Best Practice Regulatory Principles
Supporting MSME Access to Finance
Report of APEC Regional Symposium

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EXECUTIVE SUMMARY

The Symposium developed recommended best practice proposals for regulatory and supervisory approaches (summarized in Part III of the report) that would give banks and financial institutions as well as capital market players a higher level of comfort in financing MSMEs while addressing the challenges facing MSMEs in accessing finance.

The Symposium report is a partial response to G20 Leaders (and APEC Leaders) that there be a significant scale up of SME access to finance and the regulatory principles necessary to promote financial inclusion.

The symposium was well attended, including representatives from Indonesia, New Zealand, Peru, Philippines, Thailand, Vietnam, Australia and India. Central bank, securities and insurance regulatory agencies, development banks, commercial banks, academics, NGOs, the IMF, IFC and ABAC participated.

The Symposium was funded by the Australian Agency for International Development (AusAID) and jointly organized by the Australian APEC Study Centre at RMIT University and the Association of Development Finance Institutions in Asia and the Pacific (ADFIAP). The report will be referred to in advice to be provided to APEC Leaders and Finance Ministers. It will also inform a capacity building training program for senior financial system regulators to be convened in Melbourne in the 1st Qtr 2012.

The report takes into account the Basel Committee guidance to banking supervisors on the principle of “proportionality” in building “a policy and regulatory framework that is proportionate with the risks and benefits involved in innovative products and services and is based on an understanding of the gaps and barriers in existing regulation”. The report summarises the experiences of economy participants and draws on international best standards and practices.

Not surprisingly, the impact of excessive credit growth as a cause of the global financial crisis and the need for regulatory and supervisory approaches to guard against excessive credit going forward underscored the discussion on best practice regulatory principles.

Summary of major overarching themes of the Symposium

- The global financial crisis shows that there is no trade-off between strong regulation and credit availability and that misaligned incentives leading to credit growth need always to be addressed;
- MSME credit markets are fundamentally like other credit markets except they may be disadvantaged by weak legal infrastructures, institutional arrangements and governance, and poor borrowers have little or no physical collateral to signal their credit worthiness;
- Access to finance is a major constraint to the development of MSMEs in emerging markets and sound regulatory policies and laws could go a long way to alleviating that constraint;
- Economies should take a holistic approach in considering the policy framework to promote MSME access to finance;
- The participating economies in the Symposium have considerable experience and expertise in regulatory and policy responses in promoting financial inclusion and access to finance, including importantly in the use of technology and intermediaries for the provision of
financial services; the use of third party intermediaries by financial institutions can be a critically important way of promoting financial inclusion and regulatory agencies should encourage the involvement of appropriate intermediaries;

- Non-bank credit institutions and the role and scope of their permitted activities should be clearly defined by regulation; the use of third party agents to accept deposits is to be encouraged;
- Organisations financing MSMEs have diverse funding sources and products and these should be encouraged; they include leasing and factoring, credit and capital markets, venture capital and mutual funds; and
- To encourage the use of technology in servicing MSMEs will require a light regulatory approach – space is needed to avoid stifling innovation; regulators should keep abreast of innovation in the payments system and in new forms of delivery of financial services.

**Summary of some key proposed regulatory approaches**

- Sound regulatory policy should go hand in hand with supervisory capacity and implementation;
- Where appropriate, policy should facilitate the transition of microfinance institutions into banking institutions;
- Institutions providing similar financial services to MSMEs should be regulated in the same way; and financial inclusion requires judicious, supportive and proportionate regulation which encourages innovation, market based solutions and competition;
- The regulatory framework should require as a priority good governance and the regulation of intermediaries;
- Credit bureaus, collateral registers and a regulatory environment that supports information sharing between financial intermediaries and financial literacy are critically important; and
- Ideally, microfinance institutions should only take deposits as agents for high quality institutions which are regulated and supervised and can offer MSMEs access to a wide range of financial services.
PART I – INTRODUCTION and BACKGROUND

Introduction

This is the report of the Joint Regional Symposium convened by the Australian APEC Study Centre at RMIT University (AASC) and the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) from June 27-28 in Manila, the Philippines, sponsored and funded by AusAID under the PLSP APEC linkages program. The program has two components; the first was the Symposium and the second will be a training program for APEC policy makers and regulators responsible for the policy and supervision of financial institutions involved in providing finance to MSMEs in economies of the Asia Pacific region. It is intended that the report of the Symposium will form the basis of issues to be covered in the training program (to be scheduled in Melbourne in the first quarter 2012).

The objective of the Symposium was to develop “concrete best practice proposals for regulatory and supervisory approaches based on participant and expert experiences, international standards and identified challenges that would give banks and financial institutions as well as other capital market players a higher level of comfort in financing MSMEs, whilst also addressing the challenges facing MSMEs in accessing finance”.

Participants in the Symposium included speakers and representatives from APEC economies, Australia, Indonesia, New Zealand, Peru, Philippines, Thailand and Vietnam, and from India. Organisations represented were from the Central Bank of the Philippines (the Bangko Sentral ng Pilipinas), the Philippines Securities and Exchange Commission, the Bank of Thailand, the Ministry of Finance (Thailand), the State Bank of Vietnam, the Superintendency of Banking and Insurance (Peru), the International Monetary Fund, the International Finance Corporation (IFC, the World Bank Group), the Universities of Melbourne, Sydney and RMIT, ASB Bank Ltd (New Zealand), Indonesia Microfinance Association (Indonesia), Development Bank of the Philippines, Land Bank of the Philippines, Planters Development Bank (the Philippines), Rizal Commercial Banking Corporation (the Philippines), the Thai Bankers’ Association, ADFIAP, and Total Synergy Consulting Private Limited (India), and from ABAC (APEC Business Advisory Council).

Background

Small and medium enterprises (SMEs) are a key driver for economic growth and access to finance is a key constraint to development of micro, small and medium enterprises (MSMEs) in emerging economies. These factors have been widely recognized, including by APEC Leaders and Finance Ministers (in their Declarations of 2010) and in the report of the G20 SME Finance Sub-Group of the Financial Inclusion Experts Group (SMESG and FIEG). The IFC was the technical advisor for the report. The FIEG was established by the G-20 Leaders at their September 2009 meeting in Pittsburgh, USA. The SMESG report, entitled “Scaling-up SME Access to Financial Services in the Developing World” notes that:
Studies indicate that formal SMEs contribute up to 45 percent of employment and up to 33 percent of GDP in developing economies; these numbers are significantly higher when taking into account the estimated contributions of the SMEs operating in the informal sector...

A recent study by the IFC and McKinsey suggests that there are close to 365-445 million micro, small and medium enterprises in emerging markets of which 25-30 million are formal SMEs and 55-70 million are formal micro enterprises, while the rest (285 – 345 million) are informal enterprises and non-employer firms ...65-72 percent of all MSMEs (240 – 315 million) in emerging markets lack access to credit”. ¹

The Joint Ministerial Statement issued at the 17th APEC Finance Ministers' meeting held in Kyoto, Japan on 5-6 November 2010 announced the launch of an “APEC Financial Inclusion Initiative” to identify concrete actions that financial policy makers can take to expand the reach of financial services to the underserved.² Workshops for the purposes of advancing this initiative have since been held 2011 in San Francisco on 23-24 February and in Bangkok on July 21- 22. The focus of the APEC Initiative is to provide concrete and practical guidance to government policy makers to expand the provision and usage of financial services by households, individuals and self-employed entrepreneurs, including those at the bottom of economic pyramid. ³

The 2010 APEC Business Advisory Council (ABAC) Report to APEC Economic Ministers also urged “APEC economies to further improve SMME access to finance.” ⁴

ABAC’s Advisory Group on APEC financial system capacity building is now supporting access to finance for MSMEs in 2011 in three areas: i) consumer and micro/small enterprise lending; ii) grassroots savings mobilisation, and iii) remittances and cross-border microfinance.

The Symposium

The Symposium considered as a fundamental aspect of its work the fact that appropriate international standards and national regulatory policy is critical in enhancing access to finance for MSMEs. This theme, and the more general theme of the need to improve access to financial services, has been recognised in a wide variety of forums. For example, the SMESG report, recommended as one of their “four key recommendations for the G-20 leaders to implement, in order to achieve a significant and global scale-up of SME access to financial services in the developing world:

1. Endorse a set of recommendations for policymakers in the developing world to establish a supportive enabling environment for SME access to financial services in their respective countries by:

   b. Developing a supportive legal and regulatory framework;” ⁵

² http://www.apec.org/Meeting-Papers/Ministerial-Statements/Finance/2010_finance.aspx para. 10
⁴ The 2010 APEC Business Advisory Council Report to APEC Economic Ministers, page 10
The Symposium noted that the focus of the G20 Principles for Innovative Financial Inclusion is also on regulation: “The following principles aim to help create an enabling policy and regulatory environment for innovative financial inclusion”. These principles were prepared by the Access Through Innovation Sub-Group of the FIEG (ATISG) and endorsed in the G20 Toronto Summit Declaration (G20 Principles). They are now being implemented through the Global Partnership for Financial Inclusion (GPFI) established under the terms of the Multi-Year Action Plan for Development announced at the G20 Seoul Summit 2010.

There are also various initiatives being undertaken by the international standard setters (SSBs) relevant to the development of regulatory policy for the purposes of financial inclusion. This includes the August 2010 report of the Bank of International Settlements, Basel Committee on Banking Supervision, entitled “Microfinance activities and the Core Principles for Effective Banking Supervision” (Basel Microfinance Principles). This report provides guidance on the application of the Core Principles to the microfinance activities conducted by depository institutions. Further, the Financial Action Task Force, which establishes global standards for anti-money laundering and counter-terrorist financing (AML / CFT) regulations, released in June 2011 the FATF Guidance, “Anti-money laundering and terrorist financing measures and Financial Inclusion” (FATF Guidance). The paper provides guidance on designing AML/CFT measures that meet financial inclusion goals without compromising the measures that exist for the purpose of combating crime.

A further key aspect of the Symposium was a focus on proportionate regulation to facilitate access to financial services. This is also reflected in the work of the SSBs. For example, the need for proportionate regulation was highlighted in the G20 Principles. Specifically, Principle 8 “Proportionality” is “Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation”. Further, the Basel Microfinance Principles noted that the tailoring of the Core Banking Principles required “a proportional regulatory and supervisory framework that does not add significant costs to microfinance activities across different institutional types and that is also suitable for small microfinance institutions.” The FATF Guidance Paper also noted that the paper “provides the general framework to assist jurisdictions in implementing a proportionate AML/CFT system in the context of financial inclusion that is commensurate with their ML/TF risks.”

This report records the key experiences reported by participants and sets out suggested best practice principles for regulatory and supervisory approaches to access to finance for MSMEs, taking into account observations of participants and applicable international standards and guidelines.

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6 “Microfinance activities and the Core Principles for Effective Banking Supervision”, Bank of International Settlements, Basel Committee on Banking Supervision, August 2010 Page 2
PART II – SYMPOSIUM PERSPECTIVES ON BEST PRACTICE
REGULATORY PRINCIPLES TO ENHANCE MSME ACCESS TO FINANCE

Symposium presentations

This section of the report contains a summary of key points made in the formal presentations and related discussions at the Symposium. The full text of the presentations is available at: http://www.adfiap.org/news/adfiap-australian-apec-centre-hold-forum-on-msme-access-to-finance/

Regulatory approach

The need for financial inclusion to be a government priority was stressed. It was noted that, although financial sector stability and financial inclusion can be mutually supportive, financial inclusion does not necessarily follow from financial sector stability. Both objectives accordingly need attention from governments.

The importance for financial inclusion of judicious, supportive and proportionate regulation, which encourages innovation, market based solutions and competition was emphasised. Interventions by government should avoid distortions to markets. It was also noted that the growth of high frequency transactions and technology had potential to allow new entrants into the banking system and that there were arguments for liberalizing entry by allowing microfinance institutions (MFIs) to transform into banking institutions.

It was also mentioned that taxation issues remained a challenge as MSMEs often operate on the fringes of the tax system, which has fiscal implications.

International standard setting bodies (SSBs)

Discussions on aspects of the work of the SSBs and especially the G20 Principles, the Basel Microfinance Principles, FATF and the work of the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors and the International Association of Deposit Insurers stressed the following points:

- The importance of following the work of the SSBs in developing regulatory policy to enhance access to finance for MSMEs;
- The trend is to be more flexible in regulatory standards for microfinance – but with an understanding of what differentiates microfinance from other financial services;
- The need to understand both the costs and the benefits of any new regulatory policy;
- Sound regulatory policy should go hand in hand with appropriate supervisory capacity and implementation; and
The detail of regulatory policy must always be specific to the context of the economy in question and relate to the market failure that is the focus - there is no one right answer.

Financial inclusion and global regulatory reforms

It was noted that the global financial crisis highlighted three vulnerabilities:

- The failure of capital to provide adequate protection against loss;
- Delayed recognition of credit impairment; and
- The need for stronger liquidity.

The Basel Committee on Banking Supervision has initiated the reform process to address these vulnerabilities through Basel III. It was acknowledged that the reform process may in turn affect credit availability. However, it was stressed that financial stability is needed to ensure credit and, in particular, that:

- The experience of crises show that there is no trade-off between strong regulation and credit availability over the long run;
- Rapid credit growth facilitated by lax regulation leads to financial crisis and ultimately to a large contraction of credit;
- Expanding access to credit over the long term involves strengthening the credit culture; and
- Misaligned incentives that lead to excessive credit growth need to be addressed.

It was also stressed that: care should be taken not to water-down Basel III; banks may need to increase their equity to absorb shocks; there should be reliance on countercyclical capital buffers to limit the effect of falls in credit in a downturn; emphasis should be on strengthening the pricing of credit risk to ensure sustainable credit; provisioning should occur up-front under the revised international accounting rules and not when risk materializes (in a crisis) and that there is a need for coordination among supervisors to limit regulatory arbitrage.

Design of regulatory policies

Discussion focused on the following issues:

- MSME credit markets are fundamentally like any other credit markets, but with two distinguishing features:
  - Weak legal infrastructure, weak institutions and poor governance; and
  - Poor borrowers have little or no physical collateral with which to signal their creditworthiness;
The aim of policy should be to diagnose and correct market failures associated with moral hazard and adverse selection, rather than subsidising outcomes and picking winners and, in particular:

- Regulation should be light handed and enabling;
- Regulation should not stifle innovation; and
- Subsidising outcomes and picking winners is an invitation to corruption;

The first priority of policy should be good governance and regulation of intermediaries;

The second priority should be to improve the financial infrastructure, including to support credit bureaus, collateral registers and a regulatory environment that supports information sharing between financial institutions as well as to facilitate the development of payments systems which enhance financial inclusion through use of technological innovations and to enhance use of remittance services;

The third priority should be financial literacy; and

Allowing small, community based MFIs to take deposits in their own right is undesirable given the safety and soundness risk involved in their exposure to local conditions (diversification risk), the relatively high cost of prudential regulation and supervision, the regulatory arbitrage risks, and the risks for savers involved with lower prudential requirements and the potential governance issues with having local management make all lending and borrowing decisions. Ideally such MFIs could only take deposits as agents for high quality financial institutions which are fully regulated and supervised and can offer MSMEs access to a wider choice of financial services. This approach would ensure all savers in the economy have the same level of protection.

Challenges in empowering underserviced groups

The need to understand the social, market, economic, political and enforcement context as well as the regulatory context was emphasized. The regulatory implications require:

- An appropriate legal framework and especially laws supporting credit information bureaus and collateral registers, small business and consumer protection and bankruptcy and insolvency;
- Adequate institutional resources and capacity for regulatory supervision and the judiciary; and
- Appropriate mechanisms to deal with moral hazard, adverse selection and sovereign risk issues.

The issues associated with corruption were highlighted, and in particular the concerns that corruption erodes trust in the financial system, is negatively correlated with growth and that discretionary powers given to government officials tend to enhance the risk of corruption. Research suggests that a regulatory approach that encourages private sector monitoring by financial institution creditors (rather than powerful regulatory agencies) may reduce the risk of corruption.
(for example, through requiring publication of audited accounts and credit ratings of financial institutions).

**Understanding micro entrepreneurs**

Particular emphasis was placed on the need to consider the unique characteristics of micro entrepreneurs in designing credit evaluation processes and regulatory policy. MFIs, in particular, should consider alternative ways of establishing the “5 C’s of Credit” when dealing with micro entrepreneurs. They are: Character (the borrower’s reputation), Capacity (the borrower’s repayment capacity), Capital (the borrower’s equity in the business), Collateral (security to cover the loan) and Conditions (the loan terms and conditions).

**Second board listings for MSMEs**

In relation to the SME Listing Board of the Philippines Stock Exchange, it was noted that there are only 2 companies listed. The unattractiveness of the SME Board was attributed to the following factors:

- There is no incentive for underwriters to promote the SME Board because the requirements for listing on the First and Second Boards are almost the same as for the SME Board;
- It is easier to borrow from banks and other financial institutions than comply with the SME Board listing rules;
- Potential investors having concerns about SMEs’ financial viability and their lack of a track record; and
- MSMEs themselves being concerned about compliance with the pre- and post-listing requirements (for example, the continuous disclosure requirements).

**Consumption vs. investment**

The blurring of the purpose of loans between consumption and investment was noted; lending for consumption purposes, as opposed to productive purposes, is more likely to lead to over indebtedness and could result in over regulation.

**Access to financial services through new technologies**

The following approach was proposed for the creation of an enabling regulatory environment for the use of new technologies:

- Allow non-banks to offer e-money, whilst acknowledging that there may be a need for regulatory oversight;
- Allow a wide range of third parties to perform cash-in/cash-out transactions with financial institutions being clearly responsible for the authorised activities of their third parties;
• Simplify Know Your Customer (KYC) requirements for the purposes of anti-money laundering and counter terrorism financing laws (especially for low risk accounts);

• Formalize guidelines on the issuance of electronic money; and

• Allow microfinance-oriented “other-banking offices” to conduct limited transactional banking activities such as taking micro – deposits and issuing micro-loans.

_A proposed regulatory approach_

The following points were noted:

• Access to finance alone is not the “magic bullet” for SME development. A holistic approach and synchronized efforts are needed to ease constraints in other areas, such as licensing, land/property title, judicial system, levies and taxes, etc. with an appropriate financial eco-system, including suitable financial infrastructure (e.g. credit bureaus, collateral registers, payment systems, remittance services and appropriate enforcement systems) and mutually reinforcing financing channels (such as a guarantee scheme, equity funds, venture capital and private equity, capital markets);

• A balance is needed to continue supporting MSME lending while maintaining financial stability (in particular avoiding systemic risk);

• Microfinance, SME finance, and corporate finance serve different market segments, and have distinctive features. Hence, the approach and focus of their regulation and supervision should also be tailor-made;

• Consumer protection, responsible finance and financial literacy are conducive to healthy financial sector development and should be properly incorporated in the structure of the regulatory and supervision system for MSME finance;

• Country context differs. It is important to carefully examine the key local conditions if regulatory and supervision rules are to be relevant, implementable, and effective;

• Broad consultation with all stakeholders is necessary in establishing/improving regulatory and supervision rules; and

• Success lies in details and in coordination for implementation.

The need for a proportionate and scaled regulatory approach, with appropriate funding and resources for implementation was also stressed. In the same context it was noted that regulatory requirements for micro-enterprises may be different from those applicable to small and medium enterprises.

Consideration should also be given to:

• Country specific diagnostics and strategies and especially to determine gaps in MSME financing and the required MSME finance architecture;
• Supportive legal and regulatory frameworks (for example, to encourage leasing and factoring as well as lending, healthy and competitive financial sector regulations and the institutions needed to enforce contracts and security interests in collateral);

• Improving financial infrastructure (for example, through credit bureaus and registries, SME rating agencies, collateral registries for interests in movable and immovable collateral and capital markets);

• Effective government support mechanisms which avoid market distortions;

• Consistent and reliable data sources on MSME finance through a standardized definition of an MSME, surveys to establish their financing needs, requiring business registration and establishing credit bureaus;

• Building capacities of financial institutions (for example, through providing for a broader product range, wider distribution channels and access to market information); and

• Building the capacity of MSMEs (for example, through enhancing technical and business development services and access to markets and through encouraging the development of industry associations and chambers of commerce).

**Synthesis of major discussion points in support of suggested Principles**

**Summary**

The principles shown in Part III are put forward against the background of the above presentations and discussions and the specific economy experiences outlined by participants, the studies referred to in background papers for the Symposium and the work of the SSBs. In summary, participants (and the studies) note that MSMEs are a key driver for economic growth, that access to finance is a major constraint to their development in emerging economies and that sound regulatory policies and laws could go a long way to alleviating this constraint.

The Symposium specifically discussed major innovations in promoting and broadening access to financial services to underserved communities in the Philippines, Thailand, Indonesia, Vietnam, Peru and India. In developing strategies to encourage access to finance for MSMEs, there is much that can be drawn from the policy and regulatory responses to the challenges confronted in those countries, including policies encouraging the use of both new technologies and intermediaries for the provision of financial services. The Symposium discussed the major lessons learned from these countries, which can be drawn on by others. These lessons are reflected in the suggested Principles in Part III of this report.

**Economy-specific challenges and regulatory responses**

*Philippines*

Only approximately 20% of firms in the Philippines have access to formal financial services and, although attention to financial services for MSMEs is not new, the gap in access remains remarkably
strong. However, larger banks are entering the microfinance sector, including by providing wholesale loans, and new linkages and partnerships are occurring which provide for a broader range of financial services and products. Useful innovations in providing financial services have also led to the introduction of different business models. All this is seen to be leading to the building of a truly inclusive financial system. However, it is recognised that more still needs to be done, including the establishment of a credit information bureaus and further work on enhanced financial literacy for MSME entrepreneurs.

Initiatives taken in the country include:

- **Magna Carta for MSMEs (RA 9501 (2008))**: Requires that banks allot at least 8% of their loan portfolio to micro and small and 2% for medium enterprise and makes provision for the Small Business Corporation, a specialized financing and guarantee institution for MSMEs;

- **Barangay Micro Business Enterprise (BMBE) Law (2002)**: Provides for micro enterprises certain income tax and minimum wage exemptions, and other benefits such as a special credit window and other forms of assistance programs;

- **Credit Information System Act or CISA (2008) (RA 9510)**: Mandates the creation of a credit information bureau;

- **Central Bank of Philippines Regulations and Circulars on SME Lending**: These initiatives deal with issues such as capital requirements, loan documentation and risk weights;

- **Circular 704 (December 2010)- Electronic Money Network Service Providers (EMNSP)**: Smaller banks aiming to be electronic money issuers can engage services of an EMNSP, subject to an emphasis on due diligence and continuing operational review;

- **Circular No. 706 (January 2011): Updated AML rules and regulations**: provides for reduced due diligence for low risk clients and reliance on third parties to perform KYC requirements; and

- **Circular 694 (October 2010): Microfinance-oriented other banking offices (MF-OBO)**: allows MF-OBOs to perform limited transactional banking activities such as accept micro-deposits, release micro-loans, sell micro-insurance products and disburse certain government benefits.

The Central Bank has encouraged the establishment of microfinance oriented banks and has a specialized microfinance regulatory unit.

The 2010 Global Microscope on the Microfinance Business Environment Report by the Economist Intelligence Unit, ranked the Philippines as No. 2, behind Peru which retained its No. 1 position as a leader in microfinance worldwide. The Philippines was ranked No.1 for its microfinance regulatory environment. Over 797 banks regulated by the Central Bank, 27% (215) of them have microfinance related activities, and 195 are rural banks.

With the support of the Central Bank, NGOs are able to offer a range of financial services, including insurance and health as well as micro finance. There is also strong competition between banks and
rural banks. This contrasts with experience in the Pacific islands where there is little access to financial services. The next issue for the Philippines is how to make it easier for formal and informal financial institutions to work together to service underserviced communities.

**Indonesia**

Major observations were:

- There are around 200,000 MFIs in Indonesia with only around 10% considered to be financially sound;
- MFIs have significant difficulties in obtaining access to finance;
- Supervision of entities providing microfinance services is split between the Bank of Indonesia and the Ministries of Cooperatives and Finance with non-bank, non-cooperative MFIs being unregulated; and
- There is no specialist Microfinance Law although a draft was submitted to Parliament around 8 years ago.

The following proposals were considered:

- There should be a single regulator for MFIs in Indonesia and a single Ministry with responsibility for policy;
- Performance and ethical standards should be established for all financial institutions providing microfinance;
- The government guarantee (deposit insurance) applying to deposits in banks in Indonesia should also apply to savings in cooperatives and other non-bank MFIs who meet prescribed standards;
- Government should provide incentives and policies that encourage banks to provide financial access to MFIs without physical collateral; and
- There should be early consideration of the above mentioned Microfinance Law.

**Peru**

The following features of microfinance regulation were highlighted:

- There is equal regulatory treatment for all financial institutions (reference was made to the General Law for Financial and Insurance Systems (Law No. 26702) and the Rules for the Evaluation and Classification of Debtors (SBS No. 1136 – 2008));
- MFIs do not have special regulatory treatment – the idea is to create a level playing field;
- Regulation is based on the activities being carried out, rather than the institution performing the activity;
There are no interest rate caps;

The role of the regulatory in promoting access to finance includes:

- Improving transparency of information through making available details of product features and a credit bureau;
- Supporting consumer protection through provisions for transparency of terms and conditions, complaint resolution and through remedies for unfair contracts;
- Encouraging competition by allowing rural savings and loans institutions to operate throughout the country, allowing MFIs to provide a wide range of services (such as factoring and leasing), facilitating access to capital markets and through revised prudential standards;
- Promoting the use of new technologies through allowing the use of intermediaries (banking agents) and promoting mobile banking (an e-money law is proposed); and
- Promoting financial literacy, including through schools.

**Vietnam**

The following policies were noted:

- Relationship banking: is being encouraged through allowing innovative financing products (such as hybrid debt/equity products and products where the interest rate will vary with MSME performance) and encouraging the provision of finance by foreign banks with experience in MSME finance;

- Intra-firm credit: this is being encouraged through a promissory note system; and

- Policy interventions: policies being implemented include mandatory lending, providing government finance to commercial banks for on-lending to MSMEs, sharing of information between MSMEs and financial institutions about MSME financing needs and improving the supervision and governance systems of MSMEs (for example, through audit requirements).

**Thailand**

Policies to support SMEs which were discussed included:

- The Portfolio Credit Guarantee Scheme provided through the Small Business Credit Guarantee Corporation (SBCG).

- The proposed SMEs Information Centre, and
The micro-lending to villagers through the Village Fund

According to the Bank of Thailand’s Study of 2007, it was shown that only around 43% have access to the formal sector. Out of these, only 31% were able to obtain credit from commercial banks, state-owned specialized financial institutions or non-bank financial institutions. Other MSMEs obtained finance from cooperatives and unorganized sources.

It was also stressed that, in order for access to financiers to have greater confidence in supporting MSMEs, it is necessary that there be:

- Clear insolvency laws to protect the rights of creditors and to accelerate foreclosure procedures;
- A full-filing credit reporting, which increase wide ranges of MSME information such as utility bill payment records;
- An expanded view of what could constitute a collateral such as having a wide range of assets that can be used as collateral since the current law does not recognize some types of assets (examples mentioned were movable property, intangible assets and receivables); and
- Country specific, mandatory accounting standards based on international accounting and reporting standards;
- A more transparent disclosure of bank charges;
- The Village Fund scheme should be re-invigorated by improving the villagers’ financial literacy.

**India**

The following approaches were discussed:

- Financial regulation and financial inclusion must work together: the former is a must for the latter (for example, to allow for financial intermediaries and their use of technology so that they can achieve economies of scale);
- Only sound and strong institutions can deliver financial inclusion: the regulatory approach has not compromised prudential norms for deposit taking entities;
- Balancing risk and financial inclusion: It is recognized that, in designing regulatory policy, there is a need to balance the degree of risk with the need for financial inclusion;
- Small is not necessarily beautiful: there has been a recognition that small MFIs such as cooperative banks, deposit taking non-bank financial institutions and regional rural banks give rise to risks of poor governance, connected lending, geographic
concentration leading to vulnerability to natural calamities and downturns. Small entities also tend to absorb a disproportionate share of supervisory resources;

- Mandatory lending: domestic commercial banks and foreign banks are required to allocate respectively, 40 per cent and 32% of their lending to designated priority sectors. In broad terms, priority sectors include agriculture and allied activities, micro and small enterprises, education, housing and micro-credit. The priority lending requirement may also be met through financing self-help groups, MFIs, rural banks and others for on-lending to priority sectors;

- Branch approvals: approvals to open branches in more lucrative areas are subject to a requirement to open branches in underserved areas;

- No frills accounts: banks are required to offer simple accounts which have limited features but nil or low minimum balances and charges;

- Branchless banking through agents: the 2006 Business Correspondent Guidelines for the first time allowed commercial banks to offer simple savings loan and remittance products through agents;

- Know Your Customer requirements: there are simpler KYC requirements for small value accounts;

- Unique Identifier: India is in the process of issuing Unique Identification Numbers (UID) coupled with biometric identifiers to around 600 million people. The UIDCs are seen as a means of identifying customers for the purposes of KYC requirements and of facilitating entry into the formal banking system;

- Payments: under the terms of the Payments and Settlement Systems Act, 2007, the broad regulatory approach has been to permit non-banks to provide payment services which are fee-based without access to funds of the customers; and

- Consumer protection: the Banking Codes and Standards Board of India (BCSBI), which is an independent and autonomous body, has developed two voluntary consumer protection codes – one is a code of commitment setting out minimum standards of banking practices in dealing with individual customers, and the other a code of commitment to micro and small enterprises. The Banking Ombudsman can also hear complaints.

**Technical Group Discussions**

The following notes summarize the conclusions in the technical group discussions.
**Banks, Development Banks and Savings Banks**

- Institutions providing similar financial services to MSMEs should be regulated in the same way, so as to provide a level playing field and minimize regulatory arbitrage. This includes, for example, all types of institutions which take deposits;

- Government support for the provision of finance to MSMEs should only be provided for a specific purpose and for a limited period, should use existing infrastructure where possible, should involve a sharing of risk with the beneficiary of the support and a sharing of costs and have regard to the political and corruption risks with such schemes;

- Use of third party intermediaries by financial institutions is critically important for financial inclusion and should be supported by appropriate regulatory policies;

- Innovation in the provision of financial services through the use of new technologies and wider distribution networks and channels should be encouraged in developing regulatory policy; and

- Issues associated with information asymmetry are best dealt with through regulatory approaches which support the development and use of credit bureaus and secured property registers for collateral related purposes.

**Non-bank Credit Institutions**

- The role of MFIs, and the scope of their permitted activities, should be clearly defined by regulation;

- Use of third parties and agents to accept deposits is to be encouraged;

- Each economy should have a coordinating council for the development of polices in relation to access to finance for MSMEs (for example, in relation to consumer protection and financial literacy). The need to coordinate poverty alleviation programs and access to finance programs was highlighted;

- Credit bureaus and collateral registries should be supported by appropriate regulatory systems;

- Different regulatory policies may be needed for micro enterprises on the one hand, and small and medium enterprises on the other;

- Regulatory policy design should include measurement of the extent of the identified issue, and of the outreach and impact of the policy intervention. The experiences of other countries should be taken into consideration; and
• MFIs should only be permitted to accept deposits from members if they are to avoid prudential regulation (not the general public).

**Capital markets**

• There is a need to recognise that organisations financing MSMEs will have diverse funding sources;

• Diverse financing products are to be encouraged (such as leasing and factoring, as well as credit and capital markets products);

• Venture capital / private equity should be considered as a funding mechanism, and consideration given to the circumstances in which banks might be permitted to hold equity in MSMEs;

• Second Board listings are unlikely to be attractive to MSMEs given the complexity of listing rules and the transaction costs unless specific incentives, in particular tax incentives, are available to those who invest in MSMEs; and

• Mutual funds for MSMEs are to be encouraged.

**Product innovation**

• The provision of innovative financial services through new technologies such as mobile banking is to be encouraged through taking a “wait and see” approach to regulation with a view to avoiding the stifling of innovation;

• In designing regulatory policy it is critical to understand the factors relevant to MSME demand for finance, as well as any supply constraints;

• Financial literacy is critically important to encourage MSME demand for financial services and to provide the competence to understand and use the financial services when they are provided, with the latter point being especially important for innovative financial services;

• Financial system regulators should keep abreast of innovations in the payments system and new forms of delivery of financial services;

• Consideration should be given as to the regulatory implications of “green financing” where environmental considerations may be factored into product design, the required collateral or risk assessment; and

• There is a need to consider how regulatory policy can support the provision of bundled products (such as micro insurance with micro credit).
PART III - SUGGESTED BEST PRACTICE OBJECTIVES AND PRINCIPLES

The following principles are put forward against the background of the presentations and country experiences as discussed in the Symposium and drawing on the studies referred to earlier. They are proposed subject to an acknowledgment that not all constraints on access to finance can be resolved through laws and regulations and that the extent to which the principles may be adopted will depend on the social, market, economic, political, and institutional situation of the economy in question. Nevertheless they are proposed as best practice to which economies might strive.

General regulatory principles

1. **The security of the financial system is paramount.** The safety and soundness of the financial system must be maintained and balanced with the objective to enhance access to finance for MSMEs. While there cannot be any trade-off between the two, there are useful ways to achieve the balance.

2. **The fundamental causes as to why access to finance is restricted need to be understood as the first step in developing regulatory policy.** In summary, the reasons in a credit market are information asymmetry (i.e. the lender having less information that the borrower about the riskiness of a particular loan, which causes adverse selection risks), the lender having limited capacity to monitor the performance of the borrower (which causes moral hazard risks) and the lender having limited capacity to enforce a contract within reasonable timeframes. The regulatory framework and associated laws and policies related to, for example, the protection of creditor rights, and the formation of credit bureaus are the means to address the issue of information asymmetry.

3. **Financial services providers should be regulated in a uniform and consistent manner, with regulation being based on the relevant activity rather than the institution type.** The objective should be to create a level playing field where regulatory requirements are the same for the various providers of finance to MSMEs so as to minimize the risk of regulatory arbitrage.

4. **A proportionate cost-benefit approach to regulation could encourage MSME access to finance and contribute to stability and confidence.** This principle recognizes that any regulation which facilitates enhanced access to financial services to MSMEs should be proportionate to the risks borne by the lending institutions or investors. Further, a regulatory intervention should only be undertaken after careful consideration of the costs and benefits and specific consideration of its likely effect on MSMEs. Consultation between regulators and relevant institutions is also recommended in arriving at the concept of proportionate regulation.

5. **International standards and principles must be recognised.** New regulatory policies should be benchmarked against the principles endorsed by international standard setters and other bodies, including those which are specifically aimed at encouraging financial inclusion (such
as the Basel Committee’s “Microfinance activities and the Core Principles for Effective Banking Supervision” and the G20 Principles for Innovative Financial Inclusion.

Definition of an MSME

6. While it is desirable, in promoting policies to support finance for MSMEs, to have an agreed definition of an MSME, the diversity of definitions globally means that it is unlikely that a universally recognized definition is feasible. Nonetheless, there would be value in APEC seeking to define MSMEs to assist regulatory authorities in different authorities in designing common approaches to proportionate regulation and to enhance cross-country analysis of MSME data and regulatory initiatives.

National strategy

7. APEC economies should seek to establish coordinated and consultative national strategies aimed at enhancing access to finance for MSMEs. In particular, there should be close coordination between different government agencies and consultation with the private sector in developing an economy strategy and related regulatory policies to enhance access to finance.

8. APEC economies are encouraged to establish public – private MSME Councils to develop, monitor, coordinate and evaluate policies, programs and regulatory practices and approaches affecting access to finance for the MSME sector. A Council should involve consultation and collaboration with relevant Ministries, Government agencies and private sector representatives of financial institutions and with MSMEs.

9. APEC economies are encouraged to establish public MSME Data Centers with the function of assembling information necessary to facilitate Governments in designing appropriate regulatory and related policies to promote access to finance by MSMEs.

Financial services and providers

10. An objective of APEC economies should be to provide, as far as is practicable, a full range of financial services to MSMEs. Access to finance is not just about credit. Regulatory policy should aim to ensure that a wide variety of financial services is available to MSMEs, including lending and deposit taking by appropriately regulated financial institutions and related services which enhance the ability of MSMEs to participate in different financial markets including savings, insurance, payments and remittance services.

11. APEC economies should focus their efforts on policies and regulatory arrangements that make it easier for MSMEs to raise capital. This could be achieved through allowing greater access to markets by foreign banks, encouraging the provision of venture capital and private equity (such as through favourable tax treatment and possibly allowing banks to hold stock in venture capital / private equity companies with appropriate prudential safeguards) and
encouraging the listing of mutual funds through relaxed listing requirements, whilst acknowledging the need for appropriate investor protection.

**Intermediaries**

12. **Use of third parties by financial institutions to provide services to MSMEs is to be encouraged.** This principle is proposed given that in emerging economies there may be a physical or informational distance between an MSME and the relevant financial institution and recognising the prevalence of new technologies for providing financial services. The use of third parties allows financial services to be provided from a distance, and the delegated monitoring of borrowers by third parties, should be encouraged and supported through appropriate regulatory policy (for example, by making it clear that third parties can be used to collect deposits and payments and to identify and monitor customers for the purposes of depositor protection and AML/CFT laws and by providing that existing government institutions such as post offices and appropriate utilities can be used to provide these services).

Relevant safeguards could include:

a. Making it clear that the authorised financial institution is responsible for the activities of the third parties they use for the purposes of delivering financial services, including their need to comply with AML/CFT regulatory requirements and consumer / small business protection laws;

b. Requiring that cash collected on behalf of a financial institution be held in a separate and identifiable account;

c. Having clear liquidity requirements for third parties paying out cash; and

d. Requiring third parties to be appropriately trained, monitored and registered.

Further, it is recognised that economies may wish to impose specific standards in relation to the outsourcing of material functions by banks (such as IT systems).

**Innovation**

13. **Innovation is to be actively encouraged through a consultative and measured approach to regulation.** The use of new technologies and new channels to distribute financial services to MSMEs should be encouraged through fostering a collaborative approach between regulators and industry and taking a “wait and see” approach so that regulation follows innovation. This can be done through a constant dialogue between regulators and industry with a view to achieving a position where:

a. They each understand the other’s concerns and any regulatory gap;

b. Regulation evolves to responsibly reflect, and be supportive of, innovative services as they develop;
c. If there are multiple regulators involved (for example, the Central Bank and the telecommunications regulator) then their different roles are clearly defined, there is close communication between them and policies are coordinated;

d. Any regulatory approach relates to the activity and the relevant risks rather than who is providing the particular service (such as a bank or a telecommunications company);

e. It is clear that the provider of the financial service in question is responsible to the regulator for the risks involved; and

f. There are rules in place making it clear that electronic contracts can be enforced.

Collateral and credit information bureaus

14. Creating the regulatory infrastructure to support diversity in the nature of collateral should be encouraged in APEC economies. Greater access to credit will be facilitated by the establishment of credit information bureaus, secured property registers and allowing innovative products such as group lending. This principle is proposed on the basis that recognition of social, reputational and physical collateral plays a critical role in enhancing access to credit.

The regulatory approach should include at least:

a. For credit bureaus: mandatory participation by financial institutions with a preference for positive listing but providing for negative listing and an appropriate balancing of the borrower’s right to data protection by requiring consent to their information being included in the credit bureau, only allowing the information to be used for credit related purposes and by giving the borrower a right of access and correction.

b. For security registers: a clear definition of a registrable security interest which should include interests in the types of property most likely to be held by MSMEs, allowing both fixed and floating charges over property, a clear right to enforce security interests without recourse to the courts and transitional provisions to recognise existing property interests.

Consumer/small business protection

15. APEC economies are encouraged to ensure that protection of consumers and MSMEs is fully reflected in laws and regulations. In particular, economies should have in place responsible lending laws and specific rules relating to financial services requiring transparency in documentation, appropriate advice so as to enable informed decisions to be made and access to internal and external dispute resolution schemes. It is also important that support be provided for the enhancement of financial literacy.
Government support for MSMEs

16. Competitive market forces should be allowed to prevail in financial markets to the maximum extent possible. Regulatory policy should facilitate the provision of financial services to MSMEs within a competitive policy framework. To avoid misallocation of resources, APEC economies are encouraged not to implement measures which may distort the provision of those services (for example through interest rate caps, controls over fees or debt moratoriums).

17. Any direct government support designed to improve access to finance should relate to a specific market failure or an emergency situation (such as a natural disaster or post conflict). Desirably, such interventions should be for a limited period with a clearly specified end date, after an initial pilot if possible, with close measurement of the effectiveness of the initiative and through reliance on existing institutions. This principle applies to programs such as subsidised funding for microfinance institutions and MSMEs, development banking and credit guarantees. This principle is based on a view that any continuing, long term support is likely to lead to market distortions, an enhanced risk of political influence and wastage of public funds. Design is critical – there should be a sharing of risk with the beneficiary of the support and a sharing of costs. In order to minimize the risk of ineffectual interventions, pilot tests could be undertaken before there is general application of any proposed intervention. There should also be measurement of the extent of the precise problem sought to be addressed by the initiative (whether it be the pilot or a longer term intervention) and then measurement of its effect.

18. APEC economies are encouraged to refrain from introducing mandated priority sectors for access to finance (such as a mandated lending program to women or youth). Programs for a specific sector should only be provided on the basis of the principle noted above.

Institutional and supervisory framework

19. Legal institutions allowing lenders to enforce contracts and security interests are necessary to provide the basis for financing MSMEs. Lending to unknown MSMEs is especially risky if legal institutions are weak. Further, MSMEs will be reluctant to use financial services if they do not believe their rights will be enforced. Economies are encouraged to have in place courts with appropriate commercial jurisdiction which are accessible to both lenders and MSMEs, qualified and competent judges, an appropriate civil procedure code, case management and judgement enforcement resources and as well as institutions to support credit bureaus and security registers, bankruptcy and insolvency laws and laws protecting rights to intellectual property are necessary.

20. Accessible, independent and low-cost, external dispute resolution schemes for MSMEs should also be considered.

21. Supervisors should have appropriate knowledge and skills about MSMEs, the types of financial products that are provided to MSMEs and the capacity to supervise and enforce
relevant laws. Besides the needed resources, it is especially important that supervisory agencies understand the types of financial products that are provided to MSMEs, which can be quite different from the products provided to other clients. Distinctive features include: small loan amounts, short terms, frequent repayments, clients with uncertain and variable incomes, no or limited collateral, fixed interest rates, limited loan documentation, clients’ lack of financial capability, unusual loan methodology (e.g. group lending), compulsory savings and the use of new technologies such as mobile phones. Cultural backgrounds may also determine attitudes to debt and the obligation to repay.

**Legal framework**

22. **Economies are encouraged to review laws and regulatory policies and systems with a view to assessing whether there are any unjustifiable impediments to MSMEs accessing finance which should be removed.** The aim should be to have a regulatory framework which minimizes bureaucratic requirements and unnecessarily restrictive provisions applying to the MSME sector.

As a priority there should be focus on:

a. Identifying discriminatory provisions which could adversely affect the right of an MSME to obtain access to finance. For example, laws which restrict the right of women to own or mortgage property or the right of a young person to open a bank account;

b. Allowing flexible legal forms for micro and small enterprises (such as sole proprietor companies);

c. Simplification of accounting and reporting requirements for micro and small enterprises; and

d. Harmonization of licence and permit requirements and fees and charges applicable to MSMEs.

23. **Taxation policies should take into account the special needs of MSMEs and encourage informal enterprises to enter the formal sector and enhance their ability to obtain access to finance.** For example, tax policies could incentivise start-ups by providing taxation concessions for a short period after they first enter the formal sector.

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8 This point was particularly made in the Basel Committee’s “Microfinance activities and the Core Principles for Effective Banking Supervision, see especially pages 10-11