Kingdom of Thailand: TA7998 (THA) - Development of a Strategic Framework for Financial Inclusion in Thailand (Financed by the Japan Fund for Poverty Reduction)

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For: Fiscal Policy Office
Bureau of Financial Inclusion Development Policy

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CURRENCY EQUIVALENTS
(As of 1 October 2012)

Currency Unit
$1.00 = THB 31.36

ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>BAAC</td>
<td>Bank of Agriculture and Agricultural Cooperatives</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BOT</td>
<td>Bank of Thailand</td>
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<td>CAD</td>
<td>Cooperatives Audit Department (Min. Agriculture &amp; Cooperatives)</td>
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<td>CDD</td>
<td>Community Development Department (MOI)</td>
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<td>CFI</td>
<td>Community Financial Institution</td>
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<td>CPD</td>
<td>Cooperative Promotion Department (Min. Agriculture &amp; Coops)</td>
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<td>DPA</td>
<td>Deposit Protection Agency Act</td>
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<td>DTAC</td>
<td>Total Access Communications</td>
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<td>FGD</td>
<td>Focus Group Discussion</td>
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<td>FIBA</td>
<td>Financial Institutions Business Ac</td>
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<td>FIDF</td>
<td>Financial Institutions Development Fund</td>
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<td>FIPD</td>
<td>Bureau of Financial Inclusion Policy and Development</td>
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<td>FPO</td>
<td>Fiscal Policy Office</td>
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<td>FSMP</td>
<td>Financial Sector Master Plan</td>
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<td>GSB</td>
<td>Government Savings Bank</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard(s)</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>KTB</td>
<td>Krung Thai Bank</td>
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<td>KTC</td>
<td>Krung Thai Card</td>
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<td>MAP</td>
<td>Making Access Possible</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MOI</td>
<td>Ministry of Interior</td>
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<td>NBFI</td>
<td>Non-Bank Financial Institution</td>
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<td>NPL</td>
<td>Non-Performing Loan</td>
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<td>NSFII</td>
<td>National Strategy for Financial Inclusion</td>
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<td>NSO</td>
<td>National Statistics Office</td>
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<td>NVUCF or VF</td>
<td>National Village and Urban Community Fund, also referred to as Village Fund</td>
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<td>OIC</td>
<td>Office of Insurance Commission</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>SEPO</td>
<td>State Enterprise Policy Office</td>
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<td>SFI</td>
<td>Specialised Financial Institution</td>
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<td>TA</td>
<td>Technical Assistance</td>
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<td>TCRB</td>
<td>Thai Credit Retail Bank</td>
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<td>TDPRI</td>
<td>Thailand Development Research Institute</td>
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<tr>
<td>TMB</td>
<td>TMB (formerly Thai Military Bank)</td>
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<td>UNCDF</td>
<td>United Nations Capital Development Fund</td>
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<td>VF</td>
<td>Village Fund</td>
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Asian Development Bank Technical Assistance
TA 7998: Development of a Strategic Framework for Financial Inclusion
(Funded by the Government of Japan through the Japan Fund for Poverty Reduction (JFPR))

The Royal Thai Government (RTG) requested technical assistance from the Asian Development Bank (ADB) in 2010 to support the Government’s initiative to promote financial inclusion in Thailand through a highly consultative process. Approved at the end of 2011 and initiated in early 2012, the process of developing a framework for financial inclusion began with a comprehensive diagnostic of the current state of financial inclusion in the country. The diagnostic was conducted through a collaborative effort with the United Nations Capital Development Fund (UNCDF) using its Making Access Possible (MAP) methodology to support expanding access to financial services for individuals and micro and small businesses. The first part of this diagnostic investigated supply-side and regulatory environment issues including the payments infrastructure. A qualitative and quantitative demand survey was conducted which provided valuable insights on access to finance and client behavior. Other parts of the assessment investigated fields including microinsurance, financial literacy and consumer protection. The final synthesis report brings together the assessment findings and provides key recommendations for going forward.

Reports in Thailand Financial Inclusion Series

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<td>3</td>
<td>Qualitative Demand-Side Research Report</td>
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<td>4</td>
<td>Microfinance Regulation and Supervision Report</td>
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<td>6</td>
<td>Quantitative Demand Research Report – Finscope Thailand*</td>
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<td>Consumer Protection Assessment Report</td>
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<td>8</td>
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*Finscope Thailand (funded by UNCDF) is available at: [http://www.uncdf.org/sites/default/files/download/Thailand%20booklet%20final%2006%20August%202013.pdf](http://www.uncdf.org/sites/default/files/download/Thailand%20booklet%20final%2006%20August%202013.pdf)
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EXECUTIVE SUMMARY

Thailand has a diverse array of financial services providers ranging from large to small and formal to entirely informal. In this report we try to identify where regulatory constraints and opportunities exist in each segment of the market, as well as across the whole market. These regulatory issues affect each of the major drivers of financial inclusion: the commercial banks’ microfinance activities, initiatives carried out by the state development banks (SFIs), expansion of lower-tier and informal providers, and the tools that enable outreach to underserved households, including agent banking, electronic transactions, and credit information systems.

The main limitation to banks’ down-scaling their activities appears essentially the same as in many other countries: the banks are flourishing just the way they are. Corporate services, consumer and mortgage lending, investment, and the ample supply of government debt instruments absorb banks’ funds safely and profitably. The Personal Loan regulation and the Microfinance Guidelines, together with an easing of capital rules for credit risk, provided a modest incentive for banks to reach into consumer and lower-income markets. The Guidelines have not produced significant downscaling, apart from the efforts of Krung Thai Bank, a unique commercial bank that is majority state-owned. On the other hand, the personal loan business has boomed, with non-bank providers, many owned by banks, expanding consumer credit. Otherwise, perceived risks and costs are too high for the commercial banks to pursue microfinance, other than as a corporate social responsibility gesture. More significant structural changes, such as further development of the infrastructure and regulatory reform to expand branchless banking (mobile phone banking, agents etc.), may whet their appetite to reach deeper into the low-income market.

The SFIs have been quite active in extending small-scale finance to poorer and more remote communities. An important part of this role is in piloting approaches that are new to Thailand such as SFI financial and managerial support to community groups, outreach of staff beyond the branches, and tailored savings products. The losses resulting from policy initiatives implemented by the SFIs, such as soft loans for rice production and informal loan refinancing, are covered from the state budget. The SFIs are thereby able to overcome the cost and incentive problems of development finance in a way similar to NGO microfinance. But the sustainability of this model is subject to question. This is due not only to the lack of transparent accounting, but also the rapid growth of the SFIs, their involvement in essentially political initiatives, and the oversight applied to them, which appears substantially less rigorous than that applied to the commercial banks.

Equally important, is the impact of the SFIs on the financial services market. They compete with commercial banks by means of highly favorable interest rates on loans and deposits, and they play a central role in medium- and small-scale finance, although they pay neither taxes nor deposit protection fees. The SFIs’ weak repayment record as compared to the commercial financial sector has a negative effect on credit discipline in their segment of the market. The continued recapitalization of the SFIs, along with the recycling of non-performing loans, draws increasing state resources into this sector. On this skewed playing field, it is difficult for market-based microfinance to emerge.

The semi-formal and informal financial services segments are growing rapidly, showing the potential for small-scale finance but also the risks. Financial cooperatives appear to have great potential for delivering microfinance. However, in the current context, they are supervised by the Ministry of Agriculture and Cooperatives along with all the production cooperatives, and used as vehicles for state subsidies. Thus, the cooperatives are weakly governed and have produced
uneven, often quite poor, performance. The Village Funds have shown significant impact in moving credit to poor rural communities, but are also subject to weak oversight and political intrusion. There is, however, a promising movement to spin off the members’ savings deposits into locally-run intermediaries called community financial institutions (CFIs). These groups, along with informal savings groups of various kinds, are being supported, mentored, and often financed by organizations such as BAAC, the National Village Fund, and community development groups both official and non-governmental.

Many informal groups are growing largely without any control or supervision, apart from the members themselves and in some cases local leaders such as monks. These informal financial service providers operate extra-legally and thus incur no costs of registration, supervision, deposit protection, or taxation. Like the SFIs, the grassroots groups are piloting new methods and contributing substantially to financial access. But until they are in some way formalized, supervised, monitored, or networked, their expansion poses a risk of crisis and collapse. For this reason, BAAC and others have linked up with many of these groups to provide support and in doing so to exercise oversight and strengthen the groups’ governance. For the same reason, experts and policymakers increasingly see the need to create a standards and oversight mechanisms for the semi-formal and informal institutions, and to bring the larger providers within a regulatory structure. What recommends itself here is a tiered structure where greater size and breadth of services require greater formality and more stringent prudential norms – under an independent supervisory agency.

The other policy-related issues discussed in the report include branchless and electronic services, and the broader commercial environment. These affect the success of all the types of services and institutions just mentioned. In the first two categories, BOT is moving with deliberate caution, opening up agencies and e-money services in a way that largely keeps them tied to the banks. BOT appears committed to helping the financial sector capture the efficiencies of e-payments and e-money, but the non-bank licensees are constrained in widening their range of services. The credit reporting system provided by the National Credit Bureau appears to serve existing financial institution members reasonably well, but offers no clear pathway for small-scale finance to enter and benefit from the system. Thus, gaps in membership and the information base pose risks to small-scale lenders and any institutions reaching out to the unbanked. Additionally, the framework for secured finance provides far less help in facilitating financial inclusion than it would if reformed in line with good international practice.

Among the key recommendations with which the report concludes are these:

a) Consider lifting interest rate caps for microfinance loans and replacing them with credible financial consumer protections and disclosures.

b) Introduce financial inclusion metrics into the supervision and reporting standards for banks and NBFIs, and publish the audited performance data to enable public comparisons among financial institutions.

c) Encourage banking institutions to establish subsidiaries or to invest in a newly-created sector of regulated and supervised specialized microfinance institutions (see below).

d) Bring greater financial discipline, internal control, and sustainability to the SFIs by strengthening oversight, reducing ministerial discretion, and enhancing the transparency of accounts and public scrutiny of performance.

e) Consider the restructuring of SFIs or portions of them – especially BAAC – to create a specialized wholesale financing institution for microfinance.
f) Create a new licensing and supervision regime for microfinance, tiered to accommodate deposit-taking, credit-only, and small informal institutions.

g) Create a new regulatory-supervisory framework specifically for financial cooperatives to accommodate existing cooperative finance activities as well as other groups such as NGOs and informals that wish to formalize as cooperatives.

h) Establish an independent microfinance regulatory agency, drawing on expertise from existing government and sector organizations, to supervise MFIs and financial cooperatives.

i) Shift more fully toward an open-platform electronic transactions system in order to expand basic services, such as conversion between cash and e-money, as rapidly as possible to underserved populations.

j) Expand the credit information system to include all financial service customers, and strengthen incentives for non-member institutions to enter the system.
I. INTRODUCTION

Thailand has a wealth of financial services providers in a variety of niches from large to small and formal to entirely informal. Coexisting with this are many gaps in the availability of services, especially for low-income and rural populations. The policy framework has an important bearing on this picture of financial inclusion and exclusion – and the present report takes this framework as its focus.

This report attempts to identify and analyze the main legal and regulatory factors shaping the development of microfinance in Thailand, along with key infrastructural and practical influences. This work brings into consideration quite a large array of elements, some enabling and some constraining. We address such areas as financial services regulation, public sector banks, cooperatives and savings groups, the regulation of agents and electronic payment services, and various factors in the commercial environment affecting financial transactions and information flows.

Thailand is an economically dynamic upper middle income country, with Human Development Indicator measures in the middle of the development scale (Lewis, Susewan and Tambunlertchai 2013). It has a well-developed financial infrastructure that reaches the great majority of the population, leaving an estimated 9.6% of its people unbanked – a figure comparable to that found in the U.S. and other industrial countries. As with all such data, these figures mask considerable diversity including localized exclusion and privation. For example, ADB (2011) reports that some 38% of low-income families have used one or two types of financial services, while another 16% do not use financial services at all. Almost 80% of middle- to high-income families use three or more types of financial services. Nearly half of low-income households do not borrow, as compared with 27% of middle- to high-income households. About 28% of low-income households do not have access to savings products compared with 6% from middle- to high-income groups (ADB 2011).

In this paper, we look at existing institutions, services, and frameworks in order to understand how all the relevant sub-sectors of financial activity are organized and governed – and where gaps and opportunities for improvement exist. Our question is whether and in what ways the policies, rules, and organizing principles relevant to small-scale finance in Thailand either facilitate or impede expanded access and inclusion. To answer this, we look at the evidence of financial services practice as well as the policy frameworks, legal-regulatory provisions, supervisory standards, and institutional forms. As with any regulatory system, one must ask whether the norms are well-targeted, proportional, cost-effective, and feasible to administer. If not, we look to internationally recognized principles and best practices to determine what approaches could be adopted to address the need.

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1 The author wishes to acknowledge the many persons who contributed time and information through interviews, calls, and correspondence from May 2012 to August 2013. An interviewee list is available upon request.

2 Two areas not covered here but addressed in separate project component reports are insurance and consumer protection.

3 Bureau of Financial Inclusion Policy and Development (FIPD) interview

4 This compares with World Bank Global Findex dated 2011 which has only 72% of the over age 15 population holding a bank account at a formal financial institution. The difference may be due to the fact that this data seems to refer to households rather than individuals. Research by Robert Hickson.

5 These data are supported by the findings of Demirguc-Kunt and Klapper (2012) indicating that 40% of low income households and 20% of middle to high income households do not hold accounts with formal financial institutions – i.e., bank, credit union, other financial institutions (e.g. cooperative, microfinance institution), or the post office.
The analysis and recommendations must take into account the distinctive characteristics of microfinance, including the following:

- high unit costs of services,
- extension of services to poor or remote areas sometimes by means of agents and electronic funds,
- dependence on guarantees other than collateral that can be valued and used by financial institutions,
- relatively undiversified portfolios that can give rise to significant volatility (due to high levels of covariant risk) if not capably managed, and
- clients’ needs for tailored savings, credit, remittance, and insurance products.\(^6\)

We examine both existing arrangements and recommended solutions to determine whether they address these issues.

The table below provides an overview of Thailand’s existing regulatory framework for financial services, with key requirements, providers, and supervisors. The financial sector is often discussed in terms of three broad categories: formal, semi-formal, and informal providers. The formal providers are those having clear legal status and some form of oversight by the Bank of Thailand (BOT). These include commercial banks, specialized financial institutions (SFIs), and non-bank financial institutions (NBFIs) such as credit card and personal loan companies. Semi-formal financial institutions are those that have legal status, but are not supervised or examined by the Bank of Thailand, e.g., financial cooperatives and Village Funds. Informal financial institutions are those that have no legal status and are not overseen by authorities, namely savings groups and money lenders (pawn shops are included here, though they generally have legal status) (Sinswat and Subhanij 2010, citing the World Bank). We refer to this taxonomy at a few points in the report.

We proceed as follows. The following three sections deal with the relevant sources of financial services: commercial banking, state-owned institutions, and the lower tiers of institutions including grassroots providers. The two subsequent parts deal with service outreach by means of agents and electronic networks, and with broader commercial environment issues such as credit information and secured finance laws that affect financial access in practice. The last part concludes with a synthesis of key findings and recommendations for policy development and institutional reform. The analysis here is necessarily selective and partial, given the range of issues to be discussed and the need to identify key constraints and priorities in this large field.\(^7\)

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\(^6\) Generally these product attributes are: small scale, low cost per transaction, flexibility and accessibility.

\(^7\) Also, to date, spotty access to legal-regulatory documents in English has precluded a comprehensive examination of all the relevant instruments.
Table 1 Financial Services Providers: Roles and Requirements

<table>
<thead>
<tr>
<th>Institution</th>
<th>Services</th>
<th>Governing laws</th>
<th>Key requirements</th>
<th>Supervision</th>
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<tbody>
<tr>
<td>Commercial bank</td>
<td>Full service banking</td>
<td>FIBA Deposit Protection Agency Act</td>
<td>Minimum capital: THB 5 bill 28% cap (interest and fees) for microfinance</td>
<td>BOT</td>
</tr>
<tr>
<td>Retail bank</td>
<td>Limited banking</td>
<td>FIBA Deposit Protection Agency Act</td>
<td>Minimum capital: THB 250 mill 28% cap (interest and fees) for microfinance</td>
<td>BOT</td>
</tr>
<tr>
<td>SFI</td>
<td>Banking and policy lending</td>
<td>SFI acts (Deposit Protection Agency Act)</td>
<td>SEPO KPIs (and adapted BOT standards⁹) PSA accounting</td>
<td>FPO (with BOT)</td>
</tr>
<tr>
<td>NBFI</td>
<td>Credit</td>
<td>Notification of Ministry of Finance on personal loans</td>
<td>Minimum capital: THB 50 mill 28% cap (interest and fees)</td>
<td>BOT</td>
</tr>
<tr>
<td>E-money provider</td>
<td>E-money: stored value, mobile phone banking</td>
<td>Electronic Trans Act &amp; regulations</td>
<td>Electronic Transactions Commission permission for e-money</td>
<td>BOT</td>
</tr>
<tr>
<td>Banking agent</td>
<td>Deposit, withdrawal, transfer, credit</td>
<td>BOT Notification: Banking Agent</td>
<td>A financial institution or SFI in most cases Permission in some cases</td>
<td>BOT</td>
</tr>
<tr>
<td>Cooperative</td>
<td>Savings and credit</td>
<td>Cooperatives Act</td>
<td>Cooperative form 15% interest rate cap for most, 10% dividend cap</td>
<td>CAD</td>
</tr>
<tr>
<td>Village Fund/CFI</td>
<td>Savings and credit</td>
<td>Social policy</td>
<td>15% interest rate cap Village creditworthy-ness ratings</td>
<td>NVUCF, SFIs or CDD in some cases</td>
</tr>
<tr>
<td>Savings group</td>
<td>Savings and credit</td>
<td>Social policy per sponsoring ministries</td>
<td>In some cases (e.g. SPGs) loan purpose rules Members, sponsor (e.g. CDD)</td>
<td>Members, sponsor (e.g. CDD)</td>
</tr>
<tr>
<td>Moneylender/ pawnshop</td>
<td>Credit</td>
<td>Pawnshop Act</td>
<td>15% interest rate cap</td>
<td>MOI, other govt departments</td>
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8 SFIs are included in the Act but have not become members.
9 Applied by FPO, with auditing by BOT.
II. COMMERCIAL BANKS AND NBFIS

Apart from their central role in the overall economy, the banks have a potentially important contribution to make in expanding access to financial services among lower income populations, rural communities, and micro and small enterprises. This is the issue of downscaling or extending services tailored to the needs of the un- and under-banked.

Over the past decade Thai policymakers have been concerned to encourage downscaling by means of regulatory guidance or incentives for financial institutions to serve populations with little or no access to finance. Yet, the Bank of Thailand has exercised caution here, with a view to safeguarding the stability and soundness of the banking sector – a hard-won success of the post-1997 period. BOT is especially wary of directed credit, an approach tried up to the 1980s by such means as dedicating a percentage of BAAC’s (Bank of Agriculture and Agricultural Cooperatives) portfolio to agriculture. In the past, “sweeteners” were offered for banks to open branches in rural areas. They made no profit, but were able to mobilize savings. These approaches have been abandoned as a matter of policy, though some of them linger in practice. 10

A. Banking regulation

Commercial banks in Thailand exploit the full range of activities in both traditional and investment banking characteristic of the universal banking model. This direction is sometimes in tension with Thailand’s policy priorities of the past several years. These include the need for rehabilitation in the years following the 1997 crisis, the emphasis on safety and soundness that enabled the system to ride out the 2008 crisis, and the pressures from both the market and policymakers to extend new services to a wider population.

As BOT reports, the stability of Thai commercial banks improved steadily in the decade after the depths of the Asian crisis, with the ratio of gross non-performing loans (NPLs) to total loans decreasing from a peak of 50% in early 1999 to about 6% of total loans in late 2008. The increased stability is also reflected in the capital adequacy ratio (CAR or ratio of capital to risk-weighted assets), which measures banks’ capacity to absorb foreseeable losses. From the late 1990s to 2012, the CAR rose from about 10% to 16%. 11 These changes, together with policy reforms and internal strengthening of the banks, have made the system much more resilient to negative shocks. As a result, the global financial turmoil of 2008 had only limited direct impact on the Thai banking sector. 12

Systemic reform culminated in 2007 with three new laws that are central to financial services supervision:

- The Amended Bank of Thailand Act B.E. 2551,
- The Financial Institution Business Act B.E. 2551 (FIBA, replacing the Commercial Banking Act B.E. 2505 and the Act on the Undertaking of Finance Business, Securities Business and Credit Foncier Business 2522), and
- [Interview, Bankers’ Association. The incentives here reportedly included a reduction in regulatory fees for banks opening rural branches.]
- [www.bot.or.th/English/Statistics/]
- [This was helped by Thai banks’ minimal exposure to collateralized debt obligations and other problem assets (Satsanguan and Lewis 2009).]
The first two of these, according to BOT, aim to strengthen the supervisory framework by clearly distinguishing its responsibilities from those of the Ministry of Finance. The Bank of Thailand is empowered to issue notifications on most prudential matters and to enforce the rules through supervision and sanction (including closure of financial institutions). The MOF retains authority to grant and revoke licenses (upon BOT’s recommendation). Moreover, the Bank of Thailand is given additional power to conduct consolidated supervision over financial conglomerates, implement prudential regulation to comply with the Basel Core Principles, and monitor consumer protection (Satsanguard and Lewis 2009). FIBA defines financial business broadly to include banking, insurance, securities, and derivatives. Section 5 of FIBA defines BOT’s residual authority to deal with other kinds of financial activities where they affect the “overall economy of the country.”

A few other provisions are worth mentioning for their impact, actual or potential, on financial inclusion. “Financial institutions” for purposes of FIBA are commercial banks (including retail banks), finance companies (corporations engaged in “finance business”), and credit foncier (real estate finance) firms. Significantly, Special Financial Institutions (SFIs), the major providers of microfinance, are mentioned in the Act but not included as regulated institutions (see below). Retail banks are defined as limited-charter banks focused on retail and SME finance, and are excluded from high-risk areas such as forex and derivatives. Only commercial banks may accept current account deposits (i.e. checking and regular passbook savings accounts). Credit foncier companies are permitted to accept only term deposits (certificates of deposit with varying maturities). FIBA limits ownership risk by restricting single shareholders to a maximum of 10% equity, and foreign owners to an overall maximum of 25% (up to 49% with special permission from BOT).

Thus, in terms of financial inclusion, this regulatory structure provides a basic framework – with an array of limitations – that BOT can apply to the supervision of microfinance activities. Institutions and services that fit within the scope of commercial banking, retail banking, or finance business, along with other activities with potentially systemic effects, can be overseen by BOT. Non-Bank Financial Institutions (NBFIs) offering microfinance services (i.e. under the personal loan rules, see below) are not legally permitted to accept deposits.

Other legal-regulatory norms spell out in more detail what the potential providers of small-scale financial services face in striving to enhance inclusion within the regulated sector. Most obvious is the general interest rate cap of 15% applicable under the Civil and Commercial Code to lenders outside the formal financial sector. A ceiling of 28% (interest and fees) applies to small personal and microfinance loans (see below). It is unclear whether even the higher rate would accommodate the start-up costs of a regulated microfinance provider in the absence of subsidy (governmental or social) before it is able to establish a large and efficient market presence. BOT sets most of the relevant norms through notifications, including those dealing with minimum capital, capital adequacy, branching and branchless services, risk-weighting of assets, and the schedule for classification and provisioning of loans. These norms strengthen safety and soundness while imposing costs in the form of capital margins and operating requirements. The rules thus influence a bank’s ability (and incentive) to reach out to new clients and provide microfinance services. (For further discussion, see the box below.)

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13 In this case, BOT would propose a Royal Decree and supervisory regulations.
14 The author gratefully acknowledges information provided by BOT on these points.
The last of the reforms mentioned above, the Deposit Protection Agency Act, came into force in 2008, replacing the prior open-ended deposit guarantee with a one far more limited in scope. The Act applies to financial institutions as defined by FIBA, and defines deposits as monies that financial institutions receive from any person with an obligation to repay. The Deposit Protection Agency is established as the regulatory authority, with a Committee that issues regulations under the Act and a Deposit Protection Fund to cover payments to depositors. Protected deposits are comprised of savings and interest held by financial institutions – in Baht and in accounts in Thailand, excluding any deposits of persons residing outside Thailand. The amount guaranteed per account is undergoing a phased reduction from the unlimited guarantee in place in 2008 to a maximum of 1 million THB in 2016. Interviewees have expressed concern about the tax on deposits, amounting to 0.47% of deposit value, with nearly all of it dedicated to the Financial Institutions Development Fund (FIDF) bailout fund (1.4 billion THB) created in the wake of the 1997 crash.
Box 1 Capital and risk management norms

| Capital standards include 8.5% capital adequacy with an additional “capital conservation buffer” of 2.5 percent to be phased in by 2019, and a liquidity reserve equal to 6% of deposits and short-term funding. Loan classification rules were tightened in 2002, with overdue loans grouped as follows: special mention 1 to 3 months; substandard 3 to 6 months, doubtful 6 to 12 months, possible loss or write-off over 12 months. Non-performing assets require a reserve to be established equal to 100% of the difference between the balance sheet amount of the loan and the present value of expected cash flows from the debtor (or the sale of collateral). Further, the commercial banks have responded to BOT pressure – based on lingering concerns from the 1997 crash and renewed caution due to the crisis starting in 2007 – with larger safety margins, keeping capital adequacy near 15% on average, and building up extra loan loss reserves. Standards covering risk management also affect financial inclusion. The risk-weighting of assets could make it costly for an institution to pursue a substantial portfolio of microcredits, which are typically unsecured. BOT’s credit risk guideline includes unsecured credits up to THB 100,000, individual guaranteed credits up to THB 3 million, and SME loans up to THB 50 million in the same category (with a 0.75 risk-weight). There is no sub-category for microfinance or group-guaranteed loans, which presumably would be regarded as unsecured credits and subject to the same standard. Nevertheless, this treatment is better than that given by regulations in many other countries, and BOT cited financial inclusion as the rationale for adopting these standards: “[BOT] assigned new risk weights for assets related to retail customers and SMEs as a market incentive for commercial banks to service these customer segments” (BOT 2006). It is worth comparing the 0.75 norm to that applicable to fully-mortgaged housing loans (risk-weight 0.35) and Thai government securities (risk-weight 0). By contrast, in some of the other regulatory areas mentioned (e.g. capital adequacy, loan classification and provisioning), the appropriate treatment of microfinance might require more- rather than less-stringent norms – given the likelihood of covariant risk and the resulting potential for volatility.

1. Impact

Not surprisingly in light of the above discussion, Thailand’s commercial banks have tended to cluster at the high end of the economy where the profits are, primarily in corporate services. But bankers suggest that this market is now becoming saturated, with thin margins. Many of the commercial banks are moving beyond traditional clients into the supply chains. Here, they tend to compete for firms that have been established for a minimum of two to three years, with start-ups facing more difficult credit constraints.

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19 That is, regulatory capital equal to 8.5% of risk-adjusted assets, including 6% tier one capital.
20 This is part of BOT’s move to meet international standards including Basel II and III, and International Accounting Standards (e.g. IAS 39, dealing with asset classification). BIS (2012), BOT (2012), BOT Prudential Regulation Handbook (www.bot.or.th), IMF (2008), Sucheera Pinijparakarn, “Loan-loss reserves sufficient to cope,” The Nation, July 7, 2012.
21 Notification of the Bank of Thailand No. SorNorSor. 54/2551, Re: Guideline for Calculation of Credit Risk for Commercial Banks; Notification of the Bank of Thailand No. SorNorSor. 15/2555, Re: Guideline for Calculation of Credit Risk for Commercial Banks (Standardised Approach).
22 Also includes other retail loans (revolving credit, credit card, overdraft, personal loans, hire-purchase) granted to individuals, groups, and SMEs that meet BOT requirements (BOT comments).
23 Despite the effectiveness of group guarantees and the high repayment rates on microcredits in many countries, they are often treated as unsecured under prudential regulation. Among the few exceptions was the Philippines (at least until recently), which also used a 0.75 risk-weight (Meagher et al. 2006). This has relevance to minimum Capital Adequacy Ratio (CAR) requirements set by the central bank, as high risk-weighting of these portions of the loan portfolio has a tendency to lower the CAR, which may require additional (expensive) capitalization in order to remain above the minimum requirement.
24 TMB interview.
Researchers began detecting, even before the 2008 crisis, a move by the banks away from a near-exclusive focus on traditional corporate banking toward retail banking and SME clients, since this path offered better diversification and profit. At the same time, Thai banks were relying on local deposits as their main source of funds, with deposit interest accounting for about 80 percent of total income. Faced with intensifying competition, banks began modernizing their services, expanding their networks and customer base, and differentiating themselves by offering more financial products such as short-term bills of exchange, special deposits, and cross-selling of products such as life insurance and mutual funds (Satsangan and Lewis 2009). This tendency was probably encouraged also by policy initiatives such as the Financial Sector Master Plans (see below).

As a result, the banks have put in place the infrastructure for service outreach to a wider client base. ATM networks have grown, expanding deposit and payment services and enabling rural populations to open accounts and transfer funds. Banks are said to offer cheaper transfer services than the Post Office.\textsuperscript{25} Banking institutions (especially the SFIs) are extending services through sub-branches and mobile staff – suggesting that the legal requirements for bank branch infrastructure\textsuperscript{26} are not overly restrictive (again, especially for the SFIs) – as well as developing electronic platforms. As related in Lewis, Susewan and Tambunlertchai (2013), ATMs per 100,000 adults in Thailand nearly quadrupled, from just over 20 to nearly 78, in the period 2004-2010, although they remain largely concentrated in urban areas. The numbers of EFTPOS terminals as well as ATM and debit cards are on the rise.

Another trend in the sector has been a geographic concentration of credit, along with increased lending to the central government. The commercial banks, and to a greater extent the SFIs such as GSB, are using their savings from around Thailand for large projects including infrastructure-building, primarily in urban areas. Government policy promotes private sector growth champions that can compete internationally, and uses a combination of public sector tenders and private sector growth targets to press for the complementary infrastructure investments needed for this purpose. Many of the large, politically-connected Thai businesses are in the construction sector. These factors tend to tilt both commercial bank and SFI financing in favor of more profitable (and prestigious) big projects, which results in a bias against small-scale credit.\textsuperscript{27} (For further discussion, see the box below.)

\textbf{B. Financial Sector Master Plans and small-scale loan policies}

Thai policymakers have pushed for better performance by the financial sector, including increased bank downscaling, through the Financial Sector Master Plans (FSMP Phase I, 2004-8, and Phase II, 2010-14). The objectives of FSMP I were to increase efficiency in the financial system, promote financial inclusion, and strengthen consumer protection. Part of the plan was to strengthen financial institutions through voluntary mergers that would expand services in line with the universal banking model, while opening up new licenses for retail banking and foreign subsidiaries (BOT 2009).

\textsuperscript{25} Bankers’ Association interview. This issue is further developed in the supply side study for this project, Lewis, Susewan and Tambunlertchai (2013).
\textsuperscript{26} For example, physical security requirements for cash storage.
\textsuperscript{27} Thailand Development Research Institute (TDRI) and BOT interviews
The financing of public infrastructure – along with state budget outlays in other areas such as SFI and Village Fund programs – creates fiscal pressure and growth in government debt. The IMF estimates gross public sector debt at about 45% of GDP for 2012, and projects an upward trend to 50% in the next few years.\textsuperscript{28} Government demand for credit, and the safety of bonds as investments, may be competing with private sector demand, making small-scale lending (microfinance) at capped interest rates particularly unattractive for the commercial banks. The banks’ loan portfolios are additionally burdened by the applicable risk-weights and other prudential norms. The relative appeal of public debt as an asset class is evident in the size of the banks’ holdings: financial institutions (including SFIs) currently hold some 55% of domestic government debt (including state enterprise debt). The IMF has expressed concern about the sustainability of Thailand’s public debt in future.\textsuperscript{29}

Government demand for credit clearly influences financial institutions’ choices about the use of funds, thereby shaping the impact of financial inclusion policies. Yet, the evidence does not prove a public sector “crowding-out” effect.\textsuperscript{30} Interest rate spreads and levels of private sector credit, in fact, suggest otherwise. Prime lending rates stand at between 7.13 and 7.5%, while government bonds range from 2.8% (3 month) to 3.61% (10 year) – with T-bills at 3.01%, the one-day repo rate at 2.75%, and headline inflation at 2.89% (core inflation: 2.23%). Moreover, Thailand has a healthy level of credit extension in the economy, with broad money\textsuperscript{31} equal to 124.3% of GDP in 2011 (source: BOT). Thus, government debt does not in any obvious way crowd out private loans from the banks’ balance sheets. The bias against small projects is more subtle: low-risk government debt and loans to big construction firms for public infrastructure projects are among the banks’ preferred asset classes. In the absence of some additional competitive pressure or public policy imperative to downscale, most commercial banks in Thailand seem to have little reason to search more widely for new clients and new risks.

It was during this period that the Personal Loan business was authorized\textsuperscript{32}, with interest and fees capped at 28% per annum for unsecured loans and certain leases and hire-purchase contracts (“Thailand: Interest on personal loans capped at 28%.” Asia Africa Intelligence Wire, June 23, 2005). NBFIs wishing to provide this service must have minimum paid-up capital of 50 million THB and apply to BOT for permission. Beginning with FSMP I, banking services increasingly reached out to the lower income segments, especially SMEs (Banking with The Poor and the Foundation for Development Cooperation 2010). The second FSMP aims to further these gains by improving efficiency (see the box below).

In both of the FSMPs, promoting access to finance is stated as a major goal. But this is in tension with some of the other objectives. For example, efficiency and competition are to be pursued by, among other things, encouraging voluntary mergers and allowing financial institutions with good risk management more flexibility in expanding their branch network and business scope. Both of these steps may enhance efficiency and the range of services, but consolidation is not necessarily conducive to competition or to a strong commitment to small-

\textsuperscript{28} IMF (2012). Both the Thai Ministry of Finance and the World Bank report a net central government debt level of 29% of GDP (http://www2.mof.go.th, data.worldbank.org). BOT figures for government domestic debt combined with state enterprise debt amount to some 40% of GDP.

\textsuperscript{29} Ibid. BOT figures differ as above. BOT figures (Oct. 2012) show commercial banks holding some 30% of government bonds, and other financial institutions (not including private companies, insurance firms, mutual and pension funds) holding some 5.5%.

\textsuperscript{30} Though the level of SFI lending has been interpreted as such, “Govt banks crowd out private investment,” Bangkok Post, 2/03/2012.

\textsuperscript{31} M3, which includes currency, demand deposits, short-term deposits, and short-term securities other than shares.

\textsuperscript{32} Notification of the Bank of Thailand dated on 20th July B.E. 2549 on Personal Loan under Supervision for NBFIs issued by virtue of the Notification of the Ministry of Finance of 16th June B.E. 2548; Subject: Permission for business that requires authorisation according to section 5 of the Notification of the Revolutionary Committee, Issue No.58, of 26th January B.E. 2515.
scale services. For our purposes, the promotion of access is the most directly relevant component. This includes facilitating bank outreach to underserved populations, introducing new service providers with microfinance expertise, and also supporting the SFIs in serving people who are still left out (BOT 2009).

**Box 3 Summary of FSMP II**

<table>
<thead>
<tr>
<th>[The] Financial Master Plan Phase II aims to promote financial system efficiency so that financial institutions can perform their functions more efficiently, becoming more competitive, with increased financial access to the public. The plan essentially comprises three pillars.</th>
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</thead>
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<tr>
<td>The first pillar is to improve the regulatory environment and to reduce the unnecessary regulatory and legacy costs. The focus in this pillar will be on streamlining regulation, and on promoting measures and incentives to deal with legacy NPA and NPL, without compromising prudential oversight or good risk management.</td>
</tr>
<tr>
<td>The second pillar is to enhance efficiency by injecting more competition into the financial system. The focus will be on financial liberalization, increasing competition from the current and new players, and promoting greater financial access. The latter will give importance to expanding the retail banking businesses and promoting new microfinance business models and players.</td>
</tr>
<tr>
<td>And the third pillar is to substantially improve the economy’s financial infrastructure in the areas of risk management, credit information system, legal reform, information technology, and upgrading the quality of human resource. Such infrastructure is crucial for banks so that they can attain greater efficiency and more effective risk management at a lower cost.</td>
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Downscaling is a key component, with BOT asserting that it will push commercial banks to offer microfinance for the poor and ease rules to cut the operating costs of microfinance operations. BOT will permit lending on the basis of joint guarantees, while also requiring banks to keep their microfinance activities separate from other operations. Three basic approaches have been identified by BOT: (i) international microfinance institutions establishing a presence in Thailand, (ii) commercial banks setting up specialized microfinance subsidiaries, and (iii) the banks reaching out through agents such as cooperatives, or independent lending officers operating at retail stores. Each approach is meant to bring to bear existing sources of knowledge about microfinance methodologies or client bases. While BOT suggests that microfinance represents a viable business prospect for the commercial banks, the bankers themselves see it less as a line of business than as a form of corporate social responsibility with relatively low risk and low return. This suggests that uptake by the commercial banks will be minimal.

In order further to stimulate interest on the part of commercial banks, BOT issued its Microfinance Guidelines for Commercial Banks in mid-2011. Microfinance is defined as loans for business or professional purposes, for an amount not more than THB 200,000, with a 28% cap on interest and fees combined. There is no collateral or minimum income requirement, and the borrower can be either an individual or an organization. Banks are allowed to conduct this business outside of their branches and offices for the convenience of potential borrowers. The banks must provide invoices to notify their consumers of their debt burden, including payment

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33 Quote from “Financial developments and the Thai banking sector,” Keynote address by Dr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the Third Euromoney Thailand Investment Forum, Bangkok, 10 June 2009.

deadlines, outstanding debt, interest and other charges. Further, if a commercial bank wishes to provide services by a method not foreseen in the Guidelines, it can apply to BOT. Other BOT standards must be followed in such areas as asset classification, reserve requirements, debt collection, interest rate policies, service charges, and penalties. The Guidelines also apply to commercial bank borrowing by cooperatives and SMEs.

C. **Banks’ downscaling efforts and constraints**

The banks have reached out to some extent beyond their core commercial markets, for example, several maintain a substantial presence in low-income areas both urban and rural. This move was prompted in part by incentives offered in years past to encourage the opening of rural branches, and in part by the banks’ desire to cultivate “brand recognition” among a population of potential new clients. Moreover, savings accounts at the banks appear to be accessible to low-income clients in the sense that minimum deposits are small (minimum deposits generally 100-500 THB) and policies with regard to fees for low balance or inactivity are comparatively lenient. Another potential constraint is posed by Know Your Customer (KYC) requirements established by the Anti-Money Laundering Act – these tend to affect people without identity documents (although most Thai nationals have them), or those lacking citizenship or fixed addresses (these conditions would also make it difficult to get ID documents). In other words, those who may wish to open a bank account but are unable to do so would tend to be the very poor, undocumented migrants, and those who live farthest from rural bank branches.

There are a number of constraints to downscaling that BOT’s policy will have difficulty overcoming. The main ones are familiar. The banks are unaccustomed to serving the special needs of lower-income clients, while the high unit costs and information asymmetries in small-scale finance pose new risks. Prudential standards impose capital and operational costs that tend to make downscaling into microfinance unattractive to the commercial banks. Interest rate caps imposed on personal loans and microcredit are a further constraint. These factors reinforce the perception that microcredit is too expensive and too risky for the banks to take it up as a serious line of business. Some of the commercial banks are trying to “decentralize” credit and move authority to field, e.g. for loans up to THB 50,000, and to provide unsecured loans in line with the policies adopted under the FSMPs. But these steps are generally regarded as risky. Even when financial services are accessible to lower-income groups, the products on offer are not well-suited to the need. For example, lower income customers usually have few options for housing finance beyond short-term, high-interest consumer loans.

There is a continuing lack of sufficient information on the credit status of most prospective clients, especially those who have never had loans or accounts from a formal financial institution.

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35 We have not yet seen the release of any BOT standards in these areas designed specifically for microfinance.


37 BOT comments.

38 Commonly, information asymmetry favors the seller of a product due to its better knowledge of the quality of the product than the buyer. However, in this case the information bias is in favor of the buyer of services (the customer) who in the absence of sophisticated market information, has more knowledge of his or her capacity or willingness to repay than the lender.


40 Household interviews.
(see the discussion of credit information below). This issue takes on special importance as the banks explore outreach to potential client types who are less well known and considered riskier. Commercial bank models were not designed for small-scale credit or the kind of stable relationship lending, commonly used in microfinance, that builds the necessary record of information and trust over time. Banks report that they were involved in community lending in the past (for example retail-level leasing), but can no longer afford to visit borrowers or properly assess risk in rural areas. Community-based lending requires personal guarantees, even for the SFIs, or alternatively credit guarantees underwritten by the state. The consensus seems to be that the banks are not the best instrument for broadening inclusion.

Still, the commercial banks have been exploring the potential for downscaling, and some of them have experimented with new products. For several years, the banks have been moving into the SME market, i.e. firms with approximately THB 10 million to 500 million in sales. The overall population of firms at this level and below is estimated at two million. The biggest lenders in this market are Kasikorn Bank, followed by Siam Commercial Bank and TMB. As of 2009, Kasikorn was offering personal loans of THB 300,000 to 500,000 per borrower, having determined that smaller loans would not generate returns sufficient to cover operating costs. A Kasikorn official was quoted as follows: “Special institutions are necessary for lending to very small businesses, such as Grameen Bank in Bangladesh, which relies on local people in each community for operation and control, so they can save operating costs.” Other bankers agree, saying that moving further down-market would require costly reorganization. According to BOT, the banks are not making the necessary adjustments but either waiting and collecting information or easing into the microcredit market, using their existing commercial loan officers and infrastructure.

The most visible move toward downscaling has been the pilot effort by Krung Thai Bank (KTB), a majority state-owned commercial bank. One of KTB’s stated objectives is to support the government’s financial inclusion policies, which it does by such means as its KTB Community Bank project, which serves urban microenterprises, and its Loans to Village Funds program. The former provides loans starting at THB 50,000 and rising to a maximum of THB 200,000 (consistent with state policies on personal loans and microfinance) at a rate currently set at 14.5%. The latter serves the more highly-rated Village Funds (see below) with credit at rates of 5.25 to 6%. As of July 2011, KTB has a total of 920 Million Baht in micro-loans, with non-performing loans (NPLs) accounting for only 0.75 percent of all micro-credit volume (Lewis, Susewan and Tambunlertchai 2013). (The box below describes a recent KTB pilot program.)

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41 Bankers’ Assn and TDRI interviews
42 TMB interview
44 BOT interview
KTB began a pilot project in 2011 under which it is offering microcredit in 20 geographic areas for one year. The bank expects to expand the service to 200 areas across the country in 2012. The maximum loan amount is THB 200,000 per customer under Bank of Thailand regulations. Krung Thai has said that it aims to help grass-roots vendors access financing easily without resorting to loan sharks, and has set its microfinance interest rate at less than 20% (below the 28% maximum fixed by BOT).

Borrowers under the program must be vendors who have no bank statements. Bank officers work with owners of fresh markets to identify eligible vendors who require loans. The fresh market must be registered with the Public Health Ministry to ensure the quality of clients. About 240 fresh markets are registered, comprising more than 40,000 vendors, and the bank employs local people in each area to collect debts.

KTB said the microfinance portfolio would be no more than 1 per cent of KTB’s total retail banking portfolio because of the small size of each loan. KTB aims to increase the proportion of retail loans to 60 per cent within three years from 40 per cent currently.

KTB officials admitted that the maximum THB 200,000 loan is not actually sufficient for some markets such as Chatuchak in Bangkok. Furthermore, its unsecured microcredits are capped at THB 50,000. Beyond this level, a loan up to THB 100,000 requires a guarantor, and a credit in the 100-200,000 range calls for a second guarantor.

KTB has said that it wishes to incentivize borrowing and repayment in order to help vendors break away from the loan sharks (known as “helmet guys” since the collectors travel by motorbike). Thus, the bank sends staff (and agents) to the marketplace – a model also used by GSB – and provides inducements for prompt repayment including a rate increase to 20% for late payment, a rebate when on-time payment is made, and a 1% discount for good customers (i.e. payments consistently on time for one year).

Since collection is the biggest cost of its microfinance operations, KTB outsources collection to agents who are not bound by the same bank procedures, minimum wage, and other requirements. This approach required BOT approval. Other costs here include the risk of fraud or robbery, insurance against loss, and health insurance. KTB also confirms that it applies the same risk-weight to community banking loans as to regular personal loans. In its view, a viable microfinance market will require a risk-weight on a par with mortgage loans (i.e. 0.5 as compared to 0.75 for personal loans). KTB also carries NPL reserves of 100%, although its rate of non-performing loans is under 2%. This performance, together with the relative security of KTB microcredits as compared to unsecured consumer loans, could justify a lower reserve rate as both a reward and an incentive.

KTB’s future plans include raising small deposits and possibly setting up a microcredit subsidiary. In its view, a microcredit portfolio of THB 10 billion is needed to sustain a freestanding subsidiary. Further, a 20% ownership share in the subsidiary triggers consolidated supervision by BOT, an additional cost to KTB. The bank is trying to reduce the application requirements for microfinance clients. Its goal is a kind of streamlined one-stop process. Current

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46 BOT’s Notification on banking agents (9/2553) permits the appointment of representatives that are not banks, and in some cases need not be financial institutions. This makes cost savings possible, especially where agents are not required to meet standards applicable to commercial banks or public limited companies. See the section on banking agents (below).
47 KTB interview
requirements include identity and residence documentation, a market certificate or electricity bill, and approval by the spouse.\textsuperscript{48}

\section*{D. Retail banks and non-bank institutions}

FIBA provides for a second tier of banking institutions known as retail banks. The act defines them as limited-charter commercial banks focused on retail and SME finance, and excludes them from high-risk areas such as forex and derivatives. In 2005, MOF approved 4 retail bank licenses under policies adopted in FSMP (and later adopted as part of FIBA) (BOT 2006). The only institution now registered in this category is Thai Credit Retail Bank (TCRB).

At present, TCRB is the sole banking institution in the private sector that specifically targets modest income clients – salaried workers who earn between THB 7,500 and 60,000 per month, and small business operators with total assets of THB 5–200 million. Overall, TCRB's main products are in the credit and leasing categories (the latter via a leasing subsidiary), with an average loan size of THB 400,000. TCRB reported in 2011 an increase in its retail credit customer base of 37\% over the preceding year, with deposits totaling BHT 18 billion and loan volume 19.6 billion (Lewis, Susewan and Tambunlertchai 2013). TCRB seeks clients among small businesses, i.e. those with one or two employees and no financial statements, seeking to build knowledge and relationships in this sub-sector. The CEO asserts that loans are advanced on the basis of earning ability, although land and other physical collateral are used as backup.\textsuperscript{49}

It is not entirely clear why the retail banking niche has attracted so little interest in Thailand. Minimum capital requirements, which commonly form the major obstacle to successful application for a banking license, are significantly lower for retail banking. Minimum tier-one capital for a full (universal) commercial bank has been set at THB 5 billion, as compared to THB 250 million for a retail bank, a difference of 20 times. Further, procedures and criteria are in place for qualified retail banks to upgrade to full commercial bank status (BOT 2006), thus providing a graduation path from the one to the other.

Other countries with second-tier banks often limit their charters to defined geographic areas or sharply differentiate the respective services they can provide. The alternative is to establish standards and incentives that encourage a focus on a particular market segment such as SMEs and local retail services, or to have (fully or partially) state-owned banks serve this market. The most successful second-tier banks depend upon relationships with their regional and local communities (see the box below). Also, as with bank downscaling, interest rate caps can make it difficult for institutions in this tier to recover the high unit costs of extending microfinance services to the unbanked – and to finance start-up, learning, and scaling up.

\textsuperscript{48} Ibid
\textsuperscript{49} Sucheera Pinijparakarn, “TCRB to focus on small business,” \textit{The Nation}, April 17, 2013.
Box 5 The rise and fall of second-tier banks

Financial inclusion depends on there being an array of service providers differentiated into types and tiers. Classically, second-tier banking arose in the industrial countries when people founded mutual savings and loan societies to provide retail services not available from the commercial banks, which were focused on risky business ventures. The new institutions eventually became absorbed into the formal financial sector as limited charter institutions such as savings and loan institutions, regional state banks, and other kinds of community-oriented service providers. These institutions continue to offer a distinct menu of services based on a combination of long-term relationships, reliance on a defined community, and in many cases state support or policy incentives. Thailand had such community-oriented and mutual banks in the past, but they have largely disappeared as a result of taking on excess risk in the effort to compete with the commercial banks, and sector-wide consolidation.\(^{50}\) A similar dynamic led to the implosion of the bulk of the U.S. savings and loan sector in the 1980s.

The retail market in Thailand is increasingly being served by non-bank financial institutions (NBFIs). The MOF Notification on personal loans\(^{51}\) opened the market for small unsecured loans (maximum BHT 200,000) to non-bank companies, capping interest and fees at 28% per annum. These NBFIs are required to have THB 50 million in paid-up capital, to obtain a license (requiring, in effect, joint approval by BOT and MOF), and also to be registered as limited companies with the Ministry of Commerce. As mentioned above, BOT is required to apply consolidated supervision. This means that a bank providing personal loans directly and one that owns an NBFI engaged in this business are treated the same for purposes of regulatory thresholds.\(^{52}\)

At present, 27 of these personal loan NBFIs are licensed by MOF/BOT, 11 of which also provide credit card services. BOT exercises comparatively light supervision of these providers, examining (on-site) their compliance with the personal loan rules, including consumer protection.\(^{53}\) (For further discussion of NBFI services, see the box below.)

Box 6 A booming NBFI sector

A growing list of companies provide personal loans, credit cards, and cash card services (e.g. Ayudhya Card Services, Capital OK, Easy Buy, KrungsiAyudhya Card, Krung Thai Card, Promise (Thailand), and Tesco Card Services). Some companies provide a wider range of services, offering a combination of personal loans, credit card, and consumer leasing and hire-purchase services. For example, AEON Thana Sinsap (Thailand) company provides credit card services through its AEON card, personal loans, motorcycle leasing, and payment services. Some specialize in auto financing or leasing of agricultural equipment. Banks, SFIs, and dealerships also compete for this business. In terms of consumer credit, the non-bank personal loan companies have some 7 million accounts and an outstanding balance of THB 111.2 billion. Their average loan size of some THB 16,000 is just over one-quarter that of Thai banks, and half that of foreign banks – suggesting a different target market from the banks (Lewis, Susewan and Tambunlertchai 2013). This growth has increased the NBFIs’ share of all credit beyond the 9.5% estimated at the end of 2005 for the full range of non-bank institutions (Banking with the Poor and the Foundation for Development Cooperation 2010, Suwanaporn undated).

An unknown number of other companies apparently provide similar credit services. For example, most companies offering hire-purchase and lease financing to businesses are not

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\(^{50}\) BOT interview. Parts of this market niche are now occupied by retail banks, NBFIs, SFIs, and cooperatives (see below).

\(^{51}\) Notification of the Ministry of Finance under Section 5 of the Notification of Revolutionary Committee, No. 58.

\(^{52}\) This also means that the business advantage of operating an NBFI as a subsidiary of a bank is partially offset by higher regulatory standards.

\(^{53}\) BOT interview.
licensed for personal loan business, but since these transactions are not considered lending at interest, they are not subject to a rate cap. Indeed, small-scale lending is scattered across a range of institutions. Banks, SFIs, NBFIs, cooperatives, and informal financial service providers are subject to differing interest rate regimes, capital requirements, and consumer protection norms. There is no central database of small loans, though BOT does provide data on its website for personal loan and credit card loan balances. These factors make it more difficult to craft a coherent policy on second- (and third-) tier financial services, and to track progress in the various sub-sectors.

Further, the non-bank personal loan company does not appear to offer an ideal regulatory niche for microfinance. A few NGOs are reported to have tried to obtain NBFI licenses to carry out this business, but the THB 50 million minimum capital is said to pose an obstacle (Banking with the Poor and the Foundation for Development Cooperation 2010). An example is provided by the Common Interest, an NGO microcredit provider in the Chiang Mai region. That NGO applied for an NBFI license but was told it must meet the following conditions, which it found unworkable: continued use of the group lending model for all credit, no deposit-taking, and an additional capital infusion. The organization closed down.

The interest rate caps pose at least as important a barrier to microfinance, making cost-recovery difficult. It is doubtful that the regulatory framework for personal lending can accommodate the full range of microfinance methodologies. BOT has not yet fulfilled its intention to develop an appropriate regulatory category for microfinance, as it announced in FSMP II (BOT 2009):

“New entry would be permitted for service providers with expertise and proven success in microfinance. In this connection, the MOF and the BOT would consider new licenses on a case-by-case basis…”

E. Supervision issues

The banking sector is well-capitalized, conservatively managed and supervised, and has little direct involvement in microfinance. The regulatory and supervisory arrangements reinforce this orientation, and yet they have not prevented a few banks (some of them with partial state ownership, hence a dual bottom line) from focusing a significant portion of their services on small-scale clients.

The banks and licensed non-banks are dedicated to commercial and consumer finance services. In terms of small-scale services, the NBFIs have significant involvement in the provision of personal loans. The banks generally have entered the small-loan market through personal loan and credit card subsidiaries. Otherwise, they have shown very little interest in microfinance, with the exception of KTB, Kasikorn, and TCRB. The microfinance leader among commercial banks, KTB dedicates approximately 0.07% of its asset portfolio to microcredits (i.e. 200,000 THB or under). BOT treats these credits as unsecured consumer loans. As important for most of the banks is credit card business, in which customers typically are required to have 15,000 THB per month in documented income to qualify, and revolving SME credits of up to 30 million THB (which BOT assigns a risk weight of 0.75). Furthermore, the advantage to the banks of providing small-scale credits through subsidiaries – such as personal loan companies – is undercut by BOT’s use of consolidated supervision where ownership reaches 20%.

55 ADB comments.
Thus, regulatory standards and practice both show the low priority given to microfinance in the licensed banking and NBFI sectors. BOT’s prudential supervision reinforces this view. According to its 2011 Supervision Report, BOT planned to implement the Basel III standards in 2012 as follows. Thai commercial banks would be required to maintain three minimum capital adequacy ratios: a common equity ratio of at least 4.5 percent, a Tier 1 capital ratio of at least 6.0 percent, and a total capital ratio at least 8.5 percent (the same as the then-current rule). Additionally, BOT would require banks to hold a capital conservation buffer of 2.5 percent, to be phased from 2016 to 2019 (BOT 2012). In practice, the banks have been encouraged to maintain higher capital ratios than this. The average capital adequacy ratio for commercial banks in 2012-2013 is 15% of risk assets, with liquid reserves (kept in government bonds) at 6% (BOT interviews). This level of bank capitalization helps to ensure safety and soundness, but at the same time it means that credit is relatively tight. This situation makes it still more unattractive to serve smaller borrowers perceived as comparatively risky.

Moreover, BOT essentially has no experience with the supervision of microfinance as such. While its policies on personal loans and microfinance encourage small-scale services, the regulatory norms applied to micro credits are the same as those for small-business loans and individual guaranteed credits in the millions of THB. Moreover, micro credits are not segregated from other bank and NBFI assets – institutional, and especially consolidated, supervision lumps these together for purposes of analyzing risk and risk-management. BOT supervisors themselves reported having little concern, and no specific tools, related to microfinance supervision (BOT interviews).

To carry out its various functions including supervision of banks and NBFI s, BOT reports having a budget of some 3.7 billion THB (for 2012), and a staff of 3,771 (Jan. 2013). The priorities of any central bank should lie with macroeconomic stability and the safety of the banking system and its depositors – and this is true of BOT. Despite its policies and statements in favor of small-scale finance, BOT has not made this a central focus and does not appear to view it as a key part of its mandate.

A key concern of supervision is to protect savings. Unfortunately, reliable savings instruments are less easily available to low-income and rural populations in Thailand than credit. Only the commercial banks and SFIs may accept demand deposits (checking and regular passbook savings accounts) from the public, while financial cooperatives can mobilize savings from their members. Banks require only a minimum deposit of 100-500 THB for opening an account, and the requirements for maintaining an account free of charge (some account activity during the year, minimum balance sustained) are relatively lenient in international terms though not tailored to micro savers.

Under the banking law (FIBA) and related regulations, some financial firms such as credit foncier companies can accept term deposits, while personal loan providers (NBFI s) cannot. On the other hand, many NBFI s are subsidiaries of banks. In this capacity, they can channel bank funds to clients under the personal loan provision while potentially acting as depository agents for the banks to funnel savings in the other direction. Commercial bank deposits are protected by the DPA. The safety-conscious policy of ensuring a bank nexus for all collection of funds is in tension with the need to increase inclusion by opening up other kinds of deposit institution licenses.

This policy reflects Thailand’s desire to insulate the commercial banks from any possibility of a repeat of the 1997 crisis. As a result, the primary thrust of financial inclusion policy is made by other sectors such as the SFIs and Village Funds. The commercial banks’ direct contributions
toward inclusion and microfinance are largely symbolic. At the same time, the banks channel credit to the poorer clients indirectly via NBFI subsidiaries and state-guaranteed bonds that fund the SFIs, Village Funds, and other mechanisms. Thus, savings often end up in guaranteed deposits at the banks and SFIs, while state entities and non-banks carry the risk of development- and micro-lending.

Given the importance of savings, one part of BOT’s supervisory mandate that may deserve less emphasis is the oversight of credit-only NBFIIs. This is not an activity regarded internationally as a high priority for central bank monitoring. However, BOT is required to apply consolidated supervision when bank ownership of an NBFI meets the 20% threshold, and this policy appears justified in light of comparative practice and Thailand’s own history. Thus, although reducing the burden of supervising NBFIIs is attractive, the extent of bank involvement in NBFIIs might not permit such a reduction.
III. STATE BANKING: SFIS

The government-owned Specialized Financial Institutions are among the biggest suppliers of microfinance in Thailand. At the same time, their access to state funds, their policy-driven lending, and the advantageous position from which they compete with licensed institutions makes them a major concern from a regulatory perspective.

The SFIs compete with the commercial banks and others on all fronts, including deposits and credit. On the one hand, they can attract deposits by offering attractive rates and a safe haven for client funds. The SFIs benefit from a state guarantee of their deposits (without paying for deposit insurance), exemption from taxes (corporate, business, VAT), and subsidies to cover the higher cost of their policy lending and losses from their relatively substantial portfolio of NPLs. They are popularly regarded as more trustworthy than private banks, and the SFIs have the most extensive service networks outside the urban commercial districts. Competition on the deposit side is said to be keenest; both commercial banks and SFIs kept their deposit rates high during the floods of mid-2011 and their aftermath.\(^56\) The SFIs have been growing rapidly, increasing their share of the credit and deposit markets from 18% in 2003 to 27% in 2011 (a 50% increase).\(^57\)

SFIs are the biggest formal players in the Thai microfinance market, and carry out various government programs in this area. The two most prominent are BAAC, and the Government Savings Bank (GSB). While both BAAC and GSB target low income groups, BAAC’s main customer base is farmers, GSB having a larger share of urban customers. In addition to offering micro-loans directly to low income customers, many SFIs, especially BAAC and GSB, also have links with semi-formal financial institutions such as Village Funds and cooperatives (Lewis, Susewan and Tambunlertchai 2012). A survey of 3,000 people by the Fiscal Policy Office (FPO) of the Ministry of Finance showed participants’ perceptions of the relative merits of commercial bank, SFI, and Village Fund services. Commercial banks were deemed the least accessible. When Village Funds and SFIs were compared, the SFIs were rated higher for proximity and transparency, but lower on interest rates and fairness in granting loans (FPO undated).

Each of the SFIs is governed by its own statute, and all are under the supervisory responsibility of the FPO, which delegates examination functions to BOT. Some of the commercial banks have state ownership as well – for example, Krung Thai Bank is majority state-owned, and TMB is 30% state-owned. These banks fall under the purview of FIBA and BOT, although their state ownership shares (as with state-owned enterprises generally) are exercised by MOF through its State Enterprise Policy Office (SEPO). This gives the state an important voice in the direction of these banks, especially KTB. The critical point here is that, while the SFIs perform many of the same functions as the commercial banks and compete in some of the same markets, they fall under a different legal and supervisory framework. We discuss the two main SFIs below, and then return to the overall questions of governance in this state-owned sector. Throughout, we are concerned with the impact of the SFIs and the policies that they implement on microfinance and financial inclusion.

A. BAAC

BAAC has become the predominant rural lender in Thailand. It is now providing financial services both directly to farmers and through agriculture cooperatives and farmers’ associations.

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\(^56\) TMB interview
\(^57\) “Govt banks crowd out private investment," Bangkok Post (Online News: Bangkok Post Learning), March 2, 2012
at below-market interest rates. BAAC is deemed a success due to its depth of outreach to Thailand’s rural poor and its large-scale savings mobilization. By 2010, BAAC had extended its reach to approximately 98 percent of all farm families in Thailand through its 75 provincial offices, which supervise 977 branches throughout the country, along with 957 field units scattered around local areas nationwide. A field unit is essentially a credit officer who travels to client groups by motorbike and transmits information to the branch – certain steps such as disbursement of loan funds require the client to travel to the branch. BAAC is reported to have very low administrative costs (about 2 percent of total assets), partly as a result of subsidies (see below). At the end of FY 2009, a total of 6.1 million farm families had access to BAAC’s credit services. Of these, 4.5 million families were served on an individual basis, while 1.6 million families were members of agricultural cooperatives and 6,664 were members of farmers’ associations. Consistent with its rural focus, nearly all its branches are outside Bangkok, with the largest number in the Northeast (BWTP and FDC 2010, BAAC 2010, Lewis, Susewan and Tambunlertchai 2012).\(^{58}\) BAAC reports that some 30% of its credit portfolio is comprised of loans under 200,000 THB. Of its 5 million customers, about 3.5 million are farmers, many with one-year crop loans, and the remaining 1.5 million are cooperative members (BAAC interview).

BAAC’s deposit products include current accounts, savings accounts, fixed-term savings accounts, and savings accounts with special conditions. These latter accounts include Om Sap Thawichoke and Omsap Thawisin, which encourage people to save by offering incentives such as income tax exemptions\(^ {59}\) on the amount deposited and the chance for account holders to win prizes. BAAC also provides nationwide money transfer services, online loan repayment services, and payments services for public utilities. Further, BAAC runs several government projects including the rice pledging program, and the farmers’ credit card scheme. The crop pledging scheme, nominally a warehouse financing scheme for farmers, serves as a price support mechanism, since it fixes grain prices at higher than market prices, thus underwriting loss-making loans to farmers. The program is also said to be plagued by graft, theft, black market dealings, and cross-border smuggling.\(^ {60}\)

 Typically, BAAC sends staff to villages on selected days to provide financial services. BAAC makes unsecured loans to a group of borrowers (minimum of seven persons) who are liable for each other’s loans. Initial loans are at 12% per annum. If every member in the group returns both principal and interest on time, this group will be able to borrow again at a longer term and lower rate. If one member of the group does not repay on time, the whole group will not be allowed to take another loan until this member repays.\(^ {61}\) Larger loans are secured with a combination of guarantors (one or two, depending on the amount), a land title document, and a group guarantee.\(^ {62}\) Those with no income or guarantees have no access to BAAC credit. Thus, the bank encourages clients to form groups to cross-guarantee their loans. Some graduate to individual loans if they have land for collateral. The groups select their leaders, who supervise and manage the groups, recommending loans to the BAAC credit officers.\(^ {63}\) (The bank also provides services through locally-established institutions – see the box below.)

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58 Also, Ennoo Susewan interview
59 A state benefit provided as part of BAAC’s policy function.
60 Frauds include the substitution of old or spoiled rice and the theft or smuggling of warehoused stocks. Lewis, Susewan and Tambunlertchai (2013), BAAC (2010), Arunmas, Phusadee, “Fears of rice fraud rises,” Bangkok Post, May 1, 2012.
61 Doi Chang household interviews
62 BAAC interview
63 Ennoo Susewan interview
Box 7 BAAC Community Bank Project

*Smallholders and poorer rural residents have often been unable to access formal financial services. In response, BAAC in 2010 launched the Community Bank Project, which aims to improve access by strengthening community financial institutions (CFIs). The latter are local groups providing savings and credit to members. BAAC gathers or links these groups together, encouraging them to form larger “community banks,” and providing technical assistance and training in such areas as financial management. Anyone can be a member of a group, which must have a minimum of five members. Members make regular deposits, and the groups extend unsecured loans. The community banks obtain low-interest wholesale loans from BAAC and on-lend to the groups. These CFIs may (or may not) be formal organizations (e.g. cooperatives, companies, or NGOs); in any event, they are not financial institutions and are not supervised by BOT.*

The Project’s main products are micro-loans for occupational purposes, credit for the purchase of homes or real estate, educational loans, and loans to help customers pay off their debt to loan sharks. As of March 2011, BAAC provided financing to 63 community financial organizations, totaling THB 221.92 million in loans to 28,454 members (BAAC 2010, Lewis, Susewan and Tambunlertchai 2013).

BAAC lends to the Village Funds as well. BAAC credit officers work with the Village Fund’s committee, conducting a feasibility study and assigning the fund a credit score based on an assessment of its management, capital, participation of members, profit, and accounting system. As of mid-2013, BAAC had served some 19,000 Village Funds. The funds borrow wholesale at 5-7%, and on-lend to members at 9-12%. As funds spin off CFIs (see below), BAAC mentors these new institutions, helping them establish a cooperative governance structure. The CFIs get essentially the same credit terms as the funds, borrowing on average six million THB. The Village Funds and CFIs are reported to have NPLs of 7%. BAAC reports that it visits the CFIs twice per year, and requires them to send monthly cash flow statements – but not all comply (BAAC and FPO interviews).

BAAC is governed by the Bank for Agriculture and Agricultural Cooperatives Act, B.E. 2509 (1966) and regulations issued by MOF. The law provides for BAAC’s purposes, i.e. support to farmers and rural cooperatives, authorizes it to engage in activities equivalent to those of commercial banks (with some limitations), and exempts it from taxes.

**B. GSB**

GSB’s mission is to promote savings among adolescents and low income people. The bank provides all types of financial services including deposits, credit, transfers, and bill payments. GSB also carries out government initiatives, which currently include assistance to flood victims and flood prevention projects. GSB’s main microfinance offerings include loans under the government’s rural community development policy, and the GSB People’s Bank program, providing funds to SMEs and low-income individuals who want to start their own businesses. GSB distinguishes itself from BAAC in providing financial services to low-income individuals who are vendors or entrepreneurs and who do not need to be affiliated with agricultural households. In terms of payments, GSB clients can use the bank’s online payment facility for

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64 Definitions of CFIs vary. GSB includes in this category Village Funds, cooperatives, and its Community Banks (www.gsb.or.th, see below). Thus, the only prudential oversight would be provided by the NVUCF, the Ministry of Agriculture and Cooperatives, or the SFIs (principally BAAC and GSB).

65 Also BAAC interview
internet and mobile phone, credit card, utilities, insurance, and lease payments. GSB provides money transfer services through BAHTNET66 (Lewis, Susewan and Tambunlertchai 2013).

GSB’s emphasis on outreach to lower income communities is clear in its offerings and service outlets. The bank provides loans as small as THB 2,000. It delivers services through some 600 branches nationwide, a range of sub-branches and service outlets (including Islamic banking outlets), mobile service buses and boats, over 200 bank outlets at schools, and over 1,000 ATMs. The Bank has also expanded its GSB Express Service by using motorcycles to serve large and corporate customers in the Bangkok metro area. (For other GSB programs, see the box below.)

Box 8 GSB: People’s Bank and Community Bank Programs

GSB’s People’s Bank Program is one of its most popular microfinance services. Piloted in 2000 with CGAP assistance and rolled out the next year, it provides low-interest credit (less than 1 percent per month) for businesses and investment activities, with THB 72 million in budget support from the government. By 2007, the program had over 1.68 million clients with a total loan value of THB 42.4 billion (equal to 9% of GSB’s total loan portfolio), reaching THB 46 billion by December 2012.67

A further innovation in outreach is the Community Bank Program. This program elicits direct community involvement in operation and management (via an advisory committee), together with the GSB and local government. Each Community Bank is set up according to the needs of the local population and owned by everyone in the community. Members have a voice in the type of financial services provided, and are at the same time expected to maintain and improve the performance of the bank for the maximum benefit of the community. The first Community Bank was established in Chiang Mai province in 1999, with the number rising to 18 at present (www.gsb.or.th). Other government banks such as KTB and BAAC have also applied this concept to their operations (BWTP and FDC 2010).

GSB is governed by the Savings Bank Act, B.E. 2489 (1946), as amended. The Act sets out the bank’s general goals and activities, places it under the supervision and appointment power of MOF, exempts it from tax, and guarantees all of its financial obligations.

GSB is often cited as the best run of the SFIs. It collects debt repayments in small amounts, consistent with the best microfinance practice. Unlike its peers, it has not sought capital injections, and its overall NPLs have fallen to about 1%.68 At the end of 2007, GSB had a total of THB 644 billion in savings deposits and a total loan portfolio of THB 470 billion. By end 2010, these figures were THB 1.18 trillion and THB 1.11 trillion respectively. GSB’s administrative costs amounted to 1.5 percent of total assets in 2007 and 1.19% in 2010, while non-performing loans dropped from 3.67% in 2007 to 1.2% in 2010 (Banking with the Poor and the Foundation for Development Cooperation 2010, GSB 2011).

GSB has also been growing fast. Its average annual loan growth rate from 2009 through 2011 was 28%. In 2009 alone, when most banks slowed lending due to the sub-prime crisis, the GSB loan book grew by almost 40%. The bank’s deposits, meanwhile, averaged 29.5% annual growth during those three years, and 31% in 2009. These figures can be compared with 7.4%, the top loan growth of a commercial bank in 2009 or 13%, the maximum deposit growth in the same year. In 2010, a year of expansion for the financial sector, maximum loan and deposit

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66 Bank of Thailand Automated High value Transfer Network, the real-time gross settlement system for financial institutions with accounts at BOT.
68 FPO interview.
growth rates for commercial banks were 32% and 14%, respectively. (“Govt banks crowd out private investment,” Bangkok Post, 2/03/2012.) It is possible that this growth comes at the cost of weak risk management (see the box below).

Box 9 GSB’s record: too good to be true?

Not every observer is happy with GSB’s current condition. Research on GSB’s People’s Bank program suggests that overall NPLs for the bank are about 5%, while in the microfinance portfolio, NPLs may be much higher. If this is true, it is likely due to the rapid expansion of credit mentioned above, and the apparent difficulty GSB has in attracting staff and providing quality service at the level of a commercial bank. Competition and weaknesses in credit information play a role as well. In one Bangkok market, GSB has a small branch located on the premises, and sends staff to collect savings from the vendors twice a week. On one such staff visit witnessed by the author, the amounts saved ranged from THB 150 to THB 5,000. A number of loan sharks or “helmet guys” are also said to appear regularly. With a wealth of credit sources, vendors have on occasion been known to default, disappear from a particular market, and set up in another location where they could borrow from another institution. In some cases, if one spouse defaults, the other can borrow, since borrowing by multiple family members appears not to be comprehensively tracked by NCB.

C. Policy, governance, and supervision of SFIs generally

The above discussion is meant to be illustrative. Other SFIs with significant activities in the arena of financial inclusion are Government Housing Bank (GHB), The Small and Medium Enterprise Development (SME) Bank, Islamic Bank, and Thailand Post.

1. Policy functions

The SFIs engage not only in the provision of financial services after the manner of commercial banks and others, but also implement government policies or directives, or what are known as Public Service Accounts (PSAs). The PSAs are the government’s policy programs based on concessional terms and conditions to the target group. This diversity of activities poses challenges for FPO’s monitoring of SFI performance. It has been difficult for supervisors to differentiate the various parts of the business stream – PSA vs. commercial – and to determine the distinct contributions of each to SFI performance. Thus, ADB supported a project starting in 1999 to assist in developing two distinct accounting systems for these different activities, with the aim of providing more accurate performance measurement, a clearer differentiation of results for commercial versus policy activities, and more reliable budgeting for future activities. (For recent examples of major policy initiatives carried out by the SFIs, see the box below.)

The PSA system includes historical financial data, Key Performance Indicators identified by the Ministry of Finance, a corporate governance database, an early warning system, and a portfolio dataset with indicators of portfolio quality and performance. The ADB loan component of the project supported the development of restructuring plans for the SFIs. Meanwhile, a grant component helped to rationalize the government’s role within the financial sector, improve governance of SFIs, and develop strategies for SME financing (ADB and FPO undated).

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69 Interview with academic researcher in Bangkok.

70 Thailand Post opened a micro credit subsidiary in 2011 that subsequently closed down.

71 Note that the ADB TA and loan took care of BAAC, IFCT, SIFC and SICGC. Today only BAAC and SICGC remain. (ADB comments).
The government has historically relied on SFIs to provide credit to sectors of the economy not usually served by commercial banks. However, SFIs extended their services into new areas in response to a changing business environment and opportunities. As a consequence, FPO determined that its performance evaluation systems for SFIs needed systematic review and further updating. The monitoring system was to be upgraded to provide information for determining SFI self-sustainability, requirements for government support, and appropriate regulations. Further, the Best Practices Code for SFI Corporate Governance was created, providing generic articles of association for SFIs. FPO worked with BAAC, which adopted and implemented the articles of association, an experience that is expected to assist in improving the articles of association of other SFIs (ADB and FPO undated).

2. Supervision

FPO is responsible for supervising the SFIs, while SEPO monitors the performance of their different functions – with these differentiated regulatory and management functions being housed under the same roof at the Ministry of Finance. FPO reports to the Ministry, passing on its recommendations. In its supervisory function, FPO uses BOT regulations as its guidelines and accounts for the differing functions of the SFIs through the PSA system mentioned above. FPO has no supervisory norms developed specifically for the SFIs, but aims to apply the same standards as BOT uses for the commercial banks – with some exceptions. FPO also provides legal oversight, for example reporting frauds such as bribes, falsified documents, and overpriced collateral to MOF. SEPO oversees the performance of business and policy functions, essentially from a controlling shareholder perspective. SEPO monitors how profitable or sustainable the SFIs are in their purely business functions, according to a set of indicators on corporate governance, management, loan performance, and policy implementation, as well as financial return and any new capital requirements. The SFIs report quarterly, and SEPO sits on their corporate boards, representing the state’s interests.  

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72 FPO interviews
73 Presumably, in interest and administrative costs.
74 FPO and SEPO interviews.
Examinations are carried out by BOT. Section 120 of the Financial Institutions Business Act empowers MOF to delegate authority to the Bank of Thailand to “generally supervise the business” of any SFI, to require it to provide information, to remove or appoint officers by law, to prescribe policy guidelines, and to order action to be taken (or not taken). As a result, BOT receives quarterly reports from the SFIs (via FPO), inspects all of the SFIs annually, and sends its examination reports to the Ministry of Finance.

SFIs such as BAAC and GSB are intended to have the same capital adequacy ratio (8.5%) and reserve requirements as the commercial banks, while other BOT prudential standards are adjusted in their application to the SFIs. BOT carries out annual SFI bank examinations, interpreting its norms in light of the SFI laws and regulations. The key indicators here deal with composite risk (a combination of market, operations, liquidity, strategic, and credit risks). No fees are charged for supervision. In addition, the Auditor General conducts annual audits, contracting this to outside agencies.

The SFIs report monthly, using a balance sheet format provided by FPO. The latter uses a series of 28 datasets covering the CAMELS rubric, risk factors, key performance indicators, etc. The Auditor General provides quarterly audit notes. BOT sends its examination reports to MOF, which forwards them to FPO (sometimes withholding portions) for analysis and recommendations. FPO reports that it uses some BOT standards – about 20% of them – covering essentially the Basel I principles. FPO tracks warning signs, most importantly whether CAR falls below 10% (FPO interviews). In terms of regulatory-supervisory treatment of microfinance specifically, the SFIs appear to be monitored in the same way as commercial banks. As in the case of BAAC, the SFIs can lend up to 200,000 THB with no collateral, but there are otherwise no specific standards for microfinance.

The PSA system requires any government policy initiative having a fiscal impact on the SFIs to be funded from the state budget. Contingent liabilities (e.g. losses on the rice program) are not reported on the state balance sheet, but additional capital is set aside by the SFI (ADB and FPO undated). State initiatives include income guarantees, farmer credit cards, and the rice program in which warehoused grain secures loans to the growers. The latter, as mentioned, is essentially a subsidy program since the collateralized rice is valued at above-market prices, and the shortfall in sales revenue is forgiven. At the start of a program, the cabinet approves subsidies to the SFI. If a loss affects the institution’s whole annual balance sheet (net of subsidy payments), the SFI submits an invoice to the PSA to make up the difference. The advance budget allocations for such programs have been insufficient in recent years. As a result, the SFIs have advanced their own funds or gone to the money markets.

It has been proposed that FPO put in place a monitoring system to provide information on SFI self-sustainability, requirements for government support, and appropriate regulations. Moreover, FPO needs to have in place a computer-based early warning system that allowing early identification and intervention for fiduciary and related problems among the country’s SFIs. Instead, the current FPO system relies primarily on periodic reports and selective monthly financial indicators submitted by SFIs (ADB and FPO undated). It appears that at least some of these proposals have been accepted but not yet implemented.

The SFIs are advantaged by a kind of regulatory forbearance, since FPO has limited staff and capability, and as a result exercises comparatively light-touch oversight. As compared to the

75 Under the PSA system, the state should in principle cover this capital cost, but it is not clear to what extent it does so in practice.
76 BAAC, FPO interviews.
hundreds of trained staff dealing with BOT’s supervision of commercial banks and (delegated) oversight of SFIs, FPO has some 20 personnel for this purpose with only limited background in banking supervision. SEPO has similar constraints. The capacity shortfall is especially a concern for the prudential oversight of the four main SFIs that take deposits. The SFIs are also widely understood to be political instruments and centers of political authority. This strengthens their hand in dealing with MOF, which has shown great reluctance to hold them to account for lapses such as politically motivated lending (in one case, to members of parliament). Nor are the results of BOT examinations subject to the same level of public scrutiny as those done for the commercial banks. Observers have expressed concern that there are no meaningful checks and balances in the SFIs, that there is no way to vouch for their risk management systems, and that it cannot be verified whether their credits are generally reaching the target populations. Further, the SFIs are supervised by their titular owner, the MOF. Thus, accountability and transparency are diluted.77

The quality of SFI management is mixed. GSB is profitable, sending earnings to government, while BAAC is not. SME Bank has suffered losses on both sides of its balance sheet as a result of a fraud carried out some 6 years ago. This situation prompted a change of management. While SFI managing directors are contractual and can be replaced, virtually all other personnel are public servants who can be fired only with difficulty (FPO interview). This is one of many ways in which the SFIs are unlike commercial banks and other corporations.

Currently, the SFIs are nominally treated as commercial banks, except that they are responsible for microfinance and development lending. This role is supported not by regulation but by state policies backed by subsidies. Policymakers, bankers, and others in Thailand accept this division of labor, thus virtually exempting the commercial banking system from responsibility for financial inclusion efforts. In other words, the existence of the SFI sector, carrying out the state’s predominant role in microfinance and related areas, enables the commercial banking sector to continue operating in a stable and profitable manner with little more than token efforts to reach underserved populations. The profit-making sector is unlikely to do more until the SFIs are reformed.

3. Impact

The weaknesses of the SFIs on the level of governance and financial sustainability have taken on much greater significance with the rapid growth of these institutions, which now account for about one-quarter of the financial sector.78 Thus, the ratio of non-performing loans is increasingly a cause for concern. As compared to the commercial banks, with an average ratio of NPLs of just under 3%, GSB’s official figure is slightly below 1%, and the other three major SFI lenders (BAAC, GHB, IB) have an average of 7.65% (2011 figures; Lewis, Susewan and Tambunlertchai 2012).

One could regard this relatively weak repayment record as simply the cost of the SFIs’ providing the small-scale finance outreach and experimentation that the private sector will not undertake. The SFIs are furnishing public goods that are covered by the state budget. But these public goods also come with public “bads”: weak repayment discipline that can spill over into other parts of the financial sector, an unlevel playing field that private capital appears reluctant to enter, and unsustainable government credit programs drawing resources from the state budget and contributing to a growing public sector debt. This debt, in turn, is financed in part by the

77 FPO, BOT, Bangkok Bank, Bankers’ Association, Ennoo Susewan and World Bank interviews.
78World Bank interview. The share of SFIs in the overall savings and loan market is estimated to have risen from 18 to 27 percent between 2003 and 2011, “Govt banks crowd out private investment,” Bangkok Post, 2/03/2012.
SFIs’ lending to themselves (indirectly, by funding a portion of government debt) in order to cover their losses. A recent IMF report neatly captures all of the above concerns about the SFIs (see the box below).

An additional factor has been the phase-in of deposit protection limits under the DPA. The deposit guarantee dropped from the original unlimited coverage to a limit of THB 50 million per account (until a further reduction now slated for 2016). BOT has also considered raising deposit insurance premiums for commercial banks and other institutions governed by FIBA. Thus, the SFIs’ explicit guarantee of all deposits – in addition to the higher deposit interest rates that they provide – has made saving with the state banks an irresistible proposition for many. GSB, for example, saw deposits grow nearly 30% in 2011. At the time, it offered 1.5% for savings as compared to 0.87% offered by major banks. The outstanding deposits of GSB already exceed those of Bangkok Bank, Thailand’s largest commercial bank in terms of assets. According to news reports, the shift of funds to the SFIs involves not only small savers but also larger investors moving funds from stocks to SFI deposits to ensure protection of their investments and also enjoy higher returns ("GSB to benefit from cut in deposit protection," The Nation, February 6, 2012). The evidence for such a shift is mixed, and BOT officials argue that there has been no significant movement of this kind.

**IMF concerns about the SFIs**

[The SFIs] enjoy preferential treatment in terms of tax, accounting, auditing and regulatory requirements. SFIs are both owned and supervised by the Ministry of Finance. Having a different regulatory regime and according SFIs special privileges contribute to an unlevel playing field when SFIs activities overlap with those of commercial banks. Moreover, SFIs compare poorly with commercial banks in terms of banking soundness. They have higher levels of NPLs; they are less liquid and have significantly lower levels of capital. If standard prudential rules were applied to SFIs, some would need to be recapitalized. The recent World Bank Financial Sector Assessment Program (FSAP) module estimates such recapitalization needs at about 2 percent of GDP, mostly due to capital requirements for the BAAC. Since the SFIs are subject to different supervisory standards, the financial strength of these institutions could be weaker than suggested by the data, and the corresponding need for capital could be somewhat higher. In addition to past liabilities, some government plans, such as the rice price guarantee scheme and the debt moratorium for farmers, are to be implemented through SFIs and could deteriorate their balance sheets further.

The IMF calls for “decisive progress” on SFI (and fiscal) reform by clearly refocusing the SFIs’ activity on their core mandate, by applying bank supervision standards and external audits based on best international accounting practices, and by payment of implicit or explicit subsidies out of the government’s budget. The Fund also welcomes a BOT commitment to impose deposit insurance levies on the SFIs equivalent to those paid by the commercial banks (IMF 2012).

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79 Developments on the credit side are at least as worrying. The concern arises with respect to official policies such as the SFI refinancing of loan shark credits as well as the unofficial refinancing by the SFIs of non-performing commercial bank and Village Fund loans. In this way, the SFIs sometimes benefit both lenders and borrowers by restructuring individual debt, in effect becoming a “bad bank” for non-performing assets. CENFRI comments.

80 Quote from IMF (2012: 22).
IV. SEMI-FORMAL AND INFORMAL PROVIDERS

A. Cooperatives and Village Funds

This category of service providers is sometimes classified as “semi-formal,” having some form of state sponsorship or oversight but not being regulated as financial institutions. Since none of these organizations is licensed as a bank or consumer credit company, they do not fall within the Microfinance Guidelines for Commercial Banks or the Personal Loan regulation (for NBFIs). Most are subject to the general 15% interest rate cap.

Other semi-formal providers operate as NGOs, which in Thailand can register as either associations or foundations. The rules for their establishment and operation have been described as quite restrictive for microfinance providers. Foundations, for example, require a deposit of THB 200,000 (in certain cases THB 500,000) before registration, a deposit that must remain in place for the life of the foundation. Moreover, foundations are not permitted to engage in business. On the other hand, a foundation is a legal person that can conclude contracts and take other steps, and is subject to a lower tax rate (levied on gross receipts) than a company. NGOs engaged in microfinance in Thailand frequently avoid direct provision of financial services, preferring to support cooperatives or savings groups.81 Alternatively, some NGOs have explored the option of transforming into NBFIs, but have generally found this to be inconvenient, due in large part to the THB 50 million minimum capital requirement. For the savings groups and VFs, registration as a foundation or association offers a possible route to formalization, but this seems to create as many problems as it solves. In Thailand, NGOs are not a major presence in microfinance.

1. Cooperative financial institutions

The cooperative movement has a major presence in Thailand. Of the nine recognized types of cooperatives, four appear to have significant involvement in microfinance: agricultural and savings cooperatives, credit unions, and farmers’ groups. Credit unions serve non-salaried workers in markets, providing both savings and welfare support. Savings cooperatives provide savings and credit services to urban, salaried employees, and are organized by workplace. They offer salary deductions for savings, and loans requiring two guarantors. All told, there are some 12,000 cooperatives across Thailand, with a total membership of over 12 million, registered capital of THB 523 billion, and business turnover (including savings, credit, and sales) of nearly THB 1.7 trillion. In 2011, the savings cooperatives accounted for 80% of this turnover (Lewis, Susewan and Tambunlertchai 2013). The total profit of the cooperative sector was recently reported at 30 billion THB (CPD interview). Nearly 14% of rural households were estimated in 2007 to have borrowed from cooperatives.82 The Cooperatives Promotion Department (CPD) reports that there are about 1,290 cooperatives providing financial services.

Despite the growth in recent years, the cooperative sector is troubled. The number of institutions has dropped since the 1990s, with concerns being raised about outdated regulations and weak governance in the sector.83 These organizations offer only a limited menu of services, and are reported as having inadequate liquidity, insufficient business scale, and a lack of effective and efficient management systems. Evaluations done by the Cooperatives Audit Department (CAD) of the Ministry of Agriculture and Cooperatives found that in 2008, some 40.5% of cooperatives did not meet their operational standards (an improvement over 2006), with agricultural

82 BWTP (2010); “The Life Insurance Business and the Savings Cooperatives” (unpublished study).
83 FIPD interview.
cooperatives performing worst at 49% (also an improvement from 2006). Savings cooperatives and credit unions performed better at 8% and 28% respectively. The low performance was attributed to a shortage of accounting staff, leading to a lack of appropriate management information (BWTP and FDC 2010). An estimated 5% of cooperatives were shut down in the last 15 years due to the financial impact of the Asian Financial Crisis and other events such as pest infestations, bird flu, and flooding.\(^{84}\)

Cooperatives are supervised by CPD and CAD, under the Permanent Secretary of the Ministry of Agriculture and Cooperatives, as provided in the Cooperatives Act B.E. 2542 and its implementing regulations. CPD defines standards for financial cooperatives, which include credit unions and savings cooperatives, and financial activities of other cooperatives (e.g. agricultural). The Act prescribes the placement of reserve funds at state-owned banks, applies bankruptcy law to the cooperatives, and limits the outside placement of funds to bank deposits, other cooperatives, and shares of banks and state enterprises. Loans are to be made only to members, and funds can be sourced from profits, member shares and deposits, and bank credits (primarily from BAAC). The Act provides for interest rate and dividend ceilings. The credit interest rate cannot exceed 15% for most cooperatives,\(^{85}\) though most agricultural cooperatives set rates at 8-10%, and saving cooperatives at 6.5-7%. The regulations limit interest rates on deposits to 7%. Dividends are limited by regulation to a maximum of 10% of profits, with a further 10% being dedicated to reserves and 5% to the Cooperative League. There is neither a deposit guarantee nor a liquidity facility as such available to the cooperatives (CPD and CAD).

The cooperative regulations are considered complicated and onerous by cooperative managers, while CPD struggles to oversee the activities of this sector. The difficulties of financial cooperative governance and oversight have led to some discussions of reform. Large and small institutions raise different issues. Bigger cooperatives such as the Electricity Generating Authority of Thailand's saving and credit cooperative have economies of scale, high-profile board members, and political influence. Local community cooperatives are more easily managed and supervised, but are numerous and therefore expensive to supervise. This poses dilemmas in the allocation of supervisory resources. This problem is sometimes resolved in other countries by some combination of consolidation, prioritization of larger cooperatives, and strict limitation of membership to that based on a common bond.

Further, it is often the case in other countries that agricultural ministries oversee financial cooperatives, but without the requisite tools and expertise in financial system management. Many observers see the same problem in Thailand. Elsewhere, financial cooperatives have often been brought under the purview of the banking regulator, directly or indirectly. In Thailand, BOT would like the cooperatives to report all loans to the Credit Bureau, so that BOT has access to their financial information. CPD on its side argues that, if BOT engages in some form of supervision, then the financial cooperatives should have the same advantages as other financial institutions, including the guarantee afforded by the Deposit Protection Agency.\(^{86}\)

2. Village Funds
The National Village and Urban Community Fund, a 2001 initiative of Prime Minister Thaksin, supports and oversees a nationwide effort to set up local financial associations, encouraging savings, providing rotating credit for livelihoods, and furnishing social services. The government

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\(^{84}\) This is a percentage of all types of cooperatives, not just financial cooperatives. CPD interview.

\(^{85}\) Credit unions and savings and credit cooperatives may charge up to 19%. CPD interview.

\(^{86}\) *Ibid.* CPD did not comment on the financial cooperatives' willingness to pay the necessary fees for the guarantee.
provided initial seed money of THB one million to each Village Fund, creating one of the largest microfinance initiatives in the world. As of August 2012, there were 79,255 village and urban community funds. The total amount of circulating capital for all funds is THB 162 billion,\textsuperscript{87} and there are nearly 13 million members.

The Village Funds are permitted to make loans for up to two years and THB 20,000 (recently increased to 30,000) from the original seed money and a portion of interest earned. A separate account is to be maintained from members’ shares and deposits, along with the remaining earnings, and can be used for loans up to THB 50,000 for more than two years. Additional funds may be borrowed from banks, usually BAAC (Lewis, Susewan and Tambunlertchai \textit{2013}). Each village sets its own interest rate for loans, usually around 6\% per annum but not to exceed 15\%. Borrowers must have an income-generating project in order to borrow up to the normal limit of THB 20,000, but can get higher amounts if they meet a more rigorous standard of creditworthiness, and can get emergency loans of THB 10,000 without having a project.\textsuperscript{88}

Evidence suggests that that the Village Funds have been well-targeted to poor households and have increased their income, but that cost and sustainability are a concern. An FPO survey of 3,000 households, for example, found that people considered borrowing from the Village Funds especially advantageous due to low rates and the lack of a requirement of either collateral or business experience (FPO undated). A World Bank study, based on data covering nearly 35,000 households from the Thailand Socioeconomic Surveys of 2002 and 2004, found that the borrowers were mainly poor and agricultural. Village Fund borrowing in 2004 was associated with, on average, 1.9 percent more income, 3.3 percent more expenditure, and about 5 percent more ownership of durable goods.\textsuperscript{89} Research by Kaboski and Townsend (2010) found that consumption increased more than one-for-one with the credit injection, with the impact on individual households varying from minimal to very substantial. But the Village Fund intervention appears to be less cost effective on average than a simple transfer program because it saddles households with interest payments.

The cost and sustainability issue comes to the fore when repayment rates are estimated. The National Village Fund estimates NPLs at 4\% now, although they reached 10\% during flood recovery,\textsuperscript{90} and studies by the Fund and others report that only 90\% of loans from the Village Funds are fully repaid. This suggests a repayment performance similar to the average for the SFIs, although interviews suggest it is common for Village Fund members to borrow from another source and repay when pressure is exerted for collection. The recent moratorium does not apply to loans taken from the Village Funds, although borrowers do benefit in the case where their Village Fund refinanced from one of the SFIs before the cut-off date.\textsuperscript{91}

Many observers express concern about the governance of the Village Fund program. The Fund reports to the Prime Minister and not MOF or BOT – and so is essentially self-regulated.\textsuperscript{92} The National Village Fund provides guidelines on how villages should establish and manage their funds, though in practice, local operators have substantial discretion in this regard. The villages choose their own committees, who set the rules. Within the limits fixed by the Fund, they can set interest rates, maximum loan amounts, and the terms of the loans. Given this devolved

\textsuperscript{87} The current government doubled the Village Fund’s original capital in response to low savings and earnings (Lewis, Susewan and Tambunlertchai \textit{2013}), see below.
\textsuperscript{88} Village Fund interviews.
\textsuperscript{89} Though instrumental variable tests showed a smaller marginal effect (Boonperm et al. 2009).
\textsuperscript{90} National Village Fund (NVF) interview
\textsuperscript{91} Village Fund interviews
\textsuperscript{92} FIPD interview
governance structure, the NVCUF headquarters in Bangkok has only limited information on risks and liabilities, and income and expenditures of the Village Funds, and thus oversight from the center has little meaning. The lack of real prudential supervision, the paucity of reliable data on NPLs, and reports of corruption and theft affecting some of the Village Funds raise further concern (Lewis, Susewan and Tambunlertchai 2012).

This is not to suggest they are entirely on their own, however. Each village committee must open an account with either BAAC, GSB, or KTB in order to access its seed money and any further financing. The villages are given investment ratings on the basis of which they access loans from those banks. An estimated of one fifth to one half of all villages apply to the banks for expansion. Those that do so perform better than others in terms of loan recovery rates, total lending, credit ratings, and the proportion of loans going to the poor (Lewis, Susewan and Tambunlertchai 2012 citing Boonperm et al. 2012).

Recent policy discussions have focused on the future of the Village Fund system (see the box below). Village Funds are spinning off Community Financial Institutions (CFIs) that are vehicles for keeping and intermediating local savings separately from the Funds (i.e. in an account segregated from the capital contributed by government). BAAC mentors Village Funds in the process of upgrading and forming CFIs, helping the latter set up a general assembly and cooperative governance structure. The CFIs are generally informal, having no legal charter and operating in premises lent free by village authorities (BAAC interviews).

93 Ibid
94 KTB works with NVF to survey the villages and rate them single, double, or triple A for their creditworthiness (although we have not seen the actual criteria used for this). NVF interview, Lewis, Susewan and Tambunlertchai (2012).
95 Also NVF interview.
Box 10 The future of the Village Fund system

The latest recapitalization of Village Funds got underway in 2012 with assessments and plans to give each Fund an additional amount of up to THB one million. Along with augmented resources, there is a move to consolidate the Village Funds and to put them on a more sound legal-regulatory footing. One version of this is to consolidate the funds across districts to create tambon-level funds that would reach across villages (something that the funds cannot now do) and perhaps also bring smaller-scale microfinance groups into a wider network with the new district-level fund at its center. Under the mentorship of the leading state banks, Village Fund depositors are creating community financial institutions (CFIs). It is envisioned that there would eventually be funds and CFIs at village, district, provincial, and national level, with the National Village and Urban Community Fund becoming the parent bank of a Grameen-style chain of People’s Banks. Depending on their size (membership and deposits), these CFIs would be subject to either reporting only, reporting and regulation, or prudential supervision (but less rigorous than for banks). A deposit protection system is also being discussed. By the end of 2012, the aim was to identify 10,000 villages in which to pilot this approach (FPO undated).96

There are, of course, pros and cons to this idea. On the one hand, it builds in a tiered structure with graduated regulatory-supervisory standards, while also putting the SFIs in a quasi-supervisory position (at least initially). Electronic banking and information management technologies could make it possible to monitor VF portfolio quality in real time (assuming such systems are adopted across the VF network), thus enhancing oversight and discipline. If formalization of the VFs were accompanied by improved capacity and governance, then in principle it would be a positive development.97 On the other hand, unless this is handled very carefully, it could easily become a nightmare of politicized and crisis-prone financial dealing. At a minimum, the governance model and oversight mechanisms require further discussion. In general, the Village Funds have suffered weak governance with instances of fraud and fund collapse, and this record has given rise to skepticism about future prospects.

B. Grassroots providers

The other competitors to the banking system are many, and their numbers continue to grow. They include informal cooperatives, savings and sajja groups, CFIs, moneylenders, and others. The issue of concern here is that savings groups in some areas (e.g. the South) are growing in scale and expanding beyond their original communities. They appear to be growing to a scale that could become systemically significant, and their de facto freedom from regulatory control, deposit insurance premiums, taxes, and interest rate caps means that they operate at a competitive advantage vis-à-vis formal institutions that attempt to serve the low-income market.98 Researchers from CAD and other organizations have made efforts to quantify and track them, but their numbers are not known with any precision. Unlike cooperatives and Village Funds, most of them are not networked or supervised, although some promoters such as CODI provide structure and mentoring to the specific groups they support. A further tier of credit providers, often a last resort for urgent needs, are small profit-making lenders including formal pawnshops and informal moneylenders.

1. Community savings and credit organizations

Across Thailand, informal financial organizations have been set up by community leaders or citizen groups in order to promote saving among members, to provide credit to improve the lives and livelihoods of members, and to make necessary funds available to deal with emergencies. Two kinds of institutions play an especially important role in providing microfinance services to

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96 Also FPO and NVUCF interview
97 Robert Hickson and CENFRI comments.
98 De jure, on a strict reading of applicable laws and regulations, these activities are illegal unless they are carried out by a licensed institution (or a retailer financing its own sales) and conform to the relevant interest rate cap.
the low income population. These are Savings Groups for Production (SGPs), and Sajja savings groups.

SGPs are promoted by the Community Development Department (CDD) within the Ministry of Interior, which sets guidelines for operation and receives reports from each group. Although the groups are not subject to prudential regulation, they are assessed by CDD based on self-reported data, and CDD assessments can be used as an indicator for financial institutions considering loans to these groups. As of July 2012, there were a total of 26,819 SGPs in the country, with some 3.6 million members and THB 36.9 billion in savings. More than half of these groups are located in the Northeast (Lewis, Susewan and Tambunlertchai 2013).

These groups save their own money – with no government funds used – often through the method of sajja, i.e. making a commitment to save a specified sum each month. The loan methodology involves up to four guarantors, a maximum interest rate of 15%, standard forms provided by CDD including a statement of the loan’s purpose, and varied amounts although most credits are reported as being no more than THB 2,000. CDD reports a near-perfect repayment rate (99%); we have not been able to verify this. Each group establishes a collective bank account, opened by the governing committee (usually three persons). Deposits and withdrawals are handled by a delegate of the group, with two signatures required for withdrawal.

Sajja savings groups are set up by community members in order to save, provide welfare benefits, and offer loans to members. Based on the sajja agreement, members gain the right to take loans from group funds only after saving for a defined period of time. Sajja savings groups also provide members coverage for hospitalization, funerals, education expenses, and community development. Since these groups have no formal (or even “semi-formal”) status, it has proven difficult to track their numbers, membership, and funds – and there has been limited knowledge-sharing among the different groups. The known examples suggest that they grow from small beginnings such as the local initiative of a teacher or monk, some of them turning into quite large arrangements such as that of the Songkhla Sajja savings group network (Lewis, Susewan and Tambunlertchai 2013).

The scale of these initiatives becomes clearer when groups band together and work with a formal organization such as bank, or when they are linked from the start with a welfare agency or NGO. This is the case with the SPGs discussed above. There are also funds and savings mechanisms promoted by CODI that have mobilized in excess of THB 7 billion (Lewis, Susewan and Tambunlertchai 2013). Given that the self-help savings got underway as an organized movement in 1965, it is easy to imagine that they have amassed significant resources. There were an estimated 48,770 informal savings groups in early 2005, with nearly ten million members (eight million households by 2007) and over THB 13 billion in savings. Most of these self-help savings groups apply village banking or solidarity group methodologies (BWTP and FDC 2010).

Many of these grassroots savings groups have scaled up or formed networks for such purposes as providing welfare facilities. A few of the stronger ones transformed into CFIIs under the auspices of BAAC or other banks. They compete with the financial cooperatives, among others. In the case of SPGs, for example, operating without a cooperative title gives them more

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99 According to CDD, there are some 33,300 SPGs.
100 CDD interview
101 CODI also channels government funds, in the form of infrastructure subsidies and soft housing loans, directly to poor communities. Sukanda Lewis comments.
flexibility to serve their members at lower cost – but within limits and under supervision.\textsuperscript{102} As they grow, such organizations face the choice of remaining informal, registering as a cooperative or NGO, or linking up to a bank such as GSB or KTB as a semi-formal CFI. These institutions take deposits, often paying higher interest than commercial banks and some SFIs. Observers have raised the question whether there is a threshold beyond which these institutions should be required to report to a formal supervisor such as MOF.\textsuperscript{103} The unregulated growth of these entities is causing concern among policymakers (see the box below).

\textbf{Box 11 Informal microfinance groups: concerns about unchecked growth}

| Policymakers and regulators express concern about the rapid growth of informal savings institutions. They are not regulated, nor is there a clear graduation path to regulated status. Information on them is spotty, and their consumer practices conform to no particular standard. They compete with each other and with formal institutions, but it is not known how their offerings and market segments overlap or complement one another. There apparently are individual savings groups that have grown to between 100 and 200 members and THB 20 to 40 million in savings. Some are indeed moving money and offering services beyond the limits of their villages, notably in southern areas such as Songkhla. The fear is that their community-based screening and discipline will break down as they expand, raising the risk of a rapid collapse. MOF encouraged some of them to register, but the groups refused, fearing a loss of autonomy. Moreover, some of these groups appear highly dependent on their original leaders, and therefore incur the risk that these leaders could take them in the wrong direction, engage in self-dealing, or be replaced with less capable ones in the absence of institutionalization.\textsuperscript{104} |

\section{2. Moneylenders}

This sector is comprised of registered pawnshops and informal moneylenders. Globally, pawnshops provide an alternative source of short-term financing for people who are short of cash, but still own moveable property such as jewelry, electronic goods, and in some cases vehicles that can be used as security. Pawnshops in Thailand are busy when ready cash is needed, such as at the beginning of the school year – a season when these shops offer special deals.

Publicly-owned pawnshops include those run by the Department of Social Development and Welfare, the Ministry of Social Development and Human Security, and the municipalities. These, along with privately-owned pawnshops, are supervised by a dedicated office in the Ministry of Interior. There are estimated to be nearly 550 pawnshops in Thailand. Maximum loan sizes range from BHT 60,000 for government pawnshops to BHT 100,000 for municipal and private pawnshops. Pawn loans (“tickets”) have a five-month term, with interest rates in most cases graduated by the amount borrowed up to a maximum of 15% per annum (Lewis, Susewan and Tambunlertchai 2013). The governing law here is the Pawnshop Act BE 2505 (as amended).

As for informal lenders, a 2010 study found increasing reliance on this credit source by low-income people (BWTP and FDC 2010). It is likely that family members or neighbors with surplus cash are a major source of informal lending, but public concern focuses on the commercial providers. The Thai press abounds with stories of crackdowns on loan sharks, and policies aimed at increasing financial inclusion are also frequently justified on the grounds of helping keep people out of the grip of moneylenders. For example, in late 2009, police arrested 38 debt

\textsuperscript{102} The SPGs have been allowed to operate without formalizing as cooperatives since 1974, on the condition that they register with CDD and deposit their savings with KTB. The Agricultural Groups Act of 2004 requires them to register with CPD and to be supervised by CAD but with looser requirements than formal cooperatives (BWTP and FDC 2010).

\textsuperscript{103} Bangkok Bank, KTB, ADB, Ennoo Susewan interviews

\textsuperscript{104} World Bank, Bangkok Bank, Ennoo Susewan and FIPD interviews
collectors hired by illegal lenders for loan enforcement. The interest rate for these loans was reported as 2% per day. Most of the illegal lenders are known to have close affiliations with police or other senior authorities, and borrowers are reluctant to cooperate with the prosecutions. If convicted, the collectors were said to face fines of 900 baht each.105

During that same period, government responded to protests against loan sharks with a scheme offering soft loans to a million households, with a limit of THB 200,000 each, to repay informal loans. The loans would bear an annual interest rate of 12% in the first three years, though GSB offered a special rate of 0.75% per month, or 9% per year, for the duration of the loan scheme.106 BAAC took on the refinancing of farm debtors, issuing these loans in 2009-2010 (BAAC 2010). More recently, BOT has taken a different approach, discussing the possibility of licensing informal lenders as non-bank lenders in return for their compliance with legal requirements.107

In Thailand, the illegality of informal moneylending is based on a failure to register and incorporate as a non-bank lender, charging rates in excess of 15%, and using illegal collection methods (violence and intimidation). The question for Thai policymakers is how to reduce this illegality, and its ill effects, while also extending the financial “frontier” in a way that brings as large an amount of informal activity as reasonably possible within the regulated sphere (see the box below).

Box 12 Dealing with informal lenders

Informal lending exists everywhere, and it is a challenge to bring it into conformity with legal standards without simply suppressing it and thereby reducing financial inclusion. Where this has been done successfully (e.g. South Africa), efforts to prosecute illegal lenders have been phased in. This is done in parallel with the establishment of a regulatory "window" or haven for moneylenders to formalize, to come within the regulatory system, and to comply with rules on market behavior, disclosure, and reporting. In the case of interest rates, good practice suggests that rate caps (sometimes termed usury limits) should be avoided, or at least calibrated to affect only practices that are clearly abusive. Overly stringent limits encourage lenders to operate informally, meanwhile creating enforcement challenges for the regulator. In parallel, safeguards are needed to minimize household over-indebtedness, a longstanding concern of BOT and other policymakers.108 This requires a multi-pronged approach including more comprehensive credit information systems, consumer protection, financial literacy, and legal mechanisms to combat predatory lending.

C. Supervision issues

1. Cooperative finance

The cooperative sector, including some 12,000 institutions in Thailand, is overseen by several thousand employees in the promotion and audit departments (respectively CPD and CAD) of the Ministry of Agriculture and Cooperatives. CPD’s role is to promote, support, and regulate cooperatives. The promotional role is shared with the Cooperative League of Thailand, and the supervisory function with CAD.

105 "38 loan shark debt collectors held," Bangkok Post, 11-21-2009.
107 Sabayjai, Seetalavajit, "BOT works to get loan sharks under its wings," The Nation, May 2, 2012. Within weeks of suggesting this policy, BOT appeared to back off (BOT interview).
108 Comments by ADB and Sukanda Lewis.
CPD reports that it has some 3,000 employees (a third of them in Bangkok) including 790 examiners. Annual on-site examinations are required for all cooperatives. These inspections involve a SWOT analysis that includes the CAMELs factors (such as capital ratios, asset quality, liquidity and profitability) as well as factors relevant to non-financial cooperative activities such as production. The examiners follow a checklist of 137 standards (CPD interview and documents). Due to budget limitations, CPD focuses some 80% of its budget (about THB 4 billion annually) on newer cooperatives. The placement of CPD under the Ministry of Agriculture and Cooperatives has the drawback that financial services and the cooperatives specializing in them are reportedly given much lower priority than other cooperatives, receiving less than 10% of the unit’s funding (BWTP and FDC 2010).

Cooperative inspection and audit must deal with a variety of institutions. Inspections are normally annual, but institutions that are large, weak, or new may be examined twice per year. Different types of cooperatives have differing cost structures and present their finances using distinct balance sheet formats. Financial services are usually integrated in the balance sheet figures but are broken out in the profit-loss statement. CAD, with some 1,000 auditors and offices in all provinces, performs audits and reports the results to CPD. Part of this function is in effect outsourced, with the largest non-agricultural cooperatives (about 180 of them) contracting private audit firms. The Cooperative League and the federations of cooperatives are also supervised by CAD and CPD. In the case of a problem cooperative, CPD and CAD form a joint committee to seek a resolution. This could result in de-registration or replacement of management, although such steps are unusual. There are also informal groups (e.g. savings groups under BAAC or CODI) considering formalization as cooperatives – CPD reaches out to them as part of its efforts to govern the sector and increase its membership109 (CPD and CAD interviews).

Cooperative oversight is sometimes linked to external borrowing. As a factor of common stock and reserves, such borrowings are limited by regulation to 10 times, with lower ceilings for credit unions (five times) and savings cooperatives (1.5 times). The Cooperative League, the federations, and the large cooperatives lend to smaller cooperatives or to intermediary cooperatives for on-lending to the smaller groups (for example, the intermediary paying 3% interest and on-lending at 5%). These rates differ depending on how financially sound the borrowing cooperative is, or whether the loan is backed by government subsidy (in the latter case, the usual 3% rate may have to be reduced to 1%). As with the SFIs, government subsidies to the cooperatives are common, and must be separately accounted (CPD and CAD interviews).

The integration of financial services and financial cooperatives into the Ministry’s overall regulatory-supervisory system weakens oversight. As in many countries with a similar approach, cooperatives have been used to implement state welfare schemes and been subject to political intrusion. Sustainability has suffered and many institutions closed down in the past decade. At the same time, neither NGOs nor grassroots providers of microfinance have moved in any significant numbers to register as cooperatives. This suggests that the potential advantages of becoming a cooperative are outweighed by the inflexibility of formal institutional and operating requirements, and weak cooperative sector governance.

A reform that clearly recommends itself is to separate cooperative-based financial services and bring them under an improved regulatory-supervisory framework that might also embrace transforming NGOs and informals. CPD suggests that this is on the agenda, but not in the

109 CPD hopes to increase membership from 12 to 30 million.
immediate future. A further step could be to break the sector into tiers, with one segment including the largest groups such as employer-based savings cooperatives, and another segment consisting of smaller financial cooperatives.

2. Village Funds, CFIs, others

The Village Fund system has a simple structure but is evolving. A management committee selected by and among the villages makes decisions – one of the system’s priorities is to have majority participation by village residents in Fund governance. The basic structure includes a chair person, vice-chair, treasurer, and secretary, with the larger Funds also having paid staff. Shares uniformly cost 100 THB. Members can buy multiple shares, but each still has only a single vote (similar to cooperatives). The lending parameters are simple: the maximum loan is now THB 30,000 for a term of one year (less commonly, two). The Funds lend out their government-provided capital at 6%. In addition, BAAC lends to Village Funds at 5-7%, and the Funds on-lend this to members at 9-12%. Retail loans require two guarantors, while the BAAC wholesale loans are conditioned on joint liability by the management committee. Thus, the Village Funds are essentially credit-only, with contributed capital and some borrowed funds. There is no prudential supervision as such, including no capital adequacy standard (BAAC interview).

The lack of prudential standards is relevant because the Village Funds also provide savings services.¹¹⁰ The Village Fund Act requires them to maintain an account for members’ shares and deposits separate from the original capital donated by government. There is a move underway to consolidate these savings vehicles (account no. 2 of the Village Funds) and to put them on a more sound legal-regulatory footing. Initially, this involves setting up separate community financial institutions for the member-owned funds, some of them covering multiple villages or districts. These CFIs are being established and strengthened under the mentorship of BAAC and other state banks. Member-based savings and governance may be sufficient for small groups, but consolidation into CFIs and expansion beyond the original groups raises the stakes.

Village Fund administration and oversight follows Thailand’s sub-national political structure. The NVUCF (NVF) has a staff of about 250, and it depends on cooperation and support from other departments of government at various levels, along with volunteers from the Village Funds’ membership. Overall, about 8,000 people administer this system (the NVF has plans to increase this number in the coming years). Of these, 7,000 are at the tambon level, which deals directly with the funds, monitoring and mentoring them. The Funds submit annual reports that are passed up the state hierarchy to the Prime Minister’s office – the latter reports to parliament on the Village Fund system in the context of budget deliberations. The more detailed monthly reports of revenues, expenditures, and loan portfolios are kept at the Village Fund level. The Funds themselves conduct internal audit, and the central NVF office contracts audit firms for the regular external audit. These audit and reporting procedures are normally annual, but can be performed every 18 months for Funds that are free of significant problems (NVF interview).

State-contributed capital (along with interest earned and subsidies) is kept in the Village Funds’ bank accounts, usually at BAAC, GSB, or KTB. As mentioned, member savings are kept in a separate account, in most cases deposited at one of those banks. The new community-level institutions or CFIs intermediate the deposits of members drawn from the local Village Funds

¹¹⁰ Also, the regulations permit Funds to lend to each other, which increases the risks associated with individual Funds’ weakness and loan defaults. Regulations of the NVUCF, B.E. 2551.
and, increasingly, beyond. The CFIs are informal institutions that set their own rules, having no recognized legal personality, license, or supervising authority. Some of them are reported to be registering as organizations and opening bank accounts – in one case in order to provide fund transfer (remittance) services to members (Pakdeewut 2012:16).

There are an estimated 4,000 CFIs, with plans to establish and institutionalize another 10,000 now being carried out by an informal advisory group from key organizations involved in the sector (NVF, CDD, BAAC, GSB, KTB). These organizations are mentoring and training the CFIs, and in doing so they are providing informal supervision. The CFIs are growing as they increase in number, with some of them aiming to aggregate or network at the tambon level. Some are experimenting with welfare services, even retail shops, as part of their services menu (NVF, BAAC, other interviews). The NVF, CDD, and banks – with the assistance of the public administrative hierarchy – are pursuing this as an unofficial pilot.

The experiment is expected to show the model's viability and lead to replication, formal recognition, and eventually a legislative framework. For now, there is no regulation or supervision as such. Those monitoring the CFIs can only warn and persuade against unsound practice. Meanwhile, the Village Fund system continues to run in parallel, with another tranche of capital expected in the coming months. The NVF intends to propose a legislative framework under which the Funds and CFIs are linked in a branch or affiliate network (NVF and BAAC interviews). The NVF proposal will be an important step in the development of a framework for microfinance regulation and supervision. Care needs to be taken that it is not put into effect prematurely, that it accommodates evolving practice including other programs and entities that may benefit from formalizing, and that it reflects best practice.

As this last point suggests, it makes sense to address the issues of regulation and supervision as they arise across the range of semi-formal and informal microfinance providers, from financial cooperatives to Village Funds, CFIs, and informal savings and credit groups of various kinds. This is not to suggest that all should be formalized and regulated, or at least not in the short term. Rather, there is a need for analysis and policy development with respect to these service tiers, with the aim of putting in place a formal structure to accommodate those providers whose scale and activities require it or would benefit from it.

As for the other informal grassroots groups, some resemble the CFIs just discussed and operate with support, mentoring, and oversight by institutions such as CDD and BAAC. Others remain quite small in scale or grow from the bottom up with little or no technical guidance. Some are networks promoted by monks that provide financial and welfare services, and invest in local ventures such as shops and rice mills. Researchers suggest that some of these groups have large amounts of cash that cannot be deposited in a bank unless entrusted to an individual, since the group or network has no legal registration and therefore cannot open an account. These organizations do not have training or systems for risk management, and many depend upon their founding leadership but have no plan for succession. The SFIs such as BAAC are providing assistance, but their own systems and manuals are too complex and cannot readily be used by grassroots savings and credit groups. The NVF rating system, moreover, is generic and cannot provide a basis for grassroots groups to develop the systems of accounting, risk management, loan approval, and others that they need as they grow larger (expert interviews).

111 BAAC uses a simple assessment form on which financial data are entered and basic ratio analysis performed. Bank for Agriculture and Agricultural Cooperatives, “Guide to credit community financial institutions.”
Researchers and advisors are hoping to develop tailored assessment and management tools for such organizations that wish to transform into structured CFIs. As a further step, they anticipate that the larger well-run CFIs will be able to scale up to become tambon-level institutional hubs, analogous to holding companies or apex institutions. One solution here would be to provide a licensing window, with a cooperative legal structure and deposit guarantee, for the tambon-level hub institutions. The smaller providers could continue to operate informally, using local authority structures and social pressure to ensure financial discipline. One worry here is that the grassroots groups and in some cases the CFIs appear to resist the idea of regulation and oversight from outside (FPO and expert interviews).
V. BRANCHLESS SERVICES AND DISTRIBUTION

The complement to downscaling is what might be called “outreach,” i.e. using branchless methods to extend services. One approach is the direct use of non-branch methods by the banks, such as sub-branch offices, ATMs, outlets at schools and markets, and outreach by means of motorbikes and boats (see above). Alternatives that do not involve banks directly – or do not involve them at all – are agent banking, point-of-service payment and transfer systems, and electronic funds (e-money) deployed via stored value cards and mobile phones.

On both the agent banking and e-money fronts, BOT has taken a cautious, gradual approach in legalizing these services (see the box below). Each of these modalities still has regulatory restrictions that limit its potential. The rationale for going slowly appears partly prudential and partly based on the idea that Thailand is less in need of such “leapfrogging” than much poorer and more geographically fragmented countries. But rapid expansion of e-money systems, with their ability to overcome barriers of distance and cost, is a priority for financial inclusion.

A. Agents

The outsourcing of certain banking functions, permitted in principle under FIBA (art. 47), is spelled out in Bank of Thailand Notification 9/2553: Rules for Appointment of Banking Agent. The regulation authorizes six types of agents that commercial banks may use, but prohibits such agents from opening deposit accounts or carrying out loan approvals or disbursements. The main agent types – categorized by activity (e.g. Depository and Withdrawal) – can in most cases be other banks and in some cases other financial institutions or Thailand Post Co. Ltd. Electronic payment service providers may be used for credit card transactions. In contrast to the banks, finance companies112 may use agents for a more limited range of purposes: deposits, withdrawals, and transfers. Permission must be obtained from BOT for certain of these agents as well as for purposes not indicated in the regulation.113 (The table below summarizes the types, requirements, and activities of different agents.)

1. This arrangement represents a liberalization of regulatory controls. Here, BOT approves certain types of agencies, while under the prior regulation (from 2010), it required preapproval of not only agents, but also the agency agreements and systems to be used. Initially, agent approval was a laborious process involving a long list of questions, requiring some six months to complete. This is now reported to take about one month, and some agency arrangements require no prior review. KTB is a leader in this area, having experimented early on and now using agents with a real-time link to the bank. Also moving to set up agencies are other commercial banks, GSB, and BAAC. The SFIs can set up agencies without BOT approval. KTB obtained BOT approval to use certain cooperatives as agents, many of its vetted candidates having been rejected. KTB installs software to enable transactions (mainly savings deposits) at the cooperative’s offices by means of a web link to KTB, and the institutions share fees. Now, the Village

112 i.e. NBFIs, including credit card and personal loan companies.
113 The notification mentions cost savings as the rationale for permitting agents. The limitations included in the rules have a prudential rationale, constraining risks such as the potential for fraud and money-laundering.
Funds are being considered as agents, and BOT is looking into the feasibility of this under certain conditions.\textsuperscript{114}

Table 2 Banking Agents: Types and Requirements

<table>
<thead>
<tr>
<th>Type of Agent</th>
<th>Legal person</th>
<th>No Permission and no advance notice</th>
<th>No Permission but need 30 days advance notice</th>
<th>Permission required</th>
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</thead>
<tbody>
<tr>
<td>As representative of commercial bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository Agent</td>
<td>Banks</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Thailand Post Co. Ltd.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>SFIs</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Withdrawal Agent</td>
<td>Thailand Post Co. Ltd.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfer Agent</td>
<td>Thailand Post Co. Ltd.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency Payment Service</td>
<td>Banks</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Thailand Post Co. Ltd.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Electronic payment services provider</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>SFIs</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paying Agent</td>
<td>Banks</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>SFIs</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td>Yes (case by case)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>As representative of finance company</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository Agent\textsuperscript{115}</td>
<td>Banks</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other financial Institutions</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit Agency</td>
<td>Banks</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Thailand Post Co. Ltd.</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Electronic payment services provider</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td>Yes (case by case)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Adapted from: Bank of Thailand Notification 9/2553 Rules for Appointment of Banking Agent.

Meanwhile, the role of agents is shifting. Agents have been used for the physical outreach of ordinary banking services to under-banked groups – for example, the collection of cash savings. But increasingly, agent services are provided through electronic means, and this brings them under an additional regulatory framework, that dealing with electronic commerce and banking (see below).

\textsuperscript{114} E.g., having the Funds grouped under banks (to provide BOT with regulatory authority) and having regular daily office hours. KTB interview.

\textsuperscript{115} FIBA provides for credit foncier and finance companies (NBFIs) to accept term deposits. Currently, however, the only licensed NBFIs – credit card and personal loan companies – are not permitted to accept any deposits.
Thailand also has an array of non-financial companies that provide payment and transfer services. These companies include Counter Service, Tesco Lotus, and Jay Mart. These firms provide a channel for customers to pay utility and credit card bills, to make loan and insurance payments, and to conduct certain purchases. Tesco Lotus even offers customers the convenience of paying their taxes at its counters. The payments services providers have grown in part in response to the market for agency services to the financial institutions, although some (e.g. Counter Service) developed independently.

B. **Electronic services**

Increasingly across the world, banking agents, remittance and payment companies, and mobile phone companies deal in electronic funds services (independently or in partnership with banks), and are in some cases seeking to enter the microfinance field to provide complementary services such as loans. Internationally, the success of such ventures as M-PESA shows the potential of innovative private sector investment, coupled with enabling regulatory oversight, to extend financial services to the poor through electronic means.

The Electronic Transactions Act B.E. 2544 (2001) sets out the basic enabling framework for electronic commerce in the private and public sectors. It governs payments by electronic means, and empowers a licensing authority to deal with providers of electronic transactions services (which have now come to include mobile phone banking). The Act establishes the Electronic Transactions Commission (ETC), headed by the Minister of Information and Communication Technology, and includes a further 12 members representing the financial sector, the legal community, electronic technology experts, and others. The Commission develops policies, licenses service providers, and monitors operations, while financial supervision of this sector remains with BOT. A 2004 regulation requires that non-bank institutions intending to issue e-money must obtain permission from the BOT and ETC, since this issuance is similar to the deposit-taking business of commercial banks (see the box below).

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116 For example MPESA in Kenya, South Africa, India and elsewhere; and GCASH and Smart Money in the Philippines. Robert Hickson comments.

117 Some regulatory authorities, for example in the Philippines and Kenya, allow products to be launched and experimented with (unless they are expressly prohibited), normally with some form of notice to the supervisor.

118 The Act is limited to payments and is separate from telecoms law and regulation. Telecoms legislation sometimes contains more up to date and effective consumer protection regulations than financial sector or even payments legislation (CENFRI comments). Thus, licensing and regulation of mobile phone providers engaged in electronic banking is handled separately.

Box 13 Banking and e-money: the intersection

The overlap between e-money and banking is substantial. The definition of commercial banking in FIBA can be interpreted as including e-money as defined in the Royal Decree B.E. 2551. The former consists of "accepting deposits of money or accepting money from the public...and of employing such money in one of several ways..." The latter refers to an "electronic card issued by the service provider...The service user shall pay money in advance to the service provider and use such e-Money in the payment of goods, services..." Thus, e-money appears to fit the definition of a commercial banking service. But the electronic services decree and regulations allow non-banks to provide e-money services. Since these services are so similar to banking, BOT requires non-banks in this market to obtain a special license. The requirements here in practice, according to information from market players, are nearly equivalent to those for a banking license (see the discussion below).

The Electronic Transactions Act is further elaborated by the Royal Decree Regulating Electronic Payment Service Business B.E. 2551, which came into force in early 2009. The Decree, for the purpose of maintaining financial stability and enhancing the credibility and use of e-payments, establishes different categories of these services with distinct requirements:

**List A**: Services that require notification to BOT. These are payment cards and systems for purchasing a product or service from a single retailer or group ("closed loop").

**List B**: Services that require registration with BOT. These include network services (e.g., credit card) and electronic data–capturing network services, switching services through a single system, and issuing prepaid e-money to pay for products and services from multiple retailers or groups under a single management entity and distribution system.

**List C**: Services that require a license from the Electronic Transactions Commission. These include the following:

- Clearing services
- Settlement services
- Electronic payment services through any instruments or a network
- Switching services through multiple systems
- Bill payment services
- E-Money services for buying specific goods and services from many providers without restriction on the number of firms or outlets.

Providers of List C services must meet regulatory requirements including the following:

- Minimum registered capital of THB 200 million (and if the provider is foreign-based, the Thai business must be a separate legal entity).
- 100% reserve for money stored in e-wallets.

Tariffs must be clearly disclosed to customers and require notice to BOT unless fixed by regulation. The requirements for List C services are considered to be
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quite stringent in practice.120 (For discussion of how electronic flows fit within Thailand’s payment systems, see the box below.)

Box 14 Thailand: e-money and payment systems

The law and decrees on electronic transactions form part of Thailand’s overall payment systems governance. The Bank of Thailand Act (BE 2551 as amended) empowers BOT to manage the various components of the payments system. BOT set up the Payment Systems Committee to develop policies and instruments in this area, including the Payment Systems Roadmap (2012-2016), a plan for policy and system development that emphasizes efficiency, risk reduction, and consumer protection. Thailand has no overall payments systems law, although the Committee undertook to draft an act a few years ago, an effort that has been discontinued for now. The components covered by the Electronic Transactions Act, the Royal Decree, and related regulation include retail transactions as well as clearing, settlement, and transaction switching between systems. In short, these instruments provide the legal basis for the effectiveness of electronic flows through the payment systems. BOT handles the other dimensions of the payments infrastructure such as interbank check clearing, the bulk systems of BAHTNET and NITMX, and foreign exchange settlements separately according to policies it issues under its authority per the Bank of Thailand Act (BOT 2011, 2012).

The development of this sector has contributed to international concerns about Thailand’s compliance with international Anti-Money Laundering (AML) standards. The International Monetary Fund’s 2007 report on this described the framework as a combination of unenforceable guidelines, circulars, and regulations, which did not comply with the standards of the Financial Action Task Force. The Money Laundering Control Act B.E. 2551 (effective 19 November 2009) applies to non-bank e-money service providers as well as financial institutions. These providers are required to report transactions to the Anti-Money Laundering Office, comply with Know Your Customer (KYC) requirements, and conduct customer due diligence.

New regulations and amendments to the Act continue to be issued in order to bring Thailand into full compliance with international standards. Currently, customers can register quickly and easily for an e-wallet by providing details of their national identification. (National ID cards are widely held and are thus not a barrier to opening a bank account or e-wallet.) This information is then verified by the Ministry of Interior within 24 hours. There is some concern that the evolving regulations will make this process more challenging and slow development in this area (IFC 2011, BOT 2010). Others suggest that AML concerns have little relevance to microfinance, since the threshold transaction amount for the law’s application is THB 50,000.121

1. Evolution of the electronic services sector

Growth in electronic services has been increasingly rapid. At the end of 2010, BOT reported that it supervised a total of 109 licensed electronic services providers (the majority in List C) and 17 e-money operators. The reported number of e-money transactions was 221.5 million transactions, equivalent to a total value of THB 17.7 billion, and there were 11.5 million cards or accounts in the system (BOT 2010). By mid-2013, this had risen to 98 million transactions worth about THB 15 billion per month, and a total of nearly 171 million cards and accounts (including top-up cards).122 The regulatory arrangements for financial supervision and AML do not appear to have dampened enthusiasm.

120 The rules require bank-like safeguards, without allowing the range of banking functions that commercial banks could carry out by mobile phone. DTAC interview, see below. Also see IFC (2011), BOT (2010).
122 http://www.bot.or.th/English/Statistics/PaymentSystems/Pages/index.aspx.
Major electronic payment service providers include Jay Mart and Tesco Lotus. Jay Mart sells mobile phones and related items, and has developed its stores as designated payment points, and partners with Family Mart in providing payment services for products, utilities, credit card and insurance bills, etc. Customers have access to 109 Jay Mart pay points, and 713 Family Mart stores as of May 2012. Tesco Lotus is a major operator of supermarket and convenience stores, offering similar payment services at in-store service counters. As of August 2012, Tesco operated 97 hypermarkets, 36 Tesco Value stores, 105 Tesco Market stores, and 553 Tesco Express convenience stores across the country. In 2008, BOT estimated that 50% of customers paid for services at the office of the service provider, and 25% at banks – leaving considerable room for growth in electronic payment services. In terms of remittances, Thailand Post is also becoming a significant player. It offers a “Domestic Online Money Order” that can be processed and sent in 15 minutes with a fee of 50 baht for amounts up to THB 10,000 (Lewis, Susewan and Tambunlertchai 2013). The major provider in this sector is Counter Service (see the box below).

**Box 15 Payment services leader: Counter Service**

Counter Service concentrates on payments services, and has long been the biggest provider. Customers’ point of contact is with agents of the company who pay for the Counter Service franchise. The firm partners with 7 Eleven, which offers Counter Service payment facilities at its convenience stores. Counter Service provides a channel for bill payments to over 700 partners. In addition to the usual utilities, credit card, loan, insurance, and mobile phone payments, customers can also pay for bus tickets, air tickets, concert and movie tickets, hotel rooms, and course registrations through Counter Service (Lewis, Susewan and Tambunlertchai 2013).

The firm provides services through some 9,000 store outlets (mainly 7 Eleven but also BigC), some 60% of them outside of the urban areas, as well as other service points in rural districts. Counter Service charges 10 baht each (as compared to 5 baht for Tesco Lotus and Thai Post) for payments up to THB 30,000 per customer per store per day. The firm was approached by the banks several years ago to handle deposits and withdrawals, but it is precluded by the terms of its electronic payments license and the agent banking regulations (although it may serve as agent to a non-bank company, as it has done for Krung Thai Card). Having evolved from its early days handling physical cash payments, Counter Service now has a real-time electronic link to nearly all its clients. In late 2010, the firm began seeking BOT approval to provide small-scale finance services, including the handling of consumer credit applications for financial institutions (“Counter Service seeking microfinance opportunity,” Bangkok Post, 12/11/2010).123

Thailand also has a growing market for mobile banking services, which are offered through three major mobile network operators: Total Access Communications (DTAC), which paired up with Kasikorn Bank (K-Bank) to provide ATM SIM cards; Advanced Info Service (AIS), which offers money transfer services; and True Corporation, which also offers money transfer services through its True Money scheme. (Lewis, Susewan and Tambunlertchai 2013). The government is developing a framework for mobile banking services to be extended by the SFIs, partly as a means of combating loan sharks. GSB has been handed the lead role here, studying the feasibility of instant refinancing by mobile phone transfer.124 BAAC is also formulating a mobile banking product that would be offered through village agents who open BAAC accounts.125

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123 Also Counter Service interview. Electronic payment service businesses seeking to act as bank agents must also secure an agency permit from BOT.
125 BAAC interview
Both BOT and the banks are proceeding cautiously here – and Thailand has sufficient financial services to make a mobile revolution less urgent than in other countries. At the moment, it appears that there is little true mobile phone banking (True Money’s e-wallet is an example), but internet banking by smartphone is fairly common in urban centers such as Bangkok. Further, internet penetration is said not to be sufficient to support wide adoption of web banking, nor are most people comfortable using mobile phones for financial services.\footnote{TMB interview} Most villagers use cell phones for traditional communication, not for purchases or financial transactions.\footnote{Doi Chang household interviews} This suggests that uptake will not be automatic, but once mobile banking is demonstrated to work, it will spread rapidly as it has elsewhere. (For an illustration of the challenges involved in setting up mobile banking services, see the box below.) It is also well to keep in mind that this situation is constantly evolving, and significant changes have occurred since this TA began in early 2012.

C. **Policy development**

BOT is sensitive to the need for policy development in this area. In 2010, the Bank’s Payment Systems Committee presented the Payment Systems Roadmap (2012-2016) providing a framework for payment systems development. The overall goal here is to extend electronic payment services to all user groups, reduce reliance on cash and check (and the resulting costs), and promote attractive electronic payment systems. This involves establishing payment infrastructure as well as common rules and standards. The current dominance of closed-loop systems (offering services to captive groups of customers only) will thus eventually yield to a single open platform with uniform payment systems standards and practice guidelines for compliance with local and international norms. Establishing regulatory arrangements of this kind is expected to reduce payment systems duplication and operating costs. It should also improve the effectiveness of oversight, build public confidence, and thereby encourage greater use – including by rural and low-income populations.\footnote{Ideally, interconnectivity across systems and providers would become mandatory, if not by mutual agreement then by law. This would not only reduce transaction costs but also dramatically expand the scope of electronic services and platforms available to retail customers (CENFRI comments).} In addition, the roadmap looks forward to evolving cross-border linkages and to the role of payment systems in supporting trade and investment between Thailand and neighboring countries (BOT 2010).
Box 16 The challenges of a mobile banking innovator in Thailand: DTAC

The experience of DTAC illustrates the issues involved in setting up mobile banking services in Thailand. The company established a limited-scale e-wallet service (M-Pay) soon after the 2008 Royal Decree on electronic services, which enabled it to get into this market without a banking license. It also bought another existing e-wallet provider. The broad standards in the 2001 Act allowed BOT to take a conservative approach of keeping new services within the traditional framework. Meanwhile, the telecom sector has been preoccupied with developing its core services, and so the mobile banking market has been slow to evolve. For a telecom operator such as DTAC, used to dealing with its industry regulator, BOT is an unknown quantity. DTAC holds one of the 17 e-money licenses, which allows deposit-taking but no payment of interest or intermediation. E-money must be backed by bank deposits. An e-money permit is both less onerous and less advantageous than a banking license.129

DTAC conforms to the BOT strategy by integrating the security of bank infrastructure (in its partnership with K-Bank) with the nimble client service of a competitive mobile network operator (MNO). But it has been frustrated in its wider search for cooperation from the banks. This effort arises from a continuing need for synergies in the mobile banking market, and the fact that DTAC itself has ample experience in telecoms but none in banking.

For their part, banks can set up electronic banking via smart phone applications with no need to deal with the telecoms regulator. But a true (non internet-mediated) mobile e-money service uses special SIM cards or applications on basic cell phones – and this requires approval from the telecoms regulator. At the same time, BOT is encouraging the banks to provide mobile banking, perhaps with the idea that control of this market by the banks this will facilitate prudential oversight. But the banks are slow on the uptake, and firms like DTAC are struggling on their own to link up with customers, especially in rural areas, through the ubiquitous mobile phone agents and others. One possible step would be for DTAC to apply for a banking license in order to stretch its operations beyond the limits of its e-money license.130

Thus, BOT supports the move toward electronic payment systems as a key contributor to economic growth. But it is taking a deliberately cautious approach in opening up this field. Also, progress is currently slowed by inappropriate service fee structures that work against it. Banking customers tend to prefer cash, particularly when the pricing structure offered by their banks offers free withdrawals and or deposits. However, the high costs of cash management to banks, government, and businesses mean that these stakeholders need to encourage the use of alternatives to cash. BOT recommends removal of laws and regulations that impede e-payments, and the establishment of more robust payment infrastructure, as means of building public trust in a cashless society (IFC 2011, BOT comments).

A BOT survey found that consumers and businesses give greater weight to certain types of non-price factors. These include legal support for the use of e-receipts and e-documents, as well as effective mechanisms to ensure a more secure environment for e-payments. Nevertheless, BOT believes that adjustments in the pricing of certain bank transactions should be the main driver to encourage the use of electronic channels and payment instruments – yielding benefits to consumer protection as well as industry competitiveness. Regulations must continue to ensure that charges for checks are higher than for electronic fund transfers. This will align fees with costs incurred and provide an incentive for greater use of e-payments (IFC 2011).

129 DTAC interview
130 Ibid. Both banks and non-banks are allowed to provide mobile banking services, but Thai consumers are much more comfortable with bank-based services linked to (state-guaranteed) deposit accounts (BOT comments).
VI. ENABLING ENVIRONMENT

A broader dimension of the financial services market has to do with the commercial framework and infrastructure. A number of factors in this area enable or constrain the expansion of financial inclusion, such as credit reporting, the framework for secured finance, and other policy and social factors.

A. Credit information

The Asian Financial Crisis gave a strong push for the development of credit reporting in Thailand. In 2005, the Ministry of Finance approved the merger of the two existing credit reporting agencies into the National Credit Bureau, Co., Ltd. (NCB), a majority state-owned company. NCB provides consumer and commercial credit reports to its 78 members, who include domestic and foreign banks, credit card issues, personal loan companies, and others. It has information on approximately 56 million consumer accounts from 16 million people, and approximately 4 million commercial accounts from 200,000 businesses. NCB does not provide data to non-members and all members are required to submit data to NCB regardless of whether they make any inquiries. Some 80% of credit inquiries are for consumer lending. Individuals can check their own credit histories (in person, at an ATM, or online) for a fee, and can dispute any information they deem incorrect (Kunvipusilkul 2008, NCB interview 2012).

Banks report that information from the credit bureau has been extremely helpful in identifying weak applicants, and that their improved ability to assess risks has enabled them to make more loans at a higher profit. NCB is now moving to expand its services in such areas as credit scoring (including for individuals and SMEs), and to reach new clients such as leasing companies (Kunvipusilkul 2008, NCB interview).

Here, an important constraint to financial inclusion arises from the limited reach of NCB into the low-income sector. The law governing this field, the Credit Information Business Act B.E. 2545, defines both “credit” and “financial institution” inclusively. Loans, guarantees, purchases, and other transactions identified by NCB’s governing committee are to be reported. In practice, however, potential borrowers do not enter the system until they are involved in a banking transaction or in some cases a motorbike lease. Informal borrowing, trade credit, payment (or non-payment) of utility bills and other debts are not recorded in the NCB.

Further, the system is in some instances overly restrictive. Banks have complained that they are not able to obtain information from NCB on guarantors, even with consent (despite guarantees being explicitly included in the Act). Rather, guarantors must submit inquiries about themselves and forward the results to the banks – a needlessly time-consuming and inefficient process. Prior to NCB’s much welcomed offering of credit scoring services, due to begin in 2012, banks had to set up their own systems or evaluate borrowers ad hoc – another inefficient process (Kunvipusilkul 2008).

Last, membership of NCB is still not comprehensive. While most banks and NBFIIs are members of NCB, the cooperatives, the National Village Fund, and BAAC have not joined the system. For-profit financial institutions appear to have every incentive to become members of NCB.

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131 NCB interview.
132 This appears to be a result of section 3 of the Act and its interpretation. The definition of “credit information” is tied to loan applicants, which implicitly excludes guarantors (while “credit” is defined as including guarantees).
133 Also NCB interview
the case of BAAC, the option of membership is open, but the bank has said that its own information on clients is not yet organized in a form appropriate for disclosure. It is also likely that the state guarantee of BAAC’s credits partly undercuts the usual incentive in favor of membership – and a similar logic applies to the NVF.

The Act brings within its purview a range of creditors, including any “[j]uridic person established under specific legislation to operate financial activities and services,” and one “who grants credit in the ordinary course of business.” This potentially includes all formal small-scale financial services providers, as well as merchants selling goods on credit – but not informal financial service providers. In practice, credit information is reported and accessed exclusively by the members (with limited exceptions), and most creditors who are not financial institutions appear to have little interest currently in joining the system.

As a result, even with NCB, the information constraints applicable to small-scale credit are significant. It is likely, however, that the system will continue to evolve and become more inclusive. Certainly, Thailand’s universal ID system and its electronic infrastructure should make it possible to expand the system. But for now, it appears to have little relevance to financial inclusion at the low end of the market.

### B. Secured finance

Another important component of the broader market environment is the structure for collateral lending. Thailand has provisions in its Civil and Commercial Code and legislation – e.g. the Debt Collection Act of 2000 – supporting secured finance. Unfortunately, these provisions have not proven effective in bringing the system up to date. For example, SMEs comprise the segment that usually reaps the most immediate and direct benefits from secured transactions, and yet in Thailand they have difficulty obtaining working capital.

One simple (and ancient) form of secured transaction does work well and is frequently used: the pawn. But this requires the collateral to be physically held by the lender (“possessory” security), which prevents it from being used at the same time as a productive asset. A motorbike taxi jacket, for example, serves as the license or medallion for this kind of enterprise and is known to be used as security in Bangkok. The jacket is held as a pledge by the lender. This deprives the debtor of its use in earning income to repay the loan. The same applies to the use of a cash deposit in a bank account, which is also now used as possessory security (“forced savings”) against microcredits.

A thriving medium- and small-scale commercial credit market requires a system that supports a much wider range of collateral with security based on agreement and notice rather than possession (“non-possessory” security). This modern type of secured transaction allows the borrower to continue using the asset for productive purposes, generating revenues that can be tapped for repayment. Further, a secured transactions system has greater benefits for financial inclusion if it is not limited to real estate mortgages, since these transactions are costly and limited to those with documented ownership of property. (For further discussion of good practice in this area, see the box below.)

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134 BAAC is still to develop centralized banking software linking all of its branches, which makes it difficult for it to provide timely information to NCB or other authorities.
Box 17 Secured transactions: best practice

The ideal here is a system in which the widest array of goods – physical and intangible, present and future, discrete and collective – are permitted to serve as collateral. This allows lenders and borrowers to leverage as much asset value as possible. Such a system requires a clear scheme of lien priorities, a mechanism of recording and notice, and enforcement that is sufficiently certain as to make out-of-court repossession routine. This kind of system originated in the U.S. It has been refined other countries such as Canada and New Zealand in the common law world, and the Netherlands and certain of the East European countries in the civil law world.

These systems enable a wide range of lending, trade credit, leasing, securitization, and other transactions. Both small and large debtors benefit, as well as creditors of all description, whether financial intermediaries or not. This brings efficiency and security to retail and wholesale financial markets, with important benefits for financial inclusion. Where modern secured finance systems are in place, they underwrite often vast portfolios of small business credit at relatively low cost and risk. This is a simple idea but can be complicated to realize.

In Thailand, financial sector stakeholders bemoan the limitation of secured finance – at the low end of the market – to possessory, real estate, and a narrow range of other forms such as motorbike leases. An effort to reform the secured finance system came to an abrupt end with the most recent change of government. A Commercial Collateral Bill, aimed at increasing the types of assets that can be used as collateral, was approved by the Thai Cabinet in July 2009. The bill would have expanded collateral, set up registration and priority systems, and increased efficiency in enforcement.

Pending any revival of reform to the secured finance system, change will come from practical innovations within the system. Traditionally, private financial institutions in Thailand have required physical collateral (mainly in the form of real estate) or a guarantor. However, banks have become more flexible in recent years, accepting some current assets such as inventory or receivables as collateral from qualified borrowers. For example, this approach is used in the Capitalization of Assets program of the SME Development Bank. Private sector institutions have also begun using such assets to secure short-term financing, but not in small-scale transactions where this would be uneconomical. Further, inventory and receivables only have collateral value when companies are doing well, but become less viable – and more risky – during a recession, such as in the aftermath of the 2008 crisis (APEC 2012).

In light of the above constraints, financial institutions have developed instruments, both formal and informal, that serve as security or at least approximate it. Land and moveable security are reported to be used informally as collateral for small-scale credits. Individual and group guarantees serve as collateral substitutes to leverage repayment. Leasing and factoring are also used, but not to their full potential. Note that bringing credit-like transactions such as leasing and factoring into the formal secured financing system would both (a) put these deals on a par with other similar ones, thus creating consistent priorities and making collateral

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135 In Thailand (as in many developing countries), both legal provisions and practical considerations in the perfection and enforcement of liens limit the range of collateral that can be used – and the amount of debt that it can be used to secure. This need not prevent the inclusion of household or business assets in a loan contract, or the informal use of such assets to secure microcredits. The uncertainty created by the law concerns the validity of such interests against third parties and their legal enforcement.

136 TMB, Bankers’ Asn, FPO interviews.

137 Burke, Peter and Sudkhate Jungcharoen “Draft Collateral Bill Approved by Thai Cabinet,” Legal Update Thailand, 24 July 2009

138 It is also worth noting that moveable security (collateral other than real property) does not trigger more favorable risk-weighting of a loan, as compared to an unsecured credit, under BOT capital rules (and Basel III).
information comprehensive; and (b) facilitate finance leasing as well as securitization that does not require sale (as in classic factoring).

In the area of leasing, basic vehicle and motorbike leases are available, but the leasing of capital equipment less so. Nor is there specific legislation on finance leasing to bring uniformity to this area. As a result, leasing is underutilized, and the market for resale of leased equipment (other than vehicles) – a condition for effective leasing and collateral lending – can develop only slowly. Factoring suffers the same underdevelopment, due in part to the lack of specific legislation to sharpen the general guidelines given in the Civil and Commercial Code. Factoring is used in the form of firms’ sales of invoices, but is said to be quite costly for short-term working capital finance.\textsuperscript{139} SME Development Bank is engaged in this form of finance, helping to extend the market for it. The Bank is also involved in the collateralization of machinery, lending against equipment recorded in the Ministry of Interior’s Central Machine Registry, and of intellectual property such as patents and trademarks (Suwanaporn undated, APEC 2012).\textsuperscript{140}

C. \textit{Additional policy and social factors}

A wide range of factors enable (or disable) financial inclusion in Thailand. We touch on a few of the most noteworthy here. Taxes are an issue for businesses and particularly for financial services providers (less so for low-income individuals, since tax is not applied to income below THB 150,000 or on earned interest below THB 20,000). Corporate income tax rates have come down from 30% to 23% in recent years. A 7% VAT applies to goods and services, with a Specific Business Tax of 3% substituted for it in certain industries such as financial services (lower for certain banking transactions). Stamp duty of 0.1% applies to transactions such as loans, leases, hire-purchase, etc. Foundations and associations are taxed at a rate of 10% (with limited exceptions) on gross receipts including donations (Price Waterhouse Coopers, PWC 2011). These tax laws clearly affect the interests of financial services providers in deciding whether to formalize an organization or deal, and in choosing corporate or charitable organization status.

Other market environment concerns can be cited. These include labor costs – unionization and minimum wage scales are cited as factors in the expansion of bank branch networks and the use of banking agents. In down-market business and finance, issues such as permit requirements, corruption, and physical security risks may arise. Thus, the need to secure permission, pay a fee, or bribe an official in order to operate an MFI in a given locality can raise the costs of providers and clients. Insecurity can impose the need to take expensive steps to safeguard the handling and transport of cash. These factors have not been cited as major influences on financial inclusion in Thailand, though they are likely to play a role in areas that have experienced unrest.

At least as important is the quality of social capital. Some regions and localities support effective savings and credit activities that successfully leverage cross-guarantees and trust, while others are plagued by group defaults or leaders absconding with group funds. An important enabling factor here is the role of temples in the great majority of communities in Thailand. Monks have drawn on the cohesion and spiritual practices of these communities to launch a wide variety of savings, credit, self-help, and welfare initiatives, many of them achieving great success in mobilizing resources (BWTP and FDC 2010).

\textsuperscript{139} Factoring and securitization are potentially important for financial inclusion, since they would enable the refinancing of small and micro credit portfolios.

\textsuperscript{140} Also TMB interview
Research on Thai kinship networks (Kinnan and Townsend undated) suggests that these are important in financing investments that are too large to be collateralized with tangible assets and therefore must rely on social enforcement. Extended kin relationships are found to perform this function in assuring lenders that their loans will be repaid. By implication, being indirectly connected to the financial system is as beneficial as a direct connection. Not every household in a village needs to use the banking system in order to benefit, if interpersonal gifts and lending are widespread. This further suggests that evaluating financial access strictly by comparing those who use the banking system to those who do not may result in inaccurate findings. Indirect access to the formal financial system by means of group membership or social relationships, combined with the insurance-like effects of kin networks, appears to provide the greatest resilience, particularly in rural villages. Other experience affirms that indirect access alone (without the kin network) leaves people vulnerable to shocks – as well as to the breakdown of group discipline and to opportunism or coercion by group leaders.
VII. CONCLUSION AND RECOMMENDATIONS

A. Commercial banks and microfinance

Thailand’s commercial banks, being the financial sector’s center of gravity, have a role to play in financial inclusion. But in the near term, the banks are unlikely to down-scale into microfinance in any significant way. This will continue to be so as long as the banks can continue to earn healthy profits in their traditional lines of business, without regulatory or competitive pressure to move down-market. Some in banking sector believe the top end of the market is becoming saturated, and the banks will increasingly compete in the middle and smaller-scale markets. The policies adopted on microfinance and especially personal loans provide channels for this down-scaling. The impact of this appears in the growth of the NBFI sector, and bank investment in these institutions. The overwhelming focus here is on consumer credit to clients with steady, documented income. Banks and NBFIs are unlikely to go deeper into microfinance in the face of interest rate caps and competition from government-subsidized providers.

Other countries have increased bank down-scaling through policies that require or incentivize the extension of banking services to marginalized communities. In the U.S., the Community Reinvestment Act (CRA) conditions the approval of bank charters, expansions, and mergers on enforceable commitments to serve minority and low-income communities. These processes involve input from the target communities, and the usual route to commercial banks’ compliance is investment in a Community Development Finance Institution or CDFI (either a limited-charter community banking institution or an NGO) dedicated to serving the needs of those communities. (For further discussion of community banks and CDFIs, see Annex 1.) In South Africa, similar pressure is brought to bear in a process that began as a set of voluntary commitments by the financial sector and was later embodied in public policy.

Thailand has experimented with incentives for rural outreach, encouraging banks to establish a presence in outlying areas. A next step could be to set up a CRA-type process that provides incentives for banks to go beyond this and provide microfinance services tailored to rural clients not now served by the system. Such a process could condition bank licenses, renewals, mergers, and other actions on the depth of service outreach to those populations or regions. While this approach could succeed in Thailand, its record in other countries is mixed, and a number of complementary reforms would be needed. As a simpler alternative (or preliminary step), BOT could include down-scaling criteria in its supervision standards, require the banks to publish their performance according to common inclusion metrics, and report such performance in BOT’s own annual reports. This would provide the basis for public discussion and pressure for the banks to expand services.

A further alternative is to set up tiers of microfinance banks or NBFIs under BOT. Small limited-purpose banks have also been used in many developing Asian countries to provide services to lower-income and rural populations. The Philippines, for example, has thrift, rural, and cooperative banks, the different categories having diverse structures and market

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141 Instituting a CRA or similar policy would require some rationalization of the market so that banks have appropriate incentives and competition is not distorted due to the advantaged position of players such as the SFIs (CENFRI comments). The U.S. experience with this approach is mixed, though now widely regarded as positive. Similar policies in India and China (similar in concept with important differences in design) have had few successes and many disappointments.
niches. In each case, unit banking licenses are geographically circumscribed (by district), but banks in jurisdictions with different levels of urbanization and population density have distinct levels of minimum capital. Also, their loans that meet the standards of microfinance policies are given preferential treatment in terms of risk-weighting. Korea and Indonesia have comparable systems of second-tier banking (Meagher et al 2006).

More robust involvement by the banks in microfinance will likely arise from the demonstration effects of successful microfinance services. This has historical precedents, including the entry of U.S. commercial banks into retail credit and deposit services following the success of mutual banks and cooperatives in this market. Similarly, if other institutions such as the SFIs and CFIs show that there is a viable market for microfinance services, the banks may well follow. At that point, the banks could consider investing in specialized MFIs (see below).

Recommendations:

1. Consider lifting interest rate caps for microfinance loans. Replace them with a more credible set of protections to ensure transparency and competition in credit pricing, and to prevent abuse of financial services consumers.

2. Redesign state support for microfinance through the SFIs, cooperatives, and village funds in order to level the competitive playing-field and encourage investment (see below).

3. Introduce financial inclusion metrics into the supervision and reporting standards for banks and NBFIs, and publish the audited performance data to enable public comparisons among financial institutions.

4. Consider adopting a CRA-style system of performance incentives and penalties, reporting requirements, and public hearings focused on financial institutions’ efforts towards down-scaling and financial inclusion.

5. Create one or more specialized MFI licenses (see below); permit or encourage banking institutions to establish MFI subsidiaries or to invest in MFIs in order to meet the CRA-style performance criteria cited above.

B. SFIs

How might Thailand have better-performing and safer institutions that carry out the state’s priorities in small-scale finance? The critical change that is required is not so much to cut back or eliminate state ownership, but to insulate this sector to the extent possible from political intrusion. Repeated cycles of loose credit, debt forgiveness (including the moratorium and refinancings), and recapitalization of the SFIs have reinforced the role of these latter institutions as tools of state (and party) policy rather than efficient allocation of capital. The role of FPO as regulator is complicated by its status as part of the Ministry of Finance, which combines the functions of owner, political master, and supervisor. The effect on clients all too frequently, it appears, is to weaken repayment discipline.

Countries around the world have approached this problem through bank governance reform. This sometimes involves setting up an autonomous public sector institution with a budget
line and structure separate from other state organs, or more frequently some combination of corporatization and privatization. It would make sense for some of the SFIs, beginning with BAAC, to move toward a more tightly governed corporate structure. This might mean selling a significant minority share to private investors – ideally one or more Thai or foreign financial groups with a strategic interest.\(^{142}\)

In such a scenario, a reformed SFI such as BAAC would either operate as a state-owned commercial bank under BOT supervision as KTB now does, or be restructured into a wholesale or apex institution serving retail microfinance providers. In the case of BAAC, the move toward wholesale financing has been discussed in light of the unsustainable workload of BAAC staff, now serving more than 5 million households. The idea is to move from retail to wholesale banking, and in the latter capacity to assist community-based organizations and Village Funds to expand microfinance and improve their institutional structures and operations. BAAC began this work with its Community Bank Project, which has served some 20,000 clients through intermediaries and achieved an excellent performance record (Ennoo Susewan comments). The new wholesale institution would lend to MFIs, hold deposits and reserves from those institutions, link the MFIs to the broader capital market, and operate similarly to an apex or holding company by exerting oversight and building capacity among the MFIs. This upper-tier institution (or group of institutions) could play a role similar to the Landesbanken in Germany or BRI in Indonesia. (For further information, see Annex 2). Branches of BAAC and other affected SFIs could be spun off and converted into MFIs, wholly or partly privatized. They could play a role similar to the German savings banks, and the larger MFIs in other developing countries such as Cambodia (see below).

**Recommendations:**

1. Bring greater financial discipline, internal control, and sustainability to the SFIs. The methods to be used here could include increasing the role of BOT and tightening its cooperation with FPO, reducing the discretion of the Minister of Finance in the oversight of SFIs, and increasing transparency and uniformity in the supervision and state financing of SFIs.

2. Introduce a “subsidy-dependence index” (Yaron 1994) as a supervisory standard for the SFIs, and require annual publication of the resulting performance data.

3. Consider the restructuring of SFIs or portions of them – especially BAAC – to create a specialized wholesale financing institution for microfinance.

4. Consider moving the SFIs or their successors more fully into corporate structures separate from the state administration, bringing in private capital. Provide any state program grants on a competitive tender basis open to any financial institution.

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\(^{142}\) It is possible that BAAC’s role is too political for such a transformation to be workable. But it is worth noting that banks with quite similar characteristics have been successfully transformed, such as BRI in Indonesia and state-owned banks in the post-communist states of Eastern Europe.
C. Microfinance institutions

In Thailand, the time appears to be ripe for creating a regulatory system to address the range of microfinance programs and providers. This includes the Village Funds and other state programs, the financial activities of the cooperative sector, the various community and village banks promoted by the SFIs and NGOs – often termed CFIs – and the informal savings and credit groups.

The SFIs, Village Fund system, the cooperatives, and the small-scale savings and credit groups have played a vital role in extending services not supplied by the market to many communities and households with limited access. At the same time, much of this activity appears to be unsustainable or is growing rapidly with little or no supervision. This generates risk not only to the vulnerable clients immediately involved but to the financial system more generally. These approaches also appear to be less cost-effective and sustainable than many alternatives used elsewhere in the world. The question is what kind of system extends financial services to underserved groups most effectively and at the least cost. The costs include the high unit costs of small or personalized transactions, the logistical costs of moving services to under-resourced or remote areas, and in some cases the costs of specialized risk management and regulatory supervision systems.

Bringing safety, soundness, and sustainable growth to microfinance requires, at some point, establishing a regulatory framework adapted to meet the distinctive needs of microfinance models. Policymakers in Thailand increasingly acknowledge that the time has come for such a step. The various components of the market have grown to the point where a regulatory structure is needed for consolidation and further development. A range of options are available, and these need to build upon or incorporate existing systems and providers that are adding value. We have addressed the banks and SFIs above. Here we focus on what are often termed "semiformal" institutions – cooperatives and Village Funds – along with the informal groups and the CFIs (which may be either informal or semiformal, i.e. registered as organizations but not regulated).

As for cooperatives their numbers and membership are significant, and their financial services activities substantial. The difficulty is that in Thailand, as in many countries, the cooperative sector is not structured and supervised optimally to enhance financial inclusion. A key reform step would be to enact a law on financial cooperatives creating a separate regulatory structure, supervision system, and institutional requirements for cooperatives whose primary business is finance. Other necessary steps, including development of regulations and the transition to the new regime, would follow. Ideally, the new regime would accommodate existing NGOs and grassroots groups that seek to formalize as savings and credit cooperatives. The reform would need to treat financial cooperatives as financial institutions, separating them from other cooperatives. Relevant supervisors at CPD and CAD could be reassigned to an independent regulatory body (or a department of BOT). The political difficulty of such a move is likely to be high, but the potential benefits would seem to justify it.

A regulatory system for financial cooperatives could accommodate not only existing credit unions, savings and credit cooperatives, and agricultural cooperative financing activities, but could also provide an appropriate framework for Village Funds, CFIs, and informal groups that are organized along cooperative lines. Indeed, in some countries, microfinance is dominated by cooperatives (e.g. West Africa) for a combination of historical and policy reasons. Elsewhere (e.g. Mexico), a single MFI framework with elements of cooperative
governance is used by both traditional financial cooperatives and other financial institutions. In Thailand, the latter might be a viable choice, but it is more likely that new entrants to the market would find the cooperative form too constraining.

This suggests that Thailand should establish a new licensing window for microfinance, separate from the financial cooperatives. (Care should be taken to design the two systems to avoid regulatory arbitrage, e.g. by ensuring compatibility among supervisory norms and coordination between regulators in the two systems.) This will mean creating structural requirements, minimum capital, financial ratios, and other prudential norms tailored to microfinance methodologies. Often, entry requirements such as minimum capital are kept fairly low, while capital ratios and prudential standards, including loan classification and provisioning rules, are made relatively strict due to potential volatility.

Given the market context in Thailand, any microfinance licensing scheme should build in multiple tiers. The most stringent requirements should be placed on MFIs seeking to intermediate public deposits, with lesser standards for credit-only institutions, and little or no regulation for small member-based providers. This kind of model is used in a few countries such as Uganda. In Southeast Asia, the example of Cambodia is often cited, where three levels of regulation are applied to institutions of different sizes and ranges of activity – these include small providers who are not supervised, intermediate providers who must report and comply with basic requirements of registration, and the larger and better-organized ones that must obtain a license. The licensed institutions potentially have access to the widest range of microfinance activities, including public deposits. (For further discussion of Cambodia, see Annex 3.)

Recommendations:

1. Create a new licensing and supervision regime for microfinance, tiered to accommodate deposit-taking, credit-only, and small informal institutions. The tiers could include:
   a. Licensed microfinance depository institutions, which could accommodate CFIs (e.g. those established by Village Fund depositors) that reach a size threshold and take deposits; transformed (spun-off) SFI retail institutions; and transforming NGOs among others. These would be subject to prudential supervision.
   b. Registered micro lenders: Village Funds, transforming credit groups and moneylenders. These would be subject to reporting and market conduct regulation.
   c. Informal savings and credit organizations below a defined threshold.

2. Create a new regulatory-supervisory framework for financial cooperatives, separate from the existing integrated framework under MOAC. This should accommodate existing cooperatives as well as NGOs, CFIs, and savings groups that wish (or are required) to formalize, and that choose the cooperative form as most suitable. One way to do the latter is to create a lower regulatory tier for smaller financial cooperatives, and a second for large institutions including existing employer-based savings and credit cooperatives.
3. Include in the new microfinance regulatory-supervisory system the sector apex or wholesale institutions, including the National Village Fund and BAAC (or their successor institutions).

D. **Supervision**

The success of a regulated microfinance sector depends to a great extent on the quality of supervision. At the same time, effective supervision is perhaps the greatest challenge, given the range of microfinance activities, the small scale of most providers and transactions, the unique methodologies used, and the constraints on supervisory resources. Above, we have made recommendations about steps that could be taken to enhance BOT supervision of microfinance activities of the banking sector and the SFIs. Here, we focus on supervision of microfinance institutions, including cooperatives, existing semiformal institutions, and MFIs that would formalize under the regulatory provisions we have recommended above.

There are a range of issues and options here. Who should the supervisor be? Microfinance supervision is often housed in a department of the central bank or banking supervision agency. In Thailand, BOT is the most capable organization in general, but has not developed the expertise necessary in microfinance methodologies, and it is also concerned about adding on to its core macroeconomic and banking regulatory functions. A further option is to house responsibility in another government agency. FPO in the Ministry of Finance is taking the lead in policy development, while also supervising the SFIs. But its capacity appears already to be stretched, and it has not played a significant role to date in directly supervising microfinance – apart from the activities of the SFIs.

Some countries have set up free-standing regulatory agencies, or branches of an integrated financial markets regulator, to deal with microfinance. In Mongolia, for example, the Financial Regulatory Commission deals with all non-bank financial activity, including microfinance providers such as the savings and credit cooperatives. The U.K. and Germany assigns this to units of a single financial regulator. South Africa has a National Credit Regulator dealing with micro lenders, while the U.S. has separate specialized agencies dealing with credit unions, savings and loan companies, and community banks respectively. In Bangladesh, the MRA (Microcredit Regulatory Authority) has been separately established from the Central bank as a new authority to supervise MFIs (BOT comments).

The specialized microfinance regulator model appears suitable to Thailand. Ideally, it would be autonomous, on a par with BOT, and free from political intrusion. It could be part of the state administration, or it could be a self-regulatory organization (SRO) set up as a foundation, company, or NGO. The agency should disclose its supervision data on a regular basis to BOT, while coordinating with MOF. This microfinance regulator should have authority over all microfinance activities (or at least those not directly handled by commercial banks), including those of restructured SFIs, financial cooperatives, and providers registered or licensed under the new MFI window. The director and core staff could be drawn initially from FPO, BOT, CAD and CPD, and institutions with microfinance experience such as BAAC, KTB, and promoters such as CODI.

Apart from drawing personnel from these institutions, the microfinance regulator should also coordinate with them and build their capacity as indirect supervisors of informal microfinance providers. Thus, the new system would make use of the current oversight mechanism for informals, which could be described as layering or delegation. Institutions such as BAAC,
CDD, and the cooperative federations, provide a combination of wholesale finance, collective deposit accounts, technical assistance, and oversight to small-scale service providers. The wholesale/oversight institutions have developed tools for building microfinance groups, training them, and strengthening their governance and accounting. They can be required to provide periodic reports to the regulator, enabling it to monitor indirectly the growth of informal groups and the nature of their services.

The precise methods and standards to be used in supervising the MFIs will depend on the legal-regulatory framework adopted, on the models used by the providers, and on the scale and diversity of the market. It will be especially important for the supervisory standards to be discussed with the sector and for the supervisor to follow the market as much as possible. Experience and the literature provide overall guidelines in developing the system of supervision. For example, the BIS, in reviewing the application of its Core Principles to small-scale finance (BIS 2010), identifies a number of specific tasks for microfinance supervisors. They need to:

- allocate supervisory resources efficiently, especially where depository microfinance does not represent a large portion of the financial system but comprises a large number of small institutions;
- develop specialized knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly micro-lending;
- recognize proven control and managerial practices that may differ from conventional retail banking but may suit the microfinance business both in small and large institutions, specialized or not in microfinance; and
- achieve clarity in the regulations with regard to microfinance activities, and specify which activities are permitted to different institutional types, while retaining some level of flexibility to deal with individual cases.

Additional challenges will arise in keeping the unit costs of supervision within reason – difficult in systems dealing with many small institutions – and in designing and operating the system on a risk basis in order to prioritize and economize on supervisory resources.

Recommendations:

1. Establish an independent microfinance regulatory agency, drawing on expertise from existing government and sector organizations. This institution would ideally be designed to supervise both financial cooperatives and registered/licensed MFIs.

2. Set up tailored, risk-based supervisory norms and procedures (both off- and on-site) for microfinance, drawing on best practice as well as the knowledge of experienced practitioners from relevant institutions such as BAAC, CPD and CAD, and the Village Funds.

E. Outreach and commercial environment

Branchless outreach not only raises the prospect of efficient service provision to those with constrained access to banking infrastructure, but in doing so it also suggests ways of imposing greater market and regulatory discipline in the areas just discussed. KTB’s experience in working with cooperatives as agents provides one example. Agency offers a
way for smaller-scale providers to link up to larger institutions, but on condition that the
agents meet certain standards and submit to oversight by the principal. As such, agency can
serve as an adjunct or even an alternative to the apex structures discussed above.

The expansion of e-money services provides another example. When mobile banking takes
hold in Thailand and becomes the norm, the desire of various institutions to provide this kind
of facility will give BOT and the Electronic Transactions Commission leverage to enforce
standards in return for access. Those that do not qualify will need to explore other options
such as restructuring, consolidation, partnership, or a different market focus. It is worth
examining whether BOT and the Commission, perhaps in cooperation with MOF and others,
can use their leverage in favor of improved governance in the SFIs and others seeking to
offer branchless services. A decree is expected in the near future to regulate electronic
payment services provided by the SFIs, and this should help put the latter on the same
footing as the commercial banks. Further, as Thailand gains experience with e-money, BOT
should also re-assess the fit between existing requirements for providers, the development
of open electronic money platforms, and the need to connect unbanked populations as
quickly as possible.

As for the commercial environment, several things need to be done, including another effort
at secured transactions reform. The latter involves legislative change that will take time to
accomplish. In the nearer term, it will be important to expand the credit information system
provided by NCB to include BAAC and small-scale service providers to a much greater
extent than currently. This need is clear from the reports of personal over-indebtedness, the
moratorium and refinancing schemes, and the apparently common practice of borrowing
from one lender to pay another. It would also be useful to have a record of areas and
persons who have been involved in collapsed group finance schemes. The extension of
NCB down-market (or some kind of link-up between it and the various localized records and
creditworthiness checks), should help to improve information and certainty for small-scale
financial service providers. Thailand is well-placed to expand this system, since official
identity documents are now the norm, and demand is building for a more complete system.

Recommendations:

1. Shift more fully toward an open-platform electronic transactions system, and clarify
   the requirements for agents who provide purely cash-in and cash-out services –
   with the aim of expanding electronic services as rapidly as possible to underserved
   populations.

2. Expand the credit information system to include all financial service customers, and
   strengthen incentives for non-member institutions such as BAAC to enter the
   system.
CHAPTER VII ANNEXES

ANNEX 1: Community banks and CDFIs in the U.S.\(^{143}\)

Small-scale finance in the U.S. grew along lines similar to those of Germany and of the few developing countries that allowed MFIs to innovate and reach scale before imposing regulation. The early 19\(^{th}\) century U.S. saw the development of small savings and credit institutions derived from earlier British models. These were the mutual savings banks and the mutual savings and loan associations. The savings banks were initially founded as non-profit institutions, and until the mid-19\(^{th}\) century they offered the only option for people of modest means to make savings deposits.

At the time these small institutions arose, there was no system of financial services regulation. Commercial banks would not have been safe places to save money because they invested in speculative ventures and had no guarantees. However, once the savings banks and savings and loan companies (S&Ls) had demonstrated how much demand there was among ordinary people for savings deposits, the commercial banks entered the market. In the first two decades of the 20\(^{th}\) century their deposits surpassed those of the savings banks and have continued to multiply. In effect, the advent of banking regulation and then deposit insurance removed the main advantage of the savings banks and S&Ls – their much greater trustworthiness and safety (Hansmann 1990).

Since about 1980, traditional mutual savings banks and savings and loan institutions have become far less important in the U.S. Deregulation, followed by the S&L crisis and its aftermath, led to the current array of commercial banks and S&Ls offering a broader range of services, a wider geographic scale, and on a more purely profit-making basis. Thus, small and medium-scale retail banking is no longer the province of S&Ls per se, but “community banks” or “community development finance institutions” (CDFIs). Neither of these categories is defined as a specific regulatory window.

Community banks are small banks, many of them focusing on relationship banking and local retail services, intermediating deposits within a small geographic area such as a county. Their connections to the community and their ability to draw on detailed information on local clients and conditions enables them to serve a certain customer base – particularly local small businesses – better and more cheaply than large banks. The competitive advantage of community banks in this field depends on their having the autonomy of independent, self-sustaining units. The key here is that they enjoy the discretion to set their own underwriting standards and to monitor their borrowers (Whalen 2001, Meyer and Yeager 2001, Avery and Samolyk 2003, Hagendorff et al. 2007).

There is no separate licensing category for community banks, but this designation is generally used for those small financial institutions – with less than U.S. $1 billion in assets

\(^{143}\) This discussion is drawn from prior work (for ADB) by the author.
– that are not required to meet the full compliance and reporting requirements that the Community Reinvestment Act (CRA) imposes on large commercial banks. A community bank might be licensed as a commercial bank or savings and loan, as well as chartered and primarily regulated at either the federal or state level (Pinsky 2001, DeYoung et al 2004, Greber 2005).

Community banking plays a significant role in the U.S., especially poor urban neighborhoods and most rural areas. The rural areas have experienced intensifying depopulation and poverty. One study found that nearly a quarter of rural counties in the U.S. are served by no more than two banks – and many of these have little or no branching network in those counties. U.S. banks that can be defined as community banks according to size (under U.S. $1 billion in assets) are estimated to comprise some 90% of all banks, but control only about 15% of banking assets. They handle about one-third of bank loans to small businesses, some 80% of bank credit to small farms, and a sizeable share of small deposits (Keeton 2003, Betz 2006).

The category of CDFI is broader and includes community banks as well as credit unions and non-profits involved in community finance and development. CDFIs provide a vehicle for commercial banks to meet their obligations under the CRA. The CRA requires banking institutions to show that they are serving the needs and convenience of the communities in which they are established. Approval of these institutions’ branching and merger are conditional on their meeting this broad standard. Determinations are made in public hearings where evidence can be given by experts, members of the relevant communities, and activist groups. The CRA requires all banks operating in a community to provide levels of service on a par with their services generally. Thus, all are motivated to make efforts to find viable clients – or to invest in CDFIs that have existing client bases. Community banks and CDFIs, far from suffering when competing banks consolidate, appear to benefit, gaining market share due to their comparative advantage in relationship lending and access to local information (Barr 2005).

CDFIs are defined by law – including for purposes of the CRA – as small institutions (usually defined as above) dedicated to community development. They serve low-income communities by means of retail banking services to small businesses and households, and provide other development services (directly or through affiliates) such as training and outreach. CDFIs cannot be agencies of government. They are allowed to be financed or owned by federally chartered banks or bank holding companies, provided either that the parent company or group has community banking as its main business, or the ownership share does not exceed 25%. CDFIs are eligible for grants under CRA-related federal programs, and large bank investments in them are counted toward the banks’ CRA requirements.\(^{144}\) Thus, much of the capital of CDFIs comes from larger banks making CRA-related investments, along with non-profit investors, government grants, and deposits.

\(^{144}\) 12 US Code Chapter 48 – Financial Institutions Regulatory Improvement.
CDFIs are not easy to sustain and to some extent depend on subsidies. This is due to their relatively high costs. The latter are driven by small transactions and outreach activities such as training, and the limits that usury laws and political sensibilities place on their ability to charge interest and fees at a level that would cover costs (Pinsky 2001, DeYoung et al 2004, Greber 2005). High-interest lending is left to the pawnbrokers and payday lenders, whose services are in high demand but are often considered exploitative.

Although the community banks’ dependence on local markets is usually thought to make them riskier due to a lack of diversification (and this was in many cases borne out during the Savings and Loan – or S&L – crisis of the 1980s), the data suggest that this may not be true at present. A study in the U.S. found no significant correlation between local economic conditions and the performance of community banks – even those with deposits concentrated in a single county. Diversification, expanding the radius of service provision, and ownership stakes by bank holding companies – together with well-developed methods of local relationship banking and risk management – enabled the community banks to avoid the expected problems of concentrated risk (Meyer and Yeager 2001).
ANNEX 2: State-owned wholesale institutions and small-scale finance

Germany

In the 19th century, Germany had a relatively underdeveloped economy as compared with the rest of Western Europe, especially Britain. Late in the century, Germany put in place a system of universal banks in order to finance its rapid industrialization and to manage liquidity arising from its advancing economic development. This system did not, however, address the financing needs of farmers and small enterprise. The two main institutions that developed in Germany to respond to these needs were the savings banks (Sparkassen) and cooperatives (Raiffeisen institutions). Initially, these focused on small savings and were not a significant source of capital for farmers and entrepreneurs. Also, the postal savings banks came into being to facilitate savings and also to intermediate these funds to other sectors of the economy.

Thus, these institutions provided what amounted to small-scale development finance in the mid to late 19th century. The thrift and cooperative institutions were able to innovate and grow in large part because they were self-regulated. Also, since they had no access to other sources of capital, they were forced to manage deposits and member shares carefully. In the modern era, these institutions have become much more integrated into the banking system and its capital flows, and many of them became large universal banks.

Today, the large German banks operate in a separate sphere of national, EU, and global financial services markets, having a prominent role in the traditionally bank-dominated corporate finance system of the European continent. The main development-oriented banks are still the community savings banks or Sparkassen, now under the Landesbanken or state (Land) level banks that provide wholesaling and central banking services. Both types of banks have, until recently, been entirely government-owned, i.e. owned by the respective Laender and localities.

In the last decade, there have been moves to bring in private capital, although the community bankers have tended to resist this. It appears that private initiatives, lawsuits, and the standards of the European Union will force gradual opening to commercial capital. Further, government removed its blanket guarantee of liabilities, thus prompting a wave of savings bank consolidation and streamlining. Still, the German savings banks thus far have kept their commitment to their local communities, focusing on small business and low to medium-income households.

The Sparkassen are viewed as agents of local self-government. This political arrangement, with the decentralized structure imposed by the German constitution, has kept the Sparkassen from being absorbed by the commercial banks, thus preserving Germany’s three-pillar banking system (commercial banks, credit unions, savings banks). Moreover,

145 Sources for this discussion: www.dsgv.de, Hagendorff et al. (2007), Maalouf (2007), Seibel (2005), European Association for Banking History (1994). This discussion is drawn from prior work (for ADB) by the author.
state ownership of the savings banks brings with it political pressure to ensure that local financial services needs are met as fully and fairly as possible. On the one hand, this approach to community banking has drawn criticism for reducing efficiency, competitiveness, and sustainability in the interest of financial inclusion. On the other hand, it has underlined the savings banks’ commitment to meeting the financial needs of their local communities.

Indonesia

A distinctive model arose in Indonesia with the move away from state-run development banks. This produced a hybrid system well-adapted to the needs of a large, populous Asian country with significant rural poverty. Key transformations occurred in the role of Bank Indonesia (BI – the central bank) and especially that of Bank Rakyat Indonesia (BRI, the major state-owned commercial bank, now with some private ownership). As BI shifted away from a direct role in development finance, BRI increasingly took over this niche.

BRI hosts one of the world’s largest networks of microfinance providers. This network was created in the 1980s as a result of the transformation of a troubled public sector agricultural credit program. A dozen years later, BRI’s village unit (unit desa) banking system had a return on assets of 5.7% and a profit of US $177 million. BRI units weathered the monetary crisis of 1997-2000, while BRI corporate lending was severely affected by the crisis. The units surprisingly experienced a rapid increase in savings during the crisis, as did BRI as a whole, benefitting from a “rush to safety” after several private banks were closed down or taken over.

The success of the unit desa system was based on a few key design factors. Loans were made available to all creditworthy applicants for any productive purpose. This required a complete re-design of the products and services being provided by the units in order to meet the needs of economically active poor and lower-middle-class people. Also critical to success was the absence of subsidy in the credit program. Accordingly, interest rates were set at a level that would cover all the costs of the products, plus return a profit to the institution. The units choose their own customers, and hire well-trained staff. Loan terms are negotiated to correspond to the needs of each borrower, and incentives are given to borrowers who repay on time. Also, financial liberalization and a flexible approach to the prudential governance of microfinance operations made success possible.

146 Source for this discussion: Meagher et al. (2006).
ANNEX 3: Tiered microfinance regulation in Cambodia

Cambodia has established a tiered system of microfinance regulation and supervision. The system provides for four types of operators:147

- Licensed Deposit-Taking MFI
- Licensed MFI
- Registered microfinance provider (usually an NGO)
- Non-registered provider (informal provider or NGO).

It should be borne in mind that Cambodia is a poorer and less populous country than Thailand. Moreover, its financial sector was much less mature and inclusive than Thailand’s when reform got underway – and this is still very much the case. The process of formalizing microfinance began in a context where NGO microfinance was proliferating, filling in large gaps in access to finance by ordinary Cambodians, with a large part of this activity being funded and promoted by the international community. As the reform process gained momentum, the leading microfinance NGO, ACLEDA, transformed into a specialized microfinance bank (2000). This created a positive precedent for other microfinance providers (IDLO 2008, Vada 2010).

The reform process was approximately as follows. Starting in the mid-1990s, the government adopted a series of policy measures, supported by international donors (Vada 2010):

- Setting up a microfinance apex institution, the Credit Committee for Rural Development (CCRD);
- Adopting the Law on Banking and Financial Institutions, thus creating a framework that includes commercial and specialized banks as well as small-scale and rural finance institutions to be specified in the regulations;
- Adopting regulations enabling eligible NGOs and other rural finance providers to become regulated microfinance institutions;
- Creating a unit in the National Bank of Cambodia (NBC) to license and supervise MFIs;
- Establishing a Rural Development Bank (RDB) as a wholesale finance source for MFIs; and
- Adopting the regulation (Prakas) on the Licensing of Microfinance Deposit-Taking Institutions, enabling licensed MFIs that met NBC criteria to accept public deposits (2007).

Cambodia’s system (see the table below) is usually described as licensing the big MFIs and registering the medium-sized ones. The licensing provisions resemble those for commercial banks, except that the capital requirement is substantially lower. Registered providers are subject to lighter regulation and, in particular, reports sent to NBC are simplified. The small microfinance providers can operate freely with no registration or

147 Discussions of Cambodia usually break the microfinance sector into three parts (licensed, registered, informal), but the addition of a savings license adds a further layer.
Microfinance Regulation and Supervision Recommendations Report

Official oversight (Bonang and Vada undated). Further, microfinance interest rates are unregulated. Average lending rates declined from 5 to 6 percent per month initially to 2.5 to 3 percent per month in recent years. However, the main funding source of MFIs is large foreign financial institutions. Thus, the wholesale rates the MFIs pay have been affected by fluctuations in international markets – thus keeping retail rates from dropping further. Nevertheless, the NBC has issued a regulation on interest calculations for microfinance loan products based on the declining balance method, with the aim of keeping interest charges within limits (Vada 2010).

Cambodia: structure of microfinance system

<table>
<thead>
<tr>
<th>Services</th>
<th>Registered micro credit provider</th>
<th>Licensed MFI</th>
<th>MDI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis for registration or licensing requirement</td>
<td>Providers having loans outstanding of less than KHR 1 billion ($US 250,000) and less than 1,000 clients.</td>
<td>Providers having loans outstanding of more than KHR 1 billion ($US 250,000) and more than 1,000 clients</td>
<td>And: seeking approval for public deposit-taking</td>
</tr>
</tbody>
</table>
| Threshold criteria | • Register as an association or NGO  
• No minimum registered capital requirement  
• No registration fee  
• Quarterly reports to NBC | • Register as a commercial enterprise or cooperative  
• Minimum registered capital requirement KHR 250 million  
• Apply uniform chart of accounts  
• Monthly reports to NBC:  
  o Assets and liabilities  
  o Profit and loss  
  o Loan classification  
  o Solvency calculation report  
  o Other. | • Hold an MFI license at least 3 years  
• Good financial condition and sound management for at least two years before submitting the application  
• Minimum paid up capital equal to KHR 10 billion (US $2.5 million)  
• Have an effective Management Information System (MIS)  
• Have sustainable profitability of at least two consecutive years in primary operations |
| Prudential | None. | • Registered capital guarantee 5%  
• Reserve requirement 5%  
• Solvency ratio 15%  
• Liquidity ratio 50%  
• Large exposure not more than 10% of owners’ equity | • Capital guarantee: 10% of its registered capital held in an account with NBC;  
• Reserve requirement: 8% of its client deposits held in an account with NBC;  
• Large exposure limit 2-3% |

Source: Vada (2010).

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148 This is not explicit in the literature or the legal-regulatory materials we have reviewed, but is implied by the development of the sector and the regulatory framework since the 1990s.

149 The original (2000) regulation contained these triggers for registration: 100 million (US$25,000) in loans outstanding or 1,000 borrowers; 1 million (US$250) in voluntary savings or 100 depositors (BWTP undated, IDLO 2008). Presumably, any provider wishing to expand and offer more services would register as a first step.
What are the results of Cambodia’s policies? The microfinance sector continues to grow rapidly in terms of number, size, and operations. As of end 2011, there were 32 licensed microfinance institutions, of which 7 were microfinance deposit taking institutions. This development is reflected in total asset growth for the sector of 48% in 2011, to KHR 3.03 billion (US $749 million), with total loans up by 50% to KHR 2,591,263 million (USD 641.53 million) and borrowers increasing by 17% 1,141,913. Aggregate deposits surged by 180% in 2011, to KHR 459,473 million (USD 114 million). In the same period the average delinquency ratio fell to 0.22%, while total net profit increased by 63% to KHR 110,117 million (USD 27.26 million), with return on equity at 15.1% at the end of 2011. The sector continues to be largely foreign-owned, with 77% of total registered capital held by foreign shareholders at the end of 2011 (NBC 2012).
APPENDIX 1. REFERENCES


Banking with the Poor (BWTP) and the Foundation for Development Cooperation (FDC) (2010), “Microfinance Industry Report: Thailand,” Brisbane: FDC.


APPENDIX 2. LAWS, REGULATIONS, AND POLICY DOCUMENTS REVIEWED


Bank of Thailand Act B.E. 2551 as amended

Bank of Thailand Microfinance Guidelines for Commercial Banks, 2011

Bank of Thailand Notification Re: Regulation on Capital Adequacy for Commercial Banks (not available)

Bank of Thailand Notification 9/2553 Rules for Establishment of Financial Institutions (Banking Agent)

Bank of Thailand Notification No. SorNorSor. 01/2552, Re: Executing the Personal Guarantee Contract

Bank of Thailand Notification No. SorNorSor. 54/2551, Re: Guideline for Calculation of Credit Risk for Commercial Banks

Bank of Thailand Notification No. SorNorSor. 95/2551, Re: Regulation on Minimum Capital Requirement for Operational Risk

Bank for Agriculture and Agricultural Cooperatives Act, B.E. 2509 (1966)

The Cooperatives Act B.E. 2542

Cooperatives Sub-Law (summary only)

Credit Information Business Act B.E. 2545

Deposit Protection Agency Act B.E. 2551

Electronic Transactions Act B.E. 2544 (2001)

Financial Institution Business Act B.E. 2551

Government Housing Bank Act B.E. 2496 (1953)

Ministry of Finance Act (regulation) of 16th June B.E. 2548; Subject: Permission for Business according to section 5 of the Notification of the Revolution Council No. 58 (Personal Loan Under Supervision).

Ministry of Finance Notification: Business that Requires a Permit According to Section 5 of the Notification of the Revolution Council No. 58 (Business of Electronic Money Card) dated October 4, 2004 (summary only)

Pawnshop Act (BE 2505 as amended)

Regulations of the Committee on National Village and Urban Community Fund Governing the establishment and management of the National Village and Urban Community Fund, B.E. 2551.

Royal Decree on Monitoring Electronic Business (BE 2544 article 32, 33, 34 and 2) (summary only)

Royal Decree Regulating Electronic Payment Services, BE 2551, published in Royal Gazette 16 September, 2008 and enforced as of January 14, 2009.

Savings Bank Act, B.E. 2489 (1946), as amended

The Small and Medium Enterprise Development Bank of Thailand Act (BE 2545).