Role of the Financial Sector in Supporting Economic Growth and Poverty Reduction

Prof. Dr. Hans Dieter Seibel
(seibel@uni-koeln.de)

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Overview

Overview

1. The challenge of ec. growth and poverty reduction: Banking and microfinance in Europe – Lessons of history

500+ years of banking, 300+ years of microfinance

Objective of banking: **economic growth**

Objective of microfinance: **poverty reduction**

15th century:

Beginning of economic development and banking:

- Small and big business growth, international trade
- Banking: from deposit-taking to financial intermediation and business finance

Growth interrupted by wars and epidemic plagues

Poverty and the rise of microfinance (*MF*)

16th-18th century:

Tremendous increases in poverty

18th-19th century: Origin of two MF movements

Objective: **poverty reduction**

- Both movements: Savings-led, local, informal beginnings
  - First priority of the poor: Depositing savings
- Today the two largest networks of MF providers in the world

First MF movement (*origin in Europe*): Savings funds/banks for the poor

~ 1800:

- Initiated, owned, managed by communities or districts
- Sources of funds: savings of the poor (for emergencies, old age, then consumption, business);

  supplemented by charity, government funds
- Savings = loanable funds, followed by credit
- Spreading around the world: the largest MF network

  Germany:

  1778 first registered thrift society

  1801 first communal savings "bank" (*Sparkasse*)

  1838 Savings banks decree

Second MF movement (origin in G*ermany*) SHGs/credit associations/cooperatives

1846/47 hunger year, many lost their life or farms

1847 1st rural rural charity, unsustainable

1850/64 1st urban/rural SHG/credit association

Owned, managed, governed by their members

Coop. strategy of poverty reduction and growth:

Financial, supply and marketing services to individuals and enterprises

1877 Federation for services, bank linkages, advocacy

1889 Cooperative Act, expansion to 15,000 credit coops

~1900 spreading around the world

Regulation and supervision of MFOs *(Germany)*

1838 Savings banks decree

1889 Cooperative Act

Auditing: by chartered accountants or auditing federations

Limited liability of coop members

1934 Banking Act covering 18,000 MFOs:

15,000 credit coops + 2822 savings banks

Supervision delegated by the central bank

to auditing federations of the 2 networks

(Ex-) MFOs in Germany, 2010

Outreach:

429 savings banks, 15,600 branches, 50 mn clients

1138 coop banks, 13,500 branches, 30 mn clients

Sum: 1567 local MFOs, 29,100 branches, 80 mn clients

Total assets: EUR 1.8 trillion

Accounting for 40% of all deposits, 21% of credit, 21% of banking assets (*local MFOs only, without central institutions*)

Basic elements and steps of MFOs

- Self-help, based on voluntary withdrawable savings
- Initially focusing on the poor, later including non-poor
- Autonomy in management and governance
- Local outreach, *house-banking*
- Crucial importance of networks and federations
- Access to refinancing by commercial bank
- Evolution of a legal and regulatory framework
- Transformation to full-service banks
- Supervision delegated by central bank to auditing federations of the networks

Lessons of history

Commercial banks: Big business, big growth, big risks

Historical objective of MF: poverty reduction

Result of microfinance/microbanking: Universal full access to finance for all people and businesses

Crisis-resilience of savings and coop banks, low risks

Impact: Poverty reduction a result of economic growth & access to finance

Complex interaction between ec. growth, poverty reduction, fin. sector development & microfinance/-banking

- MF/MB potential fully realized in developed economies,
- great promise for developing economies

2. The challenge of self-reliance: The rise and fall of credit coops in India

2.1 The rise: self-financed

Centuries of farmer indebtedness and dispossession by moneylenders – since taxes were paid in cash

1904 Co-operative Credit Societies Act (*Raiffeisen*):

- Conducive framework of regulation and supervision
- Mandatory auditing
- Self-governance
- Self-reliance: 50% of funds shares and surplus, 10% deposits, 40% commercial credit (*Strickland 1922:51*)
- Loan interest rates 9% - 12% p.a.
- Rapid expansion: 50,000 credit coops by mid-1920s

Quotes, 1922-24

"Registrars refuse to register societies unless the applicants have been properly instructed in co-operative principles and unless there is sufficient and efficient supervision…. Nonfunctioning societies are dissolved by the Registrar." (Strickland 1922: 45)

"The societies are not managed by Government or by officials, they are in the hands of their members, subject to an audit prescribed by law and carried out by non-officials under a decreasing official supervision." (Strickland 1922: 51)

"People's Banks are the greatest benefit that India has yet received," stated a coop registrar. (Huss 1924: 82-83)

"Co-operative credit is tending to create a revolution… in rural India. The people have developed an extraordinary capacity for united action" (Prof. J. Sarkar, in Huss 1924: 83)

2.2 The fall: government-financed

1935-… Reserve Bank of India provides refinance

- Rapid increase of overdues

Post-war policy framework:

- Central planning, the State takes control
- „State partnership“ in equity, governance and management
- Bureaucracy, state intervention and loan channeling
- Multiple supervisors without power to enforce regulation

NABARD Annual Report 2007 (p. 87) on Credit Coop System (CCS):

- Low resource base, dependence on external financing, lack of professionalism, weak MIS, poor internal controls
- 51% of 106,000 primary societies (PACS) loss-making
- 26% out of 1112 cooperative banks loss-making

$4.3 billion of deposits of 120 mn members at risk

2.3 The challenge of restructuring the credit cooperative sector (CCS)

Strategies: Mergers, closures, restructuring

Estimated total cost: $3 billion:

- 92% for cleaning up balance sheets
- 8% for auditing, HR development, technology

Cost sharing:

- 68% central government (grant)
- 28% state governments (budget)
- 4% own funds of CCS

Risks:

- Restructuring a perverse incentive, rewarding defaulters
- Deepening dependence on the state
- Undermining self-reliance and the credit culture

Continuing challenge: Turning coops from government to members

2.4 The challenge of inclusive finance: SHG banking for the rural poor in India

Challenge:

A vast network of commercial, regional rural and coop. banks has not reached some 300 million rural poor

Background:

*1986 APRACA-GIZ Program „Linking Banks and SHGs"

1988-91 1st pilot project in Indonesia

NABARD's SHG Linkage Banking Program

1987 National SHG study

Strategy:

- NGOs, GOs and banks promote autonomous SHGs
- Savings and internal lending first, bank credit next

1991 Permission by RBI to open SHG bank accounts

1992 Pilot project, **1996** mainstreaming of SHG Banking

2010: 7.0 mn SHGs with bank savings accounts

100 million members

4.9 mn SHGs with bank loans outstanding

$4.6 billion bank loans outstanding

+ loans from internal funds

Self-help group in Karnataka State, India

Challenges:

- Informal SHGs, depending on NGO and GO services
- Sustainability not assured
- NABARD monitors bank linkages, not internal funds
- No information on profitability
- Recent state interference with grants, subsidies, manipulation of interest rates and margins
- Lack of growth of internal funds,

  resulting in lack of access to small short-term loans

Sector Own Control Pilot, Andhra Pradesh: Empowering SHGs and their coop federations

AP leading state in SHG Banking and federation development

- 21% of all SHGs in India, 30% of SHGs with bank loans, 42% of loans outstanding (2010)

1995 Mutually Aided Cooperative Societies (MACS) Act

AP:	22 coop district federations:	100% MACS
	1,099 coop subdistrict federations:	100% MACS
	38,300 coop village federations:	92% MACS

Pilot project:

- Establishing cooperative systems and operations at SHG and federation levels
- Building the capacity of all members, staff and leaders
- Putting members and elected representatives at the center

3. The challenge of cooperative autonomy and state control in Vietnam

- Collapse of the old system of credit coops in the 1980s
- New system of PCFs created by the State by:
  - providing a legal framework
  - putting the central bank (SBV) in control
- PCFs self-financed and self-managed
- Central Fund (CCF) majority-owned by SBV

  Transformation of CCF to a coop bank under preparation
- PCF network part of the formal financial sector:

  1990 Law on Banks, Credit Coops and Finance Co's
- PCF safety fund scheme approved by SBV in 2011
- A most successful reform of the financial coop sector

Designing a system of rural credit coops

Examining the options:

- 1991-92 a Government team visits Bangladesh, Germany, Canada
- Technical assistance offered by **DID**, funded by CIDA

Deciding on a strategy:

- Steering committee, comprising SBV as lead agency, ministries, Vietnam Cooperative Alliance

Implementation:

- Steering committees at central, provincial, district and commune levels
- New name: PCF

Mandatory training and supervision: by SBV branches

Pilot project 1993 – 2000

- Assessment 1999: 82 non-performing PCFs closed

The PCF model

- Membership: individuals, cooperatives, local enterprises, social organizations
- Governance: Elected board of 3-9, appoints MD (approved by general assembly, confirmed by SBV)
- Deposit mobilization from members and non-members
- Lending outreach restricted to one commune
- 10% of portfolio lent to poor non-members
- Approx. 30% of borrowers are women
- PCFs pay income tax up to 28% after the first 2 years

Oversight

- Daily internal control
- Random inspections by SBV branches
- Remote supervision by SBV

Reporting:

- Monthly reports to SBV and CCF branches
- SBV branches forward reports to PCF Division of SBV Supervision and Credit Coop. Institutions Dept.
- Online reporting expanding

Prudential standards and the role of SBV

- Minimum capital $6,240 (2007)
- Risk-weighted capital adequacy ratio of 8%
- Fixed asset ratio not exceeding 50% of equity
- Reserve requirements (placed interest-free at SBV) of 1% of Dong and 8% of US$ deposits
- Single borrower limit 15% of equity
- Adequate maturity matching (at most 10% of short-term deposits used for term loans)
- Observance of SBV's provisioning rules
- Regulatory framework by SBV (loan appraisal, collateral, provisioning, record-keeping, reporting)
- Supervision and enforcement by SBV, including closure

Outreach and performance of PCFs, June 2011 *(amounts in billion US$)*

	PCFs	CCF	Total
No of PCFs	1064		
No of members (million) No of non-members (mn)	1.8 2.0		
Total assets	1.5	0.6	2.1
Loans outstanding	1.3	0.3	1.6
Deposits	1.2	0.3	1.5
Overdue ratio (≥1 day)			1.1%
Return on assets			1.0%

Lessons from PCFs: success factors

- Political will to create a sustainable system
- Participatory process of examing options
- PCFs under prudential regulation and supervision
- State/SBV control without undue interference
- Enforcement of standards by closing non-performing PCFs
- Network of mutual support + safety fund scheme
- Controlled outreach to the very poor

Continual policy issue: Interest rate interference

4. The challenge of regulation: Village funds in Laos

Strong savings traditions among women

1990s: beginnings of village funds (*VFs*)

Promoted by NGOs, multilateral and bilateral organizations, GOs

Evolution: from revolving funds to savings and credit funds

Zero direct op. costs, dividends to savers and committees instead

2003: evolving VF networks at district level

2009: 26 regulated MFIs with 61,000 clients (13%)

5,000 VFs with 400,000+ members (87%)

VFs hold 78% of total assets, 86% of loans outstanding, 81% of savings, **96% of profits** of the total MF sector

4,000 deposit-taking VFs

1,000 revolving credit VFs (weak compared to DT-VFs)

MFI regulation 2008

Registration only: NDT-MFIs (<$25,000 savings)

Prudential regulation and supervision: DT-MFIs, SCUs

Compliance & enforcement gap:

- VFs are not registered
- VFs with >$25,000 are not licensed (as SCUs)

Issue:

Regulation prepared without collaboration between BOL, VF promoters and VF networks

Challenges to promoters and the regulator

- Transforming credit VFs into deposit-taking VFs
- standardizing accounting systems and processes
- expanding outreach to the remaining 4,600 villages
- expanding VF networks, establishing federations
- strengthening governance and management of VFs and VF networks
- exploring the linkage potential of banks and VFs
- revising regulation in partnership between BOL, promoters, VF networks and MF Working Group

5. The challenge of total inclusion: Village banks (*LPD*) in Bali

Rural and microfinance/-banking in Indonesia:

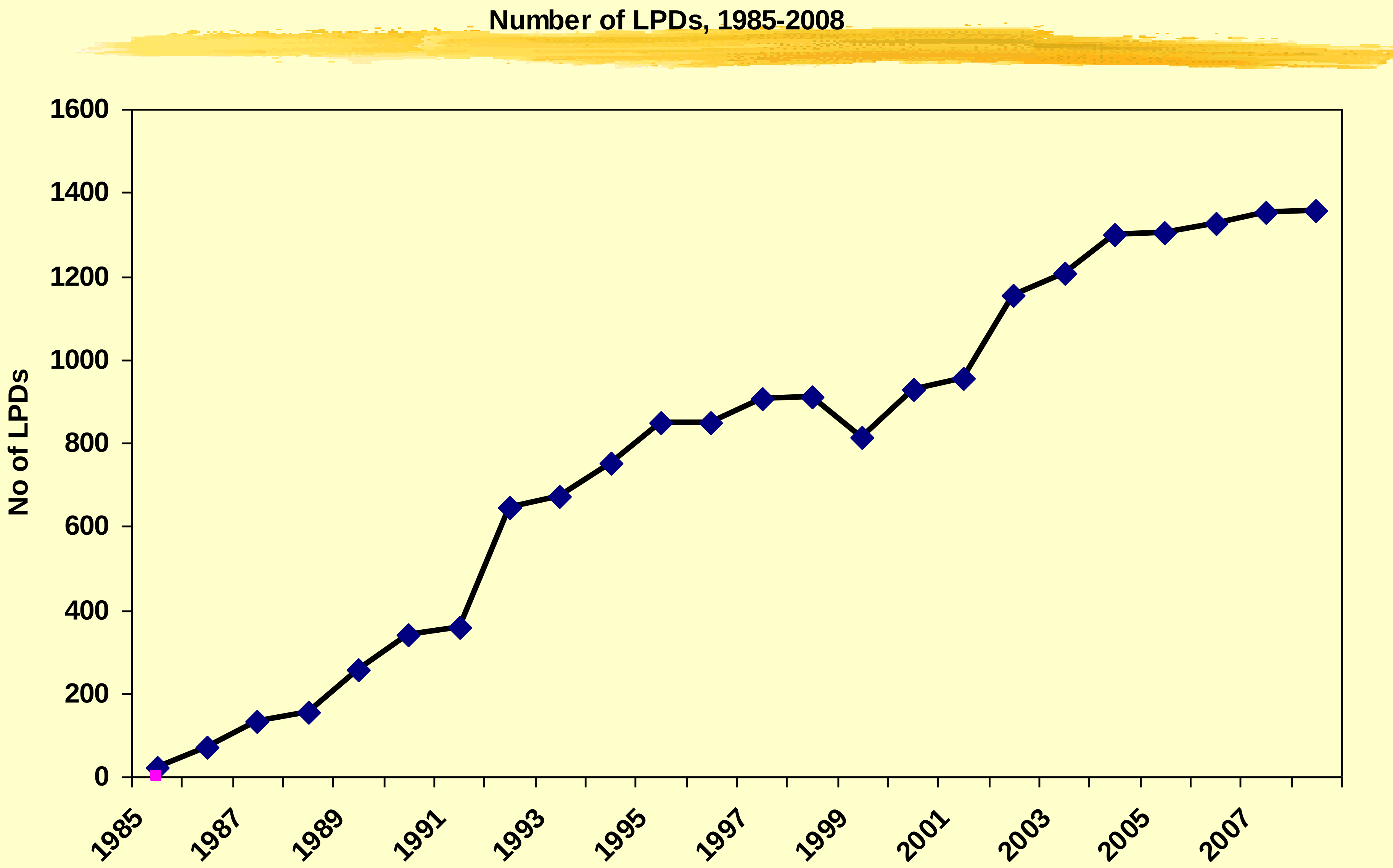
- Credit coops: stand-alone or units of coops
- Microbanking units of Bank Rakyat Indonesia and other commercial banks
- Rural banks (BPR), law of 1988, min. capital of $29,000 supervised by central bank (BI)
- SHGs, linkages with commercial and rural banks
- Credit NGOs

Lembaga Perkreditan Desa (LPD), Bali

- Bali, a Hindu island in Muslim Indonesia
- 834,000 families in 1,400 customary villages
- *1985: Lembaga Perkreditan Desa (LPD),
- regulated under provincial law of Bali (1984),
- building on, and **upgrading, traditional SHGs**
- Objectives:
  - Access to finance for all
  - Sustainable competitive institutions
  - Preservation of the cultural identity of Bali
- Owned, managed, governed by each village


BALI
LPD
DESA ADAT BEDHA
YAYASAN DHARMA WIDYA PARAMITHA
PENDIDIKAN ANAK USIA DINI
PAUD-TK HINDU

Growth of LPDs, 1985-2008



Universal and inclusive outreach, 2008

1356 LPDs covering 97% of customary villages

Average size: 912 savers, 274 borrowers

1.2 million savings accounts,	$249 million
372,000 loan accounts,	$211 million
Equity	$58 million

1.5 savings accounts, 0.5 loans per family

84% healthy, 16% weak (mostly in small villages)

Strength: culture and religion in governance

Weakness: Poor supervision by Reg.Dev.Bank

Highlights

- Regulated by provincial law in Bali, 1984
- Upgrading, and replacing, traditional SHGs
- Savings-led, only local human and financial resources
- Fully integrated into Balinese culture
- Universal coverage, one LPD in each village, 2008
- Inclusive access to finance for all

Challenges:

- Strengthening smaller institutions
- Managing the risks of larger ones
- Strengthening external supervision

6. The challenge of reforming credit delivery channels: The village units of Bank Rakyat Indonesia

1969 BRI sole lender to rice self-sufficiency program

Establishment of „village units" as credit channels

Subsidized, onerous procedures, delays, illegal charges

1983: 3617 units, arrears >50%, heavy losses

Policy change: Interest rate liberalization;
withdrawal of central bank credit supply

Options: Close them or reform them

Decision: Strategy of reform, with TA from HIID

1984, transformation to microbanking units

MBUs self-sustaining profit centers

Substantial profit-sharing incentives for staff

New savings product *Simpedes:*

- Interest rates (13%) with positive real returns
- Unlimited withdrawals at any time
- Prizes at public draws

General purpose credit product *Kupedes:*

- For everyone who is able to save and repay
- Loans from $2.50 to $5,000
- Interest rate 44% eff. p.a. (*gross*)
- 25% rebate for prompt repayment = 33% eff. p.a.
- resulting in a 95-99% on-time repayment rate

Recent adjustment of interest rate eff. p.a. after rebate, depending on size: 17%-25% nominal, **7%-15% real**

Results of reform

- MBUs profitable since 1986
- Self-financing since 1989
- Generating increasing amounts of surplus liquidity
- Resilient during the Asian Financial Crisis of 1997/98
- The largest and most profitable microbanking scheme in the developing world

4,500 microbanking units, 31 Dec 2009

Savings accounts (*cleaned*)	21.2 million
Loan accounts	4.7 million
Savings balance	$8.0 billion
Loan portfolio	$5.8 billion
Surplus liquidity	$2.2 billion
Net profit in 2009	$787 million
Arrears ratio	1.4%
Return on average assets	**10.2%**

Lessons from BRI's microbanking units

1) With attractive products, staff incentives and effective internal regulation and supervision, rural and peri-urban microfinance can be highly profitable
2) Demand for savings exceeds demand for credit
3) Savings of the poor can be mobilized cost-effectively
4) Rigorous loan monitoring and incentives for timely repayment are key success factors
5) Catering to poor and non-poor enables FIs to lower transaction costs and interest rates on loans
6) Financial sector liberalization is conducive to financial innovations (like microbanking)
7) Self-reliance & profitability make MFIs crisis-resilient

7. The challenge restructuring a state-owned commercial bank: Bank Rakyat Indonesia

Background:

*1895 as a local bank, …transformed into a national bank

1968 re-established as a commercial and rural policy bank

1970s and 1980s deregulation of the financial sector without effective supervision:

- Poor governance, insider lending, political interference
- Currency and maturity mismatches

1997/98 Asian financial crisis:

- Hyperinflation, devaluation, collapse of the banking sector

Restructuring of the banking sector, at a cost of $70bn, bank mergers, enforcement of prudential regulation

Effect of the Asian financial crisis on BRI 1998 compared to 1996

- Decline of value of total assets in US$ by 71%
- Surge of nonperforming loans ratio to 53%:
  - Corporate sector most affected
  - Microbanking sector not affected
- From net profit of 101 million to net loss of $3.3 billion
- ROA fell from 0.70% to -77.8%
- BRI bankrupt in 1998

Restructuring BRI

1998: GOI with IMF decides to restructure BRI, helped by the liquidity, profits and international reputation of the BRI Units

Restructuring in three phases, **1999-2003**

A. Implementation of operational restructuring plan

(1) Portfolio restructuring: $2.2 billion of bad loans to Bad Bank

(2) Enhancing risk management

(3) Business strategy redefinition: Focus on MSME

(4) Operational efficiency improvement, incl. IT

(5) Organizational efficiency improvement (mergers of offices…

(6)Accounting and MIS enhancement

(B) Recapitalization (2000)

- July 2000: New boards of directors and commissioners
- July/Oct 2000: Injection of $3.0 billion, repayable

Results of restructuring as of Dec 2000:

- NPL ratio at a historic low
- Profits resumed
- All financial indicators meet regulatory requirements

(C) Partial privatization (Nov 2003)

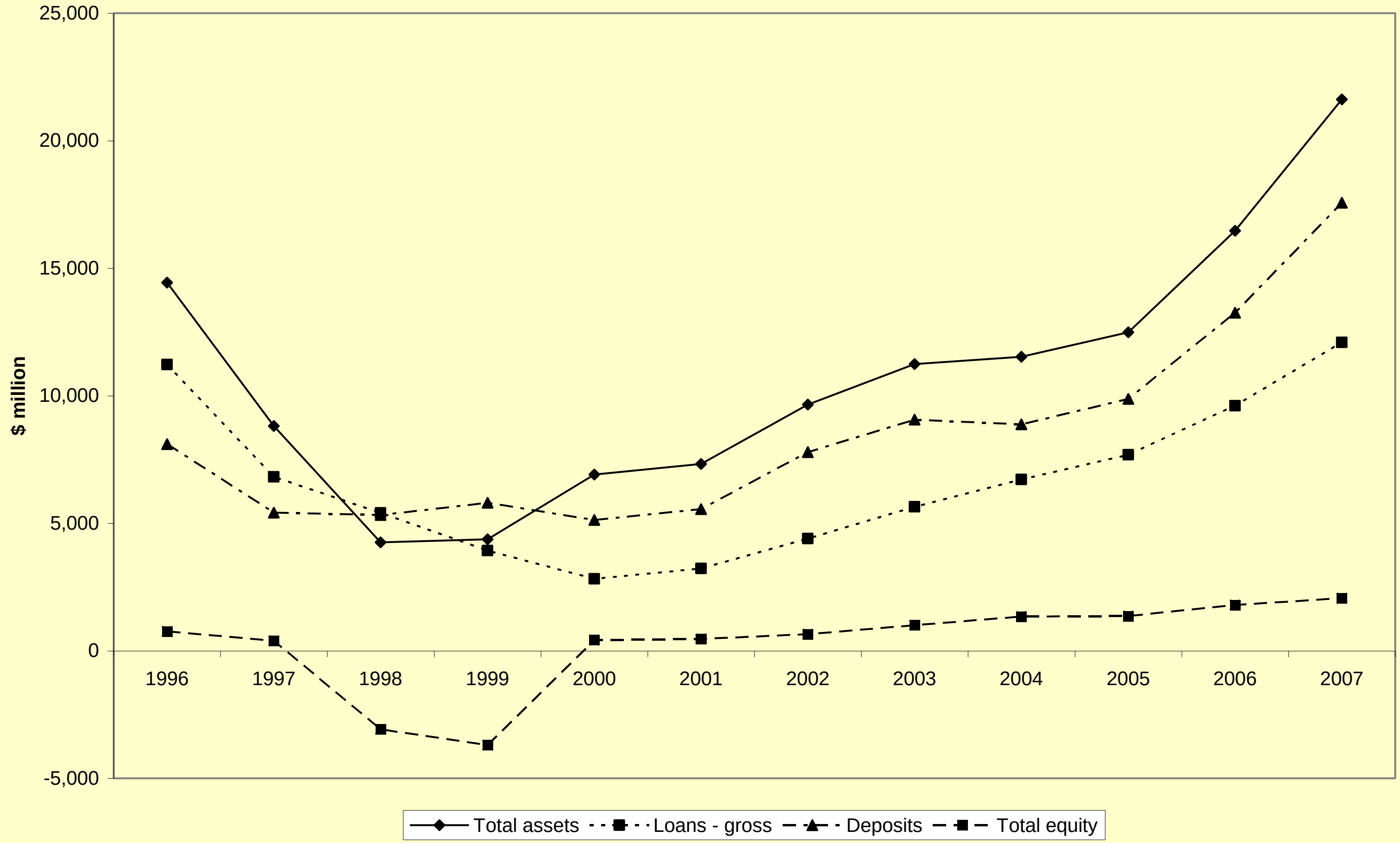
- Nov 2003, IPO at the Indonesian Stock Exchanges
- Ownership, Nov 2003: Government 59.5%; Public 40.5%

2008: BRI most profitable bank, with largest loan portfolio

Restructuring in figures, 1996-2010 (in billion US$)

	1996 *Pre-crisis*	1998 *Crisis peak*	2003 *IPO*	2007	2010
Assets	14.4	4.3	11.2	21.6	44.3
Loans	11.2	5.4	5.6	12.1	27.5
GOI recap. bonds	-	-	3.3	1.9	1.5
Deposits	8.1	5.3	9.1	17.6	36.5
Equity	0.8	-3.1	0.95	2.1	4.1
Net profit	0.1	-3.3	0.31	0.51	1.28

BRI: assets, loans, deposits, equity, 1996-2007 (in million US$)



Restructuring performance ratios

	1996	1998	2007	2010
CAR	8.7	(61.5)	15.8	13.8
NPL	10.6	53.0	3.4	2.8
ROA	0.7	(77.8)	4.6	4.6
ROE	5.3	n.a.	31.6	43.8
NIM	n.a.	(3.2)	10.9	10.8
Op. exp./op. income	93	362	69.8	70.9

Decisive factors in restructuring BRI

- Political will to restructure
- Prudential regulation and supervision enforced
- Commercial and social mandate (micro, remote areas)
- New management: Fit and proper tests; performance contract
- Commitment to good corporate governance:
  - Effective risk and compliance management
- Corporate culture:
  - Commitment to performance excellence
  - Open communication
  - Incentives for management, staff, owners, customers
- Partial privatization =>> market discipline

8. Conclusions and recommendations

Highlights

- Under the leadership of CBM enter into a participatory process of stakeholder consultation, with the objective of initiating fin. sector development for economic growth & sustainable poverty reduction.
- Abolish caps on microcredit interest rates
- Leave the definition of ceilings on microloans to each institution
- Create a legal framework for MBOs under CBM regulation and supervision, possibly delegated to auditing apexes of MBO networks.
- Focus on deposit-taking MBOs offering withdrawable savings to prevent overindebtedness and positive real returns on savings to make poor savers richer, not poorer.
- Strengthen the role of commercial banks with the objective of financing MSEs, establishing microbanking units and linking with SHGs and MBOs.

Conclusions and recommendations (1)

1) Initiating financial sector development and reform for economic growth and poverty reduction

- Establishing a stakeholder committee, the chair appointed by GoM
- Initiating a participatory process of stakeholder consultation, defining procedures and responsibilities
- Implementing and monitoring development and reform processes
- Mobilizing national, local and donor resources
- Revising regulation, deciding on focus: microfinance vs. microbanking
- Developing institutional strategies for: SHGs, CBOs, member-owned MFOs, community-owned MFOs, credit NGOs, banks, microbanking units, linkages
- Products and services to be provided: deposits, loans, money transfer, insurance, financial services
- Establishing and monitoring a sustainable capacity-building system
- *Survey:* Identifying the supply and gaps of supply of financial services to the poor, near-poor, microenterprises, SMEs

Conclusions and recommendations (2)

2) Strengthening the role of CBM/MoFR

- CBM/MoFR taking responsibility for the evolving fin. sector, formal and nonformal
- Building partnerships with financial sector stakeholders
- Establishing a microfinance/microbanking unit at CBM/MoFR and building its capacity
- Advocating the political will to create a sustainable fin. system
- Guarding the autonomy of FIs in management and governance
- Focusing on local microbanking with savings, credit & other products
- Including microfinance/-banking in financial institutions law
- Transforming credit NGOs into microbanking organizations
- Preparing appropriate regulation in consultation with stakeholders
- Effective supervision, possibly delegated to auditing apexes
- Promoting and monitoring capacity building of MFOs/MBOs
- Initiating and monitoring (agricultural) development bank reform

Conclusions and recommendations (3)

3) Promoting deposit-taking MFOs

Ownership – members, private, community or public:

- Depositing savings a priority need of the poor,
- a basis of self-reliance, crisis resilience, sustainability,
- a main source of funds with unlimited growth;
- positive real returns on savings are important for the poor – interest rates below the inflation rate make the poor poorer;
- Withdrawable savings prevent overindebtedness.
- Supporting central funds of deposit-taking MFOs

Conclusions and recommendations (4 – 5)

4) Promoting sustainable service networks of MFOs

- for expansion, capacity building, liquidity exchange, safety funds, advocacy, monitoring, auditing…
- Supporting graduation from microloans to SME loans

5) Strengthening the role of commercial banks

- Financing SMEs, big business, trade
- Establishing microbanking units for low-income clients
- Refinancing MFOs and SHGs (*Linkage Banking*)
- Strengthening and monitoring risk management

Conclusions and recommendations (6 – 7)

6) Managing the risks of:

- Inappropriate regulation
- Lack of effective supervision and enforcement
- Caps and subsidies on interest rates undermining self-reliance
- Government interference undermining the autonomy of FIs
- Inflation and negative returns on savings making the poor poorer

7) Monitoring development impact

- Planning a long-term perspective of aid
- Sustainable access to finance for all is more relevant than quick impact on the poor
- Monitoring complex interactions between ec. growth, fin. infra-structure development, banking, microfinance, poverty reduction