UNIFIM A.C.

Unión de Instituciones Financieras Mexicanas A.C.

Mexico City, May 5, 2010.

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnhplatz 2
CH-4002 Basel
Switzerland

Re: Microfinance activities and the Core Principles for Effective Banking Supervision

Sirs,

The *Unión de Instituciones Financieras Mexicanas A.C.* (UNIFIM) and the Mexican banks members of UNIFIM welcome the opportunity to share their common experience on best business practices and credit risk issues related to the microfinance sector in Mexico.

The members of UNIFIM fully support the Basel Committee's effort to extend the application of the core principles to microfinance oversight while weighing the costs of supervision and fostering financial inclusion and hereby provide their comments pertaining to the document: *Microfinance activities and the Core Principles for Effective Banking Supervision* issued by the Basel Committee on February 2010.

Our comments are issued from the perspective of Mexican commercial banking institutions operating in the microfinance sector or with microfinance activities as a main line of business and refer to three issues addressed in Basel Committee's document:

1. Definition of microfinance.
2. Individuation of microfinance as a regulated line of banking business.
3. Proactive tailoring of risk-based supervision.

The comments of the enclosed document also have the objective to promote a discussion whether the particular characteristics of Microfinance should modify the regulatory framework and emphasize the pivotal role of bank supervisors in the development of the sector.

We trust the Committee will consider valuable our contribution and reiterate our disposal to provide more information or further discuss any of the issues discussed in this document.

Yours sincerely,

Adalberto Palma Gómez
President and CEO
UNIFIM, A.C.

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COMMENTS ON BASEL COMMITTEE'S CONSULTATIVE DOCUMENT
MICROFINANCE ACTIVITIES AND THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION
FEBRUARY 2010

In response to the consultative document issued by the Basel Committee *on Microfinance activities and the Core Principles for Effective Banking Supervision,* UNIFIM (Unión de Instituciones Financieras Mexicanas), Banco Ahorro Famsa, Banco Azteca, Bancoppel and Compartamos Banco have the privilege to present their comments pertaining their main businesses sector in Mexico.

These past years, the undersigned banks have acquired extensive knowledge on credit risk and supervisory issues on microfinance portfolios while promoting a bancarization effort. Latest figures indicate that in 2009, 52% of Mexican households were not served by banks, down from 75% in 2007 and 80% in 2006 (SHCP- Uso de Servicios Financieros- April 2009). This expertise, the capacity to innovate in different market conditions and the concerns for a sustained development of microfinance activities in Mexico are summarized in the following issues and recommendations that we consider valuable when analyzing a supervisory framework for the sector:

1. Definition of microfinance

The survey undertaken by Basel's Microfinance Workgroup indicates there is no agreed upon definition and not all the countries use the term "Microfinance" to define "the provision of financial services in limited amounts to low-income persons and small informal businesses".

Recommendation:
We consider that the microfinance regulatory framework should ideally define and individuate all microfinance activities (direct loans, mortgages, deposits, insurance etc.) including their particular risks and business practices, especially in markets still in process of bancarization. An accurate definition would contribute to a more punctual and proactive supervisory work.

In our opinion, the inclusion of microcredit as a loan category, in addition to commercial loans, mortgages and consumer financing, would further differentiate this product from retail loans. A new loan category with specific characteristics as to amount, terms, frequency of payments and delinquency criteria should enable banks to transfer customers currently misallocated in the consumer category to a more representative microcredit segment.

In Focus Note No. 59 January 2010: "Does Microcredit really help poor people?" CGAP addresses the concepts of "*smoothing consumption, deal with emergencies and pay for big ticket expenses*" which we consider reflect the reality when defining microcredit. We would complement the idea of smoothing consumption with concepts like *productive loans* and *balance of the flow of irregular income streams* to further differentiate microloans from retail loans.

With respect to microdeposits, the Mexican financial authorities recently authorized banks to open low risk accounts, to be defined by each institution individually, with less stringent documentation requirements and limited transaction volumes to be used in conjunction with mobile banking. We consider these type of regulations contribute to the penetration of banking services and draw a line between simple products for non sophisticated underserved markets and products for developed market segments. UNIFIM considers the same criteria applicable in the case of microcredits.

2. Microfinance as a Regulated Line of Business

In highly concentrated banking systems with low penetration of banking services, as in Mexico´s, it is plausible that two types of institutions coexist. One type operating under a proved regulatory framework on developed markets and another type oriented to new and less developed segments in process of bancarization with regulation being developed as the industry evolves. In market-dominant institutions, microfinance activities are normally an additional business line whereas for small banks, microfinance may be the main and sole business line. This poses the risk that the authority burdens microfinance with policies and procedures for mature markets that may prevent its success.

Recommendation:
Excessive or not applicable regulation may encourage regulatory arbitrage or hinder formalization of unregulated microfinance institutions hence, the need to recognize microfinance as a separate business line with a particular regulatory framework.

Principle 7 of the Core Principles of Effective Banking Supervision indicates that *the risk management process should be commensurate with the size and complexity of the institution.* Microfinance regulation should therefore include punctual and simple standards for loan administration, problem loan management, write-offs, documentation and loan loss provisions that reflect the proximity to the customer, the success of collection practices, the use of guarantees or group lending practices, the informal nature of activities being financed and the homogeneous and fast rotating portfolio.

The application of a particular bank regulatory framework for microfinance at business lines levels is justified by the fact that microfinance banks have the same corporate governance as commercial banks, they have a robust credit process based on proprietary models, they have access to capital in the debt and equity markets, their sources of income are diversified as well as their geographical coverage. The difference with commercial banks lies exclusively in a different customer base that is joining the financial system for the first time.

The microfinance portfolio represents a small portion of the portfolio of the banking systems, is pulverized geographically diversified and is far for representing a systemic risk yet, it could be highly correlated among the different institutions.
The Fundamental Principles for Financial Regulation published by the International Center for Monetary and Banking Studies (January 2009) proposes some guiding principles on the scope of regulation and classifies financial institutions based on objective risk measures that capture the risk-spillovers from one institution to the next. According to this classification, microfinance banks could be considered initially as 'tinies´ and eventually as 'systemic as part of a herd', this implying their individual condition not to be of great concern to the authorities. However, as the loan portfolio grows, these institutions can move together as part of a large group and their correlated fluctuations may well be systemic, thus the need of some macro-prudential regulation but very limited micro-prudential regulation.

3. Proactive tailoring of risk- based supervision

Principle 8 on Credit Risk addresses the fact that *supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk).*
UNIFIM agrees that the regulatory framework should provide for sufficient flexibility to accommodate the special characteristics of microlending although we consider that this flexibility should go beyond loan documentation standards.

Recommendation:
The regulatory framework for microlending should encompass a full understanding of the individual methodology to identify, measure, monitor and control credit risks in order to avoid the extrapolation of retail lending criteria to microfinance portfolios. The accuracy of the model should be gauged by its ability to anticipate performance measures and by comparing them against peer institutions.

Principle 9 mentions that: *Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem asset and evaluating the adequacy of provisions and reserves*. UNIFIM also agrees that the supervision of problem asset management and the adequacy of reserves should be tailored to the specificities of microlending in distinctive business models.

Recommendation:
A thorough understanding by the supervisor of each business model should enable him to assess the adequacy of reserves and the relevance of the estimated probability of default and loss given default ratios which in turn, should reflect in sound capitalization ratios. Regulators should avoid the application of general factors across the industry to estimate probabilities of default or loss given default ratios.

Existing research does not allow supervisors to determine the appropriate risk weight for microfinance neither is there evidence whether microfinance institutions should be subject to a different capital adequacy ratio. At this time, the tools available are the combined experience and track records of the different players in sector: **banks, other depository institutions and microfinance non-depository institutions**, all of which should ideally report to a credit bureau system and be subject to some type of supervision, according to their complexity. The regulator should develop information gathering mechanisms from a broad sample of the institutions involved in microfinance that provide a complete view of the dynamics of the sector and timely detect signs of over-indebtedness. The combined track record of the microfinance institutions, should ease the transition to the internal ratings-based approach and leverage the 5–year data requirement to estimate loss characteristics. In our opinion, an effective supervisory work depends more on the implementation of macro-prudential sector-wide supervisory measures rather than on individual evaluation of institutions.

Overall, the regulator is expected to implement a risk-based supervision that focuses on: governance and ownership, lending methodology, internal control mechanisms and procedures which necessarily demand especially trained supervisors with the capabilities to adapt the supervisory processes to new risks different from conventional retail banking.

The fast development in Microfinance activities in underbanked economies as Mexico's, provide an extraordinary opportunity both for supervisors and microfinance banks to jointly and proactively address the applicable regulation and bolster a sound competitive environment that privileges the adherence to a regulatory framework. Given the importance of the regulatory framework banks supervisors have a pivotal role to play in the development of the industry.