Overview

The Role of Central Banks in Microfinance in Asia and the Pacific

Volume 1

Overview

Asian Development Bank

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Foreword

The financial sector landscape continues to change in most developing countries in the Asian and Pacific Region with continuing liberalization, improvements in information technology, and increasing competition in the sector. The expansion of microfinance during the last decade has added a new dimension to these changes in many countries because it is gradually allowing access by the poor and low-income households to institutional financial services for the first time, and thus setting in motion a process toward ending their financial exclusion. However, the number of poor and low-income households outside the frontier of formal finance in the region is enormous: some 90 percent of the 180 million poor households. Thus, the region continues to face a major challenge in expanding the outreach of microfinance services in a sustainable way. If the region is to fully harness the potential of microfinance for poverty reduction, it must make microfinance services accessible to a majority of the poor.

A major hurdle to expanding the outreach of microfinance services continues to be inappropriate and, at times, inadequate government interventions. It is in this context that the Asian Development Bank (ADB) initiated this study of the role of central banks in microfinance. Central banks have a potentially important role to play in the development of sustainable microfinance and the integration of microfinance into the broader financial sector. The study sought to answer two broad questions. What is the regional experience concerning the role of central banks, particularly in regulation and supervision of microfinance institutions? Based on the regional experience, what insights and recommendations can we offer to central banks and other policymakers as to how they should respond to emerging development issues in the microfinance sector?

The study covered twelve developing member countries of ADB: Bangladesh, People's Republic of China, India, Indonesia, Kyrgyz Republic, Nepal, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Vanuatu, and Viet Nam. The Foundation for Development Cooperation in Brisbane, Australia carried out the study using a team of reputed microfinance specialists from the region.

The results of the country studies are presented in two volumes. Volume 2 was released in October 2000, and presented the country studies. This volume presents an overview and synthesis of the country studies.

The analysis, results, and recommendations of the study are expected to be useful to all those concerned with the development of sustainable microfinance. We hope that they will find it useful in formulating policies that will promote sustainable microfinance systems.

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Abbreviations

ADB	Asian Development Bank
ASA	Association for Social Advancement
BKD	village credit institution/s
BPD	provincial government commercial bank/s
BPR	rural bank/s
BRAC	Bangladesh Rural Advancement Committee
BRI	Bank Rakyat Indonesia
CARD	Center for Agriculture and Rural Development
CGAP	Consultative Group to Assist the Poorest
CMF	Centre for Microfinance
DMC	developing member country
FCSCU	Financial Company for the Support and Development of Credit Unions
GBPKMI	United Movement for the Development of Indonesian Microfinance
GDP	gross domestic product
GNP	gross national product
GTZ	German government technical assistance agency
IRDP	Integrated Rural Development Programme
KAFC	Kyrgyz Agricultural Finance Corporation
LAB	local area bank
MFI	microfinance institution
NABARD	National Bank for Agriculture and Rural Development
NCC	National Credit Council
NGO	nongovernment organization
PERBARINDO	Association of Indonesian Rural Banks
PHBK	project for linking banks and self-help groups
PNG	Papua New Guinea
PRC	People's Republic of China
RCC	rural credit cooperative
RDB	rural development bank
RRDB	regional rural development bank
SHG	self-help group
SOE	state-owned enterprise
SRO	self-regulation organization
UNDP	United Nations Development Programme
USSR	Union of Soviet Socialist Republics
VANWODS	Vanuatu Women's Development Scheme
VBP	Viet Nam Bank for the Poor

Note

In this report, "$" refers to US dollars.

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Executive Summary

Overview

Introduction

This study of the role of central banks in microfinance examines the role and operations of central banks in microfinance development in twelve developing member countries (DMCs) of the Asian Development Bank (ADB). The countries concerned are Bangladesh, People's Republic of China (PRC), India, Indonesia, Kyrgyz Republic, Nepal, Pakistan, Papua New Guinea (PNG), Philippines, Sri Lanka, Vanuatu, and Vietnam.

An analytical framework for the role of central banks underpins this study

The overview of the study, presented in this volume, provides a detailed analytical framework, based on theoretical considerations and practical experience, for considering the role of central banks in microfinance. It also provides a synthesis of the key issues arising out of the country studies. The twelve country studies have been published in a companion volume. Each makes recommendations on the role of the central bank in the sustainable development of microfinance in the particular country.

Development of Microfinance

The twelve countries in the study had a combined population of around 2.9 billion in 1998. They are extremely diverse in terms of economic and social conditions. Nevertheless, poverty is pervasive. There are around 900 million poor people in the Asia-Pacific region, and more than 800 million of these are in the countries in the study.

ADB (2000a) defines microfinance as "… the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises." Poor and low income households do not generally have access to financial services but they have considerable effective demand for such services. Since the late 1970s, there has been an emphasis on establishing financial systems able to reach them on a more sustainable basis. The assumption has been that access to savings services will enable poor households to accumulate capital for investment or income smoothing, while access to credit will facilitate their making productive investments, primarily in self-employment. There is an important role for microfinance as one element in a comprehensive set of policies to reduce poverty.

There are a number of distinctive models of microfinance. In a number of countries, including Bangladesh and, to a lesser extent, Nepal and the Philippines, the

Microfinance — Much More Than Simply Credit

ADB's microfinance development strategy defines microfinance as providing a broad range of financial services such as:

- deposits
- loans
- payment services
- money transfers
- insurance to poor and low income households and their micro-enterprises.

Various models of microfinance are found in the region, of which Grameen Bank is the best known

great majority of microfinance institutions (MFIs) use a variant of the Grameen model of microfinance, based on self-selected groups of borrowers, most commonly with five members. In India, an important model involves larger and more autonomous self-help groups, promoted by nongovernment organizations (NGOs). In Indonesia and, to a lesser extent, the Philippines, a range of regulated financial institutions provides financial services in the rural areas. This diversity is to be encouraged. It is clear that no one model is suitable for all situations.

Despite the rapid growth of MFIs in recent years, their outreach remains very small compared with the potential demand. About 90 percent of the 180 million poor households in the Asia-Pacific region still have little access to institutional financial services. There is also a large number of low income households in the region that may be above the poverty line, but which nevertheless have an effective demand for financial services which is substantially unmet. Of the countries in the study, only in Bangladesh and, to a lesser extent, Indonesia has microfinance reached a significant proportion of poor households.

The outreach of microfinance is much less than potential demand for it, but sustainability problems constrain growth

It is widely accepted that if the number of microfinance clients is to grow significantly, MFIs need to become financially self-sufficient. That is, they need to be able to cover all administrative costs, loan losses, and financing costs from operating income, after adjusting for inflation and subsidies and treating all funding as if it had a commercial cost. However, few MFIs in Asia have yet attained financial self-sufficiency. Even in Bangladesh, the overwhelming majority of MFIs are not financially self-sufficient.

Role of Central Banks

The role of central banks in microfinance is affected by their role in the financial system and the economy more generally. Central banks have a number of objectives, but it is generally considered that their core objectives are monetary policy as well as prudential regulation and supervision of the banking sector. Most commentators now believe that the main contribution that monetary policy can make to economic growth and development in the long run is to maintain low inflation.

Central banks have core objectives and microfinance is at best incidental to these

There is an important distinction between "developmental" and "promotional" functions of a central bank. Developmental activities include government ownership of banks (often with direct or indirect central bank involvement), participation in the capital and management of development institutions, priority sector lending, differential interest rates, preferential rediscount rates and facilities, and credit guarantees.

It is now widely accepted that such developmental activities have not been effective in developing either the economy or the financial system. In fact, they have often had a negative effect by discouraging financial intermediation and contributing to financial repression. Some such measures have also undermined the independence of central banks and their monetary policy objectives. Developmental functions are justified, if at all, only in the very early stages of central banking. And developmental activities directed specifically at microfinance development are similarly problematic.

Developmental activities, which contribute to financial repression, are increasingly considered inappropriate

Despite the arguments against developmental activities, in practice central banks have undertaken a wide range of such activities. These developmental activities expanded in the 1950s and 1960s, when the phenomenon of financial repression was not well understood. And while the focus on developmental activities has diminished gradually over time, in many countries they have persisted throughout the 1970s, 1980s, and 1990s and are still an important feature of the financial landscape. With microfinance coming to prominence since the 1980s, central banks have also in many cases applied developmental measures to its support.

Moreover, financial liberalization by itself is not a sufficient condition for ensuring that the objectives of microfinance are met, namely, that large numbers of poor households have access to financial services on a continuing basis. Overcoming financial repression involves not only the removal of impediments to the efficient operation of financial institutions and markets, but also positive nurturing of financial markets by central banks through promotional activities. These may include measures designed specifically for microfinance, such as support for pilot projects using innovative approaches, the conduct of research, the collection and publication of data, and advocacy and training. These involve negligible commitments of financial resources by the central bank, create positive externalities and cast the central bank as innovator and catalyst. There is a continuing promotional role for central banks in developing countries, in microfinance as well as in broader financial sector development.

Promotional activities can support financial liberalization and create the conditions for sustainable microfinance

Central Bank Support for Microfinance Initiatives

Most commentators agree that the provision of financial services to the poor requires active policy support. 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 its current scale, or anything like it. Nevertheless, in considering any role for central banks in providing such support as may be deemed necessary for microfinance, it is important to consider their comparative advantage relative to that of other mechanisms and institutions.

The extent to which central banks are involved in microfinance depends in part on how central bankers themselves interpret the mandates of their respective institutions. In some countries, central bankers accept that they have an explicit role in supporting the development of sustainable microfinance. In most countries, however, they do not.

An important consideration is whether a central bank has any comparative advantage in supporting microfinance

An important category of developmental activities is directed credit requirements. Under directed credit requirements, banks are obliged to lend a certain proportion of their loan portfolios to particular sectors. Since some at least of these schemes are supposed to be for the benefit of lower income or otherwise disadvantaged groups, they impinge upon microfinance and may be represented as microfinance programs. The difficulties they experience in targeting assistance to the designated groups are well known. A number of governments continue to impose such requirements and to involve their central banks in their administration. However, directed credit requirements have generally been ineffective, and it would be more appropriate for those countries that still impose them to replace them with effective policies for supporting microfinance.

In most countries, central banks have also been active in other developmental activities to support microfinance. In most cases this has involved channeling funds through licensed banks for microfinance activities. To a lesser extent, central banks have provided support to individual MFIs and in some countries they have even maintained shareholdings in retail microfinance operations. These activities have not generally been successful. There appear to be some exceptions, however, such as support for the Grameen Bank in Bangladesh and for the rural banks in Indonesia. Support has been most successful where it has been directed to institutions with appropriate products and processes for reaching poor households and microentrepreneurs, and where the central bank has not imposed interest rate controls.

Direction of credit by central banks is a discredited form of support

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 activities. In most cases, central banks do not have comparative

Central banks should not create credit for microfinance. Any involvement in funding is problematic

advantage in such activities. Moreover, such financing has the potential to impact negatively on the balance sheet of a central bank, and hence to compromise its ability to meet its core objectives. It would be more appropriate for financial support for microfinance to be provided through other channels, such as by other government agencies (in which case it is taken up in the government budget) or by donor agencies.

In limited cases where the central bank has clear comparative advantage in dealing with the sector, there may be a role for central banks in managing funds from the government and/or donor agencies and on-lending them to retail MFIs and licensed banks. This is most likely to be the case in smaller countries where it is not feasible or appropriate to establish separate apex institutions for microfinance. Where central banks do undertake this role, there should be a clear contractual arrangement and the central bank should receive a management fee sufficient to cover all of the costs that it incurs in managing the program.

Promotional activities to support microfinance, including pilot projects, research, data collection and publication, advocacy, and training, have been undertaken by central banks in most countries. Many of these initiatives appear to have made a significant and positive contribution to the microfinance sector.

Successful central bank promotion of microfinance is quite common, but there are limits

At the same time, it should be acknowledged that the distinction between developmental and promotional activities is somewhat blurred. Central banks should not take advantage of this to conduct developmental activities under the guise of "promotion." Moreover, not all central banks should undertake a wide range of promotional activities. In some countries other institutions or agencies may have comparative advantage in some or most of the promotional activities discussed above.

Regulation of Licensed Banks

While most institutions engaged in microfinance are specialist MFIs or multi-purpose NGOs, there is also scope for licensed banks to become involved in microfinance and for MFIs to enter the formal banking sector. However, this depends crucially on how licensed banks are regulated and supervised by the central bank.

Whether MFIs can open banks or banks can get into microfinance depends on the regulatory environment

Central banks can contribute to the development of microfinance through careful and appropriately sequenced financial liberalization. This can increase the flexibility of banks and other financial institutions and enlarge the range of activities in which they engage, including microfinance. However, too rapid a process of 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.

The scope for the establishment of small financial institutions is an important factor affecting the extent to which licensed financial institutions become involved in microfinance. Small institutions appear more likely to enter the microfinance market and to be more adept at microfinancing than larger banks. In setting minimum capital requirements it is desirable to strike a balance between enabling the establishment of smaller financial institutions that are likely to engage in microfinance, and an undue proliferation of very small institutions that cannot be supervised properly.

Careful liberalization of the financial sector can stimulate microfinance

There is considerable diversity in the scope for establishing small banks. In Indonesia and the Philippines, small licensed banks have become significant elements in their financial systems. Both countries have found that licensing requirements for rural banks were initially set too low, and have recently increased minimum capital requirements. Nevertheless, both recognize the importance of small banks, and minimum capital requirements remain within the reach of those institutions that are likely to meet the other requirements for a banking license.

The capacity to establish small banks in Indonesia and the Philippines has been positive for microfinance in those countries

In a number of other countries, namely Bangladesh, PRC, India, Pakistan, and Viet Nam, it remains difficult to establish small banks. In these countries, it would be appropriate for the central bank to consider the scope for relaxing regulations which inhibit the establishment of small banks. Nevertheless, it must be acknowledged that even modest increases in the numbers of licensed banks may stretch the supervisory capacities of central banks. A third group of countries includes a number of intermediate cases.

One critical constraint that may prevent licensed banks from lending directly to the poor relates to interest rates. In eight countries, the central bank does not impose any restrictions on the lending rates applying to licensed banks. However, four countries retain some controls, and in the cases of PRC and Viet Nam these are very extensive. It would be appropriate to remove these restrictions, although in PRC and Viet Nam complete deregulation of interest rates depends on the resolution of much broader issues.

Controls on interest rates are a crucial constraint in some countries

Even where interest rates have been deregulated, there is often considerable pressure on banks to keep rates low. There may be a role for central banks to provide leadership, educating other stakeholders on the relationship between interest rates and the sustainability of microfinance, and thereby easing the constraints which prevent banks from pricing loans appropriately.

In terms of capital adequacy, most commentators suggest that capital adequacy ratios should be higher for small banks (and particularly those specializing in microfinance) than for larger banks. However, there do not appear to be any cases where such differential ratios apply in practice.

Loan classification and provisioning is another problematic area for specialist microfinance banks. There are sound reasons for specialist microfinance banks to provision their overdue loans (based on time overdue) more aggressively than is done by conventional banks. On the other hand, regulations that require high provisions for unsecured loans, even where they are not overdue, are inappropriate for specialist microfinance banks. In practice, central banks have not addressed these issues in any systematic or satisfactory way.

Neglected areas of regulation include capital adequacy requirements for small banks and provisioning norms for microfinance loans

Central banks may also need to alter prudential requirements in a number of other respects to address the particular circumstances of small banks and specialist microfinance banks. Examples of regulations that may be inappropriate for microfinance include regulations that limit the percentage of portfolios extended as unsecured loans, excessively detailed requirements concerning loan documentation and reporting formats, and restrictions on bank branching and location.

Regulation of Nonbank Microfinance Institutions

MFIs are generally not subject to regulation by the central bank. 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. But as the microfinance sector develops, there is inevitably more pressure to subject it to regulation.

Central banks do not normally regulate nonbank MFIs

Nonbank MFIs engaged in microfinance are subject to a range of registration and other requirements. Central banks are generally not involved in these processes. Some countries also impose ceilings on the interest rates that MFIs can charge to borrowers. In most cases these are not imposed by the central bank. However, there are a number of cases where the central bank does control the interest rates charged by certain categories of nonbank MFIs. It would be appropriate for central banks to remove any such restrictions. And even where such restrictions do not result from

Prudential regulation and supervision of nonbank MFIs should be restricted to those that accept savings

central bank actions, central banks may be able to lend their prestige and influence to efforts directed at their removal.

It would be neither appropriate nor possible to subject all MFIs to prudential regulation and supervision. MFIs should not generally be subject to prudential regulation and supervision unless they accept savings. Moreover, subjecting all MFIs, no matter how small, to prudential regulation and supervision would impose a very large burden on central banks and/or other supervisory agencies. Given the limited administrative resources and the frequency of government and regulatory failures in most countries, it would not necessarily result in better performance by MFIs. Indeed, inappropriate regulation could well do considerable harm.

It is possible to reach some tentative conclusions as to which MFIs should be subject to prudential regulation and supervision. In broad terms:

(i) Credit-only MFIs, and MFIs that require clients to make savings deposits in order to get loans, should not be subject to prudential regulation and supervision.

(ii) MFIs that mobilize voluntary savings from members, including credit unions, cooperatives, and self-help groups, should be subject to prudential regulation and supervision only where they exceed a certain threshold, or otherwise should be required to deposit voluntary savings with a licensed financial institution as quickly as possible after receiving them.

(iii) MFIs that mobilize deposits from the general public should be subject to prudential regulation and supervision. Institutions not subject to prudential regulation and supervision should not be permitted to mobilize public deposits.

It is generally better to modify banking laws to suit MFIs than to have special laws for them

In general, it would appear that MFIs that meet the above tests for prudential regulation and supervision should be subject to banking laws (although banking laws may need to be reformed to take account of the needs of microfinance). Special laws for MFIs may be a "second best" option where it is not possible to reform banking laws. Special laws would generally only be warranted where there are significant numbers 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.

In practice, nonbank MFIs are generally not subject to prudential regulation and supervision by the central bank or any other agency. The only exception is Nepal, where the central bank has granted limited banking authority to a number of MFIs which have in exchange accepted regulation and supervision by the central bank. While the arrangements in Nepal suffer from certain deficiencies, they have paved the way for a number of the larger MFIs to obtain experience as financial intermediaries operating between the formal financial sector and the broader NGO movement. Some now have the confidence to seek licensing as small development banks.

There has also been considerable debate in Bangladesh and India on whether MFIs should be subject to prudential regulation and supervision. In Bangladesh, most stakeholders in the microfinance sector consider there is a need to enact a separate law for microfinance, in order to protect clients' savings and encourage commercial banks to establish linkages with MFIs. Such a law would only apply to large MFIs with membership above a certain threshold, and would enable such MFIs to mobilize deposits, including from nonmembers. The role of the central bank in implementing any such law remains unclear, and most commentators consider that a separate regulatory agency should be established. However, Bangladesh is unique in the degree of relative importance which MFI financial intermediation assumes in relation to the broader financial system. This suggests the need for the central bank to be associated with the regulatory and supervisory processes.

Nepal has a special law for MFIs while Bangladesh and India are considering such laws

The scope for MFIs to mobilize savings is an area of confusion in most if not all countries. In almost all countries there are significant legal restrictions on savings mobilisation by nonbank MFIs, but these laws are either ignored or implemented in piecemeal fashion. There is always the possibility of sanctions against such MFIs where they are technically operating outside the law. It would be appropriate for central banks to clarify these situations and establish workable policy frameworks that make it clear to MFIs whether and how they can mobilize savings.

The scope for MFIs to mobilize savings is a zone of regulatory confusion in almost all countries

Credit unions and cooperatives are permitted to mobilize the savings of their members for on-lending. While in most countries these bodies are not regulated by central banks, the central bank does play a regulatory role in four of the countries studied, namely, PRC, Kyrgyz Republic, Nepal, and PNG. In smaller countries in particular, there may be a sound case for the central bank to assume responsibility for regulating cooperatives and credit unions. However, it would not be feasible for a central bank to supervise primary societies. The role of central banks should be to supervise the activities of the apex bodies for the cooperative or credit union movements and to provide general institutional and policy support, rather than imposing full prudential regulation and supervision.

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 the microfinance sector. While it is very unlikely that all MFIs would adhere to such standards, they offer the potential to improve the operations of the larger and more businesslike MFIs, and thereby to increase the sustainability of the microfinance sector as a whole. Possible approaches include imposition of lending policies by second tier microfinance institutions, self-regulation, and an independent credit rating process. It is not appropriate nor even possible for central banks to develop such performance and reporting standards unilaterally but they may be able to play an advisory role, as has been the case in Nepal and the Philippines. If central banks are to become involved, it is important that they develop a sound understanding of the microfinance sector.

Concluding Comments

The study identifies a number of important roles of central banks with respect to microfinance. Most significantly:

(i) It is generally accepted that central banks 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.

(ii) In most countries, central banks should undertake promotional activities to support microfinance, including activities such as pilot projects, research, data collection and publication, advocacy, and training. The scope of this role depends on the central bank's comparative advantage in these activities.

Important Roles for Central Banks in Fostering Microfinance

- A core function of central banks in most countries is to take the lead in matters to do with the regulation and supervision of licensed banks.
- In most countries, central banks should undertake promotional activities to support microfinance, such as pilot projects, research, data collection and publication, advocacy, and training.
- Central banks should regulate nonbank MFIs that accept voluntary savings from members, when the volume of savings exceeds a certain threshold.

Since the appropriate role for the central bank differs from country to country, recommendations tend to be country specific

(iii) There is also a role for central banks in regulating nonbank MFIs that accept voluntary savings from members, when the volume of savings mobilized by such MFIs exceeds a certain threshold.

The appropriate role for the central bank in microfinance will differ from country to country. Such differences will reflect a variety of factors. The financial system and the microfinance sector have evolved differently in particular countries, and a variety of institutional structures has emerged. The stage of development of the financial system, and of the microfinance sector within it, also differs between countries. Other relevant factors include the degree of independence of each central bank and its operational capacity.

Hence, detailed recommendations on the precise role of central banks in microfinance tend to be country specific. While it is necessary to have a consistent conceptual framework for the role of central banks in microfinance, there is a need for pragmatism in adapting basic principles to the circumstances of various countries.