

BIS Core Principles of Supervision for Effective Financial Inclusion -

A Commentary

B. Yerram Raju*

Bank for International Settlements released a consultative document in December 2015, entitled: “Guidance on the application of the Core principles for effective banking supervision to the regulation and supervision of institutions relevant to financial inclusion” inviting comments before 31st March 2016. This document meant for effective supervision of the non-banking financial intermediaries is the outcome of a survey Basel Committee on Banking Supervision (BCBS) conducted a range of practice survey in 2013 (ROP) on the regulation and supervision of institutions of relevance to financial inclusion and on financial consumer protection across 59 jurisdictions with 52 respondents.

I have kept the following ground rules in view while reviewing the Draft Document:

- Cost of compliance must be less than the cost of avoidance.
- Regulations and rules must be simple and straight forward inviting easy compliance.
- Multiple regulators impacting on financial inclusion agenda should be able to strengthen and accelerate the implementation.
- Financial Institutions engaged in financial inclusion should be able to deal with it as a portfolio for generating data and information required for proper regulation.
- Instruments, tools and techniques of supervision should be uniform across the nations.
- Financial Inclusion achievements should be subject to social audit as well.

G-20, post recession formed Global Partnership for Financial Inclusion (GPFI) to ensure the 2bn under-served and un-served or financially excluded individuals have easy, cost-effective and safe access to the financial services. “Financial innovation and financial inclusion can introduce potential benefits to the safety, soundness, and integrity of the financial system as well as potential risks to providers and customers alike and the transfer of well-known risks to new players.”¹

The document recognizes three elements of change in the financial inclusion landscape: wide ranging products offered by banks to the hitherto financially excluded, nature of institutions moving from banks to non-banks and mobile network operators and the rapidity of the change both in the products and processes. There is multiplicity of regulators and numerous regulations. Still, anti-money laundering provisions applicable for the rest of the financial system are not equally effective while nursing the ‘un-served and underserved’ individuals through financial inclusion products and processes. It came to the conclusion that nineteen of the twenty core principles outlined in its Guidance 2012 are applicable to the multiple institutions engaged in the financial inclusion effort and space. These principles of supervision have been amplified to twenty nine comprehensive, complex and cost-intensive regulations for many small nations and small institutions.

Indian financial sector offers enough scope for providing the critique:

India has substantial presence in the global financial inclusion agenda occupying 5th rank in the globe. While the share of Asia and Pacific was 88.78% in the outreach in terms of the poorest clients,

¹ Citation from (<http://www.afi-global.org>) page 1 of the Consultancy Document.

India alone accounted for 56.56% and Bangladesh 16.83% which means these two countries together account for the lion's share, 82.66%, of this regions microfinance to the poorest. Over all, India's is estimated to have 30% share in microfinance borrowers (poor and the poorest) of the world although its share in the outstanding portfolio was only 7% of the World (Reuters 2010). There are fourteen major models of Micro finance that emerged after the Nobel Lauriat Md. Yunus gave the big push in Bangladesh.

India mirrors the globe in nature, type and size, diversity and complexity of regulatory institutions. It has well established rules for coordination through the Financial Stability Regulatory Board chaired by the Union Finance Minister. Yet it has gaps in perception in so far as financial inclusion agenda is concerned.

India is at the cusp of change and is at the epicenter of growth whose stability and policies are material for global financial stability. When India noticed countries like Philippines and Kenya were offering best models in financial inclusion it has adapted them. Mobile financing is making deep inroads into the pockets of the poor. Rupay cards as retail credit card instrument is also fast apace. Where branch banking has not been able to effectively reach the poor, business correspondents as agents of commercial banks are engaged – referred to as third parties in the Draft Guidelines document.

Starting from the chit funds that still continue both in the organized and unorganized financial sector sphere in the country, India is home to all the models of non-banking financial intermediation that have been mentioned in the BCBS document cited.

Multiple institutions are involved: commercial banks and Regional Rural Banks that run SHG-Bank linkage program for the poor targeting savings, thrift, credit and livelihood promotion among the 'unserved and under-served' poor communities, NBFCs, non-deposit based financial institutions, micro finance, micro credit and micro insurance institutions etc.

There are multiple regulators regulating the non-banking financial intermediaries in India: Reserve Bank of India; Securities Exchange Board of India (controlling those companies that are equity-led with and without foreign institutional participation); Government of India, Telecom Regulatory Authority of India, Insurance Regulatory and Development Authority, and Pension Fund Regulatory and Development Authority. Coordination among the regulatory agencies is one of the issues flagged in the draft document.

Some of the Indian States have their own agencies like Society for Eradicating Rural Poverty (SERP), Mahila Saadhikara Samstha (Women Empowerment Society), Kutimba Sree etc that are providing grant and interest subsidy support for the livelihood programs organized around them. RBI treats lending to these groups as priority sector advance and exempts KYC of individual accountholders if the office bearers' KYC is obtained. RBI also clarified that presence of defaulters to the financing bank in SHG that is not a defaulter should not deter the financing bank from lending to the SHG further. Government of India in its budget 2008-09 clarified that the banks should embrace the concept of financial inclusion by meeting the entire credit requirements: '(a) income generation activities; (b) social needs like housing, education, marriage etc., and (c) debt swapping.'

Prime Minister's Jan Dhan Yojana (PMJDY) launched on 15th August 2014 as a major driver for financial inclusion saw the banks opening 140mn accounts in one and half years as compared to around 7mn basic savings bank accounts from 2005 to 2014. PMJDY also envisaged a per account credit of Rs.5000 after six months of opening the savings bank account. Banks were found to be moving cautiously on this account going by the 0.65 percent of the PMJDY accounts alone getting such credit facility.

The states have competing and sometimes conflicting interests with the financial regulator. When a few borrowers of MFIs committed suicides allegedly due to excesses in recovery of dues, Andhra Pradesh (2011) enacted a Law preventing the MFIs from charging interest rates higher than those stipulated under the Act and also to exercising right to treat any forceful recovery as extortion punishable as criminal offence on the part of MFI. MFIs in the State almost collapsed. Several Banks that lent to the MFIs had to take a severe hit in their provisions as such MFIs became NPAs with primary borrowers defaulting on their commitments. RBI later appointed a Committee under the Chairmanship of Malegam, Director of the RBI Board and a Chartered Accountant to examine the issues and suggest solutions. The Committee prescribed the ceiling on lending rates of MFIs: 26% per annum. It took nearly three years for the MFIs to become active players. There are equity based institutions and donor based institutions; there are savings and thrift led institutions; and there are livelihood and insurance institutions in the micro sphere.

National and State Governments, financial institutions, non-banking financial institutions and organizations, MFIs – both donor and equity based, financial cooperatives are all moving simultaneously to flood the financial inclusion effort. Delivery channels include the traditional savings bank, business correspondents, credit, insurance, pension payments, credit card and mobile banking of any and all the above institutions. All these are licensed entities of either the Government or the RBI.

The complexity of institutions does therefore exist. As rightly mentioned in the document, the nature, size, geographical space, and the multiple products and processes need regulation of a different alchemy.

Smaller nations pose lesser problems in risk assessment, risk management. Governance and regulation in the sphere of financial inclusion than countries like those in South Asia and China. Therefore, document presenting the supervisory principles with a broad brush is like a broad spectrum antibiotic.

Further, when 19 of the 29 core principles need to be followed, without their reference to specific geographic location or process, the principles seemed academic. Had the document contained a tabular statement of the nations that already have in position a separate law to deal with MFIs/NBFCs distinct from the financial regulator – the central bank and the nations that have government alone as regulator of such institutions as licensing authority, the section 3.1 dealing with 'powers, responsibilities and functions' would have offered a better guide for institutions to go from where they are to where they should be moving.

'The primary objective of supervision of banking supervision is to promote the safety and soundness of banks and the banking system' and financial inclusion agenda should not come into conflict with this objective. The supervisors with financial inclusion responsibilities are expected to

hedge the 'exclusion risks to the soundness of the financial system, less transparency, financial integrity, greater macroeconomic volatility and higher social and political instability.' The moot question is – can the supervisor with the best of training hedge the above risks? Why did it not prescribe the boundaries of transparency?

The second principle dealing with Legislation demands that “the Law 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 (eg 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). As a general rule, supervisors should not have responsibilities to promote or develop a sub-sector of financial institutions that they supervise.” There is no illustration as to which country has such Law in place. This looks utopian as the government may not have this as a priority item on its agenda. The Government on the other hand, may feel that the central bank has enough capacities to take care of this aspect and it is enough if it does not interfere with the financial regulator. In countries like India where the central bank scrupulously reviews the financial stability at agreed intervals and indicates the supervisory actions in response to the identified situations, a separate law by itself may not be necessary.

Where the central bank discharges both the developmental and regulatory responsibilities it called for separate it called for separate institutional arrangements with clearly delineated objectives between them and adequate financial resources to deal with them independently. The skill sets, manpower required for both the functions impose heavy financial burden on the regulator. It is unclear as to who will have to provide such resources? Should they come from the government budgets annually or from the regulator or from the institutions that are implementing the financial inclusion agenda? If this aspect is left for the government to decide, who should bear the compliance burden of this rule?

The third principle – cooperation and collaboration between the multiple regulators is indeed very necessary. Financial Stability Regulatory Board of India should be able to take care of this aspect. But this is easily said. Each Regulatory Authority has powers and responsibilities well defined and would feel uncomfortable when one or the other regulators calls for compromising such authority in the interest of financial inclusion risk management.

“The prudential supervisor may also pursue coordination and cooperation mechanisms with: (i) the financial intelligence unit, with respect to customer due diligence requirements and monitoring; (ii) foreign authorities to identify and address stability threats arising abroad; and (iii) authorities in charge of regulation and supervision of nonbank financial institutions as well as functional supervisors, where relevant, to expand participation in the financial stability policy arrangements.”, the report argues. Considering the size of financial inclusion effort's impact on the involved institutions' balance sheets, is this not an overdose of supervisory responsibility? Would it not be prudent to insist on the respective supervisor to make it an important aspect of regulatory responsibility and provide periodical confirmation in this regard?

Permitted activities and licensing requirements can actually be subsumed into one principle. Licensing requirements can specify the permissible activities.

Supervisory approach depends upon the risk profile of the institutions concerned. While being so, risk management practices should be well defined and regulated by the Board. It is governance that becomes more important to ensure effective supervision.

For example, in issues like governance, the supervisory principle should have been quite prescriptive: there shall be a written confirmation regarding the commitment of the directors over previous defaults; the raison de 'etre for being on the board of the NBFC/MFI/Bank and what he/she would contribute during his/her tenure towards the financial inclusion agenda of the institution etc.

The Principle relating to 'Supervisory techniques, instruments and tools' have been very elaborate. If these are followed, it obviously follows that the deficiencies if any are reported for review and timely correction. Key responsibility indicators "should allow the supervisor to assess portfolio quality, loan loss provisioning, risk concentrations, capital adequacy, operating costs, funding structure and liquidity position, foreign exchange exposures, and interest rate re-pricing 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." Supervisors, in other words, should be encyclopaedia. Each of the above activities requires special skill sets. Combining them as essential ingredients of a supervisor the BCBS failed to draw the distinction between the financial inclusion outcomes with that of the general banking requirements. The recommendation borders on improper expectation.

There can however be no two opinions on the need for supervisors to verify and validate the data released by the involved institutions. Data integrity even otherwise is a major issue. The supervisor must be able to fix accountability for submission of the correct data. One of the major weaknesses of the existing financial systems is the unverified data. Clean data is important for correct policy prescription. It is highly desirable that wrong data submission is penalised.

The Document fails to draw distinction between supervision and audit/inspection. Supervision is superior to audit/inspection. If the auditors fail to report irregular practices, they should also be accountable to the supervisor. The supervisory action as a surveillance mechanism post audit should necessarily allow for superior punishments that include not just monetary penalties but cancelling license to carry on the related businesses. But such action should be weighed in relation to the client protection norms. The clients in this case – the financially excluded community – cannot afford the consequences of the institutional maladies noticed by the supervisor worthy of such punitive action. Insurance/re-insurance/guarantee mechanisms should be in place to secure and protect the clients' interests.

The Committee's warning: "Supervisors designing corrective or sanctioning measures must therefore have a good understanding of the specific dynamics of traditional micro-lending, so that the supervisory measures do not lead to unintended and undesirable consequences," is very

appropriate. This ipso facto requires that the supervisors of financial inclusion institutions should be different and differently equipped to perform the tasks expected of them.

Financial Cooperatives, going by Indian experience, suffer from several inadequacies and imperfections both under law, regulation, supervision and management. It has multiple regulators and the state regulator is a victim of political interference and does not also have adequate knowledge to deal with financial products and processes unlike in the rest of 19 countries in G-20. RBI as the financial regulator has brought them under its licensing fold both the rural and urban cooperative banks. It may be easier to cancel the license in case of deviation from the regulatory norms but will still find difficult to impose financial discipline on them. The requirements spelt out in the document are but appropriate.

Consolidated supervision makes lot of sense in the context of banks financing cooperatives, NBFCs, MFIs, MFOs, or holding their accounts as operating accounts or deposit accounts, even if not lent, Business Correspondents (third parties whose businesses are insured to the extent of their daily cash collections from the basic account holders of the banks).

Strange indeed are the risk management practices painted with the same brush as that of the other financial institutions and not specific to the inclusion agenda pursued by the respective institutions. Credit, market and operational risks in relation to the institutions pursuing financial inclusion goals pose different when mapped in relation to the quantum. It is more operational and systemic risks that pose severities and these require particular attention. Retail lending in 'inclusion' credit markets is for short tenure and creation of durable assets in the hands of the clients is not so significant as to cause worry if there are no problems in due diligence and credit origination. Monitoring the loans regularly would generally ensure that repayment cycles are not adversely affected unless natural calamities overtake them. Deposit and credit insurance mechanisms are adequate enough safeguards to mitigate the credit risks. The elaboration of the nature mentioned in the document seems an overstatement of the concern.

In so far as Capital adequacy is concerned for those institutions dedicated to financial inclusion the standards specified by the BCBS at Basel 1 or Basel 2 capital adequacy standards are certainly adequate. If the commercial banks lending to MFIs/NBFCs do not due diligence in their eagerness to reach the targets of the priority sector as has happened in 2010-12, credit and market risks are going to be as serious as for high volume corporate lending. Capital provisioning should be of higher order than the normal prescription and should conform to Basel III prescriptions.

Specific problems require specific solutions. The proportionate approach that formed the assessment of compliance of the Core principles of supervision in 2012 is found wanting in this consultative document. In all, there is scope for retaining only ten of the 29 principles enunciated in the document.

**The author is an economist, independent financial consultant and risk management specialist.*

