REGULATORY POLICY FRAMEWORK FOR MICRO-FINANCE INSTITUTIONS IN BOTSWANA

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The rapid growth of various types of microfinance institutions (MFIs) around the world and the gap in knowledge on whether and how these institutions should be regulated are challenges that face Financial Regulatory Bodies all over the world. This Regulatory Policy outlines the framework that should be put in place to ensure appropriate supervision of the micro-finance sector in Botswana, including minimum requirements in respect of laws and regulations; licensing and supervision of different MFIs, prudential and non-prudential supervision, institutional arrangements and the roles of various stakeholders.

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LIST OF ACRONYMS

MFI	**Micro-finance Institution**
MDTI-	**Micro-finance Deposit Taking Institution**
ODTI	**Other Deposit Taking Institutions**
MFB	**Micro-finance Bank**
MFDF	**Micro-finance Development Fund**
CBB	**Central Bank of Botswana**
NBFIRA	**Non-Bank Financial Institutions Regulatory Authority**
PSDP	**Private Sector Development Programme**
MTI	**Ministry of Trade & Industry**
MFDP	**Ministry of Finance & Development Planning**
BOCCIM	**Botswana Confederation of Commerce, Industry and Manpower**
EU	**European Union**
CDE	**Centre for the Development of Enterprise**
CEDA	**Citizens Entrepreneurial Development Agency**
MFDF	**Micro-finance Development Fund**
SACCOs	**Savings & Credit Co-operatives**
ML/FT	**Money Laundering & Financing of Terrorism**
FATF	**Financial Action Task Force**
APR	**Annual Percentage Rate**

EXECUTIVE SUMMARY

The Government of Botswana has identified two main activities in the Private Sector Development Programme (PSDP) which were launched in 2013 under the auspices of the Ministry of Trade and Industry (MTI) and Botswana Confederation of Commerce, Industry and Manpower (BOCCIM) in partnership with the EU and the CDE. These two activities which are linked to improving access to finance are:

i) Develop a policy framework for micro financing in Botswana.
ii) Develop a Micro-finance Act that will regulate the micro-finance sector in Botswana.

It is in this regard that CDE-PSDP has recruited a Consultant to assist with the development of a Policy Framework for Micro Financing in support of an Enabling Environment for Enterprises under the framework of PSDP.

This Policy Framework document has covered the following critical areas:

a) **Categorization of MFIs for Licensing & Supervision**: The tiered approach to supervision is conducive to the development of a sound microfinance sector. It gives room for more flexibility to microfinance activities, which are still in an experimental stage. The tiered approach incorporates the fact that it may be necessary to regulate different intermediaries in a different manner. MFIs in Botswana will therefore be categorized into five tiers(Tier 1-Banks with micro-finance units, Tier 2-Savings & Loans Cos, Tier 3- Deposit-taking MFIs, Tier 4- Credit-only MFIs and Financial NGOs, Tier 5- Term & Cash lenders and Pawn Shops)
b) **Types of Institutions to be covered under the Policy Framework**: Banks that will downscale into micro-finance or have Micro-finance Units, Savings & Loans Companies(these institutions are large MFIs, which do not want to operate as Commercial Banks and will provide Savings & Credit services, e.g. Letshego may fall under this category), Deposit-Taking Micro-finance Institutions, Credit-Only Micro-finance Institutions, Financial NGOs in Credit-Only Business, Term & Cash Lenders and Pawn Shops

c) **Permitted Activities/Products**: The types of permissible micro-finance activities are: Micro-credit, Micro-savings (voluntary savings, fixed deposits, and current accounts), Micro-insurance, Money Transfer / Remittance Services. Tiers 2, 3, 4 & 5 shall NOT accept deposits in foreign currency and extend credit in foreign currency. MFIs are prohibited because most of them do not have the managerial resources or expertise to identify, control and mitigate foreign exchange risks.

d) **Minimum Capital Requirements**: The following minimum capital requirements were agreed by stakeholders:
Tier 1 – BWP 5 million; Tier 2 – BWP 1.5 million
Tier 3 – BWP 1 million ; Tier 4 – BWP 500,000
Tier 5 – BWP 50,000

e) **Capital Adequacy**: MFIs shall maintain a minimum capital ratio of not less than 10% of risk-weighted assets or such other ratio as may be determined from time to time by the Central Bank of Botswana. The items that are eligible to be included as capital, the risk weights attached to different classes of assets and the method of calculation shall be prescribed by the Central Bank's regulation concerning Capital Adequacy.

f) **The Regulatory Authority:** The Regulatory & Supervision Department under the authority of Bank of Botswana shall regulate, promote and ensure orderly growth of MFIs and take measures as it deems fit, for the purpose of promoting financial inclusion through such institutions.

g) **Loan Loss Provisions**: The regulatory framework should compel financial institutions to recognise the risk posed by past due micro-finance loans quickly and accurately. Micro-credits loan portfolio should be risk-classified and provisioned for, based on the number of days of non-performance, missed payments and/or times re-scheduled. Since micro-credits are generally repaid in short, frequent intervals (sometimes even weekly), monitoring and reporting systems, provisioning and classification standards should be tailored accordingly.

h) **Regulation of Interest Rates**: This regulatory policy framework shall not adopt an interest rate capping regime because it will not allow for full cost recovery of cost of operations of MFIs. Financial inclusion in remote areas will be impossible as a result of its attendant high costs and it will stifle competition in the micro-finance industry.

i) **Consumer Protection:** Consumer protection is necessary to safeguard the interests of consumers of micro-finance services from adverse effects brought about by undesirable practices of providers. The Regulatory Body will pursue consumer protection by:
   - ✓ preventing irregularities or transactions which have negative impact on the consumers;
   - ✓ empowering consumers to exercise informed choices and select value-for-money goods;
   - ✓ providing fair access to micro-finance products and services; and
   - ✓ opening avenues to address consumer interests and concerns.

j) **Know Your Customer (KYC) and Money Laundering**: The Regulatory Body must be satisfied that MFIs have adequate policies and processes in place, including strict “know-your-customer” rules that promote high ethical and professional standards in the financial sector and prevent the MFI from being used, intentionally or unintentionally, for criminal activities. The Regulatory Body should adopt the principles of Financial Action Task Force[1] which allows countries and institutions to follow a risk-based approach that focuses their attention and resources on people and activities posing a high risk of money laundering and financing of terrorism (ML/FT), while ensuring that reduced and simplified controls are sufficient to safeguard low-risk activities, such as low-value savings products, from abuse.

The Policy Framework has also discussed issues relating to the role of micro-finance sector in economic development, what is regulation and the rationale for regulating the micro-finance sector in Botswana.

The final report has been prepared based on benchmarking of microfinance policy frameworks of three SADC countries (Namibia, South Africa, and Zimbabwe) as well as in East and West African countries (Kenya, Uganda and Ghana).

[1] The Financial Action Task Force (FATF) is an inter-governmental body whose purposes include the development and promotion of national and international policies to combat money laundering and terrorist financing and to bring about legislative and regulatory reforms in these areas. The FATF has published Recommendations in order to meet this objective. www.fatf-gafi.org

SCOPE OF POLICY FRAMEWORK

a) The Micro-finance Regulatory Policy Framework, hereafter referred to as "the policy, provides a strategic framework and roadmap for the development of a well-integrated and sustainable micro-finance sector in Botswana.

b) This policy articulates the national vision, objectives and strategies adopted, following consultations among various stakeholders by a consultant under the auspices of Centre for the Development of Enterprise, an European Union-assisted programme for the development of the Private Sector in Botswana.

c) The policy outlines the framework that should be put in place to ensure appropriate supervision of the micro-finance sector, including minimum requirements in respect of laws and regulations; licensing and supervision of different MFIs, prudential and non-prudential supervision, institutional arrangements and the roles of various stakeholders.

d) In line with international best practice, the policy seeks to promote poverty alleviation and economic development by creating an enabling environment for the micro-finance sector to blossom into a viable financial industry.

e) The policy will enhance the provision of diversified micro-financial services which will include savings, credit, insurance, money transfer and other services.

f) The policy is based on the Core Principles of Effective Banking Supervision (The Basel Core Principles)[2].

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[2] The *Core Principles for Effective Banking Supervision* (Core Principles) are the *de facto* minimum standard for sound prudential regulation and supervision of banks and banking systems

1.0 INTRODUCTION

Today, there is a broad consensus within the micro-finance community that the regulation and supervision of micro-finance is critically important for its future development and its credibility as a development tool. Any new regulatory and supervisory framework for micro-finance will have to balance the need for financial stability, resilience, integrity and consumer protection with the need to preserve financial inclusion, innovation and healthy competition.

1.1 Role of Micro-finance Sector in Economic Development

Micro-finance entails the provision of formal financial services (credit, savings, insurance, money transfer and other services) to low income households and small enterprises to support their economic activities as well as their household financial management and consumer needs.

Micro-finance is known to have fuelled economic development in several ways. Some of these are:

a) It enables poor or low income households to access financial services which assisted them to build assets and manage financial risks better.
b) It has assisted in poverty reduction and improvement in standard of living by helping to increase the income of the poor. Increased income has enabled the poor to cater for the health and educational needs of their children.
c) Micro-finance has improved the productive capacities of communities through savings, credit and insurance, resulting into the reduction of social ills such as prostitution, drug abuse and trafficking.
d) It has promoted gender equality and empowerment of women in the community.
e) Micro-finance has provided a rapid development of Micro, Small & Medium Enterprises through the provision of loans and savings services.
f) Micro-finance promotes financial inclusion, that is, access to credit, savings, insurance and remittance services by all groups of people (whether rich or poor).

1.2 Distinctive Features of Micro-finance Business[3]

Micro-credit is at the heart of many micro-finance business models, and has a number of distinctive features. Product design, client profile and labour-intensive underwriting methodologies give microcredit a unique risk profile. Effective credit risk management thus requires different tools and analyses than for conventional retail lending. Some of the more distinctive features of microcredit include:

a) ***Micro-borrowers****.* A micro-credit provider usually caters for low-income clients, both the under-employed and the entrepreneur with an often informal family business (e.g. petty traders). Borrowers are typically concentrated in a limited geographic area, social segment or entrepreneurial undertaking. Loans are usually very small, short term, and unsecured, with more frequent repayments and higher interest rates than conventional bank loans. Many providers require higher interest rates to offset higher operational costs involved in the labour-intensive micro-lending methodology

b) ***Credit risk analysis****.* Loan documentation is generated largely by the loan officer through visits to the borrower's business and home. Borrowers often lack formal financial statements, so loan officers help prepare documentation using expected cash flows and net-worth to determine the amortisation schedule and loan amount. The borrower's character and willingness to repay is also assessed during field visits. Credit bureau data are not always available for low-income clients or for all types of micro-finance providers, but when they exist, are used as well. Credit scoring, when used, complements rather than supplants the more labour-intensive approaches to credit analysis.

c) ***Use of collateral****.* Micro-borrowers often lack collateral traditionally required by banks, and what they have to pledge is of little value for the financial institution but are highly valued by the borrower (e.g. furniture). Where the lender does take some sort of collateral, it is for leverage to induce payment rather than to recover losses. In the absence of collateral, underwriting depends on a labour-intensive analysis of the household's repayment capacity and the borrower's character.

[3] Micro-finance Activities & the Core Principles for Effective Banking Supervision, August 2010. P.10

d) ***Credit approval and monitoring***. Because micro-lending tends to be a highly decentralised process, credit approval by loan committees depends heavily on the skill and integrity of loan officers and managers for accurate and timely information.

e) ***Controlling arrears***. Strict control of arrears is necessary given the short-term nature, lack of collateral, high frequency of payments (e.g. weekly or bi-weekly), and contagion effects (see h. below) of microloans. Traditionally, monitoring is primarily in the hands of loan officers as the knowledge of the client's personal circumstances is important for effective collections.

f) ***Progressively increasing lending.*** Customers who have limited access to other financing are usually dependent upon on-going access to credit. Micro-lending uses incentive schemes to reward good borrowers with preferential access to future, larger loans (sometimes with favourable repayment schedules and lower interest rates), which raises the risk of over-indebtedness, particularly where credit information systems are absent or deficient. This feature also affects interest rate risk management, as micro-finance customers expect rates to decline as the customer's track record grows, regardless of changes in the general level of interest rates.

g) ***Group lending.*** Some micro-lenders use group lending methodologies, where loans are made to small groups of people who cross guarantee other members of the group. Peer pressure also helps to ensure high repayment levels, as the default of one group member could adversely affect the availability of credit to others.

h) ***Contagion effects.*** Tight control of arrears and peer pressure has driven traditionally sound repayment rates in most jurisdictions to date. However, the quality of individual loan portfolios can deteriorate quite rapidly, due in part to the unsecured or under-secured nature of micro-loans as well as so-called contagion effects, where borrowers who notice increasing delinquency in the institution may stop paying if they believe the institution will be less likely to offer future loans due to credit quality problems.

i) ***Currency-related risks.*** Occasionally micro-lenders lend in a currency other than that of a borrower's repayment source (e.g. sale of goods or services), so foreign currency fluctuations may affect the borrower's ability to repay. While not unique to microcredit, micro-borrowers may be less able to appreciate the nature of this exposure, much less take measures to mitigate it.

j) ***Political influences.*** Microcredit and micro-finance in general, may be seen as a political tool in some countries, tempting politicians to demand forbearance or forgiveness of loans to poor customers during times of economic stress. This might affect repayment culture of micro-finance borrowers.

1.3 What is Regulation?

1.3.1 A regulatory framework includes the laws, regulations, guidelines, rules and codes that regulated entities are required to comply with and an institution or structure for enforcing compliance.

1.3.2 The regulatory structure is therefore an institutional form which carries out supervision of the regulated entities.

1.3.3 Supervision has broadly been defined as a process of enforcing the regulatory framework. It includes the interaction between the regulatory authority and the regulated institutions that enable the regulatory authority to:

a) Monitor the financial soundness of the regulated intermediaries
b) Proactively identify and respond to emerging trends and problems in the industry and at specific institutions.
c) Enforce compliance with regulations
d) Manage the exit of failed institutions from the financial system with the aim of preventing financial system instability and losses to small, unsophisticated depositors.

1.4 Rationale for Regulating the Micro-finance Sector

a) **To preserve the soundness of the financial sector**. The core objectives of financial regulation are to preserve the stability and soundness of the financial system and to protect the deposits of the public. A primary reason for regulating and supervising traditional financial institutions is consumer protection for public depositors in financial institutions.

b) **To ensure the soundness of financial institutions in the industry**. Regulation should help in setting standards that when followed to the latter, will enhance financial institutions' soundness and thus enable their growth and sustainability, leading to economic development in the country.

c) **Information Sharing**[4]: The existence of information asymmetries defines the special nature of the financial industry and explains its heavier regulation compared to other industries (Arun, 2005; Stiglitz, 2001). In fact, the asymmetric distribution of information among the different stakeholders (shareholders, debtors, and depositors) raises the need to counterbalance their particular interests through regulation, and especially, to protect the interests of small depositors (Vogel et al, 2000; Jansson, 1997).

d) **Responsible Lending and Service Provision**: Regulations help to define the legal status of institutions, outlining the allowable and prohibited activities, as well as the scope of offering those services. This helps in creating an environment of responsible lending, for lending institutions, and other services.

e) **Consumer Protection**[5]: In stressing the importance of consumer protection in micro-finance, it has been noted that financial services can help poor people transform their lives. And if not designed and implemented properly, they can, in some cases do more harm than good, especially micro credit (McKee et al. 2010).

To help guard against this, the Smart Campaign (formerly known as the Campaign for Client Protection in Micro-finance) is to make sure financial service providers treat customers fairly, and avoid offering financial products that could harm or expose clients to unnecessary risks. The Campaign is working to establish standards for the appropriate treatment of low-income clients based on six Client Protection Principles: *Avoidance of over-indebtedness; Transparent pricing; Appropriate collections practices; Ethical staff behaviour; Mechanisms for redress of grievances and Privacy of client data.*

f) Interest Rate Controls. Regulation is intended to guard against exorbitant interest rates and pricing of MFI services that would exploit the poor. It is usually the case that when faced with an interest rate ceiling, companies and NGOs providing financial services to poor people will often retreat from the market, grow more slowly, and/or reduce their work in rural areas, or other more costly market segments because they cannot cover their operating costs.

[4] The Role of Regulation and Supervision of Micro-finance Institutions: Evidence from South Africa, and Its Implications for The Development of Non-Deposit Taking Micro-finance Regulation in Kenya. The State University of Bergamo – Italy. Masters in Micro-finance 4th Edition 2009 – 2010. P.21. By Denis Lewa Muganga

[5] Ibid, p.22

2.0 OVERVIEW OF MICRO-LENDING ACTIVITIES (2003-2013)

2.1 Introduction

The micro-lending industry falls under the jurisdiction of the Central Bank but is not explicitly regulated by them[6]. It is regulated by the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) through NBFIRA (Micro-lending Regulations, 2012-C.155-c.165). Unincorporated lenders are not required to report on their business and incorporated lenders only have to submit financial reports. Botswana does not have Usury Act to cap the interest that may be charged on loans. Micro-lenders may fund themselves in various ways, notably loans (including bank loans), owner's equity and listing on the stock exchange. The only restriction is that they are not allowed to take deposits as this is a regulated banking activity under the Banking Act, 1995.

2.2 The Regulatory Authority

The Non-Bank Financial Institutions Regulatory Authority (NBFIRA) was established as an independent regulatory agency for non-bank financial institutions in April 2008. NBFIRA is the regulator of all non-banking financial entities registered in Botswana including *Pension Funds, Asset Management, Consumer/Micro lending, Insurance and Collective Investment Undertakings.*

The principal objective of NBFIRA is to regulate and supervise non-bank financial institutions so as to foster:

a) safety and soundness of non-bank financial institutions;
b) highest standards of conduct of business by non-bank financial institutions;
c) fairness, efficiency and orderliness of the non-bank financial sector;
d) stability of the financial system, and;
e) reduction and deterrence of financial crime (Section 8, NBFIRA Act).

The NBFIRA (Micro-lending Regulations, 2012) was introduced four years after the establishment of NBFIRA in 2008 and the regulations were set up with the broad policy goal of putting order in an industry which was formerly totally unregulated and whose operations were considered a potential threat to financial and social inclusion and to overall financial stability.
This policy framework however, recommends that the regulation of micro-finance institutions in Botswana under the Tiering system (see Section 4.2.1)

[6] Access to Financial Services in Botswana. FinMark Trust Research Paper No. 1 by Genesis Analytics-March 2003

be managed by the Central Bank (Bank of Botswana). This conforms to international best practice where the Central Bank is seen as the custodian of financial stability in the economy.

2.3 Structure of the Micro-lending Sector

Before the introduction and enactment of NBFIRA (Micro-lending Regulations, 2012-C.155-c.165), the micro-lending industry was estimated to have between 1,000 and 2,000 entities (Balopi et al, 2014). NBFIRA has registered about 342 micro-lenders as at 31st May 2014. The sector was (and still is) divided into two tiers:

a) Medium/large firms which operate through substantially sound operational practices, referred to as *Term Lenders*; they provide large medium-term loans for a maximum period of 12 months at an interest rate of 15% month;

b) Small firms operated informally and through vague business conducts, referred to as *Cash Lenders;* they provide small short-term loans for a maximum period of 3 months at an interest rate of 30% per month.

2.4 Main Actors in the Micro-lending Industry

2.4.1 Term Lenders: They provide large and medium-term loans for a maximum period of 12 months at an interest rate of 15% month. Major players include:

a) **Citizens Entrepreneurial Development Agency (CEDA- Government Institution)**: CEDA was established by the Government of the Republic of Botswana to provide financial and technical support for business development with a view to promote viable and sustainable citizen owned business enterprises. CEDA offers funding for capital expenditure, stock or working capital in new and existing business ventures. It also offers training and mentoring for new and seasoned entrepreneurs and business advisory services to entrepreneurs in various skills as identified through the needs assessment that is conducted during project monitoring.

b) **Letshego Financial Services (Pty) Ltd**: It is the first consumer lending company to be established in Botswana and is still the leading provider of unsecured credit to Batswana. Letshego was established to provide unsecured loans to formally employed clients who are mainly employees of the central and local governments, para-statals or quasi government and some private companies. It operates in several African countries amongst them Botswana, Uganda, Swaziland, Tanzania, Zambia, Namibia and lately

Mozambique. Letshego is a subsidiary of Letshego Holdings Ltd which is listed on Botswana Stock Exchange.

c) **Blue Financial Services**: It is a regulated, pan-African financial services provider with a focus on the microfinance sector. Operating with transparency in 12 countries (headquartered in Johannesburg, South Africa), Blue offers ethical, innovative and affordable financial solutions to customers across the continent, according to the uniqueness of each country and its diverse cultures, to enable progress through the financial upliftment of people. Blue has now grown into a truly pan-African financial services group, providing retail financial services to customers in 12 African countries, and is expanding its operational reach to other countries. The countries currently serviced are: Botswana, Ghana, Kenya, Lesotho, Malawi, Namibia, Nigeria, South Africa, Swaziland, Tanzania, Uganda and Zambia. Blue is dual-listed on the AltX board of the Johannesburg Stock Exchange and on the Botswana Stock Exchange.

d) **Bayport Financial Services**: It is a financial service company that provides its customers with unique and tailored financial services, which range from short, medium and long-term loans to transacting services, insurance and savings products. It operates under Bayport Management Ltd (headquartered in Mauritius) with branches in other countries like Ghana, Mozambique, South Africa, Tanzania, Uganda, Zambia and Colombia.

2.4.2 Cash Lenders: They provide small short-term loans for a maximum period of 3 months at an interest rate of 30% per month. There is lack of data on their numbers and some of them belong to an umbrella body called Micro-lenders Association-which use Compuscan, a South African Based Credit Bureau System, to eliminate multiple borrowing by micro-lending clients.

2.4.3 Non-Governmental Organizations[7]: Some NGOs are involved in micro-lending and the promotion of access to financial services in Botswana. The main NGOs are:

a) **Women's Finance House trading as Thusang Basadi**: Women's Finance House is an NGO focused on the empowerment of women and provide their clients with business counselling as well as microloans for business purposes. The programme is focused on poor rural and peri-urban

[7] Access to Financial Services in Botswana. FinMark Trust Research Paper No. 1 by Genesis Analytics-March 2003

Botswana women who are already running a micro-enterprise or small business.

b) **Kgetsi ya Tsie** :This organisation is a 'rural women's community trust based in the Tswapong hills in Eastern Botswana seeking to achieve economic and social advancement for its members. They focus on businesses based on natural resources and help members to formalise and manage their respective businesses. They also help to finance their efforts through a microfinance programme based on the Grameen Bank group model.

c) **Kuru Development Trust (KDT)**: KDT is a development organisation focussing on the support and development of the San population group in Botswana. It was registered as a trust in 1996 and transformed itself into a "regional, people owned support programme" with the mandate to "assist marginalized communities in Botswana with the establishment and development of self-sustainable Community Self-Help Organisations, which will increase the capacity of these communities to gain control over their social and economic lives.

d) **Emang Basadi**: Emang Basadi is an NGO focussed on the upliftment and development of women in Botswana. This is achieved through various projects including a loan scheme.

2.5 Factsheet on micro-lending industry in Botswana[8]

- Estimated number of active micro-lenders: 1,000 to 2,000
- Number of registered micro-lenders: 229 (licensed as at December 2013)
- Out of this 229, the break-down is:
- ➢ Cash lenders(maximum lending term of 3 months) – 156
- ➢ Term Lenders A(maximum lending term of 12 months) – 29
- ➢ Term Lenders B(maximum lending term exceeds 12 months) – 19
- ➢ Application for licensing/operation withdrawn - 25
- Estimated number of unregistered and unlicensed micro-lenders: 800 to 1,200
- Licensed micro-lenders' gross loan portfolio- BWP 2.4 billion (December 2013)
- Estimated gross loan portfolio of unlicensed micro-lenders- BWP 4 billion
- Average interest rate applied, Term Lenders, about 15% per month; Cash Lenders, about 30% per month
- Commercial Banks interest rate, between 12% and 18% per annum

[8] Various documents gathered from NBFIRA

3.0 THE MICRO-FINANCE REGULATORY POLICY

3.1 Policy Vision and Mission Statement

a) To become a viable and sustainable micro-finance industry with effective outreach and impact through integration into the mainstream financial system with the support of all stakeholders.
b) To empower the economically active rural and urban low income households and micro-businesses through the provision of sustainable, affordable and accessible financial services.

3.2 Policy Objectives

The specific objectives of this policy are:

a) To promote the development of a robust, inclusive financial sector;
b) To enhance service delivery by MFIs to the economically active poor;
c) To contribute to rural transformation;
d) To promote linkages between all financial institutions and development partners;
e) To promote synergy and mainstreaming of the informal sector into the national financial system.

3.3 Policy Strategies

To realize the outlined policy objectives, the following strategies will be employed:

a) Development of an appropriate regulatory and supervisory framework for the micro-finance sector;
b) Licensing and regulation of Micro-finance Institutions (MFIs);
c) Encouragement of commercial banks to downscale into micro-finance through wholesale lending to MFIs or retail lending to consumers;
d) Promote the participation of Government in the Micro-finance Sector;
e) Creation of a Micro-finance Development Fund(MFDF) to promote micro-finance in respect of wholesale lending, guarantee funding, re-financing facility, capacity building and other promotional activities;
f) Establish a Credit Reference Bureau to enhance credit risk management practices and also aid decision making on current and potential micro-finance clients;
g) Establishment of an Annual Micro-finance Forum which will bring together Government and all other stakeholders in the micro-finance industry to discuss issues relating to the advancement of the industry;

h) Strengthening the capacities of regulators, practitioners and beneficiaries of micro-finance initiatives;
i) Collaborate with development partners, co-ordinate and monitor donor assistance to ensure equitable allocation of resources.

3.4 Policy Values

The implementation of this policy shall be guided by the following values:

a) Professionalism and Integrity;
b) Sound Corporate Governance Structures;
c) Dynamism & Flexibility;
d) Creativity & Innovation;
e) Client Orientation & Customer Focus;
f) Respect for the Environment;
g) Non-discrimination.

4.0 FRAMEWORK FOR THE REGULATION & SUPERVISION OF MICRO-FINANCE

4.1 Enabling Legal & Regulatory Framework

a) The relevant legal provisions on micro-lending in Botswana Non-Bank Financial Institutions Regulatory Authority (NBFIRA) Act 2008-46:08 and Non-Bank Financial Institutions Regulatory Authority (Micro-lending) Regulations 2012-C.155-C.165 are inadequate and lack provisions for international best practice in Micro-finance.

b) To enhance the contribution of MFIs in private sector development, this policy framework recommends the amendment to the two legal provisions above in line with international best practice. Of special importance is the introduction of savings, insurance and money transfer services to complement the full definition of micro-finance services. The drafting of the proposed Micro-finance Act will take cognisance of all these amendments, especially the introduction of savings, which hitherto was not allowed by the NBFIRA Act.

c) This policy also recommends the introduction of the name “Micro-finance Bank” (MFB) for Deposit-Taking Micro-finance Institutions which will come under prudential supervision.

4.2 Licensing & Supervision of the Micro-finance Sector[9]

4.2.1 The following tiered approach is recommended as a guide to regulate and supervise the micro-finance sector:

MFI Tiers	Type of MFI	Form of Supervision	Supervising Body
Tier 1	Banks which will downscale into micro-finance or have Micro-finance Units	Prudential Supervision	Bank of Botswana
Tier 2	Savings & Loans Companies	Prudential Supervision	Bank of Botswana
Tier 3	Micro-finance Banks(i.e. Deposit-Taking MFIs)	Prudential Supervision	Bank of Botswana
Tier 4	Credit-Only MFIs, Credit Union Co-operatives[10], Financial NGOs(Credit-Only)	Non-Prudential Supervision	Bank of Botswana
Tier 5	Micro-lenders, Term-lenders, etc.	Non-Prudential Supervision	Bank of Botswana. Umbrella Associations to be formed to serve as Self-Regulated Organizations (SROs) for these groups of MFIs

4.2.2 The stakeholders conference held on June 17th, 2014 agreed that all MFIs under the Tiering system be regulated by the Bank of Botswana because of the following reasons:

a) Two regulators for MFIs (Bank of Botswana and NBFIRA) could create regulatory arbitrage[11] opportunities for the players, especially in the credit-only institutions. These players may take advantage of loopholes/inconsistencies in the regulations to distort the financial system.

b) NBFIRA is currently not resourced in terms of skills and human resource to regulate deposit-taking MFIs.

[9] Based on Principle 3 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision-" Licensing Criteria"

[10] Credit Union Co-operatives (SACCOs), which are currently being supervised by Ministry of Trade & Industry may have to be integrated into Tier 4.

[11] A practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavourable regulation

Since Bank of Botswana is in charge of financial stability of the economy, it was agreed by the stakeholders that it regulates the entire Micro-finance industry (Tier 1-5). This is in line with international best practice.**4.2.3** This tiered approach will enable the transformation of institutions from a lower tier to a higher one when the appropriate requirements for the specific tier are met; e.g. a Credit-Only MFI can transform into a Deposit Taking MFI when it meets its requirements.
4.2.4 Some financial NGOs(FNGO), especially Women's Finance House, trading as Thusang Basadi, are currently being given some dispensation by Bank of Botswana(to which they report to), to take deposits from members because of their social or non-profit motive. However the deposits collected from clients (who are mostly women) are not on-lent but kept with Commercial Banks[12]. The proposed classification of FNGOs into Tier 4, which are non-deposit-taking could create some uncertainty for these types of NGOs as to which Tier they belong. It is recommended that the proposed Micro-finance Act specifies the appropriate regulations for these FNGOs irrespective of whether they are "for profit" or "not-for-profit" so that the incidence of regulatory arbitrage may be minimised.
4.2.5 All Deposit-Taking MFIs (Tiers 1-3) shall come under Prudential Supervision whilst Credit-Only MFIs (Tiers 4-5) will be subjected to Non-Prudential Supervision.

4.3 Prudential and Non-Prudential Regulation

As a result of the various players in the micro-finance sector, this policy gives guidance to the type of regulation: **Prudential and Non-Prudential Regulation**:-

4.3.1 Non-Prudential Regulation: This focuses on "conduct of business" and it applies to Non-Deposit-Taking Institutions. It covers:-

a) Registration of institutions to conduct the business of lending legally;
b) Periodic submission of returns;
c) Consumer protection;
d) Preventing fraud and financial crimes;
e) Setting up credit information services;
f) Developing policies with respect to interest rates;
g) Setting limits on foreign ownership and sources of capital;
h) Issues surrounding the transformation of one tier to another.

4.3.2 Prudential Regulation is aimed at protecting the financial system as a whole, as well as protecting the safety of small deposits in individual institutions.

[12] These facts were gathered at a consultative meeting with Women Finance House and at the Stakeholders Forum held on 17th June, 2014 in Gaborone, Botswana.

In addition to the requirements for non-prudential regulations, institutions should meet the following prudential standards:

a) Minimal capital requirements;
b) Limits on unsecured lending;
c) Limits on lending to a single borrower or related party;
d) Limits on investment in fixed assets;
e) Liquidity requirements;
f) Provision requirements for unsecured lending;
g) Full registration of collateral costs;
h) Requirements for branches; and
i) Standard loan documentation requirements.

4.4 Nature & Type of Institutions covered under the framework

The following types of institutions are covered under this policy framework:

a) Banks that will downscale into micro-finance or have Micro-finance Units
b) Savings & Loans Companies(These institutions are large MFIs, which do not want to operate as Commercial Banks and will provide Savings & Credit services, e.g. Letshego may fall under this category)
c) Deposit-Taking Micro-finance Institutions
d) Credit-Only Micro-finance Institutions
e) Financial NGOs in Credit-Only Business
f) Term & Cash Lenders and Pawn Shops

4.5 Permitted Activities[13]

4.5.1 The types of permissible micro-finance activities are as follows:

a) Micro-credit
b) Micro-savings(voluntary savings, fixed deposits, demand(current accounts))
c) Micro-insurance
d) Money Transfer / Remittance Services

4.5.2 All the products mentioned above should be clearly defined in laws and regulations and the MFI's risk management capabilities should be ascertained at the time of licensing to ensure its ability to manage risks inherent with such products and clients.

[13] Based on Principle 2 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision- *"The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined"*

4.5.3 Non-Permissible Activities: Tiers 2, 3, 4 & 5 shall NOT undertake the following:

a) Accept deposits in foreign currency
b) Extend credit in foreign currency. MFIs are prohibited because most of them do not have the managerial resources or expertise to identify, control and mitigate foreign exchange risks.
c) Engage in any trading activities or hold any stocks of goods for sale to their clients.

4.6 Minimum Capital Requirements[14]

MFI Tiers	Type of MFI	Minimum Capital for Licensing
Tier 1	Banks which will downscale or have Micro-finance Units	BWP 5million
Tier 2	Savings & Loans Companies	BWP 1.5million
Tier 3	Micro-finance Banks(i.e. Deposit-Taking MFIs)	BWP 1million
Tier 4	Credit-Only MFIs, Credit Union Co-operatives, Financial NGOs(Credit-Only)	BWP 500,000
Tier 5	Micro-lenders, Term-lenders, Pawn Shops, etc.	BWP 50,000

4.6.1 Not more than 25% of initial paid-up capital shall be spent on property, plant and equipment (i.e. capital expenditure). This means, at least 75% of all initial paid-up capital shall be in liquid cash resources to support operations.
4.6.2 This minimum capital shall be un–encumbered (i.e. it should not be burdened with any conditionalities, e.g. loan capital which will attract interest to the MFI, thereby increasing its cost of funds). This capital should be free equity capital.
4.6.3 This capital shall be used for MFI's operations and shall not be kept fixed in a Bank Account as it currently pertains with Term or Cash Lenders under the NBFIRA Regulations. Fixing it in a Bank Account will deprive the MFI of operational cash and does not match up with best practice.

[14] These minimum capital requirements were based on discussions held at Stakeholders Forum on 14th April 2014

4.7 Capital Adequacy Requirements[15]

4.7.1 An MFI shall maintain a minimum capital ratio of not less than 10% of risk-weighted assets or such other ratio as may be determined from time to time by the Bank of Botswana. The items that are eligible to be included as capital, the risk weights attached to different classes of assets and the method of calculation shall be prescribed by the Central Bank's Regulation Concerning Capital Adequacy. When the ratio falls below the prescribed level, the MFI shall not do any of the following without the approval of the Central Bank until the required ratio is restored:

a) Grant credits and make further investment;
b) Pay dividend to shareholders;
c) Borrow from the investing public or take deposits.
d) Any other supervisory measures deem necessary by the Central Bank.

4.7.2 In addition to the above-mentioned measures, the MFI shall be required to submit within a specified period to be determined by the Central Bank, a recapitalization plan acceptable to the Central Bank. Failure to comply with any or all of the above may constitute grounds for the revocation of the license of the MFI or require such other penalties as may be deemed appropriate by the Central Bank. MFIs are enjoined to ensure that their shareholders' funds do NOT fall below the minimum capital requirements.

4.8 Regulatory Authority and its Functions[16]

[15] Based on Principle 6 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision"- "Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement, i.e.6%

[16] Based on Principle 1 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision"- "Objectives, independence, powers, etc. of Supervising Agencies"

4.8.1 The Regulatory & Supervision Department under the authority of Bank of Botswana shall regulate, promote and ensure orderly growth of MFIs and take measures as it deems fit, for the purpose of promoting financial inclusion through such institutions. The powers and functions of this Regulatory Department shall include the following:

a) Grant a certificate of registration to the applicant MFI;
b) Introduce schemes/strategies for the orderly growth of the micro-finance services provided by MFIs so as to ensure greater transparency, effective management and good governance in an efficient manner;
c) Specify the sector related benchmarks and performance standards pertaining to methods of operation, fair and reasonable methods of recovery, management and governance including model codes for conduct of activities of MFIs;
d) Specify the form and manner of books of account to be maintained by MFIs, manner of accounting for business operations of MFIs and auditing standards relating thereto;
e) Ask for information and data from MFIs for maintaining an appropriate database in the public domain relating to micro finance services and disseminating the same through a national dissemination network;
f) Constitute a Micro Finance Development Fund and to apply the funds accruing to it to the development of the micro-finance sector in Botswana;
g) Promote the development of MFIs through training and capacity building measures;
h) Promote customer education of all institutions engaged in micro-finance services for greater awareness and for economic empowerment of micro-finance clients;
i) Support research, field research, documentation and dissemination thereof relating to micro-finance sector;
j) Co-ordinate with other agencies for the orderly growth and development of institutions engaged in the micro-finance services;
k) Document and disseminate information relating to best practices with a view to ensuring provision of micro-finance services at an affordable cost to eligible clients;
l) Perform such other functions as may be prescribed.

4.9 Unsecured lending limits

a) No MFI shall grant an unsecured loan to any one single obligor which exceeds 5% of its paid-up capital; or

b) In the case of a secured facility, not more than 10% of the paid-up capital;

c) For group loans, the exposure to a single borrower shall not exceed 1% of paid-up capital.

4.10 Loan-loss provisions [17]

a) The regulatory framework should compel financial institutions to recognise the risk posed by past due micro-finance loans quickly and accurately.

b) The first step is a clear definition of microcredit as distinguished from other loan types, to allow a differentiated definition of non-performance.

c) Micro-credits loan portfolio should be risk-classified and provisioned for, based on the number of days of non-performance, missed payments and/or times re-scheduled.

d) Micro-credits are generally repaid in short, frequent intervals (sometimes even weekly), monitoring and reporting systems, provisioning and classification standards should be tailored accordingly.

e) Re-scheduled micro-loans typically should be classified in a higher risk category than other type of loans that are the same number of days or payments past due.

f) Loan loss provisions are classified generally into 2 categories: *Provision on Performing Loans* (normally referred to as General Provision) and *Provision on Non-Performing Loans* (referred to as Specific Provision).

g) Each MFI shall apply not less than 1% as General Provision on all Performing Loans (i.e. loans without any arrears on Principal and Interest Due)

h) Specific Provisions on Non-Performing Loans may be done by each MFI based on the history of non-payment of loans. However, the following format can be a guide:

[17] Based on Principle 9 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision"- Problem Assets, Provisions & Reserves

LOAN CLASSIFICATION	LOAN LOSS PROVISION
Current Portfolio	
Current Portfolio(Performing Loans)-General Provision	1%[18]
Portfolio Past-Due 1 – 30 Days	5%
Portfolio Past-Due 31 – 60 Days	10%
Portfolio Past-Due 61 - 90 Days	25%
Portfolio Past-Due 91 - 120 Days	50%
Portfolio Past-Due 121 - 180 Days	75%
Portfolio Past-Due > 180 Days	100%
Re-scheduled Portfolio	
Current Re-scheduled Loan Portfolio	10%
Rescheduled Portfolio Past-Due 1 - 30 Days	50%
Rescheduled Portfolio Past-Due 31 - 60 Days	75%
Rescheduled Portfolio Past-Due > 60 Days	100%

i) Every MFI shall separately disclose in its audited financial statements the specific and general loan loss provisions made for loans.

j) Each MFI shall develop a Loan Write-Off Policy to ensure that over-due loans are written off appropriately.

4.11 Regulation of Interest Rates

[18] Some MFIs provide 0%; but for prudence in accounting it should not be less than 1%

a) Although interest rate caps are retrogressive to the development of a sustainable micro-finance sector, there remains a need for consumer protection, particularly in view of the captive nature of the micro-finance market.
b) It is recommended that the Regulatory Authority does not cap interest rates but each MFI should be requested to publish its Annual Percentage Rate(APR) on monthly basis so that clients can decide which institution to transact business with. The Regulatory Authority, based on this monthly publication of APRs, can dialogue with MFIs with very high interest rates to reduce them appropriately.

4.12 Liquidity, Interest Rate and Foreign Exchange Risks[19]

a) Liquidity Risk

i. Liquidity risk management should focus on maintaining adequate minimum liquidity cushion for business as usual, as well as for stress situations.

ii. Regulations may impose a cushion in the form of a reserve or liquidity ratio requiring MFIs to hold un-encumbered liquid assets against a percentage of micro deposits and a limit on concentrations from a single funding source.

iii. MFI liquidity plans should also include simple stress scenarios taking into account contagion effects that may manifest in a rapid deterioration of the loan portfolio or a run on deposits due to localised problems.

b) **Interest Rate Risk**

i. The Regulator should ensure that MFIs have in place, systems to measure, monitor and control interest rate risk, taking into account the unique behaviour of micro-finance assets and liabilities, compared to those of a diversified commercial bank.

ii. Re-pricing assumptions for micro-loans and deposits should follow the same behavioural assumptions as for liquidity risk management.

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[19] Based on Principles 14, 16 & 13 respectively of “Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision

C) Foreign Exchange Risk

i. MFIs are not allowed to take deposits in foreign currency but some may rely on international commercial borrowings to fund their loan book. Thus, there is a challenge for MFIs to manage the currency mismatch between a portfolio of micro-loans in local currency and funding in foreign currency.

ii. The Regulator must be able to evaluate how effectively MFIs manage foreign exchange risk on an ongoing basis, including cross-border financing arrangements with international lenders. Establishing a limit on the Net Open Position[20] for each foreign currency may be a risk mitigating measure for MFIs that borrow in foreign currency to fund their loan book.

4.13 Consumer Protection[21]

a) Consumer protection pertains to measures that promote the rights of clients, enable them to make informed choices and protect them from unscrupulous acts that deny them the true value and optimum benefits of micro-finance services such as credit, deposits/savings, insurance, and remittances and transfers.

b) Consumer protection is necessary to safeguard the interests of consumers of micro-finance services from adverse effects brought about by undesirable practices of providers.

c) The Regulatory Body will pursue consumer protection by:
   i. preventing irregularities or transactions which have negative impact on the consumers;
   ii. empowering consumers to exercise informed choices and select value-for-money goods;
   iii. providing fair access to micro-finance products and services; and
   iv. opening avenues to address consumer interests and concerns.

d) Consumer protection measures that MFIs shall adopt will include:
   i. transparency of transactions;
   ii. implementation of regulations on financial practices;

[20] *Net Open Position is the difference between total open long (receivable funds) and open short (payable funds) positions in a given asset (e.g., foreign exchange currency, commodity, etc.) held by an institution or individual.*

[21] Micro-finance Consumer Protection Guidebook. P.1

iii. promotion of consumer literacy; and

iv. implementation of mechanisms for filing and handling consumer complaints and grievances.

4.14 Reporting to the Regulatory Body[22]

a) The Regulatory Body will design standard reporting formats for all categories of MFIs to collect information on various performance indicators.

b) The effectiveness, timeliness, quality and costs of off-site surveillance and on-site inspections will depend on the standard reporting mechanisms in place to collect, review and analyse financial health indicators, prudential indices and statistical returns from institutions engaged in micro-finance.

c) The content of reports and their frequency will be strictly aligned to the specialised analyses that are needed for effective supervision. Some examples of standard reporting will include portfolio quality, leverage, prudential ratios, operating costs, funding structure, liquidity position, etc.

d) The Regulatory Body must have the ability to compare key indicators against performance benchmarks in the peer group.

4.15 Corporate Governance for MFIs

a) All MFIs shall adhere to basic corporate governance principles.

b) The Board of Directors of MFBs shall be primarily responsible for the corporate governance of the bank by establishing strategic objectives, policies and procedures that would guide and direct the activities and the means to attain the same, as well as the mechanism for monitoring Management's compliance.

[22] Based on Principle 21 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision"- *Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.*

4.16 Insider Lending

a) The Regulatory Body shall make rules about lending to directors, officials and employees of MFIs as follows:

b) An MFI shall not grant unsecured advances or other credit facilities:
   i. To any of its directors, amounting to more than 2% of its net-worth, and
   ii. To any of its officials and employees, amounting to more than two years consolidated salary of the concerned official/employee.

4.17 Internal Audit & Disclosure Requirements

a) Every MFI shall have an Internal Audit Unit which should ensure that its operations conform to the law as well as, to its internal rules and regulations. Every fraud or attempted fraud must be promptly reported to the Regulation Body.

b) The Board of Directors shall ensure the preparation of annual audited financial annual Accounts for disclosure to the shareholders in accordance with the constitution or rules of the MFI and the Regulatory Body.

4.18 Winding up Procedures

a) The Central Bank of Botswana/ The Regulatory Body has the power to file winding up petition against an MFI when the former is satisfied that a micro-finance institution:
   i. is unable to pay its debts; or
   ii. by virtue of provisions of the Micro-finance Act has become disqualified to carry on the activities of a micro-finance institution; or
   iii. has failed to comply with any directives or orders issued by the Central Bank ; or
   iv. the continuance of the micro-finance institution is detrimental to public interest or to the interest of the clients of the institution.

b) The filing of the application for winding up or any other application by whatever name it is called, before the appropriate authority or Court empowered to wind up the business or activities of the micro-finance institution, shall be carried out under the provisions of laws applicable to the Company & Insolvency Laws of Botswana.

4.19 Abuse of financial services (Know-Your-Customer, Money Laundering)[23]

a) The Regulatory Body must be satisfied that MFIs have adequate policies and processes in place, including strict "know-your-customer" rules that promote high ethical and professional standards in the financial sector and prevent the MFI from being used, intentionally or unintentionally, for criminal activities.

b) The Regulatory Authority should ensure that clients do not abuse the cooling off period[24] and take advantage of interest arbitrage. To prevent this it is recommended that loan disbursements should not be done during the cooling off period.

c) The Regulatory Body should adopt the principles of Financial Action Task Force[25] which allows countries and institutions to follow a risk-based approach that focuses their attention and resources on people and activities posing a high risk of money laundering and financing of terrorism (ML/FT), while ensuring that reduced and simplified controls are sufficient to safeguard low-risk activities, such as low-value savings products, from abuse.

[23] Based on Principle 18 of "Basel Committee on Banking Supervision-Micro-finance Activities & the Core Principles for Effective Banking Supervision"- Abuse of financial services

[24] A period of 48 hours given to a loan client to rescind his decision on whether to take a loan or not.

[25] The Financial Action Task Force (FATF) is an inter-governmental body whose purposes include the development and promotion of national and international policies to combat money laundering and terrorist financing and to bring about legislative and regulatory reforms in these areas. The FATF has published Recommendations in order to meet this objective. www.fatf-gafi.org

5.0 DEVELOPING THE MICRO-FINANCE SECTOR

5.1 The Establishment of Micro-finance Banks.

a) Public and private sector-driven Micro-finance banks shall be established.

b) The Micro-finance Banks shall be required to be well-capitalized, technically sound and oriented towards lending to the poor and marginalized, based on the cash flow and character of clients.

5.2 The Goals of Micro-finance Banks.

The establishment of micro-finance banks has become imperative to serve the following purposes:

a) To provide diversified, affordable and dependable financial services to the economically active poor, in a timely and competitive manner;
b) To mobilize savings for mobilization;
c) To create employment opportunities and increase the productivity of the economically active poor in the country, thereby increasing their individual household income and uplifting their standard of living;
d) To enhance organized, systematic and focused participation of the poor in the socio-economic development and resource allocation process;
e) To render money transfer/remittance services to the public

5.3 Organic Growth Path of Micro-finance Banks.

a) This policy recognizes that the current micro-finance landscape in Botswana is skewed towards term lending for salaried workers with little attention to Small & Medium Enterprises (SMEs). To address the imbalance, this policy framework shall promote an even spread of micro-finance banks and their branches.

b) Micro-finance Banks shall be expected to employ mobilized deposits in the development of rural and peri-urban areas.

5.4 Ownership of Micro-finance Banks

a) Micro-finance Banks can be established as companies by individuals, groups of individuals, community development associations, private corporate entities, and foreign investors as defined by Botswana Banking Act 1995, No.13 of 1995.

b) Commercial Banks that intend to set up Micro-finance Banks as a subsidiary shall be required to meet all the licensing requirements for Micro-finance banks as specified by the Regulator.

c) The shareholding thresholds for ownership in Micro-finance Banks may be prescribed by the Regulator from time to time in line with the existing macro-economic fundamentals. However, this policy framework recommends that there should be no restriction on foreign ownership since the latter have the required expertise and equity capital which are necessary at the infant / developmental stage of the micro-finance industry in Botswana.

6.0 PARTICIPATION OF EXISTING MFIs

6.1 Commercial Banks.

a) Commercial Banks currently engaging in micro-finance services, and do not wish to set up a subsidiary, shall be required to set-up a department/unit for such services and shall be subjected to the provisions of the regulatory and supervisory guidelines as stipulated by the Regulator.

6.2 Micro-lending Institutions.

a) This policy recognizes the existence of credit-only, membership-based micro-lending institutions (i.e. Term and Cash lenders). Such institutions shall continue to engage in the provision of micro-credits to their targeted population but will have to abide by the dictates of the Regulatory Body.
b) They will also remain prohibited from mobilising deposits from the general public, except under special dispensation as mention in Section 4.2.4 above. However, in giving dispensation to such category of MFIs, the likelihood of regulatory arbitrage must be considered.

6.3 Transformation of existing Micro-lending Institutions.

a) Existing Micro-lending Institutions that wish to convert fully to a Micro-finance bank shall be required to obtain an operating license which meets the specified provisions as stipulated by the Regulatory Body.

7.0 ROLES & RESPONSIBILITIES OF KEY STAKEHOLDERS

The roles of the various stakeholders, namely the government, the Bank of Botswana, Apex Bodies, Micro-finance Institutions and Development Partners shall include the following:

7.1 The Government:

The Government, through its various ministries and arms, shall be responsible for:

a) Maintenance of a stable macro-economic environment;
b) Creation of a conducive legislative and regulatory framework that encourages sustainable and efficient growth of micro-finance sector and eliminates barriers of entry into the financial market;
c) Provision of basic infrastructure (electricity, water, roads, tele-communication, etc.) so as to enhance private sector participation and enterprise promotion to facilitate the provision of financial services to low income people in remote areas;
d) Channelling subsidies to selected sectors of the economy involved in poverty alleviation initiatives through the Micro-finance Development Fund to avoid duplication of efforts and conflicts of interest;
e) Mobilize resources, through budgetary provisions, to build institutional capacity and innovation within the Apex bodies and MFIs;
f) Co-ordinating donor intervention efforts in line with the provision of this policy so as to achieve desired impact.

7.2The Bank of Botswana:

The Bank of Botswana, charged with the oversight of the country's financial sector, shall be responsible for co-ordinating the implementation of this policy through its Regulatory and Supervisory Department as follows:

a) Adopting and implementing an appropriate regulatory and supervisory framework that promotes regulatory harmony, healthy competition and development of the micro-finance sector;
b) Minimizing regulatory arbitrage through periodic reviews of the policy and issuance of regulatory guidelines;
c) Prudential supervision of all MFIs that qualify to be in tiers established for prudential and non-prudential supervision;
d) Maintaining a database of all licensed MFIs, thereby ensuring that their contribution to the economy is tracked;
e) Enforce compliance with all guidelines and regulations pertaining to the sector that shall be issued from time to time;

f) Managing and administering the Micro-finance Development Fund on behalf of Government.

7.3 APEX Bodies:

This policy encourages the formation of Apex Bodies/Umbrella Associations and their functions will include:

a) Supporting capacity building initiatives for various MFI's technical assistance/training programmes;
b) Advocating for consumer protection practices by all Micro-finance institutions
c) Providing an appropriate interface between regulatory authorities and micro-finance practitioners
d) Provide regulatory guidelines and rules for MFIs in Tier 5(Term & Cash Lenders, Pawn Shops) so that these Umbrella Associations can become Self-Regulating Organizations (SRO) for these category of MFIs.
e) Sourcing funding for the micro-finance sector;
f) Promoting international micro-finance best practices.

7.4 Providers of Micro-finance Services: Micro-finance practitioners shall include, among others, commercial banks, micro-finance banks, micro-finance institutions, building societies, Savings & Credit Co-operatives (SACCOs), Term & Cash Lenders, Pawn Shops. Their duties shall include:

a) Observe sound and ethical risk management and corporate governance practices;
b) Provide effective and efficient financial services as spelt out in the regulations governing their operations;
c) Undertake appropriate recruitment and retention of qualified professionals through transparent and competitive processes;
d) Adopt continuous training and capacity building programmes to improve the skills of staff;
e) Strictly observe their fiduciary responsibility, remain transparent and accountable in protecting clients' deposits, in compliance with their lending policies and regulatory requirements;
f) Promote and provide demand-driven and diversified products and services to the economically active poor.

7.5 Commercial Banks and Building Societies:

a) The policy recognises the importance of the provision of wholesale funds for MFIs to expand their outreach to rural markets

b) The policy will therefore foster linkage strategies between commercial banks, building societies and MFIs to enable the latter to source funds and re-financing facilities for on-lending purposes.

c) The policy encourages commercial banks and building societies to leverage their existing infrastructure by down-streaming their services to cater for the low income segments of the economy, especially the rural poor.

7.6 Developmental Partners:

a) Development partners, which include the donor community, have been instrumental in the development and implementation of micro-finance programmes in Botswana through the provision of grants, subsidized funds and technical assistance.

b) Development partners are expected to co-ordinate their efforts to ensure that their programmes are in compliance with micro-finance best practices and provisions of this policy framework. To ensure the development of sustainable MFIs, their services will include:

    i. Offering funds and technical assistance for the development of the micro-finance sector in Botswana;
    ii. Provision of financial assistance at concessional rates for endeavours like housing, income generation projects and community-based projects;
    iii. Capacity building through dissemination of international best practices in micro-finance through organizing workshops and conferences.

8.0 POLICY REVIEW & MONITORING

It is critical to ensure that all key stakeholders in the micro-finance sector deliver on their key result areas as outlined in this policy framework.

a) Pursuant to this, the Annual Micro-finance Forum, in conjunction with the Central Bank/Regulatory Authority, will be responsible for periodic monitoring and evaluation, of the effectiveness, efficiency and relevance of the policy to the development of the micro-finance sector.

b) An annual conference on micro-finance shall be held to deliberate on progress made in achieving policy objectives and key challenges facing the micro-finance sector.

9.0 CONCLUSION

This policy framework provides a roadmap and strategic direction for all key stakeholders operating in the micro-finance sector in Botswana. It will serve as a source document for the drafting of the Micro-finance Act for Botswana and also subsequently as a reference document for the drawing of Rules and Regulations for all categories of MFIs in Botswana.
Section 4 of this document, i.e. FRAMEWORK FOR THE REGULATION & SUPERVISION OF MICRO-FINANCE (4.1-4.19) should form the basis of subsequent legislation, regulation and supervision of MFIs in Botswana.

It is envisaged that the comprehensive adoption of the policy framework will promote poverty alleviation, stimulate economic development by creating an enabling environment for SMEs and also laying a strong foundation for macro-economic stability through outlining principles and guidelines that will ensure the development of future prospects for all stakeholders.

BENCHMARKING REPORT - MICRO-FINANCE REGULATORY POLICY FRAMEWORKS FOR 6 COUNTRIES IN AFRICA.

INTRODUCTION

The Terms of Reference for developing a Micro-finance Regulatory Policy Framework for Botswana required the benchmarking of micro-finance activities in South Africa, Namibia & Zimbabwe. However, after the first stakeholders workshop on 15th April 2014, it was agreed that the benchmarking be expanded to cover 3 more countries- Kenya, Uganda and Ghana so that a blend of international best practices in the micro-finance industry be brought to bear on the industry in Botswana. The following write-up and appropriate tables summarize the benchmarking report for the six countries with respect various critical areas of micro-finance regulation. This report would satisfy the requirement for the Contract Addendum which was signed by me and CDE, dated 9th June 2014.

THE NEED TO REGULATE MICROFINANCE ACTIVITIES

The theoretical argument on the need to regulate the microfinance services is premised on three critical factors:

1) To protect depositors who will then have confidence in the financial institutions to entrust them with their savings.
2) Regulation ensures that financial institutions are sound with enough capital and earnings to cover risks of intermediation and make them sustainable in order to alleviate poverty.
3) Regulation will protect consumers from abusive lending and collection practices.

There is therefore the need to establish appropriate legal framework for microfinance institutions so as to create an enabling environment for financing SMES, community-based organizations and individuals in Botswana.

BENCHMARKING STANDARDS

The following standards were used in benchmarking micro-finance activities in the six countries:

a) Regulatory Authority
b) Tiered Approach to Regulation & Supervision
c) Minimum Capital Requirement
d) Permitted Activities
e) Types of Institutions
f) Regulation of Interest Rates
g) Limitations on foreign ownership

1. THE REGULATORY AUTHORITY

Out of the six countries benchmarked, the Regulatory Authority is the Central Bank in four countries and this corresponds to international best practice. It is therefore recommended that the Bank of Botswana shall regulate, promote and ensure orderly growth of MFIs in Botswana.

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	NAMIBIA	ZIMBABWE	KENYA	UGANDA	GHANA	BOTSWANA (PROPOSED)
1.REGULATORY AUTHORITY	**Microfinance Regulatory Council (MFRC)** is the only approved regulatory institution under the Usury Act Exemption Notice	**Namibia Financial Institutions Supervisory Authority (NAMFISA)**	**Central Bank of Zimbabwe** for MFIs. SACCOs by Ministry of Co-operatives	**Central Bank of Kenya** for Deposit-taking Inst. & Umbrella Assoc. for Non-Deposit taking Inst.	**Central Bank of Uganda** for Deposit-taking Inst. & Self-Regulatory Org through Umbrella Associations for Non-Deposit taking Inst.	**Central Bank of Ghana**-All MFIs through the Non-Bank Financial Institutions Act 2008, Act 774	**Recommended:** **Central Bank of Botswana**

2. THE TIERED APPROACH TO REGULATION/SUPERVISION

The tiered approach reflects the concept of microfinance as a line of business. It gives room for more flexibility to microfinance activities and incorporates the fact that it may be necessary to regulate different intermediaries in a different manner.
Many countries which have moved towards a tiered financial and regulatory structure[26] include Bolivia and Peru in Latin America; and Uganda, Ghana and Zambia in Africa. A number of countries in Eastern Europe -- e.g., Albania, Bosnia and Georgia – are restructuring their banking laws and prudential regulations to establish a tiered approach to accommodate specialized financial institutions with capitalization requirements much lower than those for regular commercial banks.

RECOMMENDATION: Four out of six countries have adopted the tiered approach. The micro-finance industry in Botswana should adopt the tiered approach to regulation as practiced by many countries noted above.

[26] A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines by Joselito Gallardo-November 2001

BENCHMARK STANDARD		COUNTRIES BEING BENCHMARKED						
		SOUTH AFRICA	**NAMIBIA**	**ZIMBABWE**	**KENYA**	**UGANDA**	**GHANA**	**BOTSWANA (PROPOSED)**
2.THE TIERED APPROACH TO REGULATION /SUPERVISION		All money lenders whose transactions fall within the scope of the Usury Act Exemption Notice.(Term & Cash Lenders & NGOs)	Multi-purpose Co-operatives providing Microfinance(MPCM), SACCOs & SCAs, Micro-lenders & NGOs registered with NAMFISA	**Tiering System**: **Tier 1**- Banks & Building Societies; **Tier 2** - Microfinance Banks; **Tier 3** -Savings & Credit Union Cooperatives; **Tier 4**- Microfinance Institutions.	**Tiering System:** **Tier 1** - ROSCAs and ASCAs; **Tier 2**- Credit-only/ Non Deposit -taking MFIs; **Tier 3**- Deposit -taking MFIs.	**Tiering System:** **Tier 1** – Banks; **Tier 2** - Credit Institutions; **Tier 3**- Deposit-Taking Institutions; **Tier 4**- Non-deposit taking Institutions.	**Tiering System:** **Tier 1** - Rural Banks, Savings & Loans Cos; **Tier 2** - Deposit-taking FNGOs, Credit Unions; **Tier 3** - Non Deposit-taking FNGOs; **Tier 4** - Susu Collectors, Money Lenders.	**Recommended Tiering System:** **Tier 1**- Micro-finance Units of Banks; **Tier 2** – Savings & Loans Cos; **Tier 3** – Deposit-taking MFIs **Tier 4** – Credit Only MFIs, FNGOs; **Tier 5** – Term & Cash Lenders, Pawn Shops

3. MINIMUM CAPITAL REQUIREMENT

If regulators do decide to introduce special deposit-taking licenses for MFIs, the level at which the minimum capital requirements are set will ultimately be critical. Caution must be taken not to set the limit too low so as to i) overburden the prudential regulator, and ii) allow ill-prepared financial institutions to potentially place the savings of vulnerable low-income savers at risk. On the other hand, setting the minimum capital limit too high may result in the deposit-taking license not being taken up, with little or no impact on financial access. Best practice is for regulators to institute conservative capital requirements at first, with an option of increasing these later. This practice will avoid regulators being overburdened by an influx of new institutions that it cannot monitor effectively.

RECOMMENDATION: The recommended minimum capital requirements are conservative with the option of revising them upwards when activities in the micro-finance industry have stabilized.

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	NAMIBIA	ZIMBABWE	KENYA	UGANDA	GHANA	BOTSWANA (PROPOSED)
3.MINIMUM CAPITAL REQUIREMENT	Info not available	N$10million (@$1m) [27]for MFIs	Deposit taking = $5m, rising to $10m in 2020[28] Credit only =$20,000, rising to $50,000 in 2020	Deposit taking nationwide =60m KS=@$697,000; Deposit-taking in community=20mKS=@$232,000	Tier 1-Banks = $2m Tier 2-Credit only = $500,000 Tier 3-Deposit taking = $250,000	Tier 1-Banks = $40m; S&L =$5m Tier 2-Deposit MFIs=$167,000 Tier 3-FNGOs =$100,000 Rural Banks = $100,000	**Recommendation**: Tier 1 (Banks)=5m BWP(@$625,000) Tier 2(Savings & Loans Cos) =1.5m BWP($187,500) Tier 3(Deposit Taking MFIs) =1m BWP($125,000) Tier 4(Credit Only MFIs)=500,000 BWP ($62,500) Tier 5 (Term Lenders) =50,000BWP($6,250)

27 PROMOTING MICROFINANCE ACTIVITIES IN NAMIBIA-A REGULATORY AND SUPERVISORY PERSPECTIVE by Postrick Mushendami et al. Bank of Namibia Working Paper WP-2/2004

28 RESERVE BANK OF ZIMBABWE-CIRCULAR TO MONEYLENDING AND MICROFINANCE INSTITUTIONS NO. 04-2014/BSD: Minimum Capital Requirements for Microfinance Institutions. 18.02.2014

4. PERMITTED ACTIVITIES

(A) REGULATORY PRINCIPLE: Regulations should state clearly the activities that different types of MFIs are allowed to conduct. The permitted activities (taking into account the associated risk of each), should be related to the level of regulation (prudential/non-prudential) that the institution is subjected to.

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	NAMIBIA	ZIMBABWE	KENYA	UGANDA	GHANA	BOTSWANA (PROPOSED)
4. PERMITTED ACTIVITIES	Micro-credit, Deposits not allowed	Micro-credit, Deposits not allowed	Micro-credit, micro-savings, micro-insurance, money transfer/remittance services	Micro-credit, micro-savings, micro-insurance, money transfer/remittance services	Micro-credit, micro-savings, micro-insurance, money transfer/remittance services	Micro-credit, micro-savings, micro-insurance, money transfer/remittance services	**Recommended:** Micro-credit, micro-savings, micro-insurance, money transfer/remittance services

(B) RECOMMENDATION: Regulations should clearly define the type of permissible activities that an MFI is allowed to engage in. These allowances should be based on the capacity of the institutions and the level regulation that they are subjected to (i.e. prudential or non-prudential).

5. TYPES OF INSTITUTIONS

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	NAMIBIA	ZIMBABWE	KENYA	UGANDA	GHANA	BOTSWANA (PROPOSED)
5. TYPES OF INSTITUTIONS	Term & Cash Lenders, NGOs	Term & Cash Lenders, SACCOs, NGOs, informal moneylenders and Stokvels	1.Banks & Building Societies 2.Micro-finance Banks 3.SACCOs & Credit Union Coop 4.MFIs & NGOs	1.Commercial Banks 2. Micro-finance NGOs 3.SACCOS, ROSCAs, ASCAs 4.Moneylenders 5.Parastatals, Societies	1.Commercial Banks 2.Deposit-taking MFIs 3.Credit-Only MFIs 4.FNGOs	1.Rural Banks 2.Savings & Loans Cos 3.Deposit taking MFIs 4. Non-Deposit taking FNGOs & non-profit NGOs 5.Susu Cos, Money Lenders	**Recommended:** 1.Banks with Micro-finance Units 2.Savings & Loans Cos 3.Deposit-Taking MFIs 4.Credit-Only MFIs 5. Financial NGOs 6. 6.Term & Cash Lenders and Pawn Shops

6. REGULATION OF INTEREST RATES

Administrative costs of lenders do not vary in proportion to loan amounts. As such, “MFIs cannot continue to provide tiny loans unless their loan charges are considerably higher in percentage terms than normal banks”. As it is politically difficult to set interest rate limits high enough to offset the high operation costs, interest rate caps should be avoided.

RECOMMENDATION: To align with international best practice and to promote financial inclusion, it is recommended that interest rates should not be capped.

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	**NAMIBIA**	**ZIMBABWE**	**KENYA**	**UGANDA**	**GHANA**	**BOTSWANA (PROPOSED)**
6. REGULATION OF INTEREST RATES	Interest rate caps present as per Usury Act. Monitored by MFRC	Interest rate caps present as per Usury Act. Monitored by NAMFISA	No interest rate cap. Market determined rates	No interest rate cap. Market determined rates	No interest rate cap. Market determined rates	No interest rate cap. Market determined rates	**Recommended:** No caps on interest rate recommended. Interest rates to be determined by market conditions.

7. LIMITATIONS ON FOREIGN OWNERSHIP

Foreign resources, including donor or NGO, are most often the available resources for MFIs, particularly those that are yet to prove their sustainability. Foreign entities also have the expertise and equity investments for the micro-finance industry. Foreign ownership restrictions can therefore be problematic.

RECOMMENDATION: The shareholding thresholds for ownership in Micro-finance Banks may be prescribed by the Regulator from time to time in line with the existing macro-economic fundamentals. However, this policy framework recommends that there should be no restriction on foreign ownership since the latter have the required expertise and equity capital which are necessary at the infant / developmental stage of the micro-finance industry in Botswana.

BENCHMARK STANDARD	COUNTRIES BEING BENCHMARKED						
	SOUTH AFRICA	**NAMIBIA**	**ZIMBABWE**	**KENYA**	**UGANDA**	**GHANA**	**BOTSWANA (PROPOSED)**
7. LIMITATIONS ON FOREIGN OWNERSHIP	**Banks**: No person shall hold more than 15% of controlling shares unless permission is given by the Registrar of Banks **Micro-lenders**: Determined by the law governing each organizational structure	Dominance of foreign ownership in most financial institutions [29]. Plans are advanced to institute a mix of locally owned and foreign owned institutions.	No restriction to foreign ownership. However, indigenisation laws are being encouraged.	Shareholding (local or foreign) is limited to a maximum of 25% in order to reduce undue influence over the policies and operations of the institution by majority shareholders [30]	Shareholding (local or foreign) is limited to a maximum of 49% in order to reduce undue influence over the policies and operations of the institution by majority shareholders [31].	Shareholding of MFIs such as Susu Co, Deposit taking FNGOs, Money Lenders- RESTRICTED TO ONLY GHANAIANS [32] Shareholding in non-deposit taking MFIs may be **exclusively Ghanaian**, **exclusively foreign** or **jointly Ghanaian and foreign**	**Recommendation**: No restriction on foreign ownership since the latter have the required expertise and equity capital which are necessary at the infant / developmental stage of the micro-finance industry in Botswana

[29] NAMIBIA FINANCIAL SECTOR STRATEGY: 2011-2021

[30] KENYA-THE MICROFINANCE ACT, 2006-THIS EDITION INCORPORATES AMENDMENTS UP TO 1ST JANUARY, 2014. SECTION 19 (1) & (2)

[31] UGANDA-THE FINANCIAL INSTITUTIONS (OWNERSHIP AND CONTROL) REGULATIONS, 2005, SECTION 18(1) & (2)

[32] LICENSING REQUIREMENTS FOR MICROFINANCE INSTITUTIONS (TIER 2 & TIER 3 INSTITUTIONS)- BANKING SUPERVSION DEPARTMENT BANK OF GHANA

APPENDIX 2- 25 Core Principles of Effective Banking Supervision

25 Core Principles of Effective Banking Supervision

Principle 1 – Objectives, independence, powers, transparency and cooperation

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2 – Permissible activities

The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3 – Licensing criteria

The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4 – Transfer of significant ownership

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5 – Major acquisitions

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6 – Capital adequacy

Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7 – Risk management process

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8 – Credit risk

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). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9 – Problem assets, provisions and reserves

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10 – Large exposure limits

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11 – Exposures to related parties

In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12 – Country and transfer risks

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13 – Market risks

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14 – Liquidity risk

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a *day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.*

Principle 15 – Operational risk

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well-defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17 – Internal control and audit

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18 – Abuse of financial services

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19 – Supervisory approach

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20 – Supervisory techniques

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 21 – Supervisory reporting

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22 – Accounting and disclosure

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23 – Corrective and remedial powers of supervisors

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

Principle 24 – Consolidated supervision

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25 – Home-host relationships

Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Adapted from:

Micro-finance Activities & Core Banking Principles for Effective Banking Supervision

Basel Committee on Banking Supervision- August 2010.Bank for International Settlements

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