the Core Principles generally offer a suitable framework for supervisors of depository microfinance activities, four consistent themes with regard to their implementation emerged throughout in the analysis, indicating the need for microfinance supervisors to: i) allocate supervisory resources efficiently, especially where depository microfinance does not represent a large portion of the financial system but comprises a large number of small institutions; ii) develop specialised knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly microlending; iii) recognise proven control and managerial practices that may differ from conventional retail banking but may suit the microfinance business both in small and large institutions, specialized or not in microfinance; and iv) achieve clarity in the regulations with regard to microfinance activities, particularly the definition of microcredit,[21] and specify which activities are permitted to different institutional types, while retaining some level of flexibility to deal with individual cases.

Some Principles will apply equally to banks and ODTIs regardless of the nature of microfinance activities, or complexity and size of supervised ODTIs. Most Principles, however, require some degree of tailoring in their implementation compared to conventional retail banking. This approach would incorporate the need for specialised knowledge of supervisors to identify and measure risks that are specific to microfinance, particularly to microcredit; additional effort to allocate supervisory resources efficiently; as well as a proportional regulatory and supervisory framework that does not add significant costs to microfinance activities across different institutional types, and that is also suitable for small microfinance institutions.

Principle 1 – Objectives, independence, powers, transparency and cooperation

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with

[20] Specifically, CP 4, 5, 10, 12, 13, 24 and 25.

[21] The definition of microcredit for prudential purposes may not be appropriate for other purposes (eg defining the scope of permitted lending activities for non-profit tax exempt MFIs).

laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 1 applies equally to supervisors of banks and ODTIs engaged in microfinance.

Supervisors of ODTIs engaged in microfinance require the same clarity of mandate, independence, accountability, transparency, legal foundation, legal powers, and inter-agency/ministry cooperation as supervisors of commercial banks. The banking supervisor – or other authority with similar skills, expertise, resources and credibility – is normally the most appropriate supervisory body for ODTIs of sufficient significance[22] to warrant prudential oversight, leveraging on its existing skills and infrastructure and ensuring a level playing field. Further, non-financial authorities rarely have the resources, expertise, and independence to deal with these intermediaries effectively. Where multiple agencies are involved in the supervisory process, they should ensure that there is sufficient coordination, cooperation and information sharing necessary for the discharge of their duties. However, it is very important that the authorities charged with microfinance supervision develop specialized expertise in this area and exercise a fair level of coordination to avoid distortions stemming from conflicting approaches.

Principle 2 – Permissible activities

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 2 should be tailored to ODTIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions, which may differ from banks.

The types of permissible microfinance activities, including microcredit and microsavings,[23] but also potentially payments, remittances and other money transfer services, and microinsurance,[24] should be clearly defined in laws and regulations and tied to the size of the institution and its ability to manage risks inherent with such products and clients. Certain activities, such as offering checking accounts or engaging in foreign trade financing, may be

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[22] See CP 3 and 19 for further discussion of issues related to supervising large numbers of small institutions. Further guidance with regard to the assessment of systemic importance of financial institutions has been recently developed by staff of the BIS, the International Monetary Fund, and the Financial Stability Board for submission to the G20 Finance Ministers and Governors. See "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations."

[23] Typically the permitted retail deposit mobilization activities of banks and ODTIs engaged in microfinance are not limited as to amount or customer profile, though there may be limitations on other product features. One Asian survey respondent, for example, only permits newly licensed specialized microfinance depository institutions to issue term savings products until the licensee has established a track record with the asset/liability management challenges of retail deposit taking generally.

[24] The survey did not seek information on permitted activities of either banks or ODTIs with respect to payment and settlement services or the sale or underwriting of microinsurance. The regulatory and supervisory issues associated with these services fall outside of the scope of this report. For further reference on these topics, see the General Principles for International Remittances Services, of the Committee on Payments and Settlement Systems, and Issues on Regulation and Supervision of Microinsurance, of the International Association of Insurance Supervisors.

beyond the managerial resources or expertise of smaller or less seasoned ODTIs. Permission to engage in sophisticated activities should be substantiated by management's experience and ability to identify, control and mitigate more complex risks.

Microfinance activities permitted to be conducted by ODTIs and banks should be clearly defined in laws or regulations, including the array of products permitted such as microsavings and perhaps other products such as microinsurance. Of particular importance is the definition of microcredit, which may include loan amount, term, frequency of payments, underwriting methodology and other criteria.[25]

Defining microfinance as one institutional form may curb competition, encourage regulatory arbitrage, or hinder formalisation and integration of unregulated or informal providers into the regulated financial sector. This may impact other areas of regulatory concern, such as the ability to control financial crimes, when a number of unregulated financial services providers are outside the supervisory fold.

Regardless of the regulatory and supervisory framework in place, microfinance customers must have a means to verify whether their institution is regulated and/or supervised by the banking or other financial authority. Authorities should maintain and publish a current list of licensed and supervised ODTIs and require them to prominently disclose their status, so that the public is able to differentiate supervised from unsupervised providers. The public often relies on regulators and supervisors to avert pyramid schemes or other illegal deposit taking, so even when countries choose to not oversee some providers for cost-benefit considerations, supervisors must remain alert to and have the authority to deal with the illicit provision of financial services nonetheless.

Microcredit providers may require cash collateral to demonstrate a borrower's ability (and provide an additional incentive) to make payments and to serve as security for the loan. These are frequently termed "compulsory savings." These funds are sometimes deposited in a third-party bank or kept in low-risk securities, so as not to be intermediated by the microfinance institution. As long as the loan balance exceeds the amount of cash collateral, and the collateral is not intermediated, there is no risk to the "depositor" and this activity should not trigger prudential oversight. Further, in situations where the cash collateral exceeds the loan balance temporarily, the costs to prudentially regulate and supervise such exposures would likely outweigh the risks, although supervisors should continue to monitor the level and materiality of these exposures in their jurisdictions to avoid undue risk to customer funds.

ODTIs may offer ancillary services in addition to traditional financial intermediation, such as business skills training to micro-entrepreneurs. Non-financial services should be conducted in a separate entity and ring-fenced from the activities of the financial institution to minimise conflicts of interest and risk to the bank's or ODTI's safety and soundness.

Principle 3 – Licensing criteria

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and

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[25] The regulatory definition of microcredit for prudential purposes may not include all features that characterize the microlending methodology, and may differ from definitions used for other purposes, such as defining the permitted activities of a non-profit tax-exempt MFI.

its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 3 should be tailored to ODTIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions, which may differ from banks.

Licensing frameworks

Where systemic significance is minimal, a risk-based approach to licensing (which may mean applying different licensing standards) allows countries to reduce the burden on supervisory resources without undue risk to the financial system or depositors. However, monitoring and surveillance are still needed to identify when certain players or sectors grow to such an extent that the risks become systemically significant, requiring a different approach. With new technologies (eg mobile phones and the use of non-bank agents) being increasingly deployed by financial institutions to serve low-income customers who were previously excluded from formal financial systems, the speed with which risk grows or concentrates in individual institutions may be different from that historically observed in conventional retail banking.

Countries may implement a tiered framework to allow previously unregulated credit-only microfinance institutions such as NGOs[26] to gradually upgrade the quality of their management, governance and operations to allow for participation in the formal financial sector under flexible entry rules. The tiered licensing framework attempts to align permitted activities with licensing and operating requirements – for example, from credit only to deposit taking, from non-prudential to prudential regulation. This approach is not without challenges and to ensure its objectives are achieved, supervisors should make certain that a sufficient yet manageable number of qualified entities exist to justify the resources expended to license and oversee them. To the extent possible, they should monitor the unregulated market for signs of undesirable business practices that could hamper regulated entities, by means of unfair competition and deterioration of overall credit discipline. The tiered approach should be reviewed in such cases.

The wide variety of institutional forms and approaches to licensing and supervising microfinance means in some jurisdictions the licensing and supervisory authorities may not be the same. In such a situation, the supervisor’s prior consent should be obtained on each specific licensing application and there should be an adequate level of information sharing and coordination between the different authorities. Licensing authorities should also have sufficient knowledge of the microfinance business.

Legal forms

NGOs or other ownerless entities should not be allowed to operate as deposit taking institutions[27] given their lack of shareholders to infuse new capital in the event that the

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[26] Non-profit organisations are typically referred to as “non-governmental organisations” or “NGOs” among practitioners of microfinance, which is not a legal term in most jurisdictions, but rather covers a number of different types of ownerless legal entities.

[27] This would not preclude the acceptance of cash collateral (aka mandatory savings) described previously.

institution's solvency is threatened. An increasing number of NGO microfinance institutions are converting to for-profit companies such as regulated financial firms, including deposit taking institutions. This institutional "transformation" [28] may be driven by an NGO's need for additional sources of capital; desire to offer services such as deposits that are restricted to licensed and supervised institutions; or to comply with newly-adopted regulation or legislation designed to formalise and consolidate the microfinance sector.

Supervisors should construct a coherent regime for processing applications from "transformed" microfinance institutions, including (1) standards for NGO and foreign ownership; (2) acceptable non-cash capital contributions (eg loan portfolio), where desired; and (3) strong corporate governance rules.[29]

Newly-organised for-profit microfinance institutions may propose having non-profit investors as well as for-profit investors. The latter may have, in most cases, greater financial resources and incentives to monitor management decisions, although not all private investors are alike: specialised investors such as development financial institutions may also have weaker incentives to monitor the risk-taking behaviour of management compared to conventional bank shareholders. Regulation and supervisory practices should therefore be sufficiently flexible to consider on a case-by-case basis the shareholder suitability and diversification requirements of ODTIs as well as differing governance issues that may arise when there is a mix of non-profit and for-profit owners. There may be room for discretion regarding the proposed ownership structure of such applicants in the short-term, while requiring in the medium-term owners that will best ensure adequate capitalisation, good governance and a sufficient degree of monitoring over the management of the institution.

Other licensing criteria

The basic licensing criteria for prudentially regulated ODTIs should not vary materially from that of banks – eg suitability of shareholders and management, capital, governance, risk management – although some tailoring will be necessary so that the criteria are feasible in relation to the institution's size, complexity, structure and operations, and justify the amount of effort put into licensing procedures. This requires a good level of understanding of microfinance and microfinance institutions by the licensing authority. Given the importance of loan officers for soundness of the microfinance business, the licensing authority should also request and assess proposed loan officer compensation schemes and training policies, to ensure that they both discourage excessive risk taking behaviour and do not weaken governance.

Lower initial capital for ODTIs may be appropriate given the limited complexity, scope and size[30] of their operations, especially in rural areas, provided the threshold is high enough to (1) discourage unviable candidates and (2) yield a manageable number of institutions to

[28] In the microfinance lexicon, "transformation" often refers to a transaction in which a microfinance business is transferred from one institution to another, usually by an ownerless NGO to a new or existing for-profit company. For example, an NGO may transfer its loan portfolio and other assets, liabilities, and employees to a new company in exchange for shares in the new company and/or other remuneration. See Lauer 2008 for discussion of the legal and ownership issues surrounding such activities.

[29] Lauer 2008

[30] It is important to note that microfinance does not only attract small institutions. There are large financial institutions that are specialised in microfinance as well, and even some large international banks have been offering microcredit in their local markets.

supervise. In exchange for lower initial capital, supervisors should limit the kinds of activities permitted to such institutions. Minimum initial capital for ODTIs should at least:

- support the basic infrastructure needed to operate profitably, taking into account higher overall operating costs of microfinance providers compared to commercial banks;
- cover the cost of fixed assets plus operating losses projected for the first few years of operations, taking into account the comparatively fewer alternative sources of capital support than commercial banks; and
- ration the number of financial licenses that will require supervision while not posing an undue barrier to entry for otherwise qualified organisers who want to establish or transform to a regulated, deposit taking institution.

In defining initial minimum capital of supervised cooperative entities, particular attention should be given to regulatory or statutory restrictions (or lack of thereof) on withdrawal of member shares.[31] Start-up requirements for cooperatives may also include minimum thresholds such as maximum number of members and geographical scope.

Principle 4 – Transfer of significant ownership

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 4 applies equally to banks and ODTIs engaged in microfinance.

There are no issues specific to microfinance.

Principle 5 – Major acquisitions

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 5 applies equally to banks and ODTIs engaged in microfinance, with isolated situations warranting a tailored approach.

Major acquisitions by ODTIs, including cross-border operations, occur but are still relatively uncommon. At least two types of acquisitions by ODTIs may warrant a tailored supervisory approach: (1) acquisition by one ODTI of the assets and liabilities of a competing microfinance provider as part of merger/consolidation, particularly where each has a different form of ownership (eg one stock, one NGO); and (2) acquisition of an entity that provides non-financial services related to microfinance, such as ancillary social services for clients (eg medical services). In addition to ensuring such acquisitions pose no undue risks, treatment should be consistent with other Principles, such as permissible activities (CP 2), licensing (CP 3) and operational risk (CP 15).

[31] An extended discussion of issues around cooperative capital is included in Core Principle 6.

Principle 6 – Capital adequacy

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 6 should be tailored to (a) the nature of microfinance risks for all institution types, and (b) the size and constituents of capital of ODTIs engaged in microfinance.

Definition and calculation of regulatory capital

Where supervisors choose to align ODTI capital requirements with Basel II standards, the Standardised or Simplified approaches are most appropriate, as compliance with more advanced measurement techniques may be beyond the resources or expertise of many ODTIs or even banks specialized in microfinance. Under the Basel II framework, microloans are usually categorised as "Other Retail Exposures" across different institutional types, based on a presumption that microloans exhibit similar characteristics to a large pool of small, diversified loans that have lower volatility in relation to macroeconomic events than larger exposures.[32] However, so called "contagion effects" may result in a higher proportion of defaults if a relatively small number of loans go bad, so there is less granularity than that of Other Retail Exposures. Also, while microloans have historically shown a lower correlation to country level macroeconomic shocks compared to commercial loans, losses may be linked more strongly to localised events, given the high degree of interdependency of low-income borrowers. Selecting an appropriate level of regulatory capital requires a clear regulatory definition of microfinance products, particularly microcredit. Additionally, adequacy or leverage standards should be over the minimum liquidity ratios or reserves.

Defining regulatory capital for cooperative ODTIs is particularly challenging, since capital invested by members can generally be withdrawn if the member decides to leave the cooperative. There is a general consensus[33] that the definition of higher-quality capital for cooperative financial institutions should focus on accumulated earnings plus reserves that are not earmarked for specific expenditures. Unless regulation imposes restrictions on the withdrawal of share capital, member shares should not be considered a part of higher-quality regulatory capital.[34]

Capital adequacy ratios

Where ODTIs have fewer options to raise additional capital compared to banks, or exhibit a more pronounced risk profile,[35] a higher CAR may be warranted. Specifically:

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[32] This paper also recognizes that some countries may offer alternative mechanisms to protect the safety of savings collected by some ODTIs, such as guarantee schemes and restrictions on investment of depositor's funds. In principle, such schemes would not substitute for prudential standards applicable to similar institutions in a given jurisdiction.

[33] See Range of Practice 1 (c) and 4.

[34] This issue is under discussion in conjunction with the evolution of international capital standards. National regulators are encouraged to use their discretion to adjust their own cooperative capital rules to align with emerging guidance and sound practice.

[35] See Jansson et al 2004 and Christen et al 2003

1. Some specialised microfinance institutions may lack investors/owners that are able to i) respond promptly to calls for capital and ii) scrutinise management critically to protect their investments, which may inhibit maintenance and growth of the capital base.

2. Management and staff of microfinance institutions may be relatively inexperienced participants in the formal financial sector. At the same time, the supervisory agency may also be inexperienced at judging and controlling microfinance risks.

3. New – and even seasoned – microfinance organisations tend to grow faster compared to traditional banks, which puts a heavy strain on managerial resources and information and monitoring systems.

4. Compared to banks, most ODTIs engaged in microfinance have less diversified loan portfolios, funding sources and geographic scope, making them more vulnerable to adverse economic conditions at the local level.

5. Microloans manifest deterioration in portfolio quality faster than commercial loans, due to their shorter average duration and more frequent repayments. Also, so-called contagion effects amongst low-income borrowers in the same location can increase delinquencies exponentially.

6. Capital may also deteriorate more quickly as a result of delinquency and loan losses in a specialised microfinance institution or limited scope cooperatives than a commercial bank. This is due to the relatively higher upfront lending costs that cannot be offset by revenue sources other than the loan revenues that may be available for diversified banks.

Principle 7 – Risk management process

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 7 requires specialised knowledge and supervisory methodologies for both banks and ODTIs engaged in microfinance.

Microfinance does not have a long track record as a business line or institutional type compared to conventional banking, so risk management processes may be less developed. New microfinance providers and microcredit portfolios also tend to grow very fast, which puts heavy strain on management and systems. Further, the supervisory agency may be less experienced with judging risks in microfinance products such as microsavings and microinsurance, and particularly microcredit. Specially trained supervisory staff is needed to assess the quality of the risk management process adopted by the supervised institution. With respect to microfinance institutions, supervisors usually should focus on credit risk, as the loan portfolio is the main asset, although other risks can be equally significant some situations. The location and relative significance of microfinance within a diversified institution should also affect how supervisors approach oversight of risk management; where microfinance is one of many lines of business in a diversified financial institution, risks may be more easily mitigated.

Supervisors must be aware of potential governance weaknesses in ODTIs compared to banks and implement regulation and supervisory practices to mitigate them. Some types of investors, such as non-profit shareholders, might be associated with governance and ownership structures that lower incentives for operational efficiency and responsiveness to capital calls.[36] Governance in financial cooperatives poses additional challenges for supervisors given the membership-based structure and operation.[37]

The nature and risks of microfinance business are evolving rapidly, requiring dynamic risk management oversight and trend monitoring by supervisors. A number of microfinance institutions have diversified their activities and geographic scope with new products and technologies, or partnerships with commercial banks and other financial and non financial institutions. In light of the forgoing, it is important for supervisors to develop systems to track and respond to changing risks in ODTIs and in the microfinance sector as a whole.

Principle 8 – Credit risk

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 8 should be tailored in banks and ODTIs engaged in microfinance to the specificities of microlending. Supervisors should take into account the context in which microlending occurs, ie as a business line within a large diversified bank versus a specialized microfinance organisation in which microloans comprise a significant proportion of total assets. Specialised knowledge of labour-intensive microlending methodologies is imperative for supervisory efficacy.

Product design, client profile and loan underwriting methodologies give the microlending business distinctive risks;[38] thus, effective credit risk management for microlending requires different knowledge and tools from those required for conventional retail lending. While the regulatory and supervisory framework should require financial institutions providing microcredits to have written manuals and policies with regard to the screening, approval, monitoring and collection of these loans, it should also provide for sufficient flexibility to accommodate the special characteristics of the microlending methodology in question, particularly its labour-intensive nature, the likely use of alternative collateral and the possible use of a group lending approach. Regulators and supervisors should set simple loan administration and documentation standards that are efficient and feasible to maintain relative to the nature of the customers and their businesses, which may differ from those of conventional retail lending. Formal documentation should focus on information that attests to

[36] This is not to imply all microfinance entities with historical NGO roots remain small and poorly governed. For instance, Compartamos – an important microfinance institution in Mexico – began its activities as a NGO. Today, Compartamos is a profitable microfinance bank that conducted a successful initial public offering in 2007.

[37] Many countries in the survey recognise that poor governance is a major source for failures and distress in financial cooperatives, so this should be an area of careful supervisory review. Conflicts of interest arise from the fact that owners are also borrowers and depositors of a financial cooperative. Potential problems resulting from this governance structure are poor credit underwriting and management, inappropriate loans to related parties, and frauds.

[38] Refer to the Introduction of this report for a brief summary of the distinctive features of microfinance.

the client's identity and place of residence (bearing in mind that often alternative forms of identification, such as biometrics, may be used due to the lack of official identification documents or fixed addresses), accompanied by the data collected, analysed and produced by the loan officer. A clear regulatory definition of microcredit as distinguished from other loan types is necessary for adequate supervisory oversight of microcredit risk.

Principle 9 – Problem assets, provisions and reserves

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 9 should be tailored in banks and ODTIs engaged in microfinance to the unique risks of microlending compared to other loan types, particularly with respect to loan provisioning and classification requirements.

The regulatory framework should compel financial institutions to recognise the risk posed by past due microfinance loans quickly and accurately. The first step is a clear definition of microcredit as distinguished from other loan types, to allow a differentiated definition of non-performance. Although the supervisor should have enough flexibility to deal with unique situations, microcredits normally should be risk-classified and provisioned for based on the number of days of non-performance, missed payments and/or times rescheduled. Since microcredits are generally repaid in short, frequent intervals (sometimes even weekly), monitoring and reporting systems, provisioning and classification standards should be tailored accordingly. Rescheduled microloans typically should be classified in a higher risk category than other type of loans that are the same number of days or payments past due. The supervisor should also be able to assess the institution's policies and procedures to manage bad loan workout.

Principle 10 – Large exposure limits

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 10 should be tailored in banks and ODTIs engaged in microfinance to manage the risks in geographic or sector concentrations often observed in microloan portfolios.

Microfinance providers, especially those that are cooperatively owned, generally exist to serve a targeted community or entrepreneurial undertaking(s), making traditional limits regarding industry or geographic exposures impractical. Supervisors must take this aspect into consideration and not unduly penalise microfinance for focusing on specific geographic regions or economic activities. Instead, the focus should be on risk management processes, systems and supervisor review to reduce or mitigate the risk of such concentrations (See Core Principles Methodology Essential Criteria 3-5). The supervisor should also be able to identify systematic concentrations across different institutions.

Principle 11 – Exposures to related parties

In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place *requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.*

Principle 11 should be tailored to ODTIs engaged in microfinance. Where governance is weak, supervisors may enhance restrictions or prohibitions on related party transactions. Conversely, member-owned institutions that are very widely held may warrant flexible treatment for loans to non-management members.

Some ODTIs may be more likely to suffer from poor governance and insider abuse given their ownership structure and the characteristic decentralised microlending methodology. In addition, newly formed institutions may have similar problems due to inexperience and face fast growth usually observed in microfinance. Conservative restrictions on related party transactions are indicated for such institutions, along with efforts to improve governance and risk management processes and culture. At the same time, supervisors should be attentive to the impact of broadly defining "related party" when imposing limitations, as they may impair lending to members of widely held financial cooperatives who may not have close ties to the power structure of the institution.

Principle 12 – Country and transfer risks

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 12 applies equally to banks and ODTIs engaged in microfinance.

There are no issues specific to microfinance.

Principle 13 – Market risks

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 13 should be tailored to ODTIs engaged in microfinance with respect to their foreign currency borrowings.

Microfinance providers should be able to match currencies of funding and lending if they are allowed to take deposits in local currency. Some may rely on international commercial borrowings, usually in hard currency, but smaller entities do not usually have access to hedging instruments to mitigate currency risk. Thus, a challenge regarding market risk for ODTIs is to manage the currency mismatch between a portfolio of microloans in local currency and funding in foreign currency. Supervisors must be able to evaluate how effectively ODTIs manage market risk on an ongoing basis, including cross-border financing arrangements with international lenders.

In addition to requiring processes to measure, monitor and control foreign currency risk, regulators should restrict an institution's net open position by establishing limits in relation to capital and/or earnings impact in each currency and for all foreign currencies. ODTIs should also be required to conduct simple scenario analyses and contingency planning, according to the complexity of their operations and funding sources. During an ODTI's or a microfinance bank's start-up, where it may be very dependent on foreign currency funding until deposit taking reaches critical mass, some flexibility in the short-term could be provided under the condition that in the medium-term local currency funding is increased so as to comply with the established limits. Trading should be prohibited for ODTIs and also for banks specialized in microfinance lacking the necessary pool of expertise to manage risks in trading book .

Principle 14 – Liquidity risk

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 14 should be tailored in banks and ODTIs engaged in microfinance to take into account the unique features of microfinance assets and funding liabilities.

The specific dynamics of assets and liabilities in a microfinance institution make guidance on liquidity risk management different than for a comparably structured commercial bank, which should be incorporated into requirements for sound systems and processes to measure, monitor and control liquidity risk.[39] Regulations may impose a cushion in the form of a reserve or liquidity ratio requiring ODTIs to hold unencumbered liquid assets against a percentage of micro deposits and a limit on concentrations from a single funding source. Some flexibility may be given to microfinance institutions in their first years of operation as a regulated entity, provided that stricter supervisory monitoring is conducted.

Liquidity risk management should focus on maintaining adequate minimum liquidity cushion for business as usual, as well as for stress situations. ODTI liquidity plans also should include simple stress scenarios taking into account contagion effects that may manifest in a rapid deterioration of the loan portfolio or run on deposits due to localised problems. Where ODTIs are exposed to foreign exchange risk (CP 13) they should also undertake separate analysis for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in the aggregate and for each significant individual currency.

Principle 15 – Operational risk

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 15 requires a deep understanding of the distinctive risks and trends in microfinance operations – including outsourcing and decentralised and labour-intensive credit methodology – in order to adequately evaluate risk management and internal controls in banks and ODTIs engaged in microfinance. Supervisory tools and analyses may differ for ODTIs compared to those used for banks.

[39] See BCBS 2008 for an expanded discussion of general liquidity risk management and supervision and Brom 2009 for liquidity risk management in microfinance institutions.

Although a common general framework for risk management should apply to all supervised institutions, regulators and supervisors should identify practices and trends in microfinance that differ from conventional retail banking when designing and enforcing requirements for operational risk management. For example, the decentralised and labour-intensive lending methodology typical of microcredit, although crucial to contain microcredit risk, has significant implications for operational risk management and internal controls, in comparison with conventional retail banking.

An important trend in microfinance involves outsourcing activities[40] – such as collecting deposits and verifying customer identity – to retail establishments under agency agreements.[41] Agent banking also may be linked to the use of electronic and mobile phone banking delivery channels, in increasingly complex and far-reaching outsourcing arrangements. New delivery channels, by relying heavily on technology and third-party relationships can add extra layers of complexity in risk management therefore requiring tailored operational risk standards. These standards should be carefully crafted to avoid curbing innovative models while ensuring the safety and soundness of institutions and customer funds.[42] Aligning standards with industry trends requires supervisory personnel to develop a deep understanding of how new business models function and design specific tools and procedures to identify signs of increased operational risk in microfinance operations. [43]

Principle 16 – Interest rate risk in the banking book

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 16 should be tailored in banks and ODTIs engaged in microfinance to take into account the unique features of microfinance assets and funding liabilities.

Supervisors should ensure that ODTIs, and in particular microfinance institutions including banks, have in place systems to measure, monitor and control interest rate risk, taking into account the unique behaviour of microfinance assets and liabilities, compared to those of a diversified commercial bank.[44] Repricing assumptions for microloans and deposits should follow the same behavioural assumptions as for liquidity risk management (CP 14). Just as client expectations extend loan maturities longer than the contractual tenor would indicate, repricing opportunities may also not align with the maturity or reset date unless the lender offers truly variable rate loan products or loans that re-price at maturity due to a change in funding costs. However, it is less common for a microlender to pass on changes in its cost of funds to clients in the short term than a bank, so such lags need to be accounted for. If funding is in foreign currency the institution should construct its gap analysis by currency as well, to account for variations in interest rate changes for different currencies.

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[40] The Basel Committee defines outsourcing as "a regulated entity's use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the regulated entity, now or in the future." (BCBS 2005)

[41] See Range of Practice, 3, C.

[42] See BCBS 2001, 2003, and 2005, and Lyman et al 2008.

[43] Refer to CP 18 for related discussion of customer due diligence in outsourced activities.

[44] Guidance for this section draws primarily from Brom 2009 due to limited coverage in the survey.

While sophisticated tools to measure interest rate risk are increasingly available, measurement requirements for ODTIs should be in line with their information systems and general experience level, as well as the relative sophistication of its products and risk posed by their activities. ODTIs and other microfinance providers tend to offer a handful of fairly simple products, so sophisticated modelling is not necessary in most situations.

Principle 17 – Internal control and audit

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 17 should be tailored in banks and ODTIs engaged in microfinance to take into account that microlending methodologies may require different organisational arrangements and controls from those of conventional retail banking. Supervisory tools and analyses may differ for ODTIs from those used for banks.

Strong internal controls and audit procedures are crucial for microcredit portfolio performance and the overall financial health of microfinance institutions. The most important issue involves certain features of microlending, such as decentralised lending procedures.[45] These characteristics increase the need for a well-designed loan administration process and sound compensation schemes for loan officers, as well as an efficient information system that is adequate to the complexity of the institution. Loan and client documentation requirements should be flexible enough to accommodate otherwise sound practices that differ from conventional retail lending. Other emerging practices in microfinance, such as the use agent banking to make available payment and other money transfer services, microsavings and microinsurance and to facilitate disbursement and repayment of microcredit, may also call for organisational structure and internal controls that differ from conventional retail banking.

Granting greater flexibility for institutions to define controls that fit microfinance operations may be offset by requesting greater detail in the regular reports to the supervisor, especially with regard to controls in place for managing the health of the microloan portfolio. In addition, the supervisor should make sure the control environment is sufficient to ensure compensation schemes and training policies for loan officers discourage excessive risk taking and deterioration in governance, and that internal audit function has specialised expertise and tools to detect weaknesses in the lending methodology and compensation policies, as well as to identify and reduce frauds.[46]

Principle 18 – Abuse of financial services

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional

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[45] Refer to the Introduction for details.

[46] See BCBS 2006b.

standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 18 should be tailored to the risks posed by low-value or low-risk microfinance operations undertaken by banks and ODTIs, particularly low-value savings products.

The FATF[47] allows countries and institutions to follow a risk-based approach that focuses their attention and resources on people and activities posing a high risk of money laundering and financing of terrorism (ML/FT), while ensuring that reduced and simplified controls are sufficient to safeguard low-risk activities, such as low-value savings products, from abuse.[48] A risk-based approach better aligns crime prevention concerns, financial inclusion objectives, the rational use of supervisory resources, and the specificities of the microfinance business and clients. It also gives scope to the potential complementarity of financial inclusion and law enforcement goals, by contributing to a reduction in informality. Microfinance, given its unique cost structure,[49] the distinctive clientele, and the prevailing product features, requires such a risk-based approach.[50]

The FATF recommendations allow flexibility, especially with respect to small transactions and accounts that pose limited risk. For example, they do not require institutions to request and verify a customer's address, although this is common practice in developed countries and is required by some developing countries.[51] Within the low risk context, countries may decide what measures are appropriate. Where microfinance clients lack proof of identity, income or residence, or are geographically isolated, it may be inappropriate to impose customer due diligence measures that require formal documentary proof.[52] A risk-based approach also implies that any policies, processes and internal controls that institutions are required to adopt to detect criminal activity should be commensurate with the risk of their criminal abuse for ML/FT and should reflect their size, complexity and capacity.

The use of technology, such as mobile phone banking, as a means to increase access to low-income and hard-to-reach customers, poses some specific risks of abuse. However, appropriate product restrictions and the use of the information system to monitor clients and transactions can ensure that the risk remains low.[53]

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47 The Financial Action Task Force (FATF) is an inter-governmental body whose purposes include the development and promotion of national and international policies to combat money laundering and terrorist financing and to bring about legislative and regulatory reforms in these areas. The FATF has published Recommendations in order to meet this objective. www.fatf-gafi.org

48 FATF 2007

49 Isern and de Koker 2009 discuss the linkage between the cost of disproportional AML/CFT controls and the attractiveness of microfinance activities.

50 Given that microfinance is particularly present in what the FATF has described as "low capacity countries", additional guidance may be sought in the FATF's "Guidance on Capacity Building for Mutual Evaluations and Implementation of the FATF Standards within Low Capacity Countries', February 2008.

51 Isern and de Koker 2009

52 Likewise, several surveyed countries permit financial institutions employ agents to undertake elements of their customer due diligence measures in order to facilitate geographic penetration of financial services. See Range of Practice Survey, 3, E.

53 Chatain et al 2008

Principle 19 – Supervisory approach

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 19 requires specialised knowledge and supervisory methodologies for both banks and ODTIs engaged in microfinance. Cost and feasibility considerations may allow for alternative supervisory arrangements to cover numerous small institutions that pose low systemic risk, without undermining the supervisor's ability to gather information and monitor different markets.

Where financial cooperatives are large or do business (lending and deposit taking) with non-members, the case for prudential regulation and supervision is most compelling.[54] Authorities may determine that ODTIs that do not hold a significant proportion of public deposits or offer a narrow scope of products to a limited customer base may be licensed, regulated and supervised in a tailored manner consistent with their specific risks and circumstances and the regulatory practice and tradition of their jurisdiction. This is especially true for small financial cooperatives that lend members' share deposits and savings to other members only, as the cost of supervision may outweigh the benefits. [55]

The capacity and cost-effectiveness of supervisory structures and processes are key considerations when new regulations are being drafted for the microfinance sector, particularly when they create new institutional types with different entry requirements, such as a tiered framework. If not enough attention is given to the costs of overseeing a large number of small institutions and the expertise that is necessary to examine them, the supervisor runs the risk of not being able to effectively enforce its regulations, increasing its reputational risk.

Microfinance introduces risks that may be unfamiliar to prudential supervisors whose previous experience is with conventional retail banking. To ensure that microfinance activities are conducted safely and by sound institutions, a knowledgeable team of supervisors is needed with deep understanding of the business of microfinance and microfinance institutions and their distinctive risks and dynamics. The team must be able to develop customised supervisory tools and procedures, as some of those applied for conventional retail banking may not be as effective. Depending on the regulatory framework, supervisors must be able to evaluate microfinance risks in both specialised microfinance institutions and diversified commercial banks.

Lack of expertise as well as supervisory capacity – which is pronounced in low-income and many middle-income countries – may lead supervisors to experiment with alternative approaches, especially in the cooperative sector. For example, supervisors may assign a prudentially regulated and supervised apex entity oversight responsibility for smaller institutions; delegate its supervisory function to another government agency or independent auditors; or exempt entirely some entities or markets from supervision and regulation. Delegated supervision is not without risks.[56] Agencies other than the prudential supervisor

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[54] However, sometimes even in small member-only cooperatives members may be in no better position to supervise management than a large bank's depositors would be.

[55] This is particularly advisable in situations where business practices adopted by very small unregulated institutions do not harm members.

[56] Delegated/auxiliary supervision is a form of indirect supervision with roots dating to 18^{th} century Europe, used primarily for financial cooperatives. In this regime an agent (the delegated or auxiliary supervisor) performs

may lack adequate resources and expertise, operational independence and remedial powers to fulfil their responsibilities. This is especially true for external auditors, who should not in any case have supervisory responsibility in lieu of prudential supervisors. In fact, there are very few successful examples of delegated or auxiliary supervision. Also, while the supervisor may avoid individual monitoring of many small entities, it could incur considerable costs to implement, evaluate and improve the auxiliary supervisory model.

Principle 20 – Supervisory techniques

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 20 requires specialised knowledge and supervisory methodologies for both banks and ODTIs engaged in microfinance.

Supervisors must be trained and have comprehensive knowledge of the differences between microfinance and conventional retail banking, and the particular risk profiles of microfinance institutions to set up and consistently apply an appropriate mix of on-site and off-site supervision tools to evaluate the condition of the institutions engaged in microfinance, and to establish measures to address identified weaknesses. Supervisors must have the authority to conduct on-site inspections and develop a supervision policy that effectively integrates off-site and on-site functions.

Given the characteristics of microfinance and the dynamics of assets and liabilities in a microfinance institution, some techniques used to supervise conventional retail banking activities are not appropriate. This is particularly true for analysis of microcredit portfolio quality, ownership and funding structures, which may pose different risks from those in conventional retail banking, as discussed above in the respective Principles.

Principle 21 – Supervisory reporting

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 21 should be tailored to ODTIs engaged in microfinance in a manner that is commensurate with the type and size of their transactions, which may differ from banks.

The effectiveness, timeliness, quality and costs of off-site surveillance and on-site inspections will depend on the standard reporting mechanisms in place to collect, review and analyse financial health indicators, prudential indexes and statistical returns from institutions engaged in microfinance. The content of reports and their frequency must be strictly aligned to the specialised analyses that are needed for effective supervision. For example, where

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tasks associated with the supervisory function on behalf of the supervisory authority (the principal supervisor). The agent usually is a body set up by the network of cooperatives, but could be any other independent party like an auditing firm or a rating agency. Some make a distinction between delegated and auxiliary supervision: in the former case, in addition to surveillance and reporting activities, the delegated supervisor may enforce corrective actions, or, rarely, intervention and liquidation orders. (Cuevas and Fischer 2006) weekly monitoring of loan portfolio delinquencies is indicated, reliable reports should be available for managerial, supervisory and auditor review as needed.

To avoid imposing unduly burdensome reporting on microfinance activities, supervisors should identify the key risk indicators that need to be monitored and comprise standardised reports, which must minimally allow the supervisor to assess portfolio quality; leverage; prudential ratios; operating costs; funding structure and liquidity position; foreign exchange exposures; and interest rate repricing gaps. Supervisors should require institutions engaging in microfinance to participate in credit bureau systems where relevant data for microfinance borrowers is available, which is not a reality in all jurisdictions. The supervisor must have the ability to compare key indicators against performance benchmarks in the peer group. Reports of internal and external auditors must also be available to collect information about microfinance activities in supervised institutions.

Principle 22 – Accounting and disclosure

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 22 should be tailored so that disclosure requirements for small ODTIs engaged in microfinance are based on supervisory cost-benefit considerations.

Supervised institutions must be able to properly record and disclose their microfinance operations in a transparent and standardised format for the benefit of all stakeholders. Since the health of a microcredit portfolio is reflected in arrears, it is important that the management information system (MIS) produces, at a minimum, reliable and timely data on delinquency, restructured loans, and write-offs. The supervisor must also ensure that accounting practices and MIS allow for the timely creation of loan reserves. The application of the same standards for accounting and disclosure for banks and ODTIs is desirable, regardless of being local or international standards.

To fulfil their responsibilities, external auditors must have sufficient expertise in microfinance. There should be a mechanism in place for rejecting or rescinding the appointment of an auditor that has inadequate expertise or independence, either by the banking supervisor or another authority. Supervisors and accounting standard setting bodies should cooperate where possible to ensure accounting rules and principles are aligned with safety and soundness objectives in microfinance, although allowing for some discretion to whether apply international financial reporting standards to microfinance activities, in particular to specialized microfinance institutions..

Principle 23 – Corrective and remedial powers of supervisors

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

Principle 23 requires specialised tools to deal with weaknesses in banks and ODTIs engaged in microfinance, as some corrective measures typically used in commercial or conventional retail banking will be less effective or inadequate for microfinance institutions or activities.

The supervisor should have powers, policies and procedures to address supervisory concerns in a variety of situations, including the orderly resolution of problem ODTIs, application of fines, and revocation of licenses when ODTIs engage in unsafe or unsound practices, or do not otherwise observe prudential standards. All supervised ODTIs should be subject to the same disciplinary regime existing for banks, and adequate tools to require corrective action should be available. However, some tools used by banking supervisors to achieve remedial action may not be as effective in microfinance. For example, restricting lending activity (stop-lending orders) can have negative consequences for the quality of the existing microloan portfolio, because the promise of follow-on loans to current microborrowers may be a strong incentive for loan repayment. Moreover, some types of microfinance-focused entities, particularly financial cooperatives, may justify special corrective tools.[57]

Principle 24 – Consolidated supervision

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 24 applies equally to banks and ODTIs engaged in microfinance.

ODTIs tend to be stand-alone entities, and substantially smaller than banks in terms of assets and deposits. If ODTIs do become part of financial groups, supervisors must be able to evaluate the risks posed by financial and non-financial activities on the group in the same manner as they do for banks.

Principle 25 – Home-host relationships

Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Principle 25 applies equally to banks and ODTIs engaged in microfinance.

While still relatively uncommon in microfinance, cross-border operations should require information exchange and coordination between home and host supervisory authorities, through formal and informal arrangements. Information sharing and communication may be challenged by the presence of authorities other than banking supervisors, and unequal familiarity with microfinance risks between home and host countries.

[57] For example, a country in the sample of the Range of Practice survey restricts new memberships in financial cooperatives during the implementation of a correction/restoration plan.

PART II - Range of practice in microfinance supervision and regulation[58]

Survey methodology and terminology

(i) Scope of the survey

The Microfinance Workstream distributed a survey in early 2009 to (a) collect information on current practices in regulation and supervision of microfinance conducted by different types of financial institutions and (b) frame the discussion about how and to what extent the Core Principles apply to microfinance supervision and regulation. The survey targeted fifty-two supervisory authorities, covering members of the Basel Committee[59] and non-members where substantial depository microfinance activities take place (although not all significant markets responded). Twenty-seven authorities responded to the survey: fourteen Committee members, and thirteen non-members. This represents thirty-two countries[60] (nine high-income, fourteen middle-income and nine low-income countries).[61] Regional distribution of authorities which responded includes Latin America/Caribbean (8), Asia (3), Africa (6), Eastern Europe/Central Asia (2), and developed/industrialised nations (8).

The survey focused primarily on credit risk, capital and operational risks as well as supervisory capacity and techniques. It did not intend to cover all aspects of microfinance oversight, only issues that are in the remit of banking supervisors. Consequently, some common issues – such as interest rate ceilings, tax treatment, or subsidies to microfinance institutions and activities - were outside the scope of the project.

The focus of the survey was on institutions that accept deposits from the public, although responses also provided comparative information about the regulatory and supervisory framework applicable to non depository microcredit institutions. This includes banks, and non-bank financial institutions envisaged by footnote 6 of the revised Core Principles, which states: "In countries where non-bank financial institutions provide deposit and lending services similar to those of banks, many of the Principles set out in this document would also be appropriate to such non-bank financial institutions. However it is also acknowledged that some of these categories of institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system". Footnote 11 of the Core Principles Methodology further specifies: "These institutions should be subject to a form of regulation commensurate to the type and size of their transactions".

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[58] The number of responses to each question in the survey varied, so from time to time the Range of Practice may compare the frequency of responses to some denominator other than 27 (the total number of authorities responding to the questionnaire) . Although survey responses are confidential, country names are noted in the report where the data cited is publicly available or the respondent agreed to be named.

[59] At the time the survey was conducted, the Basel Committee's membership consisted of 13 countries, namely Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Membership was expanded during the course of 2009 and references in this paper to Basel Committee "members" and "non-members" refer to these 13 original member countries.

[60] The difference between total respondents and total countries is due to the fact that member-countries of the Economic and Monetary Community of Central Africa – CEMAC (Cameroon, Central African Republic, Chad, Congo ROC, Equatorial Guinea, and Gabon) were represented in this survey by the Central Bank of Central African Countries – BEAC. We use the terms "country" and "jurisdiction" throughout the report to include responses provided by BEAC, as CEMAC members adopt the same rules, unless otherwise stated. We also classify CEMAC in this report as a low/middle income "jurisdiction", although its individual countries have various income levels, including one high-income country.

[61] Where the report presents information by income level of respondents, the categories align with World Bank classifications of high-income, middle-income (upper-middle income and lower-middle income), and low-income countries). Refer to Annex I for a list of participating countries and their income levels.

The survey questionnaire was organised in three sections:

1. Background information: this section gathered facts and figures relevant to each country's broader context, such as the proportion of deposits held by non-bank deposit taking institutions, existence of policies aimed at promoting financial inclusion, number of non-bank deposit taking institutions and official definitions of microfinance and microcredit.

2. Regulation of microfinance activities: this section focused on differences in each country's laws and regulations between microfinance activities and conventional retail or small and medium enterprise (SME) banking. Questions covered permissible activities; licensing criteria; capital adequacy; risk management processes; internal control and audit; credit risk, problem assets, provisions and reserves; exposure to related parties; liquidity risk; operational risk; and abuse of financial services.

3. Supervision of microfinance activities: the aim of this section was to understand the differences in the supervisory framework for the various categories of institutions involved in microfinance, with a focus on deposit taking institutions other than banks. It covered supervisory authority, exceptions to supervisory coverage, delegation of supervisory powers, capacity and specialisation, supervisory techniques and tools, remedial powers, and accounting and disclosure requirements.

To facilitate the comparison of regulatory and supervisory practices across different institutional types, countries and regions, the survey defined three groups of institutions:

1. Banks: institutions licensed for taking deposits from the general public and subject to supervision in the meaning of the Core Principles.

2. Other deposit taking institutions (ODTIs): institutions that are authorised to collect deposits without necessarily being subject to the same regulation and supervision as banks. This may include institutions such as financial cooperatives that are regulated differently from banks,[62] postal banks, microfinance banks and others. Although member contributions into a financial cooperative are considered as deposits for the purposes of this report, occasionally a jurisdiction, at the discretion of its national legislation, may exclude such funds from the legal definition of "deposits".

3. Microcredit institutions (MCIs): institutions that lend for limited amounts, without being authorised to collect deposits. The questionnaire gathered data on credit-only institutions primarily for the purpose of illustrating differences in regulatory and supervisory treatment between deposit taking (banks and ODTIs) and non-depository microfinance institutions.

[62] The term "financial cooperatives" includes a diverse group of member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks, or other terms that differ across regions of the world. (Cuevas and Fischer 2006) Financial cooperatives that are supervised in substantially the same way as banks were included in the "Bank" category by some survey respondents.

(ii) Conceptual issues

Definition of microfinance

As there is no internationally accepted definition of "microfinance", to facilitate cross-country analysis the questionnaire defined microfinance as the provision of financial services in limited amounts to lower income households and small, informal businesses, whether there is a formal regulatory definition of microfinance in a given jurisdiction or not. Microfinance is thus broadly viewed as a business line that can be carried out by a wide range of institutions providing a range of financial services, such as lending, deposit taking, insurance, payments and funds transfers.

Other relevant terminology

"Non-banks" is used to refer to any institution that is not a "bank" as defined above, including ODTIs and MCIs. Non-banks may include "specialised microfinance institutions", used in this document to refer to any institution that focuses on microfinance activities. The terms "microlending institution" and "microcredit institution" are used to refer to MCIs as defined above.

The term "non-prudential" is used to denote regulation and supervision that does not have the ultimate aim of protecting the stability of the financial system or retail depositor funds. These rules and processes would cover, for example, registration, consumer protection, fraud and financial crimes prevention, credit information services, interest rate policies, and tax issues.[63]

(iii) Limitations

While the survey attempted to incorporate responses from as many countries with significant microfinance activity as possible, some major countries were not able to participate and some regions rendered a higher response rate than others. Likewise, the secondary research, which included reviewing the current literature and publically available information, did not attempt to produce a complete picture of non-participating countries. As such, the Range of Practice presented in this report should not be considered exhaustive or globally representative. It should also not be considered a summary of best practices.

1. Permissible activities and licensing

A. Regulatory approaches to defining microfinance

The term "microfinance" is often used to refer to the provision of a variety of financial services to low-income persons and small, informal businesses, although there is no globally accepted regulatory definition for such activity. Fifty-nine percent of the surveyed countries reported having some sort of definition related to microfinance in their financial laws or regulations. Most also have definitions of "microcredit". Some, but not all, of the survey countries define microcredit for the purpose of classifying loan portfolios, setting provisions, and otherwise differentiating rules applicable to regulation and supervision of microcredit portfolios from those applicable to conventional retail portfolios of banks. Thus some respondent countries include specific parameters, such as the maximum loan size, maximum income or assets of the borrower, and source of funds to be used to repay the loan. For

[63] Microfinance Regulation and Supervision Resource Center http://www.microfinanceregulationcenter.org/resource_centers/reg_sup/basics#2

example, one Latin American respondent defines microcredit as “credits that are [re]paid from funds originated by commercial, industrial, or rural activities, or services (…) as well as credits to small entrepreneurs, natural or legal persons who own microenterprises, or to groups of natural persons.” Other countries in the sample focus on loan size, as did this African respondent: “A microfinance loan means a credit facility granted to an individual single end user whose maximum amount should not exceed 2% of the institution’s core capital.” A Central Asian country defines microcredit as “monetary funds provided by microfinance organisations (…) to natural persons, or societies or legal entities”.

The surveyed countries’ regulatory definitions of microcredit serve various other purposes, such as imposing compulsory investments in microcredit by banks[64]; allocating public funds to certain activities,[65] or defining interest rate limits.

Fewer countries in the sample define the business of microfinance. Definitions usually characterise specialised microfinance institutions and distinct regulatory frameworks. A Southern African country defines microfinance as “The business of providing financial services essentially through very small or medium transactions.” In a Central African country, microfinance is “An activity that consists of at least one of the following: a) extending credit, b) collecting savings, or c) extending credit and collecting savings, from a clientele not commonly served by the banking system.”

Some countries define the term "microfinance institution" to refer to NGOs or other entities engaged only in the delivery of microcredit, or require a minimum level of microfinance activity from a specialised microfinance entity. For instance, an African banking regulator requires that microloans represent at least 70% of the loan portfolio of deposit taking microfinance institutions.

In addition, the majority of respondent countries – including high-income jurisdictions – have explicit policies to facilitate the ability of persons to access financial services. Such policies include guaranteeing the right of access to bank accounts;[66] regulating prices, allowing the use of retail agents by banks, simplifying customer due diligence for low value accounts;[67] permitting the use of itinerant branches or servicing points, lowering capital requirements in low access or underdeveloped regions, providing loans through government programs, or giving tax incentives. Out of five respondents that do not have explicit financial access

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[64] For instance, in Brazil commercial banks are required to invest 2% of their demand deposits in microcredit. For this purpose, microcredit is defined as loans that: a) target low-income natural persons, natural persons which own simplified bank accounts up to a certain balance or small- and micro-entrepreneurs; b) have interest rates up to 2% per month (or 4%, if directed to working capital loans) and c) have upper limits on their value and maturity.

[65] In high-income countries, these concepts were specifically defined within government programs for the promotion of credit to micro-entrepreneurs, rather than being set in financial laws or regulations. For example, the Official Credit Institute (ICO) in Spain is a government financial agency attached to the Ministry of Economy and Finance that grants loans to those who do not normally have access to financing channels. In South Korea a government program (Microfinance Foundation) uses funds from dormant deposits to conduct “welfare businesses”, which are, in essence, microfinance businesses.

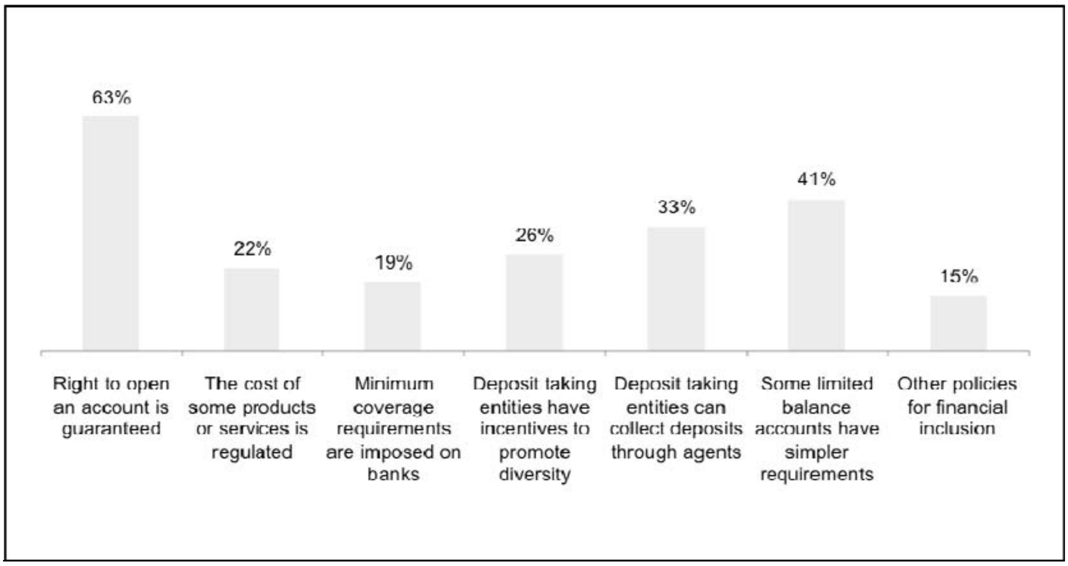
[66] In France, for instance, if a bank refuses to open an account for a person, it is required to inform him/her that Banque de France will guarantee access to “basic banking services” in another bank. This feature is called “droit du compte”. Such procedure gives access to the "service bancaire de base" which is a free package for basic transactions.

[67] Accounts with lighter customer due diligence are becoming more common in developing/emerging countries as a measure to promote financial inclusion. One much commented case is that of Mzansi accounts in South Africa. See Bankable Frontier Associates 2009.

policies in place, four are high-income countries that very likely have high levels of financial access already.

Chart 1

Respondents with explicit policies to promote ability to open bank accounts (out of 27 respondents)



B. Types of institutions and permissible activities

The survey revealed that a variety of institutional types engage in microfinance activities. Many of these institutional types are overseen by banking supervisors. In line with their different activities on both sides of the balance sheet, these entities garner different licensing and prudential standards – or may have no oversight at all.

Deposit taking financial institutions that are licensed and supervised are required to be chartered as corporations or financial cooperatives in the large majority of cases in the surveyed countries. One respondent licenses and supervises non-profit organisations as well, allowing them to mobilise deposits.[68] Regulation and supervision mainly falls along institutional versus functional lines; that is, very few of the surveyed countries regulate and supervise microfinance as an activity regardless of institutional type.

Banks

"Banks" include the traditional definition of commercial banks and similar institutions (eg savings banks).[69] Generally speaking, the extent of banks' engagement in microfinance activities varies considerably within and across countries. Commercial banks have been increasingly participating in microlending in particular, which may reflect enhanced

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[68] In three high-income countries, NGOs receiving government funds for microcredit are scrutinised by government agencies and may be asked to hold a minimum amount of capital, but are not subject to prudential standards.

[69] Some high-income countries and two middle-income countries classified cooperatives and microfinance banks under the "banks" category, as their prudential regime is largely identical to banks. Important differences between these regimes are highlighted in this report, whenever applicable.

competition, social responsibility concerns, government suasion, or a combination. In some countries, it may simply reflect the fact that the bulk of the retail market is low-income.

Other deposit taking institutions – ODTIs

Other institutions besides banks take deposits from the public in virtually all countries. Nineteen respondents[70] reported 58,622 ODTIs, with three of them having particularly high numbers: Indonesia (44,539), Kenya (5,124), and the Philippines (6,000). In the remaining countries, there is an average of 197 ODTIs per jurisdiction. The two high-income countries that provided data on ODTIs (South Korea and Australia[71]) account for only 236 ODTIs combined.

The limited data available were consistent with current assumptions that ODTIs do not hold a significant proportion of total deposits in the financial system in most countries, although exceptions exist, such as Rwanda (10%), Indonesia (10%) and Peru (6%). The relative importance of microfinance may be greater on the lending side. In Nicaragua, the microfinance sector – which is only partially regulated – serves 53% of all borrowers in the financial system.[72]

In most countries where specialised deposit taking microfinance institutions exist they are prudentially regulated and supervised.[73] There is a rich diversity of ODTIs and regulatory frameworks:

Cooperatives

Most countries used the “ODTI” category to report on their cooperative sectors (variously known as credit cooperatives, cooperative banks, building societies, mutual savings and loans associations, etc). Cooperatives that do business with non-members are usually prudentially regulated and supervised, as are cooperatives that lend to and take deposits only from their members (member-only) in high-income countries, regardless of their size. In low- and middle-income countries the regulatory and supervisory regime for member-only cooperatives varies, but tends to fall under a non-prudential regulator. In one country in the sample – Russia – though the law provides for prudential regulation of financial cooperatives, member contributions are not considered as deposits according to the law; therefore cooperatives are not considered as deposit-taking entities.

Specialised deposit taking microfinance institutions

In addition to cooperatives, the category ODTI includes specialised microfinance entities that exist in many jurisdictions (none high-income). In nearly half of the respondent countries the legal and regulatory framework has a specific window for deposit taking institutions other than banks and cooperatives. These institutions offer limited services such as small loans, and low-balance savings and current accounts to low-income individuals and small- or micro-

70 Not all countries provided detailed data on ODTIs. In general, the survey responses did not provide enough information to draw conclusions with regard to the size and amount of deposits held by ODTIs. There are also fewer secondary sources for information on ODTIs than for the banking sector in participating countries.

71 Data on the number of ODTIs in Australia was gathered from the Australian Prudential Regulation Authority website (www.apra.gov.au) and used in combination with data provided for the survey.

72 Vega 2005.

73 An interesting case exists in Indonesia, where 80% of the population of the province of Bali is served by non-prudentially regulated deposit-taking microfinance institutions (BWTP 2009).

businesses.[74] The range of permitted activities varies across countries, but generally they have a more limited scope than commercial banks. Also, they are not commonly subject to geographic limitations that may apply to financial cooperatives in some jurisdictions.

To illustrate how these entities may be defined, a microfinance bank in a South Asian country is defined as a “deposit taking institution regulated separate from commercial banks with different standards for licensing and supervision, whose principal business is to provide microfinancing and related banking services to the poor and underserved segment of the society”. In this country, at least 80% of the total portfolio of microfinance banks must consist of loans that do not exceed US$1,800.

In some instances, tiered regulatory frameworks have been created to facilitate previously unregulated microfinance providers such as NGOs to become regulated participants in the formal financial sector. For example, one Latin American country has different regulatory windows for specialised microfinance entities according to their legal status and type of ownership, including cooperatives. These windows allow for gradual expansion of permitted activities, including deposit taking for more mature institutions.

Microcredit Institutions - MCIs[75]

The category “MCIs” represents credit-only microfinance entities specialised in offering loans to low-income individuals and small- or microenterprises and are not allowed to collect deposits.[76] These entities are subject to a wide variation of oversight, ranging from simple registration to prudential supervision. They assume a variety of commercial (eg limited liability or joint stock companies) and non-profit (eg associations, foundations) forms.

C. Licensing criteria and procedures

Licensing procedures

The majority of countries responding to the survey subject at least some of their ODTIs to licensing procedures with a banking authority or the central bank, which can reject the request on the basis of unfulfilled criteria or missing information. In most cases the authority granting the license is also in charge of supervision.[77] Financial cooperatives that do business only with members tend to be licensed or registered by a government agency other than the banking authority or central bank, such as the ministry of finance, labour or cooperatives, and are not normally prudentially supervised.

Fewer countries impose a licensing or authorisation requirement on MCIs. In some, the license is given by a public agency or authority other than the banking authority, central bank or finance ministry, and in two there are no minimum licensing criteria, only simple registration.

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[74] Some middle-income countries are currently considering regulatory reforms to increase the scope of their specialised microfinance deposit taking entities.

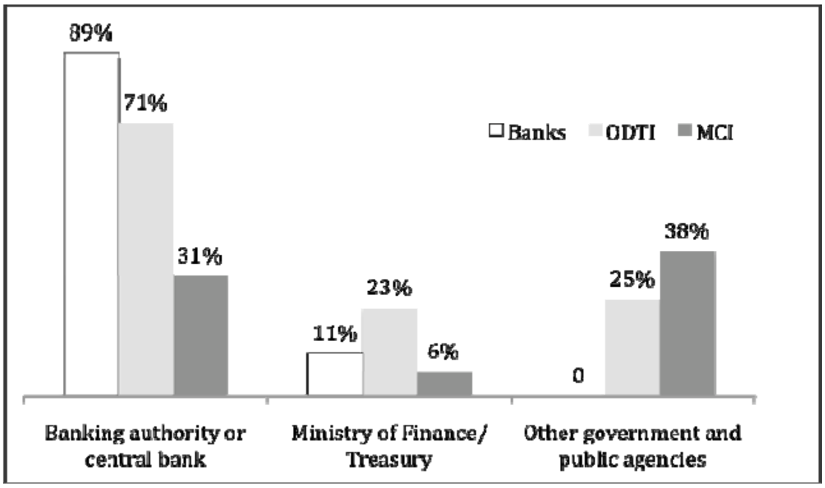
[75] Surveyed countries also referenced a host of other unlicensed or unregulated credit-only providers not captured by these survey categories, such as informal moneylenders or pawnbrokers.

[76] In many countries the regulations also make clear distinction between consumer credit and microcredit, subjecting them to different prudential rules. Some flexibility is emerging in this regard. For instance, a draft law in France intends to allow MCIs to offer consumer loans.

[77] In the two high-income countries where the supervisor is not the licensing authority for ODTIs, the two agencies have a formal mechanism to exchange information.

Chart 2

Which authority delivers the license/authorisation?
(% of respondents - multiple responses possible)



Licensing criteria

Most licensing authorities in the surveyed countries set clear requirements by which the application is evaluated. Licensing criteria are set in the financial laws or regulations in most countries, for most institutional types. These criteria include initial capital; background checks and professional experience of management; identity, suitability and financial strength of major shareholders; assessment of business plan; and legal, managerial, operational and ownership structure.

<u>Minimum initial capital</u>

All countries surveyed require minimum initial capital for banks. All but one require minimum capital for ODTIs that are not cooperatively owned. Cooperatives that are subject to prudential regulation – and some that are not – must also comply with initial capital standards. Less than a third of the surveyed countries require minimum capital for MCIs.

The great variety of minimum capital standards and country contexts make cross-country comparison impractical. However, it is worth pointing out some parameters used by the sampled countries to determine minimum requirements. In low- and middle-income countries, minimum capital levels within the same institutional category (including banks) may depend on the location of the institution. For instance, minimum capital for rural banks in Indonesia ranges from US$50,000 to US$504,000 according to distance from Jakarta and provincial capitals of Java and Bali. In Argentina, initial capital for financial cooperatives is related to the number of branches and the location of the cooperative. With the exception of South Korea, none of the criteria based on location is found in high-income countries.

ODTIs that are not cooperatives are required to have minimum capital that is roughly half to one-third of that imposed on commercial banks in the surveyed countries. For example, in Mexico, the *sociedades financieras populares* (a type of ODTI) with at least US$7.5 million in capital operate in a manner similar to banks, while the lowest minimum capital requirement for Mexican commercial banks is US$11 million.

In the cooperative sector, minimum capital varies mainly due to size (eg assets, deposits) and location, and in all countries it is many times lower than for banks. In Brazil, higher minimum capital applies to cooperatives that are not affiliated with a federation (which is directly overseen by the banking supervisor), than to those that have such affiliation. The

Australian supervisor sets the minimum capital for cooperatives and banks on a case-by-case basis.[78]

Some countries have tiered approaches to capital and other requirements. In Brazil, institutions at each level of the cooperative system are subject to different standards (eg federations of cooperatives must have a higher minimum capital, but lower capital adequacy ratio). Tiered licensing frameworks sometimes give flexibility to the supervisor to decide what type of license to grant (eg regional v. countrywide operations) based on the applicant's: i) capital structure; ii) corporate governance; iii) information technology systems; iv) target clientele; and vi) feasibility study.

Table 1

Minimum capital imposed on banks and other depository entities in selected countries
(approximate USD values)

Country	Banks	Cooperatives	Non-cooperative ODTIs
Brazil Upper-middle income, BCBS member	$7,400,000	Federations of Credit Unions: $25,674 Federated Credit Unions: $1,284 Cooperatives of Micro-entrepreneurs: $4,279 Open bond credit cooperatives: $8,558 Non-Federated Credit Cooperatives: $1,840	No specific regulation
Honduras Lower-middle income	$15,870,000	$3,700,000	NGOs (Organizaciones Privadas de Desarrollo Financiero): $58,000
Indonesia Lower-middle income, BCBS member	Rural Banks: $50,403 - $504,032	No minimum capital apply	No minimum capital apply
Italy High income, BCBS member	$9,000,000	Mutual Banks: $3,000,000	No specific regulation
Peru High-middle income	$7,601,883	Caja Municipal de Ahorro y Credito: $345,584 Caja Municipal de Credito Popular: $2,038,635 Caja Rural de Ahorro y Credito: $345,584	Entidad de Desarrollo a la Pequena y Micro Empresa: $345,584 - $3,822,834
Kenya	$3,100,000 (being increased to $13,106 by 2012)	No specific regulation	From $300,000 to $800,000

Other criteria

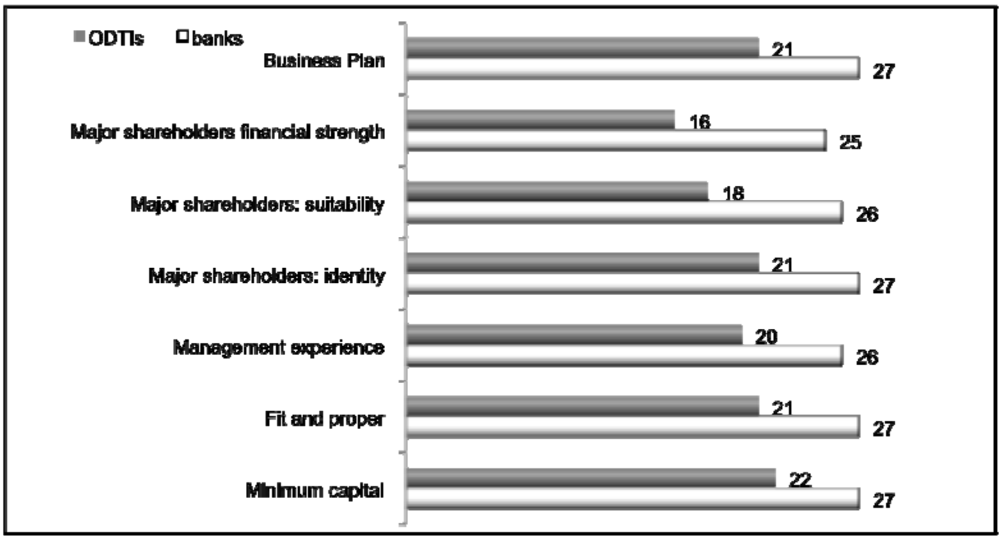
Fit and proper requirements apply in most jurisdictions for both banks and ODTIs, including all that have specialised deposit taking microfinance institutions. Banks' and ODTIs' managers must demonstrate absence of previous criminal conviction and professional experience in nearly all countries surveyed. The majority of surveyed countries also require information on the identity and suitability of major shareholders from banks and ODTIs.[79] Most jurisdictions where ODTIs are supervised ask for a business plan during the licensing process, while banks need to present a complete business plan in all countries. Fewer countries require these items from MCIs.

[78] Australian Prudential Regulation Authority (www.apra.gov.au/adi/ADI-authorisation-applications.cfm).

[79] A few supervisors in the sample noted that ownership structure and corporate governance are two of the most relevant aspects to be analysed during the licensing process of cooperatives and microfinance institutions.

Chart 3

Number of respondent countries that set criteria to obtain a license/authorisation or register



Only a few countries (all middle- and low-income) reported applying explicit exemptions to licensing requirements for non-bank institutions under a certain size, or with limited scope of operations. However, many respondents reported being less strict when analysing applications for smaller non-bank institutions with regard to the completeness and sophistication of the business plan and the evaluation of management. At least three countries have explicit exemptions for small cooperatives, leaving them outside the supervisory purview while larger ones are fully regulated. In Chile, the exemption applies to member-only cooperatives with capital under US$14 million and in Mexico it applies to member-only cooperatives with assets lower than US$1.9 million. In South Africa, a cooperative bank with deposits greater than approximately US$2.6 million is supervised by the banking supervisor; those with deposits between US$100,000 and US$2.6 million are subject to delegated supervision, and smaller institutions are exempt.

D. Participation in deposit insurance schemes

ODTIs are permitted to participate in deposit insurance schemes in 13 of 23 jurisdictions which responded to this question. Eight of those countries provide the same coverage as banks, while the other five offer different coverage. Two low- and middle-income countries are currently developing a deposit insurance system for ODTIs. In one country, an insurance scheme exists specifically for non-banks (including cooperatives) that requires faster reimbursement of funds than the bank deposit insurance scheme. In another example, second tier cooperatives (that is, cooperatives of cooperatives) are required to set aside funds to guarantee deposits of their members; each cooperative system’s coverage is different.

2. Arrangements for ongoing supervision and supervisory tools

A. Objectives and powers of supervisors

According to the survey, there is a fair level of clarity and transparency concerning responsibilities and objectives of different supervisors charged with microfinance supervision. However, when carrying out their responsibilities, agencies involved in the supervisory process other than the banking supervisor may lack adequate resources and expertise, sound governance, operational independence and remedial powers to deal with problem institutions or system-wide crisis. Some respondents note that, given the rapid pace of development in the microfinance industry and the entry of banks into this market, their laws and regulations may be not updated as timely as necessary.

When more than one agency is involved in the supervisory process, survey responses indicated common deficiencies in coordination, cooperation and systems for information sharing among different microfinance supervisors. In some middle- and low-income jurisdictions, supervisors report lack of authority to gather information on non-depository entities or depository institutions overseen by another agency, particularly in the cooperative sector, where the supervisory arrangement is more fragmented.

B. Supervisory approach

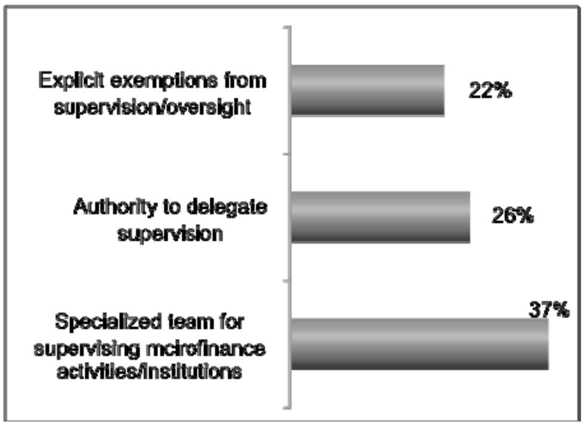
The separation of responsibilities and objectives of different agencies involved in supervision of microfinance institutions varies by institutional types, in the large majority of countries surveyed. For instance, in a given country supervision of financial cooperatives may be beyond the resources of the supervisor, while microcredit entities could be supervised by the banking supervisor. Some countries, including three high-income countries, have explicit exemptions from supervision or lighter oversight for licensed financial institutions with low level of risk, mainly based on their size (ie assets, deposits, clients). Overall, there is mixed recognition among supervisors in the sample that allocation of scarce resources should take into account the relative risks posed by small institutions and the different tools available to mitigate those risks.

Most of the sampled countries license and supervise at least some of their ODTIs. In over 90% of cases, licensing and prudential supervision of ODTIs is conducted by a banking supervisor. Different approaches are common in middle- and low-income countries, where some groups of depository entities, particularly cooperatives, may be out of reach of any prudential regulator/supervisor. In one country the banking supervisor registers and regulates cooperatives while not conducting prudential supervision. Five respondents informed that MCIs are prudentially supervised by a banking authority. All of them are middle- or low-income countries that have created special regulatory windows for this type of institution.

Nearly half of the respondent countries in the sample that have ODTIs and/or MCIs (all low- and middle-income countries) have specialised teams for supervising microfinance. In most, this is a relatively new development emanating mainly from regulatory reforms that created specialised windows for microfinance institutions. Only two supervise microfinance as a business line that cuts across different types of institutions including commercial banks, as opposed to a specialised activity of microfinance institutions. Specialised supervision may focus on, for example: (a) evaluating microfinance lending policies and procedures; (b) reviewing the adequacy and effectiveness of the management information system for microfinance operations; (c) evaluating credit and operational risks and verifying compliance with regulations; or (d) reviewing audit and internal controls of microfinance operations.

Chart 4

Supervisors of Banks, ODTIs and MCIs
(% of respondents)



While the supervisor in all countries has the authority to do on-site inspections in banks, not all are authorised to examine ODTIs[80] and MCIs. Except for those countries with a specialised microfinance unit, supervisory processes and techniques are largely identical to those used for monitoring banks.

Table 2

Authority to conduct onsite inspections
(number of respondents)

In Banks (out of 27 respondents)	27
In ODTIs (out of 24 respondents)	20
In MCIs (out of 16 respondents)	8

Only seven (26%) supervisory authorities are explicitly allowed to delegate supervisory roles to another entity. None of them are high-income countries. This reflects an emerging arrangement for dealing with the burden of supervising large numbers of small institutions such as financial cooperatives. For example, such delegated or auxiliary supervision arrangements can be found in Brazil and is currently being implemented in Mexico,[81] where the banking supervisor holds responsibility for overseeing all financial cooperatives (except those under a certain size in Mexico that are explicitly exempted from licensing and supervision), but only directly supervises a few (second tier cooperatives). Auxiliary supervisors are responsible for monitoring the larger group and regularly disclosing the financial and managerial information of all entities that they monitor.

80 This excludes jurisdictions where certain types of deposit taking institutions such as cooperatives are not supervised at all.

81 It should be noted that neither supervisor has authorisation to delegate entirely their supervisory responsibility. Supervisors are still fully liable for the prudential soundness of these institutions.

C. Supervisory reporting

Those jurisdictions that prudentially supervise ODTIs conduct off-site monitoring using data from prudential reports, statistical returns and publicly available information. Supervisors are less strict with reporting requirements for ODTIs and MCIs in comparison with banks. While all supervisors in the sample require financial statements (balance sheet, profit and loss statement) from banks, 21 (out of 24 that have ODTIs) require them from ODTIs and only a few require them from MCIs. Frequency of reporting is significantly lower for MCIs, but in most jurisdictions it is only slightly lower for ODTIs, compared to banks. Reports such as funding structure and problem assets are required in fewer jurisdictions for all institutional categories.

Table 3

Reporting requirements
(number of respondents)

	Financial Statements	Problem assets	Funding structure
Banks (out of 27 respondents)	27	23	21
ODTIs (out of 24 respondents)	21	15	14
MCI (out of 16 respondents)	7	5	5

D. Corrective and remedial powers

The majority of supervisors reported having authority to use a range of corrective and remedial tools over banks and ODTIs. The most common are fines related to non-compliance with prudential rules. One respondent also reported having the power to restrict the ability of federations of cooperatives to take new members during the implementation of a correction/restoration plan. Another has the power to remove shareholders from institutions and sell their shares. Likewise, most supervisors have authority to impose administrative sanctions and apply for criminal sanctions in a range of circumstances, for both banks and ODTIs.

The survey results suggest there is less clarity concerning circumstances that justify such measures in the case of ODTIs, particularly the cooperative sector, compared to banks. Corrective and remedial powers, including the authority to impose administrative sanctions, are less evident for MCIs.

Table 4

Remedial and corrective powers available to the supervisor (number of respondents)

	Banks 27 respondents	ODTIs 24 respondents	MCIs 16 respondents
Require the institution to take prompt remedial action	27	21	8
Restrict the current activities of the institution	26	21	8
Remove or restrict the powers of the management	26	20	7
Provide for the interim management of the institution	24	20	6
Impose sanctions on the institution	26	21	9
Fine	26	21	7
Remove the license or authorisation	26	20	9
Impose sanctions on management	25	20	7

E. Accounting and disclosure

In the large majority of jurisdictions, banks are required to publish annual financial statements, mostly according to internationally recognised standards such as the International Financial Reporting Standards (IFRS), and have these statements audited in accordance with internationally accepted practices and standards. ODTIs are subject to the same requirements in most surveyed countries. The use of local chart of accounts is more common for ODTIs than for banks.

3. Risk management

A. Risk management process

Most supervisors in the surveyed countries require banks and ODTIs to establish a risk management process, although ODTI supervisors do so less often than banking supervisors. The emphasis is on general risk management, and credit, market and operational risks. Similar to banks, ODTIs are, in most countries, required to have a risk management strategy approved by the board; policies and processes for risk-taking; risk evaluation; and monitoring and control function, with duties clearly segregated from risk taking, internal audit and compliance functions. Where risk management processes are required, a plan for this area must be provided as part of the licensing procedures with the caveat that some countries are less strict in the evaluation of these plans for small entities. Mexico has a tiered approach to regulating risk management: only more complex institutions need to have a risk committee and monitor market risk. Another middle-income country (not a Basel Committee member) has set explicitly lower requirements for risk management in microfinance institutions, based on their exposure to low-income clients. MCIs are not regulated in the same level as banks and ODTIs.

Chart 5

Requirements on risk management strategy, policies and processes (% of respondents)

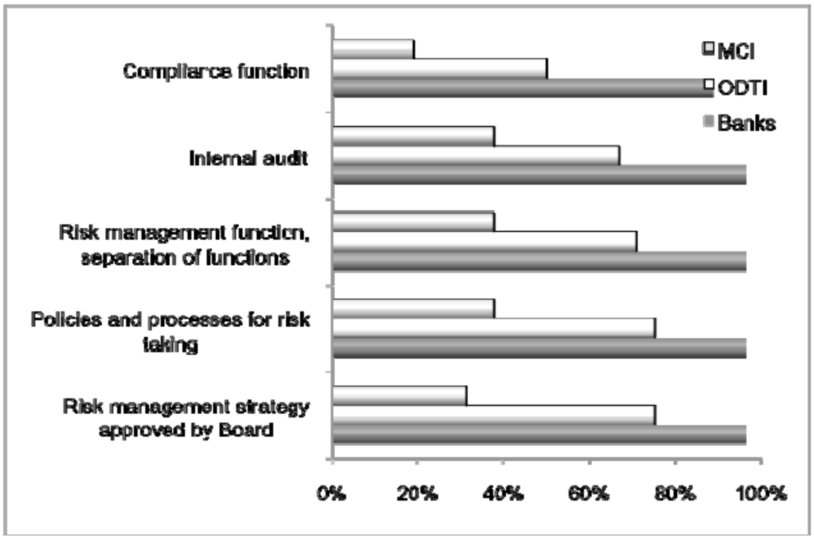
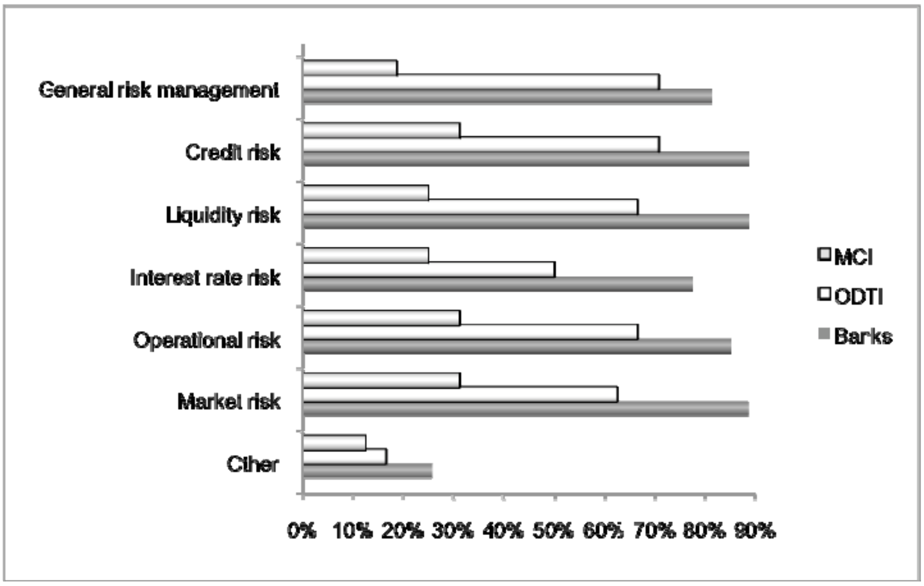


Chart 6

Types of risk management requirements (% of respondents)



B. Credit risk

The complexity and distinctive features of microlending, especially the decentralised lending process, raise important risk management issues for microfinance activities and institutions. For example, according to the available literature, fraud in microlending (eg creation of phantom borrowers and misappropriation of payments) occurs primarily at the level of the loan officer, which is with decentralised lending methodologies.[82]

While most countries require regulated ODTIs and banks to adopt and maintain policies for the approval of new credit exposures or the renewal and refinancing of existing exposures, very few (all low- and middle-income countries) have differentiated requirements for microfinance loans, credit administration policies and loan documentation. Even less common are specific rules for microlending in credit cooperatives.

Lending methodology

Unsecured lending is permitted in most surveyed jurisdictions to all institutional types, although regulations do not usually distinguish clearly between secured and unsecured lending, or provide explicit rules covering unsecured microlending. As a result, microloans may fall under general unsecured lending rules requiring higher provisioning regardless of the underwriting standards, or limitations for individual or aggregate exposures.[83] In one jurisdiction, unsecured loans in banks cannot be larger than US$6,250 to a single person. In another, unsecured lending is limited to 30% of the regulatory capital of any institution. Another country limits a bank's unsecured lending to 50% of its total capital. Most countries also do not specify in their regulation the types of guarantees and securities needed to

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[82] Jansson et al 2004

[83] In the context of Basel II, unsecured lending may always produce higher loss given default (LGD) according to some Basel Committee member countries that participated in the survey.

qualify a loan as secured for provisioning purposes, regardless of the institutional type. This leaves a good amount of supervisory discretion over underwriting methods.

Microcredit can be based on a group lending model (also known as village banking or solidarity groups), a methodology usually employed for very poor clients. Eight countries in the sample – all of them low- and middle-income – have regulatory provisions for group microcredit methodologies applied by banks, ODTIs and MCIs. In such cases, existing lending limits are either not applicable or higher than for individual loans. A few countries have developed supervisory programs that deal specifically with group lending. In one Asian country, for instance, supervisors evaluate the incentives and the performance of loan officers using different parameters for individual and group lending methodologies.

Most reporting countries do not impose regulations for banks, ODTIs and MCIs prohibiting extensions of credit to persons without commercial and tax registration, accounting and financial statements or those not up to date with tax contributions. Where they do exist, such restrictions are more common for banks. On the other hand, one country reported having an explicit exemption from such prohibitions for microcredit loans.

Loan classification

Regulations usually outline criteria for classifying loans in banks, ODTIs and MCIs, although microcredit is a separate asset class in only a few jurisdictions (none high-income). In the vast majority (78%) of sampled countries loan classification rules apply equally to conventional retail loans and microcredit, for all institutional types. Most jurisdictions that have specific rules for classifying microcredit use the criteria to determine provisions and credit impairment.

Provisions and reserves

Where there is special treatment of microcredit, provisioning usually starts earlier than conventional retail lending and migrates faster to higher risk levels. Microcredit also is considered overdue earlier in jurisdictions that have specialised microlending regulation. Some jurisdictions surveyed require a minimum level of provisioning for performing microloans as well. At the other end of the spectrum, only a few surveyed countries (20% of 25 respondents) recognise alternative underwriting methodologies typical of microfinance that may receive favourable treatment for provisioning purposes.

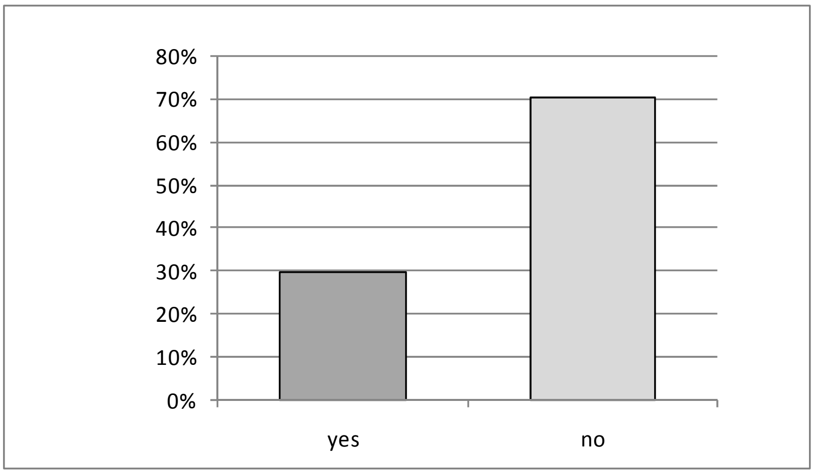
An example of specialised microfinance treatment is provided by an African country, where the regulation establishes five risk levels for bank loans. The three highest levels are provisioned at 20%, 50% and 100%. Comparatively, the ODTIs in this jurisdiction classify microloans according to days in arrears only, eg 30-89 days, 90-179 days, and 180 or more days. Provisions are set for each category at 25%, 50%, 100%, respectively. Another African country uses a stricter schedule from that applicable to banks.

Large exposure limits

The limited information provided by the survey on exposure or concentration limits suggest the presence of stricter rules for ODTIs than for banks. In one country (low-income), loans to a single borrower at a specialised microfinance institution cannot exceed 10% of the core capital, while the limit is 25% in commercial banks. In a middle-income country, microfinance institutions can lend up to 30% of the loan portfolio to a single borrower, while there is no such limit for banks.

Chart 7

Respondents that require provisions to be raised earlier/sooner when microcredit falls in arrears than in the case of banks' conventional retail loans (% of 27 respondents)



C. Operational risk

Operational risk management

All but one surveyed country require banks to have risk management policies and processes to identify, assess, monitor and mitigate operational risk. Such requirements might be set in regulations regarding internal controls, governance, internal auditing. The same rules apply to ODTIs in 64% of the surveyed jurisdictions where they are supervised. Only one country reported having specific rules dealing with operational risk in microfinance institutions. In another, specific operational risks of microfinance are recognised not in the regulations, but in the supervision manual.

Table 5

Operational risk management requirements (number of respondents)

	Does the regulation require specific risk management policies for operational risk?	If so, are they specifically tailored to microfinance operations and techniques?
	Yes	Yes
Banks (out of 27 respondents)	26	0
ODTIs (out of 24 respondents)	14	1
MCIs (out of 16 respondents)	3	0

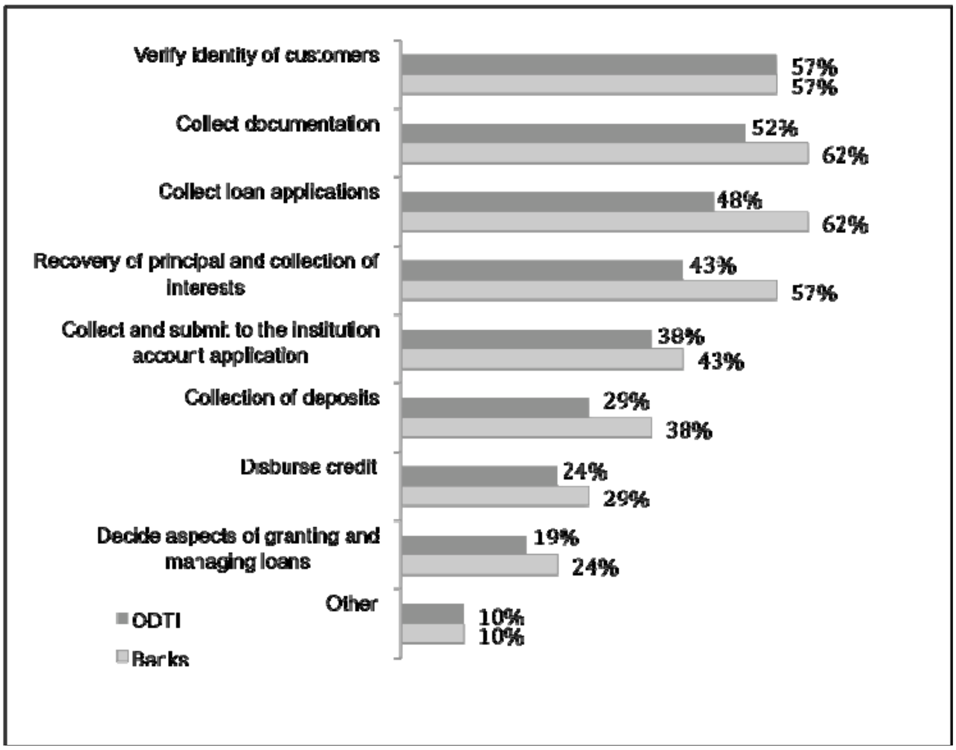
Outsourcing

Many jurisdictions, including high-income countries with little microfinance activity, have explicit regulatory permission – or do not prohibit – financial institutions to outsource activities such as collecting deposits, to non-bank retail agents. In Australia, for instance, the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* allows entities to outsource some functions, such as customer identification, to third party agents. However, the entity retains responsibility for compliance with the Act. The most commonly permitted outsourced activities among the countries in the sample are verifying customer identity, collecting client documentation, and receiving loan applications. Permissions are mostly for banks and some types of ODTIs, while there is usually no specific regulation for MCIs and cooperatives.

Outsourcing by ODTIs is broadly covered by the framework for operational risk management, which is not usually tailored to the use of retail agents. Banks in most jurisdictions are explicitly required to comply with a range of minimum standards for outsourcing, including those involving cash-handling by third parties. All high-income countries and most Basel Committee members apply specific outsourcing principles for banks and prudentially supervised cooperatives, but the framework for ODTIs is less clear in low- and middle-income countries. Moreover, the supervisor has access to outsourced institutions for oversight purposes in most jurisdictions.

Chart 8

Activities that can be outsourced to retail agents (% of respondents)



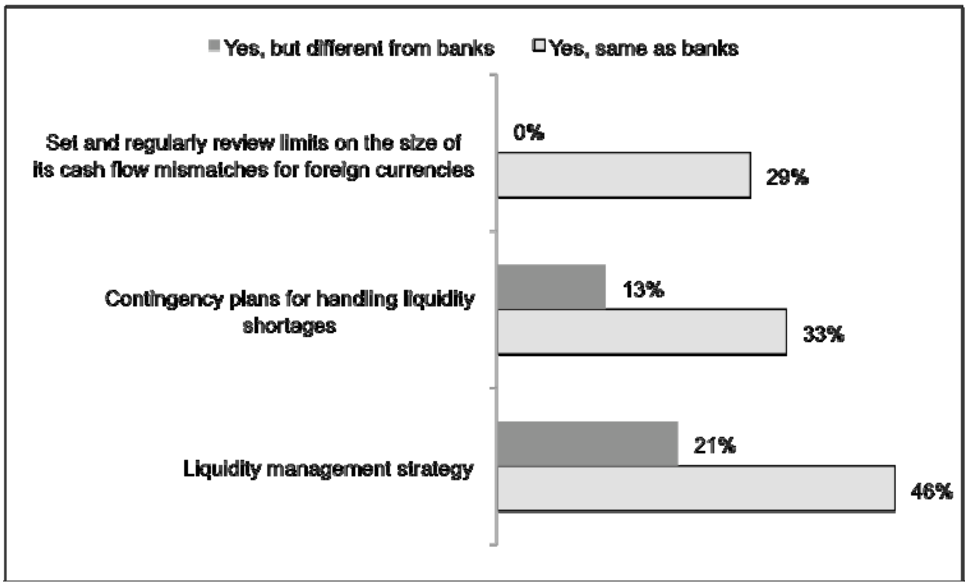
D. Liquidity risk[84]

Many surveyed countries apply the same liquidity risk management regulation to banks and ODTIs. Most supervisors require covered ODTIs to have a liquidity management strategy and may also require contingency plans for handling liquidity disruptions, and set and regularly review limits on the size of its cash flow mismatches for foreign currencies. In a few cases the rules were specially designed for microfinance institutions or microfinance operations. There are often no provisions for diversification of funding sources for ODTIs, or even banks in some countries.

84 In addition to information from the survey results, this section draws primarily from Brom 2009.

Chart 9

Respondents that require liquidity management from ODTIs
(% of respondents)



In addition to deposits, commercial borrowings are an important source of liquidity for many microfinance providers, adding to the complexity of the risk management process.[85] Funders include international aid agencies, multilateral development banks and development finance institutions (eg International Finance Corporation) that specifically target microfinance providers. Funding may also be secured via specialised investment pools, often referred to as Microfinance Investment Vehicles (MIVs).[86] Provision of these funds is concentrated in a handful of large lenders, often in hard (ie non-local) currency. Publicly-funded wholesale or apex lenders may also provide a local source of funding. [87]

E. Abuse of financial services

The large majority of countries in the survey subject banks to AML/CFT controls that follow all FATF recommendations (exceptions apply only to some FATF recommendations such as those on politically exposed persons).[88] All countries require banks to comply with customer due diligence controls, reporting of suspicion transactions, and record-keeping.

ODTIs and MCIs are required less often than other types of institutions such as banks and money or value transfer service providers to implement FATF-related compliance controls. Similarly, in the jurisdictions where cooperatives are not prudentially supervised they are not

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85 CGAP 2008.

86 An MIV is an investment entity with at least 50% of its portfolio invested in microfinance institutions/portfolios in emerging countries and/or other MIVs.. CGAP 2009a.

87 Wholesale/apex lenders may be private commercial banks, development banks, NGOs, donor programs or government entities. CGAP 2009a.

88 The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing and to bring about legislative and regulatory reforms in these areas. The FATF has published Recommendations in order to meet this objective. www.fatf-gafi.org

required to implement such controls. In most places where AML/CFT controls are imposed, rules are largely the same for all types of institutions, but some countries have lighter rules for smaller institutions, such as exemption from having a formal AML/CFT compliance unit or function.

Only 30% of the respondents (most middle-income) reported having undertaken a formal AML/CFT risk assessment to identify and define low-risk operations.[89] Some, although not conducting a formal AML/CFT risk assessment, have used the flexibility built into the FATF recommendations to implement simpler customer due diligence procedures for some products targeting low-income persons, such as low-value savings accounts, mobile phone based bank accounts and e-money. For example, twelve surveyed countries allow third party agents to check clients' identification documents on behalf of a supervised financial institution, for account opening and other transactions. Two countries reported having lower client documentation requirements or exemptions for people receiving government welfare payments. Isern and de Koker (2009) offer additional examples of simplified measures used by various countries:

- customer due diligence: acceptance of non-standard identification documents, where appropriate (United Kingdom); exempting specific low value products from elements of the standard customer due diligence processes and extending timelines for such processes for existing clients (South Africa);[90]
- management information systems: allowing appropriate record-keeping systems by small institutions, by not prescribing types or level of technology (Indonesia);
- transaction reporting: allowing both electronic and hard copy reporting of reportable transactions (South Africa); and
- compliance function: all businesses and all their employees must report suspicious transactions but only accountable institutions are required to appoint/designate a compliance officer (South Africa).

F. Exposures to related parties

Generally, regulation in the surveyed countries allows banks to have exposure to related parties more often than they allow ODTIs and MCIs. Countries that supervise ODTIs limit exposures to related parties for the most part, and may impose other restrictions such as prohibiting unsecured loans to major shareholders. Where countries impose limitations on the volume of related party exposures, they tend to be stricter for ODTIs than for banks; for example, one low-income country limits ODTI loans to a related party to 2% of the core capital individually and 20% in the aggregate while for banks, these limits increase to 20% and 100%, respectively. Other countries may only require institutions to have internal policies for related party lending without setting specific limits. Related-party exposures may also affect regulatory capital in many jurisdictions. For example, in Mexico they receive a credit risk weighting of 115%.

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[89] FATF recommendation 5 notes: "In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures". See also section 2 of the FATF Guidance on the risk-based approach, and De Koker 2009a for a definition of "low-risk" in the FATF context.

[90] De Koker (2009) found that while some abuse of exempted financial products in South Africa occur, the level of abuse was substantially lower and the amounts involved were much less compared to the abuse of standard, non-exempted products.

Table 6

Are there restrictions concerning exposures to related parties?

	Banks *27 respondents*	ODTI *24 respondents*	MCI *16 respondents*
Exposures to related parties allowed	25	14	5
Requirements that they be made on an arm's length basis	16	7	4
Amount limited	23	9	4
Deduction from regulatory capital	10	1	2

Given cooperatives' community-oriented purpose and *modus operandi*, supervisors may also set limitations on a single member's ownership. In a middle-income Latin American country, for instance, members cannot own more than 10% of the capital, if an individual, or 49%, if a legal entity. In another jurisdiction in the same region the limit is 15% for legal entities.

4. Capital adequacy

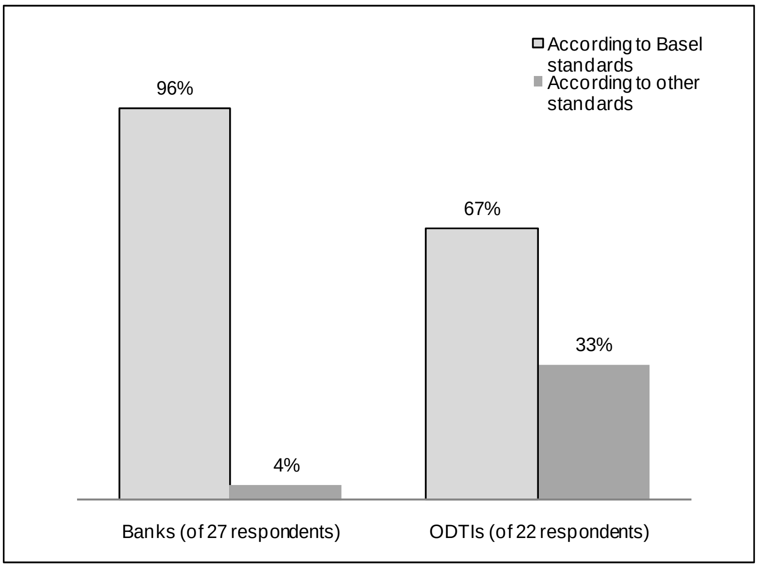
Definition of regulatory capital and framework

Regulatory capital in banks and ODTIs is defined according to Basel standards in the majority of countries included in the sample. Other definitions are used for some types of institutions to substitute for or complement the Basel framework. With respect to member shares in financial cooperatives, some supervisors impose restrictions on redemption of shares or exclude the volatile portion of share capital from the definition of regulatory capital.

Basel standards are also used to define and calculate the regulatory capital ratio for banks and, in several countries, for ODTIs. In jurisdictions where Basel II is being implemented, few (all Committee members) use these parameters for financial cooperatives as well.

Chart 10

How is capital defined? (% of respondents)



Capital adequacy requirements

Capital adequacy requirements among survey respondents tend to be higher for ODTIs than for banks. In countries without specialised microfinance regulation, however, the same CAR is applied for both. In sectors where cooperatives are prudentially regulated, the survey results suggest they face higher CAR requirements than other types of ODTIs.

Rules vary immensely among the countries that have ODTIs other than cooperatives. Some (4 out of 16) apply Basel I, but other approaches are used as well, from not requiring a CAR at all to imposing various other types of leverage or asset-weighted ratios. For example, Kenya imposes a capital to total deposit liabilities requirement on ODTIs of at least 8%.

A handful of sampled countries require a leverage ratio for MCIs, ranging from 10% to 12%. The majority of countries do not impose a risk-weighted capital requirement on MCIs.

Table 7

Capital adequacy ratio in selected countries

	ODTI	**Banks**
Kyrgyzstan	18% - specialised microfinance deposit taker	12%
Honduras	15% - retail specialised microfinance deposit taker 10% - wholesale specialised microfinance deposit taker	10%
Chile	10% - cooperatives	8%
Brazil	17% - independent cooperatives	11%
Mexico	8% - cooperatives	8%
Australia	8% - cooperatives (higher charges may apply in formative years)	8% (higher charges may apply in formative years)
Bolivia[1]	10% - specialised microfinance deposit taker	10%

[1] Bolivian Financial System Supervision Authority: www.asfi.gov.bo

Coverage of risks in capital adequacy ratios

In most cases, CAR requirements for ODTIs cover credit risk only. Other risks are usually separately reserved using flat ratios/limits. In Pakistan, 1.5% of the ODTI's loan portfolio is reserved to cover market and operational risk. In Brazil cooperatives with no foreign exchange exposure and total assets of under approximately US$2 million are not required to allocate capital for market risk, but their CAR requirement is raised by 200 basis points. In Mexico charges for ODTI market risk follow a tiered system according to the level of complexity.

Treatment of microloan portfolio

As a business line, microloan portfolios in countries responding to the survey receive mostly the same treatment given to other retail exposures as defined in the Basel II framework for credit, market and interest rate risks. Only two countries in the sample have specific capital treatment for microcredit portfolios, compared to other loan types in banks.

References to countries in the sample have specific capital treatment for microcredit portfolios, compared to other loan types in banks.

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Additional resource:

Microfinance Regulation and Supervision Resource Center
http://www.microfinanceregulationcenter.org

Annex I

Participating Countries and Institutions[91]

Country	Income level[92]	BCBS membership
Argentina	Upper middle income	Member
Australia	High income	Member
Brazil	Upper middle income	Member
CEMAC *Low/Middle income (for the purpose of this report only)* Cameroon Central African Republic Congo, ROC Gabon Equatorial Guinea Chad	 Lower middle income Low income Low income Upper middle income High Income Low income	Non-members
Chile	Upper middle income	Non-member
Colombia	Upper middle income	Non-member
France	High income	Member
Honduras	Lower middle income	Non-member
Indonesia	Lower middle income	Member
Italy	High income	Member
Japan	High income	Member
Kenya	Low income	Non-member
Kyrgyzstan	Low income	Non-member
Mexico	Upper middle income	Member
Mozambique	Low income	Non-member
The Netherlands	High income	Member
Nicaragua	Lower middle income	Non-member
Pakistan	Lower middle income	Non-member
Peru	Upper middle income	Non-member
Philippines	Lower middle income	Non-member
Russia	Upper middle income	Member
Rwanda	Low income	Non-member
Saudi Arabia	High income	Member
South Africa	Upper middle income	Member
South Korea	High income	Member
Spain	High income	Member
Uganda	Low income	Non-member

91 In addition to the respondents above, the survey was also sent to Bangladesh, Bolivia, Cambodia, Ghana, India, Ecuador, El Salvador, Mongolia, Nigeria, Tajikistan, Belgium, Canada, China, Germany, Luxembourg, Sweden, Switzerland, the United Kingdom, the United States, Czech Republic, Hong Kong SAR, Poland, Singapore.

92 Income classification is according to the World Bank's Atlas method, as of July 2009. See http://go.worldbank.org/K2CKM78CC0.

Annex II

List of Members of the Microfinance Workstream

Central Bank of Argentina	José Rutman, Co-Chair Cristina Pailhé Miguel Delfiner Anabela Gomez
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Reserve Bank of India	Prashant Saran
Bank of Italy	Giovanni Carosio Alessio de Vincenzo
Comisión Nacional Bancaria y de Valores, Mexico	Angelica Gonzalez Saravia
Netherlands Bank	Rudi Kleijwegt
Superintendencia de Banca y Seguros, Peru	Narda Sotomayor
Bangko Sentral ng Pilipinas, Philippines	Gerardo A. Butardo
Central Bank of the Russian Federation	Alexey Simanovskiy Oleg Letyagin
South African Reserve Bank	Errol Kruger Sandra de Lange
International Monetary Fund	Aditya Narain
World Bank	David Scott
BCBS Secretariat	Keng Heng Tan