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Implementation of Basel II in Microfinance Sector of Pakistan

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Abstract

The Basel, the new accord on banking regulation and supervision covers the risk of capital and credit risk. Basel II covers the additional risk of market which completes the first and second pillars. It includes the disclosure of basic information to its market participants. This information is a sum of risks that institution has to face, capital risk exposure, risk assessment process, capital adequacy of the bank, the techniques to account fall the risks. The aim of the study was to implement Basel II in microfinance sector of Pakistan. The study is unique because it is never analyzed before in microfinance sector of Pakistan. The discussion method was used for results and results of the study shows that new accord will definitely help the managers and practitioners to evaluate the performance of this sector.

Keywords: Basel 1, Basel II, Capital Accord, Microfinance, CAR, Operational Risk, Market Risk.

1. Introduction

1.1 BASEL II

The first international accord on banking regulation and supervision Basel I was published in 1988. The purpose of Basel I was to establish a direct link between capital of a bank and its credit risk. According to this a bank must have high level of capital equals to its high credit risks level. But the risk identified by Basel I does not express the multiple risks that can be faced by banks. That's why while developing Basel I the Basel committee considered the failures of international banks in developed countries (*Enrique & Sergio, 2006).* In 2004, the Basel II accord was signed, seeking to improve risk assessment, provide incentives for better risk management, and substantially increase the transparency of bank operations.

The objective of Basel II was to strengthen the soundness and stability of the international banking system and to therefore maintain at least the current level of capital in the system while enhancing competitive equality and to introduce a more risk sensitive framework that closely aligns internal economic capital with regulatory capital*(Basel Committee on Banking Supervision, June 2004).* The Committee believes that the revised framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits in the internationally operating banks.

There are three pillars in the Basel II. The First Pillar provides the determination of minimum and eligible capital that is required to overcome and calculate capital charges in the area of three kinds of risk; credit risk, market risk and operation risk. The standard approach is allowed as well as Basel committee expects banks to create their own techniques like IRB and AIRB to account fall their internal risk. The Second Pillar states the supervisory review process, designed to ensure that bank has a strategy and assessment process for its capital adequacy and supervisors have reviewed the bank's capital adequacy and assessment strategy, make it sure that the bank has the ability to maintain its minimum capital requirement and the eligible capital requirement must not fall below to support the risk characteristics of a particular bank. The Third Pillar completes the first and second pillars. It includes the disclosure of basic information to its market participants. This information is a sum of risks that institution has to face, capital risk exposure, risk assessment process, capital adequacy of the bank, the techniques to account fall the risks. *(Hubert Edwards, 2004)*

1.2 MICROFINANCE

Half of the six billion population of World close to three billion people have not more than 2 dollars income a day. And within this poor part of the population one of the five children never see its 5th birth year (WDI, 2010). To increase development of the world the United Nations boost international development, the countries of the World gathered at United Nations and UN develop Millennium Development Goals to alleviate poverty from all around the globe up to 2015. After that number of countries held an International Conference for Financing International Development in Monterrey, Mexico to create action plans and implementation of Millennium Development Goals the Millennium Development Goals will prove difficult to achieve. In that regard, microfinance is a form of financial development that has as its primary aim poverty alleviation. According to oxford dictionary microfinance defines as:

> *"a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers."*

Micro credit, lending small sums to poor or near-poor households, achieved prominence in the 1980s, thanks to innovative programs such as the Grameen Bank, launched by Mohammed Yunus, and enthusiastic support from government officials, including President Clinton (*Michael S. Barr, 2005*). Microfinance eradicates poverty and supports poor by lending small amounts and micro crediting. Microfinance is not only lending small amounts as it is perceived; it also includes insurances transactional services and most important savings. Now there are two ways for this sector of economy, whether to charge high interest rate to sustain and work efficiently or provide loans on low rates and continue to helps poor communities. When we see the last thirty year track record of micro finance institutions, they have done a magnificent work in alleviating poverty and root it out from a number of societies like Bangladesh. The microfinance supported communities have a remarkable increase in household's income, increase in savings and rapid development in education and health sectors. Another non-financial benefit of microfinance is that it empowers women and other minorities in a society. It is said that micro finance smoothens the consumption pattern of individuals.

2. Microfinance in Pakistan

Microfinance is still new concept in Pakistan and not remained the area of research. Pakistan is a developing country with population of 170.6 million. GDP growth rate was 2.00% in 2010 which is far less then 9.0% in 2005. Unemployment rate of Pakistan is 15% and literacy rate is 54.2% (163). 32.6% people of Pakistan are living under the poverty line. In Pakistan the micro financing was started in 1982. The very first microfinance institute in Pakistan is Orangi Pilot project in Karachi and then Aga khan rural support program (AKRSP) *(World Bank Report on 'Performance and Transparency: A survey of microfinance in South Asia' Page No. 67).* By 1990's many NGO's started their operations in microfinance sector across the country. In 1996 Kashf foundation has started its work to provide microfinance facilities all over the country. In Pervaiz Musharaf's era (1999 to 2008) the government launched many programs to alleviate poverty and enhanced and supports micro finance network all across the country. Pakistan government has established Pakistan Poverty Alleviation Fund (PPAF) with the help of World Bank in the year of 2000. The second step taken by government was the establishment of Khushhali Bank which offers several micro finance products like house financing, car loans, leasing, insurance and personal loans. As rate of return is much higher in micro financing that is why a good number of people shown their interest in investing their money in micro financing *(Khushhali Bank's annual report 2007)*. Now there are 9 microfinance banks in Pakistan:

- NRSP
- The First Micro Finance Bank Limited
- Khushali Bank Limited
- Karakuram Bank

- Network Micro Finance Bank
- Pak Oman Micro Finance Bank
- Rozgar Micro Finance Bank, Karachi
- Tameer Microfinance Bank Limited
- Kashf Microfinance Bank Limited

In Pakistan there are problems such as default rates that, in some instances, are too high, and there is a general need for greater transparency regarding loan performance and credit risk, which microfinance organizations face in this country. Our focus is elsewhere, however; I want to look at how microfinance can contribute more broadly to financial development in Pakistan. Basel II, the new accord of capital, is not adopted in microfinance sector in Pakistan yet. The main pillar of Basel II is the capital adequacy requirement for internal rating based (IRB) risk. According to IRB, the banks are required to have the capital against the estimated risk of credit *(BCCB 2003).* The main problem of Basel II Capital Adequacy Requirement (CAR) is that it is unable to control in case of business cycle fluctuations (Karunasena 2008). According to Capital requirement banks have to retain more capital than they have before to avoid the risk of loss when the default of the clients is increasing and the microfinance institutions are unable to give more credit and the cost of retaining capital will increase than its profit.

3. Risks Associated to MFIs in Pakistan

3.1 Credit Risk

Credit risk is the most significant risk in microfinance sector. It is a risk that the money a MFI provides is not coming back and the clients may default. Whenever there's an extending of loan to a client, a risk evolves i.e. risk of being not able to recover its loan due to incapability of the client to pay back the money it borrowed, this is the credit risk. Credit Risk is directly related to portfolios of a MFI. It becomes more risky for a MFI as it provides unsecured loans. MFIs provide loans to their clients without any collateral. So they don't have any asset to meet their losses in case of default.

In context to Pakistan the MFSI have to deal with greater credit risk as they deal with mostly clients having lower literacy and poor financial position. As MFI generate their earnings through investing in portfolios with clients savings and donors that trust MFI. The risk is that MFIs wouldn't be able to fund their portfolios if their clients become defaulter. As a result they will not able to meet their obligations and loose not only their principle amount but the confidence of the donors and the depositors also.

In Pakistan MFIs can not remain too much conservative in the process of funding as they wouldn't be able to run their cycle and it will restrict their growth. They also can not act exhilarated as it will generate more losses for their organization and increase the risk of defaulting. Hence Microfinance institutions in Pakistan have to establish an effective risk management system so they can achieve a sustainable growth without getting involved in higher risk.

Credit risk evolves from internal factors as well as external factors broadly can be divided into two categories: *Transaction Risk* associated to the individual borrower. When a borrower takes loan and is incapable of repaying it. *Portfolio Risk* is associated with a loss in a portfolio. Portfolio risk may results due to the external factors like economical, political, communal and specific to a particular industry.

3.2 Operational Risk

Its is defined as the risk that evolves due to internal factors such as incapability of the personnel's ,the system, lack of technology also the external factors such as natural disasters. Basel Committee on Banking Supervision defines operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events" (International Convergence of Capital

Measurement and Capital Standard, 2005).

In 2000's after the IT revolution in Pakistan, microfinance sector is also influenced by the technological changes in banking sector. Uses of computers, advance software, automated teller machines, biometric devices and microchip cards are used in today's modern banking system as well as in MFIs.

High reliance on advance technology and low human interaction lead to high operational risk. Weak internal control system, weak business and human ethics also enhance the operational risk.

In case of Pakistan inadequacy of internal process lead to weak internal controls. There are no set of parameter and regulations for internal control and compliance programs in MFIs. In Pakistan there are no standard policies for record keeping and reporting information. Weak internal process for daily bases transactions, cash distributions, collections and handling are also disqualifications of MFIs in Pakistan. Lack of internal controls results in fraud, errors and corruption. These all faults lead operational failures and finally results in management failure. One very important thing is that the operational risk is not bounded by only one department its cross departmental i.e. human resource, technology etc.

Human resource factor as seen in recent years organizations now believe to invest in HR factor in order to generate good work force, companies are now running programs like mentoring, career development, employee retention programs etc. which thus result in highly loyal and skilled work force.

There are operational risks associated with processes and operations, these risks can be controlled and can be overcome by managing properly the internal management systems which include cash planning, cash handling, disbursement procedures, internal checks – monitoring and audits.

3.3 Market Risk

The risk that occurs due to the rise and fall in the market or due to the dissemblance in assets and liabilities of the organization. With the growth in MFIs in Pakistan, composition of their assets and liabilities is also growing, that increases the market risk. Most importantly operating in a country like Pakistan, where markets rapidly change due to political, social factors and international market fluctuations, this increases the market risk of MFIs operating in Pakistan.

4. Implementing Basel II on MFIs

In above section we have discussed the risks associated to MFIs in Pakistan. Basel II provides an excellent solution to cover all these risks on institutional level and sector level. The question is how three pillars of the new accord covers these risk?

4.1 Pillar I

First aspect of new Accord is the standardized approach which is more clarified version of Basel I. After making improvements the standardized approach is more simple and easy to apply that it can be implemented in most of the developing countries. In Pakistan MFIs can follow the approach in order to apply the Basel II. There is a theory that unregulated borrowers of MFIs are intended to require their 100% capital. The new accord supports MFIs to reduce their regulatory capital as compare to Basel I as micro-finance portfolios are granular. So according to new accord MFIs are posed to be less risk oriented (Kathryn Imboden, 2005). For this reason the capital required in the relation of credit risk can be lower in case of regulated MFIs. However, capital requirements under Pillar 1 will most likely not be lower for several reasons. First point is that supervisory authorities should assign higher risk weights to micro-finance. For any kind of risk authorities may assign more risk weights, like 75% to microfinance. As determined in Basel committee member countries that weights may assigned on the basis of past experiences and domestic market practices. An important point to discuss here is the strong track record of the MFI's while there is a perception of higher risk in field of microfinance in Pakistan. MFI's still didn't provide any answer to the question about actual track record in developing countries as opposed to the perception of higher risk. The risk can not always perceive on the basis of past experiences and track record of financial institutions. Although there is a strong past record of micro financing in developing countries but in Pakistan there still exists a higher risk related to credit which should be backed by a higher regulatory capital. So supervisory authorities may recognize it that management of microfinance should be supervised under the new accord.

Second point to describe is that the capital adequacy ratio for all the financial sector or specifically microfinance sector should be considered by supervisory authority itself.

As operations and processes of a MFI play an important role in its growth and to merge into financial markets. Adding operational risk to regulatory capital requirements increase cost for operational risk and might offset any capital savings on credit risk. So the capital requirement for operational risk is the essential part of Basel II accord. Third kind of risk that Pillar 1 covers is market risk. By adding market risk to regulatory capital requirement, institution can check to what extent it is integrated in financial markets. Market risk is about the adverse price movements such as interest rates and exchange rates. CAR is an important approach to cover issues related to market risk.

4.2 Pillar II

It involves the supervisory review practices. Incase of Pakistan supervisory control is the core issue for MFIs. Microfinance sector of Pakistan must have to increase and improve the expertise and supervisory review process. Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with results of the process. Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum level required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored. For a good supervisory control in field of microfinance, a good understanding of microfinance issues and SME sector of Pakistan is required.

4.3 Pillar III

It is a complement to Pillar I & II and its purpose is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on capital risk exposure, risk assessment process and capital adequacy of the bank. This process is determined by the disclosure of institutions financial and operational information accurately and timely. Financial and operational disclosure and accountability is the key element to build strong microfinance sector. Financial information disclosure is a step to create and improve the efficiency of internal operations and enhance the creditability of institutions in financial markets (Kathryn Imboden, 2005).

Implementing and accepting the overall principles and objectives behind these three pillars means an integrated risk assessment and control system in MFIs in Pakistan.

In sum, microfinance sector is more attractive for implementing Basel II than other financial institutions in Pakistan for several reasons: (1) supervisory practices in microfinance sector of Pakistan are unsound and sluggish, 2) High credit risks in microfinance sector of Pakistan, and (3) the restrictions by commercial investors and lenders to MFIs' lending has limited their ability to leverage themselves.

While applying Basel II in Pakistan, it would be a decision of the central supervisory authorities in the country. It is the decision of supervisors to implement Basel II on the entire MFIs sector or they can choose specific MFIs in the country. As explained in first part of the article Basel II not only provides complex calculations to avoid risks but also provide a framework for a better supervisory control.

In countries where Basel II is applied, a group said that the capital requirement will be crippled and the other group of analysts notifies an excessive increase in current capital requirement in developing countries, keeping in mind that institutions should hold an appropriate capital to back the higher risk. Capital requirement for G-10 countries are estimated increase by 11% and for other group of countries is increased by 12%, which shows not a statistically significant difference. In Pakistan the national authorities have the obligation and assignment to implement the accord in MFI's sector and to analyze the possible outcomes of the application of the accord to MFIs (Quantitative Impact Study, 2003).

5. Conclusion

The impact of BASEL II on microfinance sector of Pakistan is most importantly comes in form of good governance and better supervision. Analysis shows that developing countries are not willing to implement new accord but the emerging markets and developing countries who said "yes" to new accord shown significant and prominent improvements in area of risk based supervision and management culture. Now first point is that the willingness of supervisory control in Pakistan to implement the new accord in microfinance sector. Second point is that supervisory authorities are willing to implement and adopt BASEL II principles on the entire microfinance sector or on specific institutions in their jurisdiction. The purpose and recommendation of Basel committee was not to apply new accord partially. Supervisory authorities are advised to evaluate the pros and cons of the new accord before adopting it for banking sector in their country.

Basel II depends on risk based supervision in financial institutions. The adequate capital requirement under pillar I is not the basic function of new accord. The most significant function is classified under pillar II which is supervisory control. Basel II provides a risk sensitive supervisory control. This can effect all financial institutions in Pakistan including MFIs and will improve their management policies and techniques. Better supervision motivates more financial outreach. This will generate confidence and trust in investors and donors and increase in financial market integration of MFIs.

Working in a better risk sensitive environment is a good thing and can result in consistent growth and development. But implementing the new accord requirements will not only increase the cost in form of more regulatory capital but the most prominent cost is the administrative cost to improve and engage a better supervisory review process and controls. While the MFIs and regulatory authorities are adopting the Basel II principles, it leads to increased administrative cost.

MFIs, Operating in Pakistan, are recommended to hold more capital that will increase their cost of funds they are generating from international lenders from Middle East, Gulf and other international institutions. New principles give access to micro finance institutions to capital because of higher risk categorization for them as borrowers. It can decrease the international capital inflows in Pakistan.

Apart from criticizing, looking at the bright side, new Basel accord can engage a risk based supervision and better understanding and management of risk faced by MFIs in Pakistan. Basel II creates a risk based supervision culture. By implementing Basel II on MFIs in Pakistan, it can help to improve the understanding and awareness about microfinance sector. The biases and errors can be removed with the help of new accord. It is the duty of supervisory authorities to asses the timing and process of implementing it on national level.

In ending lines it should be clarify that the capital adequacy is not the single and important factor in case of MFIs. There are other more important factors related to MFIs performance. Supervisory control and better management are the more important factors for the MFIs. Basel II not only provides the basis for regulatory capital requirement but also provides a better framework for supervisory control and good management.

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