

7 Conclusions

7.1 Diverse Roles for Central Banks

This study has discussed the role of central banks in microfinance. It is generally accepted that the central bank should take the lead in matters to do with the regulation and supervision of licensed banks. In the absence of a separate bank supervisory agency (as is soon to be established, for example, in Indonesia), this is a core function of the central bank. However, with regard to support for microfinance initiatives and regulation of nonbank microfinance institutions (MFIs), the appropriate role for the central bank in microfinance may differ from country to country. And even in the case of the regulation of licensed banks, the specific policies adopted by central banks may differ as a result of country-specific factors.

A number of factors may contribute to differences in the roles of central banks between countries. The financial system and the microfinance sector have developed differently in particular countries, and different institutional structures have emerged. In some countries such as India, Indonesia, Nepal, and Sri Lanka, the central bank is already actively involved in the microfinance sector. In others, including Bangladesh, People's Republic of China (PRC), Kyrgyz Republic, Papua New Guinea (PNG), and Vanuatu, it has had relatively little involvement. And in some countries, most notably Bangladesh and the Philippines, there are other important institutions in the microfinance sector, such as second tier institutions and networks of MFIs. Where such institutions are operating effectively, it is appropriate for the central bank to act in a supporting capacity rather than trying to duplicate their activities.

The stages of development of the financial system and the microfinance sector are likely to be important variables here. In countries with relatively developed financial systems and/or microfinance sectors, such as Bangladesh and the Philippines, there are more likely to be other significant institutions already involved in the microfinance sector. In other countries, such as PRC, Kyrgyz Republic, and Viet Nam, this is not the case. The size of the country is also relevant. Countries with small populations such as Kyrgyz Republic, PNG, and Vanuatu cannot support the range of institutions found in larger countries. In these small countries it is unlikely to be cost effective to establish specific institutions to support the microfinance sector. Hence, in such countries, and in others with less developed financial systems, it may be appropriate for the central bank to take a more proactive stance, although still primarily one of promotion and leadership. On the other hand, resource constraints facing central banks are likely to be even greater in smaller countries than in large countries. Hence, activities to support microfinance will need to be relatively modest, and should be targeted to those areas where the central bank can make the greatest contribution.

Other relevant factors include the degree of independence of the central bank and its operational capacity. Where central banks operate independently of government and have effective arrangements for the prudential regulation and supervision of licensed banks, they are likely also to be effective in discharging their microfinance responsibilities. Even in these cases, however, central banks will need to adopt new approaches based on the specific requirements of the microfinance sector. By contrast, where central banks are not independent or require institutional strengthening, and are not able to carry out their core functions effectively, their involvement in the microfinance sector should probably be more limited. The question of resources is also important. In countries where central banks have barely

With regard to MFIs, the appropriate role for a central bank will differ from country to country

The nature of a financial system, its history, and its stage of development all affect the role a central bank might play

The independence of the central bank, its resources, and its capacity to carry out core functions are all relevant

enough resources for their core functions, any significant additional responsibilities relating to microfinance may impose unacceptable burdens.

Central banks differ in their degrees of independence. While no central bank is completely independent of government, central banks in PNG, Philippines, and Vanuatu have for the most part achieved considerable operational independence. At the other end of the scale, central banks in the South Asian countries and the economies in transition generally have limited independence and are required to carry out a range of government policy initiatives.

All of the central banks studied suffer from resource constraints and have difficulty in effectively supervising the financial institutions already within their control. A number require significant institutional strengthening to enable them to establish sound frameworks for prudential regulation and supervision. Any proposals to increase significantly the number of institutions subject to regulation by the central bank would need to be carefully thought out, and the central bank would require increased resources and institutional strengthening for the purpose. Again, however, situations differ greatly between central banks, and some have much greater capacity than others.

Detailed prescriptions are country specific

For these and other reasons, the scope for constructive central bank activity in the microfinance sector differs from country to country. Detailed recommendations on the precise role of central banks in microfinance tend to be country specific, and institutional arrangements developed in one country may not be directly applicable in others.⁹ While it is necessary to have an appropriate and consistent conceptual framework, pragmatism is needed in adapting basic principles to the circumstances of each country.

7.2 Central Bank Support for Microfinance Initiatives

Microfinance has relied heavily on support from governments, donor agencies and, to a lesser extent, central banks. Had it not been for such support, it is unlikely that microfinance would exist on anything like its current scale. Nevertheless, in considering any role for central banks in supporting microfinance, it is necessary to consider their comparative advantage for this task in comparison with other mechanisms and institutions.

With some important exceptions, developmental activities for microfinance have generally not been successful

Central banks have supported microfinance through a range of developmental activities. In most cases, this has involved directed credit requirements and channeling funds through licensed banks. Such developmental activities have generally not been successful, although there are some important exceptions, including support for the Grameen Bank in Bangladesh and for the rural banks (BPR) in Indonesia.

In general, there does not appear to be a case for central banks to use their own resources for lending to or refinancing retail MFIs or licensed banks for microfinance. In most cases, central banks do not have any comparative advantage for such purposes. Moreover, any such support has the potential to impact the balance sheet of the central bank negatively, and hence to compromise its ability to meet its key objectives.

⁹ See, for example, the country studies in the companion volume to this one: ADB, 2000. *The Role of Central Banks in Microfinance in Asia and the Pacific: Country Studies*. Manila: Asian Development Bank.

In limited cases, there may be a case for central banks to manage funds from the government and/or donor agencies and to on-lend them to retail MFIs and licensed banks, where the central bank has clear comparative advantage in doing so. In large countries with reasonably well developed financial systems and/or microfinance sectors, such as Bangladesh, India, Indonesia, and Philippines, it is extremely unlikely that the central bank would have such comparative advantage. Even where the microfinance sector is not so well developed, as in PRC, Pakistan, and Viet Nam, and in medium-sized countries such as Nepal and Sri Lanka, it would normally be inappropriate for the central bank to undertake the wholesaling function.

However, in smaller countries such as Kyrgyz Republic, PNG, and Vanuatu, it would probably be neither feasible nor appropriate to establish a separate second tier institution or other entity responsible for microfinance. While in such countries it may be more efficient for the government or donor agencies to support retail MFIs directly, there may be a case for central banks to perform the wholesaling function if and when this is required under government or donor projects. Where central banks do undertake this task, there should be a clear contractual arrangement and the central bank should receive a management fee sufficient to cover all costs it incurs in managing programs.

In most countries, central banks have undertaken promotional activities to support microfinance, such as supporting pilot projects using innovative approaches to microfinance, conducting research, collecting and publishing data, and undertaking advocacy and training. Many of these initiatives appear to have made a significant and positive contribution to the microfinance sector. There appears to be a case for central banks in all countries to conduct such activities. However, this case may be stronger in smaller countries. Where, for instance, the central bank is the only agency with expertise in issues relating to banking and finance, it may be the only feasible agency to support activities such as capacity building and training for MFIs.

Promotional activities have made a positive contribution to microfinance in many countries and continue to be appropriate

7.3 Regulation of Licensed Banks

The scope for licensed banks to become involved in microfinance depends in large part on the regulatory framework in place in a country. In the absence of a separate supervisory agency, regulation and supervision of licensed banks is a core function of the central bank.

Central banks can contribute to the development of microfinance through careful and appropriately sequenced financial liberalization. Some countries have largely liberalized their financial systems, while others such as PRC and Viet Nam still have highly regulated financial systems. In most countries, further liberalization can contribute significantly to the development of a sustainable microfinance sector. However, too rapid liberalization can contribute to financial instability. It is increasingly accepted that liberalization should be gradual, and that it is important to focus on strengthening the central bank before and during the liberalization process. Moreover, financial liberalization by itself is not a sufficient condition for ensuring that large numbers of poor households have access to financial services on a continuing basis.

Whether provisions exist for the establishment of small financial institutions is an important determinant of the extent to which licensed financial institutions become involved in microfinance. There is considerable diversity in the approaches taken to establishing small banks. In Indonesia and the Philippines, small licensed banks have become an important part of their financial systems. In a number of other

In most countries, further financial liberalization would help, as would freedom to establish small financial institutions

Deregulation of interest rates is very important

Prudential regulation and supervision of all nonbank MFIs is not appropriate

countries represented in this study, it remains very difficult to establish small banks. A third group of countries among those studied represent intermediate cases. In setting minimum capital requirements it is desirable to strike a balance between establishment of smaller financial institutions likely to engage in microfinance, and creating an undue proliferation of very small institutions that cannot be supervised properly. The appropriate balance will differ from country to country, depending largely on the strength of each central bank.

One critical constraint that may prevent licensed banks from lending directly to the poor relates to interest rates. In four countries, the central bank retains some controls over interest rates. Deregulation of interest rates is very important if banks are to operate microfinance programs on a sustainable basis. However, complete deregulation of interest rates does not appear to be an option in PRC or Viet Nam at this stage. In PRC, for instance, the banking system has a high proportion of nonperforming loans, many of which are to state-owned enterprises in severe financial difficulties. Deregulating interest rates would very likely lead to dramatic increases in defaults, and could trigger the collapse of banks and other financial institutions. Somewhat similar considerations apply in Viet Nam. In such countries, it would be appropriate for the central bank to explore the scope for introducing greater flexibility in interest rates for microfinance loans, rather than attempting the premature deregulation of interest rates in general.

Even in countries where interest rates have been deregulated, there is often considerable pressure on banks to keep them low. There may be a role for central banks to impress on other stakeholders the relationship between interest rates and sustainability. Other important issues concerning the regulation of licensed banks and microfinance include capital adequacy ratios and loan classification and provisioning.

7.4 Regulation of Nonbank Microfinance Institutions

Nonbank MFIs are generally not subject to prudential regulation and supervision by the central bank or any other agency. Indeed, it would be neither appropriate nor possible to subject all MFIs to prudential regulation and supervision. In broad terms:

- (i) Credit-only MFIs and MFIs that require clients to make savings deposits in order to borrow should not be subject to prudential regulation and supervision.
- (ii) MFIs that mobilize voluntary savings should be subject to prudential regulation and supervision where they exceed a certain threshold.
- (iii) MFIs that mobilize deposits from the general public should be subject to prudential regulation and supervision.

In countries where the microfinance sector is small and offers limited products focusing primarily on credit, the central bank can safely ignore the question of regulation. Indeed, regulation is more likely to stifle the sector than to facilitate its development. This is probably the situation in most countries, and is certainly the case in PRC, Kyrgyz Republic, Pakistan, PNG, Vanuatu, and Viet Nam.

As the microfinance sector develops in a country, there is inevitably more pressure to subject it to regulation. Moreover, the advent of a wider range of savings products raises important issues relating to the protection of depositors. These considerations explain the increased attention to regulation in Bangladesh. To a lesser extent, they also explain the increased attention to regulation in some other countries, such as India and Nepal (and in Nepal, the central bank has already granted limited banking authority to a number of MFIs in exchange for regulating and supervising

them). Nevertheless, even in these countries only a limited class of nonbank MFIs should be subject to prudential regulation and supervision; in broad terms these are MFIs that mobilize voluntary savings and exceed a particular threshold.

The size and degree of development of the microfinance sector is also relevant in considering whether to establish special laws for regulating MFIs. Special laws should only be considered where there is a significant number of MFIs suitable for licensing but which cannot use an existing window. This implies that there is a significant number of MFIs that are close to financial self-sufficiency and have appropriate risk management strategies in place. No country in the study meets this criterion. Even in Bangladesh, only a very small number of MFIs are financially self-sufficient.

The scope for MFIs to mobilize savings is an area of confusion in most, if not all, countries studied. In just about all countries there are significant legal restrictions on savings mobilization by nonbank MFIs, but these laws are either ignored or implemented in a piecemeal fashion. It would be appropriate for central banks to clarify the situation.

In smaller countries such as PNG, Vanuatu, and possibly Kyrgyz Republic, it may not be cost effective to create a separate agency for regulating cooperatives and credit unions, and it may instead be appropriate for the central bank to assume this role. However, prudential regulation and supervision of primary cooperatives or credit unions would be neither appropriate nor feasible. The role of the central bank should be to supervise the activities of the apex bodies for the cooperative or credit union movement, and to provide general institutional and policy support.

If it is accepted that prudential regulation and supervision are not appropriate for most categories of MFIs, it is necessary to consider other means of establishing standards for them. It may be appropriate for central banks to take part in developing such standards. In countries with a range of institutions involved in the microfinance sector, such as Bangladesh, Nepal, and Philippines, the central bank may take more of a monitoring function. In countries with fewer MFIs and without effective networks of MFIs or second tier institutions, the central bank may need to act more as a leader and coordinator. This is especially likely to be the case in smaller countries such as Kyrgyz Republic, PNG, and Vanuatu. However, if central banks are to become involved in developing standards, it is important that they develop a sound understanding of the microfinance sector. In many cases, central banks are not yet well equipped for the task.

The growth of savings raises issues, but only MFIs mobilizing savings over a certain threshold should be caught in the net

Central banks in every country need to clarify the situation of savings

There are other approaches to standard setting

7.5 Recommendations

As noted previously, appropriate recommendations concerning the role of any particular central bank in regard to microfinance will differ from country to country. Each of the twelve country studies makes a number of specific recommendations based on the circumstances of the particular country concerned. Nevertheless, it is also possible to make a number of generalized recommendations for central banks in the Asia-Pacific region based on the analysis in this report, as follows.

Central Bank Support for Microfinance Initiatives

- (1) Central banks should consider their comparative advantage relative to other mechanisms and institutions when determining whether or not they have a role in supporting microfinance.

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- (2) Countries that still impose directed credit requirements should replace these with more effective policies for supporting microfinance.
 - (3) In general, central banks should not use their own resources for lending to or refinancing retail MFIs or licensed banks for microfinance activities.
 - (4) In certain limited cases, there may be a case for central banks to manage funds from the government and/or donor agencies and to on-lend them to retail MFIs and licensed banks, where the central bank has clear comparative advantage in doing so. Where central banks do undertake this task, there should be a clear contractual arrangement and the central bank should receive a management fee sufficient to cover all costs it incurs in managing programs.
 - (5) Central banks should consider undertaking promotional activities to support microfinance, in line with their comparative advantage in relation to other institutions and mechanisms. Such promotional activities may include supporting pilot projects using innovative approaches to microfinance, conducting research, collecting and publishing data, and undertaking advocacy and training.
 - (6) On the other hand, the case for central banks to support innovation should not be used as a pretext for them to engage in developmental activities requiring significant central bank financing.
 - (7) Central banks should be involved, together with other stakeholders, in developing an appropriate policy framework for microfinance.

Regulation of Licensed Banks

- (8) Careful and appropriately sequenced financial liberalization is an appropriate objective of central bank policy, depending on circumstances in each country, and will contribute, among other things, to the development of microfinance.
- (9) In setting minimum capital requirements for licensed banks, central banks should strike a balance between enabling the establishment of smaller financial institutions that are likely to engage in microfinance, and avoiding an undue proliferation of very small institutions that cannot be supervised properly.
- (10) Central banks should remove remaining restrictions on interest rates to enable licensed banks to provide microfinance services on a sustainable basis.
- (11) Where it is not feasible to deregulate interest rates completely, central banks should explore the scope for the introduction of greater flexibility in interest rates for microfinance loans, even if interest rates on certain other categories of loans remain regulated.
- (12) In countries where interest rates have been deregulated but where there is pressure on banks to keep them low, central banks should consider activities to impress on other stakeholders the relationship between interest rates and sustainability.
- (13) Central banks should consider whether capital adequacy ratios for small banks (and particularly for small banks specializing in microfinance) should be higher than for traditional banks.
- (14) Central banks should consider whether loan loss provisioning requirements for microfinance banks should be stricter, based on time overdue, than for traditional banks.
- (15) On the other hand, central banks should ensure that loan loss provisioning requirements do not discriminate against unsecured loans, and should be flexible in considering other indicators of asset quality.
- (16) Central banks should consider whether supervision methods are appropriate for microfinance portfolios. It may be appropriate to consider the scope for risk-based supervision.
- (17) Central banks should ensure that other regulations are appropriate for the particular circumstances of small banks and specialist microfinance banks.

Regulation of Nonbank Microfinance Institutions

- (18) Central banks should remove any interest rate restrictions on nonbank MFIs that are within their control. Even where such restrictions do not result from central bank actions, central banks may be able to lend their prestige and influence to efforts directed at their removal.
- (19) Central banks should clarify the legal situation regarding savings mobilization by MFIs.
- (20) Credit-only MFIs and MFIs that require clients to make savings deposits in order to borrow should not be subject to prudential regulation and supervision by the central bank or any other agency.
- (21) MFIs that mobilize voluntary savings should be subject to prudential regulation and supervision, generally by the central bank, where those savings exceed a certain threshold.
- (22) MFIs that mobilize deposits from the general public should be subject to prudential regulation and supervision by the central bank.
- (23) Central banks should only consider special laws for MFIs where there is a significant number of MFIs suitable for licensing but which cannot use an existing window.
- (24) In smaller countries in particular, central banks should consider regulating cooperatives and credit unions. However, prudential regulation and supervision of primary cooperatives or credit unions would not be appropriate. The role of central banks should be to supervise the activities of the apex bodies and to provide general institutional and policy support.
- (25) Central banks should consider working with other stakeholders to develop performance and reporting standards for those MFIs that are not subject to prudential regulation and supervision. If central banks are to become involved in developing such standards, they should develop a sound understanding of the microfinance sector.
- (26) Central banks should consider monitoring second tier MFIs and credit rating agencies involved in the microfinance sector.