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Comments on BCBS Guidance Document on Financial Inclusion

Input from an Expert Risk Management Perspective

Risk Management Initiative in Microfinance

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Introduction and Context

The Risk management Initiative in Microfinance (RIM) is a membership-based industry initiative focusing on raising the standard of risk management in microfinance.[1] Our membership includes financial inclusion thought leaders such as ADA and the CFI at Accion, investors such as Triple Jump and Oikocredit, and international networks such as AccessHolding, Aga Khan Agency for Microfinance (AKAM), and PAMIGA. We have achieved our goals through the creation of the Risk Management Graduation Model (RMGM), a comprehensive, scalable, and double bottom line risk management framework for financial institutions at different tier levels of development.[2] We also actively achieve our mission through the implementation of the RMGM and promotion of stronger risk management within member institutions. Furthermore, we promote stronger risk management at industry conferences and through advocacy within initiatives similar to reviewing and commenting on this BCBS Guidance document. All of this is carried out to ensure that the topic of risk management is approached in a manner appropriate to the double bottom line sector in which we all operate, taking into account the profile of clients we serve.

Fundamentally, RIM believes that the types of clientele within financial inclusion warrants institutions to exhibit a greater responsibility for client well-being – moving beyond a "do no harm" approach to a "do good" approach, requiring and motivating financial institutions to actually do good in the lives of the clients they serve. Although risk management is a key aspect of this discussion, the fundamentals go beyond sound risk management, governance, regulation, and current initiatives within financial inclusion. They touch on more fundamental gaps in the industry which threaten its ability to affect positive change and realize responsible financial inclusion. RIM believes that the responsibility to "do good" goes beyond "not doing bad", which often is discussed through the lens of causing reputation risk at the institutional, national, or global scale. RIM believes that the responsibility to "do good" also goes beyond sound credit risk management and adherence to the client protection principles – although these are steps in the right direction. With poor clients' well-beings at stake, the question begs itself, "Who is ultimately responsible for the actions of institutions which ultimately put their clientele at risk?"

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[1] RIM's Position Paper is available for download at: http://www.riminitiative.org/graduation-model/#toggle-id-5
[2] The RMGM Technical Paper is available for download at: http://www.riminitiative.org/graduation-model/#toggle-id-5

RIM's Risk Management Graduation Model and Proportionality in Compliance to Core Principles

Within the key revisions made to the Guidance document in 2012 was the inclusion of the concept of proportionality within compliance to the Core Principles. One key challenge regulators and a broad spectrum of financial institutions have in complying with these Core Principles (especially Core Principle #15 – Risk Management Process) is understanding a relevant proportional approaches to risk management they should adhere to ensure they are indeed meeting BCBS guidelines. This has been puzzling and a challenge at best for many financial institutions.

RIM has developed the Risk Management Graduation Model (RMGM) framework which is a proportional approach to risk management for institutions involved in financial inclusion. It proposes detailed guidelines with respect to the type of policies, limits, risk monitoring tools, and risk management tools expected for institutions within different levels of organizational development. This framework was developed and reviewed by a number of the key risk management experts within the industry and was tested and is being implemented in over 23 countries in Sub-Saharan Africa, Latin America, MENA, South East Asia and Eastern Europe and Central Asia regions globally.

When thinking about providing detailed guidance ("The What" and "The How") within this or future Guidance documents, the RMGM framework would be an excellent starting point to providing financial regulators and institutions detailed information of how to put proportionality into practice in an effort towards compliance with BCBS guidelines.

Comments and Suggested Inclusions into Guidance Document

The following information included in this document is presented within the position that a greater emphasis on double-bottom-line and appropriate risk management through a proportional approach to both risk management and supervision will position financial inclusion for sustainable growth in the future. We do not intend for these comments to be exhaustive in nature, but rather to provide tangible examples of how the BCBS Guidance document can be improved to address some of the key structural challenges. We hope this document can provide the basis for a continued conversation with the BCBS Workstream on Financial Inclusion of how appropriate approaches to risk management and risk management oversight can strengthen the financial inclusion sector for the long term.

Our specialized team of experts has reviewed the Guidance document and has come up with two key areas we believe are critical for its strengthening:

1) Level of detailed on "the What" or "the How" provided for within the criteria relevant to financial inclusion
2) Integration of social performance and consumer protection (Annex A) as a central aspect of the approach to supervision of institutions engaged in financial inclusion

Provided below are details related to these two key areas and the location in the document we believe these comments would be best addressed.

Section of the Document	How/What	Integrating Social Performance and Consumer Protection (Annex A) into Body Text of Document
Principle 14: Corporate Governance	• #14(3): Necessary to have at least one independent member of Audit Committee.	• Principle #3: Equitable and fair treatment of consumers (p.37) ○ Integrate into business culture from a governance perspective (ie. "tone from the top") • Principle #6: Responsible business conduct of financial services providers and authorized agents ○ "Duty to act with due skill, care, and diligence in the provision of any financial service or product to consumers should thus accompany fair treatment duty as an integral part of the corporate governance and business culture of financial institutions, and minimum standards for responsible business conduct could be set out in law, regulations, guidelines, or codes." (p.38)
Core Principle 15: Risk Management Process	• Currently, most MFIs do not have robust, comprehensive risk management systems and structures but should have if taking deposits from the public or engaged in mobile money or payment products.	• Inclusion within risk management process the definition of risk as "the possibility of adverse events occurring and their potential for financial losses and negative social performance." This double bottom line approach ensures that risk management process reflects the double bottom line nature of industry. • Principle #3: Equitable and fair treatment of consumers (p.37)
Core Principle 17: Credit Risk		• 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, and after the sale of a financial product." (p. 37) • Principle #5: Financial education and awareness - including benefits of financial education and awareness on ability and willingness to pay of clients. (p.37)
Core Principle #19 – Concentration	• No clear definition of how to determine concentration	

Risk and Large Exposure Limits	• #1(a) – Given the type of clients a financial inclusion institution is dealing with, a lower ratio would be more prudent from a mission drift perspective. Is there any reason why this type of institution would have a single exposure of 10% of capital given that its credit portfolio is comprised of very small exposures (especially within MFIs)?	
Core Principle #20 – Transactions with Related Parties	• Since governance should be probably less strong in lower tiered institutions, specific attention should be put attention on EC #6 and EC #7, strongly mitigating risk at an operational level.	
Core Principle #22 – Market Risk	• #2 – Approved by the board and regularly updated • #3(d) – Include independent testing of models? This is, however, included within CP#23. • #3(e) - Not applicable for most MFIs who do not have a trading book • #4 - Relevant only for MFIs who have a trading portfolio	• Market risk should not be passed on from financial inclusion institutions to clients or more broadly carried by customers themselves. • Supervisors should approach the market risk at two levels: (i) the institution itself and (ii) at the level of the customer.
Core Principle #23 – Interest Rate Risk in the Banking Book	• Interest rate risk in the banking book is not taken into consideration. • Risk analysis based on behavior and not pure contractual elements should be emphasized • #1 (add'l) – economic value approach isn't most widely used measure of interest rate risk in financial inclusion. Would also include threat to current period net interest income. • #2 – Approved by the board and regularly updated	
Core Principle	• #1 – Second point of this	

#24 – Liquidity Risk	is relevant only for internationally active banks, not financial inclusion. • #4(c) - Collateral positions are not relevant to most MFIs. This speaks to collateral pledged by a bank or other counterparty when they borrow funds (usually very short term) from another bank. The exception is some MFIs which do post collateral if hedging with TCX. • #5(g) - This is key because it is often assumed that government securities could be sold quickly and at face value and that is often not the case in countries where	
Core Principle #25 – Operational Risk	Why are the other categories not mentioned? E.g. damage to physical assets (due to natural disasters etc.). It is not strictly following the op risk event categories. Further: exploring the definition of Operational risk: • People: errors / mistakes (fraud is mentioned) • Systems: technical systems / IT systems • Processes: mentioned • External events: man made / natural disasters.	• Mystery shopping is mentioned several times, probably too advanced for the intended markets (p.35) • Statistical and qualitative information on consumer complaints: highly dependent on a well-functioning complaints mechanism (p.35) • Principle #3: Equitable and fair treatment of consumers (p.38) • Principle #6: Responsible business conduct of financial services providers and authorized agents (p.38) ○ "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. Inadequate remuneration policies may incentivise excessive risk-taking and irresponsible behaviour toward clients." (p.38)
Core Principle #26 – Internal Control and Audit	#1(a): add: too much dependency on one person; too close relationship between the Board and management no operational /	Principle #3: Equitable and fair treatment of consumers (p.37)

	qualified Board; see also principle 14. #1(d): add: safeguarding Business continuity #3: independent compliance officer is not to be expected in small organizations; combination with risk or audit is a practical solution #5(b): appraisal by the Board and CEO? Audit tracking is missing	
Core Principle #27 – Financial Reporting and External Audit	#1: Special attention for the quality, suitability and the level of integration of the IT systems. This might negatively influence the reliability of the data #5: Assessment of the loan loss provision; capital set aside for risks including operational risk; proper valuation of fixed assets, e.g. seized collateral (property, land titles)	
Annex A – Financial Consumer Protection in the Financial Inclusion Context	General Comments related to Annex A: 1) No reference is made to industry standards (MFT, CPP, SPTF, PIIF); so if not the standards themselves, why not mentioning the basic principles? 2) Role of investors: investors require more and more adherence to these principles.	