

# PROCEEDINGS OF THE 49<sup>TH</sup> SEACEN GOVERNORS' CONFERENCE AND HIGH-LEVEL SEMINAR

21-23 November 2013  
Kathmandu, Nepal



The **SEACEN** Centre



Nepal Rastra Bank

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49<sup>TH</sup> SEACEN GOVERNORS' CONFERENCE  
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## Foreword

As the role of the financial sector in the attainment of inclusive growth is important, it is imperative to devise a comprehensive strategy to steer financial sector development in this direction. In this regard, the theme of the 49<sup>th</sup> SEACEN Governors' Conference/High-Level Seminar on "Financial Sector Development Strategy for Inclusive Growth" was timely and valuable for moving forward to a new financial architecture as well as on reassessing the role of the financial system in supporting sustainable and broad-based growth.

In addition to this theme, the topic of "Regional and International Financial Issues" was also discussed during the Governors' Conference. The discussion was useful towards developing capacity and enhancing resilience of the domestic economies at the time of global shocks. A High-Level Seminar followed this event and three sessions were held in the Seminar, the first being on "New Financial Architecture, Macroprudential Regulation and Supervision for Financial Stability and Growth," the second on "Emerging Issues on Inclusive Finance for Growth" and the final session on "Capacity Development in SEACEN Member Economies." These sessions elaborated on the emerging issues and examined the challenges that central bank/monetary authorities were facing at the moment.

These proceedings of the Conference and High-Level Seminar are published jointly by The SEACEN Centre and Nepal Rastra Bank, the organizer and the host of the event respectively, with the expectation of wider dissemination of the discourse to the benefit of stakeholders at large. It is especially meaningful for Nepal Rastra Bank since it is the second time around since the Bank's admission as a SEACEN member to play host to the Annual Board of Governors Conference in conjunction with the SEACEN Board of Governors Meeting - the last being in 1987. The publication of these proceedings is also seminal, marking the first publication of its kind for a SEACEN Governors' Conference/High-Level Seminar.

At this juncture, we would like to acknowledge the efforts of those who have contributed to the success of this event. We would like to highlight the contribution of the Office of the Governor and event rapporteurs, Dr. Bhubanesh Pant, Director, Research Department and Mr. Guna Raj Bhatta, Assistant Director, Research Department of Nepal Rastra Bank respectively. The

contributions of SEACEN officials are also gratefully acknowledged. Lastly, the views expressed in these proceedings are those of the speakers and do not necessarily reflect those of Nepal Rastra Bank, SEACEN, or the SEACEN member central banks and monetary authorities.

Dr. Yuba Raj Khatiwada  
Governor  
Nepal Rastra Bank  
Kathmandu, Nepal

Hookyu Rhu  
Executive Director  
The SEACEN Centre  
Kuala Lumpur, Malaysia

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## SUMMARY OF PROCEEDINGS

### Opening Session

1. The 49<sup>th</sup> Conference/High-level Seminar of the Governors of the South East Asian Central Banks (SEACEN) Research and Training Centre and the 33<sup>rd</sup> Meeting of the SEACEN Board of Governors were hosted by the Nepal Rastra Bank on 21-23 November 2013 in Hyatt Regency Kathmandu, Nepal. Governors and representatives of eighteen SEACEN member central banks and monetary authorities participated.
2. The event was inaugurated by Rt. Honorable President of the Federal Democratic Republic of Nepal, Dr. Ram Baran Yadav. In his inaugural speech, Rt. Honorable President underscored the role of the financial sector for inclusive growth and noted that the government, private sector-led financial institutions and cooperative organizations need to work together to lead the process of inclusive development. He noted that it is important to have a sound legal framework and infrastructure coupled with access to finance for uplifting all the segments of society and equally sharing the prosperity among the people.
3. Dr. Yuba Raj Khatiwada, Governor of Nepal Rastra Bank (NRB), while delivering the welcome address, underlined the major economic challenges of the region such as those emerging from volatility in capital flows and exchange rates as well as from the presence of informal markets and shadow banking. He underlined the need to properly integrate monetary, regulatory and supervisory functions into coherent frameworks for the maintenance of financial stability and promotion of inclusive economic growth. Mr. Naidansuren Zoljargal, Chair of SEACEN Board of Governors, in his response address, drew attention to the significance of financial inclusion and literacy programs for financial integrity, stability and inclusive growth.
4. Keynote Speaker Mr. Naoyuki Shinohara, Deputy Managing Director of International Monetary Fund (IMF), while delivering the keynote address, noted that financial inclusion can stimulate employment and thus promote inclusive growth. Outlining some short- and medium-term challenges facing

emerging economies of Asia including access to finance, paucity of large corporate bond market restricting long-term investment for infrastructure projects, and emergence of shadow banking, he reiterated that the IMF is committed to promoting financial sector development and inclusive growth in the Asian economies, with priority given to spillover effects through enhanced surveillance. Mr. Shinohara also appreciated the policies and measures introduced by NRB towards financial sector development and inclusive growth.

5. In his address, Honorable Finance Minister of Nepal Mr. Shanker Prasad Koirala shed light on the measures undertaken by the Government of Nepal to promote inclusive financial system to support sustainable economic development of the country. He highlighted the continuous support of the Government for addressing the issues of financial system through fiscal, trade and other sectoral policies. Mr. Koirala also mentioned that Nepal is drafting the Financial Sector Development Strategy and that the country is participating in the joint IMF/World Bank Financial Sector Assessment Program (FSAP). The Inaugural Session came to a close with the Vote of Thanks delivered by Mr. Gopal Prasad Kaphle, Deputy Governor of NRB.

### **Governors' Conference**

#### **Session 1: Round Table Discussion on Conference Theme "Financial Sector Development Strategy for Inclusive Growth"**

6. The first thematic session included a round table discussion on the conference theme "Financial Sector Development Strategy for Inclusive Growth". The session chair, Dr. Yuba Raj Khatiwada, Governor of Nepal Rastra Bank, highlighted the major issues for discussion, focusing on financial access to rural people, building a new architecture for inclusive finance and growth and addressing the existence of shadow banking, among others.
7. Speaker of the session, Mr. Johannes Zutt, Country Director of the World Bank for Nepal and Bangladesh, presented a broad sector-wide strategy for attaining growth, including inclusive finance. He examined the significance of building a solid foundation for the financial sector to support overall growth; improving sector-wide efficiency in mobilizing savings and their allocation



to productive uses, benefitting everyone; and exploiting opportunities for leveraging finance, particularly for larger economic inclusion. While analyzing these issues, Mr. Zutt cited the case of Nepal. He agreed with the view that financial inclusion is a crucial enabler of both poverty reduction and shared prosperity. He noted that savings and payments have a strong association with poverty reduction, while access to credit and other financial services can facilitate improved access to water and electricity, housing, education and economic opportunities.

8. Presenting the background paper on behalf of NRB, a representative from NRB illustrated that liberalized and unregulated financial market may leave a large portion of society out of financial services which may further deteriorate income inequality and reduce the quality of economic growth. He indicated that both pace and pattern of growth matters as these would 'trickle down' to the poorer segments of society. He examined the role of the financial sector in achieving inclusive growth. In this regard, the representative from NRB suggested some measures for reengineering the financial sector that supports inclusive growth and provided some insights into activities carried out with regard to financial inclusion with examples from Nepal. He concluded that there was a need for a financial sector development strategy to guide the financial sector for supporting inclusive growth, especially in emerging economies.
9. With the floor open for discussions, Governors stressed on the need of market based, proportional and regulatory provisions for inclusive finance. They highlighted the need to explicitly craft the role of the financial sector in contributing to sustainable inclusive growth, including efforts to restructure institutional and operational frameworks of financial institutions. Governors also observed that it is essential to formulate financial sector development strategies for all customers, ranging from small savers to small- and medium-scale industries. They emphasized the need to advance financial literacy to empower all people and to implement effective consumer protection policies. The need to ensure an efficient allocation of resources and sound risk management of the financial sector for inclusive growth was also emphasized. Summarizing the discussions, Chair Dr. Khatiwada focused on the cost of inclusiveness, primarily efficiency cost, transaction cost and associated risks that need to be addressed by central banks while formulating a financial sector development strategy for inclusive growth.

## **Session 2: “Regional and International Financial Issues”**

10. Session 2 of the Conference was chaired by the Mr. U Kyaw Kyaw Maung, Governor of the Central Bank of Myanmar. The speaker for the session was Mr. Odd Per Brekk, Director of IMF.
11. Mr. Odd Per Brekk briefed on the global and regional economic outlook laying emphasis on weak growth with downside risks. He noted that although Asia was a global growth leader, new risks were emerging. Presenting some policy challenges of the financial sector in Asian economies, Mr. Brekk underscored the need of fiscal adjustment to build fiscal buffers and a strong monetary framework along with investment in infrastructure. Acknowledging the existence of shadow banking and low financial integration compared to trade integration within the region, Mr. Brekk called for structural reforms in Asia for achieving long-term growth and regional financial integration.
12. After the floor was opened, Governors discussed the key downside risks in the global economy and their potential adverse effects on regional economies. They shed light on the pace and quality of growth rather than just the growth rate. The need to develop capabilities and enhance the resilience of the economy for dealing with adverse external shocks was recognized. Governors also acknowledged the need to strengthen networking and collaboration within the central banking fraternity on regional issues pertaining to greater global integration and financial stability.

## **High-Level Seminar**

### **Session 1: “New Financial Architecture, Macprudential Regulation and Supervision for Financial Stability and Growth”**

13. The first session of the High-level Seminar was chaired by Dr. Perry Warjiyo, Deputy Governor of Bank Indonesia while the Speaker was Mr. Jaime Caruana, General Manager of Bank for International Settlements. The discussants included Mr. Ravi Shankar Menon, Managing Director of Monetary Authority of Singapore and Mr. Maha Prasad Adhikari, Deputy Governor of Nepal Rastra Bank.

14. In his presentation, Mr. Jaime Caruana stressed on the need of pro-active and system-wide supervision to focus on procyclicality and systemic risk in the financial sector. He was of the opinion that authorities must have the capacity and the willingness to implement macroprudential and microprudential policies during times of uncertainty. He also emphasized the role of monetary policy to fill in the “cracks” in the regulatory framework and constrain incentives for increased leverage. He mentioned that monitoring of bank lending is not enough in itself but needs to be complemented by analyzing patterns of financing through capital markets.
15. The first discussant of the high-level seminar, Mr. Ravi Shankar Menon expressed the view that institutions and their financial regulation have both become more complex and therefore need more supervision. He opined that while monetary policy has a strong effect on credit cycles, it is not sufficient for securing financial stability. Similarly, where financial cycles are not in synch with macroeconomic cycle, monetary policy may not be appropriate for use against credit cycles and macroprudential policy now becomes indispensable. The second discussant Mr. Maha Prasad Adhikari expressed the view that the new macroprudential approach to regulation and supervision needs to be integrated with the existing microprudential structures. He noted that the reform in financial sector policies is an ongoing task that demands policies for equitable growth with no compromise on financial stability. During the floor discussion, Governors accentuated the role of both macroprudential policies and monetary policy since the former can be complementary to the latter but suggested that more research needs to be conducted on this issue for facilitating financial stability and growth.

#### **Session 2: “Emerging Issues on Inclusive Finance for Growth”**

16. The last session of the high-level seminar was held on 22 November 2013. While the Session was chaired by Dr. Prasarn Trairatvorakul, Governor of Bank of Thailand, the Speaker of the session was Mr. Thierry de Longuemar, Vice President of Asian Development Bank and the discussants were Mr. Amando M. Tetangco, Governor of Bangko Sentral ng Pilipinas and Mr. Barry Trevor Whiteside, Governor of Reserve Bank of Fiji.

17. In his presentation, Mr. Thierry de Longuemar provided an overview of financial inclusion, highlighting barriers to access, the potential of innovative financial services, and the need for risk-based regulations, consumer protection and financial education. He laid emphasis on the need of inclusive finance for economic self-realization and for 'breaking the vicious cycle of poverty'. He expressed the view that inclusive finance has a significant impact on financial institutions as well as on micro-, small- and medium-enterprises, thereby leading to the creation of employment opportunities and promoting broad-based pro-poor growth. Illustrating the case of less access to finance and the gender imbalance of the access in Asia and Pacific region, Mr. Longuemar opined that attention should be given to innovative models such as branchless banking and financial literacy for fostering financial inclusion. He also pinpointed three fundamentals for inclusive finance, namely developing regulatory frameworks; innovation in financial education and capacity building; and consumer protection policy.
18. The first discussant Mr. Amando M. Tetangco cited the Bangko Sentral ng Pilipinas' vision of an inclusive financial system and what the central bank was doing to achieve this vision. He also focused his discussion on two important issues namely balancing financial inclusion, stability and integrity and linking financial inclusion and inclusive growth with the context of Filipino experience. He opined that regulators can balance the objectives of financial inclusion, stability and integrity through the appropriate application of existing prudential rules. However, the challenge lies in translating the proportionality principle into actual practice. Likewise, he viewed that though financial inclusion can impact the real economy and facilitate inclusive growth, more empirical evidence of this correlation was needed since only with precise measurement can one say that the real positive impact is being felt by the poor. Another discussant Mr. Barry Trevor Whiteside outlined the Fijian model of inclusive finance. He supported the view that financial inclusion is a catalyst in reducing poverty and improving the living standards of the poor and most vulnerable. He noted that financial inclusion has to be made a national agenda and be fully supported by the Government.
19. During the floor discussion, Governors emphasized the need for according priority to infrastructure in the economy such as technological development in general and affordable telecommunications services in particular, for the

success of inclusive finance. The Chair concluded by stating that there has to be easy access to infrastructure and financial literacy, which must be expanded before introducing innovative models.

**Special Session on “Capacity Development in SEACEN  
Member Economies”**

20. In this special session on “Capacity Development in SEACEN Member Economies” a presentation was made by Mr. Wimboh Santoso, Executive Director, Southeast Asia Voting Group of IMF. The session was chaired by Mr. Hookyu Rhu, Executive Director of The SEACEN Centre.
21. Mr. Wimboh Santoso provided an update on the Fund’s focus and delivery on capacity development, given the challenging environment to maintain stability and enhance inclusive growth. He mentioned that technical assistance (TA) has been directed to build capacity in the design and implementation of poverty-reducing growth programs in recent years. Low and lower-middle income countries continue to obtain the bulk of TAs. He also raised the issue of more demand for TAs and training in the region despite the resource constraints of the IMF. During the floor discussion, Governors brought up the issue of duplication of activities by IMF and The SEACEN Centre as well as the need for more regional and joint capacity development programs.

**OPENING SESSION  
SPEECHES AND ADDRESSES**

**WELCOME ADDRESS**

**BY**

**DR. YUBA RAJ KHATIWADA  
GOVERNOR  
NEPAL RASTRA BANK**

**WELCOME ADDRESS BY  
DR. YUBA RAJ KHATIWADA  
GOVERNOR, NEPAL RASTRA BANK**

Chief Guest Rt. Honorable President of Federal Democratic Republic of Nepal,  
Dr. Ram Baran Yadav

Honorable Minister of Finance, Mr. Shanker Prasad Koirala

Chair of SEACEN Board of Governors and Governor of the Bank of Mongolia,  
Mr. Naidansuren Zoljargal

Fellow SEACEN Governors, Distinguished Keynote Speakers, Delegates, Ladies  
and Gentlemen

It gives me a great pleasure to welcome you all to this 49<sup>th</sup> SEACEN Governors' Conference/High-Level Seminar and 33<sup>rd</sup> Meeting of the SEACEN Board of Governors being held in Kathmandu. I am thankful to the SEACEN Governors for trusting us to host this important event after 26 years. We last had the opportunity to host this important event in 1987 while I was myself a junior officer at the Nepal Rastra Bank. We are immensely delighted and feel highly honored to have the opportunity to host this important event and are overwhelmed by the gracious presence of Rt. Honorable President of Nepal, Honorable Minister of Finance, fellow Governors and other dignitaries.

Ladies and Gentlemen

Let me take this opportunity to congratulate fellow Governors and collaborators on the occasion of 30<sup>th</sup> Anniversary of The SEACEN Centre whereby our collective efforts along with other non-member contribution have taken the Centre to a greater height of recognition and pride. This is evident from the increased members including central banks from Asia's largest and emerging economies, growing attraction for more membership, and increased capacity of the Centre in research and training. The Centre has also created a platform and an opportunity for all of us to discuss the emerging global financial issues of our common interest. I do expect continued support of my fellow Governors of the SEACEN Board and our collaborators in furthering The SEACEN Centre to the stage of great height and recognition.



Ladies and Gentlemen,

In the changing economic landscape, central banks are growingly entering into their non-conventional roles; and we have been seeing a paradigm shift in our roles and responsibilities. The advent of the recent global financial crisis has not only exposed more complex and intricate macro-financial linkages in the transmission mechanism of the monetary policy, this has also shifted our attention towards that of the financial stability and economic growth. Growing global financial integration, financial innovation and evolution of new financial products and massive use of electronic technology in financial services have made our job even more challenging.

Emerging Asian market economies are now characterized by rapid financial globalization and integration which has contributed to increased volatility of capital flows and rapid transmission of financial crises. Deepening and broadening of the financial sector has created more financial risks and vulnerabilities in the financial system of our economies. The presence of informal markets and shadow banking which often leads to a weaker transmission of the monetary policy has made the central banks' role more challenging. Increasing new financial products triggered by sophisticated information technology, massive cross-border capital flows resulting in volatility in exchange rates and uncertainty of the spillover effect in the domestic economy are added challenges for us central bankers towards making our financial system more stable, inclusive, and economic growth friendly.

These challenges call upon the central bank authorities to recast monetary policy objectives and instrument, to strengthen regulation and supervision and exercise macro-prudential measures as a complement to monetary policy. Priority has to be accorded in identifying all the sources of risk and imbalance that can have systemic implications for the economy's growth and stability. Our monetary policy also needs to address how financial resources are better allocated to promote growth and jobs along with ensuring macro-economic stability. Furthermore, there is a need to effectively integrate or coordinate monetary, regulatory and supervisory functions into coherent frameworks for the maintenance of financial stability and promotion of inclusive economic growth.

This 49<sup>th</sup> Governors' Conference and High-Level Seminar aims to discuss some of these pertinent issues. What we have learnt is that financial system can have robust growth and can be stable only in an environment of real economy growing in a sustainable manner. Thus a strategy to promote economic growth must be an integral part of the financial sector development strategy. Deliberations and discussions on these important subjects have drawn the interest of the global leaders including the central bankers and international financial institutions, particularly after the recent financial crisis. We will have the opportunity to hear thoughts and views on these relevant topics from the distinguished speakers from renowned institutions. I hope that it will be very much rewarding to all of us.

Fellow Governors and Distinguished Delegates,

For many of you, this may be the first time in Nepal or you may be visiting Nepal after an interval. I hope that your stay in Nepal will be refreshing and memorable one. You will have an opportunity to explore more about our rich culture, nature and the friendly people during your stay and during the social events that would take place following the meetings.

Let me close my remarks by once again welcoming Rt. Honorable President, Honorable Finance Minister, fellow Governors and distinguished delegates to this 49<sup>th</sup> Governors' Conference/High-Level Seminar and the Meeting of Board of Governors in Nepal. I look forward to a rewarding discourse and exchange of views and experiences among fellow Governors which will help better deliver our central banking roles and responsibilities.

Thank You.

**ADDRESS**

**BY**

**MR. N. ZOLJARGAL  
GOVERNOR OF THE BANK OF MONGOLIA  
AND  
THE CHAIRMAN OF THE SEACEN BOARD  
OF GOVERNORS**

**ADDRESS BY  
MR. N. ZOLJARGAL  
GOVERNOR OF THE BANK OF MONGOLIA  
AND  
THE CHAIRMAN OF THE SEACEN BOARD OF GOVERNORS**

Dr. Ram Baran Yadav,  
Rt. Honorable President of the Federal Democratic Republic of Nepal,

Dr. Yuba Raj Khatiwada,  
Governor of Nepal Rastra Bank,

My fellow Governors and distinguished speakers,

Ladies and Gentlemen,

Good morning.

It is my pleasure to deliver this address today at the 49<sup>th</sup> SEACEN Governors' Conference/High-Level Seminar. As the chairman of the BOG, let me extend a warm to every one of you. I would also sincerely extend my gratitude to Dr. Yuba Raj Khatiwada, Governor of Nepal Rastra Bank for hosting these important SEACEN events. I would like to commend the excellent preparation work done by Nepal Rastra Bank with collaboration with the SEACEN Centre.

Ladies and Gentlemen,

The themes for this year's SEACEN Board of Governors Conference and Seminar are indeed timely, namely, *Financial Sector Development Strategy for Inclusive Growth* for the Conference and *New Financial Architecture, Macroprudential Regulation and Supervision for Financial Stability and Growth* for the Seminar. As the financial sector develops in a rapid manner, we are often distracted by the bigger picture and often overlooked the importance of financial inclusion. Financial inclusion is defined as enabling everyone, I emphasise, everyone, regardless of their level of income or social status to access appropriate financial services or products. Looking from another angle, being financial excluded, that is not being able to access to mainstream financial

services does not only create hardship but also aggravates inequality for the most vulnerable and disadvantaged section of our community.

We, as central bankers, must continue to address the issue of financial inclusion, to ensure all “unbanked” individuals become “bankable.” No doubt, financial inclusion matters need policy makers to be caring, innovative and to be able to garner broad-based support from all parties concerned. The Centre for Financial Inclusion at ACCION lists the following Visions for financial inclusion which we should all seek to implement.

These are to:

1. Continue striving to provide financial services to the hard to reach, still-neglected populations.
2. Improve the quality of services. It is insufficient to count someone as “included” who receives only a single service or whose service is expensive, inconvenient, or unsuited to his needs.
3. Highlight consumer protection as a key element in a market-based system.
4. More practically, the existence of a consensus vision is helpful in organizing players and making policy choices.
5. Points toward roles for multiple actors, with government providing a supportive environment.
6. Keeps the market in mind. The driver of service expansion is economic sustainability for providers.
7. Draws attention to providers like microfinance institutions that seek out harder-to-reach segments.
8. Provides a framework for evaluating specific actions.

The financial inclusion framework must take into account the demand side and the supply side, That is, consumers and financial sector providers respectively. On supply side, financial institutions need to design appropriate products and services and market them appropriately while on the other side of the coin, customers need to be equipped with sufficient knowledge of these products and

services. I would say financial inclusion and financial literacy go hand-in-hand.

Ladies and Gentlemen,

Naturally one recognises that there is indeed a connected complementarity between financial stability, financial integrity and financial inclusion, overall economic growth and stability. This brings me to the issue of financial stability and the seminar's theme on "*New Financial Architecture, Macroprudential Regulation and Supervision for Financial Stability and Growth*."

The global financial crisis of 2008 highlights a very important fact for central bankers. Firstly, price stability does not guarantee financial stability, secondly, we need to focus on procyclicality and, systemic risk of the financial system and thirdly, while price stability remains the main focus of central banks, many of us are now given a more explicit mandate to promote financial stability. Given these developments, we need to have a holistic view of integrating supervisory policies with other policies, in particular, monetary and macro-prudential policies. Macro-prudential policy is defined by the Financial Stability Board, the IMF and the BIS as 'a policy that use primarily prudential tools to limit systemic or systemic-wide financial risk, thereby limiting the incidence of disruptions in the provision of key financial services that can have serious consequences for the real economy. Let me emphasis once again that, it is indeed timely for us to critically review a potential new financial architecture which incorporate macro-prudential regulation with monetary and supervision policies for financial stability and growth.

Finally, allow me to conclude by wishing everyone here productive and rewarding Conference and Seminar. Thank you.

**KEYNOTE SPEECH**

**BY**

**MR. NAOYUKI SHINOHARA  
DEPUTY MANAGING DIRECTOR  
INTERNATIONAL MONETARY FUND**

**KEYNOTE SPEECH BY  
MR. NAOYUKI SHINOHARA  
DEPUTY MANAGING DIRECTOR  
INTERNATIONAL MONETARY FUND**

21 November 2013

*As Prepared for Delivery*

Right Honorable President, Honorable Finance Minister, Governors, Excellencies, and Distinguished Guests. Good morning! It is a great pleasure to join you today for the 49<sup>th</sup> SEACEN Governors' Conference and High-Level Seminar. I would like to express my gratitude to the organizers, particularly to Governor Khatiwada of Nepal Rastra Bank, and to all who have contributed to the excellent organization of this event. This has given me a wonderful opportunity to again visit this beautiful country.

This conference on **“Financial Sector Development Strategy for Inclusive Growth”** takes place at an important time for the economies and financial systems of emerging and developing Asia.

Asia has made great progress over the last decade, not least in reducing external debt, lowering corporate leverage and allowing greater exchange rate flexibility. This has set the region on a high growth path, supported by financial systems that have remained robust in the face of the global financial crisis. But this year we have seen increased financial volatility in anticipation of tapering by the U.S. Federal Reserve, and more importantly growth prospects have weakened a little. Indeed in October we downgraded our forecast for the emerging Asia region by almost a full percentage point relative to six months ago.

Nevertheless, developing the financial sector continues to hold the promise of sustained and more inclusive growth. But there are medium-term challenges that have to be addressed first. I would like to focus on some of these as well as the near-term challenges.



## Medium-term Challenges

Limited access to financial services by a large portion of the population hinders inclusive growth and constrains the region's economic potential. So the challenge is boosting access to financial services, and in particular access to banks. Here in Nepal, the central bank is promoting broader access to financial services, both by extending the reach of banks and through microcredit institutions. Increasing financial inclusion is especially critical for countries where social vulnerabilities have recently increased. Financial sector policies could also help channel credit to job-creating small- and medium-size enterprises, which often face severe constraints to accessing finance. This is especially true for countries where the share of the working-age population is rising.

While domestic capital markets in Asia are developing apace, there is still significant room for them to grow, not least to help promote investment. And this is the second challenge I would like to flag. Issuance of local-currency *government* bonds has increased, in part due to the Asian Bond Markets Initiative. But the infrastructure investment needed to sustain growth will require higher availability of long-term funding. Larger *corporate* bond markets can facilitate financing of these infrastructure projects, and also help banks diversify the maturity structure of their liabilities.

Third, there is the challenge of greater financial market integration. Asia's financial markets are not as integrated among themselves as with the international markets. For instance, cross-border financial flows still take place mainly with advanced economies outside Asia. Closer regional financial integration, for example as envisaged in the ASEAN Economic Community by 2015, could also help channel funds from net saving countries to borrowers, and enable better risk sharing across countries. Financial market integration will likely advance in the period ahead, creating more opportunities for growth within Asia but also new risks.

The fourth challenge relates to the emergence of nonbanking institutions. As capital markets develop, nonbank financial players will become more prominent, which generates new risks. No doubt they provide a valuable addition in the financial system. However, it is essential to put in place prudent and

comprehensive regulatory-supervisory frameworks that extend beyond banks to include the monitoring of the shadow banking sector.

### **Short-term Challenges**

I will now turn to the short-term challenges. Earlier this year, with the prospect of tapering of quantitative easing by the U.S. Federal Reserve, Asia faced a wave of capital outflows. While the overall impact has been manageable, some countries such as India and Indonesia have been subject to greater market stress. Market conditions have stabilized and indeed improved in recent months. However, these developments have highlighted the urgency of addressing the region's short-term challenges.

Tapering will eventually come, so Asia needs to be ready, especially those economies with weaker fundamentals and higher exposures to global financial conditions and external demand. In some countries, the effects of tapering could be amplified by domestic financial vulnerabilities arising from high household debt and leveraged corporates. Countries with strong fundamentals and credible policies would be able to offset imported tightening through lower policy rates and fiscal support. But others that have delayed reforms, left fiscal vulnerabilities untackled, or tolerated high inflation, might be forced to respond with a pro-cyclical tightening that would further weaken growth.

A second short-term challenge concerns monetary policy. The current accommodative monetary stance provides some insurance against downside risks in those economies with subdued inflation and slowing activity, and there would be scope for easing should downside risks materialize. But where inflationary pressures and reliance on foreign inflows are high—as in India and Indonesia—or where credit growth has been overly expansionary—as in Mongolia and Lao PDR—monetary policy may need to be further tightened.

There is also the challenge of rapidly rising asset prices and credit growth experienced in some parts of Asia. The resulting financial imbalances need to be addressed through a combination of monetary and macroprudential policies as well as regulation. For example, in China, the priority is to advance financial reforms to prevent a further buildup of risks and foster a more efficient allocation of investment. Macroprudential policies together with strong micro-prudential

efforts will continue to play a role in safeguarding financial stability, protecting the financial systems as global conditions tighten.

I would also like to underscore the urgent need to strengthen the regulatory framework. Here in Nepal, the Nepal Rastra Bank is strengthening supervision—diagnostics of individual institutions are being conducted, improvements to the legal framework are in train, and a crisis management framework is being developed. Much has been done in the region, but the process is incomplete. Delays in these reforms are a source of continued vulnerability and are causing regulatory uncertainty that may affect banks' willingness to lend. Financial supervision needs to become more comprehensive, forward-looking, and risk based.

Further work is also needed on the fiscal side. For most countries a moderate pace of consolidation is warranted to rebuild fiscal space. Should growth disappoint, there is generally scope to allow automatic stabilizers to operate and in some cases provide fiscal support. But for countries with high deficits and debt, there would be little room for countercyclical fiscal policy. The case for structural reforms has become even clearer, and the relative calm in the global financial markets offers an opportunity for further progress on this front.

Finally, I would like to stress that the IMF's mandate calls for it to support the efforts of countries that are addressing many of the challenges that I have just outlined. We continue our efforts to support sustainable financial deepening in countries with shallow financial systems. We continue to support members in developing policies to tackle volatile capital flows, and in preparing for and managing spillovers from the anticipated scaling back of monetary accommodation in the advanced economies. We are tracing out the interconnections within countries—say, between the financial sector and the real economy—and between countries. In today's interconnected world, the spillovers from domestic policies may well feed back to where they began, and we have been giving these implications a lot more attention in our surveillance. The IMF also stands ready to provide financing in support of appropriate adjustments and reforms, as an essential element of the global financial safety net. We also continue to strengthen the IMF's lending toolkit—for example, we are exploring the possibility of enhanced synergies with regional financing arrangements.

In closing, let me say that policymakers' responses will, of course, need to be tailored to individual countries' needs. Nonetheless, we can continue to learn from each other's experiences. We at the IMF look forward to contributing to financial sector development in Asia, and even closer cooperation with SEACEN members.

Thank you.

**ADDRESS**

**BY**

**MR. SHANKER PRASAD KOIRALA  
HONORABLE MINISTER OF FINANCE  
FEDERAL DEMOCRATIC REPUBLIC OF  
NEPAL**

**ADDRESS BY  
MR. SHANKER PRASAD KOIRALA  
HONORABLE MINISTER OF FINANCE  
FEDERAL DEMOCRATIC REPUBLIC OF NEPAL**

Chief Guest Rt. Honorable President of Federal Democratic Republic of Nepal,  
Dr. Ram Baran Yadav

Dr. Yuba Raj Khatiwada, Governor, Nepal Rastra Bank

Chair of SEACEN Board of Governors and Governor of the Bank of Mongolia  
Mr. Naidansuren Zoljargal

Mr. Naoyuki Sinohara, Deputy Managing Director, IMF

Honorable Vice Chairman NPC

Chief Secretary of Government of Nepal

Distinguished SEACEN Governors, Keynote Speakers, Delegates and Ladies  
and Gentlemen

I feel highly honored and privileged to be a part of this important function, which  
is being organized NRB and SEACEN Centre at a time when the country has  
just accomplished a historic election to the Constituent Assembly.

On behalf of the Government of Nepal and on my own, I take this opportunity  
to congratulate Nepal Rastra Bank and SEACEN Centre for and organizing this  
very important program again here in Nepal. I also congratulate the Centre for  
successful 30 years of existence with significant contribution to regional research  
and training.

Distinguished guests, ladies and gentleman

As we all are aware, the global economy is still in a weak condition. The sovereign  
debt crisis of Euro zone and budget crisis of the USA have left warning signals

to the global economy. Asian economic growth keeps on decelerating. While the IMF has trimmed its forecast for global economic growth to 2.9 percent this year, developing Asia's growth pace is expected to be marginally reduced to 6.0 percent in 2013. This is primarily due to growth moderation in the Asian region's two largest economies, China and India. Nevertheless, the global economy has withstood a major crisis; and hopefully it will come to normal track very soon.

Ladies and Gentlemen,

Let me take this opportunity to share some of the recent macroeconomic indicators of the host country. Although the economic growth has hovered around 4 percent and inflation at close to double digit, other indicators such as balance of payments, revenue collection, stock exchange indicator and other macroeconomic and fiscal indicators, remained highly encouraging. Despite the increasing trend of merchandise trade deficit arising from low growth of exports relative to imports, the satisfactory level of remittance inflows have contributed in maintaining current account surplus, thereby strengthening the external sector balance. Consequently, foreign exchange reserves have built up and are adequate for financing merchandize and service imports of more than 10 months.

I am very happy to note that over the past decade the financial sector in Nepal has both deepened and broadened. However the financial service outreach is still limited to urban and accessible areas only. The Government of Nepal is strongly committed to promote inclusive financial system to support sustainable economic development in the country. The Government is addressing these issues through coordinated fiscal, monetary, trade and financial policies. With a view to stabilize the monetary and financial sector, the Government of Nepal has initiated the formulation of Financial Sector Development Strategy with the involvement of key financial sector regulators and stakeholders. Also, Nepal has recently entered into the Financial Sector Assessment Program, which is being jointly conducted by the World Bank and the IMF. The results from this assessment would highlight weaknesses and risks as well as provide necessary recommendations to address those gaps and strengthen the domestic financial sector.

I believe that in a world of global integration, regional collaboration and cooperation among the central banks is inevitable to discuss and chart the regional challenges and take appropriate policy measures to safeguard against unexpected crisis and vulnerabilities. Central bank's role is preeminent in ensuring the financial stability and economic growth in the country. The recent financial crisis also justifies the need for regional discussions and collaboration among the central banks. I feel that this 49<sup>th</sup> SEACEN Governors' Conference / High-Level Seminar and the 33<sup>rd</sup> Meeting of the SEACEN Board of Governors, is an effort towards that direction. Discussions and deliberation on important issues among the central banks will help generate learning for the financial stability and economic growth.

I would like to express our sincere gratitude to the Rt. Honorable President for gracing the important program at a time even the country is moving towards political stability with the successful accomplishment of the recent election of Constituent Assembly.

I would also like to express our sincere thanks and appreciation to IMF, World Bank, IFC and other multi-lateral and bilateral development partners for their support for socio economic development of Nepal. I do hope that the level of cooperation and partnership between us will further enhance at a higher rate in the days to come as well.

Finally, I wish this conference a grand success.

I hope that all the distinguished delegates will have a pleasant, comfortable and memorable time during your stay here in Nepal.

Thank you very much for your kind attention!

Thank you!



**INAUGURAL SPEECH**

**BY**

**CHIEF GUEST DR. RAM BARAN YADAV  
RT. HONORABLE PRESIDENT OF  
FEDERAL DEMOCRATIC REPUBLIC OF  
NEPAL**

**INAUGURAL SPEECH BY  
CHIEF GUEST DR. RAM BARAN YADAV  
RT. HONORABLE PRESIDENT OF  
FEDERAL DEMOCRATIC REPUBLIC OF NEPAL**

Minister of Finance of Government of Nepal, Governors from SEACEN Central Banks,

Senior Officials of International Financial Institutions, Speakers, Delegates,

Ladies and Gentlemen.

I am delighted to be along with you in this 49<sup>th</sup> SEACEN Governors' Conference and 33<sup>rd</sup> Meeting of the SEACEN Board of Governors. Let me thank the organizers for choosing Kathmandu and giving me the opportunity to inaugurate this important event amid this august gathering.

I understand that finance stimulates economic growth and the quality of financial services also affects the quality of economic growth. With credible financial policies, the benefits of economic growth have to reach to the poor and low-income population in order to ensure a sustainable and inclusive economic development of the country. The government, private sector led financial institutions and cooperative organizations need to work together to lead the inclusive development process. While the government needs to provide legal framework and ensure the basic infrastructural facilities, the financial sector has to enhance access to finance to the people's doorstep. The inclusive financial services enable the people to safeguard from risks and vulnerabilities for uplifting their living standards. The profit seeking private sector financial services will, however, not be able to encompass all sections of society into affordable financial services. So the community and cooperative financial services would also be necessary to fill in the financing gap in the economy.

There is a need to craft plans and policies for empowering poor and low-income population, ensuring gender equality and enriching the social development in order to encourage the low income population to take part in the process of the country's economic development. In this regard, the financial sector plays a catalyst role

through making access to financial services like deposit, credit, transfers, insurances and remittances, along with spreading financial literacy and addressing people's financing needs and constraints.

I understand that you all, the Heads of Monetary Authorities representing SEACEN members along with eminent Speakers from the renowned international financial institutions, are exploring your thoughts and ideas on this important subject of inclusive growth and the role of the financial sector to this effect. Sharing and exchanging views on economic and financial issues of common interest and 'best practices' adopted by SEACEN economies would offer learning opportunities to all the delegates on the theme of the Conference.

I believe that results achieved from this Conference will serve as a great milestone in the inclusive economic growth process and will contribute to the reduction of poverty and promotion of sustainable development.

Nepal intends to move ahead as a peaceful, democratic and prosperous nation with inclusive development. The role of finance for us in securing an inclusive development path would be very important. I hope this Conference will bring in new ideas and policies for moving in that direction. I also hope that this conference will be highly successful towards sharing ideas and learning from each other's experiences. I am also confident that the delegates will have a pleasant stay in Nepal and that you would be able to explore and enjoy our rich nature, tradition and culture.

With this note, I declare this event open.

Thank You.

**VOTE OF THANKS**

**BY**

**MR. GOPAL PRASAD KAPHLE  
DEPUTY GOVERNOR AND COORDINATOR  
OF HIGH LEVEL PROGRAM  
MANAGEMENT COMMITTEE  
NEPAL RASTRA BANK**

**VOTE OF THANKS BY  
MR. GOPAL PRASAD KAPHLE  
DEPUTY GOVERNOR AND COORDINATOR OF HIGH-LEVEL  
PROGRAM MANAGEMENT COMMITTEE  
NEPAL RASTRA BANK**

*21 November 2013*

Right Honorable President of the Federal Democratic Republic of Nepal Dr.  
Ram Baran Yadav

Honorable Minister of Finance Mr. Shanker Prasad Koirala

Chairman of SEACEN Board of Governors' for 2013, Governor of Bank of  
Mongolia Mr. Naidansuren Zoljargal

Respected Governor of Nepal Rastra Bank Dr. Yuba Raj Khatiwada

Honorable Governors

Distinguished Keynote Speaker of the Governors' Conference, Deputy Managing  
Director of the IMF, Mr. Naouki Shinohara

Fellow Deputy Governors, Distinguished Delegates and Guests,

Ladies and Gentlemen,

The SEACEN Governors' Conference/High-Level Seminar has just been inaugurated. The last time Nepal had the opportunity to hold this event was in 1987. We are delighted to host this important event again. I believe this event is a useful regional forum for the SEACEN Governors, policy makers and regulators to exchange views and experiences on different cross-cutting themes.

As the Coordinator of the High-Level Program Management Committee, I feel privileged to deliver the vote of thanks. First of all, I would like to express our deep gratitude to Right Honorable President Dr. Ram Baran Yadav for kindly

accepting our invitation to inaugurate this event and deliver his inaugural address. We are honored by your presence and poignant words on inclusive growth and the role of the financial sector. This had added special value to the event. Right Honorable President has duly noted that the government, private sector-led financial institutions and cooperative organizations need to work together to lead the process of inclusive development.

I would also like to thank Honorable Minister of Finance, Mr. Shankar Prasad Koirala for his noteworthy remarks on what measures the Government of Nepal is undertaking to promote inclusive financial system to support sustainable economic development of the country.

I would also like to offer my sincere appreciation to the respected Chair of SEACEN Board of Governors for 2013, Governor of Bank of Mongolia, Mr. Naidansuren Zoljargal, for delivering his inspiring response address. I would take this opportunity to thank honorable governors for their gracious presence in this ceremony.

I would also like to thank respected Governor of Nepal Rastra Bank, Dr. Yuba Raj Khatiwada for his welcome address and guidance throughout this event.

My special thanks go to the distinguished Keynote Speaker, Deputy Managing Director of the IMF, Mr. Naoyuki Shinohara for making himself available despite his very busy schedule to deliver his stimulating keynote speech. I am sure that his views shared with us will be of utmost benefit for all of us and will nourish further discussions during the Conference. I would also like to thank other distinguished speakers and resource persons who have travelled from different parts of the world to share with us your valuable insights.

I would like to offer sincere thanks to all the distinguished delegates for being a part of this event. I am optimistic that your participation will contribute to enhancing the quality of the interactions and output.

My heartfelt thanks also goes to the Executive Director and Staffs of The SEACEN Centre and many others involved, including the Programme Management Committee and the Secretariat, who have worked tirelessly for the preparation and successful convening of this event.

Let me end this vote of thanks by again saying thank you to you all and wish you all a very pleasant stay in Kathmandu.

**GOVERNORS' CONFERENCE**

**SESSION 1: ROUNDTABLE DISCUSSION  
ON FINANCIAL SECTOR DEVELOPMENT  
STRATEGY FOR INCLUSIVE GROWTH**



**FINANCIAL SECTOR DEVELOPMENT  
STRATEGY FOR INCLUSIVE GROWTH:  
BACKGROUND PAPER**

**BY**

**NEPAL RASTRA BANK**

**FINANCIAL SECTOR DEVELOPMENT STRATEGY FOR  
INCLUSIVE GROWTH:  
BACKGROUND PAPER<sup>1</sup>**

**Abstract**

The focus of economic planning has shifted from simply economic growth to the need for also reducing inequality through people's wider participation in economic activities. This changing emphasis is reflected in the discussions for broad-based and inclusive growth. However, a conceptual gap remains with regard to the role of the financial sector in contributing to this growth. This paper attempts to fill this gap and highlights some characteristics of the financial sector that contribute to productive employment and promote inclusive growth. The characteristics can be reflected in (i) financial access, (ii) credit policy and (iii) financial safety net, among others. All these characteristics require a more active role of financial sector regulators and suggest a system that is stronger than simply inclusive finance. Hence, it can be labelled as inclusive finance plus. For achieving this, while restructuring of the financial sector is necessary, guidance to the financial sector is required for shaping its pathway. A credible financial sector development strategy is essential to ensure wider access to financial services, prudent allocation of financial resources, and effective provision of financial safety nets for achieving and sustaining inclusive growth.

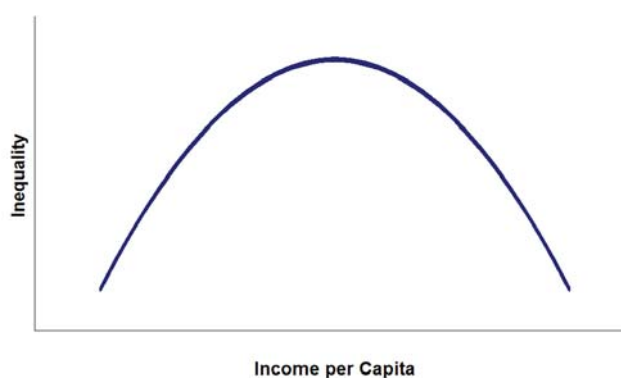
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1. Prepared by Nepal Rastra Bank for presentation at the 49<sup>th</sup> SEACEN Governors' Conference/ High-Level Seminar, 21–23 November 2013, Kathmandu, Nepal. The contribution of Dr. Min B. Shrestha, Dr. Binod Atreya, Dr. Nephil Matangi Maskay and Dr. Bhubanesh Pant in drafting this background paper is acknowledged.

## 1. Background

Economic growth does not necessarily reduce poverty; nor does it raise employment. Often rapid growth widens inequality. This, in turn, makes growth unsustainable. This understanding has taken time to be established. The concept of economic planning till later twentieth century was based on the assumption that there was a trade-off between income growth and inequality. This concept is exemplified in Kuznet's (1955) hypothesis, which explicitly shows a trade-off between income per capita and inequality, where moving rightward along the Kuznets curve involves a combination of an increase in income per capita with a deterioration of income distribution. However, after a certain point in the trajectory of income per capita, a "turning point" occurs where inequality eventually starts to decline (Figure 1). The consensus at that time was that the benefits from economic growth (that is, graduating up the levels of income per capita) would eventually "trickle down" to lower echelon of society and thus the deterioration in inequality would be naturally self-correcting. Hence, economic planning during the later part of 20<sup>th</sup> century focused on enhancing economic efficiency through liberalization, deregulation and privatization. This also implied a diminishing role of the state in the economy.

**Figure 1: Hypothetical Kuznets Curve**



Source: Kuznets (1955).

The prescription of international financial institutions in the early period was thus a sole focus on enhancing the efficiency, such as of the financial sector, through liberalization and deregulation. This also resulted in reducing the role of the state in the financial sector as in other economic activities. Many countries followed similar prescriptions under the aegis of international financial institutions. Nepal, a low income developing country, also followed this track starting from the late 1980s—examples in this regard include the liberalization of trade, industry, and financial institutions licensing policy, deregulation of interest rates, full convertibility of current account, liberalization of capital account and deregulation of administered prices, among others.

However, the experiences of many countries with policies for accelerating economic growth through economic liberalization and privatization find that while those activities have indeed spurred economic growth and reduced aggregate poverty levels, they have instead resulted in widening of income inequality (UN, 2010). Further, the lack of validation of the Kuznets curve was worrying to most policy makers where empirical evidence “defied the notion that the fruits of growth eventually trickled down to the poorer segments of developing societies, causing the emergence of concern about the distributional effects of growth” (Ranieri and Ramos, 2013). There was thus a shift in development thinking, which focused on the economic growth process with acknowledgement that there is a role for the state for promoting inclusive growth and reducing inequality.<sup>2</sup>

In the above context, perception slowly changed from that of a trade-off to an understanding that economic growth and equality can, and should, go hand in hand. This understanding opened up an era of economic thinking and planning in which a host of factors increasingly oriented the debate toward how to promote economic growth with equality without having to reach the threshold for inequality to naturally self correct. This initiated discussion of pro-poor growth—growth that actually benefits the poor and led to more state income distribution schemes. While the concept of pro-poor growth is clear and logical, there is no clear consensus on its definition—that is, there is the “weak but absolute definition of pro-poor growth” which refers to increased income for the poor, while the “relative

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2. This was apparent in World Bank’s 1974 publication entitled *Redistribution with Growth* and subsequent policies, such as India’s 3rd Five Year Plan (as quoted in Ranieri and Ramos, 2013, p. 2).

definition of pro-poor growth” refers to growth that leads to disproportionate increases in incomes among the poor (which is accompanied by declining inequality). Further it was felt that transfer schemes were not the answer in the long run and could be problematic even in the short run by imposing significant burden on state budgets.

Amidst this unfolding discussion over pro-poor growth, the concept of inclusive growth emerged. It differs from the concept of pro-poor growth since it places emphasis on participation of all people regardless of their income category for benefitting from the growth process. As with discussion on pro-poor growth, there is also no consensus definition for inclusive growth; however, inclusive growth focuses on productive employment and refers both to the pace and pattern of growth, which is taken as being interlinked and therefore must be addressed together. Thus, growth can be taken as inclusive when it creates economic opportunities at large along with ensuring equal access to them.

This background paper focuses on how the financial sector can contribute and promote inclusive growth. While there has been significant discussion on inclusive growth, a gap exists in this regard. This paper attempts to fill the gap and intends to:

- Discuss the role of financial sector in achieving inclusive growth;
- Examine some issues for reengineering the financial sector that supports inclusive growth, including the need for a credible financial sector development strategy; and
- Provide insights into some activities undertaken with regard to financial inclusion, with examples from Nepal.

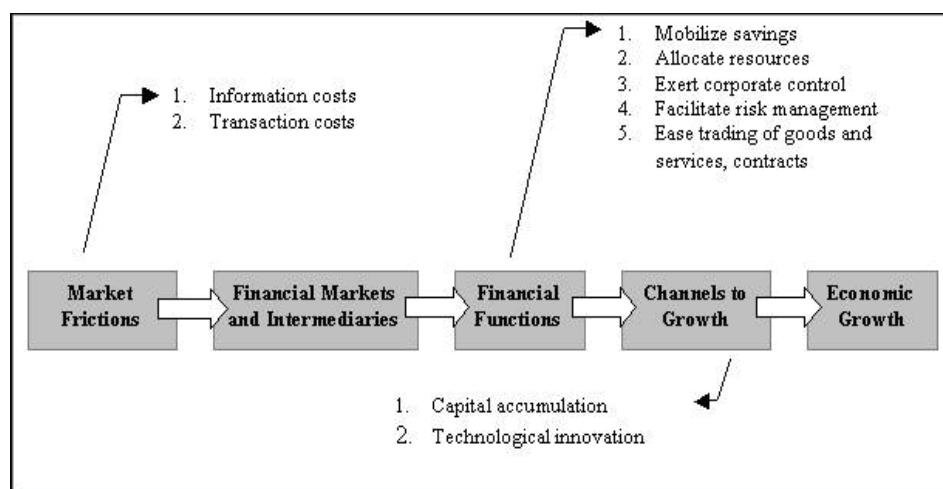
The paper ends by highlighting some issues such as the need for a financial sector development strategy to guide the financial sector for supporting inclusive growth, especially in emerging economies.

## 2. Role of Financial Sector for Acheving Inclusive Growth

Financial sector is taken as the set of institutions, instruments, and the regulatory framework that permit transactions to be made by incurring and settling debts, that is, by extending credit. The conventional perspective is that the financial sector plays an important role in economic development since it facilitates the allocation of credit and fuels economic growth. This is based on the IS-LM framework which implicitly assumes that the financial sector is able to efficiently allocate scarce funds and risk. In this regard, financial sector development can enhance competition among financial intermediaries and therefore enhance the quality of financial services that are provided to the rest of the economy. An efficient financial sector lowers the cost and risk of producing and trading goods and services and thereby provides the essentials for income-growth and employment creation, thus making a vital contribution to raising standards of living (Sen, 2010).

The conceptual channels by which financial sector development leads to economic growth are illustrated in Figure 2 below. It depicts how financial intermediaries are related to economic growth by means of overcoming market frictions (such as information costs and transaction costs) and affecting saving and resource allocation decisions. Some economists find two channels through which each financial function may impact growth: capital accumulation and technological innovation (Levine, 1997). The financial sector affects resource allocation either by altering the savings rate or by reallocating the savings among different capital producing technologies. In terms of technological innovation, the functions carried out by the financial sector affect economic growth by altering the rate of technological innovation.

**Figure 2: The Financial Sector-Economic Growth Nexus**



Source: Ozer (2008).

Some cross-country level works (King and Levine, 1993 and Levine and Zervos, 1998) suggest that measures of financial sector development (such as credit to GDP ratio) are vigorously related to economic growth. Even the endogenous growth literature, building on 'learning by doing' processes, allocates a special role to finance (Aghion and Howitt, 1998). Further, cross-country findings also show that financial sector promotes growth through increase in productivity (Ayyagari, Demirgüç-Kuntand and Maksimovic, 2007). Moreover, it has also been revealed that financial sector development plays an instrumental role in moderating the impact of external shocks on the domestic economy (Beck, Lundberg and Majnoni, 2006). Some studies (Balakrishnan et al., 2013) find that financial sector development not only promotes but facilitates the even distribution of economic growth.

However, it has also been exhibited that while financial sector development can result in higher economic growth, it is unclear whether or not it will lead to greater poverty reduction (Holden and Propenko, 2001). Two factors are responsible for this. One, the impact of financial sector development on poverty reduction is itself governed by the level of income or asset inequality in the

country. For countries with high levels of inequality, the impact of growth on poverty, and thus of finance on poverty, will be less than that for countries with low levels of inequality. Two, financial sector development may itself aggravate inequality in the country. Thus, as banks and other financial intermediaries increase in size and number, they may opt to lend only to those who possess collateral and who can borrow against such collateral. Poorer households or small and micro enterprises which do not have access to collateral may be rationed out of financial markets. Thus, the conventional measure of financial sector development does not really capture the distribution of credit, but only focuses on an aggregate perspective.

Prior to addressing the distribution concern of credit, it should be first clear that the foundation of economic growth is critical for having inclusive growth. In this regard, financial sector development and its stability is a precondition for any kind of growth; and it implies the ability of the financial sector to smoothly carry out its key economic functions at all times, including in stress situations and periods of structural upheaval. In particular, it refers to financial sector deepening and an efficient allocation of financial resources and risks along with the provision of a well functioning financial infrastructure, such as payment and settlement system. Financial stability as such is a precondition for the real economy to generate jobs, promote economic activities and sustain economic growth. The primary role of the central bank and other regulatory authorities thus appears to ensure macroeconomic and financial stability. In this respect, the monetary authority must accord priority on its primary role for macroeconomic and financial system stability (Khatiwada, 2013).

Beyond this macroeconomic perspective and for contributing to making growth inclusive, three characteristics for the financial sector (i.e. the microeconomic perspective) are highlighted:

- The first characteristic is access to finance, which is an essential ingredient of the economic development process. Modern development theories stress the key role of access to credit for economic growth, of any kind it may be. In many developing countries, small-scale enterprises and micro-entrepreneurs face severe financing constraints; and financial services, particularly micro and SME finance provided by financial sector, ensure wider economic participation, create jobs and self employment, and realize their



full potential. Likewise, access of the poor and vulnerable groups to finance is a pre-requisite for inclusive growth, poverty reduction and well being. Further, it empowers the vulnerable groups by giving them an opportunity to participate in economic activities, to have a bank account to save and partake in credit, and to access other financial services thereby facilitating them to break the chain of poverty.

- The second characteristic is a mechanism that supplies credit to basic production sectors without compromising on the quality of financial services. In this regard it is essential that there be sufficient allocation of credit to the sectors which engage large section of labour force. If necessary, state subsidies on interest, insurance premium, on credit plus services, etc. could be part of this targeted program. Such an allocation promotes formalization of informal sector, links finance to real output, and creates more jobs.
- The third characteristic is a financial safety net: The financial sector has an instrumental role to play in providing financial and social protection (a “safety net”) to the society at large. Financial sector can play a vital role in ensuring basic liquidity and credit flows even at a time of financial crisis along with enhancing and protecting the income of the poor, in providing insurance (at the micro level) and in facilitating safe, prompt and affordable money transfers and payments.

The financial sector does not automatically take above mentioned characteristics which facilitate inclusive growth. This implies that the role of the state and the regulators has to be reassessed with the new paradigm of economic planning targetting economic growth with equality. The notion of a tradeoff between economic growth and inequality has also been challenged by the East Asian experience of high growth and low levels of inequality and suggests that there is a role for “state strategic activism in coordination with key private-sector elements” (Ranieri and Ramos, 2013). Development does not happen naturally and instead requires enacting the appropriate policies (Stiglitz and Squire, 1998). For attaining inclusive growth and development, leadership is important along with resource. Therefore, the G8 countries have agreed to “cultivate a broad-based government commitment to financial inclusion to alleviate poverty” as the

first principle for innovative financial inclusion. In this regard, the proactive approach of state actors, namely financial sector regulators, is needed in addressing the policy and regulatory framework which also link both macroeconomic and microeconomic perspective as well as ensuring coordination with all the stakeholders that are vital for inclusive growth.

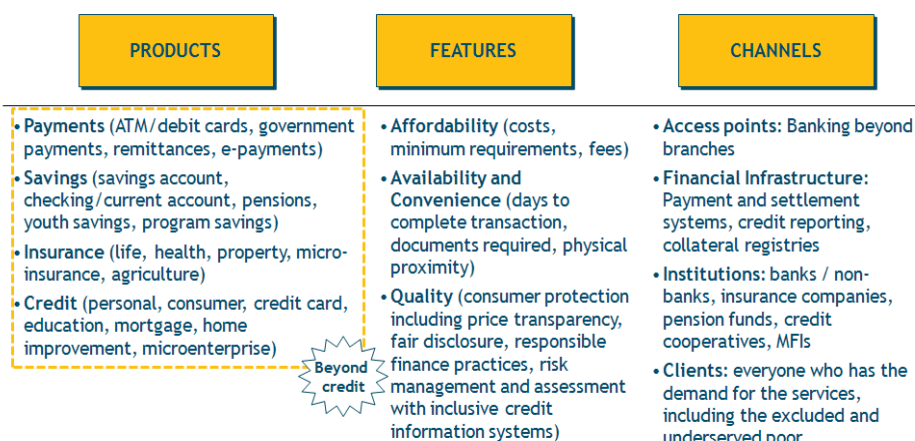
There also exists a bi-directional feedback loop from inclusive growth to the financial sector. An inclusive growth makes more people bankable and thus widens the demand for financial services at large. The feedback from inclusive growth (which leads to productive employment) to financial sector is via access to the productive resources and quality of financial services that widens and deepen the financial sector and thus ensure financial stability.

## **2.1 Stronger Inclusive Financial Sector**

Preceding discussion suggests that the characteristics of financial system that supports inclusive growth is typically an inclusive financial system. This subsection elaborates on those characteristics and discusses this type of financial sector.

**Defining Inclusive Finance:** Inclusive finance is defined as a “state in which all people of working age have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients” (Stein, 2010). It encompasses normally the access of financial services, at reasonable cost, especially to low income groups (Kanter and Nagabhusan, 2012). It focuses on (a) access at a reasonable cost of all households and enterprises to the range of financial services for which they are “bankable”, (b) sound institutions, guided by appropriate internal management systems, (c) financial and institutional sustainability as a means of providing access to financial services over time, and (d) multiple providers of financial services, so as to bring cost-effectiveness and a wide variety of alternatives to customers (UN, 2006). The key dimensions of inclusive finance are summarized in Figure 3.

**Figure 3: Key Dimensions of Inclusive Finance**



Source: Stein (2010).

Figure 3 suggests that “access” of financial services to the rural households is the heart of inclusive finance. It is viewed that safe savings, appropriately designed loans for poor and low-income households and for micro, small and medium-sized enterprises, and appropriate insurance and payments services can help people to increase incomes, acquire capital, manage risk, and work their way out of poverty.

The significance of inclusive finance stems from the fact that more than 75% of the world’s poor are excluded from formal financial services (Demirgüç-Kunt and Klapper, 2012). About 60% of the population in East Asia and 80% of that in South Asia do not have access to the formal financial system. These data suggest a great challenge and the need for inclusive finance to serve the rural populace. However, deepening itself may not translate into financial services being broadly available across firms and households, making “access to finance” equally important (Balakrishnan et al., 2013).

There are diverse service providers including commercial banks, development banks, micro finance institutions, licensed non-bank financial intermediaries, cooperatives societies, postal saving banks, Financial Non Governmental Organizations (FINGOs), and informal organizations (such as self-help trusts and money lenders) involved in delivering financial services in this market. The promoters of these institutions range from the government to the non government and community organizations. Donors' roles are also equally important in promoting such services in low income countries. These organizations are guided by their respective policies, rules and modules of operations and often influence the institutional financial, and operational models of the financial organizations.

**Constraints to Inclusive Finance:** There are constraints at both the demand and supply sides of inclusive finance which have limited the access of financial services to the rural poor. It is suggested that (a) geography or physical access, (b) lack of proper documentation, and (c) high prices, minimum account requirements and fees work as constraints for inclusive finance (Demirgüç-Kunt, 2010). United Nations (2006) has also highlighted that (a) cultural factors, (b) mistrust of financial institutions, (c) transactions costs, (d) financial literacy and skill capacity, and (e) access to basic infrastructure are the barriers to inclusive finance from the demand side. The supply side factors comprised of the following: (a) financial viability of microfinance institutions, (b) real and perceived risk in micro lending, (c) institutions and linkages with the formal sector, and (d) approaches and products.

Personal and cultural characteristics (such as caste systems, exclusion of ethnic minorities, religious beliefs, gender, age, and requirements of various legal documents) have discouraged the rural poor from accessing the financial services. Gender biasness is often noted prohibiting credit facilities to women (Demirgüç-Kunt et. al, 2013). Service providers, including insurance organizations, that normally target middle-aged economically active population and restrictive clauses make it difficult to avail financial services for older and younger population. The required documentation (identification card, citizen certificate, birth certificate and legal paper for asset holding) and the cumbersome policies often discourage rural households from banking and other financial services.

Collateral based lending practices of the financial intermediaries and lack of bankable collateral among the poor, and particularly among women - who own very small fraction of family property in their name - result in systematic exclusion of such people from bank credit. Even in micro finance services which focus on collateral free lending under group guarantee, there are exclusionary trends in group formation itself. In a society where social classes exist, the ultra poor and some section of the society are left out in the very group formation process. So even the collateral free lending practice becomes exclusionary if due care is not given to encompass the ultra poor or 'outcasted' people through better social mobilization.

Mistrust on financial institutions restrains the demand for financial services. Generally, customers want safety and security of their funds as well as convenience, liquidity, confidentiality, good service, credit facilities, and good returns from service providers. If these factors are limited and cases of corruptions and misuse of funds are reported, this would likely have a negative effect on the trust and creditability of the service providers, thereby restraining the demand of financial services.

Transaction costs is an issue of discussion in inclusive finance. Higher interest rates have always been an issue for micro finance. Compared to the commercial banks, MFIs' interest rates are higher due to high operating costs for small transactions. Similarly, literacy and capability programs help the rural households to make informed decisions. But, in its absence, rural households are unable to know how bank operates, their rights and obligations, contractual and legal consequences and skills and knowledge for operating businesses; and these restraint the poor people to make informed decisions. The significance of basic infrastructure stems from the fact that it improves the capability of rural households in accessing education, health services, business opportunities and reducing risks of operations.

Understanding the poor people's financial needs, behavior, and preferences and translating them to a better service offering need to be considered for increasing the demand of financial services. The need, therefore, is to move away from a conventional approach (selling products to client) to a client-centric approach.

Looking at the supply side, financial viability of the institutions involved is an issue raised on the ground that the objective of 'double bottom line'; that is, seeking profit versus pursuing economic and social development, is a concern for service providers. The other issues such as high costs involved in small transactions, economies of scale, lack of capital, weak human resources and capability, wider competition with the larger banks and dependency on donors' funds, among others, add complexity for financial viability. Lending to small borrowers is still conceived as a risky business. Despite the research evidences (Christen, 1997 and Chowdri, 2004) that credit to poor households is comparatively less risky, lending to rural households is perceived as a risky business because of geographical distance, difficulties in monitoring and supervision, problems in generating data and information and also due to inherent weaknesses of the service providers. Lack of financial intermediation with mainstream financial market restrains MFIs to increase their credit portfolios due to constraints in borrowing funds, mobilizing savings, and accessing debt and short-term funds. The need for innovation in products and delivery mechanisms in line with customer needs, want and affordability is another challenge for service providers.

**Beyond Inclusive Finance:** The above discussion largely covers characteristic of access to finance. Financial inclusion is a multifaceted agenda with very wide-ranging categories, including microfinance, micro-insurance, micro savings, payment systems, agent banking, and the like. Stakeholders include the state, state actors, nongovernmental organizations, interested members of the international community, regulators, financial and non-financial service providers, consumers, and the public. Thus two further characteristics are necessary in this regard, namely:

- **Credit Policy:** Credit policy ensures supply of credit for driving economic growth. However the distribution of credit should not be left to the financial sector since it naturally provides credit to the most profitable venture. Often times, the financial market also tends to misallocate funds, like in the real estate or property market. In this regard, it is essential that there be credible sectoral allocation of credit to the identified productive sectors. Additionally, one important area is targeted credit, which, if allowed to run on basic market

principle and on transparent fiscal or budgetary support will better ensure financial inclusiveness. The failure of previous models of directed credit should help us to refine the approach and make it successful for sustainable inclusive financial development.

- **Financial Safety Nets:** Promoting inclusive growth requires the government to formulate national strategies on social safety nets to mitigate the effects of shocks and vulnerabilities associated with their livelihoods. Social safety nets are also needed at least to meet the minimum needs of the chronically poor people, who may not be able to benefit from the opportunities created by growth strategies due to circumstances beyond their control. Livelihood shocks may emanate from ill health, economic crisis, natural disaster and unemployment, among others. Generally, policies on social safety nets could include (a) labor market policies and programs aimed at reducing the risks of unemployment, (b) social insurance programs to cover the risks of ill health, disability, and (c) social assistance and welfare schemes; among others (Ali and Zhuang, 2007). Financial safety net, a new concept in broader safety net definition, is emerging as an important pillar of social safety net, particularly at the time of financial and economic crisis.

Financial services are important to carry on social protection, as micro finance could help in income and job protection, credit guarantees and micro insurance of business (like crop and livestock insurance) for business protection, thus protecting the poor from business failure, loan delinquences or indebtedness. Deposit insurance which was often been negated on moral hazard ground works through the promotion of financial inclusion by reinforcing confidence in financial institutions and potentially leading to more savings among the poor. Access to deposit insurance should provide a measure of protection to small savers, provided they are informed about safe places to store their money. Many deposit insurance systems include as a public policy goal, thus protecting small depositors at times of financial crisis. The provision of financial life line (minimum financial service like liquidity and credit provision) becomes a crucial at the time of market failure.

**Role of the State Regulators:** There exists greater coordinating role of financial sector regulators. The G8 countries have vowed for a broad-based government commitment to financial inclusion to alleviate poverty as the first principle for innovative financial inclusion. The government proactive approach is thus needed

in (a) addressing the policy and regulatory framework, (b) harnessing the national and international funds for inclusiveness, (c) developing safety nets mechanisms and institutions, (d) encouraging broad based participation from industrial and financial sectors to the rural sector, (e) strengthening data management literacy programs, and (f) ensuring coordination with all the stakeholders that are vital for inclusive growth.

The coordination principle requires creating an institutional environment with clear lines of accountability and enforcement within the government and among regulators, and also encouraging partnerships and direct consultation across government, business, and other stakeholders. All this taken together would thus result in a stronger form of inclusive finance which would contribute to achieving inclusive growth.

### **3. Reengineering the Financial Sector for Inclusive Growth: Need for a Financial Sector Development Strategy**

From the discussion in the previous sections, it is clear that there is a need to reengineer the financial sector for inclusive growth. This includes the re-orientation of central bank roles and responsibilities including the setting of monetary and financial policy objectives, choosing policy instruments and focussing on specific services that are more inclusive. There is also a need to think over the actors of development finance. As experience shows, while states have often malfunctioned in financial service delivery, the private sector has been exclusionary mostly in the access to such services at affordable price or cost. This has created a space for community and cooperative organizations to deliver affordable and accessible financial services to the poor. The role of state as a facilitator to these organizations would be crucial.

The legal (such as single objective), regulatory (such as overly focus on financial stability than on access) and operational aspects (such as letting the market to credit concentration, emphasizing collateral based lending practices, overlooking perverse incentives in banking) of the central banking may call for a revisit if we are trying to reengineer the financial system. More to that, the services of other financial institutions including the deposit taking, insurance and capital market ones have to be reworked out for making such services effectively and easily available to a wider spectrum of the society.



No doubt, controlling consumer price inflation would continue to be the top priority of central bank. But asset price bubbles created by excess liquidity injection are equally damaging to the economy and people at large. Both price increases will leave those who rely on wages and salaries, as well as those without wealth in the form of physical and financial assets, relatively worse off. Especially, credit expansion without the corresponding rise in the productive capital stock will exacerbate the distributional impact of asset price increases and raise the cost of financial intermediation.

While discussing the need for a financial sector development strategy that caters inclusive growth with stability, it is necessary to set defined roles and responsibilities of different stakeholders of the financial system. One key stakeholder which often comes on debate is the state and its role in the financial system. While the past has seen state led financial development in several countries and also the state led rescue of the financial crisis, a credible financial sector development strategy calls for a balanced role of the state in financial market. So would be the role of global oversight and policy advisory agencies like the Fund and the Bank. Due recognition must be given to the grass root community and cooperative organizations which provide financial services to those who are left out by the large financial service providers. While shadow banking contributes a lot towards access to inclusive finance, it may also be a source of financial instability if it is deeply interconnected with the formal financial system. A credible financial sector development strategy will have to consider the regulatory and supervisory framework of such agencies, ensure their good governance, and reduce the risk of spillover effect of shadow banking friction to the formal financial sector.

The private sector market players have often worked irrationally implying that often regulators have to properly oversee and guide the market, if necessary. As invisible hand of the market would also be the invisible cause of the financial crisis, new norms for market discipline and oversight by the national and international regulators and oversight agencies have to come in public discourse, of course not limiting this among the larger economies.

Financial market imperfections such as asymmetric information and costs associated with transactions and contract enforcement affect the poor and small-scale entrepreneurs severely, as they do not have collateral, credit histories or connections. These obstruct capital from flowing to poor individuals, even if

they hold projects with high prospective returns, thus reducing the efficiency of capital allocation and aggravating inequality. By addressing these imperfections and generating enabling conditions for financial markets and instruments to develop—such as insurance products that facilitate adjustment to shocks—financial sector regulators can, therefore, not only spur growth but also help ensure that it is distributed more evenly.

While there is scanty evidence that empowering regulators augments bank stability, it has been exhibited that regulations and supervisory practices that force accurate information disclosure and promote private sector monitoring boost the overall level of banking sector and stock market development (Barth, Caprio and Levine, 2006). On the other hand, little significant impact of regulatory and supervisory practice on financial development of low-income countries is also observed (Detragiache, Gupta and Tressel, 2005).

Various researchers provide lessons on which financial regulatory strategies enhance inclusive finance and which policies obstruct it (Beck, Levine and Levkov, 2010 and Houston, Lin and Ma, 2010). They pay attention on the value of regulations and supervisory practices that foster competition and transparency and that continuously seek to eliminate policies that create incentives for financiers to undertake socially harmful—though privately profitable—investments. Such regulatory practices raise the quality of financial services, lower the cost of those services, deter corruption in credit allocation and exert a disproportionately significant impact on the living standards of lower income households. A regulatory strategy focused on competition, transparency and incentives has the advantage of fostering a sustainable inclusive growth. Such experiences are the building blocks of the financial sector strategy serving for inclusive growth.

In aggregate, the following considerations may act as a guide for reengineering the financial sector which serve the poor as well as promotes inclusive growth:

- The setting up of tiered regulatory structures can help calibrate and tailor regulation and supervision to the specific products and services offered such as focusing of small and medium enterprises, fostering diversity in institutional models. Introduction of risk-based regulation and supervision is currently a

challenge in the global context. Coordination among financial sector regulators such as the central bank, insurance and capital market authorities, state and para-state agencies which monitor shadow banking and micro finance has to be in place.

- Enhancing the supervisory capacity for adequate supervision of a large number of small institutions (which may necessitate setting up a supervisory Second Tier Institution) is important, taking into consideration the expansion of financial institutions and financial innovation that is taking place at the retail financial level. A decentralized or delegated supervisory set up will prevent the central bank from overstretching itself to micro-business. It is unsafe to promote market entry without the necessary supervisory tools and the capacity to apply them to monitor new (and old) market participants.
- Including access to finance in banking regulations and supervisory practices denotes that the two traditional aims of prudential regulation—safety of funds deposited in regulated financial institutions and the stability of the financial system—need to be supplemented by a third goal of achieving universal access to financial services. This also includes incorporating the informal market/shadow banking system, such as cooperatives. There should also be efforts for identifying and removing hurdles to financial access—including those that restrain competition—without directing particular outcomes.
- Expanding credit availability by promoting rural finance, ensuring that regulations (such as loan classification criteria and capital requirements) do not discriminate against the provision of finance to the rural poor, extending micro-credit, promoting credit information sharing, and developing venture capital markets would largely expand credit availability (Balakrishnan et al., 2013). There is also a need for changing financing norms and practices (i.e. redefining collateral criteria, shift from collateral based to project based lending, easing banking language, etc).
- Increasing access to savings accounts and other financial services will lead to the poor getting financial security and safety nets, managing risks against shocks and also investing in new business opportunities. In this light, there is a need to scale up the financial service network including exchange and remittance services, and payment and settlement system appropriately so

that its benefits are ensured thereby contributing to greater financial inclusion. But we need to be clear that access to bank accounts do not necessarily ensure inclusive growth; access to credit and other financial services are more important. Ignoring this fact, we may be too tokenist in financial inclusion policy.

Overall, there exist a number of policies that support or obstruct financial inclusion. Growth with equity policies attempt to foster economic growth and strengthen opportunities for poor and low-income people to raise their income and build assets. A macroeconomic policy structure with excessive government deficits too often crowds out credit to the private sector just as an exceptionally tight macroeconomic policy too often chokes off private demand for credit and economic growth. General institutional weaknesses in a country can impede its development, wider inequality and invite financial crisis. On some instances, governments should intervene directly in the economy and the financial system to protect the public. At other times, they can be most effective in protecting the public by promoting competition and transparency among private entities. This implies promoting competition by facilitating entry of new competitors and maintaining a diversity of types of financial service providers. The above discussion suggests that the reengineering of the financial sector needs more directed guidance from the state.

For giving guidance to the financial sector, several countries have developed financial sector development strategy. After the financial crisis and particularly amid the growing discussion on how to ensure inclusive growth, the role of finance has drawn all of our attention. Coming to a common framework for a financial sector strategy that serves towards inclusive growth would not be an easy job, but on going discourse should guide us to a tailor made approach to formulate such a strategy.

#### **4. Nepal's Experiences on Inclusive Finance**

Nepal is encountering challenges for inclusive growth which could be supported also by financial inclusion. The majority of the people are still outside the boundary of formal banking services. Although there has been a significant increase in the number of banking in service in the rural areas, it is not proportional to the large population living in these areas. In this respect, Nepal Rastra Bank's monetary

and financial policies, in addition to giving due emphasis on macroeconomic and financial stability, is oriented to support inclusive growth through its credit policy and financial access strategy. Allocation of bank credit has been encouraged to promote agriculture (which provides jobs and livelihood to two-thirds of the households) and energy which is so critical for inclusive growth. There is a deprived sector lending requirement for banks and financial institutions, special refinance facility to cottage and small industries, and enterprises run by women and specified community, refinance facility with concessional interest rate to productive sector, and interest free loan to banks to open branches in rural areas. Financial literacy programs are directed towards financial inclusion and inclusive growth.

The NRB has taken following measures to enhance financial access, namely:

- Licensing of microfinance institutions in underserved areas is encouraged while the licensing for banks and other financial institutions is on moratorium.
- Interest free loan up to Rs. 10 million is provided to financial institutions for opening up new branch in specified district with inadequate financial access.
- Branchless and mobile banking in rural areas is encouraged.
- Financial literacy programs are being carried out through audio -visual and print media.
- Oversight of saving and credit cooperatives has been done to support the state regulator in widening financial services.

The NRB is also aware of the importance of credit policy. In this regard, the Bank has issued certain directives:

- Commercial banks, development banks and finance companies are required to provide 4.5%, 4% and 3.5% of total credit to deprived sector respectively.
- Banks and financial institutions are required to extend 20% of their credit to productive sectors (agriculture, energy, tourism and small & cottage industries) comprising at least 12% in agriculture and energy sectors. Development banks and finance companies need to submit a plan to extend 20% of their total credit to productive sector in the next 3 years.

- To ease availability of credit to productive sectors, banks and financial institutions are restricted to extend more than 25% of their total credit to real estate sector including housing.
- Special refinance facility with very low interest rate (1%) for loan extended by banks and financial institutions to cottage and small industries, enterprises run by women and small enterprises run by people of specified communities
- Refinance facility is being provided to banks and financial institutions at concessional interest rate against good loan extended to productive sector.
- Microcredit facility is being provided to rural people on concessional interest rate from Rural Self Reliance Fund (created by the government and the Bank) along with interest subsidy to good borrowers.
- Refinance facility is provided to banks and financial institutions for small & medium enterprises' loan up to Rs. 10 million.
- Project loan up to Rs. 0.5 million extended by banks and financial institutions to enterprise run by women entrepreneurs is counted in deprived sector loan and refinance facility is provided to BFIs against such loan.
- Banks and financial institutions are allowed to extend project loan up to Rs. 10 million in agriculture farming such as coffee, tea, orange, livestock and dairy products on the basis of viability of the projects.
- Steps are taken to extend some amount of collateral free loan to small farmers and business enterprises.

Other regulators have also issued directives related to capital market and insurance which are inclusive in nature. They include the following:

- Access to equity participation of local community in hydropower projects.
- Deposit insurance for small depositors of up to Rs. 0.2 million.
- Mutual funds catering financial instruments to the small savers.
- Mandatory crop and livestock insurance service for the farmers.
- Wider participation of the people in the equity of financial institutions.

The NRB is aware that the financial sector has broadened, and in this regard is taking measures to enhance coordination with other regulators such as the following:

- It is working together with government agencies and other regulatory bodies of financial sector such as Insurance Board, Security Exchange Board of Nepal, and Cooperative Department to promote financial inclusion.
- For this, a “High-level Financial Sector Coordination Committee” has been established and is being chaired by Honorable Finance Minister in which NRB Governor and head of other regulatory agencies are members.

Overall, in order to safeguard financial stability, increase in access to finance and facilitate in achieving inclusive growth through development and expansion of financial sector, formulation of a financial sector development strategy is in progress in coordination with the Government of Nepal and other relevant stakeholders. Support of the World Bank and IMF is being mobilized for this purpose. Financial Sector Assessment Program to begin soon would be instrumental in this regard.

## **5. Conclusion and Observations**

Evidence suggest that the financial sector, if left alone to the free market, not only may leave large section of society out of financial services but also may heighten inequality by adversely affecting the quality of economic growth. Thus, there is a need for steering its development pathway through a financial sector development strategy to optimally contribute to inclusive growth. To realize the objective of financial inclusion, financial services for poor and low-income people should be viewed as a vital and integral component of the financial sector. This sector should include a gamut of financial institutions, each with its own comparative advantages.

This paper has raised a number of issues for further discussions among the state actors in order to alleviate poverty through inclusive growth mechanism. Some important points for discussions are as follows:

- How can the state or the market promote financial sector development that supports growth and reduces inequality, with adequate financial and economic stability?
- What would be the key financial market regulatory strategies that foster inclusive finance to promote 'good' economic growth?
- How is it possible for state actors (such as the Central Bank or Monetary Authority) to bring about a more inclusive financial sector that leads to broad-based financial sector development?
- How can access to financial services be expanded and deepened until the financial sector can be called "inclusive"?
- How can the global and regional financial architecture support the kind of financial system the emerging and low income economies of our region are looking for?

The above issues and discussions suggest that distribution of income and economic opportunities is very important for inclusive growth. The State can potentially play an important role in the distribution of economic opportunities through policy and programs, and in creating an enabling environment for other stakeholders, including the financial sector, to participate in the process of reducing poverty and improving equality. The financial sector, through inclusive finance mechanisms, can definitely contribute to economic growth, inclusive and sustained, as it offers appropriate and affordable financial services to the people to help them generate economic activities and improve their welfare. It is acknowledged that there are constraints for inclusive finance, both in demand and supply sides. The importance of developing safety nets mechanisms is also recognized for the sustainability of inclusive growth. In this regard, the degree of regulation of the financial sector is a challenge for state actors. Reengineering the financial sector that supports inclusive growth calls for concerted efforts at the national and international levels.



There is a diversity of financial institutions in the SEACEN region and the experiences of countries differ. Some indicators of financial inclusion of the 19 SEACEN members are provided in the Annex. Institutions, policies and practices that do well in one country may not perform well in another. However, sharing experiences with each other would be a great advantage for countries to learn the lessons and best practices.

It is observed that financial sector development strategies for building inclusive financial sector have to be creative, flexible, and appropriate to the national situation. No one can formulate an effective financial sector development strategy in isolation. In this regard, multi-stakeholder dialogues that draw together government, central bank, regulatory and supervisory authorities, the full array of financial institutions, associations, academic experts, civil society, donors, investors and the private sector can facilitate the understanding of limitations and the development of a national strategy. Addressing the above issues and learning from the experiences of those who have achieved success will pave a way for other countries to develop their financial sector development strategy and guide the financial sector to achieving inclusive growth.

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Annex

**Financial Inclusion Indicators of SEACEN Economies**

	Economies	Percent of adults with an account at a formal financial institution*	No. of deposit accounts per 1000 adults**	No. of branches per 100,000 adults**	ATMs per 100,000 adults**
1	Brunei Darussalam	-	2188.49	22.22	90.53
2	Cambodia	3.67	145.64	4.38	6.66
3	China, P.R.	63.82	35.89	7.72	37.51
4	Fiji	-	1059.89	10.53	36.77
5	India	35.23	1042.47	11.38	11.21
6	Indonesia	19.58	708.12	9.59	36.47
7	Korea, Republic of	93.05	4884.75	18.41	-
8	Lao PDR	26.77	-	2.71	12.92
9	Malaysia	66.17	2305.31	19.91	52.94
10	Mongolia	77.72	3829.09	68.82	45.10
11	Myanmar	-	144.26	1.87	0.09
12	Nepal	25.31	451.41	8.43	7.50
13	Papua New Guinea	-	202.49	1.88	8.45
14	Philippines	25.56	497.57	8.13	19.31
15	Singapore	98.22	2180.57#	9.76	58.12
16	Sri Lanka	68.53	-	17.49	15.41
17	Chinese Taipei	87.31	-	-	-
18	Thailand	72.67	1468.10	11.77	84.16
19	Vietnam	21.37	-	3.18	21.16

\* and \*\* refer to the data of 2011 and 2012, respectively.

# stands for number of depositors per 1000 adults.

Source: World Bank (2011) and IMF (2012).

**LEVERAGING THE FINANCIAL SECTOR  
FOR INCLUSIVE GROWTH:  
CHALLENGES FOR NEPAL**

**SPEECH**

**BY**

**MR. JOHANNES ZUTT  
COUNTRY DIRECTOR FOR NEPAL AND  
BANGLADESH  
THE WORLD BANK**



**SPEECH BY  
MR. JOHANNES ZUTT  
COUNTRY DIRECTOR FOR NEPAL AND BANGLADESH  
THE WORLD BANK  
ON  
LEVERAGING THE FINANCIAL SECTOR FOR INCLUSIVE  
GROWTH: CHALLENGES FOR NEPAL**

Your Excellency Mr. N. Zoljargal, Governor, Bank of Mongolia and Chairman  
of the SEACEN Board of Governors

Your Excellency Dr. Yuba Raj Khatiwada, Governor, Nepal Rastra Bank

Your Excellencies, Governors

Distinguished Guests

Ladies and Gentlemen

**The Importance of the NRB Strategy**

Good morning. I would like first to congratulate the NRB team for preparing the important and well-articulated approach paper that will be the focus of this session, that is, the paper on developing a *Financial Sector Development Strategy for Inclusive Growth*.

From the point of view of the World Bank, this focus on inclusive growth as an overarching objective is welcome and timely. As some of you may know, the World Bank has recently adopted the twin goals of ending extreme poverty *and* promoting income growth of the bottom 40% of the population in each country. This second goal captures precisely the emphasis of the paper on inclusive growth.

More specifically, the merit of the paper is to sketch a broad sector-wide strategy for achieving growth that includes but is not restricted to inclusive finance. Instead it stresses the importance of:

- Building solid foundations for the financial sector to support overall growth (because without growth, inclusive growth will remain elusive);
- Improving sector-wide efficiency in the mobilization savings and their allocation to productive uses – which benefits everyone; and finally
- Exploiting opportunities for leveraging finance, specifically for greater economic inclusion.
- In this context, and given that we are in Nepal and that the Nepal Rastra Bank is hosting this conference, I would like to reflect a bit on where Nepal stands.

**First, Nepal has Done an Impressive Job at Laying and Consolidating the Foundations of the Financial Sector.**

The first key step – taken some 10 years ago – was to restore the basic health of the financial sector. Over the past decade, Nepal has implemented major financial sector reforms that substantially improved the sector's ability to carry out its core functions and resilience to shocks. To enumerate just a few key accomplishments:

- The Nepali financial system moved from being majority state-controlled to a market-based system dominated by private banks (which now represent 79 % of total banking sector assets).
- Resolute action was taken to clean up bank balance sheets. In the past, the quality of financial intermediation was limited by substantial amounts of nonperforming loans (NPLs) and insolvency (of state-controlled banks). In response, the Government (with the support of development partners like the World Bank and DFID) developed and implemented a comprehensive program of financial sector reforms<sup>1</sup>, which included (i) revising and adopting

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1. Financial Sector TA Project in 2002/Financial Sector Restructuring Project in 2004 (completed in 2011).

laws and regulations to improve the regulatory framework, (ii) enhancing the capacity of the central bank, and (iii) restructuring the two large state-controlled commercial banks.

- Last but not least, the authorities did a remarkable job, through a challenging period, in maintaining overall macroeconomic stability, which is a key underpinning of financial sector health.

When the real estate bubble burst in early 2011, the financial authorities also demonstrated maturity and acted with the appropriate mix of speed and calm to restore stability.

In particular, they responded by (i) strengthening the central bank's legal authority to resolve problem banks, (ii) establishing a resolution framework for problem banks, (iii) initiating a diagnostic study of systemic financial institutions, (iv) establishing a deposit insurance scheme, (v) initiating the recapitalization of state-owned banks, and (vi) promulgating several bills related to Anti Money Laundering.

### **So, Looking Beyond Sector Stability, What Should We Say About the Remaining Pillars of an Inclusive Growth-Focused Financial Sector Strategy?**

In my view, the time is now ripe to move to the next generation of policy challenges namely: how proactively to leverage the financial sector for economic growth. In particular, much more can be done to expand (i) the efficiency, (ii) the affordability and (iii) the reach of the financial sector.

While Nepal's financial sector has witnessed significant growth in the number of financial institutions, there are still important gaps in terms of (i) the type of products available, (ii) the quality of services and (iii) the extent to which access to finance expands beyond the main urban centers (in a country where 85% of the population is rural).

- Firms are not well served. Most registered firms rely on internal funds to finance the bulk of their investments and their working capital needs. According to the 2013 Enterprise Survey, while 86% of the firms have a bank account, only 35% have a line of credit or a loan from a financial institution (lower than in 2009, when the ratio was 39%). This is consistent

with global data where more than 4 out of 5 formal SMEs have some account services with formal financial institutions, yet only a few receive the credit they need.

- In addition, very few firms use banks to finance investments (13%) and expenses (10%). As a result, registered firms consider access to finance as the third most important obstacle for the investment climate in Nepal and up to 40% of firms perceive it to be a major or very severe constraint to day-to-day operations
- Likewise households, particularly rural households, have inadequate access. For most, access to finance is exclusively through microfinance institutions (MFIs) and unlicensed cooperatives that have expanded rapidly and constitute a major source of risk. As a result, financial intermediation costs continue to be high in the rural or unbanked areas.

In short, there are numerous challenges to be tackled. These include:

- Poor financial infrastructure, such as the absence of an operating registry to record liens on movable assets and the fact that the credit bureau only covers loans larger than NPR 1 million;
- Inhibiting regulation: by some measures Nepal has the highest number of documents required to access financial services;
- A lack of appropriate financial products: the most popular bank product, overdrafts, is inappropriate for many small businesses;
- Obstacles to the use of modern technology;
- Problems with credit information infrastructure; and
- A weak framework for credit enforcement: MSMEs (which constitute the majority of firms in Nepal) for instance, are burdened by high collateral requirements and resort to internal sources of funding.

### **So How can Nepal Move Forward?**

How can Nepal help citizens and businesses to obtain convenient access to a range of diversified, high quality, and affordable financial services?

With this approach paper to a Financial Sector Development Strategy, the central bank of Nepal has already taken exactly the right step in the right direction, and the World Bank is certainly ready to provide assistance in this important endeavor. As some of you may know, the World Bank recently launched a global Financial Inclusion initiative to provide tailored multi-year technical assistance and capacity-building to countries in setting and achieving financial inclusion targets and implementing their financial inclusion strategies. This will scale up its already substantial support to countries in implementing and achieving their financial inclusion targets and goals.

I strongly agree with the paper's contention that much more could be done to "understand poor people's financial needs, behavior and preferences" as a precondition to designing appropriate 'client-centric' solutions. The Bank can help specifically on this analytical agenda.

Nonetheless, and without preempting the conclusions of such important analysis, here are a few of the core ingredients that I would expect to see reflected.

The core objective should be a new focus on non-traditional borrowers, which the growing numbers of financial service providers still don't serve adequately. To deliver on this objective would require upgraded infrastructure, new products and tailored delivery mechanisms.

Under upgraded infrastructure:

- Nepal needs a national payments system.
- There is also urgent need for better credit reporting, covering not just corporates and medium-size enterprises but also the bottom of pyramid, which should be underpinned by an appropriate oversight and consumer protection framework;
- The movable collateral registry (the Secured Transaction Act was passed several years ago but not fully implemented) needs to move away from dependence on fixed or real estate collateral, to benefit MSMEs and small holder farmers.

Under the category of new products:

- Microfinance and cooperatives development could go a long way in expanding access to finance but also, as the paper rightly stresses, providing additional protection to households and SMEs against economic shocks.
- In addition, Nepal dramatically needs to develop specific access channels and products linked to remittances, which account for a whopping 25% of GDP and are now almost entirely channeled to consumption rather than investment.

Under the category of tailored delivery mechanisms

- I am particularly convinced of the potential for technological innovation to contribute to bridging the financial inclusion gap. This comes partly from my experience in Kenya, where I lived for five years, as the World Bank's Country Director, while the mobile money revolution swept across the country. Agent and mobile phone banking succeeded in making financial services widely accessible, and they were often augmented with financial literacy programs to enable new consumers to benefit from financial inclusion. Farsighted regulators can enable competing financial service providers and consumers to take advantage of technological innovations and access financial services more cheaply and safely.
- Another avenue would be to expand government-to-person (G2P) payments through bank and transaction accounts.

This is a daunting agenda and one which will need to be pursued while maintaining and expanding efforts to ensure system-wide stability and resilience. In fact expanding the reach of the financial sector could add more pressure on the foundations. In this respect I look forward to the results of the IMF-World Bank Financial Sector Assessment Program (FSAP), which will begin shortly here in Nepal.

As I conclude, I would like to reiterate that financial inclusion is an important enabler of both poverty reduction and shared prosperity. Savings and payments are strongly linked to poverty reduction, while access to credit and other financial services can enable improved access to water and electricity, housing, education and economic opportunities. Better access to financial services and investment helps MSMEs grow their businesses and create more formal sector jobs, which pay better and longer than informal employment.

As we then engage in a broader discussion with the participants, I would be personally particularly interested in hearing views from other country representatives on some of the paper's original recommendations, such as active state promotion of credit flows to productive and employment generating sectors (in a context of high informality) – the paper talks specifically of “state strategic activism in coordination with key private-sector elements” – as well as on ways in which remittances could be better leveraged for investment. The latter in particular strikes me as a huge unrealized opportunity for Nepal.

I thank you for your attention and look forward to our discussion.

**SESSION 2: REGIONAL AND  
INTERNATIONAL FINANCIAL ISSUES**



**“REGIONAL AND INTERNATIONAL  
FINANCIAL ISSUES”  
GLOBAL AND REGIONAL ECONOMIC  
OUTLOOK - KEY FINANCIAL SECTOR  
CHALLENGES IN ASIA**

**BY**

**MR. ODD PER BREKK  
DIRECTOR  
REGIONAL OFFICE FOR ASIA  
AND THE PACIFIC  
INTERNATIONAL MONETARY FUND  
(Slides are in Annex 1)**

**HIGH-LEVEL SEMINAR**

**SESSION 1: NEW FINANCIAL  
ARCHITECTURE, MACROPRUDENTIAL  
REGULATION AND SUPERVISION FOR  
FINANCIAL STABILITY AND GROWTH**

**ADDRESSING RISKS TO FINANCIAL  
STABILITY IN ASIA**

**SPEECH**

**BY**

**MR. JAIME CARUANA  
GENERAL MANAGER  
BANK FOR INTERNATIONAL SETTLEMENTS**

**ADDRESSING RISKS TO FINANCIAL STABILITY IN ASIA  
SPEECH BY  
MR. JAIME CARUANA  
GENERAL MANAGER, BANK FOR INTERNATIONAL  
SETTLEMENTS**

**1. Introduction**

I'd like to thank Governor Khatiwada, the Nepal Rastra Bank and SEACEN for inviting me to a conference in such a beautiful location.

This session is on "New financial architecture, macroprudential regulation and supervision for financial stability and growth."

One month ago we had a symposium in Basel celebrating the 25<sup>th</sup> anniversary of the first Basel capital accord. Among the topics that were discussed there was one which I think is particularly relevant when thinking about the appropriate financial architecture to preserve financial stability. The question was: How do we keep up with continuous innovation and change in the financial system? In a highly dynamic and complex world, our imperfect knowledge tends to leave regulatory design permanently in catch-up mode.

In the discussion in Basel, there were several responses to the question:

One response was that our imperfect knowledge means that it is important to have large buffers and proper incentives in the regulatory framework. Large buffers in both capital and liquidity would protect the system from shocks that we just cannot anticipate. These buffers would not only allow the system to withstand the shocks, if properly calibrated, they would also make banks internalise systemic risks. The idea of buffers is not limited to the financial area. Fiscal buffers, or if you want fiscal space, will also be critical in providing credible backstops and avoiding negative feedback-loops should the unexpected happen.

The second response also arose from the notion that no regulation, no matter how sophisticated, will be able to account for all potential cases, situations and changes. This means we will need a much more proactive process of supervision,

one with a system-wide perspective. Preserving financial stability will require the capacity and the willingness to act and the ability to make full use of macroprudential and microprudential policies.

Of course, the authorities in Asia have understood this all along. There is a rich history here of devising and implementing macroprudential measures. Already back in the 1990s, if not earlier, Asian central banks used various prudential instruments in order to mitigate systemic vulnerabilities. Hong Kong and others used ceilings on loan-to value and debt-to-income ratios. New measures are being tried all the time, including a levy on foreign exchange liabilities of banks in Korea. Preliminary analysis suggest that the results of the Korean levy have been favourable.

A third response arose from the recognition that any regulatory framework will have some “cracks”, meaning it can cover some parts of the system but not all. As a consequence, we may need the help of other policies to promote financial stability. In particular, monetary policy could play the important role of determining the universal cost of leverage, which is what would be needed to fill in the cracks.

I will not delve into the first point here today. Let me just mention that we have made significant strides in this area. The new Basel rules call for higher and better quality capital as well as minimum liquidity buffers. For capital, we have identified systemically important banks and have set more stringent standards for them. In addition, we now provide for buffers to be built up during booms and drawn down in time of stress. The on-going work on setting additional “bailinable debt” and minimum standards on haircuts will provide additional capacity to absorb shocks. Not only do these buffers make the system considerably stronger than before, they also help align incentives so that they reflect the macroprudential dimension.

True, all these buffers will impose some costs on banks. But these up-front costs would bring longer-term benefits to the system as a whole. And the more resilient system should allow the global economy to grow with fewer interruptions from financial crises and with crises that are smaller than before.

Today, I'd like to focus on the other two aspects – that of proactive systemic supervision and that of the role of monetary policy. These two are key ingredients in any new architecture that is robust to the myriad risks of financial stability. This narrow focus should be seen as only a part of a comprehensive financial stability framework, one which includes a wide range of policies and institutional settings. In this broad framework, while banks tend to get most of the regulatory attention, it is important to monitor developments in the financial system as a whole. In this regard, I would like to draw your attention to a recent development that bears watching. I have in mind the dramatic change in the patterns of funding flows, particularly in Asia. I am referring to the rapid growth of corporate bond issuance in hard currencies, or as Hyun Song Shin has called it, the new phase of global liquidity.

## **2. Being Systemic and Proactive with Supervision**

As I said, the Basel III capital and liquidity standards set a new framework for a sound and stable banking system. They provide a solid foundation on which to build a more systemic approach to bank supervision.

Yet, while capital and liquidity standards are essential, they are not sufficient. Strong standards need the support of strong supervision, just as strong supervision needs the support of strong standards. In the wake of the recent global financial crisis, the Basel Committee undertook a reappraisal of its core principles for banking supervision, resulting in revised principles in 2012. Supervision should be intrusive, proactive, comprehensive, adaptive and conclusive.

Supervision should take a systemic view, integrating the macroprudential with the microprudential approaches. What does it mean to be more systemic? It means at least two things. First, we must pay greater attention to systemically important banks. Second, we must adopt a system-wide, macro perspective and be ready to take pre-emptive action. Let me say something about each of these two principles.

First, regarding systemically important banks, the Basel Committee has proposed a methodology for identifying such banks at the global level. It relies on five broad indicators of systemic importance: size, interconnectedness, substitutability,

complexity and cross-border activity. These indicators have now allowed us to identify 28 *global* systemically important banks or G-SIBs.

We can use a similar methodology to identify *regional* systemically important banks as well as *domestic* ones. Once we identify these banks, we can supervise them more closely, perhaps following the regulations already formulated for the G-SIBs.

Second, this kind of supervision requires not only a new and different kind of expertise, but more importantly also the capacity and willingness to act. These include the capacity to conduct group-wide consolidated supervision and the ability to challenge banks' business models, their corporate strategy, governance, risk profiles, ROE targets and capital plans. Also necessary will be the willingness to exercise judgement and to act pre-emptively under uncertainty.

In order to achieve a system-wide macro perspective, an important tool is macro stress tests. In contrast to the traditional stress tests that banks and other institutions had been doing and that focused on the tail risks in financial variables, macro stress tests impose macroeconomic tail risks, such as a sharp decline in GDP or a fall in property prices. Another difference is that supervisors impose the scenarios uniformly across a cross-section of banks, rather than stress testing each bank on an individual basis.

You may remember that such macro stress tests were applied to good effect to US banks in 2009. Supervisors put the nineteen largest American banks through the tests, and found a few not to have adequate capital. These banks proceeded very quickly to raise the needed capital. I believe this was an important turning point in the US subprime crisis. Indeed the Dodd-Frank Act now requires US supervisors to apply macro stress tests every year to all but the smallest banks.

After the Financial Stability Board last met in Moscow on November 8, they recommended the application of comprehensive stress tests with "severe but plausible scenarios" as a vital tool for mitigating financial stability risks. In general, these tests should take into account factors that might amplify financial distress.

One caveat I should mention is that at their present state of the art, macro stress tests are still more useful as a crisis management tool than as an early-warning device. None of the many stress tests that was performed before 2008 warned us about the crisis that was about to come. This is because the art of stress tests involves the formulation of scenarios that are severe yet plausible. The subprime crisis actually unfolded in a series of scenarios that would have been considered highly implausible before the event. The 2009 US stress tests worked well in part because they were done when the crisis was already underway and appropriately severe scenarios seemed plausible. Those stress tests helped to manage the crisis. But given the complexity of the global economy, the challenge is to formulate crisis scenarios that would seem plausible *before* the crisis.

Nonetheless, macro stress tests can usefully lend transparency to a supervisor's financial stability goal and serve as a basis for dialogue with the financial sector. Indeed, in the present environment, when there are already clear hints that at least some major central banks could begin exiting from a prolonged period of extraordinarily monetary accommodation in the foreseeable future, the FSB's recommendation that authorities communicate the impact of scenarios that consider "high asset price volatility and an overshooting of long-term interest rates relative to fundamentals" is timely. The need for supervisors to gauge the impact of such scenarios is especially relevant for those emerging market economies and smaller advanced economies that have experienced rapid growth in credit and property prices in the past few years and are now at a late stage of their economic cycles.

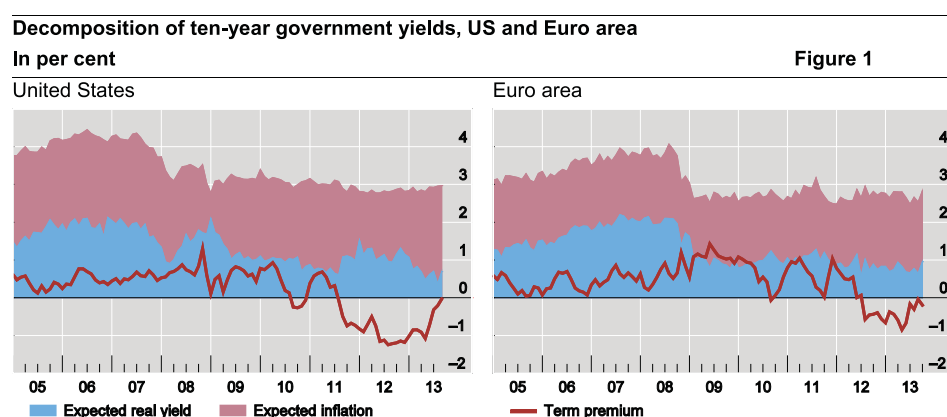
How far would long-term interest rates adjust? Figure 1 provides some indication. It shows the decomposition of US and euro area long-term interest rates into an expected path of real short rates (the blue area), expected inflation (the dark pink area), and a term premium (the red line).<sup>1</sup> Against the backdrop of the Federal Reserve's large-scale asset purchases, the US term premium was deep in negative territory in 2012 (left-hand panel). Although the ECB does not actually engage in similarly large-scale asset purchases, its stated readiness to do so also saw a decline in term premium in the euro area in the second half of 2012

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1. P. Hördahl and O. Tristani, "Inflation Risk Premia in the Euro Area and the United States," Forthcoming in the *International Journal of Central Banking*.



(right-hand panel). All these will need to reverse at some point – indeed, some adjustments already occurred earlier this year following the first utterance of “tapering.” But there is still some way to go before term premia return to pre-crisis levels. And considering how rapidly long-term rates rose earlier this year and how sharply asset markets reacted, overshooting of long-term rates and further asset price volatility are indeed very plausible scenarios going forward.



Sources: Bloomberg; Datastream; BIS calculations.

### 3. Filling in the Cracks with Monetary Policy

Let me now turn to the second aspect, namely the need to fill in the “cracks” the regulatory framework.

What we have come to realise is that financial cycles are often more powerful than we thought. Regulatory and prudential policies – including macroprudential policies – alone are not sufficient to rein them in. The historical evidence is that macroprudential policy tools are much less effective in constraining financial booms than strengthening resilience in specific sectors (eg macroprudential tools can help limit the quantity of mortgages and thus banks’ exposure to the housing market, but cannot directly control the volatility in house prices). In addition to their technical constraints, macroprudential measures can also be weakened over time by regulatory arbitrage. The perimeter of regulation is limited and regulated entities can often find ways to circumvent regulation. Recall that in the midst

of one of the biggest bubbles of the century – that of Japan in the 1980s – the authorities did mandate at the time controversial limits on real-estate lending by banks. However, bank loans were subsequently transferred to specialised housing loan companies, with an eventual claim on the public purse.<sup>2</sup> There are also current examples of financial institutions outside the reach of supervision frustrating policy efforts to rein in excesses. The shadow banking activities in mainland China are a case in point.

All this means that policies other than prudential ones must also play a part in promoting financial stability. Fiscal policies that gain fiscal space during the financial cycle<sup>3</sup> and structural policies that facilitate the correction of sectoral misallocation of resources are also very important, but I would like to concentrate my remarks on monetary policy.

Monetary policy that takes into consideration not only the business cycle but also the financial cycle can be a useful complement to prudential policies, especially when financial stability risks appear high. Monetary policy sets the universal price of leverage in any given currency, and this price resists regulatory arbitrage. To the extent that the economy and financial system are market oriented, monetary policy can “get in all the cracks”, as Governor Jeremy Stein put it.<sup>4</sup> The market price of leverage constrains hedge funds operating off-shore and other financial institutions operating beyond the reach of regulation. Indeed, one could view the short-term liquidity squeeze in the inter-bank market in China this summer in this light. Authorities allowed market prices to help rein in the growth of risky lending to shadow banking sector.<sup>5</sup>

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2. T. Ito, (2000), “The Stagnant Japanese Economy in the 1990s: The Need for Financial Supervision to Restore Sustained Growth,” in *Crisis and Change in the Japanese Financial System*, Edited by T. Hoshi and H. Patrick.
  3. Borio, C., (2012), “The Financial Cycle and Macroeconomics: What Have We Learnt,” *BIS Working Papers*, No. 395, December.
  4. Stein, J., (2013), “Overheating in Credit Markets: Origins, Measurement, and Policy Responses,” Speech at Research Symposium Sponsored by the Federal Reserve Bank of St. Louis, St. Louis, Missouri, February.
  5. Ma, G. and C. Shu, (2013), “Interbank Volatility in China,” *BIS Quarterly Review*, September.

Among a number of central banks in the Asia-Pacific region, despite the widespread adoption of inflation targeting frameworks, there has been for some time the recognition that monetary policy tools should not be dismissed were asset prices to pose a risk to financial stability. For instance, before the two policy rate rises in 2003, the Reserve Bank of Australia communicated with the public on the risks of an overheating housing market.<sup>6</sup> In China, the conventional monetary policy measures of the People's Bank show a very high correlation with macroprudential measures taken by the domestic financial authorities more generally to curb housing price booms.<sup>7</sup>

At the same time, we must recognise that monetary policy is not a panacea and its effectiveness is not without limits.<sup>8</sup> Here we must distinguish between crisis management and crisis resolution. While all policy levers must be pulled to prevent implosion of the financial system in the crisis, in the resolution (and consolidation) phase, priority should be given to structural policy and balance sheet repair to allow for a self-sustaining recovery.<sup>9</sup> Authorities should combine recapitalising banks with enforcing loss recognition. In short, just as we should not rely only on prudential policy, we should also not overburden monetary policy.

#### 4. The New Phase of Global Liquidity

I mentioned in my introduction that the guardians of financial stability should not focus only on some parts of the financial system (eg only on banks), but should monitor more broadly the evolution of the financial system as a whole. Indeed,

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6. Heath, A., F. Packer and C. Windsor, (2012), Introduction to the Proceedings of a Reserve Bank of Australia-BIS Conference on Property Markets and Financial Stability, Sydney Australia, 20-21 August.

7. Kuttner, K. and I. Shim (Forthcoming), "Can Non-interest Rate Policies Stabilise Housing Markets? Evidence from a Panel of 57 Economies," *BIS Working Papers*.

8. Bech, M., L. Gambacorta and E. Kharroubi, (2012), "Monetary Policy in a Downturn: Are Financial Crises Special?" *BIS Working Papers*, No. 388, September.

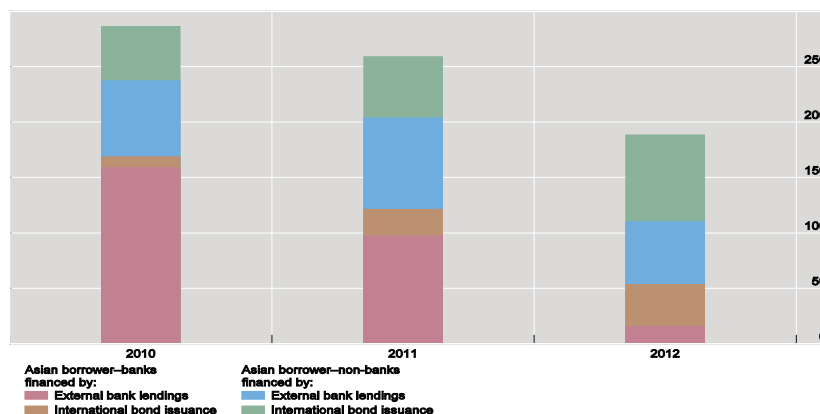
9. One well-known example of effective restructuring of the banking system, which required considerable fiscal support, is that of the Nordic banking system restructuring in the early 1990s. By contrast, in Japan, a financial crisis around the same time was not accompanied by balance sheet repair for many years, due to political resistance to the use of taxpayer money. Despite very expansive monetary policies, the economy took longer to recover.

in this regard, I would like to highlight a potentially important development: namely, the growing private sector indebtedness through offshore debt financing. Many emerging markets are moving from a reliance on international banking flows to international bond flows. In a recent address, Hyun Song Shin has described this as “the second phase of global liquidity”.<sup>10</sup> Global liquidity is being increasingly transmitted through the bond market, particularly through demand for debt securities that are sold across borders to global investors.

This new reliance on bond financing is especially pronounced in emerging Asia. In Figure 2<sup>11</sup> the stacked bars show the different components of net external financing for Asian emerging economies since 2010. Although external bank lending to banks in emerging Asia (the dark pink portion) has slowed dramatically, the issuance of debt securities by banks (the brown portion) has grown. Similarly, while the increase in external bank loans to non-bank borrowers in Asian emerging

**External financing of emerging Asia**  
In billions of US dollars

**Figure 2**



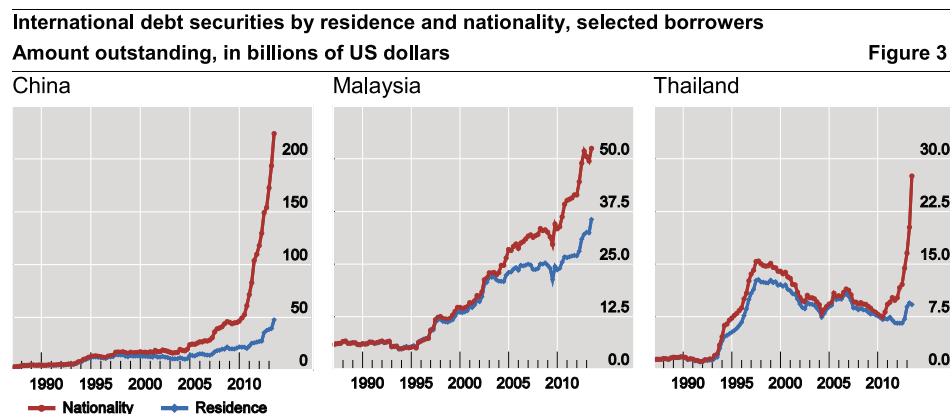
Sources: Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; BIS Locational Banking Statistics by Residence; BIS calculations. External bank lending includes all currencies. Emerging Asia includes China, India, Indonesia, Malaysia, South Korea, Thailand, Philippines, Chinese Taipei.

10 Shin, Hyun Song, (2013), “The Second Phase of Global Liquidity and Its Impact on Emerging Economies,” Keynote Address at Federal Reserve Bank of San Francisco Asia Economic Policy Conference, November 3-5.

11 Based on data from a presentation by P. Turner on “The Global Long-term Interest Rate, Financial Risks and Policy Choices In EMEs,” at the Inter-American Development Bank Meeting in October 2013 as well as additional BIS international banking statistics.

economies has been slowing (the blue portion), their net issuance of international bonds has risen significantly (the green portion).

In this second phase of global liquidity, the distinction between the residence of the borrower and its nationality is quite important. Figure 3 illustrates this for China, Malaysia and Thailand. In each case the value of outstanding international debt securities is plotted both by residency of borrowers (the blue lines) and nationality of borrowers (the red lines). The difference between the two lines reflects the offshore issuance by local borrowers. The difference has historically been very small, but since the global financial crisis it has widened for each of the three countries. China now has four times more international debt securities outstanding when calculated on a nationality basis as opposed to a residency basis. Thailand and Malaysia have three and one and a half times as much, respectively.



Source: BIS International Debt Securities Statistics.

Increased borrowing via offshore securities markets can be a mixed blessing from a financial stability perspective. To be sure, increased external financing by corporates via the bond market can be a healthy development. In contrast to bank loans, which tend to be shorter term, bond market finance tends to bind investors and issuers over the medium to long-term – and is thus relatively less susceptible to sudden reversals. To the extent that the corporates accessing external markets are those of higher quality and have foreign exchange income as a natural hedge, concerns about currency mismatches and defaults should also be contained.

However, financial stability concerns may arise if the demand for international debt securities is so buoyant such that even good quality borrowers overextend themselves or that lesser quality corporates with little capacity to manage currency and maturity mismatches are also able to load up on debt. Furthermore, offshore debt may also not be registered as capital inflows as well as not be fully captured by the national debt statistics, which might lead the relevant authorities into complacency.

In any case, these developments bear continued monitoring and deserve our efforts to understand them better.

## **5. Conclusion**

To conclude, allow me to reiterate the following points:

First, while bank regulation is absolutely necessary, it is not enough. We need supervision that is proactive and systemic in approach.

Second, prudential measures – including the new macroprudential tools – are extremely useful, but there are often circumstances in which these will not be enough. In those situations, we will need the help of other policies. In particular, monetary policy that can play an important role by “filling in the cracks”. It could serve as a complement to macroprudential measures by leaning against the boom phase of the financial cycle.

And third, monitoring bank lending is important but it is not enough. At present there is a new development that bears watching closely and deserves our efforts to understand it better. I am referring to the growing external financing in Asia in the form of bonds issued in foreign currencies.

But of course, our work is far from done. As financial systems and their inter-linkages grow more complex, there is much we still need to understand, not least some of the new risks related to off-shore debt finance that I have just discussed.

Nonetheless I am confident that we can, not least by learning from each other's experience, continue to improve our approaches and to apply them so that we can reduce the risk of financial instability in Asia. If there is anything that the turbulence of the past five years has taught us, it is that it will be worth the effort.

**SYSTEM SUPERVISION AND  
MACROPRUDENTIAL POLICY**

**PANEL REMARKS**

**BY**

**MR. RAVI MENON  
MANAGING DIRECTOR  
MONETARY AUTHORITY OF SINGAPORE**



**PANEL REMARKS BY  
MR. RAVI MENON  
MANAGING DIRECTOR,  
MONETARY AUTHORITY OF SINGAPORE  
AT SEACEN BOARD OF GOVERNORS HIGH LEVEL SEMINAR  
ON  
SYSTEMIC SUPERVISION AND MACROPRUDENTIAL POLICY**

**A new financial landscape is emerging.**

- Financial institutions are more inter-connected
- Financial sector and the real economy are more inter-connected
- Financial markets across countries are more inter-connected

**Jaime Caruana makes three points about approach we need to take in response to this new landscape.**

- We need to emphasise *supervision* as much as regulation
- We need to take a more *systemic* approach in regulation and supervision
- We need to use *monetary policy* more actively to address the gaps in achieving financial stability

I agree with all three points, though I have some nuances on the last.

**First, as we step up regulation post-crisis, we need more supervision, not less.**

- Regulation is about setting rules. Supervision is about ensuring rules are actually followed, how they are followed, and whether they are appropriate for the particular institution.

**Institutions have become more complex and therefore need more supervision.**

- This means greater interaction with boards and senior management and better understanding of firms' business models.
- We can never set capital, liquidity, or other regulatory standards that are suitable for every FI given the great diversity in their business models, risk appetites, and risk management capabilities.

**Regulations have become more complex and therefore need to be complemented by more supervision.**

- There are growing concerns over complexity of new regulatory frameworks and distrust over bank's use of internal models.
- This has led to calls for simpler and more comparable approaches - increasing popularity of using backstops, floors and standardised approaches.
- But simpler rules also mean lower sensitivity to bank-specific risks.
- So we need both standardised approaches and risk-based regulatory requirements. And they need to be complemented by close supervision that can assess their applicability to individual FIs.

**Second, we need to take a more systemic approach in supervision.**

**We must continue to step up efforts to address the TBTF problem.**

- An important new dimension in emerging regulatory landscape is development of a comprehensive policy framework to deal with TBTF institutions.
- Caruana has already elaborated on these efforts. I would just add that FSB's approach to ending TBTF has focused on not just reducing the probability and impact of their failure, but also the capacity to *resolve* them without taxpayer bailouts.

**System-wide risk can sometimes be larger than the sum of the parts.**

- “Connecting the dots” may reveal common exposures and extensive webs of interdependence between FIs that may not be immediately apparent.

**Individual risk-reducing actions by individual FIs can sometimes end up increasing systemic risk.**

- Sometimes, if all banks carried out at same time actions to manage their risks in anticipation of a market stress, that in turn could cause the market to cease functioning properly and add to systemic risks.

**Third, while monetary policy has a strong effect on credit cycles it is not sufficient for securing financial stability.**

- I agree that credit cycles are an important cause of financial instability.
- I also agree that monetary policy has strong effect on credit cycles.
- And I agree – up to a point – that monetary policy can therefore fill cracks in efforts to sustain financial stability.
- But risk of using monetary policy in this way is that it could potentially:
  - dilute objectives of monetary policy
  - compromise its focus
  - create confusion in market
  - unhinge inflation expectations.
- If we want to use monetary policy more proactively to lean against credit cycles, one possibility is to justify it on basis that credit cycles and asset price developments will eventually impact CPI inflation.

**But where financial cycles are not in synch with macroeconomic cycle, monetary policy may not be appropriate for use against credit cycles and macroprudential policy becomes necessary.**

- First, dealing with a sector specific distortion (e.g. pricking a property bubble) may require very sharp increases in interest rate to be effective and this may have unintended spillovers on financial stability.
- Second, macroeconomic conditions may not be conducive for using monetary policy. If a country is experiencing GDP growth that is at trend and inflation that is on target, using monetary policy to tame a sharp increase credit growth over this period would end up imposing significant collateral damage on broader economic activity.
- In short, monetary policy cannot do all the work needed to ensure financial stability and needs to be complemented by macroprudential policies.

**FINANCIAL ARCHITECTURE,  
MACROPRUDENTIAL REGULATION AND  
SUPERVISION AND GROWTH:  
A DISCUSSANT NOTE**

**BY**

**MR. MAHA PRASAD ADHIKARI  
DEPUTY GOVERNOR  
NEPAL RASTRA BANK**

**(Slides are in Annex 2)**

**SESSION 2: EMERGING ISSUES ON  
INCLUSIVE FINANCE FOR GROWTH**

**EMERGING ISSUES ON INCLUSIVE  
FINANCE FOR GROWTH**

**PRESENTATION SPEECH**

**BY**

**MR. THIERRY DE LONGUEMAR  
VICE PRESIDENT  
ASIAN DEVELOPMENT BANK**

**PRESENTATION SPEECH OF  
VICE PRESIDENT THIERRY DE LONGUEMAR  
ASIAN DEVELOPMENT BANK  
AT SEACEN BOARD OF GOVERNORS HIGH-LEVEL SEMINAR  
ON EMERGING ISSUES ON INCLUSIVE FINANCE FOR  
GROWTH**

**1. Need for Inclusive Finance**

Over the last decade, ensuring reliable and affordable financial services to every individual, or financial inclusion, became an important global policy agenda. Financial inclusion means reaching out to those who are not reached by conventional formal financial institutions—so called unserved populations. Financial inclusion means not only providing credit, but also the full range of financial services including savings, insurance, pensions, money transfers, and remittances. Financial inclusion also means providing support for financial literacy and consumer protection.

Access to finance is necessary for all members of society. But it is particularly important for poor and low income populations. Access to finance will provide poor people opportunities to save and invest, and protect them from various risks such as natural disasters, illness, and loss of livelihoods. Access to finance will enable poor and low income people to make economic self-realization and give chances to break the vicious cycle of poverty.

Benefits of access to finance are not only limited to economic and material wellbeing of individual households, but access to finance also has an important impact on social development, empowerment, and gender equality. Since the 1980s, microfinance institutions, or MFIs, made laudable efforts in reaching out to poor and low income people. Many MFIs have a particular focus on women. We have witnessed such MFIs' efforts yielded strong social impacts especially on women's empowerment.

Financial inclusion has an impact on financial institutions as well. Poor and low income people, if properly served, are often most loyal, reliable, and dynamic customers. They can significantly expand financial institutions' market base and



profitability. For the economy at large, enhanced access to finance will stimulate economic activities and can develop micro, small, and medium enterprises. The potential for positive social and economic impact from expanded financial inclusion is immense.

Eradicating poverty and hunger is a priority among the eight Millennium Development Goals (MDGs). During the UN General Assembly in September this year, world leaders agreed to scale up action against poverty and adopt the next set of goals—Sustainable Development Goals (SDGs) to succeed MDGs beyond September 2015. As discussed in the United Nations Conference on Sustainable Development—Rio+20 Conference—in June 2012, it is expected that SDGs will include poverty eradication as a continued priority and emphasize inclusive and equitable economic growth, and employment building. To meet SDGs objectives, we need to scale up our efforts to expand access to finance to create employment opportunities and promote broad-based pro-poor economic growth.

## **2. Status of Inclusive Finance**

Over the last decade, there have been a growing number of formal financial institutions including ones targeting poor and low income people. Accordingly, access to formal financial services expanded rapidly. However, despite the growth, we still face a great challenge. More than half the world's working-age population does not have access to quality, affordable formal financial services. Globally, 50% of adults do not have access to formal regulated financial institutions which include banks, credit unions, cooperatives, finance companies, MFIs, or post offices. That's about 2.5 billion adults, and 90% of them live in Africa, Asia and Pacific, Latin America, and the Middle East. In Asia and the Pacific countries, 55% of adults have accounts at formal financial institutions, while in South Asia; the figure is only 33%. Those unserved, or financially excluded populations, rely only on unregulated semi-formal or informal institutions, such as microfinance nongovernment organizations (NGOs), unlicensed cooperatives, community based-savings and credit groups, or informal sources of finance, such as money lenders.

In high income economies, nearly all of the adult populations have access to formal financial services. In those countries, adults who have accounts with regulated financial institutions amount to 89%. While in low income economies, the figure is as low as 24%

There is also an imbalance in access to finance between men and women. Overall, 47% of women have access to formal financial institutions. But in low income countries, only 20% of women do. The population in the richest quintile—the top 20% of the income distribution within the economy—is on average more than twice as likely having account at formal institutions as compared to the people at the lowest quintile.

Poor and low income households, like any other households, need a variety of financial services. But access to non-credit financial services such as savings, insurance, and pensions for those people is still limited. MFIs have made considerable achievements in reaching out to poor and low income groups. But they tend to emphasize credit rather than savings. Or, often the existing legal and regulatory framework in the country does not allow MFIs to provide savings to their members. In low income countries, only 11% of the total population has active savings accounts with formal financial institutions. This is a serious missed opportunity because the poor needs savings products as well as credit products. If both savings and credit services are offered, the demand for savings services exceeds the demand for credit by a wide margin.

Insurance is generally easily accessible in the advanced economies. But insurance for poor and low income people is limited partly because of the lack of appropriate insurance products that meet with the poor's particular risk coverage needs. To fill this gap, the growing number of public and private organizations started insurance for low income people—so called microinsurance. But the outreach of microinsurance is still limited and currently covers only 5% of the estimated 3 billion potential clients in developing countries.

People maintain accounts at formal financial institutions not only to borrow or save, but also to receive salaries, payments from governments, or remittances. In developed economies, it is common to use bank accounts to receive money, but it is less so in developing countries. In developing countries, only 8% of adults used a bank account in the past year to send or receive money. Penetration of formal account based remittances is particularly important for developing countries. Significant portions of the populations in developing countries work abroad and remit money. Some countries receive remittances equal to one third or above of their GDP.

### 3. Barriers for Inclusive Finance

To achieve full financial inclusion, institutions in the private, public, and social sectors must develop innovative models to sustainably deliver affordable, high-quality services to the poor and low income people at large. But why are people financially excluded? They are excluded because the existing financial system does not effectively address their constraints and needs. During the last decade, banks, MFIs and other organizations made tremendous efforts in establishing new models and developing products to address multiple constraints and particular needs of the poor. But there are still widespread barriers in access to finance, especially in the areas of access, product, regulation, and financial literacy.

Access is a significant challenge. People are financially excluded because they live in areas where there are no branches or outlets of formal financial institutions. The majority of the poor and low income people in developing countries live in rural areas. Extending financial services to rural areas is difficult. Road and telecommunication infrastructure tend to be underdeveloped, which makes the installation of branches or ATMs costly. Also, rural areas are scarcely populated and have fewer financial transactions than urban areas, which makes maintaining a branch prohibitively expensive. Often, ridged or slow branch licensing policies by the regulators can deter expansion of branch networks. But more so, limited transactions and viability are the main causes for scarce presence of formal financial institutions in rural areas.

Product and service development are behind the demand and often do not meet the needs of the poor and low income people. Many poor people do not have proper identification documents to open accounts. They may not afford to travel a distance to go to a bank branch because, in addition to travel cost, they may have to forgo a day's wage. Maintaining accounts is also costly for the poor. All these factors deter the poor to access formal financial institutions.

Even if they want to obtain loans, poor households' assets are often informal and they may not have proper land titles or savings at financial institutions that could be used as collateral. Most of those people have no recorded financial history. Even if they can obtain loans, the repayment schedule often does not match the poor's income stream.

As mentioned earlier, despite the various efforts made by MFIs so far, penetration of insurance, payments, and remittances among the poor and low income people is still insignificant. Most insurance products do not meet the poor's particular risk coverage needs such as livestock damages or crop failure, or premiums are too high for the poor to afford. Distribution is also an issue. Often it is too costly for the insurers to reach a large number of geographically widespread low value customers. For the same reason for accessing to formal bank accounts, for most of the poor, existing payments and remittance services are too costly or inconvenient, and the majority of the poor uses non-bank based payments and remittance services such as money transfer companies or hand carrying.

The sector needs to develop appropriate products that are compatible with poor and low income groups' needs, affordable and financially viable. There is still a gap in understanding the poor's needs and demands. Scaling down or reducing the price of existing products will not work for the poor. More innovative approaches in product design and delivery mechanisms are necessary to attain full financial inclusion.

Existing regulations are usually focusing more on protecting traditional financial-services clients and may not well serve the needs of poor clients. Regulations could also be obstructive for innovations that would be necessary to expand access for poor households. For example, many regulators prohibit non-bank financial institutions such as microfinance NGOs from intermediating financial products such as savings or insurance. Other issues include strict limits on uncollateralized lending, and strong know your customer (KYC) norms. Those rules would virtually make it impossible for the undocumented poor individuals to access formal financial institutions. It is, of course, critical to ensure that regulations protect consumers from predatory activities and promote an appropriate distribution of risk. But for better access to finance, regulations shall encourage product innovation and service development, while at the same time, ensuring safety and security for poor consumers.

Limited financial literacy — knowledge or understanding of financial services and products — may serve as a barrier for financial inclusion. If individuals are not familiar or comfortable with financial products or institutions, they are unlikely to use them. Financial literacy is a combination of clients' understanding of financial products and their ability to comprehend financial risks and opportunities. With proper financial literacy, clients shall be able to make informed decisions

and choose appropriate products to improve their financial wellbeing. It is widely expected that greater financial knowledge would help poor clients overcome various financial difficulties in case of adverse events. But poor and low income groups generally have low levels of financial literacy, which will deter them from using formal financial products, even if they are available.

#### **4. Global Initiatives for Inclusive Finance**

Despite these challenges, it is encouraging to see that recently many global initiatives have emerged in this area. In 2009, G20 launched the financial inclusion initiative and set the Principles for Financial Inclusion to guide governments to make financial services more inclusive. The G20 Principles encourage the governments to take a leadership to enhance broad and market-based financial inclusion, ensure consumer protection and develop financial literacy and capability. The Principles also advocate building a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services, and based on an understanding of the gaps and barriers in existing regulations.

At the 2010 Toronto meeting, G20 launched the Financial Inclusion Action Plan. The Plan is to promote international coordination and information sharing for innovations in financial inclusion. For this, in coordination with the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), the International Finance Corporation (IFC), and the World Bank, G20 established a Global Partnership for Financial Inclusion to provide a systematic coordination and implementation structure for the Financial Inclusion Action Plan.

Consistent with G20 financial inclusion principles, ADB places financial sector development as one of the five core strategic areas of interventions to support inclusive growth. ADB commits in its long-term strategic framework—Strategy 2020—to strengthen its support to the finance sector at the regional and national levels by helping to develop financial infrastructure, institutions, and products and services. To promote inclusive growth, it will seek to create an enabling environment for microfinance, rural finance institutions, and small and medium enterprises (SMEs), and will explore the use of technologies to expand the reach of the formal financial system to rural areas.

ADB will support our developing member countries' efforts to enhance the financial access for the traditionally underserved poor households, vulnerable groups including women and minorities, and SMEs to promote inclusive economic growth through both its sovereign and non-sovereign operations.

ADB believes microfinance should go beyond credit and include savings, payments and remittance services, insurance and pensions. ADB will support mobile banking, particularly in our developing member countries where traditional bank branch networks have not proven practical or cost effective because of geographic conditions or low population density. ADB will also support development of efficient mechanisms for remittances. ADB will do so directly through non-sovereign operations, collective financing or guarantee arrangements or indirectly through policy support. At the same time, ADB will promote the financial literacy of and consumer protection for the user of microfinance services.

For microfinance, ADB has cumulatively invested in \$2 billion for 24 public sector loan projects; \$70 million for 91 technical assistance (TA) and grant projects; and \$540 million for four non-sovereign operations. For SME, ADB has provided in total \$840 million public sector loans for 18 projects; \$9.5 million for 19 TA and grant projects; and \$607 million for 53 non-sovereign operations. Along with loan and grant projects, ADB also emphasizes knowledge management and capacity development on inclusive finance.

## **5. Innovations for Inclusive Finance**

Globally, both public and private organizations have made significant efforts to expand access to finance at an accelerating pace, and recent developments suggest that full financial inclusion is within reach over time. Various organizations are leveraging technology; innovations in distribution, risk management, and product development; and are deepening their understanding of lower-income customers to develop sustainable business models. These efforts opened a new horizon to expand access to finance.

Using mobile technologies in extending financial services to the financially unserved areas-so called branchless banking-is a recent revolution. The initiative was started about a decade ago. But the expansion of branchless banking has accelerated over the last several years due to the success of M-Pesa in Kenya

and other renowned schemes. Currently, there are estimated over 140 branchless banking schemes operational globally. Africa is the center of branchless banking, with more than one-third of global schemes, followed by Asia and the Pacific and Latin America. While the majority of schemes are still at developing stage, some have already become financially viable.

Branchless banking is considered to be one of the most promising strategies to offer financial services to unbanked populations. Most of the schemes use mobile phones as the device to interface with account providers, some schemes use Point-of-Sale (POS) devices with cards, and some use the combination of both. The existing branchless banking schemes are largely divided into 'bank-based' and 'telco-based' models. In the bank-based model, financial institutions work with networks of non-bank retail outlets, such as convenience stores, gas stations, or post offices-so called agent networks-to deliver financial services to clients. In the telco-based model, financial institutions are not involved, but customers transact electric money through accounts held by telecom companies or mobile network operators.

The innovation has profound implications for financial inclusion especially by addressing the access issue. Branchless banking is successful in reaching unbanked people because it involves extensive networks of non-bank retail agents. Many of the 2.5 billion unserved adults may live in areas where there are no bank branches but they most likely have access to grocery stores, gas stations, or post offices. Poor people are more familiar with those retail outlets than with bank branches.

Branchless banking enables financial service providers to establish a physical presence in close proximity to customers without building new branches, thus enabling them to dramatically expand their reach at lower costs. But benefits of branchless banking are not limited to reduced costs of access to cash and means of payments. It also provides poor people access to various services from which they were previously excluded. With branchless banking, poor people's potential access to insurance, savings, and remittance services is dramatically increased.

The commercial potential from branchless banking is also significant. Today, an estimated 1.7 billion unbanked people have access to mobile phones. Use of mobile financial services among those people can be significantly increased if



banks and mobile operators adopt new technologies, expand sustainable agent networks, and establish cost-effective and viable models. Expansion of branchless banking is expected to bring significant revenues for the banking and mobile money industry with increased transactions, fee incomes, and cost-efficient airtime distribution.

## **6. Emerging Issues for Inclusive Finance**

Technologies and innovations significantly expanded the potential for financial inclusion, but the question is who is going to pay for it? Providing financial services to poor households has been and will continue to be expensive. The microfinance sector reached over 200 million customers, but the sector also has been heavily subsidized. In many countries, MFIs receive grants or concessional loans from the governments or external donors, or they are exempted from certain regulatory compliances or tax obligations. But it is obvious such subsidies are not sufficient to include 2.5 billion more people in the formal financial system. It is also true that subsidies often work against financial inclusion by undermining financial institutions sustainability and discouraging the industry's innovations and efficiency improvements.

The answer to the question is we have to make poor people to pay for their financial services. In many cases the poor are willing to pay for the financial services that they value. For micro credit, the interest rate is not the top consideration for poor people in taking credit. Rather, reliability of services and access are key considerations. But to make financial services more affordable to poor customers, it is meaningful for the policy makers and regulators continue to subsidize infrastructure and outreach. Infrastructure such as credit information services or financial training institutes will help financial institutions to provide cheaper and efficient services. Better road networks or telecom infrastructure certainly help financial institutions to reach poor and low income people.

Recently, consumer protection has surfaced as an important issue in financial inclusion as competition grows within the industry and protests related to over indebtedness, improper debt collection practices and high interest rates occur. It is timely to raise concerns about predatory lending and enhance ethical behavior especially among these who serve poor and low income customers. Policy makers and regulators have an important role in this area. They shall promote appropriate treatment of customers with focus on avoidance of over-indebtedness, transparent



pricing, appropriate collection practices, ethical staff behavior, mechanisms for redress of grievances, and privacy of customer data. The key for effective consumer protection is a complementary policy by formulating and enforcing regulations according to the risks posed in the financial system, while at the same time, respecting the industry's innovations and market development efforts.

Technology based branchless banking opened a new frontier and will definitely be a driving force to enhance financial inclusion. However, the innovation also brings a new challenge. Policy makers and regulators are increasingly facing a common issue—how to create a regulatory environment which encourages innovations to scale up branchless banking, while at the same time ensuring the sector's stability and security.

Since the late 1990s, across the world, regulations and requirements to combat money laundering and financing of terrorism-Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT)-are continuously expanding. AML/CFT is a key concern for governments and regulators in formulating financial regulations. Branchless banking has potential to serve unreached customers with the involvement of a wide range of non-bank retail agents. But this involvement of non-bank agents poses a new challenge in AML/CFT. Also, applying the regular CDD/KYC norms to low value clients is costly and can potentially prohibit the expansion of branchless banking.

The central banks around the world made impressive innovations in regulations. Regulators started allowing agents to perform customer due diligence (CDD)/KYC checks and remote account opening, or simplifying the documentation requirements taking into consideration of the poor's limited ability to produce formal documents. Regulators are also realizing that electronically enforced maximum allowable transaction, turnover, and balance thresholds can also reduce AML/CFT risks. More and more innovations are expected to happen in this area. But, a key for branchless banking friendly regulations will be a proportionate policy. A proportionate policy means to formulate and enforce regulations in a way to achieve an optimal result in financial inclusion by maintaining a balance between appropriate AML/CFT risks control and space and flexibility for innovations for the industry to grow.

Branchless banking involves multiple organizations such as banks, mobile technology providers, and agents. This involvement of multiple organizations will

potentially increase risks for consumers. In such a complex setting, consumers, especially poor ones, may find it difficult to complain if they face fraud or misconduct. Providing adequate consumer protection for a large number of clients with limited financial literacy will be a challenge. But there are ways to address this issue. For example, mobile banking service providers can establish a simple complaint mechanism using the same mobile system that is used for financial transactions. Risks to consumers from agent fraud can be addressed through regulation establishing consumer liability limits or legally defining liability of financial institutions in case of agent misconduct. Policy makers' and regulators' continuous effort in providing meaningful protection for branchless banking customers will be encouraged.

Interoperability which enables consumers to use multiple services providers to access their accounts is still a new topic in branchless banking. Interoperability in branchless banking could significantly improve efficiency and lower the prices for consumers. If mobile money platforms are interconnected, a customer with an account with one service provider can send or receive money to or from the account of a customer with a different service provider. Currently, there are not yet sufficient discussions on best practices and regulations on interoperability, and more exchange of ideas on this subject is needed.

## **7. Way Forward**

Over the years, many organizations and individuals made dedicated efforts for financial inclusion, and their achievements are impressive and encouraging. I believe with right regulations and policies, we can create an environment that can fulfill our goal of financial inclusion. Lastly, I would like to reiterate three important fundamentals for inclusive finance:

- First: Development of regulatory frameworks. Regulations shall be framed to promote innovations, but at the same time ensure appropriate risk management and consumer protection.
- Second: Innovative approaches in financial education and capacity development. Financial education shall include information dissemination on financial innovations such as branchless banking, e-money, and remittances.
- Lastly, policy implementation of consumer protection. Measures can include new models of information sharing, access and analytics of data, credit

information systems around new technologies, to prevent over-ineptness and client exploitation.

I strongly believe that concerted efforts among policy makers, regulators, and financial sectors will overcome the barriers for financial inclusion and contribute to improve the economic lives of millions of unserved people.

Thank you.

**EMERGING ISSUES ON INCLUSIVE  
FINANCE FOR GROWTH  
PRESENTATION**

**BY**

**MR. AMANDO M. TETANGCO, JR.  
GOVERNOR  
BANGKO SENTRAL NG PILIPINAS**

**PRESENTATION BY  
MR. AMANDO M. TETANGCO, JR.  
GOVERNOR, BANGKO SENTRAL NG PILIPINAS  
ON  
EMERGING ISSUES ON INCLUSIVE FINANCE FOR GROWTH<sup>1</sup>**

**1. Emerging Issues on Inclusive Finance for Growth**

Honorable governors, fellow central bankers, good afternoon. I am pleased to participate in this panel alongside a distinguished set of speakers.

Mr. de Longuemar provided a comprehensive overview of financial inclusion, highlighting barriers to access, the potential of innovative financial services, and the need for risk-based regulations, consumer protection and financial education.

We started an interesting discussion on inclusive finance in our first roundtable yesterday. My contribution to this conversation today is to provide the focused perspective of a regulator.

**2. Presentation Outline**

First, I will share the Bangko Sentral ng Pilipinas' (BSP) vision of an inclusive financial system and what we are doing to achieve this vision. Then, I will expound on two selected issues raised by Mr. de Longuemar, using examples from our country experience; and end with a few concluding thoughts.

**3. The BSP and Financial Inclusion**

Together with a growing number of central banks<sup>2</sup>, the BSP is committed to pursue financial inclusion alongside our more traditional responsibilities of price

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1. Presentation delivered by Bangko Sentral ng Pilipinas (BSP) Governor Amando M. Tetangco, Jr. during the 49<sup>th</sup> SEACEN Governors' Conference/ High-Level Seminar 2013 in Hyatt Regency, Kathmandu, Nepal.

2. Ninety percent of the 142 countries surveyed by the World Bank/CGAP (2010) have some financial inclusion agenda under the purview of the main financial regulator.

and financial system stability. We believe that inclusion and stability are mutually reinforcing. A strong financial system can expand outreach, respond to market needs, sustain sound operations, and responsibly provide services. Conversely, a deep, diversified and inclusive system boosts financial stability.

The BSP's role as regulator is to establish a market-based environment that enables the financial sector to the public, regardless of socio-economic status, so that they can benefit from having access to formal financial services, build assets and eventually improve their quality of life. While we encourage the market to be the frontrunner in financial development and financial inclusion, we are not leaving them alone to do as they please. Our philosophy as regulator is to provide the appropriate incentives as well as sanctions to influence how the market moves or behaves, and to intervene when necessary to ensure that it moves in the right direction. This same philosophy underpins the financial inclusion initiatives of the BSP.

The recent tragedy caused by Typhoon Yolanda (Haiyan) that hit the Philippines emphasizes an urgent need for all our systems – including our financial system – to address inefficiencies and exclusion issues that tend to perpetuate poverty and expose our people to extreme vulnerabilities.

#### **4. Philippine Country Context**

Now, what is the situation on the ground? Although the Philippine banking system has been steadily growing through the years, access to finance remains a challenge in the country. To date, 37% of our municipalities still do not have a banking office.<sup>3</sup>

The archipelagic geography of our nation imposes physical barriers in bank penetration and financial service delivery. Banking services remain concentrated in urbanized and populous regions. For instance, 43% of the total number of deposit accounts and 68% of the amount of bank deposits are in the National Capital Region.<sup>4</sup>

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<sup>3</sup> BSP, June 2013.

<sup>4</sup> PDIC, June 2013.

Surveys also show that only 2 out of 10 households have a deposit account<sup>5</sup>; and only 10.5% of the adult population obtained a loan from a formal financial institution in the past 12 months<sup>6</sup>.

From a commercial standpoint, these numbers show a large untapped market where financial institutions may find business opportunities to expand their client base. From a regulatory perspective, these numbers reinforce the need for serious action to address access gaps.

## **5. Vision for an Inclusive Financial System**

Thus, the BSP is intensifying initiatives to achieve financial inclusion, which we define as “a state wherein there is effective access to financial services for all Filipinos.” This definition describes a financial system which:

1. Offers a diversity of products that match the need of target markets, of high quality, and provide good value;
2. Encourages competition among a variety of strong financial institutions, whether banks or non-banks;
3. Allows innovations to improve efficiencies and drive down costs;
4. Protects consumers from predatory finance; and
5. Enhances consumers' capacity to make wise financial decisions.

## **6. BSP Strategy for Financial Inclusion**

We have defined a corporate strategy for financial inclusion, which is illustrated on this slide. We embedded the financial inclusion agenda in the work of various units in the BSP focused on (1) Regulation and supervision, (2) consumer protection and financial education; (3) advocacy programs; and (4) measurement. Our initiatives under each area purposely address the very barriers to financial access that were earlier presented.

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<sup>5</sup> BSP Consumer Finance Survey 2009.

<sup>6</sup> World Bank, 2011.

Let me give a couple of examples:

- (1) Our regulations allow banks to offer a range of microfinance products, which include microdeposits, microinsurance, and different types of microcredit for business capital, agriculture and housing purposes – because we recognize that the financial needs of the poor are as varied as the regular consumer. To expand the quantity of access points, we allowed banks to establish micro-banking offices and use the electronic money network, to reach markets which are otherwise not economically feasible to serve.
- (2) Another example is the regulation on KYC that expands the range of acceptable IDs that may be used to open a bank account; which includes a certificate issued by the village chief. Since there is no national ID system in the Philippines, this regulation addresses one of the biggest barriers for the poor to transact with banks.

Also, to complement inclusion-friendly regulations, we are implementing price transparency and market conduct standards for consumer protection; a nationwide Economic and Financial Learning Program for targeted audiences, including the unbanked; and other activities that advocate financial inclusion. Consistent with evidence-based policymaking, we are improving our data and measurement efforts to systematically monitor the progress and impact of our initiatives.

Seamless internal coordination and synergy are ensured through the Inclusive Finance Steering Committee within the BSP, which I chair. This committee provides strategic direction to the operating units tasked to implement various elements of our financial inclusion agenda.

## **7. Burning Issues**

In the course of our financial inclusion work, two issues have constantly emerged, which also surfaced in the presentation paper. The first question on this slide refers to a practical issue – how can regulators promote financial inclusion through innovative solutions without compromising prudential standards? The second question refers to a measurement issue – is there enough empirical proof that financial inclusion leads to inclusive growth?



## 8. Balancing Inclusion, Stability, Integrity

The answer to the first question is theoretically straightforward – regulators can balance the objectives of financial inclusion, stability and integrity through the appropriate application of existing prudential rules. However, the challenge lies in translating the proportionality principle into actual practice.

Let me share the BSP experience to demonstrate how we leveraged the proportionality principle in regulating innovations like electronic money. Two major factors enabled the birth of e-money in the Philippines: market innovation and an enabling regulatory environment.

When the two largest telco companies in the country proposed their own versions of e-money products, the BSP basically listened. There were a range of regulatory concerns to deal with, notably on the safety of stored values, liquidity management, money laundering risks and consumer protection concerns. Even with these issues, we also recognized the game-changing potential of e-money to advance financial inclusion. Thus, consistent with a “test and learn” approach, pilot e-money products were authorized as early as 2004. It was only after fully understanding the business, its operating models and attendant risks, did the BSP issue in 2009<sup>7</sup>, the regulatory framework for e-money. Since then, we have been refining our regulations<sup>8</sup> to manage emerging risks as e-money providers continue to innovate.

## 9. Proportionality in Practice: E-Money

This slide provides some insight on how the BSP practiced the proportionality principle in regulating e-money products and providers. We note that we have adhered to accepted prudential norms, but calibrated our regulatory requirements commensurate to the magnitude or materiality of identified risks.

We clearly delineated e-money from deposits, thus an e-money wallet is non-interest bearing and not covered by deposit insurance. This allowed even non-

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7. BSP Circular 649 (E-money issuance).

8. BSP Circular 704 (Outsourcing to e-money network service providers).

banks like telcos, to participate in this business by establishing subsidiaries that can be licensed as electronic money issuers or EMIs. These non-banks are subject to proportionate capital and licensing requirements since their operations are focused only on the e-money business. They are likewise required to set-up risk management systems, as appropriate to mitigate evident risks.

For example, liquidity risks are managed through the imposition of transaction limits on individual e-wallets<sup>9</sup>. The amount of issued electronic values must also be equivalent to the actual cash<sup>10</sup> maintained in a depository or settlement bank.

EMIs may outsource their e-money systems to technology providers, as well as link to agent networks, as long as they bear full accountability for counterparty risks and agent behavior. AML/CFT risks are addressed as KYC is required at every cash-in and cash out point. EMIs likewise comply with monitoring and reporting of suspicious transactions. We have also explicitly required EMIs to establish dedicated consumer assistance mechanisms for e-money customers.

Admittedly, there are no set rules in practicing proportionality because country contexts and regulatory priorities differ across jurisdictions. However, the principle of risk-based supervision allows sufficient flexibility for regulators to create ample space for innovative financial services like e-money, to reduce financial exclusion in our countries, without endangering the stability and safety of financial systems. It is noteworthy, that even international standard setting bodies are at various stages in developing inclusion-related guidance, signaling that financial inclusion can be complementary with the objectives of stability and integrity.

## 10. Some Results

Some results...these figures are just some statistics showing key results of our e-money regulations. Let me highlight that e-money is also now being used for meaningful retail payments such as pay-outs of conditional cash transfers and other government to persons payment; for example, the payment of pensions to retired military personnel. At the moment, this technology is also a channel

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9. Aggregate amount of transaction should not exceed P100,000 per e-wallet per month.

10. Cash and other liquid investments like government securities.

available for donations to typhoon victims so that citizens can conveniently and safely send value to government agencies conducting disaster relief operations.

## **11. Linking Financial Inclusion and Growth**

Moving on to the second issue...while we all agree that financial inclusion can impact the real economy and facilitate inclusive growth, we need more empirical evidence of this correlation. There is a growing body of qualitative and quantitative research that link inclusion with growth, notably showing that access to financial services makes a positive difference in people's lives<sup>11</sup>. However, we need to build this body of proof by documenting, measuring and monitoring the progress of financial inclusion initiatives. This is why we have made measurement a key element of the BSP corporate strategy for financial inclusion. Only with precise measurement can we truly say that we are indeed making real positive impact that is felt by the poor, ordinary people on the ground.

## **12. Conclusion**

Let me conclude by sharing some lessons learned in our pursuit of financial inclusion. At the end of the day, our primary responsibility as regulator is to ensure that the Philippine financial system remains healthy. Innovative products and business models need not be stifled through heavy-handed regulation. Given their potential to rapidly drive down the level of financial exclusion in our country, these innovations must be allowed to flourish within a proportionate regulatory environment.

Exercising proportionality however requires commitment and deliberate effort if we were to achieve the right balance of inclusion, stability, integrity and even consumer protection.

It also requires constant upgrading of supervisory capacities in light of the fast pace of innovations. Measuring the progress and impact of our inclusion-related regulations and programs is necessary to determine their effectiveness and impact. This also requires regulatory commitment because financial inclusion measurement goes beyond financial and supervisory reporting.

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11. Dupas & Robinson, 2009; Levine, Loayza and Beck, 2000.

As the BSP moves forward, we are seeing an urgent need for multi-stakeholder collaboration because financial inclusion is only one, albeit an important element of inclusive growth.

### **13. Conclusion (Inclusive Growth Chart)**

This is reflected in this complex slide. Inclusive growth can only be achieved when multiple factors like macroeconomic stability, good governance, infrastructure, innovation and other socio-economic factors are at their optimum levels.

As such, we are taking initial steps to craft a national strategy that provides a platform for government, the private sector and other stakeholders to dialogue and work together to make financial inclusion, and eventually, inclusive growth, a reality.

Thank You.

**FINANCIAL INCLUSION IN FIJI – THE  
JOURNEY SO FAR**

**BY**

**MR. BARRY WHITESIDE  
GOVERNOR  
RESERVE BANK OF FIJI**

**(Slides are in Annex 3)**

**SPECIAL SESSION ON  
CAPACITY DEVELOPMENT IN SEACEN  
MEMBER ECONOMIES**

**CAPACITY DEVELOPMENT IN SEACEN  
MEMBER ECONOMIES**

**BY**

**MR. WIMBOH SANTOSO  
EXECUTIVE DIRECTOR  
SOUTHEAST ASIA VOTING GROUP  
INTERNATIONAL MONETARY FUND**

**(Slides are in Annex 4)**

## **ANNEXES**



**ANNEX 1**

**“REGIONAL AND INTERNATIONAL  
FINANCIAL ISSUES”  
GLOBAL AND REGIONAL ECONOMIC  
OUTLOOK - KEY FINANCIAL SECTOR  
CHALLENGES IN ASIA**

**BY**

**MR. ODD PER BREKK  
DIRECTOR  
REGIONAL OFFICE FOR ASIA  
AND THE PACIFIC  
INTERNATIONAL MONETARY FUND**



**"Regional and International Financial Issues"**  
Global and Regional Economic Outlook  
Key Financial Sector Challenges in Asia

Odd Per Brekk  
Director  
Regional Office for Asia and the Pacific  
November 21, 2013









**World Economic Outlook**

## Global growth still weak, with risks on the downside

- Global economy projected to grow at a slightly lower pace in 2013 than in 2012, with growth picking up modestly in 2014
- Shifting cyclical positions
  - Appreciably weaker prospects in major emerging market economies
  - Some stabilization in the euro area
  - Expansion in the United States
- Downside risks still dominate the outlook
  - Crisis risks from AEs lowered, but policy actions needed to keep them at bay
  - New risks from growth slowdown in EMs
  - Financial market volatility is expected to ease, but there are risks that it will persist

## The WEO growth forecast has been revised down, mainly on account of emerging economies

WEO Real GDP Growth Projections  
(percent change from a year earlier)

								
	World	U.S.	Euro Area	Japan	Brazil	Russia	India	China
2013 (Oct. 2013)	2.9	1.6	-0.4	2.0	2.5	1.5	3.8	7.6
2013 (Jul. 2013)	3.1	1.7	-0.6	2.0	2.5	2.5	5.6	7.8
2014 (Oct. 2013)	3.6	2.6	1.0	1.2	2.5	3.0	5.1	7.3
2014 (Jul. 2013)	3.8	2.7	0.9	1.2	3.2	3.3	6.3	7.7

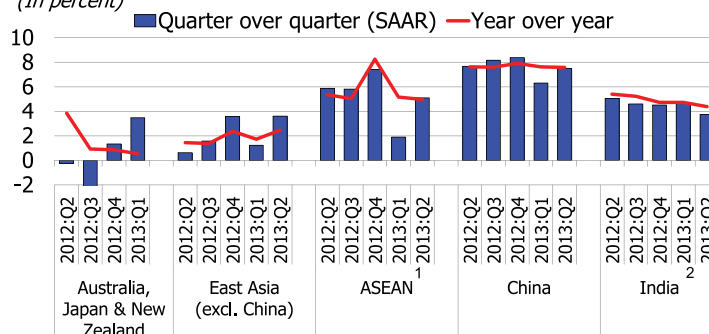
Source: IMF, World Economic Outlook.

## Outlook for Asia

### Growth has slowed across much of Asia ...

**Asia: Changes in Real GDP at Market Prices**

(In percent)

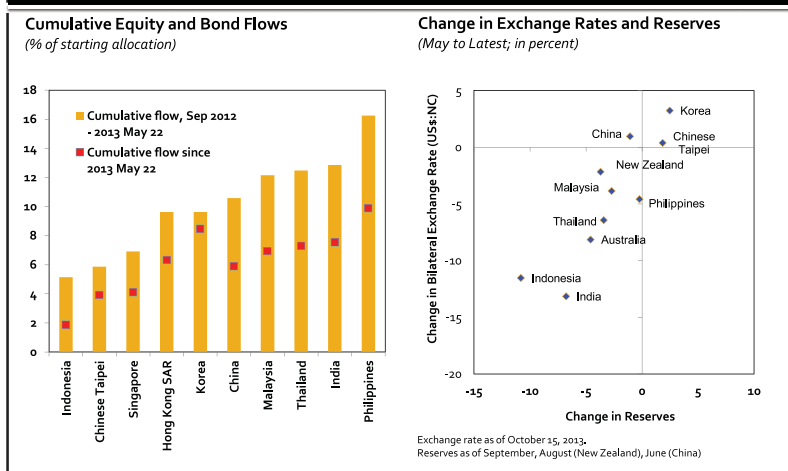


Sources: CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

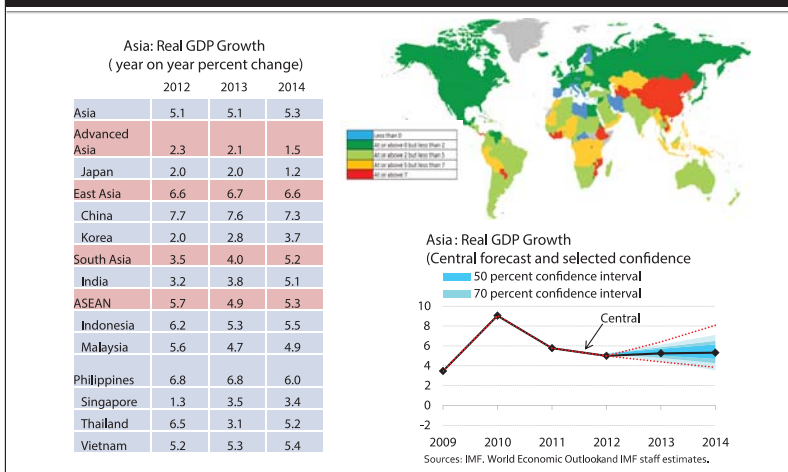
<sup>1</sup> ASEAN includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

<sup>2</sup> India's GDP is at factor cost

## ... and Asia has not been spared from the re-pricing of financial assets



## Still, Asia remains the global growth leader



## Economic Policy Implications

### Policy Challenges for Advanced Economies: What needs to be done?

- Euro Area: Banking repair; banking union; structural reforms
- Japan: Medium-term fiscal consolidation plan, proper speed and concrete measures; structural reforms
- US: Reduce fiscal uncertainty; monetary policy communication

### **Policy Challenges for EM and Developing Economies: What needs to be done?**

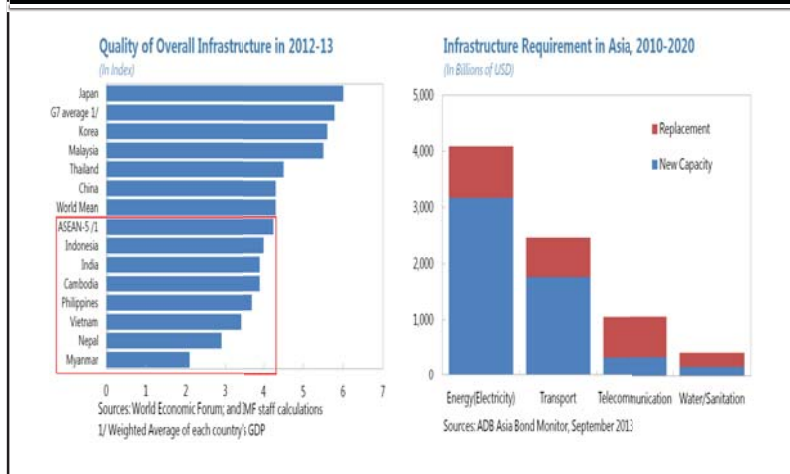
- Ensure macro house is in order – fiscal adjustment, stronger monetary policy frameworks
- Accelerate structural reforms – address bottlenecks in infrastructure
- Let the exchange rate adjust in response to shifts in capital flows – although there could be room for capital flow management measures and intervention in certain circumstances

### **Asia's Financial Sector: Some Key Issues**

## Challenges in the Financial Sector in Asia and the Pacific

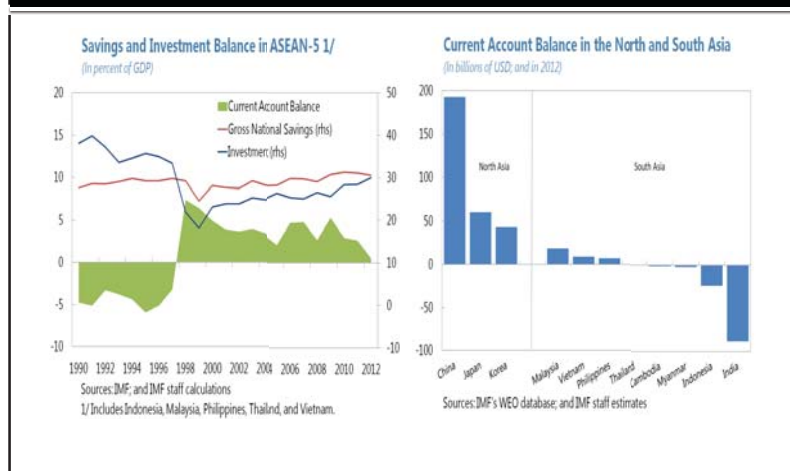
- Infrastructure investment and growth
  - Saving and investment patterns
  - The role of regional financial integration
  - Policies to promote integration
  
- Resilience against external shocks
  - Shadow banking in Asia ...
  - ... including in China
  - Some policy considerations

## Infrastructure : Quality and Investment Needs

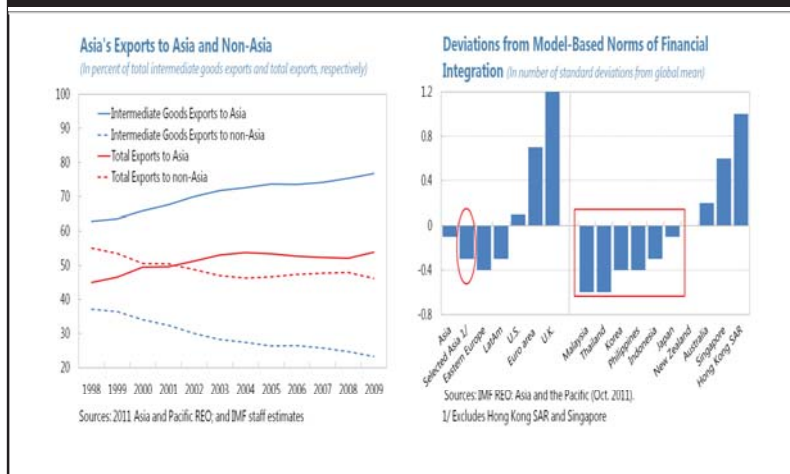




## Asia: Saving and Investment



## Asia: Trade integration is advanced, while financial integration is lagging

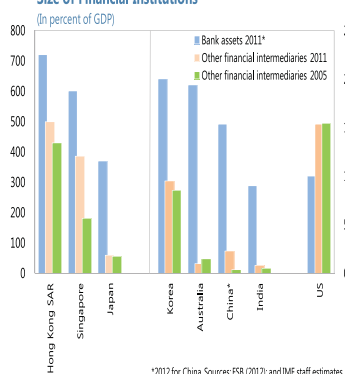


## Asia: Financial Integration

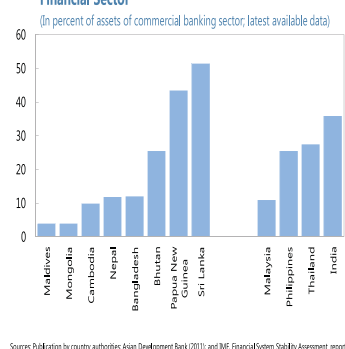
- Asian Bond Markets Initiative (ABMI)
- Initiatives for ASEAN financial integration
- Cross border Public-Private Partnerships

## Asian finance: Still bank-dominated, but the size of non-banks is growing

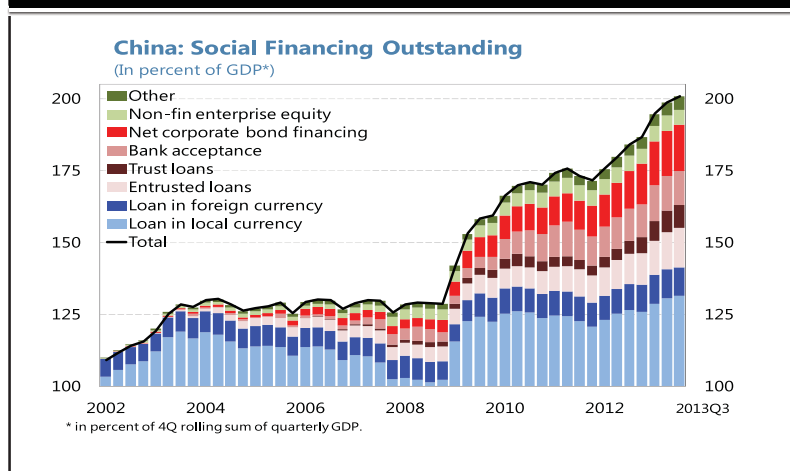
Size of Financial Institutions



Emerging and Frontier Asia: Size of Nonbank Financial Sector



## China: Non-traditional instruments on the rise



## Shadow banking entails both benefits and risks

- Key benefits
  - Arises in some cases to satisfy unmet financing needs
  - Promotes market-based credit allocation
- Key risks
  - Interconnections between banks and shadow banks
  - Financial sector becomes the propagator of initial shocks (a source of systemic risks)
  - Difficult to regulate and supervise
  - Might entail moral hazard

### Policy Recommendations for Shadow Banking

- Address existing distortions in the mainstream financial system
- Strengthen buffers for banks deemed to have high exposures to shadow banks
- Regulations on those nonbanks acting as shadow banks
- Collect consistent information to detect other forms of shadow banking

### All told ...

- Global growth subdued and dynamics changing
  - A slowdown in emerging markets
  - A gradual pickup in advanced economies
  - Downside risks continue to dominate
- Global economic policy agenda
  - AEs: credible medium-term fiscal frameworks, repairing financial systems
  - EMs: prepare for monetary policy normalization, adjust to lower growth
  - Asia: implement structural reforms to boost long-term growth
- Asian finance: Medium-term growth and resilience
  - Regional financial integration
  - Supervision of shadow banking



**Thank you !**

Odd Per Brekk  
Director  
Regional Office for Asia and the Pacific  
November 21, 2013

**ANNEX 2**

**FINANCIAL ARCHITECTURE,  
MACROPRUDENTIAL REGULATION AND  
SUPERVISION AND GROWTH:  
A DISCUSSANT NOTE**

**BY**

**MR. MAHA PRASAD ADHIKARI  
DEPUTY GOVERNOR  
NEPAL RASTRA BANK**



**49<sup>th</sup> SEACEN Governors' Conference,  
High Level Seminar  
21 November 2013, Kathmandu**



**Financial Architecture, Macro  
Prudential Regulation and  
Supervision for Financial  
Stability and Growth:  
A Discussant Note**

**Mr. Maha Prasad Adhikari  
Deputy Governor, NRB**



## Discussion Outline

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- Introduction
- Growth
- Financial stability
- Financial Architecture
- Macro Prudential Policies
- Conclusion

## Introduction

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- The concept of financial architecture and macro prudential regulation and supervision are broadly directed to minimization of possible systemic risk and its devastating impact on the financial system and to the economy.



## Financial Sector Policies for Growth

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- It is experienced that there is strong correlation between economic growth and financial sector development.
- Higher economic growth will generate demand for the banking services and ultimately explore financial sector development. Based on this, financial sector is dependent on the real sector performance.
- On the contrary, we can also argue that by having more advanced and developed financial sector in hand, we would be able to allocate its resources for the economic development.

## Financial Sector Policies for Growth

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- This argument also failed in many cases as we had come across many crises just at the time when financial sector was doing well and the banks were melting profits and distributing attractive dividends.
- Hence, the growth vs. financial sector developments are complementing each other and should go together. For this, the financial sector policies need to be designed to have a consistent functioning of banking industry and be able to serve on a sustainable basis.

## Financial Sector Policies for Growth

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- Growth again is debated with equity. Initially, we do have feeling that if we have growth, it will automatically ensure equity. However, in practice it has a different track to follow.
- In order to have sustainable growth that ensures equity, the financial sector policy needs to have some intervening components on its prudential policies.
- It is evidenced particularly in developing and emerging economy that players in the financial market are more guided by profits, dividends and their current performance than the sustainability of their economy; hence, the equity component on its policies is essential.

## Financial Stability

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- In the financial market in any part of the globe, it is normally believed that their financial sector would explore and contribute for the growth if the regulatory burden is reduced.
- However, the best practice in the financial sector management is that it needs to be well regulated and adequately monitored.
- It is also evidenced that problem in the financial market would not correct over a short period of time. It is experienced that the detection of such problem is also a difficult task in real time. In many cases, once detected, it has become irreparable.

## Financial Stability

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- ❑ Once the problem arises in the financial market, it becomes a big headache to the financial sector supervisor and the central bank. The hard earned reputation is under question and the time and resource deployed for the correction is not computable.
- ❑ Hence, the prudential policies and the supervision for the financial sector are, as we understand, inevitable.
- ❑ It was in place and always followed best supervisory practice in the global financial market. Despite this, we are encountering crises again and again.

## Financial Stability

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- ❑ It shows that the demand for less regulation is not justified. The existing framework seems either inadequate or technically not sufficient to address the deregulation and underlying risk underwritten by the financial market.
- ❑ For this, the BIS/ BCBS is rigorously working on new regulatory and supervisory standard providing new financial architecture for more proactive and preventive measure for regulation and supervision.

## Financial Architecture

- BCBS initiatives, particularly for addressing the financial market developments with its standard:
  - Basel Core Principles for Effective Supervision.
  - Capital Accord, 1988
  - New Framework 2004; Basel-II
  - New Framework 2012; Basel-III
- Macro prudential components – additional pillars with combining elements on these pillars.

## Financial Architecture

- Basel Core Principles for Effective Supervision.
  - Licensing
  - Prudential Regulations
  - Effective Supervision
  - Problem Bank Resolution
- Capital accord, 1988
  - Improved international capital level
  - Benchmark on banking soundness
  - Enhanced transparency
  - Harmonized the capital standard
  - Provided level playing field

## Financial Architecture

- New Framework 2004; Basel-II,
  - Risk based-qualitative capital
  - Supported by three strong pillars
  - Different approaches
  - Capturing key banking risk through capital

Huge efforts and a paradigm shift on computation of capital with above features. However, before implementation of this standard in a full fledged manner, there have been crises in the world; some issues have been raised with regard to the inadequacy of this framework.

## Financial Architecture

- New Framework 2012; Basel-III
  - Liquidity coverage strengthening.
  - Capital buffer- counter cyclical, conservation, etc.
  - Address to procyclicality effect of Basel-II
  - Higher quality capital to globally active banks.

## Macro Prudential Policies

- The macro-prudential approach to supervision focuses on the financial system as a whole and involves the monitoring, assessment and mitigation of systemic risk, namely the likelihood of failure of a significant part of the financial system.
- It is important to recognize that systemic risk is partly indigenous as it depends on the collective behavior of financial institutions and their inter-connectedness, as well as on the interaction between financial markets and the macro-economy.

## Macro Prudential Policies

- New macro-prudential approach to regulation and supervision has to be integrated with the existing micro-prudential structures. Macro- and micro-prudential supervision are complementary components and are part of the overall financial supervisory framework.
- A range of macro-prudential tools is available and the choice of the appropriate tools to address emerging systemic risks remains a challenge, requiring further analysis in order to identify the most efficient and effective instruments for the implementation of macro-prudential policies.

### Nepal's Status on Some of the Key Tools

- Loan to Value Ratio: Yes
- Limits on Lending-SOL : Yes
- Debt to Income Ratio : No
- Limits on FC lending: Yes
- Limits on Maturity Mismatch: Yes
- FC Mismatches: Yes
- Stress Testing: Yes
- EWS: No
- RBS: Yes

### Nepal's Status on Some of the Key Tools

- Capital standard: Yes
- Countercyclical element: No
- Dynamic provision element: No
- Control over dividend : Yes
- Minimum equity capital requirement: Yes
- Restriction on interconnectedness: Not sufficient
- Restriction on credit to risk takers: Yes
- Clear macro prudential policy objective approved: No

## Conclusion

- Hence the reform in financial sector policies is an ongoing task that requires policies for equitable growth with no compromise on financial stability.
- In addition to regulatory framework in place, the early warning system, stress testing, consolidated supervision and risk based supervisory mechanism are some of the key tools available for the supervisor.
- The benefits of soundness of individual institutions will be useful to the system if and only if we are able to enforce macro prudential measure.



**ANNEX 3**

**FINANCIAL INCLUSION IN FIJI – THE  
JOURNEY SO FAR**

**BY**

**MR. BARRY WHITESIDE  
GOVERNOR  
RESERVE BANK OF FIJI**

49<sup>th</sup> SEACEN Governors Conference, High-Level Seminar and  
33<sup>rd</sup> Meeting of the SEACEN Board of Governors

**Session 2: Emerging Issues on Inclusive Finance for Growth**

**Financial Inclusion In Fiji – The Journey So Far**

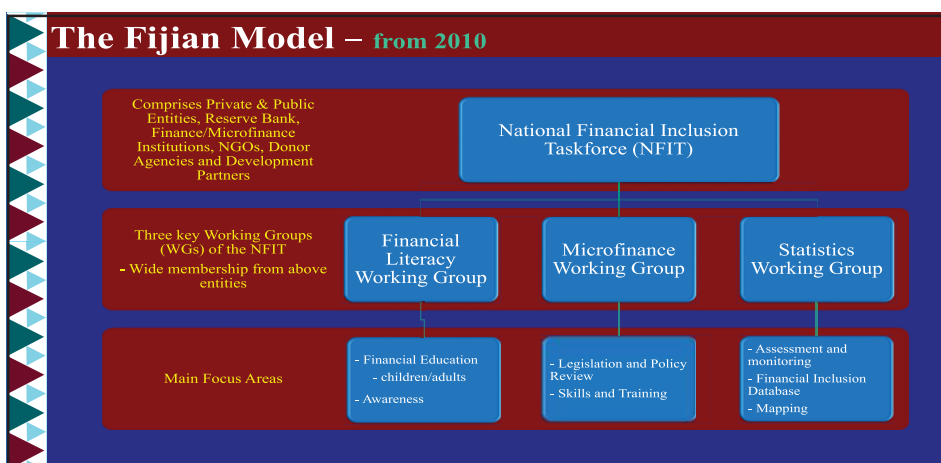
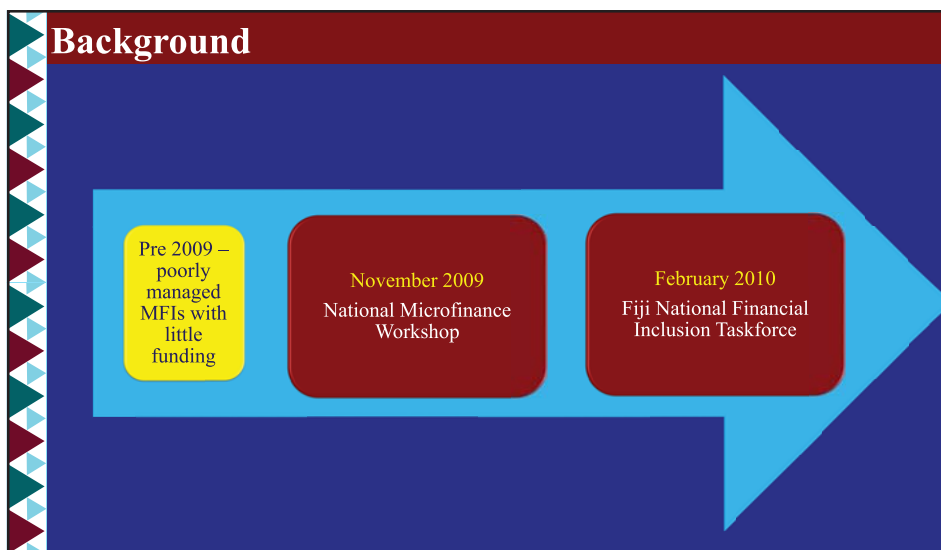
22 November, 2013

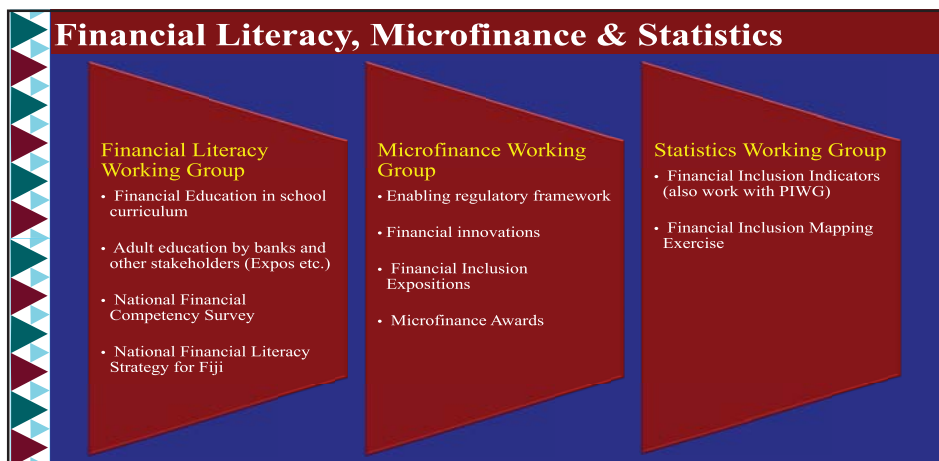


**Barry Whiteside**  
Reserve Bank of Fiji

**Outline of the Presentation**

- ❖ Background
- ❖ The Fijian Model
- ❖ Financial Literacy, Microfinance and Statistics
- ❖ Some Financial Inclusion Achievements
- ❖ Issues and Challenges
- ❖ Way Forward
- ❖ Conclusion





### Some Financial Inclusion Achievements ctd.

- ❖ **Mapping exercise** (near completion)
- ❖ **Financial Inclusion initiatives** (banking via mobiles, trucks, agents, MPaisa, Digimoney, G2P, Micro insurance etc.)
- ❖ **93% of 150,000 unbanked target** (about 50% of total underserved Fijians)
- ❖ **AFI Maya Award**

### Issues and Challenges

- ❖ **Delivery of appropriate and affordable financial products and service.**
- ❖ **Consumer protection/ empowerment and financial education.**
- ❖ **Creating an enabling regulatory environment.**
- ❖ **Data issues**

## Way Forward

- ❖ Fiji Financial Inclusion Strategy 2010 – 2014
- ❖ Need to take stock and set another medium strategy
- ❖ Implementation of National Financial Literacy Strategy for Fiji
- ❖ National Demand Survey for Public feedback

9

## Conclusion

- ❖ Financial inclusion is a catalyst in reducing poverty and improving the living standards of poor and most vulnerable.
- ❖ For Financial Inclusion to be successful there needs to be a collaborative effort by all stakeholders.
- ❖ This has to be made a national agenda and Government must fully support this initiative.



**ANNEX 4**

**CAPACITY DEVELOPMENT IN SEACEN  
MEMBER ECONOMIES**

**BY**

**MR. WIMBOH SANTOSO  
EXECUTIVE DIRECTOR  
SOUTHEAST ASIA VOTING GROUP  
INTERNATIONAL MONETARY FUND**



## Capacity Development in SEACEN Member Economies

49<sup>th</sup> SEACEN Governors' Conference, High Level Seminar and  
33<sup>rd</sup> Meeting of the SEACEN Board of Governors  
Kathmandu, Nepal  
November 21 -23, 2013

Wimboh Santoso  
Executive Director  
Southeast Asia Voting Group  
International Monetary Fund

## Outline

Objective and the context

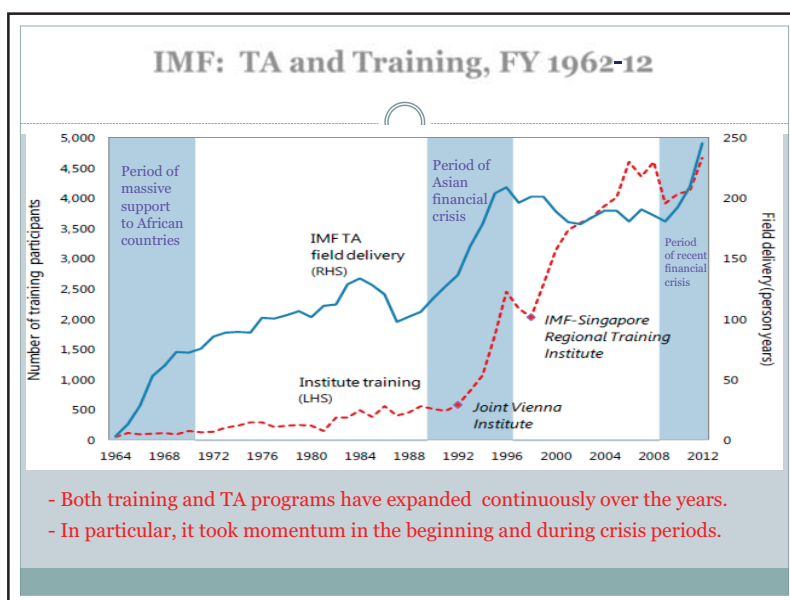
IMF's focus on capacity development

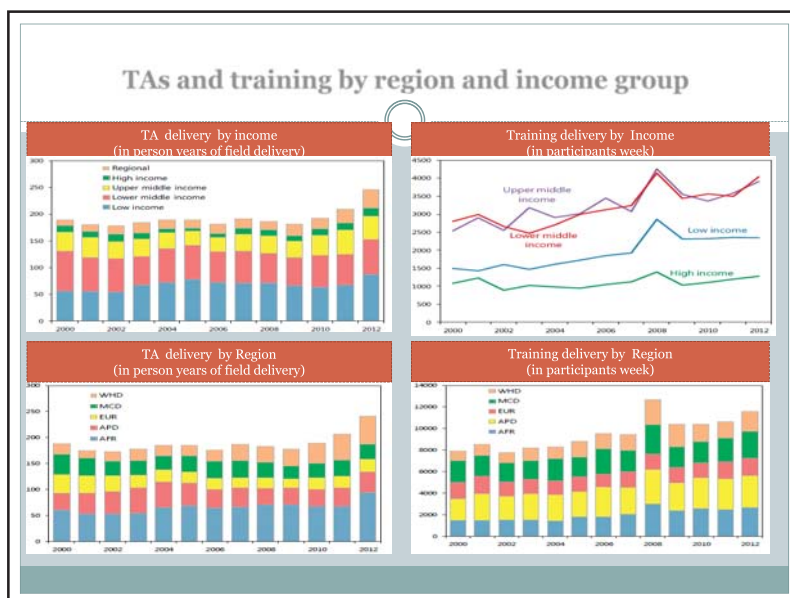
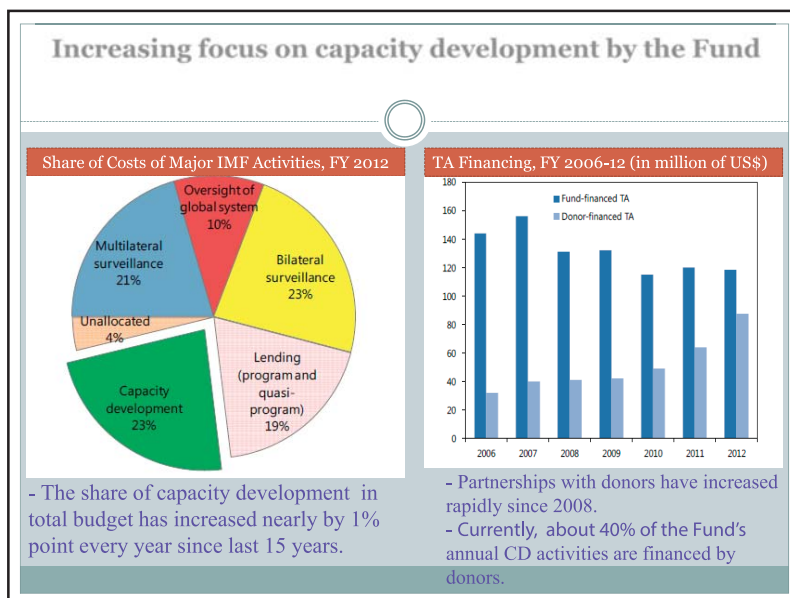
Capacity development issues in SEACEN countries

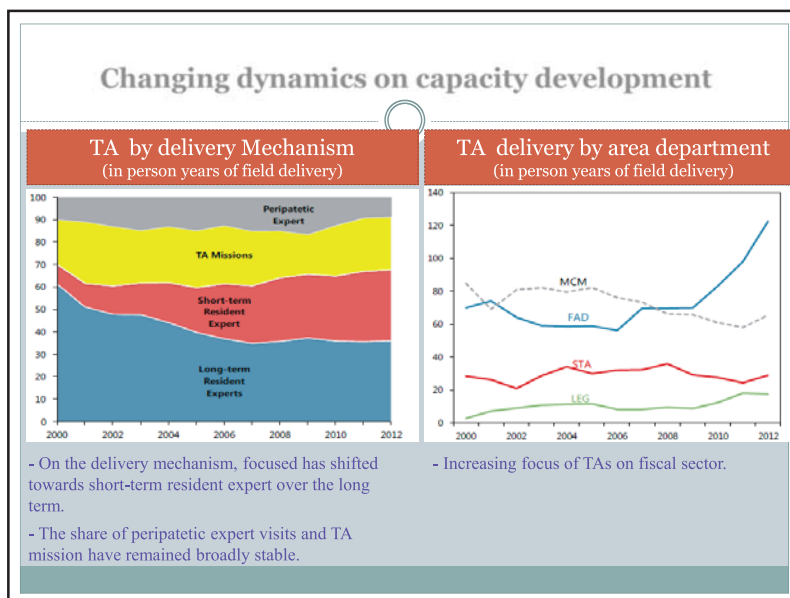
Challenges and issues for discussion

### Objective and the context

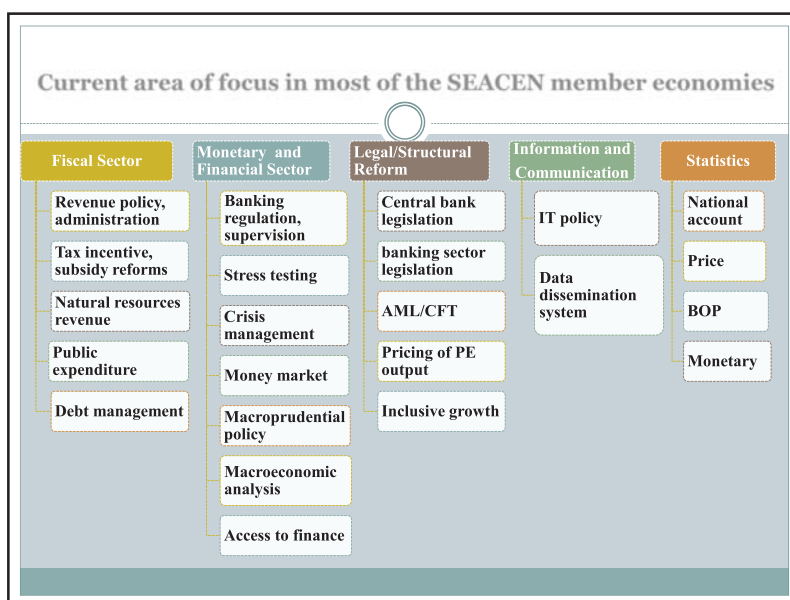
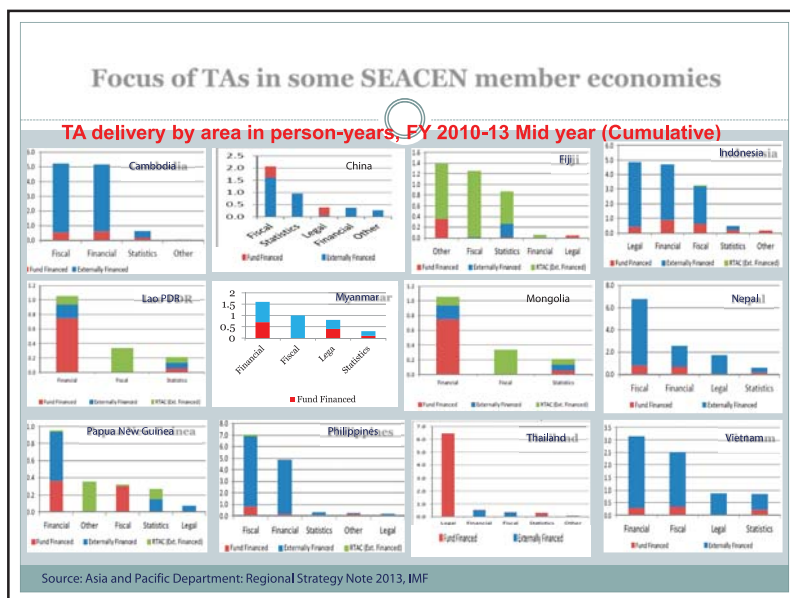
- ☒ To update the Fund's focus and delivery on capacity development, given the challenging environment to maintain stability and enhance inclusive growth.
- ☒ To highlight the common issues on capacity development in our region, and
- ☒ To solicit the view of honorable Governors to strengthen the role of IMF to enhance capacity development.







- ### Highlights of current focus on capacity development
- The Fund stands ready to respond to any changes in demand for capacity development arising from new challenges facing global economy.
  - The Fund continues to improve the coordination of capacity development with surveillance and program activities.
  - TA has been directed to build capacity to design and implement poverty-reducing growth programs in recent years.
  - Low and lower-middle income countries continue to receive the bulk of TAs.
  - The Fund continues to strengthen its collaboration with donors.

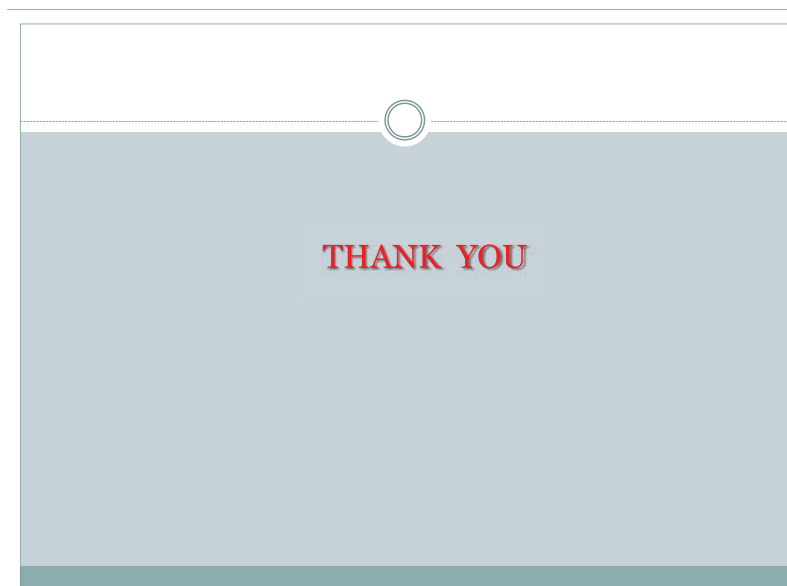


### Challenges - Going forward !

1. Manage growing demand of TAs and training given resource constraints.
2. Generate more resources – need more collaboration with donors and leverage on resources/experts in the region.
3. Improve training and TAs delivery mechanism – initiate more tailored packages focusing on regional common issues, determine priorities and focus on areas where the Fund has comparative advantage.
4. Strengthen the role of regional training centers – ensure more coordination and collaboration among regional training institutes and TA providers.

### Issues for discussion

- Do Governors find the Fund's existing program effective in meeting the capacity building requirement in our region?
- Do Governors observe any room for further improvement in the Fund's program for capacity development?
- Do Governors see room for the Fund to enhance collaboration with SEACEN?



**ANNEX 5**

**PRESS COMMUNIQUÉ**



**NEPAL RASTA BANK HOSTED  
THE 49<sup>TH</sup> SEACEN GOVERNORS' CONFERENCE/HIGH-LEVEL  
SEMINAR AND  
33<sup>RD</sup> MEETING OF THE SEACEN BOARD OF GOVERNORS  
21-23 November 2013, Kathmandu, Nepal  
Press Communiqué**

1. The 49<sup>th</sup> Conference/High-Level Seminar of the Governors of The South East Asian Central Banks (SEACEN) Research and Training Centre and the 33<sup>rd</sup> Meeting of the SEACEN Board of Governors were hosted by the Nepal Rastra Bank on 21-23 November 2013 in Kathmandu, Nepal. Participating in the Conference/High-level Seminar and Meeting were Governors and representatives of eighteen SEACEN member central banks and monetary authorities<sup>1</sup>. The programs were inaugurated by Rt. Honorable President of the Federal Democratic Republic of Nepal, Dr. Ram Baran Yadav who delivered his Inaugural Address. Remarks were also delivered by Honorable Minister of Finance, Mr. Shanker Prasad Koirala. The Governor of the Nepal Rastra Bank, Dr. Yuba Raj Khatiwada delivered his Welcome Remarks and Mr. Naidansuren Zoljargal, the Governor of the Bank of Mongolia as Chairman of the SEACEN Board of Governors also addressed the forum. Deputy Governor of the Nepal Rastra Bank, Mr. Gopal Prasad Kaphle delivered the vote of thanks.
2. The theme of the Conference/High-Level Seminar was “*Financial Sector Development Strategy for Inclusive Growth.*” In his Inaugural Address, Rt. Honorable President of Nepal, Dr. Ram Baran Yadav emphasized the importance of financial inclusion policies for reducing poverty and enhancing economic development to achieve shared growth for all segments of the population. Mr. Shanker Prasad Koirala, Honorable Minister of Finance

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1. The nineteen SEACEN members are Autoriti Monetari Brunei Darussalam, National Bank of Cambodia, People's Bank of China, Reserve Bank of Fiji, Reserve Bank of India, Bank Indonesia, The Bank of Korea, Bank of the Lao PDR, Bank Negara Malaysia, The Bank of Mongolia, Central Bank of Myanmar, Nepal Rastra Bank, Bank of Papua New Guinea, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Central Bank of Sri Lanka, Central Bank, Chinese Taipei, Bank of Thailand and State Bank of Vietnam.

highlighted the important role of SEACEN in providing a platform for collaboration and cooperation among its members to address regional issues and challenges. Mr. Naoyuki Shinohara, Deputy Managing Director of the International Monetary Fund (IMF), in his keynote address remarked that financial inclusion can spur employment and thus promote inclusive growth. He also highlighted several challenges faced by emerging economies in an environment of greater financial integration. He emphasized that the IMF is committed to promoting financial sector development and inclusive growth in the Asian economies, with greater attention to be accorded to spillover effects by way of enhanced surveillance.

3. In his speech on “*New Financial Architecture, Macroprudential Regulation and Supervision for Financial Stability and Growth*”, Mr. Jaime Caruana, General Manager of the Bank for International Settlements stressed on the need for more proactive supervision to focus on procyclicality and systemic risk in the financial sector. He viewed that authorities must have the capacity and the willingness to implement macroprudential and microprudential policies during times of uncertainty. The other distinguished speakers were Mr. Johannes Zutt, Country Director for Nepal and Bangladesh, the World Bank, who spoke on “*Financial Sector Development Strategy for Inclusive Growth*”; Mr. Odd Per Brekk, Director of the IMF, who spoke on “*Regional and International Financial Issues*” and Mr. Thierry de Longuemar, Vice President for Finance and Risk Management, Asian Development Bank, who spoke on “*Emerging Issues on Inclusive Finance for Growth*”. A background paper on the theme was also presented by a representative of the Nepal Rastra Bank.
4. Governors highlighted the need to explicitly craft the role of the financial sector in contributing to sustainable inclusive growth. These include efforts to restructure institutional and operational frameworks of financial institutions. Governors also noted that there is a need to formulate financial sector development strategies for all customers, ranging from small savers to small and medium scale industries. The strategy should promote the use of technology and cooperation among the various stakeholders to enable greater access to financial services. Governors also stressed the need to advance financial literacy to empower all people and to implement effective consumer protection policies. The need to ensure an efficient allocation of resources

and sound risk management of the financial sector for inclusive growth was also emphasized.

5. Governors discussed the key downside risks in the global economy and their potential adverse effects on regional economies. The need to build capabilities and enhance the resilience of the economy to be positioned to deal with adverse external shocks was acknowledged. Governors also saw the need to strengthen networking and collaboration within the central banking fraternity on regional issues related to greater global integration and financial stability.
6. Governors discussed the importance of macro financial linkages and that the development in the financial sector has far-reaching consequences on the real economy. Macroprudential policy can effectively accompany monetary policy that takes into account financial cycles in promoting financial stability. Governors stressed that as non-banking institutions become more prominent, prudential and supervisory frameworks must be extended beyond the conventional banking system to include shadow banking.
7. At the 33<sup>rd</sup> Meeting of the SEACEN Board of Governors, the budget and the SEACEN Centre's program of activities for FY 2014 were approved.
8. Governors accepted with thanks the offer of the Bank of Papua New Guinea to host the 50<sup>th</sup> SEACEN Governors' Conference/High-Level Seminar and the 34<sup>th</sup> Meeting of the SEACEN Board of Governors in 2014.
9. Governors also expressed their appreciation to Governor of Nepal Rastra Bank Dr. Yuba Raj Khatiwada and the Nepal Rastra Bank for the excellent arrangements and warm hospitality in hosting this year's SEACEN Governors' Conference/High-Level Seminar and SEACEN Board of Governors Meeting. Governors also welcomed the joint seminal initiative by the Nepal Rastra Bank and SEACEN Centre to publish the proceedings of the Conference and the High-Level Seminar.