Basel Committee
on Banking Supervision

Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion

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Contents

List of abbreviations

AC	Additional Criterion
AML/CFT	anti-money laundering/combating the financing of terrorism
BCBS	Banking Committee on Banking Supervision
BCG	Basel Consultative Group
CDD	customer due diligence
CPMI	Committee on Payments and Market Infrastructures
EC	Essential Criterion
FATF	Financial Action Task Force
FinCoNet	International Financial Consumer Protection Organisation
FSAP	Financial Sector Assessment Program
G20	Group of Twenty
GPFI	Global Partnership for Financial Inclusion
IMF	International Monetary Fund
MNO	mobile network operator
OECD	Organisation for Economic Co-operation and Development
RoP	range of practice
UN	United Nations

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1. Introduction

As stated in the foreword to the 2012 Core Principles for Effective Banking Supervision ("Core Principles") of the Basel Committee on Banking Supervision ("Committee"), "effective banking supervisory practices are not static. They evolve over time as lessons are learned and banking business continues to develop and expand".[1] This Guidance is intended to help supervisors respond to changes and innovations in the products, services and delivery channels of financial institutions working to reach the approximately 2 billion adults currently unserved or underserved by formal financial institutions ("unserved and underserved customers").[2] The Guidance may also help supervisors respond to innovations not specifically designed for unserved and underserved customers.

Financial inclusion can introduce potential benefits to the safety, soundness and integrity of the financial system. However, it can also bring potential risks to providers and customers alike, and entail the transfer of well known risks to new players.[3] Research at the IMF suggests that financial inclusion significantly increases macroeconomic growth, although broadening access to credit can compromise macrofinancial stability when combined with poor quality of banking supervision (Sahay et al 2015). This Guidance examines the risks presented by banks and non-bank financial institutions[4] in their endeavour to reach unserved and underserved customers and, using the lens of the Core Principles, guides prudential supervisors on the application of a proportionate regulatory and supervisory approach.

As previously noted by the Committee, "[p]roportionate regulation and supervision calls for a supervisory approach commensurate with the systemic importance and risk profile of supervised institutions. In the financial inclusion context, this requires effective allocation of supervisory resources, as well as specialised understanding of the changing nature – and sometime also level – of risks that accompany progress on financial inclusion".[5] Such allocation of resources is particularly challenging in low-income countries, where supervisors typically have responsibility for multiple institutional types and multiple functions in the face of significant resource and capacity constraints.

1 BCBS (2012).

2 As of 2014, approximately 2 billion adults did not have an account at a formal financial institution. While many of these persons are not served by *any* formal financial institution, some may have access to and use other formal financial services, such as insurance. Some of the adults *with* an account are "underserved" either because they do not use their account or they do not have access to other needed financial products or services (eg credit, insurance). A global average of 15% of adults with an account do not use it (based on a 12-month reporting), with the figure being as high as 43% in some jurisdictions, including some with large populations. Demirgüç-Kunt et al (2015).

3 Awareness of financial inclusion developments as well as their benefits and risks is demonstrated by the number of countries in which supervisors are taking actions to support or encourage financial inclusion. The Alliance for Financial Inclusion, a global network of central banks and other financial regulatory institutions working on financial inclusion, represents more than 90 jurisdictions. http://www.afi-global.org.

4 This Guidance uses the term "non-bank financial institution" to refer to financial institutions – including both deposit-taking and non-deposit-taking financial institutions – that provide deposit and lending services similar to those of banks (see Annex C), in accordance with the 2012 Core Principles.

5 BCBS (2015a, p 25).

The Guidance addresses the specific application of some Core Principles to the regulation and supervision of non-bank financial institutions – which in many countries are the primary providers of financial services striving to serve unserved and underserved customers. This Guidance is provided to reinforce the importance of proportionate regulation and supervision of such institutions. As noted in the 2012 Core Principles, "[i]n countries where nonbank financial institutions provide deposit and lending services similar to those of banks, many of the Principles [. . .] would also be appropriate to such nonbank financial institutions". Consistent with this statement, this Guidance, as it applies to banks may also apply to such non-bank financial institutions. However, the 2012 Core Principles also "acknowledged that some of these categories of [nonbank financial] institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system".[6] In some countries, non-bank financial institutions, while not systemic based on the value of funds they intermediate, may present a systemic dimension due to the number and type of customers they serve.

Today's broad landscape of financial service providers striving to serve unserved and underserved customers can quickly move beyond the remit of a traditional banking supervisor. In this light, the Guidance can be useful not only to prudential supervisors,[7] but also to payment overseers and other authorities engaged in the regulation and supervision of non-bank financial institutions. Telecommunications regulators and others with oversight over non-financial firms participating in innovative financial services are likely to find the Guidance useful. As the Guidance addresses issues related to anti-money laundering and combating the financing of terrorism (AML/CFT) and to consumer protection, it will be relevant to authorities with responsibility for financial integrity and financial consumer protection as well as data protection and competition. This Guidance can also help promote cooperation and collaboration among this wide range of authorities.

Many of the unserved and underserved customers reside in countries that are not BCBS members. In recognition of this, the Guidance is intended to be useful to both BCBS member and non-member countries, including those countries in which supervisors are striving to comply with the Core Principles and which may implement this Guidance gradually over time. The Guidance also recognises and reflects the significant variation across the globe in the composition of financial sectors – particularly regarding the relative importance of banks and non-bank financial institutions, the size and complexity of the institutions, and the supervisory structure. The Guidance can help promote productive and constructive dialogue between supervisors and assessors regarding the regulation and supervision of financial institutions targeting unserved and underserved customers.[8]

[6] BCBS (2012).

[7] In many countries, the prudential supervisor is the central bank or a separate banking supervisor. In some countries, the finance ministry, a specialised agency or other department (eg cooperative development agency, microfinance regulatory authority) may be the prudential supervisor for one or more types of non-bank deposit-taking institutions.

[8] The IMF and the World Bank Financial Sector Assessment Program (FSAP) assesses countries' level of compliance with the Core Principles. Topics related to financial inclusion have become increasingly prevalent in FSAPs conducted jointly by the World Bank and the IMF (GPFI (2016, p 86)). The World Bank has drafted and piloted a guidance note for assessors that aims to help standardise the treatment of financial inclusion as a cross-cutting theme in FSAPs.

2. Background to the Guidance

2.1 Financial inclusion and global policy

In recent years, a growing number of governments have made financial inclusion a policy priority.[9] These country-level developments coincide with the emergence of new global actors such as the G20's Global Partnership for Financial Inclusion (GPFI)[10] and the appointment of the UN Secretary General's Special Advocate for Inclusive Finance for Development. The global financial sector standard-setting bodies are increasingly engaged as well, moving to incorporate financial inclusion explicitly in their work.[11]

In parallel to these significant developments, the global financial crisis of 2007–09 prompted new thinking about the relationship between the core safety and soundness objective of banking supervision and financial consumer protection (see Annex A). More recently, there has also been an exploration of the relationship of the safety and soundness objective with the objectives of financial inclusion and financial integrity (see Annex B). Awareness of the risks of financial exclusion has also increased among some global standard-setting bodies.[12]

2.2 2012 revisions to the Core Principles

The Committee revised the Core Principles in 2012, taking into account significant developments in the global financial markets and regulatory landscape since the issuance of the 2006 Core Principles. A key revision was to incorporate the concept of proportionality, in order to accommodate a diverse range of banking systems. In the context of the standards imposed by supervisors on banks, the proportionality concept is reflected in those Principles focused on supervisors' assessment of banks' risk management, where the Principles prescribe a level of supervisory expectation commensurate with a bank's risk profile and systemic importance. The 2012 revisions also gave greater attention to the complementarity between macroprudential and microprudential elements of effective supervision, urging supervisors to assess risk in a broader context than that of the balance sheet of individual institutions (for example, considering the macroeconomic environment, subsector trends and risks posed by non-banks).

2.3 The Basel Committee on Banking Supervision and financial inclusion

Formal engagement by the Committee on financial inclusion commenced in 2008, with work to identify the range of practices in both Committee member and non-member jurisdictions with regard to regulating

[9] Thirty-six of the 52 jurisdictions responding to a 2013 range of practice survey on the regulation and supervision of institutions relevant to financial inclusion (further described in the subsection "The Basel Committee on Banking Supervision and financial inclusion") have a national financial inclusion strategy, national microfinance strategy or a specific policy statement establishing a financial inclusion mandate or goal at the national or organisational level. BCBS (2015a).

[10] The GPFI was established at the G20 Seoul Summit in December 2010 as the main implementing mechanism of the G20 Financial Inclusion Action Plan and a platform for peer learning, knowledge sharing, policy advocacy and coordination among G20 and non-G20 policymakers and other stakeholders.

[11] GPFI (2016). In addition to the BCBS, the global financial sector bodies currently engaged with the GPFI are the Committee on Payments and Market Infrastructures (CPMI), the Financial Action Task Force (FATF), the Financial Stability Board, the International Association of Deposit Insurers, the International Association of Insurance Supervisors and the International Organization of Securities Commissions.

[12] FATF, the international standard-setting body for AML/CFT, has formally recognised financial exclusion as a money laundering and terrorist financing risk, as reflected in the Declaration of the Ministers and Representatives of FATF approving the organisation's 2012–20 Mandate. See also GPFI (2011, 2012 2016) for further discussion on the linkages between financial inclusion, financial stability, financial integrity and financial consumer protection.

and supervising microfinance activities by banks and other deposit-taking institutions. This work informed the Committee's 2010 guidance on applying the 2006 version of the Core Principles to microfinance activities.[13]

In November 2012, the Basel Consultative Group (BCG) began work on financial inclusion with the goal of helping the Committee gain, on an ongoing basis, a deeper understanding of the country context, constraints and unique market features associated with inclusive finance. Three elements of the changing financial inclusion landscape were of particular relevance. First, the types of products offered by banks and other financial institutions reaching unserved and underserved customers have expanded in the past decade from microcredit to innovative savings, payments and transfers as well as insurance underwritten by insurance companies and distributed by a range of providers. Second, the providers are both banks and non-banks – including deposit-taking institutions as well as new players such as mobile network operators (MNOs) – working with retail agents that act as the primary interface with customers.[14] Third, the pace of change has been rapid.

In 2013, the BCG conducted a range of practice survey on the regulation and supervision of institutions relevant to financial inclusion (RoP Survey). The RoP Survey included questions on the respondents' financial sector landscape and financial inclusion developments, on the application of selected Core Principles relevant to financial inclusion, and on financial consumer protection issues. Valid responses were received from 52 respondents representing 59 jurisdictions evenly spread across four income groupings and covering all regions. The results of the RoP Survey revealed significant variation among respondents on the number of different categories of financial institutions reaching (or potentially reaching) unserved and underserved customers, the number of institutions in each category, and the number and type of supervisory authorities.

A report on the results of the RoP Survey (RoP Report)[15] provides a snapshot of today's regulatory and supervisory approaches towards the rapidly evolving landscape of financial institutions engaged in reaching unserved and underserved customers.

The RoP Survey and RoP Report have provided key background information for the preparation of this Guidance. However, as numerous respondents have revised their regulations and their supervisory approaches since the cutoff date for the data in the report, this Guidance also relies on secondary-source material and the experiences and input of numerous supervisors, including the feedback received during and after the consultation period.

2.4 Terminology

The Guidance applies to a range of different institutions. Given the different terminology used across countries, the Guidance uses the following terms (each defined in Annex C) for different categories and groupings of institution: *e-money issuer*, *financial cooperative, microfinance institution, microlender, non-bank deposit-taking institution*,[16] *non-bank financial institution* and *non-financial firm*. Annex C also explains the correlation of these terms with the terms used in the RoP Survey and RoP Report.

13 BCBS (2006, 2010b).

14 GPFI (2014).

15 BCBS (2015a).

16 As noted above, the term "non-bank financial institution" is used in this Guidance in accordance with its use in the 2012 Core Principles, that is: financial institutions – including both deposit-taking and non-deposit-taking financial institutions – that provide deposit and lending services similar to those of banks.

The Guidance covers a range of financial products and services offered by banks and non-bank financial institutions, from traditional microlending, which has been the main product targeting unserved and underserved customers in several jurisdictions for many years (see Annex E), to more recent innovations designed specifically for unserved and underserved customers. This Guidance uses general terms to refer to some innovations, such as *e-money*[17] and *digital stored-value products*. Terms not explicitly used in this Guidance but used by some jurisdictions in their laws or regulations (and widely used in the discussion of financial inclusion outside laws and regulations) include: *digital credit* (which may include loans extended and repaid via customers' mobile phones or other digital transactional platforms), *mobile wallets* ("stored-value accounts" offered directly by MNOs to their phone customers) and *mobile money* (funds transferred and received via mobile phones, whether or not associated with a stored-value account).

3. Guidance on the application of the Core Principles

This Guidance is not intended to inhibit the entry of new providers or the adoption of new technologies or to increase supervisory burdens. This Guidance, building and expanding on the 2010 guidance on the application of the 2006 Core Principles to microfinance activities, fundamentally reflects the need for proportionate application of the 2012 Core Principles on the regulation and supervision of small and non-complex institutions striving to serve unserved and underserved customers, which typically engage in small transactions, including borrowings and deposits. A key component of such an approach is the use of new supervisory tools, including the use of technology to assist supervisors and financial institutions in gathering, transmitting and processing data and information.[18]

Of the 29 Core Principles issued by the Committee, this Guidance addresses 19 Core Principles where there is a need for providing additional guidance in their application to the regulation and supervision of the financial institutions engaged in reaching the financially unserved and underserved. It does not create new principles and does not exclude applicability of any Core Principle to any market development relevant to financial inclusion. In the case of the remaining 10 Core Principles not explicitly mentioned in this Guidance, there is at present little or no supplemental guidance or illustration needed for their application to the supervision of financial institutions targeting unserved and underserved customers.[19]

For each of the Core Principles discussed, this Guidance addresses those Essential Criteria (ECs) and Additional Criteria (ACs) which have specific relevance to the financial inclusion context.

3.1. Core Principles on supervisory powers, responsibilities and functions

Principle 1: Responsibilities, objectives and powers

An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal

[17] The Guidance cites the definition of e-money used in CPMI (2014).

[18] This use of technology is increasingly being referred to as "fintech" when used for innovations in financial products, services and businesses; and "regtech" when used for regulatory and compliance purposes by regulators or financial institutions.

[19] The 10 Core Principles that have not been covered are: 6 (Transfer of significant ownership), 7 (Major acquisitions), 13 (Home-host relationships), 19 (Concentration risk and large exposure limits), 20 (Transactions with related parties), 21 (Country and transfer risks), 22 (Market risk), 23 (Interest rate risk in the banking book), 26 (Internal control and audit) and 27 (Financial reporting and external audit).

powers to authorise banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.

Taking into account EC 1, when there is more than one authority responsible for supervising banks and non-bank financial institutions, (i) the responsibilities and objectives of each supervising authority should be clearly defined in legislation and publicly disclosed, and (ii) a credible and publicly available framework should be in place to avoid regulatory and supervisory overlaps and gaps, particularly with reference to different types of non-bank financial institutions.

As stated in EC 2, the primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. The banking supervisor may carry out other responsibilities as long as they do not conflict with, and are subordinate to, this primary objective.[20] Supervisors with financial inclusion responsibilities may consider the risks that financial exclusion poses to the safety and soundness of the financial system. These include less transparency, financial integrity risks,[21] greater macroeconomic volatility,[22] and higher social and political instability.

At the same time, EC 2 should be applied taking into account the broader financial sector landscape of a country – for example, by interpreting the reference to "banks and banking system" to include licensed non-bank deposit-taking institutions if they serve a significant number of customers.[23]

In order to enable the supervisor to comply with EC 6,[24] the applicable law or regulation should require any non-financial firm that provides financial services as one of its main activities either to become registered or licensed or to establish a separate legal entity to seek registration or a licence to operate. This is of particular importance in countries where the innovation in products and services is undertaken by non-financial firms. In addition, as required by EC 7, the law should provide the supervisor with the power to review the activities of parent companies and of companies affiliated with parent companies – such as a mobile network operator that is the parent company of an e-money issuer – to determine the risks such activities may pose to the safety and soundness of the supervised institution and the system where it operates.

Principle 2: Independence, accountability, resourcing and legal protection for supervisors

The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.

If the banking supervisor oversees several different types of financial institutions,[25] it should – in accordance with a proportionate approach – prioritise the allocation of supervisory resources based on the institutions' risk profiles and systemic importance, taking into account the different mitigation

[20] "The banking supervisor might […] in some jurisdictions be tasked with responsibilities for (i) depositor protection, (ii) financial stability, (iii) consumer protection, or (iv) financial inclusion." BCBS (2012, p 5).

[21] FATF (2013a).

[22] Dabla-Norris and Srivisal (2013).

[23] As previously observed, this Guidance uses the term "non-bank deposit-taking institutions" in accordance with the 2012 Core Principles. In countries where these non-bank deposit-taking institutions are numerous, very small, and geographically remote, alternative supervisory approaches may be applied (see guidance on Core Principle 8 and Annex D).

[24] EC 6 requires that supervisors have the power to take corrective action with respect to, or impose sanctions on, any bank – and, pursuant to BCBS (2012), any non-bank financial institution – that is not in compliance with applicable law or regulation or otherwise engages in unsafe or unsound actions that have the potential to jeopardise the banking system.

[25] Among the respondents to the RoP Survey, on average the prudential supervisor covered four of the six categories of financial institutions defined in the Survey.

approaches adopted by the institutions.[26] If the supervisor takes a different approach to supervising a particular subsector or grouping of institutions (see guidance on Core Principle 8), the supervisor should be clear and transparent about its objectives, its approach and its accountability framework (EC 3).[27]

In several countries, governments have created new, or have expanded the range of activities of existing, state-owned financial institutions with the aim of promoting financial inclusion. In such cases, legislation should ensure that supervisors have powers and operational independence to carry out proportionate and effective supervision of such institutions without government or industry interference (EC 1). Similarly, in order to avoid industry interference and institutional conflicts of interest, supervisors must not have management responsibilities in the financial institutions they supervise.[28] As a general rule, supervisors should not have responsibilities to promote or develop a subsector of financial institutions that they supervise. If supervisors also have such developmental responsibilities or objectives, they should clearly publish these objectives (EC 3) and discharge their duties in relation to such objectives in a manner consistent with the long-term sustainability and soundness of the institutions they supervise. This should be supported by institutional arrangements that provide for effective coordination and ensure independence between the developmental function and the regulatory and supervisory functions to reduce conflicts of interest.

Supervisors responsible for multiple types of institutions require adequate resources to conduct effective supervision and oversight. They should be financed in a manner that does not undermine their autonomy or operational independence (EC 6). The RoP Survey showed that less than 50% of respondents carried out supervisory staff training on topics relevant to financial inclusion. As supervisors are confronted with an evolving landscape – eg new types of institutions that can grow quickly in number, scope and scale, new products and services, and new arrangements among banks and non-banks, including the use of retail agent networks as a primary customer interface – they should regularly evaluate staff skills and projected staff requirements over the short and medium term and implement measures to bridge any gaps in numbers and/or skill sets identified (EC 7).

Principle 3: Cooperation and collaboration

Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.

Most often, banks are supervised by the central bank or a separate banking supervisor. Prudential responsibilities over one or more types of non-bank deposit-taking institutions may be assumed by the banking supervisor or by other authorities, such as a specialised non-bank regulator, the finance ministry and, in some cases, the cooperative agency.[29] There may also be separate functional supervisors – focusing on such topics as financial integrity, deposit insurance, consumer protection, competition and data protection – and sectoral supervisors that supervise financial institutions offering different types of financial products (eg credit, insurance, securities, payments). The innovative digital financial products and

[26] Such prioritisation in the allocation of resources is particularly challenging in low-income countries, where supervisors are typically responsible for multiple institutional types *and* multiple functions and are coping with resource and capacity constraints. For 75% of the low-income respondents to the RoP Survey, the prudential supervisor had five or more responsibilities beyond prudential supervision.

[27] A subsector of financial institutions may be based on their core activity (eg traditional microlending, consumer lending, payday lending, e-money issuing or financial cooperatives) and other features (eg geographical location, customer types, risk profile).

[28] For example, in some countries the central bank may be involved in key decisions regarding the activities of state-owned financial institutions, including development banks and microfinance institutions.

[29] Among RoP Survey respondents, the average had two authorities covering the prudential regulation and supervision of the six categories of financial institutions defined in the survey. The maximum number of prudential authorities was four.

services being offered to unserved and underserved customers may involve all of these authorities as well as regulators and supervisors of non-financial firms providing the delivery channel for such products and services, such as the telecommunications agency that oversees MNOs.[30]

Cooperation and coordination among these regulators and supervisors are key to developing an effective regulatory and supervisory framework for financial institutions targeting unserved and underserved customers, in particular: (i) to design informed and proportionate rules and requirements for the licensed institutions; (ii) to delineate regulatory and supervisory responsibilities as clearly as possible so as to avoid or minimise overlaps and gaps as well as arbitrage by institutions offering similar products; (iii) to avoid or minimise inconsistent or overly burdensome requirements that interfere with implementation of policy objectives, including financial inclusion; and (iv) to effectively share information about risk sources or events that may affect the financial system, including risks arising from non-financial sectors (eg telecommunications, retail).

To that end, formal and informal arrangements should be in place and should work in practice (i) for cooperation, including analysis and sharing of information (eg on the often fast-paced developments of new products and services); and (ii) for undertaking collaborative work with all relevant domestic and foreign authorities with responsibility for the safety and soundness of banks, non-bank financial institutions and non-financial firms engaged in the delivery of such products and services as well as the stability of the financial system (ECs 1 and 2). The sharing of information with domestic and foreign authorities must involve taking reasonable steps to determine that any confidential information so released will be used only for the purposes of supervising the institutions involved (EC 3).

There should be clear and strong cooperation and coordination mechanisms between the prudential supervisor and the authority with financial consumer protection responsibilities (or between different units if these functions are under the same supervisor). For instance, consumer complaints data provided by the consumer protection authority (or supervisory unit) to the prudential supervisor could be an indicator of potential weaknesses in the institutions involved and thereby contribute to an early warning system. Similarly, the authority or unit with financial consumer protection responsibilities can benefit from data on consumer complaints received by the prudential supervisor and from prudential supervisory findings that manifest potential consumer or market conduct risks. Also, there should be an active consultation process among the relevant authorities for the drafting of regulations and guidelines for institutions that fall under the regulatory and supervisory jurisdiction of more than one authority.

The prudential supervisor may also pursue coordination and cooperation mechanisms with: (i) the financial intelligence unit, with respect to the detection and monitoring of suspicious transactions; (ii) foreign authorities, to identify and address stability threats arising abroad; and (iii) authorities in charge of regulation and supervision of non-bank financial institutions as well as functional supervisors, where relevant, to expand participation in the financial stability policy arrangements. Increased supervisory dialogue with the industry would also facilitate earlier identification and better understanding of market developments, innovations, and new risks and risk mitigants.

Principle 4: Permissible activities

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

Commercial banks are typically permitted to engage in a wide number of activities, while non-bank financial institutions typically engage in a narrower range of activities, which are often limited to lending and possibly taking deposits. Increasingly, various types of non-bank financial institutions targeting unserved and underserved customers are also engaging in one or more of the following activities:

[30] Among RoP Survey respondents, the average number of prudential and other supervisors was four, although the averages were lower for lower-income countries than for higher-income countries.

domestic and international transfers (remittances); issuing payment cards or e-money; using agents to interact with customers; acting as an agent of another financial institution; and acting as a distributor of basic insurance.

Certain activities, such as offering chequing accounts or engaging in foreign trade financing, may be beyond the managerial resources or expertise of smaller or less seasoned non-bank deposit-taking institutions. Permission to engage in sophisticated activities should be substantiated by a thorough supervisory assessment of the financial institution and the capacity of its management to identify, control and mitigate more complex risks.

In addition to having a limited array of permitted activities, non-bank financial institutions targeting unserved and underserved customers often offer simpler financial products and services than those offered to middle- and high-income customers. In some cases, the difference is one of size, eg smaller loans, smaller account balances and lower-value transactions, which can translate into more limited risks both to the institution and to the financial system. Insurance products for unserved and underserved customers may also have simpler payout processes than the products targeting other market segments. Also, such insurance products and microcredit often have simpler documentation. Non-bank financial institutions engaged in simpler activities and offering simpler products may typically face a different and more limited range of risks.

Some non-bank financial institutions may offer ancillary non-financial services, such as business skills training for micro-entrepreneurs. Supervisors shall require that these services be conducted by a separate entity and ring-fenced from financial intermediation to minimise conflicts of interests and undue risk exposures.

As required by EC 2, the permitted activities of a specific type of financial institution should be clearly defined, either by the supervisor or in laws or regulations.[31] However, such permitted activities should be sufficiently broadly defined to permit innovation. At the same time, the supervisor should monitor the emergence of new products and services (eg through market monitoring, allowing providers to launch and test pilots with real customers in a monitored and controlled environment, or studying similar developments in other countries) and be ready to modify the list of permitted activities, as needed.

While the taking of deposits from the public should be reserved for banks and non-bank deposit-taking institutions that are licensed and subject to supervision (EC 4), institutions that offer e-money and other digital stored-value products not defined as deposits may also need to be licensed and subject to supervision as appropriate for the risks involved. This may be the case for non-bank e-money issuers, which are emerging in many jurisdictions as important financial institutions providing an alternative to conventional deposits to unserved and underserved customers. In some cases, this may mean that a non-financial firm, such as an MNO, is required to establish a separate legal entity to offer financial services, such as e-money issuance and digital value storage.

The supervisor or licensing or registering authority should maintain a public list of registered, licensed and supervised financial institutions (EC 5) that should be kept current. The list should be clear and comprehensible and should indicate for each type of institution: (i) the permitted activities; (ii) the supervisory authority; and (iii) whether deposit insurance is available to the deposits placed with them – and, if so, from whom. Each such institution should be required to disclose its status prominently – both at branches and through agents or other third parties acting on its behalf.

Principle 5: Licensing criteria

The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the

[31] Each term that identifies a category of licensed, supervised financial institutions should also be clearly defined by law or regulation (ECs 1 and 3).

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

Commercial banks are licensed by or, in some cases, on the recommendation of the banking supervisor or the central bank. The same authority may license non-bank deposit-taking institutions; in some countries, applicable law may specify a different licensing authority (EC 1).[32] While some non-bank financial institutions are registered but *not licensed*, this shall not be permitted for deposit-taking institutions. A proportionate approach to licensing (eg less stringent licensing criteria and procedures for institutions with a low risk profile) allows authorities to allocate the level of resources appropriate for the range of activities that financial institutions are permitted to carry out and the risk posed to the financial system or depositors.

The basic licensing criteria may be similar across different types of institutions, regardless of whether they primarily target unserved and underserved customers. These criteria include the suitability and financial strength of major shareholders and sources of the initial capital (EC 5),[33] the minimum initial capital requirement (EC 6), and fit and proper criteria for the proposed board of directors and senior management (EC 7). However, the specifics of each such criterion may differ, reflecting the varying risks posed by the products, services and delivery channels designed for unserved and underserved customers as well as the institutional structure.

A graduated set of licensing criteria commensurate with the permissible activities of financial institutions may be put in place. This will contribute to ensuring that all deposit-taking institutions aiming to provide financial services to unserved and underserved customers are authorised to do so under a licensing framework that can build such customers' trust in the system.

A graduated set of criteria could also encourage unregulated microlenders to upgrade the quality of their management, governance and operations, and become regulated and supervised institutions (although formalisation is not a supervisory objective). Supervisors should, to the extent possible, monitor registered but not licensed non-bank financial institutions to identify when certain players, subsectors, products or delivery channels evolve to such an extent that the risks they pose individually or collectively become material, requiring adoption of a licensing approach that is appropriate for such cases.[34] (Similarly, an institution's migration into the next tier with stricter licensing requirements should be commensurate with its evolving risk profile).

In many countries, there are examples of non-profit microfinance institutions having "transformed" into for-profit, regulated financial institutions, including deposit-taking institutions.[35] Supervisors (and licensing authorities, where applicable) should construct a coherent regime for processing applications from "transformed" microfinance institutions.

32 In the majority of RoP Survey respondent jurisdictions, one authority licensed all deposit-taking institutions. In many RoP Survey respondent jurisdictions, financial cooperatives are licensed by the finance ministry or the general cooperative authority.

33 Non-governmental organisations or other ownerless entities (eg associations, foundations) should not be allowed to operate as deposit-taking institutions given that they lack shareholders with the incentive and capacity to infuse new capital in the event that the institution's solvency is threatened.

34 With new technologies being increasingly deployed by financial institutions to reach unserved and underserved customers (eg mobile phones, retail agents), the speed with which risk grows or concentrates in such institutions may be different from that historically observed at conventional banks.

35 In the microfinance lexicon, "transformation" typically refers to a transaction in which a non-profit organisation transfers its microfinance business to a new or existing for-profit company in exchange for shares in the new company, cash or other assets of equivalent value. Lauer (2008).

Newly organised for-profit microfinance institutions may propose having non-profit investors as well as for-profit investors. Not all investors are alike: for-profit investors may have greater incentives to monitor management decisions, while some specialised microfinance investors may have weaker incentives or capacity to oversee the risk-taking behaviour of management. Requirements on shareholder suitability and diversification and on governance structures should be crafted to reflect acceptable scenarios that may arise when there is a mix of non-profit and for-profit owners. In the case of small institutions with limited, low-risk activities, an initial proposed ownership structure may be appropriate in the short term, on a temporary basis, while requiring – in the medium term – owners with more substantial financial assets that will best ensure adequate capitalisation, good governance and a sufficient degree of monitoring over the management of the institution.

Determining the appropriate minimum initial capital requirement (EC 6) for institutions with similar risk profiles is of particular importance. Lower minimum initial capital requirements for non-bank financial institutions with typically narrower scope of activities, smaller size and reduced complexity (compared with banks) are most likely appropriate. However, the threshold should be high enough (i) to support the basic infrastructure needed to operate sustainably; (ii) to ensure that the capital will be adequate to cover unexpected losses from material activities and risks that will be assumed; and (iii) to indicate the minimum financial capacity and commitment of the new entrants. In some countries, in an effort to encourage uptake, the minimum initial capital for a new type of non-bank financial institution has been set too low, leaving the institution with insufficient funds to acquire the requisite operating systems and technology and to absorb the typical initial losses of a start-up. An excessively low requirement can also result in high numbers of relatively weak institutions or institutions engaged in riskier business models. Start-up requirements for financial cooperatives may also include minimum thresholds such as the number of individuals indicating their commitment or intention to become members, or limited geographical scope. Particular attention should be paid to regulatory or statutory conditions under which withdrawable member shares may be considered for the calculation of minimum initial capital.

Other licensing criteria – the proposed strategic plan and operating plan, projected financial condition, corporate governance and ownership structure, risk management policies, and internal controls, including the planned oversight of outsourced functions[36] – are of particular importance when applied to institutions offering new products, services or delivery channels as well as new arrangements between the applicant and other financial or non-financial firms. To adequately assess the strength of an applicant's proposed plans, policies and internal controls, the assessor should be familiar with the risks of these new products, services and delivery channels, including the data security risks of new technologies and the operational and other risks of using an agent network to interface with customers unfamiliar with using formal financial products and services (EC 8). The licensing authority should also determine that the applicants' governance and ownership structure would not hinder effective supervision and enforcement (EC 4), including on financial consumer protection issues and oversight of outsourced parties.

In many countries, innovative financial services targeting unserved and underserved customers are being offered by banks or non-bank financial institutions in partnership with non-financial firms. Institutions offering digital stored-value products that are not defined as deposits – as opposed to the channel for transmitting payment or transfer instructions – may need to be licensed. In some cases, this may mean that a non-financial firm, such as an MNO, is required to establish a separate legal entity to offer financial services.

Principle 8: Supervisory approach

An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups,

[36] The capacity to oversee agents is crucial, as the financial institution should remain liable for all actions carried out by an agent acting on behalf of the institution pursuant to an agency agreement (see guidance on Core Principle 15).

proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

Depending on the context, supervisors may adopt different supervisory approaches to certain institutions or subsectors. Any such approach should be based on a good understanding of the risk profile – including systemic importance, specific risks, dynamics and structure – of such institutions, and on a well defined methodology to establish a forward-looking view of their risk profile, both of which are required by EC 2. For instance, some jurisdictions have large numbers of small, non-complex and non-systemic individual banks or non-bank financial institutions – such as financial cooperatives, rural banks and microfinance institutions – targeting large numbers of unserved and underserved customers. Often, due to resource constraints, supervisors are not able to assess the risk profile of each and every individual institution on an ongoing basis at the same frequency or with the same intensity as they do with respect to medium-sized and large institutions.

Some jurisdictions apply different approaches, such as a *collective approach* or an *auxiliary supervision approach (*see Annex D).[37] Both approaches focus on off-site monitoring at a subsector level as well as targeted supervision of individual institutions. These approaches do not eliminate individual reporting requirements or risk assessments, but are applied based on the overall view of the subsector and on strong off-site analyses. Industry-wide surveillance helps with the identification of risks of vulnerabilities in individual institutions. Minimum standards are established for the whole subsector, but not all institutions are subject to frequent on-site inspections (as is typically the case for medium-sized and large institutions).

When financial institutions engaged in financial inclusion assume a significant size (eg in terms of assets, deposits, or number of customers) or risk profile, supervisors should focus on supervision of the individual institutions.

Regardless of the overall approach taken towards certain types of institutions, the ECs under Principle 8 are highly relevant in a context where innovative institutions, products and channels target unserved and underserved customers. For instance, as prescribed in EC 4, the supervisor should take into account the macroeconomic environment while making a risk assessment of the particular institution or group of institutions, as is done for banks and banking systems. EC 4 also asks for analyses of cross-sectoral issues, such as linkages between a particular subsector and other supervised non-banks and banks. Also, the supervisor must establish a clear framework or process for handling supervised institutions in times of stress, such that actions to handle or resolve problem institutions (ECs 6 and 7), including in sectors subject to alternative approaches, are taken in a timely manner.

In addition, as some sectors catering to the unserved and underserved may be outside the supervisory perimeter, a robust surveillance system for market monitoring will help supervisors comply with EC 8, by identifying the emergence of bank-like or illegal activities such as financial pyramids and other non-regulated schemes. Supervisors should have access to quantitative and qualitative information that helps them monitor developments in their jurisdiction, identify emerging risks, assess the systemic relevance of regulated and unregulated financial services providers, products and channels, and evaluate whether or how they should be regulated, or whether they should be considered illegal or too risky to continue operating in the market. This would help minimise potential loss of customer funds and deterioration of confidence in the financial sector and the supervisor's credibility.

[37] Another alternative approach, the use of external experts, is briefly described in Core Principle 10.

Principle 9: Supervisory techniques and tools

The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

Supervisors must have a good knowledge and understanding of the risk profile and internal control environment of financial institutions as well as the risk profile of their institutional types, not only to determine the supervisory approach (see guidance on Core Principle 8) but also to employ the most effective tools and techniques and the mix of on-site and off-site activities, and corrective measures (EC 1). As noted, initiatives targeting unserved and underserved customers may include numerous small financial institutions, greater diversity of institutions, products and delivery channels, and a greater number of third parties working with such institutions (whether related or contractually engaged as agents, partners or otherwise). Such diversity may require greater reliance on off-site supervision as well as deployment of different supervisory tools from those used for conventional banking. For instance, the quality of a traditional microloan portfolio[38] usually cannot be assessed in the same manner in which it is done for conventional commercial loans (eg with respect to sampling techniques; the checking of client documentation; the analysis of follow-on, restructured and delinquent loans; the quality of customer service and monitoring; and the focus on larger exposures). Other examples are institutions delivering pre-approved loans through mobile phones using alternative credit scoring and credit screening models developed by outsourced parties, as well as institutions using retail agents as a delivery channel for their products and services. The supervisor may conduct an inspection of a third party such as an agent network manager. Supervisors may greatly benefit from the use of technology for the identification, analysis and assessment of risks associated with an increasingly complex financial sector landscape (eg tools to facilitate the gathering, transmitting, checking, processing and analysis of regulatory returns).

Based on the knowledge of the particular subsectors and the supervisory approach chosen for each subsector, the supervisor establishes policies and procedures and a coherent process for planning and executing the supervisory activities in a consistent manner (EC 2). Where the supervisor relies more heavily on off-site supervision, the need to build a robust surveillance system increases, as it enables the development of early warning indicators, which could inform supervisory responses and actions. Such a system should enable the supervisor to identify emerging risks that may be common to other institutions serving similar client segments, delivering similar products or adopting similar strategies (eg partnerships to deliver services through mobile phones).

Supervisors should have a good level of intra-agency (EC 2) and sometimes inter-agency cooperation, coordination and information-sharing arrangements that are working effectively (see guidance in Core Principle 3) to produce an array of useful and constant information sources as determined by EC 3. For instance, in addition to financial data, a valuable source of information may be consumer complaints, particularly in fast-growing markets. Supervisors may establish a framework for receiving and analysing complaints statistics (directly from both financial institutions and alternative dispute resolution mechanisms, or indirectly from a financial consumer protection authority or unit[39]) as a technique that helps in the identification of main business conduct and corporate governance weaknesses, issues with new products or channels, and regulatory compliance matters that could affect the financial strength of a given institution or a particular sector.

A good surveillance system relies largely on standardised reporting by supervised institutions. Other sources may include self-assessments conducted by the institutions, publicly available information and market intelligence. Supervisors may coordinate with agencies in charge of collecting, reviewing and publishing additional statistics (eg assets or credit portfolio of unregulated, unsupervised non-bank

[38] See Annex E for a description of the traditional microlending methodology.

[39] See Annex A for information on the use of complaints from a consumer protection perspective.

financial institutions, national surveys including household debt levels or mobile penetration levels). Coordination may facilitate not only data collection, but also the improvement of the national data infrastructure that could feed the supervisor's analyses and its understanding of new client segments.

All supervisory tools listed in EC 4[40] could be useful for supervising banks and non-banks targeting unserved and underserved customers, and the extent of reliance on each will depend on the approach chosen for a particular subsector, the range of institutions, the range of products, their delivery channels, and the systemic importance, size, risk profile and complexity of each institution. Peer comparisons are of great importance in a good surveillance system and in particular for alternative supervisory approaches (see the discussion of two alternative approaches in Annex D) where the supervisor plays a more indirect role. The supervisor may dedicate significant resources to analyse and to understand the business models of a particular subsector and the dynamics among participants to help achieve its supervisory goals.

Coordination with other authorities (EC 5) may be relevant when supervising certain subsectors, such as those relying on telecommunications services. It is also crucial in jurisdictions where financial institutions are owned by firms regulated by other authorities. (See guidance on Core Principle 3.)

Timely communication of supervisory findings to supervised institutions (EC 8) is even more important if alternative supervisory approaches are adopted, to ensure they remain relevant. The supervisor also communicates concerns raised by the assessment of one or more institutions or from industry-wide surveillance to other institutions or their umbrella organisations. The supervisor may also communicate its risk management expectations to the subsector as a whole. Dialogues with and feedback from the industry may be sought, especially in the case of new subsectors and new risks.

The supervisor cannot outsource its prudential responsibilities to third parties. However, supervisors may choose to use external auditors (EC 11) or other specialised third parties to conduct assessments in areas where in-house knowledge is lacking, such as in the assessment of technological platforms that are the core of many subsectors reaching unserved and underserved customers (eg non-bank e-money issuers). When using the assessments carried out by third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties.

Periodic independent reviews of supervisory tools (AC 1) should be of great importance for the supervision of financial institutions targeting unserved and underserved customers, with respect to both (i) innovations that may require new and different tools in the future and (ii) alternative supervisory approaches (as described in Annex D).

Principle 10: Supervisory reporting

The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.

With respect to financial institutions targeting unserved and underserved customers, supervisors may adjust the reporting requirements to make sure they have the information needed to understand the business models and related risks (EC 1), and to carry out effective and proportionate supervision. To avoid unduly burdensome reporting requirements, supervisors need first to identify the key risk indicators that need to be monitored. Such key indicators should allow the supervisor to assess portfolio quality, loan loss provisioning, risk concentrations, related-party transactions, capital adequacy, operating costs,

[40] The five tools listed in EC 4 are: (i) analysis of financial statements and accounts; (ii) business model analysis; (iii) horizontal peer reviews; (iv) review of the outcome of stress tests; and (v) analysis of corporate governance, including risk management and internal control systems.

funding structure and liquidity position, foreign exchange exposures, and interest rate repricing gaps. Supervisors should have the ability to compare key indicators against performance benchmarks within peer groups. Reports of internal and external auditors may also be used to collect information about particular activities in supervised institutions.[41]

Adjustments to reporting requirements could capture the risks arising from innovative business models, including those adopted by institutions targeting unserved and underserved customers (EC 1). For instance, supervisors may require institutions that use the traditional microlending methodology to provide detailed information on credit risk, such as the ageing of past-due accounts, the distribution of allowance for losses based on the ageing buckets, or the levels of written-off accounts. This will allow them to assess the adequacy of loan loss provisions and the potential impact of the current exposures on capital levels. In the case of e-money issuers, supervisors may require reporting of the volume and type of transactions, as well as value of outstanding e-money issued, to be able to gauge whether supervisory measures are necessary with respect to both the issuers and the deposit-taking institutions holding the funds backing the e-money issuance. Supervisors may also require information on the network of agents used for service delivery and on the profile of a particular client segment. Proportionate reporting requirements may apply to both new institutional types and established institutions offering new products, services or delivery channels.[42]

With a view to ensuring the reliability and usefulness of the supervisory reports received from regulated entities, the supervisor must provide reporting instructions that clearly describe the accounting norms and principles to be used in preparing supervisory reports, particularly where the regulated entities are not mandated to apply international or national accounting standards. The supervisory norms and principles should be based on accounting principles and rules that are widely accepted internationally (EC 2).

Supervisors may also consider collecting standardised statistics on consumer complaints from financial institutions directly when such statistics are not requested by a financial consumer protection authority, and complementing them with statistics on complaints presented to other entities (eg alternative dispute resolution mechanism). This will help supervisors carry out comprehensive and prospective analyses of, and monitor changes in, the risk profile of financial institutions (EC 4).

Supervisors should have the authority to enforce compliance with requirements to submit timely and accurate information (EC 8). At the same time, supervisors should be mindful of potential challenges faced by some types of financial institutions targeting unserved and underserved customers (eg limited information systems, personnel and skills).[43] Supervisors may provide guidance to such institutions on how to prepare and submit regulatory returns.

Supervisors shall strive to verify the validity and integrity of regulatory returns (EC 9), although this will be challenging in some instances, where there is limited on-site work.[44] Ideally, supervisors would have a system that automatically flags unusual data patterns, such as significant changes in the value of specific variables from one reporting period to the next, and/or inconsistencies observed between the value of individual variables and that of aggregate indicators. In the case of subsectors composed of a large number of small financial institutions, supervisors may use external experts not only to verify the

[41] Consistent with Core Principles 26 and 27, supervisors should aim to ensure that auditors have adequate expertise, resources and tools to carry out their work adequately, so that supervisors can further rely on their reports; and should have the power to reject and rescind the appointment of an external auditor with inadequate expertise, independence or professionalism.

[42] The information needs to be comparable and based on the same dates (stock data) and periods (flow data) (EC 5), enabling comparisons with institutions in the same peer group.

[43] All regulated and supervised institutions, however, should make the minimum investment necessary to have adequate management information systems, commensurate with their complexity and size. In some countries, small institutions may cooperate to build subsector information systems able to generate and report the information required by the supervisor.

[44] In the case of auxiliary supervision (see Annex D), the umbrella organisation may play a role in ensuring data reliability.

validity and integrity of regulatory reports (EC 9) but also to carry out specific supervisory tasks (EC 10). This may include analysis of detailed quantitative or qualitative information provided by supervised institutions, and examination of specific aspects of their operations. Supervisors must assess the suitability of external experts for the designated task(s) and the quality of the work performed taking into consideration conflicts of interest that could influence the output and recommendations by external experts.

Cooperation and coordination among supervisory authorities on reporting requirements is important to avoid unnecessarily burdening the institutions through, for example, very similar reporting requirements from different agencies (see guidance on Core Principle 3).

Principle 11: Corrective and sanctioning powers of supervisors

> *The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking licence or to recommend its revocation.*

The need for an adequate range of supervisory tools to bring about timely corrective actions applies equally to banks and non-bank deposit-taking institutions engaged in financial inclusion. However, among respondents to the RoP Survey, supervisors more often have the authority to use corrective and remedial powers with respect to banks than with respect to non-bank financial institutions (including non-bank e-money issuers, which in several countries have greater outreach to unserved and underserved customers).[45]

Some countries permit non-financial firms such as MNOs to engage in regulated financial activities such as e-money issuing. As noted in the guidance on Core Principle 1, the law or regulation should require non-financial firms to become either registered or licensed (which might, in some jurisdictions, mean a requirement to establish a separate legal entity that is registered or licensed for purposes of engaging primarily in regulated financial activities).[46] This would facilitate supervision by the prudential supervisor and the implementation of prompt corrective actions or sanctions. Without such a registration or licensing requirement, the supervisor's authority to exercise corrective and remedial powers over such firms may be limited and the supervisor may not be able to intervene in a timely and effective manner to resolve the non-financial firm. Also, the supervisor may not have the tools, skills or power to assess the financial health of the e-money issuer if its core business is non-financial – although this challenge could be mitigated through explicit coordination and cooperation arrangements with the authority directly supervising the non-financial firm (see discussion of Core Principle 3).

Some financial institutions relevant to financial inclusion, including non-bank e-money issuers, may be subject to less intensive supervision than banks or to alternative supervisory approaches (see discussion of Core Principle 8). Supervisors should ensure that their approach to supervision and their supervisory tools enable them to monitor such institutions more closely. In addition, supervisors should engage closely with other authorities (eg the telecommunications regulator) to obtain timely information on emerging risks relevant to non-financial firms or third parties and to respond quickly and in a coordinated manner.

Supervisors need specific knowledge of providers' business models aimed at unserved and underserved customers and their risks when designing and using proportionate corrective and sanctioning measures, as some tools typically used for conventional retail banking may be less effective or or may be inadequate, and some may be applicable only to certain subsectors. Also, innovative business products

[45] The RoP Survey showed that 98% of respondents are granted the power to require commercial banks to take prompt corrective/ remedial action, while only 61% are granted the same power over non-bank e-money issuers or distributors.

[46] Entities engaged in deposit-taking activities should be licensed. See guidance on Core Principle 4.

and services may, in the initial years of operation, be offered by only one or a few providers. The risk of interrupting or reducing availability of such products and services reinforces the need for well designed measures.

Some of the corrective and sanctioning tools that are appropriate for financial institutions engaging in traditional microlending (see Annex E for a discussion of the unique features of traditional microlending) may differ from those typically used for conventional retail bank lending. For instance, restricting lending can have negative consequences for such microlenders since the implicit promise of follow-on loans to current borrowers is an important incentive for loan repayment. Also, if the lender is unable to generate new loans to cover the high upfront costs of the labour-intensive traditional microlending methodology, its capital base may deteriorate quickly. Market solutions – eg mergers and loan sales – may be problematic, as traditional microloan portfolios may lose value when sold or transferred.[47] If such market solutions result in or send a signal of a change in the close relationship between client and lender, incentives for repayment may be reduced.[48] Supervisors designing corrective or sanctioning measures must therefore have a good understanding of the specific dynamics of traditional microlending, so that the supervisory measures do not lead to unintended and undesirable consequences.

Financial cooperatives may also require specific corrective and sanctioning actions due to their membership-based structure and, in some countries, their system-based organisation.[49] The requirement for a financial cooperative to raise additional capital may be more challenging due to its capital and ownership structure.

Supervisors may also consider alternative approaches, in which strict corrective or sanctioning measures against one provider may produce the desired behaviour changes or curb undesired behaviour in other providers with similar business models (see "collective approach" in the guidance on Core Principle 8 and in Annex D). The challenges in the design of prompt corrective actions and sanctions should not discourage their implementation, since their absence would weaken supervisory effectiveness and eventually impact negatively on the safety and soundness of the supervised financial institutions.

Principle 12: Consolidated supervision

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

A common recent development in many countries is the increased participation of non-financial firms with wide distribution networks that are used to improve physical access to financial services by previously unserved or underserved customers. These firms include international or domestic retail department stores and telecommunications companies that may offer financial products and services as agents of financial institutions or that directly provide credit facilities to their customers. These non-financial firms may be parents of a licensed financial institution or affiliated to the same parent company of a financial institution.

Depending on the systemic relevance of a financial institution and its risk profile, supervisors should strive to understand the financial and non-financial businesses of the group to which the institution is affiliated; the parent company's corporate culture, business goals and incentives; and how these factors may impact the way that the financial institution's operations are carried out. Supervisors should aim to understand how the market share of the group, as well as its structure and internal dynamics and the economic sectors in which it operates, may impact the risk profile of supervised financial institutions, including the risks that non-financial firms may bring to the safety and soundness of the financial

[47] See Rozas (2009).

[48] See Annex E for a description of the traditional microlending methodology.

[49] In some countries, financial cooperatives are organised in structured systems in which individual cooperatives form higher-level structures such as federations, associations, central cooperatives and cooperative banks.

institution (EC 1). In some cases, contagion and reputation risks stemming from firms affiliated to or the parent company of the supervised financial institution can be quite high. A group-wide view becomes particularly important due to the increasing presence of new players targeting unserved and underserved customers and the delivery channels that they use.

Supervisors should also pay attention to the establishment, by regulated financial institutions, of special purpose vehicles or group entities that may be outside the supervisor's remit, to undertake activities such as providing credit. Besides gaining operational efficiencies, such decisions may also be motivated by regulatory arbitrage objectives. Here again, a group-wide view by the supervisor is essential to identify and act upon risks posed by unregulated activities within the group to the regulated entity or to financial stability.

Supervisors should have clear direct authority to review, and should review, the main activities of parent companies of financial institutions targeting unserved and underserved customers, including non-financial parent companies, as well as companies affiliated to the parent companies that have material impact on the safety and soundness of the financial institution and the financial system (EC 5). Supervisors should be able to take appropriate and effective supervisory action where required, including, in the case of non-financial parent companies, the establishment and enforcement of fit-and-proper requirements for owners and senior management (AC 1).

3.2 Core Principles on prudential regulations and requirements

Principle 14: Corporate governance

The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.

Robust corporate governance is of great importance in institutions targeting unserved and underserved customers, as it ensures responsible and sustainable financial inclusion based on a culture that reinforces values such as sound risk management and the fair treatment of customers (see Annex A for a discussion on financial consumer protection). Some non-banks may have governance structures and practices that are significantly different from those of banks. This would require from the supervisor a good understanding of how such structures work and their impact on the institution's risk profile. In situations where the supervisor might not be able to exercise the same level and intensity of regulation and supervision over such non-banks, the supervisor will tend to rely more on robust corporate governance standards.

The supervisor should issue guidance on its expectations for sound corporate governance and disseminate such expectations to the institution's board of directors (EC 1). Supervisors can also set appropriate minimum requirements for board structures (EC 3) and fit-and-proper criteria for board members (EC 4), and develop some guidance to help institutions conduct self-assessments of their level of compliance with principles and regulatory requirements for sound corporate governance.

Supervisors should check whether there is effective Board oversight and participation when board members live abroad and participate in the board of multiple institutions, a situation that may be commonly found in some types of institutions engaged in financial inclusion. Moreover, it is relevant to note that, in many countries, state-owned banks (eg rural banks, postal banks and development banks) may pose specific challenges in terms of governance.[50] In such situations, supervisors should require the financial institutions to follow the same principles of good governance required of privately owned banks.

The above characteristics would theoretically call for greater supervisory scrutiny of financial institutions catering to unserved and underserved customers. Regular assessment of corporate governance (EC 2) may require frequent engagement with an institution,[51] which may be challenging for supervisors with limited resources particularly where the number of institutions providing such services is high. Potential alternative approaches to supervision are discussed in Core Principle 8.

The supervisor should determine that (i) the board of a financial institution establishes and communicates corporate culture and values, for example through a code of conduct (EC 5); and (ii) the board and senior management of a financial institution understand and effectively manage and mitigate the risks posed by the operational structure (EC 8). To the extent that a financial institution's use of third parties – whether as agents, agent network managers, or partners providing data processing or other services – becomes significant, it will be important for the financial institution to ensure that its culture and values are upheld and that the financial institution has the capability to manage and mitigate the risks. The supervisor should ensure that transparency is adequate to address the concerns of transactions with related parties that are addressed in Core Principle 20.

EC 8 also has applicability to non-financial firms authorised to offer financial services directly to consumers. Non-financial firms engaged in financial services[52] may pose challenges for supervisors assessing their governance structure or addressing other supervisory concerns, not only because their structure will differ from those of financial institutions more familiar to the supervisor, but also because their main business is not within the remit of the financial supervisor. (See discussion of Core Principle 12.) Obstructions to supervision may be introduced, even inadvertently, by the firm, and attention to the supervisor's concerns may be limited depending on the importance of the financial business to its overall business. The supervisor's access to information may not be as effective as it would be if the provider were a separate legal entity. Last, the supervisor may not be able to ensure that the board of the non-financial firm has enough expertise in the financial business under supervision.

Principle 15: Risk management process

The supervisor determines that supervised institutions have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.

Supervisors should be well informed and have good understanding of the business models, risk types, risk sources and risk exposures of banks and non-banks catering to unserved and underserved customers. With these inputs, supervisors will be able to set proportionate (not necessarily lower) expectations of risk management strategies, policies and processes commensurate with the varying scale and complexity of operations, risk profile and systemic importance of different institutions, and determine that the supervised

[50] See OECD (2015) for further discussion on distinct governance challenges faced by state-owned entities.

[51] See EC 7 of Core Principle 9 in BCBS (2012); and guidance on corporate governance principle 13 (The role of supervisors) regarding regular interaction of supervisors with directors and senior management, in BCBS (2015b).

[52] As noted in the guidance on Core Principle 4, non-financial firms engaged in activities such as e-money issuance may need to be licensed and supervised. In some jurisdictions, this may mean that the non-financial firm will need to establish a separate legal entity to issue e-money.

institutions have established these expectations and that they are appropriate (ECs 1 and 2). Supervisors can make such determinations primarily during licensing (in the case of small financial institutions), during ongoing supervision (including through meetings with board members or senior management), and when the supervised institution introduces new products or services or delivery channels, according to the supervisory approach adopted (see discussion of Core Principle 8). Well informed supervisors will be able to systematically review and adjust their expectations of risk management processes for providers targeting unserved and underserved customers as needed. Supervisors should determine whether the board and senior management have a good understanding of, and are able to obtain sufficient information on, the specific risk areas that could pose threats to the safety and soundness of their operations (EC 4), in particular those risks associated with innovative products, services and channels (EC 8).

Key risk management challenges faced by financial institutions targeting unserved and underserved customers may relate to the lack of a comprehensive view of risks in a fast-changing environment, unavailability of qualified staff, and deficient management information systems. Supervisors should particularly assess financial institutions' policies and processes to manage risks arising from outsourced parties, as these are highly relevant when targeting unserved and underserved customers, given the prevalence, for example, of the use of agents as the main interface with retail customers. Financial institutions should ultimately hold responsibility for the outsourced activities, so they need to have specific mechanisms to ensure regulatory compliance, such as to ensure that agents follow relevant consumer protection and AML/CFT rules.[53] Also relevant is the increased use of alternative credit scoring and screening models developed by outsourced third parties (see guidance on Core Principle 17). Supervisors should require that financial institutions test and validate these models and understand the limitations and uncertainties relating to their output. This could be done as well at the subsector level, depending on the supervisory approach taken (EC 6). Recently, it has become increasingly important for supervisors to require and determine that financial institutions have adequate policies and processes to manage consumer protection risks, ensure fair treatment of customers and provide an effective customer care system (see Annex A).

Supervisors should also pay special attention to the adequacy and integrity of the information systems in supervised institutions (EC 7). These systems are crucial for proper recording of transactions and management of accounts and secure storage of personal data. In the case of small transaction accounts offered to unserved and underserved customers as well as loans delivered to such customers via mobile phone, the information system should allow the monitoring and management of risks associated with the use of third parties that are often providing agency services for the delivery of such new products (EC 8). Information systems should also allow for the timely and reliable creation, processing and transmission of risk management reports to senior management, particularly in the case of fast-changing environments. Information systems should be strengthened in parallel with changes in types of risks and customer profiles as well as portfolio of products, services and channels offered by the financial institution.

Supervisors should monitor the resources available for risk management in financial institutions targeting unserved and underserved customers (EC 9), and assess whether there are resource constraints and the reasons behind such constraints. For example, the business model of financial institutions applying the traditional microlending methodology places greater responsibility on loan officers (see Annex E), making it harder to segregate risk management and risk-taking functions – a situation that can still be mitigated through other mechanisms. On the other hand, financial institutions may face rapid increases in exposures and sources of risk due to a combination of high demand and increased offerings of new products, services or delivery channels. This could strain risk management capacities initially planned for

[53] The applicable law or regulation should indicate that the financial institution remains liable for all explicitly or implicitly authorised actions of an agent acting on behalf of the institution pursuant to an agency agreement, and that this agreement clearly states the institution's liability. The regulation may also require that such agreement specify agent responsibilities and the actions that the financial institution can take when responsibilities are not fulfilled or rules are not followed by the agent.

a lower level of business operations. Supervisors should ensure that there is a balance between the financial institution's risk appetite and its capacity to manage risks.

When issuing standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk (EC 11), supervisors should pay special attention to the specific risks arising from the products, services, channels and types of institutions catering to unserved and underserved customers, in order to set standards commensurate with these characteristics. Such standards may vary from those imposed on institutions catering to other market segments.

Supervisors should require and carefully review, especially at the licensing stage, the contingency arrangements for ensuring business continuity during disruptions to the operations of financial institutions using digital delivery channels to reach unserved and underserved customers, particularly if they rely on the uninterrupted services provided by third parties (EC 12), including agents and telecommunications services.

Taking into account the potentially greater contagion risks (eg traditional microlending institutions) and reputational risks (eg state-owned banks) faced by some types of institutions targeting unserved and underserved customers, supervisors should require and determine adequacy of the policies and processes of the individual institutions to address such risks (AC 1).

Principle 16: Capital adequacy

The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.

As explicitly stated, implementation of the capital adequacy regimes under Basel I, Basel II or Basel III is not a prerequisite for compliance with the Core Principles. This is of great relevance for the proportionate (ie risk-based) implementation of capital adequacy requirements, particularly with respect to smaller, less complex institutions (EC 1). Further, EC 4 permits capital adequacy requirements to vary from bank to bank based on its risk profile. While AC 1 states that capital requirements imposed on non-internationally active banks are to be broadly consistent with the principles of the Basel standards, its application to certain types of non-internationally active banks and non-banks engaged in financial inclusion requires consideration of the need to be proportionate. Where supervisors choose to apply Basel standards, Basel I or the simplified approach of Basel II may be adequate for less complex and non-systemic banks and non-bank institutions. Compliance with advanced measurement techniques may be beyond the expertise of many institutions (including some banks), and ensuring compliance with them may become costly.

Indeed, the RoP Survey indicated that some respondents, as an alternative to Basel standards, do not impose a capital adequacy ratio on institutions other than commercial banks, but impose simpler requirements such as a minimum nominal capital and leverage ratio. For non-bank e-money issuers, supervisors may substitute capital adequacy ratios with requirements to protect client funds. For example, the non-bank e-money issuer is often required to set aside, in an account with a prudentially regulated financial institution, an amount equivalent to the total e-money issued and to take other measures to protect the customers' ownership of such funds.[54]

[54] This document recognises that some jurisdictions (eg the European Union) impose, in addition to fund protection measures, an ongoing capital requirement variable according to the size of the e-money operation, for the purposes of loss absorption. This is an evolving discussion in many countries where non-bank e-money issuers are operational.

While ECs 1 and 2 emphasise the importance of adequately defining the qualifying components of regulatory capital, this task may be particularly challenging for small financial cooperatives.[55] Some specific measures may be adopted, depending on the structure, size and sophistication of a particular cooperative sector: (i) restricting redemptions of shares unless capital adequacy ratio is kept at a minimum level equal to or higher than that specified by regulation; (ii) requiring cooperatives to make liquidity deposits in a second-tier entity or to use another comparable facility; or (iii) applying capital adequacy requirements on a group or system basis (eg at the level of a federation or a central cooperative). For the last two measures, the liquidity and solvency of the cooperatives will depend on the liquidity and solvency of the second-tier entity. Consequently, these entities must be well regulated and supervised.

A proportionate approach does not always result in lower capital adequacy ratios. Supervisors may impose higher capital adequacy requirements (sometimes temporarily) to compensate for weaknesses in certain subsectors.[56] For example, small financial cooperatives may face difficulties in raising additional capital in times of stress or may not have adequate contingency plans (EC 6 [b]) due to their membership-based operations and decision-making process.

Several characteristics of traditional microlending (see description in Annex E) might justify: (i) higher capital adequacy ratios for financial institutions deeply engaged in this type of activity than those imposed on diversified financial institutions or institutions not as engaged in such activity; or (ii) a tailored approach to risk-weighted assets that differentiates traditional microlending from "other retail exposures" – the asset category typically assigned to microloans under the misguided assumption that they exhibit features similar to those of a large pool of small, diversified loans. The following characteristics of traditional microlending are particularly relevant: (i) the defaults in traditional microloans usually result in loss, with limited recovery through collateral; (ii) borrowers that notice increasing delinquency in the institution may stop paying if they believe that the institution will be less likely to offer follow-on loans due to credit quality problems; (iii) the high operational costs of generating and maintaining high volumes of short-term small loans, which indicates that a relatively low level of delinquency will de-capitalise a specialised traditional microlender more quickly than it would a diversified commercial bank; and (iv) losses in traditional microloan portfolios may be linked more strongly to localised events given the high degree of interdependency of low-income borrowers and the typical regional concentration of microfinance institutions. In general, selecting an appropriate level of regulatory capital will require a clear regulatory definition of different types of microcredits and a good understanding of the local context with respect to microfinance operations (see guidance on Core Principle 17).

Principle 17: Credit risk

The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.

The changes introduced in 2012 to this Core Principle focused on clarifying the institution's responsibility to manage its credit risk throughout the entire credit life cycle, following sound risk management policies and processes that include on- and off-balance sheet risks and take into consideration the market and

[55] Member shares issued by mutual and cooperative banks could be treated as common equity for regulatory purposes provided that they meet the permanence and loss absorption criteria, as per BCBS (2011). 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 capital definitions and other elements of regulatory capital requirements to align with emerging guidance and sound practices.

[56] The majority of respondents to the RoP Survey that set higher capital adequacy ratios than what is required by the Basel standards were from lower-middle- and low-income jurisdictions.

macroeconomic context in which credit risk arises. These modifications are highly relevant to supervisors dealing with an expanding range of microlenders (eg traditional microlenders, payday lenders, bank and non-bank consumer lenders), and types of products offered.

In order to make an adequate assessment for ensuring compliance with Core Principle 17 and its ECs, supervisors need to distinguish financial institutions using traditional microlending methodologies (described in Annex E) from those using other less labour-intensive methodologies. In many countries, microlenders (particularly banks) are extending large numbers of very small loans based on credit scoring which uses alternative client information often supplied by third parties, such as bill payment history, non-financial data from social media, mobile phone usage and big data analytics.[57] These loans may be closer to consumer loans in terms of risk management methodologies, although there is not yet enough experience to make a general statement about their performance compared with traditional microlending. Some models also use new delivery channels (eg pre-approved loans delivered through mobile phones and payroll-based loans).

It is important for supervisors to familiarise themselves with newer, alternative credit scoring and screening techniques, and to be satisfied that the lenders using them adequately test their strength. Also, given the emergence of business models in which third parties participate in the loan delivery process (for example, digital delivery of credit by mobile phone or payment card) and may supply non-financial data and data analytics, supervisors may also strive to understand whether and how the use of such third parties affects credit risk management and whether the lenders (and their boards) are aware of the assumptions and limitations of outsourced methodologies (in line with EC 3 [a] and [g]). As new methodologies emerge, it is important that the lender retain responsibility for setting credit approval policies and credit limits (EC 3 [b] and [e]). Supervisors must determine that lenders, regardless of their size, have commensurate but robust information systems (EC 3 [d]), which are critical for good credit risk management and without which an effective supervision of credit risk is hampered.

Further, special attention may be paid to financial institutions engaging in riskier business models or products such as those relying on high delinquency rates (eg lending to clients with low credit scores) and offering products with high inherent risks (eg loans in a currency different from that of the borrower's income). Specifically, inquiry is appropriate into whether lenders are reassessing the borrower's payment capacity every time a new loan is being extended, in line with EC 3 [c], or are instead creating debt traps for certain delinquent customers. This is critical for loans to financial consumers with little or no experience in the formal financial sector and low financial capability, and who may more readily take on credit without reflecting on their needs or their capacity to pay back. Lending to customers with high risk of overindebtedness is also important vis-à-vis the financial health of the financial institutions if they are underestimating the risks and underpricing the loans.

The negative consequences of consumer overindebtedness may be significant, not only for financial inclusion but also for financial stability[58] – high delinquency levels affecting one financial institution could cause negative spillover effects on others operating in the same market and lead providers to label entire categories of consumers as "unlendable". Supervisors should require that financial institutions targeting unserved and underserved customers have policies and processes in place to monitor and avoid overindebtedness (in line with EC 4).[59]

The proliferation of formal, informal, regulated and unregulated microlenders with varying business models raises further concerns regarding debt stress and potential systemic consequences of overindebtedness in some jurisdictions. Such concerns have driven efforts to improve credit information

[57] The changing nature of microfinance is captured, for instance, in CSFI (2014).

[58] See FinCoNet (2014).

[59] See policy tools to curb debt stress in Davel (2013).

(both positive and negative) on a broader set of customers of providers beyond banks. In some jurisdictions, credit information on unserved and underserved customers may not be available, accurate or reliable.[60] An effective credit information system that includes the full range of bank and non-bank lenders serving different market segments, including the unserved and underserved, is critical for avoiding overindebtedness. Public and private sector efforts to raise consumer awareness of the risks of overindebtedness would also be important.

Principle 18: Problem assets, provisions and reserves

> *The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.*

Core Principle 18 and its ECs apply to different types of microlenders, but a tailored approach is required with respect to institutions engaged in traditional microlending (described in Annex E), especially regarding asset classification and provisioning (EC 7). For example, in traditional microlending, past-due loans should move to riskier categories with higher provisioning and be classified as non-accrual more quickly than other types of loans (EC 5). Different approaches may also be considered for certain innovative microcredit products that rely on alternative credit scoring models and delivery channels (as discussed in the guidance on Core Principle 17) as supervisors gain knowledge about their performance.

To build a flexible but appropriate regime for problem assets, supervisors need to understand microlending dynamics and the local market practices. Care may be warranted when using external experts in assessing a lender's policies and processes for classification and provisioning of microcredits (EC 2), making sure that such experts have adequate knowledge of innovations in microlending. Particular attention should be paid to rescheduled, refinanced reclassified microcredits to avoid circumvention of the classification and provisioning standards (EC 5). Rescheduled microcredits typically should be classified in a higher risk category than microcredits presenting the same number of days or payments past due. The supervisor may also consider the unique features of loans to small farmers, which are often "bullet loans" requiring special treatment separate from other microfinance loans.

EC 4[61] is of great relevance for supervisors implementing a problem asset framework for financial institutions targeting unserved and underserved customers, as the performance of their microloan portfolios is increasingly linked to the macroeconomic environment,[62] and often highly influenced by the specific market conditions and the country's political situation. These factors, which impact the likelihood and speed of portfolio deterioration, should be accounted for by the supervisor when assessing the classification and provisioning of microloan portfolios. Supervisors may try to reduce the impact of negative macroeconomic conditions by establishing dynamic provisioning that mandates higher provisioning requirements in periods of high economic growth; such provisions could be used to meet provisioning requirements in recession periods.

The supervisor must be satisfied that the institution's policies and processes to grade, classify, monitor and provision loans recognise the risks stemming from market dynamics and are supported by adequate information systems. The generation of accurate and timely data (EC 6) will allow the supervisor

60 The RoP Survey showed that 81% of respondents have one or more credit bureaus or registries that collect information on microcredit, but non-bank lenders are less likely to be required to report to and consult such credit bureaus/registries than banks. For analysis and recommendations on the development of credit information systems that cover all types of microlenders, see Lyman et al (2011).

61 "The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions." BCBS (2012).

62 See, for instance, Di Bella (2011), Wagner (2012), Wagner and Winkler (2013) and Kruijff and Hartenstein (2014).

to run tests tailored to microfinance (EC 5), including accuracy tests that will help it spot instances of non-compliance or tampering with the policies and rules.[63] Ensuring robust information systems in supervised institutions is essential for achieving effective implementation of ECs 6 and 10, which require the supervisor and the board, respectively, to obtain timely and appropriate information on the condition of the asset portfolio. The final decision on loan provisions must not be outsourced to any third party.

When setting up requirements on the valuation of risk mitigants (EC 8) applicable to traditional microlending, the supervisor should consider that risk mitigants are less often used by microlenders and, when used, they are used differently from conventional banking. When a microlender obtains collateral, it usually does not cover the value of the loan and often the collateral is not expected to be enforced due to the high enforcement costs relative to the loan amount. This is particularly the case in countries with weak judicial and legal systems. Possession of charge over collateral is expected to evoke better repayment behaviour. (See Annex E for discussion of key features of traditional microlending relevant to asset quality and credit risk.)

Finally, a tailored approach to traditional microlending should be based on a clear and appropriate regulatory definition of microcredit, microloan, microfinance loan or similar term applicable to banks and non-bank financial institutions implementing this particular methodology.

Principle 24: Liquidity risk

The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.

Implementing Core Principle 24 requires specialised knowledge of the specific dynamics of assets and liabilities in institutions targeting unserved and underserved customers – particularly traditional microlenders – and the nature, structure and behaviour of funding sources, which may differ from those of complex, large banks.

Liquidity requirements should reflect the risk in the context of the markets and macroeconomic conditions in which the supervised institutions operate (EC 2). Every institution engaged in financial inclusion should develop a robust liquidity management framework including strategy, policies and processes consistent with its size, scope and complexity (EC 3). As the types of institutions and their products (including those that target unserved and underserved customers) become more diverse and complex, the application of Core Principle 24 becomes more challenging, requiring the supervisor to keep abreast of emerging business models and to develop understanding of the changed liquidity risk (for instance, how the innovative credit products targeting unserved and underserved customers, discussed in Core Principle 17, impact liquidity management). Finally, the institutions engaged in financial inclusion, regardless of their size and complexity, should have good information systems (EC 4 [c]) to allow effective identification, aggregation, monitoring and control of liquidity risk exposures.

[63] For useful guidance on microfinance portfolio assessments, see Christen and Flaming (2009).

The specific assets typical of traditional microlenders (see description in Annex E) introduce liquidity risks that are different from those of conventional, diversified banks and non-banks.[64] As the promise of follow-on microloans is an important incentive for borrowers to repay (with the treatment and response of individual borrowers having a potentially significant impact on other borrowers of the same institution), a traditional microloan would usually behave like a long-term asset,[65] the proceeds of which may be unavailable in a liquidity shortage. Traditional microlenders also face the potential for rapid deterioration of capital in the case of loan defaults as they usually rely on their loan portfolio as their most important source of revenue.

In many countries, a non-bank e-money issuer is required to place an amount equivalent to the total outstanding e-money it has issued into a restricted account of one or more deposit-taking institutions to guarantee the availability of funds for customer withdrawals. Some jurisdictions may also apply other liquidity requirements to e-money issuers, but the supervisor should be mindful of the costs of liquidity maintenance and the consequent impact on the operational viability of the supervised institutions (for example, e-money issuers).

The market for savings and current accounts is also transforming, in particular with respect to the ease with which unserved and underserved customers can open accounts and carry out transactions through a wider range of channels. There is limited data on the behaviour and stability of low-value deposits maintained by low-income customers in banks and non-banks, and it is not clear whether there are significant differences with mainstream retail bank deposits.[66] It is important to note that sources of funding for many institutions reaching unserved and underserved customers (which often differ from those of conventional banks) may have difficulty responding quickly in the event of liquidity shortfalls. In some markets, microfinance institutions borrow heavily from local banks for onlending, exposing both lenders and borrowers in the event of market-wide deleveraging.[67] Finally, non-bank deposit-taking institutions may not have access to central bank liquidity facilities, impacting contingency funding plans (EC 6).

The above factors may justify supervisors requiring a higher liquidity requirement or focusing on high-quality, highly liquid assets, particularly for small institutions, with less expertise and capacity in asset and liability management and in designing and testing contingency funding plans.[68] The supervisor may consider imposing a cushion in the form of a reserve or liquidity ratio, requiring institutions to hold sufficient unencumbered liquid assets (for example, as a percentage of deposits) and limiting concentration of funding sources, which could be introduced in a phased manner for institutions in their first years of operation, subject to stricter supervisory monitoring in the early phases.

Liquidity risk management should focus on comprehensively measuring and forecasting cash flows and maintaining an adequate minimum liquidity cushion for business-as-usual and stressed situations, taking into account the likely behavioural responses of relevant actors. The application of ECs 5–7 (eg establishment and regular review of funding strategies, robust contingency funding plans, and stress testing) to institutions targeting unserved and underserved customers should be commensurate with the complexity, scope, size, risk profile and business model for each type of institution and should

64 In fact, although not always the case, non-banks engaged in traditional microlending generally hold relatively large amounts of cash or highly liquid assets such as government bonds. With complex, diversified banks, this could be viewed as inefficient intermediation.

65 See Brom (2009). It is important to recognise that the microfinance business is an evolving one, and the assumption of follow-on loans as a strong or the main incentive for loan repayment may vary across providers and across countries. Specific knowledge of the particular market on the part of supervisors is warranted.

66 For studies on deposits in microfinance institutions, see Westley and Palomas (2010).

67 For an analysis of microfinance crises, see Chen et al (2010). The link between microfinance and local and global markets is further explored in Kruijff and Hartenstein (2014).

68 The RoP Survey showed that having differentiated liquidity requirements for banks and other deposit-taking institutions is not common. A differentiated approach is more common with respect to financial cooperatives.

not be unduly onerous. However, while setting these requirements, supervisors should be mindful of the potential contagion effects that may manifest in geographically concentrated markets or in microloan portfolios, as discussed in the guidance on Core Principles 16 and 17.

Principle 25: Operational risk

> *The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.*

Supervisors should determine that financial institutions reaching unserved and underserved customers are cognisant of the distinct operational risks associated with their products and delivery mechanisms as well as the target customers and other characteristics of the market that they serve (ECs 1–3). In evaluating whether operational risk frameworks put in place by the supervised institution are adequate, the supervisor should understand the potentially fast-evolving roles played by third parties involved in the delivery of the financial services, including third-party providers that may access information on payment accounts and provide payment initiation services to users. The supervisory assessment should aim at ensuring that operational risk is managed without stifling innovation.

Supervisors should be able to ascertain that financial institutions targeting unserved and underserved customers have the necessary internal controls and information systems in place to ensure that risks are appropriately managed (including consumer protection and conduct risks). Examples of operational risk events related to financial inclusion include the following:

- Internal fraud: A non-bank e-money issuer can manipulate the books (to steal customer funds) so that it appears that the e-money on its books matches the funds deposited in a trust account or custodial account with a deposit-taking institution.[69] Although e-money is a relatively simple financial product, this does not mean that the risks of manipulation are lower or that the controls are simpler than risks and controls involved in managing deposit accounts.
- Execution, delivery, and process management; external fraud: The use of agents as the primary customer interface – including to accept deposits and loan repayments and to enable withdrawals – introduces new operational risks and consumer protection risks in addition to the common outsourcing risks (EC 8). Long distances between a financial institution and its agents can make oversight of agent actions difficult, introducing increased risk of fraud and theft, abusive treatment of customers, and failure to handle customer data confidentially.[70] Policies and procedures governing the selection, training and oversight of agents should be designed to address these risks.
- Clients, products and business practices: Customers new to formal financial services and digital financial transactions may lack familiarity with the technology applications and the complexities of digital interfaces, which may result in them sending value to the wrong mobile number or forgetting the security measures of the mobile device. Digital financial transactions often rely on electronic (as opposed to paper-based) records and receipts, which can sometimes give rise to availability- and reliability-related issues due to interruption of service. These issues may undermine customers' trust in the institution and its products, services and/or channels.
- Business disruption and system failures: Financial institutions targeting unserved and underserved customers may be operating in areas that lack basic infrastructure or are prone to

[69] A trust account or custodial account may help ensure that the funds of e-money clients are not available to other creditors of the e-money issuer.

[70] The data security and fraud problems are further exacerbated by a practice common among customers new to digital financial services: to give their passwords to agents.

interruptions in the delivery of basic services. Disruptions in service may impact the provider's reputation and result in a loss of customer confidence not only in the specific company but also in digital delivery mechanisms. Financial institutions using digital platforms as the sole means of serving customers need business continuity measures to address the risk of disruptions on the platforms used (EC 4). Supervisors should understand and consider the practical realities in serving these areas while balancing the need for the supervised entities to put in place mechanisms to address risks resulting from this type of operating environment.

Both on the digital platforms and in the networks of agents, it must be clear to the supervised institutions that they have the final responsibility to the supervisors and customers for, among other things, the protection of consumers' personal and financial information. Supervisors should have the authority to look into the implementation of service level agreements if deemed necessary, and take action when there are risks arising from the non-implementation of certain provisions (EC 8).

In some countries, the delivery by both banks and non-bank financial institutions of financial services to unserved and underserved customers via mobile phones is concentrated in one or two MNOs. Supervisors should monitor these situations to assess whether such financial institutions become more vulnerable to, or exposed to new sources of, operational risks (eg service unreliability or disruption) and, if they do become so, require them to diversify or establish appropriate contingency plans to address stress in the service providers or the unavailability of a service provider (AC 1). The supervised institution and the supervisor would benefit from periodic testing of the contingency plans for its operational feasibility during stress situations.

Principle 28: Disclosure and transparency

The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

Supervisors should require all financial institutions (i) to adhere to minimum accounting and disclosure standards, which promote comparability, relevance, reliability and timeliness of disclosed information (EC 1); and (ii) to disclose on a regular basis minimum quantitative and qualitative information that is commensurate with their risk profile (EC 2), easily accessible and understandable. Supervisors should take into account potential limitations in the technical capacity of, and resources available to, non-bank financial institutions as well as their potential need for more intensive and detailed guidance and orientation on the preparation of public disclosures.

When establishing disclosure requirements, supervisors should take into account differences in risk sources and exposures associated with different financial institutions, products and channels targeting unserved and underserved customers (AC 1). For example, with respect to institutions engaged in traditional microlending, the shorter terms of the microloans and the potential for more rapid deterioration in the quality of loan portfolios should be taken into account. With respect to e-money issuers, disclosure regarding how customer funds are being held (eg in a trust account with a bank) as well as the different actors involved in the provision of services (eg account administrators, IT providers, agent networks) would be relevant. Disclosure on business models, geographical, sector or customer base concentration, and governance structures are also important for financial institutions tending to unserved and underserved customers; as well as disclosure of related parties (EC 3), including non-financial firms (eg retail stores or MNOs) and third parties with an agency or other outsourcing relationship. Disclosure requirements should strike an appropriate balance between the need for meaningful disclosure (for market conduct and consumer protection purposes) and the protection of proprietary and confidential information.

In accordance with EC 5, supervisors should regularly publish easily understandable and accessible quantitative and qualitative information on each subsector they supervise (eg analytical reports on products, services, delivery channels, institutions, customers and key developments, and databases with historical and current statistical information). Supervisors may publish this information on their website for easy access by the general public and/or distribute to other actors that can then transmit this information to the wider public (eg consumer organisations, research institutes and journalists). Such disclosures by the supervisors can serve as inputs to the supervised institutions for their risk management and business strategies. Supervisors may also publish guidance notes or have direct conversations with such actors to expand outreach and improve understanding of market information.

Principle 29: Abuse of financial services

The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

AML/CFT regulation should follow a proportionate or "risk-based approach" – consistent with the FATF standards[71] – requiring financial institutions to adopt enhanced CDD measures for transactions or products that present higher AML/CFT risks and permitting them to use simplified CDD measures where risks are lower.[72]

Subject to a jurisdiction's assessment of its money laundering and terrorist financing risks, financial inclusion products and services may present lower risk if they are subject to appropriate restrictions such as: (i) low-value limits, whether for account balances, individual transactions or total value of transactions in a given period; (ii) geographical restrictions (eg no or limited international transactions); or (iii) restrictions on the customer who may be offered and use the products and services (eg only individuals).[73] Among RoP Survey respondents, the most common means of establishing "lower risk" was the imposition of low-value thresholds. Where risks are *proven* to be low, the regulator should have the option to grant limited exemptions from AML/CFT obligations, and should do so where appropriate.

Regulation that requires documentation to verify identity can potentially create barriers to access to financial services and products. It is therefore important to consider the purpose and design of the verification measures and to accept non-standard identity verification – provided that it uses reliable and independent-source documents, data or information – in jurisdictions that lack a reliable national identity document or other widespread means of identity verification.[74] For services that involve remote account opening via mobile phone or agent, explicit permissibility of non-face-to-face CDD by agents or mobile device is essential. (This may include the use of biometric technologies.)

Appropriate understanding and employment by banks and non-bank financial institutions of simplified CDD is especially important as overly strict compliance with CDD rules can prevent unserved and underserved customers from accessing formal financial services and products and potentially increase the risk of money laundering and terrorist financing by shifting transactions to the informal economy. Supervisors should provide appropriate guidance as to what the risk-based approach to CDD entails – including with respect to ongoing due diligence and monitoring – and communicate the importance of managing the risks of individual account holders when applying such a risk-based approach.[75] Consistent

71 See Annex B for a brief overview of recent steps FATF has taken that are relevant to financial inclusion.

72 Regulation should require financial institutions to assess their money laundering and terrorist financing risk. See examples of higher- and lower-risk activities articulated in the Interpretive Note to FATF Recommendation 10, in FATF (2012).

73 This is consistent with paragraph 17 of the Interpretive Note to FATF Recommendation 10 (FATF (2012)).

74 See FATF Recommendation 10 (FATF (2012)).

75 Supervisors should also understand the drivers of and reasons for a financial institution not applying simplified CDD to lower-risk products, where allowed. For further discussion on this issue, see FATF (2016).

with FATF standards, where there is an actual suspicion of money laundering or terrorist financing risk, enhanced due diligence should be applied regardless of any threshold or exemption.[76]

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Annex A

Financial consumer protection in the financial inclusion context

The importance of accompanying financial inclusion efforts with proportionate financial consumer protection policies cannot be overstated. The need for financial consumer protection primarily arises from an inherent imbalance of information, power and resources between financial institutions and consumers, particularly in the case of unserved and underserved customers. Consumer protection aims to ensure that all financial institutions offering similar products follow minimum rules of engagement with consumers and do not engage in business practices that may cause harm to consumers, ultimately introducing risks to the long-term health of the financial sector, including through deteriorated public confidence.

Consumer protection also highlights the importance of having well informed consumers who know, understand and act on their rights and responsibilities, are capable of understanding and assessing the risks and rewards involved in using basic financial products and services, and are able to make financial decisions accordingly. This can be difficult for unserved and underserved consumers who typically have little experience with financial institutions and low levels of financial capability.[77] Also, the consequences of their financial missteps may be more severe than for other consumers, such as exclusion from the financial system, loss of funds or assets, and social exclusion. It is worth noting that financial education and financial consumer protection are complementary policy objectives and that each may increase the effectiveness of the other. However, financial education cannot substitute for regulation and supervision in the establishment of an effective financial consumer protection framework.

1. Developments in financial consumer protection

In the 2012 Core Principles, the BCBS acknowledged, as a precondition for effective banking supervision, that each jurisdiction needs a well developed public infrastructure in which consumer protection laws (and other business laws) are consistently enforced and provide a mechanism for the fair resolution of disputes. Several international bodies and jurisdictions have also placed increased emphasis on financial consumer protection and the linkages with financial stability, especially after the 2007–09 global financial crisis.[78] In 2011, the G20 Finance Ministers and Central Bank Governors endorsed the High-level Principles on Financial Consumer Protection (High-level Principles) developed by the G20/OECD Task Force on Financial Consumer Protection in close cooperation with the Financial Stability Board, other global bodies, and consumer and industry associations.[79] The High-level Principles were designed to complement existing

77 World Bank (2013) defines financial capability as the internal capacity to act in one's best financial interest, given socioeconomic environmental conditions. It encompasses the knowledge, attitudes, skills and behaviours of consumers with respect to understanding, selecting and using financial services, and the ability to access financial services that fit their needs.

78 For example, in 2012, the World Bank released *Good Practices for Financial Consumer Protection*; in 2013, the International Financial Consumer Protection Organisation (FinCoNet) was created to provide guidance and further collaboration among national authorities responsible for financial consumer protection; in 2008, Accion's Center for Financial Inclusion launched the Smart Campaign as a global private effort to promote a set of Client Protection Principles in the microfinance industry.

79 G20/OECD (2011).

international financial principles and guidelines, without addressing sector-specific issues dealt with by standard-setting bodies.[80]

2. Guidance for supervisors

An effective financial consumer protection framework requires the participation of multiple stakeholders,[81] including authorities with financial consumer protection responsibilities and prudential supervisors.[82] The High-level Principles (and the subsequent reports on effective approaches that support their implementation)[83] serve as the framework for the discussion below on core policy, regulatory and supervisory aspects of particular relevance for supervisors of financial institutions engaged in activities related to financial inclusion that also have a financial consumer protection mandate.

Principle 1: Legal, regulatory and supervisory framework

Supervisors could play a role in strengthening the financial consumer protection framework by identifying areas where there are legal and regulatory inconsistencies, overlaps or gaps (eg between a banking law and a consumer protection law, or a banking regulation and a regulation applicable to microfinance institutions), and by coordinating with other authorities to amend (or issue new) laws or regulations (consistent with guidance on Core Principle 3). Inter-agency coordination and consultation with non-governmental stakeholders (eg industry associations and consumer organisations) are needed to have a set of consumer protection rules that are proportionate, incorporate consumer research insights,[84] and take into account different consumer risks associated with different types of products, services and channels, particularly those targeting unserved and underserved consumers (including cooperative members and micro-entrepreneurs formed as legal entities that may not fall within the legal definition of "consumer"). These supervisory actions would contribute to a consistent and proportionate legal, regulatory and supervisory consumer protection framework applicable to banks and non-bank financial institutions (consistent with guidance on Core Principle 1).

Principle 2: Role of oversight bodies

There is no one-size-fits-all approach to effective institutional arrangements for financial consumer protection. Prudential supervisors in many jurisdictions have incorporated consumer protection into their mandates, while in other jurisdictions financial consumer protection remains the remit of other authorities (eg a separate market conduct authority). Whatever the scenario, it is crucial that all financial institutions be overseen from a consumer protection standpoint and that the oversight body (or bodies) have a clear and undisputable consumer protection authority. This authority should include powers to carry out enforcement actions (consistent with guidance on Core Principle 1), as well as appropriate governance,

80 G20/OECD (2011).

81 Other stakeholders include general consumer protection, competition and data protection authorities; deposit insurers; other financial supervisors (eg cooperative agency, microfinance authority); payment overseers; finance ministries; alternative dispute resolution mechanisms; and telecommunications regulators.

82 The RoP Survey showed that, in more than 70% of respondents, the prudential banking supervisor also has financial consumer protection or market conduct responsibilities.

83 The Task Force released two connected reports presenting sets of underlying assumptions that further clarified and explained each High-level Principle, and illustrating effective approaches to support the implementation of each High-level Principle. See G20/OECD (2013, 2014).

84 Insights from market research analyses focused on consumer perceptions, attitudes and experiences with financial products, services and providers. Consumer research methodologies include mystery shopping, focus groups, in-depth interviews, and quantitative and qualitative surveys.

operational independence, accountability and resources (guidance on Core Principle 2 may be useful), and clear and consistent processes (guidance on Core Principle 9 may also be useful). This is particularly relevant for non-bank deposit-taking institutions and non-bank e-money issuers outside the remit of financial supervisors, considering that they may be covered – with respect to consumer protection legislation and regulation – exclusively by general consumer protection authorities with limited supervisory and enforcement powers.

There are three main types of consumer protection supervisory activities: market monitoring, off-site supervision and on-site supervision. Guidance on Core Principle 8 (regarding greater emphasis on market monitoring and off-site supervision, at an individual or subsector level, in the case of small, non-complex and non-systemic financial institutions) is also applicable to consumer protection supervision. Multiple techniques and sources of information, often different from those used for prudential supervision, may be used to identify and assess emerging and increasing consumer risks that affect the risk profile of financial institutions and may pose risks to the financial sector or a subsector. Useful market monitoring and off-site supervision techniques include analysis of statistical and qualitative information on consumer complaints (from both the complaints handling unit inside a financial institution and external mechanisms); monitoring of advertising and marketing materials, and media articles or reports; analysis of standard agreements or disclosure formats; and review or commissioning of consumer research (eg focus groups, in-depth interviews, consumer surveys, mystery shopping). On-site supervision techniques may include meetings with representatives from non-governmental sectors (eg consumer associations); assessment of compliance with consumer disclosure rules by visiting branches and other channels (eg agents); analysis of complaints logs in customer centres; and mystery shopping to assess compliance with rules during the sales process or when a complaint is raised. This wide range of techniques merits the implementation of a specialised supervisory training programme.

Prudential supervisors with a consumer protection mandate may face challenges in the concomitant implementation of both responsibilities, given the different nature of consumer protection risks, different skill sets needed, the risk of underplaying the importance of consumer protection problems, and potential conflicts between supervisory actions addressing prudential and consumer protection concerns. One way of addressing such challenges is by increasing specialisation of supervisory staff, which might happen gradually, or by establishing cooperation arrangements with other supervisory authorities at the local and/or international level.[85] The incorporation of a consumer protection mandate would require adjustments by the prudential supervisor (eg building staff capacity, modifying organisational structure, issuing new regulations, creating new manuals and procedures, implementing new supervisory tools). Strengthening intra-agency coordination would also be crucial.

Inter-institutional coordination challenges are often heightened due to the presence of multiple authorities with financial consumer protection responsibilities (eg 60% of RoP Survey respondents vested responsibility for financial consumer protection in two or more separate authorities, including 35% of respondents where such responsibility was vested in three or more authorities). These challenges may be addressed through multiple forms, including written agreements or coordination forums. Regardless of the form, they need to have effective mechanisms to ensure active and continuous participation of different agencies. Effective coordination and cooperation are crucial especially between prudential and consumer protection supervisors. For further discussion on this area, see guidance on Core Principle 3.

85 At an early stage, prudential supervisory staff may receive specialised training to carry out consumer protection supervision. Later on, a specialised consumer protection team may be set up inside a general division or a risk unit (eg operational risk). The specialised team could develop internal manuals, policies and procedures; train staff; lead or advise supervisors; review supervisory reports; and propose enforcement or corrective actions. A specialised and dedicated consumer protection supervision unit may eventually be established separate from prudential supervision, with clear functions, appropriate resources and available enforcing mechanisms. For more information, see Dias (2013).

Principle 3: Equitable and fair treatment of consumers

The duty of equitable and fair treatment should be an integral part of the corporate governance and business culture of financial institutions (which should ensure such treatment by their outsourced parties, in particular their agents). They should treat their customers fairly and equitably and act with good faith at all stages of the provision of any financial service or product to consumers. Authorities with financial consumer protection responsibilities should require financial institutions to include fair treatment and customer care duties in internal manuals, risk management procedures, control functions and agreements with outsourced third parties, and to implement an adequate, integral customer care mechanism available at all stages of the customer relationship.

When designing and implementing a consumer protection regime, it is important that authorities take into account the special challenges faced by vulnerable consumers, who are often illiterate, semiliterate or innumerate; who have little or no experience in the financial sector; who may be under high financial distress or with very low income; whose first language is not an official one; or who are elderly, disabled, immigrant or part of minority groups. Higher potential for abuse may result in greater than expected risk-taking and internal frauds, which could lead to increased reputational risks.

Principle 4: Disclosure and transparency

Financial institutions should disclose clear, simple, comparable, free-of-charge information (including, at a minimum, terms and conditions, key facts statements, rates and fees) that helps consumers before, during[86] and after the sale of a financial product. Other relevant information may include disclosure of the regulator or supervisor of the financial institution, agency arrangements, deposit insurance coverage of financial products (consistent with guidance on Core Principle 4),[87] and contact information for recourse mechanisms. Specific requirements on standard, consistent and easily readable terms and forms are key to increasing disclosure effectiveness. Authorities should take into account the special challenges presented by the offering of digital financial products, including the need to test the effectiveness of simple, short disclosure provided via mobile devices, and the characteristics of the main customers of these products, who may include vulnerable consumers (see High-level Principle 3). Authorities may also help raise awareness on consumers' responsibility to disclose accurate and relevant information to financial institutions.

Authorities can use mystery shopping and other tailored on-site supervision techniques (see discussion on High-level Principle 2) to assess compliance with disclosure rules, particularly rules with a timing element (eg oral disclosures and explanations during the sales process).

Principle 5: Financial education and awareness

Prudential supervisors are increasingly assuming financial education responsibilities.[88] Even when they do not have such responsibility, supervisors may be able to play a leadership role (eg in the development of national financial education strategies or programmes). In any case, authorities with financial consumer protection responsibilities have a unique role to play in providing clear explanations of key legal and regulatory provisions regarding (i) the consumer protection obligations of financial institutions and their agents; (ii) the rights and responsibilities of consumers; and (iii) the mandate and responsibilities, including enforcement and sanctioning actions, of the authorities.

86 For guidance on point-of-sale disclosure in relation to savings or investment products in the banking sector (as well as insurance and securities sectors), see Joint Forum (2014).

87 Disclosure about deposit insurance coverage is especially relevant in the context of financial innovations, where e-money products may be issued by non-banks and may or may not be considered a deposit depending on the applicable legal framework in a jurisdiction.

88 Prudential supervisors in 48% of the RoP Survey respondents have financial education responsibilities.

If there are several supervisors overseeing the financial system (eg central bank, banking supervisor, financial cooperative supervisor, deposit insurance agency, consumer protection agency, data protection agency), they should also clearly communicate their specific responsibilities to the public. Furthermore, they should disclose the use of any alternative supervisory approaches and publish a list of licensed financial institutions under their remit (as per guidance on Core Principle 4).

Principle 6: Responsible business conduct of financial services providers and authorised agents

The negative consequences of consumers acquiring unsuitable financial products may be significant for both financial inclusion and stability (as indicated in the guidance on Core Principle 17 regarding overindebtedness risk). When unsuitable products are marketed or distributed by agents that unserved or underserved customers know locally and trust, this may cause loss of consumer confidence not only in a specific agent but also in the delivery channel or subsector as a whole, or the financial sector in general.

Duty to act with due skill, care and diligence in providing financial services or products to consumers should thus accompany fair treatment duty as an integral part of the corporate governance and business culture of financial institutions. Minimum, clearly defined and understandable standards for responsible business conduct could be set out in law, regulations, guidelines or codes, with input from providers and consumers.

Financial institutions should assess their customers' financial situation, needs and capabilities before agreeing to provide them with a product, service or advice. Financial institutions should be responsible for the actions that their staff and agents carry out on the institution's behalf and should train staff about the products and services they can offer to customers. Authorities may use diverse supervisory techniques (eg mystery shopping) to assess the quality of service provided by financial institutions and share findings with prudential supervisors. Authorities should also pay special attention to the financial institution's remuneration structure and policies, which should promote a sound risk culture where not only risk-taking but also risk outcomes are taken into account, and employees are encouraged to act in the interests of the institution as a whole and its clients.[89] Inadequate remuneration policies may incentivise excessive risk-taking and irresponsible behaviour toward clients.

Principle 7: Protection of consumer assets against fraud and misuse

Protection of consumer assets against internal fraud and misconduct committed by financial institutions is key to maintaining consumer confidence in the subsector where they operate, especially in the context of new products, services, channels and providers. From a traditional microlending perspective, there should be clear mechanisms for microlenders to return compulsory savings to their borrowers, enforced by relevant authorities. Two separate elements of financial inclusion models introduce new risks of internal fraud and misconduct: (i) the increased use of outsourced parties in the provision of financial services (eg retail agents, technological platform provider, customer account manager); and (ii) new institutions engaged in the issuance and handling of e-money.

With respect to e-money, internal fraud may arise from manipulation of accounts by the e-money issuer (see guidance on Core Principle 25) or a third-party account manager, which may rapidly lead to the failure of an institution. Strong coordination among policymakers, prudential supervisors, financial consumer protection authorities and deposit insurers or resolution authorities may be helpful in developing a cogent legal, regulatory and supervisory framework that aims to safeguard customer funds in the event of the wind-up of a non-bank e-money issuer and to have mechanisms for agile reimbursement of individual e-money clients so as to avoid impacting public trust in e-money issuers generally (and potentially confidence in the financial sector more broadly).

[89] For further guidance on remuneration, see BCBS (2015b) and Financial Stability Board (2009).

Regarding external fraud, there should be at least one authority with clear powers to terminate fraudulent activities perpetrated by unregulated or informal providers. In several jurisdictions, this authority relies on the prudential supervisor or the financial consumer protection agency.[90] The use of market monitoring techniques could help such an authority in the early identification of fraudulent activities (see guidance on Core Principle 8 and High-level Principle 2). The existence of a clear legal or regulatory definition of activities that can only be carried out by a licensed or registered entity may provide a clear basis for the termination of fraudulent activities (see guidance on Core Principle 4).

Principle 8: Protection of consumer data and privacy

Data and privacy protection is salient in the context of recent financial innovations that use a varied range of consumer data (eg usage of mobile phone services, utilities payment history, tax payment) to create algorithms that forecast debt payment behaviour. In many cases, one or more non-financial firms are in charge of gathering and processing information from different sources and then producing a credit scoring scale to be used by a financial institution when offering a credit (see guidance on Core Principle 17).

Financial institutions should be required to (i) keep confidential consumers' personal and financial information; and (ii) take other data protection measures. Unless information-sharing is based on a clear legal obligation, financial institutions should inform consumers about how and when their information is shared, give consumers access to their data, and enable consumers to correct mistaken information in credit bureaus and records of financial institutions.

Principle 9: Complaints handling and redress

Financial institutions should (i) have adequate internal complaints handling procedures (including responsible staff); (ii) clearly disseminate this information to their clients, both directly and through any delivery channel they may be using; and (iii) submit to authorities periodic reports with statistical information on the complaints they receive.

There should be external redress mechanisms to address consumer complaints that are not adequately resolved via the internal mechanisms of financial institutions. In many jurisdictions, underserved consumers may assume that the supervisor provides the recourse mechanism. Supervisors could help increase consumer awareness (eg through their website, call centre, official communications) about existing recourse mechanisms. In some jurisdictions, prudential supervisors have already taken on the responsibility of resolving disputes.[91] However, given the challenges that dispute resolution presents for supervisors – including the time commitment, developing a specific skill set, and potential conflicts of interest – they may wish to encourage the use of alternative dispute resolution mechanisms (eg financial ombudsmen, mediators, arbitration bodies, conciliation schemes, small claims courts) specialised in financial sector issues.[92]

Complaints information collected by redress mechanisms should follow minimum standards that allow for comparison, consolidation and analysis, as well as identification of cases where consumers only requested information and of possible complaint duplication. Cooperation among different stakeholders will be essential to develop an effective system for complaints analysis. This information could also be used in prudential supervision as mentioned in guidance on Core Principles 9 and 10.

[90] The RoP Survey indicated that the prudential supervisor or central bank has leading powers to terminate the operation of a fraudulent scheme in 50% of respondents, whereas the financial consumer protection authority has such powers in 13% of respondents.

[91] Prudential supervisors in 35% of the RoP Survey respondents engage in dispute resolution.

[92] For guidance on basic principles of operation of such mechanisms, see for example Thomas and Frizon (2012) and INFO Network (2014).

Principle 10: Competition

Authorities should pay special attention to individual and industry-wide competitive practices in unserved and underserved market segments to identify abusive or unfair business practices harming or limiting options for consumers. Responsive measures (eg recommendations, regulations, corrective actions, sanctions) should be taken in coordination with competition and other authorities, such as the telecommunications authority or payments overseer. The use of adequate monitoring and supervision tools (eg mystery shopping, focus groups, advertising review) can help authorities understand the market context and the effect of such abusive or unfair practices on consumers and take better-informed supervisory decisions.

Annex B

Developments in guidance on anti-money laundering and combating the financing of terrorism

In the past few years, the FATF has taken significant actions that make it easier for policymakers to pursue financial inclusion goals while combating money laundering, terrorist financing and other financial crimes. First, the FATF adopted an expanded and clarified risk-based approach to AML/CFT regulation and supervision as a cornerstone of the 2012 revised FATF Recommendations. Second, in its revised Methodology for assessing compliance with the FATF Recommendations, the FATF incorporated assessment of the effectiveness of a country's AML/CFT regime for the first time. The list of factors that assessors may consider in their compliance evaluations explicitly includes financial inclusion policy objectives and financial exclusion. In addition, reflecting its understanding that financial exclusion can compromise a country's ability to track financial crimes by increasing the numbers of people using informal providers, the FATF issued updated guidance on financial inclusion (FATF (2013a)); guidance on prepaid cards, mobile payments and internet-based payment services (FATF (2013b)); and guidance on money or value transfer services (FATF (2016)).

In 2014, in response to the changes in the FATF's standards, the BCBS issued a set of guidelines regarding sound management of risks related to money laundering and financing of terrorism.[93] The guidelines seek to align the BCBS standards with the FATF's Recommendations and replace the BCBS's earlier, rule-based approach to customer due diligence (CDD). The 2014 guidelines provided detailed guidance on how to manage standard and higher risks and referred supervisors to the FATF's guidance paper on financial inclusion and its "useful guidelines on designing AML/CFT procedures that are not overly restrictive to the financially or socially disadvantaged".[94] In addition, the BCBS reiterated statements made in earlier BCBS documents[95] underscoring the importance that "customer acceptance policy [not be] so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged".[96]

As the expanded and clarified risk-based approach to AML/CFT differs importantly from the strict, more rule-based CDD approach that banks were previously called upon to implement, banks require supervisory guidance to undertake appropriate money laundering and terrorist financing assessments and to move from their former strict rule-based CDD measures to AML/CFT measures that respond appropriately to higher as well as lower risk.

93 BCBS (2014).

94 BCBS (2014).

95 See BCBS (2001) and BCBS (2003), which was added as an attachment to the 2001 document.

96 BCBS (2014).

Annex C

Definitions of certain terms; correlation with terminology used in the BCG Range of Practice Report

The terms listed below do not have universally recognised definitions and may be defined in various ways by different jurisdictions' laws and regulations. However, for the purposes of their use in this Guidance, they have the meanings noted below.

- **Deposit-taking institution:** Bank and any other financial institution licensed to take deposits and intermediate such funds, including financial (savings and credit) cooperatives. The term does *not* include: any institution that engages *only* in remittances – that is, transferring funds from a payer or transferor to a payee or transferee subject to a limited maximum holding period (eg in the range of two to five days); or any informal savings scheme, such as a rotating savings and credit association comprised of a small group (eg 25–50 people).
- **E-money issuer:** A bank or non-bank that issues e-money.[97] This Guidance does not address closed-loop systems (such as retailer gift cards), where the e-money can only be used to purchase goods and services offered by the e-money issuer.
- **Financial cooperative:** A member-owned and member-controlled financial institution governed by the "one member, one vote" rule. Financial cooperatives often take deposits or similar repayable funds from, and make loans only to, members, although some also serve non-members. The term includes credit unions, caisses, cajas, cooperative banks, and savings and credit cooperatives.
- **Microcredit:** Small credit typically provided to unserved and underserved customers, in particular the underemployed, self-employed or informally employed poor and low-income individuals and microenterprises.
- **Microfinance institution:** A financial institution that provides financial services, including microcredits, to unserved and underserved customers. A microfinance institution is a type of microlender.
- **Microlender:** A legal entity or an individual engaged primarily in extending microcredits. Examples of microlenders include microfinance institutions, and banks specialised in offering microcredit to unserved and underserved customers.
- **Non-bank deposit-taking institution:** Any deposit-taking institution that is not a bank.[98]
- **Non-bank financial institution:** Any licensed or registered financial institution that is not a bank. (This term is used in the same way in the Core Principles.)
- **Non-financial firm**: Any business primarily dedicated to activities other than provision of financial services. (This term is used in the same way in the Core Principles.)

[97] The CPMI defines e-money as "a digital equivalent of cash, stored on an electronic device or remotely at a server". CPMI (2014).

[98] There are various jurisdictions that group as "traditional depository institutions" banks as well as savings associations and credit unions and *exclude* these institutions from terms such as "non-bank deposit-taking institution" or "non-bank financial institution". As defined in this document, the term "non-bank deposit-taking institution" reflects its use in the 2012 Core Principles.

- **Traditional microlending methodology:** The lending methodology described in Annex E.

The six RoP Survey terms, which were also used in the RoP Report, are: "commercial bank", "other bank", "financial cooperative", "other deposit-taking institution", "microcredit institution" and "non-bank e-money issuer or distributor". These terms were selected to enable gathering and analysis of data on the treatment of different types of banks (commercial banks, non-commercial banks, and cooperative or mutual banks) and of different types of non-banks: financial cooperatives, other deposit-taking institutions (defined in the RoP Report as excluding financial cooperatives), non-bank e-money issuers or distributors, and microcredit institutions. The RoP Survey results also enabled the comparison of treatment of banks versus non-banks. The inclusion in the RoP Survey of questions on microcredit institutions was intended to help determine whether microcredit activities are regulated and supervised differently based on institutional type.

As a result of the findings from the RoP Survey, there was no need in this Guidance to distinguish particular issues pertaining to different types of banks, so only the term "bank" is used. In contrast, the Guidance discusses specific regulatory and supervisory treatment of e-money issuers, which are significantly different in terms of operations and risk from e-money distributors that are not issuers. For that reason, the RoP Survey term "non-bank e-money issuer or distributor" is not used in this Guidance; the term "e-money issuer" is used. And while the term "other deposit-taking institution" was used in the RoP Survey, the Guidance uses the term "non-bank deposit-taking institution", which is the term used in the Core Principles.

Table C.1 below compares the terms used in this Guidance with the terms used in the RoP Survey and RoP Report.

Comparison of terms used in Guidance and RoP survey/report* — Table C.1

Guidance terms	RoP Survey and RoP Report terms	Comments
Bank	Commercial bank Other bank, ie non-commercial bank	Guidance term "bank" includes both RoP Survey terms (commercial bank and other bank)
E-money issuer Non-bank e-money issuer	Non-bank e-money issuer or distributor[99]	There is some overlap. Guidance terms "e-money issuer" and "non-bank e-money issuer" do not include non-bank e-money distributors
Financial cooperative	Financial cooperative	Identical terms
Microfinance institution	Other deposit-taking institution	RoP Survey term "other deposit-taking institution" includes Guidance term "microfinance institution" but is broader. For example, other deposit-taking institutions may target a broader population than the unserved and underserved
Microlender	Microcredit institution	Guidance term "microlender" is not limited to financial institutions but includes any legal entity or individual
Non-bank deposit-taking institution	Financial cooperative Other deposit-taking institution	Guidance term "non-bank deposit-taking institution" includes both RoP Survey terms ("financial cooperative" and "other deposit-taking institution")

[99] The grouping of non-bank e-money issuers with non-bank e-money distributors was intended to draw in more responses (although the results may have been less illuminating as a result of such grouping).

Comparison of terms used in Guidance and RoP survey/report*		Table C.1
Guidance terms	RoP Survey and RoP Report terms	Comments
Non-bank e-money issuer	Non-bank e-money issuer or distributor	Guidance term "non-bank e-money issuer" does not include non-bank e-money distributors
Non-bank financial institution	Financial cooperative Other deposit-taking institution Non-bank e-money issuer or distributor Microcredit institution	Guidance term "non-bank financial institution" includes institutions falling under four RoP Survey terms: "financial cooperative", "other deposit-taking institution", "non-bank e-money issuer or distributor"; and "microcredit institution"

Annex D

Two alternative supervisory approaches for large numbers of small institutions

1. The collective approach

One potential alternative supervisory approach for large numbers of small institutions is based on a collective view of certain subsectors, in particular when a subsector is comprised of numerous small institutions using similar business models.[100] (This approach is used by at least two RoP Survey respondents to cover rural banks.) To be able to establish a forward-looking view on the risks posed by such a subsector, including potential risks to the broader financial system, prudential supervisors strive to understand the dynamics among participants, which could dictate the potential contagion effect of the failure of one institution; trends in concentration; determinants of growth and investment; the specific risks of the main products offered; the delivery channels used; and the key incentives for risk-taking. As prescribed in EC 4 of Core Principle 8, the macroeconomic environment and its impact on the particular subsector is included in such a forward-looking view.

Supervisors also analyse cross-sectoral issues, such as linkages between a particular subsector and other subsectors, to gauge the potential impact of the failure of the subsector as a whole or of a large subsector participant. For instance, non-bank e-money issuers may distribute loans for banks in some jurisdictions. The failure of a large non-bank e-money issuer could impact the partner bank's performance if the loan portfolio is of considerable size and could impact other institutions using the issuer's distribution network (ie agent network) for the delivery of the same or other products or services (eg payments). The supervisor may also consider the potential for loss of confidence in the financial system or parts of it due to failures in a subsector with linkages to other subsectors (or a perception of such linkages among the general public), such as a loss of confidence and a deposit run on banks due to a crisis in the microfinance sector.

A collective approach to supervision is mostly based on off-site monitoring of indicators at the subsector level, but also involves on-site inspections at individual institutions. Collective industry surveillance can help with the identification of risks of vulnerabilities at the institutional level. The supervisor may establish minimum standards for the subsector,[101] and conduct assessments in a few institutions, such as the market leaders and a few smaller participants. The supervisor may extrapolate the results of such assessments to the entire subsector and use them to improve its understanding of the subsector on such topics as current risk management practices, business models and practices, main assets and liquidity sources, and target market segments. The corrective and sanctioning measures applied to individual institutions could be a deterrent to other institutions in the subsector. Similarly, prompt regulatory action could affect the whole subsector, eg regulations prohibiting certain products or activities that expose institutions to risks beyond the risk management capacities observed in the subsector generally or pose undue risks to consumers. To make this possible, the supervisor needs to constantly

[100] A subsector of financial institutions may be based on their core activity (eg traditional microlending, consumer lending, payday lending, e-money issuing, or financial cooperatives) and other features (eg geographical location, customer types, risk profile).

[101] Subsector minimum standards may cover such topics as corporate governance, specific procedures for credit risk management (as discussed with respect to Core Principles 17 and 18), and specific procedures for management of distribution channels such as agents.

interact with market participants both to clearly communicate its expectations and the results of individual assessments and to obtain feedback from them.

2. Auxiliary supervision approach[102]

"Auxiliary" supervision, which has been used most often with respect to financial cooperatives, involves reliance on another organisation – referred to in this Guidance as an "umbrella organisation" – to play a defined supervisory role. An umbrella organisation may be, for example, a second-tier cooperative, a federation, a cooperative bank or a deposit insurance fund. If there is no existing umbrella organisation, then this approach may not be an efficient means of supervising large numbers of small non-bank financial institutions.

Auxiliary supervision facilitates supervision by the prudential supervisor; it does not substitute for supervision by the prudential supervisor.[103] The prudential supervisor focuses on off-site monitoring of the subsector, as well as of individual institutions, and conducts supervision of the umbrella organisation – including an assessment of the quality of its supervision of individual institutions. The prudential supervisor conducts individual assessments when deemed necessary (and much less frequently than is done for umbrella organisations). From the supervisor's standpoint, auxiliary supervision is an input for monitoring, and may decrease the risk of this subsector, which in turn reduces the need for intensive ongoing supervision of individual institutions.[104] Thus the supervisor retains ultimate legal responsibility for supervision and enforcement. The supervisor may also – depending upon the specifics of the arrangement – retain the power to revoke the supervisory responsibilities of the umbrella organisation and to overturn its assessments and the corrective measures taken against individual institutions.

The practice of auxiliary supervision varies widely based on the history, legal and regulatory framework, and market structure of the jurisdiction in question. For example, the level of formality of the supervisory role played by the umbrella organisation and how that impacts the role of the official supervisor varies from minimal formality to a role verging on delegated authority for supervision. Other commonly varying elements include the type of institution acting as the umbrella organisation and the number of umbrella organisations in a market. Their governance and funding also vary.[105] The legal and practical arrangements between the supervisor and the umbrella organisation, the activities assigned to the umbrella organisation, the reporting process, and the supervisor's oversight of the umbrella organisation also vary greatly across countries. For instance, the umbrella organisation may be required to set up a common information system for financial reporting to the supervisor, or each individual cooperative may be required to report directly to the supervisor.

To establish a clear, effective and efficient operation of the umbrella organisation, its mandate, responsibilities and activities should be clearly defined in regulation. Its responsibilities and activities may include the powers or duties to:

- enforce compliance by individual institutions with applicable regulation;

102 For a discussion on auxiliary supervision of financial cooperatives, see Cuevas and Fischer (2006).

103 Auxiliary supervision is very different from a situation in which a separate financial supervisory authority is created only to regulate and supervise financial cooperatives, for example, and the prudential supervisor is not involved.

104 This objective has prompted some countries to prohibit the operation of financial cooperatives unless they are affiliated to an umbrella organisation under supervision by the prudential supervisor.

105 For example, one respondent to the RoP Survey created, through regulation, a supervisory unit under the deposit protection fund for financial cooperatives. This body is funded by levies imposed on the individual cooperatives covered by the deposit protection fund, and supervises only cooperatives with assets above a set minimum threshold. Supervision is conducted by regional sub-units.

- promptly take previously defined corrective measures against individual institutions, under the circumstances defined in the regulation or agreed upon with the supervisor;
- report to the supervisor any difficulty when performing its supervisory role and any suspicion of illicit activities or major weaknesses in individual institutions;
- conduct inspections on specific institutions when requested by the supervisor;
- monitor implementation of measures recommended by internal and external auditors of the individual institutions; and
- monitor implementation of corrective or enforcement measures imposed by the supervisor, as well as of business plans presented to the supervisor.

As with any supervisory approach, auxiliary supervision has potential weaknesses, the most important being the inherent conflicts of interest, that is: between the supervisory role of the umbrella organisation and (i) the promotional and advocacy roles it may play with respect to the sector it covers; and/or (ii) the commercial relationships it may have with individual institutions (eg if the umbrella organisation is a second-tier cooperative providing financial services such as liquidity and guarantee facilities). Other shortcomings that may affect many emerging market economies and developing economies include the lack of expertise, capacity, information systems, or financial and other resources needed by the umbrella organisation to conduct supervision.

Building an effective auxiliary supervision model may require intensive "coaching" by the prudential supervisor to the umbrella organisation, which may put a strain – even if temporary – on supervisory resources. Supervisors considering auxiliary supervision may also need to assess the viability of adopting measures to mitigate risks, such as the need to reform the legal framework for financial cooperatives. Finally, the risks of an auxiliary supervisory model may be weighed against the risks, to the bank supervisor, of: (i) not conducting supervision of individual institutions at all; and (ii) failing to implement other supervisory approaches (eg direct supervision). Finally, strong political support at high levels of government may be needed not only to implement measures to mitigate potential risks of the auxiliary supervision approach, but also to ensure that the approach is not abused by powerful or influential individual institutions or umbrella organisations.

Annex E

Traditional microlending

Traditional microlending has a number of distinctive features that result in a unique risk profile. As discussed in the Guidance, effective credit risk management requires different tools and analyses from those applicable to both conventional retail lending as well as recent innovations in microlending.

The main distinctive features of traditional microlending include:

(i) *Target clients*. A traditional microlender usually caters to unserved and underserved customers, both the underemployed and the entrepreneur with an often informal family business (eg petty traders). Borrowers are typically concentrated in a limited geographical area, social segment or entrepreneurial undertaking.

(ii) *Labour-intensive methodology*. 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 are also assessed during field visits. Credit information systems do not always cover unserved and underserved clients and are not necessarily accessible by all types of microlenders, but when they exist, they may be used as well. Importantly, credit scoring, when used, complements rather than supplants the labour-intensive procedures.

(iii) *Credit approval and monitoring*. Because traditional 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.

(iv) *Use of collateral*. The borrowers often lack the collateral traditionally required by banks, and what they have to pledge is of little value for the microlender but highly valued by the borrower (eg TV set, furniture). Where the microlender does take some sort of collateral, it is for leverage to induce payment rather than to recover losses.

(v) *Loan terms and loan documentation*. Loans are usually very small, short-term and unsecured, with more frequent repayments and higher interest rates than conventional retail bank loans. Many providers require higher interest rates to offset higher operational costs involved in the labour-intensive traditional microlending methodology. Loan documentation is generated largely by the loan officer through visits to the borrower's business and home.

(vi) *Controlling arrears*. Strict control of arrears is prioritised given the short-term nature, lack of collateral, high frequency of payments (eg weekly or bi-weekly), and contagion effects of microfinance loans (as discussed below). Traditionally, monitoring is primarily in the hands of loan officers, as the knowledge of the client's unique circumstances is important for effective collections.

(vii) *Progressively increasing lending*. Traditional microlending uses incentive schemes to reward good borrowers with preferential access to future, larger loans (sometimes with more favourable repayment schedules and lower interest rates), which raises the risk of overindebtedness, particularly where credit information systems are deficient. This feature also affects interest rate risk management, as borrowers may expect rates to decline as the customer's track record grows, regardless of changes in the general level of interest rates. "Follow-on loans" are one of the most distinctive features of traditional microlending.

(viii) *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 can help to ensure the high repayment levels usually observed in this methodology, as the default of one group member could adversely affect the availability of credit to others.

Specific risks include:

1. *Payment default and contagion effects*. Tight control of arrears and peer pressure have driven traditionally sound repayment rates in many jurisdictions to date. However, the quality of individual loans can deteriorate quite rapidly, due in part to their unsecured or undersecured nature 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.
2. *Currency-related risks*. Microlenders may lend in a currency other than that of a borrower's repayment source (eg sale of goods or services), in which case foreign currency fluctuations may affect the borrower's ability to repay. While this is not unique to traditional microlending, these borrowers may be less able to appreciate and mitigate the risks.
3. *Political interference*. Traditional microlending may be seen as a political tool in some countries, tempting politicians to demand forbearance or forgiveness of loans to poor customers during certain times, or offering interest-free loans that may impact the repayment culture in certain groups of borrowers.