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Comments for Basel Microfinance Draft from members of the SEEP Financial Services Working Group. The comments do NOT reflect the official opinion of the SEEP Network or the Financial Services Working Group, but of individual members:

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Our perspectives come from hands-on work and experience with a range of microfinance institutions that are recently licensed, or not necessarily regulated, but that are interested in transformation to regulated institutions.

General Comments:

1. It might be worth emphasizing that MFIs, including non-deposit taking institutions, should adhere to guidance provided in Basel's September 1998 document "Framework for Internal Control Systems in Banking Organizations." Internal controls are often identified as a sector weakness; particularly as cost-cutting measures leading to improved bottom line performance is often rewarded by institutional stakeholders.
2. As noted in the Draft, supervisory / regulatory skills are generally lacking to oversee the sector. However, this should be reason to become informed and skilled, and not reason to avoid the sector, be less vigilant in protecting the public trust, nor monitor the risks and activities of financial service providers serving the microfinance sector. Central banker training of regulators focusing on sector regulation by BIS or other relevant global bodies, could be conducted. There is also increasingly a good amount of country-specific regulatory experience, and there could be a review of what has and has not worked, in order to inform the design and upgrade of regulatory approaches. It is well-understood that the "path" taken by regulators varies, and it is not necessarily a "one-size fits all" approach.
3. As MFIs offer deposits, there is an increase in risks to the population, and a higher risk because the affected population is generally vulnerable and without social or financial security. In addition, most of the countries engaging in microfinance activities do not have deposit insurance supports, or MFIs do not qualify for deposit insurance, another risk to the deposits of people generally considered to be living in poverty.
4. Financial Sector: the licensing and supervising bodies for the banking sector are not always under a common umbrella. There are reasons for this (i.e. to "prevent the fox from guarding the henhouse"), but there are also risks. Licenses may be issued without regard for supervisory cautions, information or reports. Therefore, if there are 2 separate bodies, our suggestion is that the licensing body must also, in addition to the supervisory body, be aware and informed of the risks in the microfinance sector. This is particularly true because of the higher risk level cited in the previous point.
5. In general, the principles raised are very broad, and perhaps intentionally so as an initial draft. For the most part, this is a valuable perspective, but the writers are of the opinion that the basic guidelines on assessing asset risks, on capital adequacy

and liquidity should in many cases be more conservative for microfinance banking. Much of an institution's portfolio is usually unsecured, short term in nature, and at high risk of rapid decline (due to frequent repayments, group lending methodologies, the effect of multiple borrowing, and no credit bureaus for the sector) and therefore calls for stronger risk management.

6. Onsite supervision of the microfinance sector, as in the commercial banking sector is very important, but often very weak in actual practice. Again, this is not a reason to avoid the sector, but to be informed and vigilant in onsite supervision.

Specific Comments on Main Body:

7. Page 9 – "It is important that MFIs mobilizing deposits are subject to regulation and supervision commensurate to the type, complexity and size of their transactions." We are of the opinion that MFIs need an additional evaluation of risk management, governance and management systems because they are generally weaker in the sector and therefore in need of more supervision.
8. Top of Page 13 – The 4 themes in the first paragraph are important and well explained. We are in full agreement.
9. Principle 2 described on page 14 is relevant and well articulated. Publishing a list of MFIs publicly is an important means for customers to verify the legitimacy of the institution.
10. Page 15 addresses technology as an MFI's possible delivery channel of services. We note that the use of non-encrypted software is a great risk for many institutions.
11. Outsourcing of operations in an MFI is not simply downloading administrative burden, or demonstrating strategic efficiencies. It is actually adding a layer of needed due diligence and related risk management that the institution cannot be absolved of.. This relates to Principle 15 that covers operating risks.
12. Compensation schemes may often drive the wrong type of behaviour and whether related to performance or to options in capital structuring, should be prudently assessed and applied.
13. Principle 6 addresses capital adequacy (pages 17 – 19). Our opinion is that MFIs CAR should be prudent and invariably higher than the 8% minimum suggested by BASEL for financial intermediaries. The rationale outlined on page 18 is strong in this regard.
14. Risk Management (page 19) is outlined in Principle 7 and in our view is typically weakly appreciated, developed or applied in institutions. Supervisory bodies should be particularly vigilant to this weakness.
15. Principle 8 on page 20 outlines credit risk in microfinance. A lot of information on clients in this sector is not reliable; however, at a minimum the client's identity and place of residence are critical pieces of information. This might also be relevant to Principle 18, the abuse of financial services.
16. Principle 11 on Exposures to related parties related to weak governance culture in microfinance institutions should be highlighted. There is often potential for some form of "political interference."

17. Page 22 summarizes principle 13 – market risks and page 24 principle 16 on interest rate risk. Both these areas of risk are important to include and emphasize as asset/liability management (including foreign exchange rate risk), reporting and monitoring are often weak skill sets in the sector.
18. Principle 17 described on page 24 – Internal control and Internal audit --- need strong emphasis. Many institutions take shortcuts in the risk, audit, control process in order to reduce costs. This increases profits -- results that are often rewarded by donors and investors.
19. The quality and transparency of financial reporting (e.g. IFRS complaint) is also a need for many institutions (Principle 22), and the writers believe that convergence to IFRS, particularly through disclosure notes, and the enhanced financial statements will improve reporting quality in the sector.