Nout Wellink: The significant role of microfinance and supervisory issues

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the ING Microfinance Seminar "A billion to gain – the next phase", Amsterdam, 16 June 2008.

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Introduction

1. I am pleased to be joining you today and to be speaking to so many microfinance experts. Before starting I would like to commend the conference organisers for putting together such a comprehensive programme on this important topic. Microfinance is becoming ever more relevant, and there can therefore be no doubt that we need to keep it on our agendas. Today, I want to touch upon two issues. I will start with the significant and increasing role of microfinance to combat poverty in the world. This role cannot be called "micro" anymore. Then, I will discuss some supervisory issues that follow from the microfinance concept.

Microfinance is booming

2. To start off with: microfinance is booming! It all started in the 1970s with the Nobel price laureate Mohamed Yunus, who was the first to experiment with the provision of very small – or micro- loans to people in Bangladesh. He then founded the famous Grameen bank. And nowadays, it cannot be denied that microfinance has successfully enabled extremely impoverished people, especially women, to engage in self-employment projects. These people were previously considered unbankable, as they typically do not meet even minimal qualifications to gain access to traditional credit, such as steady employment or a verifiable credit history. Microfinance allows them to generate income and to begin to build wealth and ultimately exit poverty. The term microfinance is generally used for the provision of financial services, in most cases micro-loans, to the poor, and many people have begun to realise its opportunities. Indeed, the concept of microfinance has been accepted as an effective means to reach out to the poor. And this conviction is not just confined to charitable institutions, but can beyond doubt be called a worldwide drive. Microfinance institutions have notably expanded their loan portfolios. Data from The Microfinance Information Exchange show that over the period 2001-2006, the number of micro credit borrowers each year increased on average by 19%. Over the same time period, the average loan portfolio grew by an annual 30%. This is huge. For comparison, in the EU-25, the average loan portfolio growth reaches a mere 6.4%. By the end of 2006, globally more than 1100 MFIs were active, comprising over 59 million borrowers. Also savings accounts surge, totalling 16 billion US dollars in 2006 and 68 million savers.

3. Meanwhile, also private organisations and investors have found their way to microfinance and microfinance institutions, and devote ample resources to them. Although exact figures are not available, it has been estimated that in 2006 worldwide $ 4 to 5 billion was invested in microfinance institutions. Especially investors with a long-term perspective, such as pension funds, consider microfinance an attractive investment. This is no wonder: usually returns are in line with market averages, while risks are relatively low. Moreover, microfinance shows a low correlation with international financial markets and hence provides diversification benefits.

4. And on top of this, as we can see here today, microfinance starts to attract increasing interest from commercial banks, including ING. One element evidencing this interest is the financial support provided by way of loans to or investments in microfinance institutions. But in my opinion, a second element is far more important: namely the sharing of expertise in

banking business and the provision of assistance and training. Enhanced cooperation between existing financial institutions and microfinance institutions contributes to the development of local financial markets. For example, commercial banks may help microfinance institutions expand their portfolios with saving services, varied loan products and insurance, while microfinance institutions in turn may facilitate the development of commercial banks' customer base. Furthermore, microfinance institutions may build upon the existing IT and risk management infrastructure of commercial banks.

5. Another reason for the remarkable growth of the microfinance sector is that new technological developments are quickly being picked up. Recently, I came across an internet organisation set up to enable private individuals to lend money to poor people in developing countries. The creditors can actually see and choose the persons to whom they lend. The money is transferred to the person via a local microfinance institution. Another innovative feature of this concept is that the loan providers receive regular updates on the borrower. This brings the benefits of microfinance really at your doorstep! And look, for instance, at the telecommunication industry. Rapid innovations have made it possible to conduct your banking operations via mobile phone. For banks, it offers the opportunity to transmit loan applications and check credit details instantly. For microfinance, this means a real breakthrough. As you know, a core problem for microfinance institutions is the geographically wide dispersion of their client base. This makes it difficult to serve clients in very remote areas and drives up expenditures. Operational costs can be as high as 15 to 20% of loans, compared to less than 5% for banks in industrialised countries. The introduction of mobile phone banking now makes it possible to reach millions of people, in a fraction of a second and without the high costs of establishing an extensive network of offices. Such cost savings are important for microfinance institutions, as they allow them to reduce interest rate margins while not impairing profitability.

6. These positive figures are truly good news. As a central banker, I care for economic growth and the reliable functioning of financial markets. And microfinance clearly contributes to these goals. For one, microfinance stimulates households to start business activities. Access to credit allows poor people to take advantage of economic opportunities, thus contributing to local economic development and job creation. Second, microfinance fills a gap in the traditional financial infrastructure, which did not provide for lending to the poor. Indeed, broad access to financial services is a key characteristic of a deep and efficient financial system. It is encouraging to see that the market is now taking over the role which was previously only performed by governments or NGOs. And third, more and more microfinance institutions have become real financial intermediaries and now also offer deposit facilities to households. As such, microfinance can help households to smoothen their consumption over time, reducing saving and borrowing constraints. Such constraints are particularly relevant for poor households because their incomes are often uncertain and they generally lack collateral. At the same time, deposits form an additional funding base for microfinance institutions and decrease their dependency on external funding. In these ways, microfinance enhances economic growth, enriches financial markets and increases welfare of individual households.

Role for the prudential supervisor

7. But this is only one reason for my interest in microfinance. The other one follows from my role as prudential supervisor. This brings me to the second remark I want to make today. So far, the growth of microfinance has, by and large, occurred outside a regulatory framework. But as a depositor, you expect your bank to be safe and not to take undue risk, so that you can retrieve your money at all times. If the bank accepts too much risk, it may no longer be able to meet its obligations to depositors. Therefore, in most countries, only licensed banks are allowed to attract deposits from the public. Licensed banks are subject to prudential supervision and have to comply with an extensive and strict set of regulations. The prudential supervisor requires banks, for example, to have in place an effective risk management

system to screen, price and manage risks. For microfinance institutions, the protection of depositors is especially important. If a microfinance institution runs into trouble and cannot repay its depositors, this will affect a very large group of people who do not have the buffers to cushion such a loss. The effects of such a failure on individual borrowers´ and their families´ lives can be disastrous.

8. The need for depositor protection is underlined by the finding that the quality of the micro credit portfolio may deteriorate very rapidly. If some debtors are unable to repay their loans, this may induce other debtors to default on their loans as well. This perverse incentive may be especially strong in the case of credit provided to a group of persons. Furthermore, micro credit risks are usually more correlated than those of a traditional bank, since the loan portfolio generally consists of a relatively homogenous group of people who depend on the regional economy. Also, as costs are generally higher microfinance institutions may have smaller financial buffers. At the same time, in many cases it will be difficult for the microfinance institution to raise additional capital on short notice. For deposit-taking microfinance institutions, prudential supervision is hence of high relevance.

9. Though most agree that prudential supervision of microfinance institutions is needed, it is not yet clear what this supervision actually should comprise. Compliance with prudential rules can be costly to supervised entities and may be especially burdensome for microfinance institutions. Under circumstances, supervision may even stifle such a valuable and booming sector as microfinance. In devising a supervisory framework for microfinance activities, we therefore have to take the unique characteristics of microfinance into account. Most conspicuous of these characteristics is perhaps the lack of physical collateral. Other characteristics specific to microfinance institutions that need to be taken into account are a quick turnover rate, high operational costs and a different lending process. Also know-your-customer requirements are burdensome, as many poor people do not have a passport or other proof of identity.

10. We also need to be mindful of the large differences between microfinance activities and microfinance institutions from one country to another. For instance in Brazil, a popular form of microfinance is the use of correspondent banking, or in other terms "branchless banking". Due to the sheer size of this country, commercial banks are only located in the main cities and did not or could not offer financial services to people in distinct villages until 1999. With the lifting of several regulations in that year, commercial banks were allowed to set up relationships with non-financial and non-bank firms to provide a wider range of services. Many banks contracted local chains, for instance grocery stores, pharmacies, etc., which were allowed to handle simple banking operations on behalf of the financial institution. However, the financial institution itself is the ultimate provider of financial services and remains responsible in the end. In India, in the 1999s, microfinance evolved quite successfully through so-called Self Help Groups. In these groups, 10 to 20 persons pool savings, collectively obtain loans and lend to each other. And in Bolivia, the most successful microfinance institution was incorporated as a commercial bank in 1992.

11. But despite these differences, microfinance supervision should not and cannot be a complete divergent regime. A different supervisory framework for microfinance activities carries the risk of unbalancing the international level playing field. Moreover, many banking standards already offer flexibility to allow for the level of complexity and size of institutions, the level of risks or the existence of international activities. And all the same, supervision of microfinance institutions need not be harmful per se. Adequate supervision may also enhance the perceived legitimacy of microfinance institutions and improve their operational management, due to for instance the higher standards for reporting and financial control. This may broaden their access to funding, allowing them to expand their financial activities and serving more clients. Furthermore, there may exist a positive relationship between the development of supervisory guidance for microfinance activities and for supervision in general. So taking all this together, we should search for a tailor-made solution within the scope of existing regulation.

12. One such solution can be found in the Basel Core Principles. To support supervisors worldwide in building and improving a set of prudential regulations, the Basel Committee for Banking Supervision has developed this set of minimum standards for sound supervision. The Core Principles provide a benchmark for a wide range of supervisory aspects, in areas such as licensing, capital adequacy, risk management, and more. In total there are 25 Principles. But, I stress, these are principles, not rules, and require further specification. The Basel Committee considers that many of these Principles would also be appropriate for non-bank financial institutions that offer deposit and lending services similar to those provided by banks. But the Committee also recognizes that some of these categories of institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system. However, they need some form of regulation commensurate to the type and size of their transactions. How should we tailor regulation to the unique characteristics of microfinance activities? The Basel Committee is currently working on illustrating what forms regulation can take, keeping in mind the diversity of the sector. That is why this effort is a collective one, and why the Committee works together with supervisors from all over the world in the Committee's International Liaison Group, as well as the IMF, the World Bank, CGAP and regional groups of banking supervisors.

Concluding remarks

13. Ladies and gentlemen, I will conclude. Microfinance is booming. It is now widely acknowledged as an effective way to reach out to the poor. And, as I said in the beginning, this belief is not just confined to charitable institutions, but felt the world over. Still, the current market size forms only a small part of the estimated global demand for microfinance services. As such, the broadening of financial services offered by microfinance institutions, specifically the deposit-taking facilities offered by many microfinance institutions, is a welcome development. In parallel with this, the role of the prudential supervisor will become ever more relevant. Prudential supervision can contribute to inclusive financial systems by taking account of the specific characteristics of microfinance while not disturbing the international level playing field. The efforts of the Basel International Liaison Group will be an important step forward in this regard. Furthermore, adequate supervision may enhance the perceived legitimacy of microfinance institutions, improve their operational management and extend their access to funding.

In this way, microfinance not only contributes to the economic development of a country, but also enriches the financial system and financial supervision. So maybe, rather than "A billion to gain", it's a question of "Billions to gain"! Thank you.