

**ABI Position paper on  
the Basel Committee on  
Banking Supervision's  
consultative document  
"Microfinance activities and the  
Core Principles for Effective  
Banking Supervision"**

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## Introduction

The Italian Banking Association (ABI) appreciates the Basel Committee on Banking Supervision's ongoing commitment to microfinance supervision. This commitment was evidenced in February 2010, with the publication of the consultative document "Microfinance activities and the Core Principles for Effective Banking Supervision".

The Basel Committee's report contains guidelines on supervising microfinance activities and represents an important framework of current practices and experiences in countries from different regions and with different income levels.

It gives greater exposure on the matter at the international level and confirms the importance of microfinance, something which is increasingly being offered by banks and non-bank financial institutions in many countries.

In particular, the document draws international attention to microfinance especially with respect to its supervisory aspects and promotes further development in the regulatory national frameworks defining the areas of applicability.

ABI has prepared this position paper on the basis of comments received by the dedicated interbanking Working Group on Microcredit.

ABI's comments aim to support the Committee's attempt to develop adequate guidance for the application of the Core Principles to microfinance activities conducted by depository institutions. The comments benefit from ABI's expertise in banking sector regulation and supervision, and the significant work that ABI has done to foster microfinance in Italy.

Also the main purpose of this document is to take this opportunity of the consultation to describe ABI's position on the issues raised by the Basel Committee with reference to microfinance and the potential application of these principles in Italy.

## General observations

Italian banks and ABI believe microfinance could represent a very effective way to close the gap between demand and supply on the access to financial services, as it is able to improve, on the one hand, financial and social inclusion and, on the other hand, to develop innovative opportunities for the banking sector.

The Italian Banking Association has developed a set of initiatives regarding microfinance at the national and local level.

ABI is constantly mapping out services and different institutions engaged in microfinance activity (including banks, non-governmental organizations, microfinance institutions, etc.). A recent survey shows that the number of banks engaged in microcredit programs, sometimes in partnership with public institutions, equals approximately 250 representing more than 73% of the retail market. The services supplied by banks include payment (49%), financing (20%) and savings (31%) services. For the purpose of the survey, ABI and the Italian Ministry of Welfare worked together with different stakeholders in order to provide banks and relevant players with a definition on microfinance, based on a common understanding of the issue. This definition is relevant for institutions and stakeholders active on the credit market.

Moreover, according to ABI, microcredit is a social business to be developed at this pre-competitive stage through cooperation amongst banks and public institutions. Microcredit is therefore not seen as a philanthropic activity, but a specific segment of business that plays an important role aimed at including, from the financial point of view, unbankable people, who don't have credit-history or adequate guarantees.

ABI's position with respect to microcredit calls for an appropriate business approach, regulations and transparency mechanisms. Since microcredit is also developing in Italy, its underlying products and processes must be cost effective, meaning that the invested amounts should be able to cover at least the direct and indirect costs associated with the operation. In the hopes of fostering a market infrastructure, Italian banks are cooperating, with one another, e.g., sharing statistics able to represent trends and loans' performance. This is the main goal of a project carried out in conjunction with the Italian Ministry of Economy and Finance and CRIF (a company operating in the field of credit information) aimed at establishing a credit bureau dedicated to microcredit operations.

With respect to public intervention, ABI believes that the priority should focus on creating a national guarantee fund, able to stimulate market growth.

## Comments

First of all, it should be emphasized that the general comments issued by ABI focus on the supervision and regulation of microfinance in a developed country and financial market such as Italy's.

With respect to the definition of microfinance given in the Committee's consultative document, ABI noted that the expression *"the provision of financial services in limited amounts to low-income persons and small, informal businesses"* might be too generic.

The Association proposes a more structured definition with regard to its possible application in Italy.

In the survey carried out by ABI and the Ministry of Welfare on the financial situation of Italian families after the crisis, a common definition of microfinance was agreed upon as a *"supply of credit, saving, payment, transfer and assurance services, allocated in condition of sustainability, suitable to facilitate the financial inclusion of vulnerable parties"*<sup>1</sup>.

In order to give a more structured definition, a regulatory intervention should focus on: i) providing the first access to credit (no prior credit-history and guarantees); ii) the maximum amount of loans to be determined in a dynamic way, based on the market average, rather than on absolute value; iii) the acknowledgment of the specificity of processes and products of microfinance activities.

However, it is also necessary to consider other definitions such as the one adopted by the European Commission, which sets the threshold at 25,000 euro for microcredit.

From the mapping activity, ABI identified two forms of microcredit: "microcredit for business" and "microcredit for consumption". It would be appropriate to distinguish between these two forms of microcredit given the deeply diverse features of products and services. "Microcredit for business" can be a sustainable - for the operator - and affordable - for the beneficiaries - financial product, able to reward costs and risks and to help beneficiaries generate new income; while instead "microcredit for consumption" represents a form of "social credit", in terms of a credit supply for people without the means and the potential to have them. Thus, this form of microcredit must count on public or private subsidies for its

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<sup>1</sup> Financial vulnerability means the degree of exposure of people to external events or mistakes in individual choices, considering their initial condition and their economic, family, and health situation.

development and it could not be solicited as a market. Regulators should appreciate this characteristic of the microcredit business.

The consultative document highlights the need that supervisory and regulatory authorities possess the necessary technical skills to manage the differences, on process and product, between microfinance and traditional credit. The Committee considers, on the one hand, the risks of this activity and supervisory costs and, on the other, the role of microfinance in fostering financial inclusion. According to ABI, this perspective should be considered and national authorities should lessen administrative burdens in managing the practices of microcredit.

Additionally, it is essential to identify clearly the intermediaries engaged in microfinance, and banks must be specifically included as there are no reasons justifying that non-bank institutions should have a reservation of activity.

Herebelow are ABI's observations on some of the core principles. We have no comments on the principles not referred to below.

**Principle 1** (Objectives, independence, powers, transparency and cooperation)

According to this principle, a new supervisory authority should not be established in Italy. The Association supports the adoption of a supervision model where microfinance activities should be entrusted to the national institutions that already have this responsibility, that is to the authorities that already supervise the credit.

**Principle 2** (Permissible activities)

Microcredit (and microfinance) should be defined with respect to the characteristics of products rather than those of the operators. The process of evaluation of microcredit loans should be characterized by: i) a specific evaluation model; ii) a tutoring activity devoted to the beneficiaries during all phases of the credit process; iii) a possible partnership with high-skilled tutoring institutions. In this connection, an official register for specialized tutoring institutions could be created.

With regard to the outsourcing of tutoring activities, the Association highlights that this should not be compulsory, but only an opportunity given to operators. Following the example of MiFID ("Markets in Financial Instrument Directive"), with the purpose of minimizing conflicts of interest, it would be sufficient to provide, from an organizational point of view, internal assistance to institutions engaged in microfinance, without the obligatory outsourcing of services.

## **Principle 6** (Capital adequacy)

In order to boost the development of microcredit, there is a need to reduce commercial banks' capital requirements for microcredit operations. Banks adopting advanced methods of internal rating should be able to show the reduced percentage of microcredit defaults. On the contrary for banks that use standard methods, a suitable ad hoc calibration should be considered, so as to recognize the appropriate incentive considering the risk of this particular portfolio.

## **Principle 19** (Supervisory approach)

Similar to the comments on principle 1, the Association proposes to entrust the responsibility of microfinance supervision to the national authority that already oversees credit.

## **Principle 21** (Supervisory reporting)

In this matter, it is important to emphasize the already mentioned project between ABI, the Ministry of Economy and Finance and CRIF to create a database to share information on microcredit loans. This collaboration aims to give all operators of the sector the access to credit and soft information, to provide evaluation of a tutor's performance and to favour financial inclusion throughout commercial banks.

Finally, the Association agrees with the need to recognize microcredit activity as a specific form of credit in Italy in order to build an adequate track-record for the development of the market and to define a specific average of market rate (similar to a usury threshold) and the characteristics of the loans.

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The Italian Banking Association recognizes the important role of effective banking supervision over microfinance activities and hopes that the comments presented herein will facilitate the international discussion and the reporting of the final document.