

Financial Regulatory Issues for Financial Inclusion



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ABSTRACT

The region is home to more than half of the world's unbanked adults. The total credit gap for micro, small and medium enterprises (MSMEs) is also the largest in Asia, particularly in East Asia, with the most number of MSMEs as compared to other regions of the world. This implies that there are numerous barriers to enhancing financial inclusion in the region. Most of these barriers can be overcome by well-designed regulatory frameworks. There are, however, some challenges for regulators in creating such regulatory frameworks. For example, while national policymakers are giving increasing recognition to policies that promote financial inclusion, regulators have been more prudent about financial inclusion due to higher credit risks and lack of documentation associated with small borrowers. This leads to the important issue of how to strike a right balance between financial inclusion and financial stability. In this respect the paper analyzes whether increasing credit access and account penetration can be tackled from a financial stability perspective. It then examines what kind of obstacles international and national regulatory framework face in the development of financial inclusion and provides several solutions to overcome these obstacles.

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A. INTRODUCTION

Financial inclusion is seen by most policymakers as a way to reduce poverty and boost shared prosperity for society. In fact, a growing body of evidence suggests that access to financial services can reduce poverty, raise income, and promote economic growth¹. Nevertheless, the overextension of credit to noncredit-worthy borrowers and relaxation in underwriting standards could lead to instability. As the United States sub-prime crisis of 2007 and India's 2010 microfinance crisis shows, uncontrolled expansion in access to financial services could lead to financial instability and social discontent without proper supervision and regulation. The common feature of both crises is that although financial institutions were able to report high profitability for years through a rapid growth in loans, this led to large indebtedness among noncredit-worthy borrowers contributing to financial instability and social discontent². In this respect, while national policymakers are giving increasing recognition to policies that promote financial inclusion, regulators have been more prudent about financial inclusion due to higher credit risks and lack of documentation associated with small borrowers. Efforts to promote financial inclusion raise many challenges for financial regulators, and require creative responses to these challenges. The key challenge is how to achieve the goal of financial inclusion, such as through providing basic financial services for the poor, while maintaining the stability of the financial system. To this end, a proportional approach to regulation can be an essential mechanism for the development of financial inclusion while maintaining financial stability. Such an approach balances the risks and benefits of financial inclusion against costs of regulation and supervision. It is well recognized as an important mechanism by the standard-setting bodies (SSBs)³. There are also a growing number of countries officially committed to a policy agenda of implementing this principle in their regulations to improve financial inclusion. However, although the SSBs have added considerable specificity to the concept of proportionality in their standards, the application of this principle in everyday practice of regulation and supervision leads to many questions not yet explicitly addressed by the SSBs.

Importantly, there is no universally accepted definition of financial inclusion. Some of the international organizations define financial inclusion. For example, The Consultative Group to Assist the Poor (CGAP) defines financial inclusion as “a state in which all working age adults have effective access to credit, savings, payments and insurance from formal service providers” and defines effective access as “convenient and responsible service delivery, at a cost affordable to the customer and sustainable for the provider.” Using this definition, this paper analyzes regulatory issues only in terms of account penetration and access to credit.

¹ Overview of Financial Inclusion, Regulation, and Education, Naoyuki Yoshino and Peter Morgan, 2016.

² During India's 2010 microfinance crisis, fresh lending to micro finance institutions by banks during the year 2011-12 declined by over 38% resulting in reduction of gross loan portfolio by 14%. For the United States, the Gini Index reduced to 40.46 from 41.75 during the sub-prime crisis, between 2007 and 2010.

³ SSBs refer to the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Financial Action Task Force (FATF), the International Association of Deposit Insurers (IAIS), and the International Association of Insurance Supervisors (IAIS)

B. RELATIONSHIP BETWEEN ACCOUNT PENETRATION AND FINANCIAL STABILITY

1. Account Ownership

Account ownership is a first step toward financial inclusion. Increasing the amount of account usage and promoting diversity in the depositor base would build up a more stable retail base of deposits, reducing banks' dependence on noncore financing which is more volatile in periods of stress. Preliminary evidence suggests that a 10% increase in access to bank deposits can reduce the likelihood of a withdrawal of deposits in periods of stress by 3-8 percentage points⁴. This study supports the view that low income savers tend to maintain steady financial behavior through the economic cycle in terms of deposit keeping. So, broadening deposit access by including low income savers will tend to raise the stability of deposits, which enhances the liquidity conditions of banks in stress periods⁵. The recent global crisis also demonstrated that the banks that did not depend on stable retail sources but relied on wholesale funding struggled to access the wholesale funding market, which caused a liquidity crisis during the global financial crisis⁶.

Greater use of formal accounts can also improve the efficiency of the process of intermediation between savings and investments by reducing the cost of credit and facilitate business expansion through increased availability of low cost deposits. Moreover, since a significant segment of financially excluded households and small businesses make financial decisions independent of the monetary policy actions of the central bank, an increase in use of formal accounts can improve the transmission of monetary policy. Greater inclusion encourages consumers to move their savings away from physical assets and cash into deposits and helps more consumers to smooth their consumption over time. This makes interest rates more effective as a policy tool and it may facilitate central banks' efforts to maintain price stability⁷.

In this respect, the greater use of formal accounts has a positive impact on financial stability and efficiency. This is illustrated in figure 1 and 2. While most of the countries with high account penetration have smaller financial stability risk, countries with low account penetration have low financial institution efficiency. Account penetration can therefore be promoted extensively from a financial stability perspective.

⁴ Financial Inclusion for Financial Stability: Access to Bank Deposits and the Growth of Deposits in the Global Financial Crisis." Policy Research Working Paper, Han, Rui, and Martin Melecky, 2013.

⁵ Financial inclusion and financial stability: are they two sides of the same coin?, H R Khan, 2011.

⁶ Financial crises and bank funding: recent experience in the euro area, Adrian van Rixtel and Gabriele Gasperini, 2013.

⁷ Financial inclusion – issues for central banks, Aaron Mehrotra and James Yetman, BIS, 2015.

Figure 1⁸. Account Penetration Versus Stability, 2014

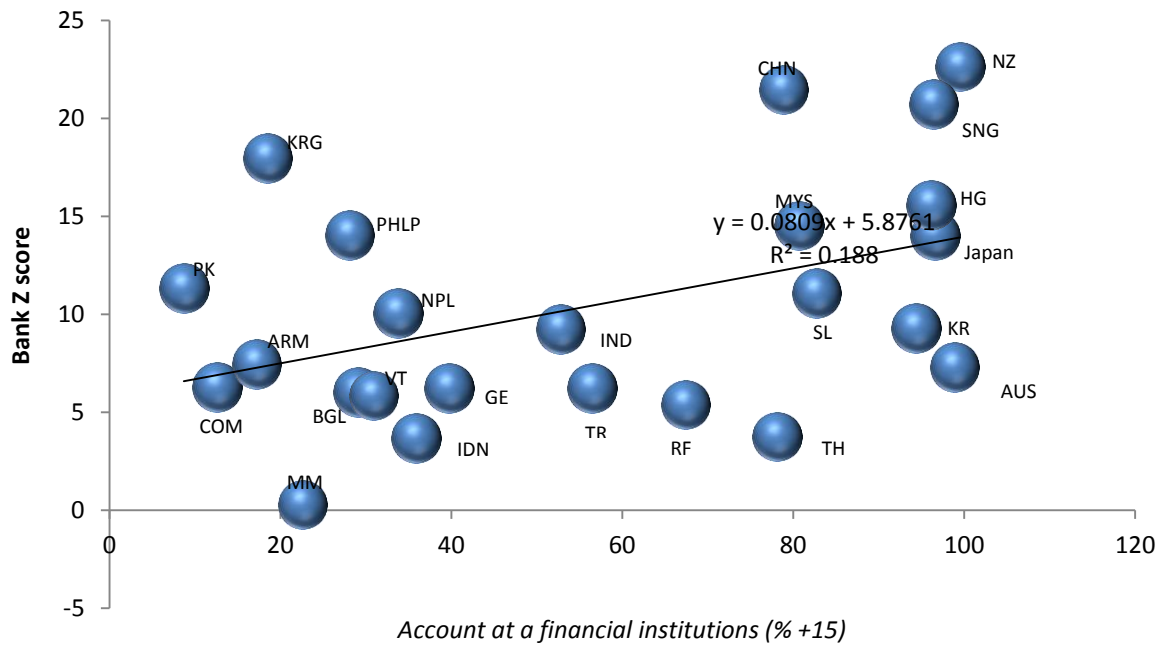
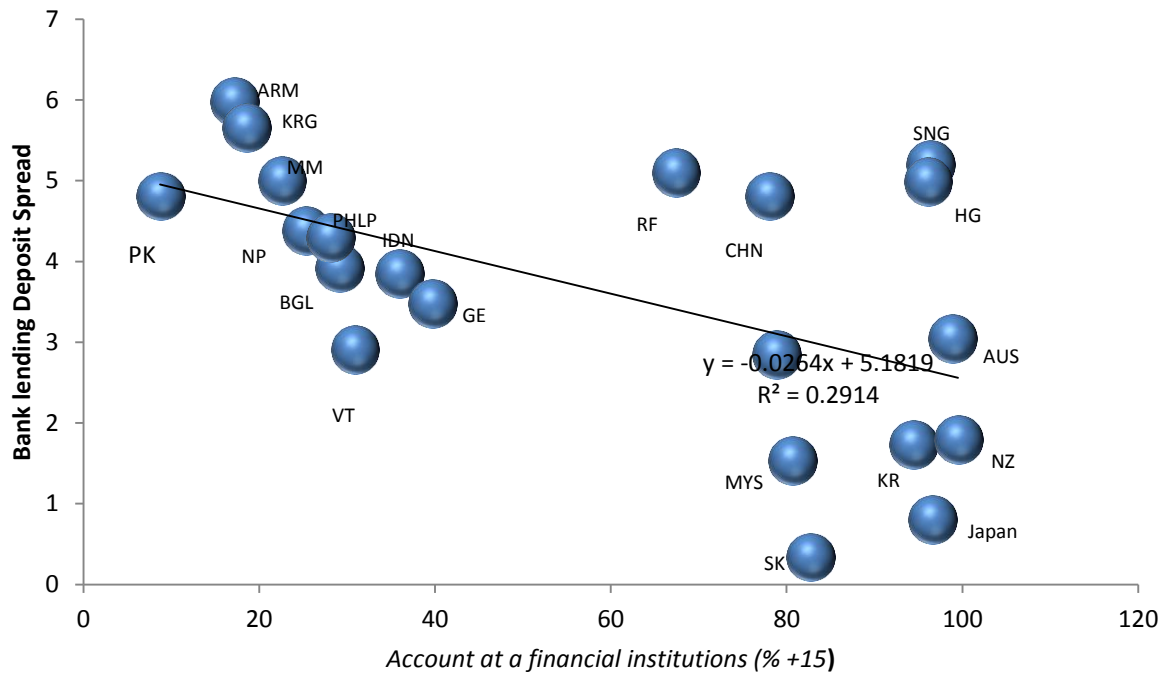


Figure 2. Account Penetration Versus Efficiency, 2014



However, account penetration data come with some caveats. For example, the aggregate number of bank accounts is not the same as the number of depositors, since while some individuals may have multiple accounts, some accounts may be dormant. According to IMF data, many people in advanced economies have multiple bank accounts, whereas for every ten people there are barely

⁸ The bank z-score is a ratio, defined as $(ROA + equity)/assets/sd(ROA)$, where ROA is average annual return on end-year assets and $sd(ROA)$ is the standard deviation of ROA. A lower z-score means a lower distance-to-distress, that is, bigger financial stability risks.

AUS: Australia, SNG: Singapore, MYS: Malaysia, CHN: China, IND: India, IDN: Indonesia, PHLP; Philippines, NZ: New Zealand, JP: Japan, RF: Russian Federation, KR: Republic of Korea, PK: Pakistan, NP: Nepal, CP: Cambodia, BG: Bangladesh, VT: Viet Nam, MM: Myanmar, COM: Cambodia, ARM: Armenia, NPL: Nepal, KRG: Kyrgyz Republic, GE: Georgia, TR: Turkey, HKG: Hong Kong China, TH: Thailand, SL: Sri Lanka

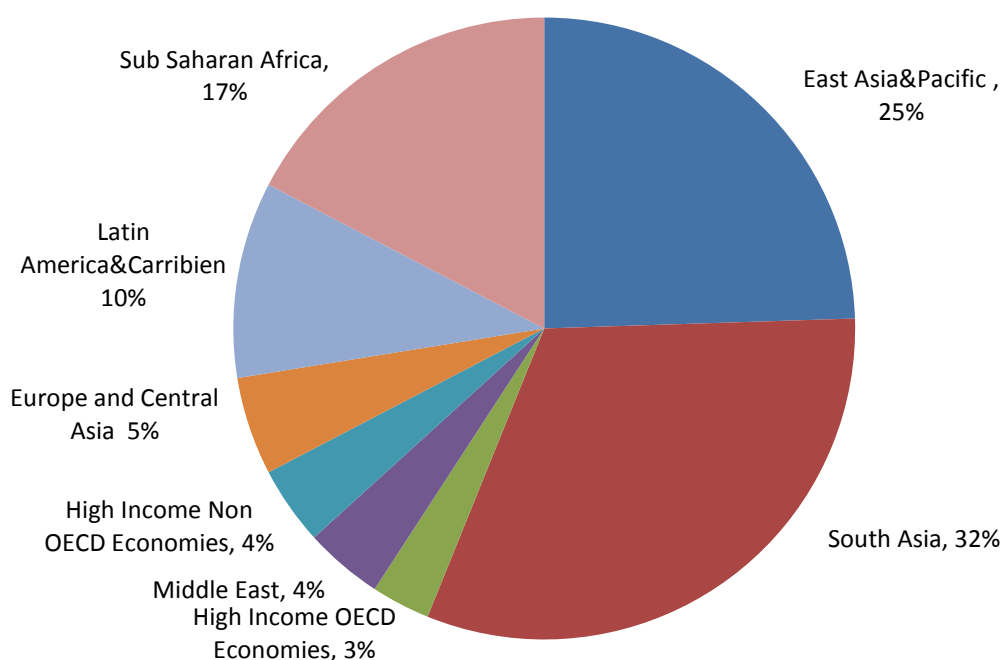
two bank accounts in low-income economies. The 2014 Global Findex data from the World Bank shows that while 37% of adults with an account do not make any deposits in a typical month globally, 46% and 65% of adults with an account do not make any deposits in a typical month in East Asia and Pacific and South Asia, respectively. Policy makers should take into account this caveat when they form a strategy on increasing account penetration.

2. Trends in Account Ownership in Asia and Pacific

The account ownership for countries in Asia and the Pacific shows a wide variation, ranging from 1.8% to 99.5%. However, according to Global Findex Data, South Asia and East Asia and the Pacific are home to more than half of the world's unbanked adults, accounting for 55% of the world's unbanked population (Figure 3). Three countries in the region, China, India, and Indonesia, together account for 38% of the world's unbanked. While India is home to 21% of the world's unbanked adults and about two-thirds of South Asia's, China and India account for 12% and 6% of the world's unbanked, respectively⁹.

Globally in 2014, 16% of adults reported that they used their mobile phone in the past year to access their accounts. While high income OECD and Sub-Saharan countries had the largest percentage of account access through mobile phone, East Asia and the Pacific countries followed these groupings with 17%. However, use of mobile phone in accessing accounts was very low in South Asia with less than 10%¹⁰.

Figure 3. Adults Without An Account %, 2014

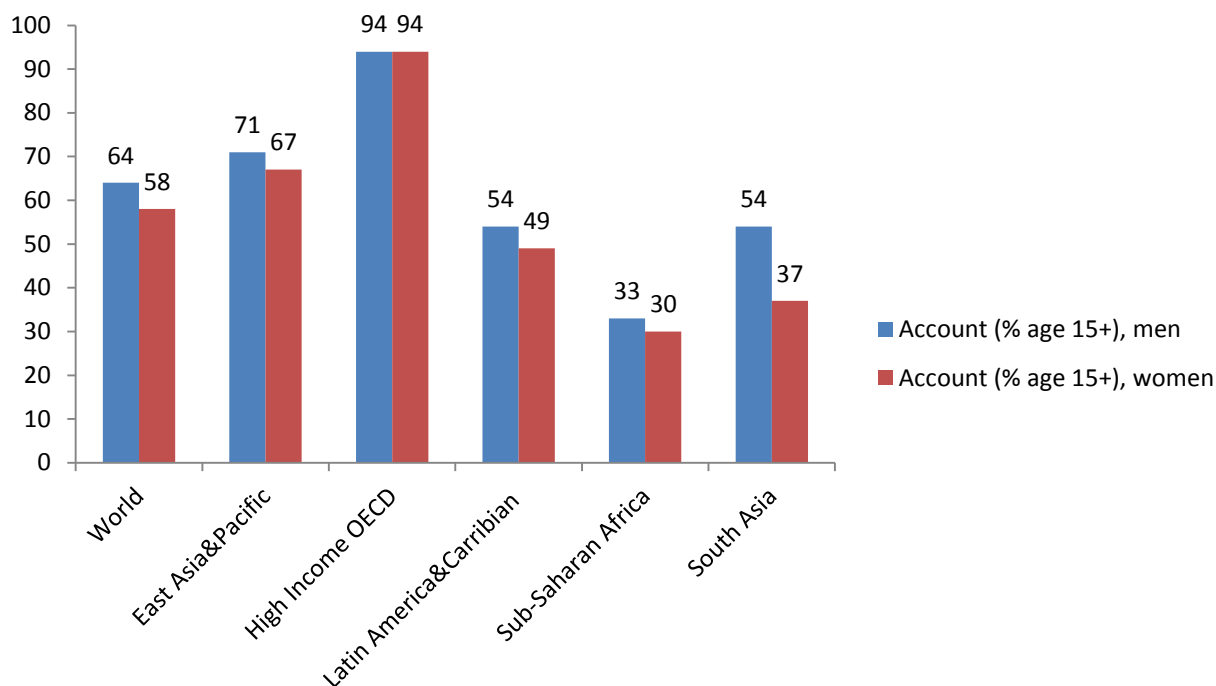


The gender gap in account ownership is also high in the region when compared to other regions. While in the region, on average, adult accounts for women stood at 49.3% in 2014, the average for the world was about 58%. On the other hand, although the gender gap in account ownership is very small in advanced OECD economies where 94% of all adults have an account, the gap is particularly large in South Asia where only 37% of women have accounts (Figure 3).

⁹ The Global Findex Database

¹⁰ Ibid

Figure 3¹¹. Gender Gaps in Accounts in 2014



C. FINANCIAL REGULATORY FRAMEWORK CHALLENGES IN PROMOTING ACCOUNT OWNERSHIP

There are many barriers that prevent people from opening an account in financial institutions, such as high account fees, onerous documentation requirements, travel distance, legal hurdles and other market failures. Nevertheless, there is growing recognition that most of the barriers that limit access to financial services can be overcome by a well-designed regulatory framework. To expand account ownership, the regulatory framework is expected to be designed to facilitate expanding account ownership, such as through licensing bank agents, introducing tiered documentation requirements, requiring banks to provide basic or low-fee accounts, and allowing the evolution of new technologies such as mobile money. In this context, there are some challenges for regulators to create such a regulatory framework facilitating account penetration. For example, regulators should carefully design the document requirements in a way that does not prevent people from opening an account in a financial institution by considering cautious safeguards related to money laundering. In the same way, regulators should strike a balance between providing incentives for the development of new technology that may pose systemic risk to the economy and maintaining financial stability. In this respect, a proportional approach to regulation that balances the costs and benefits of regulation relating to financial stability, integrity and inclusion can be an essential means for promoting financial inclusion. In the following pages, the potential positive effects of proportionality criteria applied to financial regulations on promoting account ownership is illustrated.

1. Proportionate Regulation and Anti-Money Laundering and Countering Financing of Terrorism (AML/CFL)

Disproportionate implementation of the AML/CFL regimes may have unintended consequences such as excluding individuals and legitimate businesses from the formal financial system. For example, the documentation requirements arising from money laundering regulations for opening an account may exclude workers in the rural or informal sector who are less likely to have wage slips or formal proof of residence. According to the 2014 Global Findex data base, 18% of unbanked respondents in the world cited the documentation requirements for opening an account as a key reason they did

¹¹ Ibid

not have a formal account. The Financial Action Task Force (FATF)¹² recognized that reinforcing financial inclusion and formal services to be secure and easy at a reasonable cost is important for any regime combating money laundering operations. In this respect, FATF overcame the adverse effects of documentation requirements on financial inclusion arising from money laundering regulations by abolishing documentation requirements imposed before 2012 which were required to be respected at all levels and by all financial sectors regardless of their size and the nature of the services provided as well as the risk volume they were exposed to. FATF's new requirements brings the application of proportionality principles into the implementation of the money laundering law. In accordance with these new requirements, when clients have a low-risk profile the regulator should have the option of allowing an exemption from AML/CFT controls for certain limited transactions and application of reduced or simplified customer due diligence procedures where appropriate. This is important as overly-strict AML/CFT rules can prevent unserved and underserved customers from accessing formal financial services and products and potentially increase the risk of money laundering and terrorist financing by shifting transactions to the informal economy¹³.

2. Proportionate Regulation and Remittances

Remittances play a key role for many Asia and the Pacific economies. East Asia and the Pacific is the top remittance recipient amongst all geographical regions. Remittances to this region are \$127 billion in 2015. India is the world's largest remittance recipient, attracting about \$69 billion in remittances in 2015. Other large recipients in 2015 were China and the Philippines with \$64 billion and \$28 billion respectively. Remittances are generally subject to AML/CFT regulations to prevent their misuse. However, badly designed regulations that are disproportionate to the problem they are designed to tackle can lead to unintended side effects. This leads to poor families in many parts of the world facing serious challenges including nutrition, access to health care and education. For example, major international banks continue to close their correspondent banking accounts in money transfer operators (MTO) to limit exposure to money laundering and other financial crimes. Between 2012 and 2014, 84 accounts of 32 Philippine remittance providers (including both banks and MTOs) were closed by 33 foreign banks in 13 major remittance-sending countries.¹⁴ It is for this reason that the 2007 Committee on Payments and Settlement Systems/World Bank called for remittance services to be supported by a proportionate legal and regulatory framework that is not overly restrictive and burdensome relative to the possible issues it is designed to tackle in relevant jurisdictions.

3. Proportionate Regulation and Innovation

New delivery technologies, such as mobile banking, no-frills bank deposits and agent banking, hold promise for promoting account penetration as they cut across various regulatory domains, including banking, telecommunications, payments systems, and anti-money laundering regimes. Further, with new technologies being increasingly deployed by financial institutions to reach unserved and underserved customers, the speed with which risk grows or concentrates in such institutions may be different from that historically observed in conventional banks. Therefore, the regulatory authority should be familiar with the risks of new delivery technologies to adequately assess these risks. However, in many cases, service providers are not banks (such as mobile network operators), which makes a consistent supervisory and regulatory approach more difficult. For example, in India, currently 27 private prepaid instrument providers that are not subject to prudential regulations are allowed to offer digital wallets up to a maximum of Rs50,000. However, many risks with regard to identification and monitoring of money laundering and financing of terrorism may arise from these

¹² FATF is an intergovernmental body aimed at combating money laundering, terrorist financing, and related threats to the integrity of the international financial system

¹³ The Basel Committee on regulation and supervision for financial inclusion, BBVA Research, Lucia Pacheco / David Tuesta, 2016

¹⁴ <http://www.worldbank.org/en/news/press-release/2016/04/13/remittances-to-developing-countries-edge-up-slightly-in-2015>

payment systems. One solution to overcome this problem can be to convert these prepaid instrument providers to payment banks to be subject to bank supervision.¹⁵

Many regulatory authorities are not familiar with the new delivery technologies. So, spending a lot of time and energy in developing a comprehensive framework without first observing and understanding risks and how the market is developing can result in an ill-tailored regulatory framework that does not cover material risks arising from these new technologies. Regulators should therefore immediately define the role of these new actors that was not previously subject to financial regulation and supervision. In this respect, a proportionate regulatory stance allows for experimentation and pilot testing of approaches that could promote financial inclusion. This stance also provides the necessary flexibility to determine and measure risks related to these products and find ways to manage those risks. For example, a “test and see” approach is seen as a more effective approach which allows regulatory authorities enough time to follow the market to identify perceived risks and to approve operations of these firms on ad hoc basis. In this way, regulations can be carefully tailored to market needs by fully considering the risks arising from new technologies. This approach was successfully used by the Philippines in preparing e-money regulations issued in 2009. But at the same time, such regulations should be created and implemented in a way that creates a level playing field between banks and nonbanks.

4. Proportionate Regulation and Consumer Protection Regulations

Since farmers, women, poor and low-income customers have little experience with formal financial institutions, they generally face challenges to understand the innovative products and services offered as well as their rights and responsibilities as financial consumers. Without basic protective measures, previously excluded and inexperienced consumers may be subject to abusive sales and collections practices and risk being sold products that do not fit their needs and may even be harmful. For example, the 2014 Global Findex data from the World Bank showed that 13% of adults without a formal account state lack of trust in banks as a reason for not having an account. A proportionate consumer protection regime can address the issue of trust by balancing between protective measures and the cost of these measures for financial institutions. In this context, a proportionate consumer protection regime is designed in a way that does not set the bar so high that responsible providers are dissuaded from entering the market or offering new services by tailoring regulation and supervision to the specific risks observed in the market.¹⁶ In particular, countries that have lower levels of regulatory and supervisory capacity should use the principle of proportionality in their regulations and supervisions, which requires careful prioritization of the most important risks observed and incremental phasing-in of consumer protection measures over time as markets and regulatory and supervisory capacity develop. Cambodia is a good example on how taking fairly simple first steps can lay the groundwork for fair, competitive, and efficient delivery of financial services. In Cambodia, little consumer protection regulation was in force which focused on basic protection. Then, the central bank took the step of prioritizing problems facing microloan customers such as transparent pricing and implementing simple rules on price calculation and disclosure.

In this context, as a first step, it is recommended that countries that have lower levels of regulatory and supervisory capacity should focus on basic protections, such as transparent pricing and fair treatment and avoid setting the consumer protection bar so high that responsible providers are dissuaded from entering the market¹⁷.

The development of consumer protection in the region varies from country to country. For example, in Japan, a consumer hotline for consumer protection established by the Financial Services Agency

¹⁵ Overview of Financial Inclusion, Regulation, and Education, Naoyuki Yoshino and Peter Morgan, 2016

¹⁶ Global Standard-Setting Bodies and Financial Inclusion for the Poor Toward Proportionate Standards and Guidance, CGAP, October 2011

¹⁷ Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance Laura Brix and Katharine McKee, 2010

provides a valuable source of information for the regulator. In Thailand, the Bank of Thailand opened its Financial Consumer Protection Center to inform consumers about their rights and responsibilities as consumers of financial services to reduce consumers falling prey to fraudulent practices, and to facilitate informed decision making by consumers. However, consumer protection programs seem less well developed in India, Indonesia, and the Philippines¹⁸.

D. RELATIONSHIP BETWEEN CREDIT ACCESS OF SMES AND FINANCIAL STABILITY

The business model of the banking sector is not appropriate to meet the full needs of financial services of low income populations because of the lack of credit history of poor people, rigid collateral requirements, low survival rates of SMEs and high transaction cost of small amount of credit, amongst others. For example, according to a survey of four countries, naming China, Republic of Korea, India and Malaysia, four major barriers of financial institutions regarding SMEs' access to finance were identified as the following; (i) collateral and guarantees as prerequisites for loans, (ii) complicated procedures to borrow money, (iii) a strict lending policy of financial institutions, and (iv) high lending rates.¹⁹ For these reasons, a new business model was designed to overcome these problems in providing financial services to poor people. The micro finance institutions (MFIs)²⁰ adopted this new business model relying on group lending and frequent personal interaction between borrowers and loan officers. However, this model also has some limitations in financing low income populations and SMEs such as lack of grace periods, frequent payments, and joint liability that may prevent investing in innovative areas thought to be risky.

Financial inclusion does not mean finance for all at all costs by avoiding all limitations arising from the credit process of MFIs and banks. Scholars have suggested both positive and negative ways that increased access to credit could affect financial stability. Some recent studies show that higher access to credit adversely affect banking stability without good quality of supervision and regulation. The adverse effect of expanding credit access on bank stability is more evident in countries with weaker bank supervision as measured by lower observance of the Basel Core Principles for Effective Banking Supervision (BCPs)²¹. This is because the redistribution of credit toward new borrower segments who are, on average, riskier clients may adversely affect the risk profile of bank lending in the presence of weak supervision. This situation is also valid for MFIs. If they are not properly regulated, an increase in lending by these groups could dilute the overall effectiveness of regulation in the economy and increase financial system risks²². Some examples, such as India illustrated in box 1, clearly shows that the expansion of credit without appropriate regulatory and prudential tools can lead to financial crises. However, other scholars suggest that increased lending to smaller firms leads to greater diversification of bank assets which could reduce the overall riskiness of a bank's loan portfolio²³.

¹⁸ Overview of Financial Inclusion, Regulation, and Education, Naoyuki Yoshino and Peter Morgan, ADB, 2016

¹⁹ Capital Market Financing for SMEs: A Growing Need in Emerging Asia, Shigehiro Shinozaki, 2014

²⁰ Microfinance institution is an organization that offers financial services to low income populations. While almost all give loans to their members, many offer insurance, deposit and other services. For-profit MFIs are referred to as Non-Banking Financial Companies (NBFC)

²¹ Ratna Sahay, et al. 2015. Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?

²² Financial Stability and Financial Inclusion, Peter J. Morgan, Victor Pontines, ADB, 2014

²³ Khan, H. R. 2011. Financial Inclusion and Financial Stability: Are They Two Sides of the Same Coin? Address given at BANCON 2011. Chennai. 4–6 November.

Box 1: Microfinance Sector Crisis In India²⁴

In October 2010, the microfinance sector in India's Andhra Pradesh state was in the middle of a major crisis. An analysis shows that the roots of the crisis were in the rapid rise of loans disbursed by specialized MFIs since the late 1990s. The liberalization of India's economy and its financial sector after 1991 changed the composition of lending: credit from the private sector (especially MFIs and nonbank financial institutions) rapidly rose, even as the state remained a driving force in the background. Evidence suggests that the expansion of Indian microfinance did have some—relatively limited—impacts. At the same time, the spectacular growth and profitability of Indian MFIs in many cases also led to multiple borrowing and excessive indebtedness among low-income clients. While India's MFI crisis had its roots in the rapid and, at times, insufficiently regulated growth of MFIs, there were also other factors that contributed to the crisis. First, the development of an appropriate institutional infrastructure lagged behind the rapid growth of the MFI sector. This is particularly true for the establishment of reliable credit reporting systems for MFI borrowers that could have limited problems of overindebtedness and of borrowing from multiple lenders. These problems were aggravated by the absence of well-functioning personal bankruptcy laws that could have allowed for the orderly discharge of excessive debts. Second, the MFI sector faced competition from grossly subsidized state government programs that extended credit to borrowers at the bottom of the pyramid under soft conditions, and this arguably contributed to problems of overindebtedness and moral hazard in loan repayment. Finally, the sector was affected by overt political interventions in the credit market: state governments encouraged MFI clients to stop repaying their loans ahead of elections. Hence, the Indian case illustrates how the rapid growth of low documentation lending is particularly problematic in environments with an insufficiently developed legal and institutional framework and environments in which political interventions in the credit market are common

Furthermore, some studies also suggest that while microcredit has significantly positive welfare effects if used as a means for consumption smoothing and risk management, the effects of microfinance on investment and entrepreneurship are relatively small²⁵. For example, in Mongolia, about half of all microcredit business loans are used for the purchase of domestic appliances by the household²⁶. Therefore, the economic benefits of financial access to credit need to be carefully evaluated by considering their effects on both consumption smoothing and investment.

In this context, while Figure 4 shows that there is little correlation between the share of SMEs obtaining finance and bank NPLs, Figure 5 illustrates that the correlation is positive between share of SMEs obtaining finance and per capita GDP. This implies that the possible benefits of developing access to credit of SMEs are more than the possible costs of it in the region. Countries should therefore focus on eliminating barriers that limits their financial institutions from extending credit to SMEs. These limitations can be divided into three categories, namely market-driven factors, regulatory factors, and infrastructure limitations. In section E, we only consider regulatory barriers.

²⁴ Global Financial Development Report, Financial Inclusion, World bank ,2014

²⁵ Ibid

²⁶ Ibid

Figure 4. Bank NPLs and the Share of SMEs in Total Commercial Bank Loans²⁷

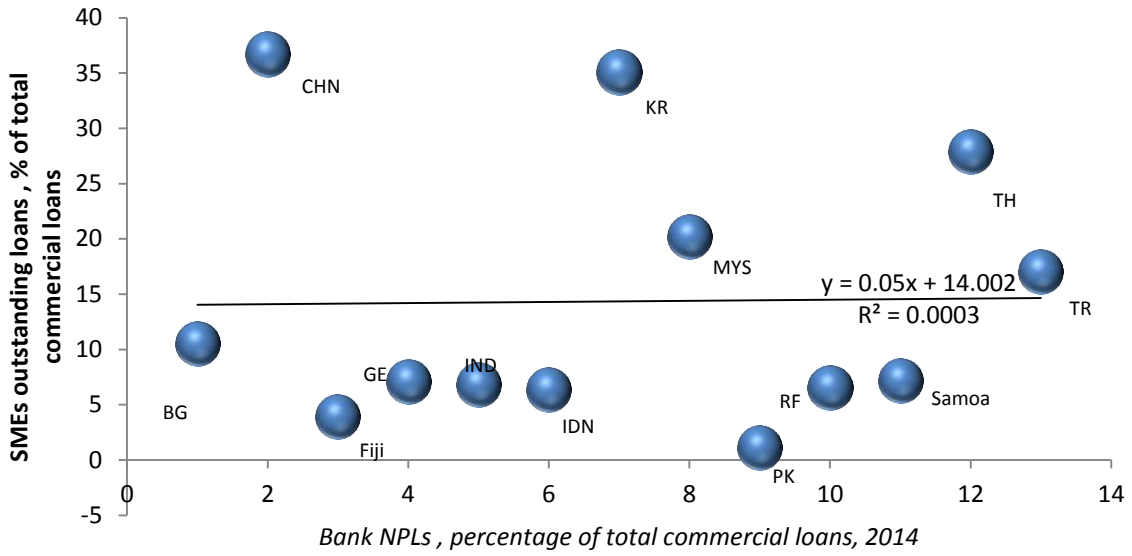
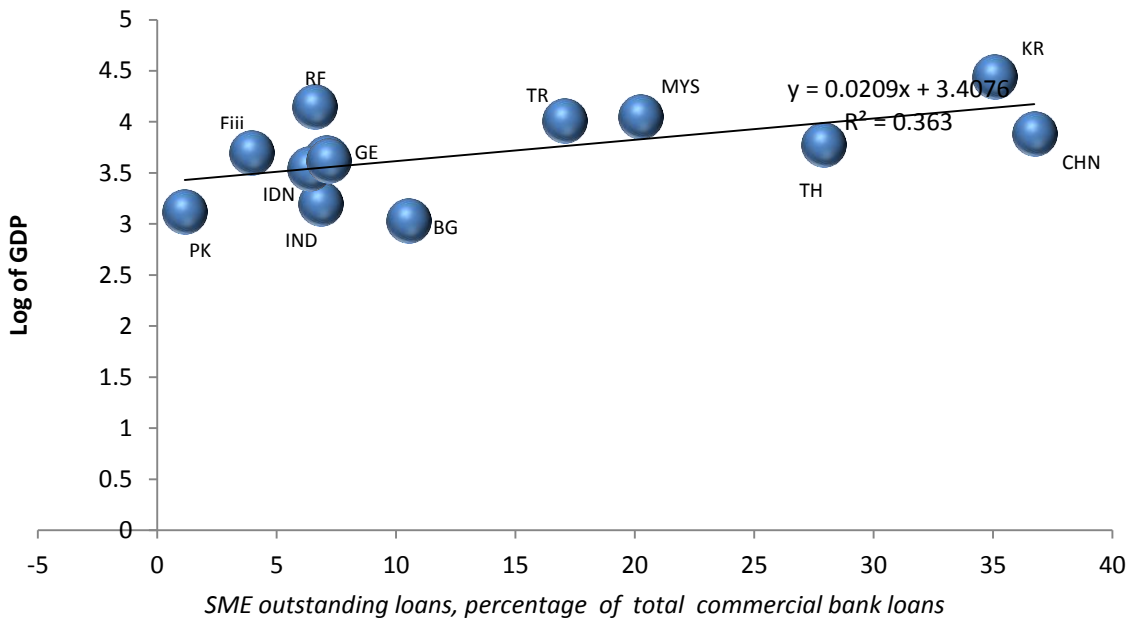


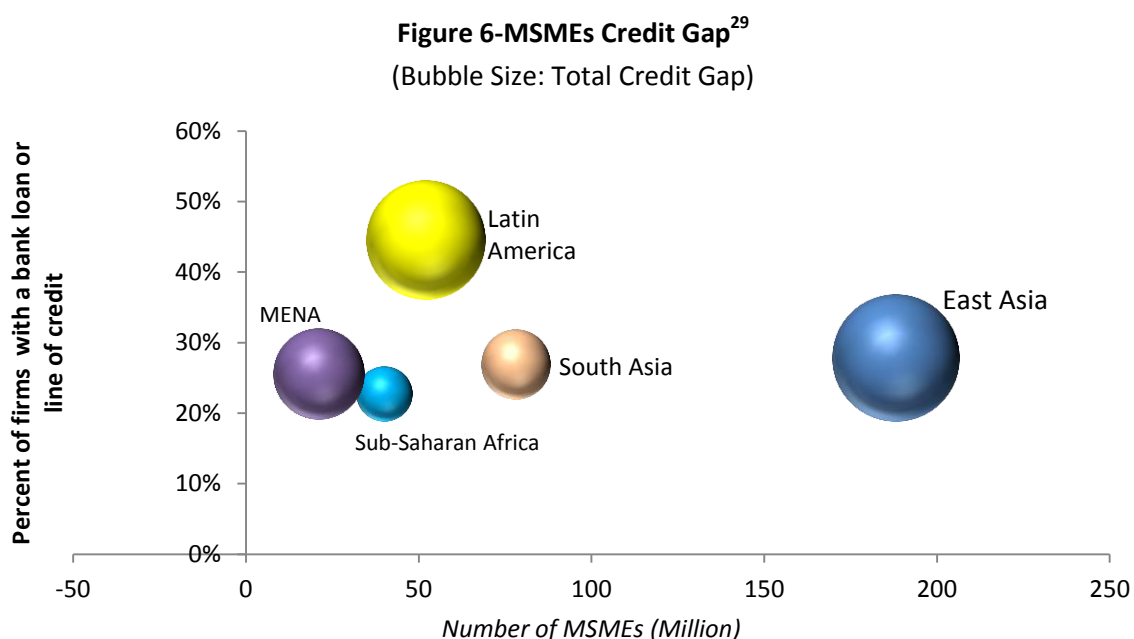
Figure 5. Log of GDP Versus SME Outstanding Loans, 2014



²⁷ MYS: Malaysia, CHN: China, IND: India, IDN: Indonesia, RF: Russian Federation, KR: Republic of Korea, PK: Pakistan, BG: Bangladesh, GE: Georgia, TR: Turkey, TH: Thailand

1. Trends in Access to Credit and Capital Market Financing in Asia and Pacific

The total credit gap²⁸ for micro, small, and medium-sized enterprises (MSMEs) was the largest in East Asia with the most number of MSMEs as compared to other regions (Figure 6). Among the regions, Asian SMEs have especially poor access to credit. Less than 15% of Asian SMEs have bank credit lines, compared to 24% in Latin America and 28% in Central Asia and Eastern Europe. The percentages of MSMEs that have a loan or an overdraft, compared to all MSMEs in need of finance, are only 9% and 7% in East and South Asia respectively.



These current gaps are significant, and they do not seem to be overcome with a group-lending or small-loan approach by lenders. Overall, Asian banks consider lending to SME customers as being of a higher cost and a higher risk as compared to lending to large, often state-owned enterprises³⁰.

For low-income countries, microfinance and funding from non-bank companies are more prevalent than bank credit for MSMEs. In these countries, most SMEs rely on their own capital and informal lending bodies for their business operations. However, for lower middle-income countries, equity finance options for SMEs are also available besides banks and non-bank financing. Bank lending availability is more prevalent in the upper middle-income or high-income countries. (Figure 7). However, although leasing and factoring are typically part of the operations of banks or their subsidiaries across all countries, these industries have yet to be well developed in Asia³¹. When considering that the bank-centered financial systems could not solve the supply-demand gap in lending of small and medium-sized enterprise (SMEs), it is certain that the diversification of financing modalities beyond conventional bank lending is better to serve the financing needs of SMEs.

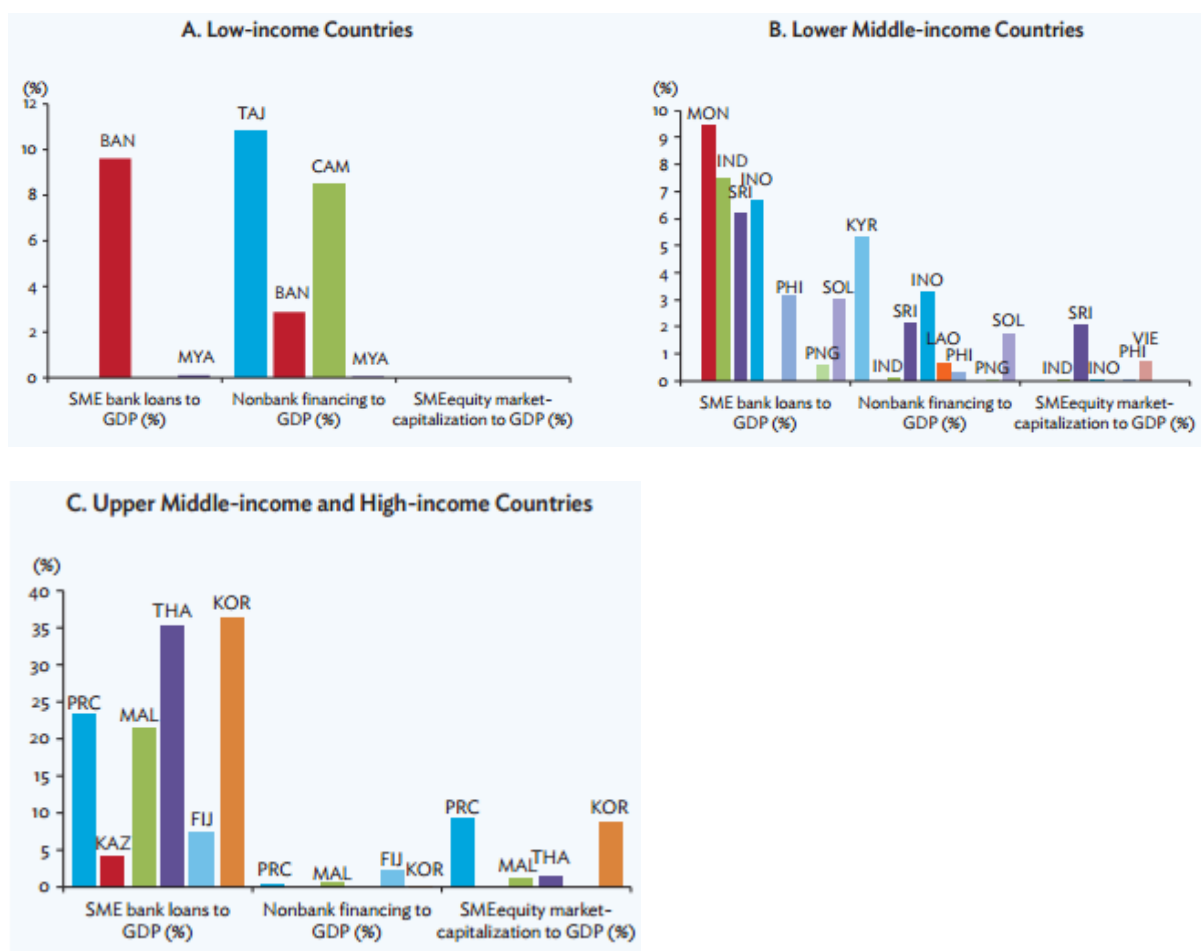
²⁸ Credit gap refers to the difference between the actual credit extended and the total credit needed by MSMEs

²⁹ <http://smefinanceforum.org/data-sites/ifc-enterprise-finance-gap>

³⁰ Asia Finance Monitor ADB, 2014

³¹ Asia SME Finance Monitor ADB, 2014.

Figure 7-SME Access to Finance³²



E. FINANCIAL REGULATORY FRAMEWORK CHALLENGES IN PROMOTING ACCESS TO CREDIT AND CAPITAL MARKET FINANCING

1. Banks

Although Basel frameworks are prepared for international banks, most countries apply these rules to their local banks. There are three types of Basel Regulatory Frameworks implemented by countries, named Basel I, II and III. Since Basel I was criticized for not being risk-sensitive, Basel II that is more risk sensitive than Basel I was developed. However, global financial crises demonstrated that Basel II rules do not work as intended. For example, regulatory capital calculated under Basel II could not absorb losses well enough. So, Basel III introduced a new capital definition and liquidity and leverage ratios and increased risk weights for some assets in the calculation of the capital adequacy ratio.

While Basel I consists of only Pillar I, Basel II and III are structured around three pillars. Pillar I illustrates how the minimum capital requirements should be calculated for what a bank must hold to cover its exposure to credit, market and operational risk. On the other hand, since the Pillar I

³²Ibid.

BAN = Bangladesh, CAM = Cambodia, PRC = China, FUJ = Fiji, IND = India, INO = Indonesia, KAZ = Kazakhstan, KOR = Republic of Korea, KYR = Kyrgyz Republic, LAO = Lao PDR, MAL = Malaysia, MON = Mongolia, MYA = Myanmar, PHI = Philippines, PNG = Papua New Guinea, SME = small and medium-sized enterprise, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, VIE = Viet Nam.

Nonbank financing refers to microfinance institutions, finance companies, credit unions, leasing, factoring, and venture capital investments.

SME equity markets refer to SME exchanges in BSE & NSE (IND), Diri Savi/CSE (SRI), IDX (INO [10 SMEs listed]), SME Board/PSE (PHI), UPCoM (VIE), SME Board & ChiNext/SZSE (PRC), ACE (MAL), mai (THA), and KOSDAQ/KRX (KOR)

approach is unlikely to cover the entirety of risk exposures, such as credit risk concentration or reputational risk, the second pillar of the framework was developed to fill this gap. Pillar II is concerned with supervision reviews that aim to ensure that a bank's capital level is sufficient to cover its overall risk. Since credit risk concentration or reputational risk is difficult to quantify, Pillar II includes more qualitative provisions than Pillar I and requires using supervisory judgment to measure such risks. In accordance with the Pillar II framework, the supervisory authority has a chance to differentiate regulatory prudential limits where appropriate, and apply criteria of materiality in order to determine the applicability or otherwise of particular rules to different classes of institutions.

However, most of the low income countries implement Basel I, which does not include Pillar II. For this reason, they do not have a chance to differentiate prudential limits for their different classes of institutions by using Pillar II tools of the Basel framework. These countries can overcome this problem by migrating to a risk-based supervision approach that entails a departure from 'one-size-fits-all' requirements applied uniformly to all banks regardless of their size or risk profiles.

Meanwhile, Pillar III relates to details of minimum levels of public disclosure.

i. Proportionality and Basel Accords

Money put aside for regulatory capital against credit, operational and market risks and for liquidity risk is a bank's most expensive resource. That is why the Basel Accords are seen as one of the most important causes of high interest rates and rigid collateral requirements applied on credits by banks. There are certain arguments about the adverse effects of the Basel regime on access to credit. For example, the Basel risk-weighting approach in fact encourages portfolio concentrations in low-weighted assets such as government bonds and lending between banks. This is because risk weighting for assets is skewed in favor of sovereign debt and lending between banks, which have a risk weighting of 0% (if rated AAA). This could generate a crowding-out effect on private loans, as banks are encouraged to lend to governments or other banks rather than to private enterprises. The weighting system also favors many large enterprises over small ones; large companies with good external credit ratings (AAA) are assigned a 20% risk weight, whereas SMEs that are unrated have risk weightings of 100% or 75%. In this situation under Basel III, the difference in core Tier 1 capital the bank needs to hold against their loans is remarkable: 7% of the loan for SMEs with 100% risk weighting, as opposed to 1.4% (7.0% x 20.0%) for a large company with an AAA rating. Like the risk-weighting system, the liquidity coverage ratio could also push banks to reduce their liquidity risks by shortening the length of maturity of their financing to match with their maturity of liabilities and holding a higher share of cash, which can lead to a crowding-out effect on private loans, particularly to SMEs.

To avoid these concerns and facilitate credit access, the Pillar I framework can be tailored by regulatory authorities to be less burdensome, more proportionate and more fit-for-purpose by differentiating regulatory prudential limits, where appropriate, for different classes of institutions in accordance with the Pillar II framework. For example, to prevent portfolio concentration in low-weighted assets (sovereign debt) and encourage banks to extend credit to private firms or SMEs, supervisors can differentiate capital requirements for banks having portfolio concentration by applying capital add-on requirements³³ in accordance with pillar II. But the difficulty in implementing Pillar II is consistency across the various components of the prudential regulations. Thus, implementation of Pillar II requires well qualified supervisors who have an ability to use their judgment to tailor the prudential regulations to different classes of institutions.

In all these respects, proportionality, if applied correctly, can enhance the effectiveness and efficiency of the prudential regime and increase the credit access of SMEs and poor people. On the

³³ Capital add-on requirement refers to that capital adequacy ratio (CAR) of this bank can be increased in accordance with capital add-on requirement in case that bank's CAR does not include material risks that bank faces such as credit concentration or reputational risk.

other hand, this approach can also be misused as a step back from the post-crisis commitment to high standards of prudence, or relaxation of the new regime if the supervisory authority does not have operational independence, skilled staff, accountability, clear strategy and robust internal organization that ensure urgent action to be taken where necessary.

ii. Proportionality and Basel Core Principles for Effective Banking Supervision³⁴

Disproportionate prudential regulatory ratios, such as capital adequacy ratio and liquidity ratio, are not the only barriers that adversely affect access to credit. Other disproportionate regulations regarding the opening of branches or ATMs may also restrict SMEs in accessing credit in remote areas. For example, between the 1970s and the 1990s, India's bank branching regulations that required banks to open four branches in unbanked locations for every new branch opened in an urban area led to high default rates among rural branches. This program therefore was ended in 1991³⁵. This example clearly shows why regulatory authorities should prepare regulations that create optimal institutional design for safety and soundness. In this respect, Basel Core Principles (BCPs) can be used by countries as a benchmark for assessing the quality and effectiveness of their legislative, regulatory and supervisory frameworks to prevent the adverse consequences of design regulations such as India's bank branching regulations. For example, "Guidance on the application of the BCPs relevant to financial inclusion issued by Bank For International Settlement" recommends using a graduated set of licensing criteria commensurate with the permissible activities of financial institutions. In this way, this criteria leads to unregulated financial institutions upgrading their quality of management, governance and operations, and becoming regulated and supervised institutions within a planned process.

BCPs are intentionally high-level and principles-based in nature. Therefore each jurisdiction should exercise sound discretion to tailor the application of the BCPs to its own domestic context. They are also adopted by the International Monetary Fund (IMF) and the World Bank as the basis to assess the effectiveness of a country's bank supervisory system under the Financial Sector Assessment Program (FSAP). Under the criteria of BCPs, the concept of proportionality is frequently referenced. From the perspective of individual banks, the notion of proportionality would require that actions taken or prudential requirements imposed are tailored to the risk profile and systemic importance of a particular bank. At a broader level, expectations under the BCPs would also have to be proportionate to the environment in which the bank operates. For instance, the application of the BCPs should take into account a country's level of economic development and the complexity of its financial system. In this respect, all criteria of BCPs including proportionality should be utilized by regulatory authorities in tailoring and implementing the Basel Regulatory Frameworks (Basel I,II and III) for their banks. However, most of the regulatory authorities, particularly in low income countries, do not have adequate capacities to tailor and implement their Basel Regulatory Framework in accordance with high-level principles of BCPs.

2. Micro Lending³⁶

An effective credit information system that includes the full range of bank and non-bank lenders serving different market segments, including the unserved and underserved, is critical for preventing overindebtedness. In many countries, while microlenders (particularly banks) extend large numbers of very small loans based on credit scoring, they use alternative client information often provided by third parties, such as bill payment history, nonfinancial data from social media, mobile phone usage and big data analytics. However, the problem is that there is not yet enough experience to make a

³⁴ BCPs that are different from Basel Regulatory Framework (Basel I,II and III) refer to criteria and principles that illustrate how any regulatory frameworks besides Basel I, II and III should be implemented in a jurisdiction (For example, BCPs have also made reference to money laundering regulatory framework or licensing of financial institutions and accounting standards) BCPs consist of 29 high-level principles regarding the implementation of prudential regulations.

³⁵ Global Financial Development Report, Financial Inclusion, World bank, 2014

³⁶ The lending of very small amounts of money at low interest, especially to SMEs, start-up company or self-employed person

general statement on whether these loans are closer to consumer loans in terms of risk management methodologies. It is therefore difficult to analyze whether risk management methodologies including credit scoring are closer to consumer loans or newer alternative credit scoring and screening techniques should be developed for these lending³⁷.

Identification and other documentation requirements are important in the credit assessment process but these requirements can also pose problems for SMEs in countries that do not have universal individual identification systems. Lack of reliable information on the identities and credit histories of borrowers generally leads to higher collateral requirements and engaging in the costly screening of borrowers prior to approval, or refusal to lend to certain segments of the borrower population altogether. Most developed economies have national identification systems that make it easy to identify borrowers uniquely and track individual credit histories. But this is a challenge in many less developed countries where no universal identification system exists. This makes lenders reluctant to provide financial services and credit to new clients. MFIs have traditionally addressed this problem by relying on group lending and frequent personal interaction between borrowers and loan officers. However, until now, the volume of microlending has not been enough to support microenterprise investment and firm growth due to the stiff repayment requirements and joint liability that can discourage investment, especially innovative investments. According to this system, group members have to pay more if a fellow borrower makes a risky investment that goes bad, but they do not enjoy a share of the profits if the investment yields returns.

The adverse effects of identification and other documentation requirements on collateral requirements can be avoided to some degree by the introduction of movable collateral registries that have potential to increase firms' access to finance by allowing them to leverage movable assets, such as inventory, crops and equipment, into capital for investment and growth. For example, law reform and new centralized online registry for movable assets launched in March 2012 in Vietnam. After 18 months of operation of the new registry, 170,000 new loans with a value of \$2.5 billion were registered and 340,000 searches conducted. It is estimated that around 90,000 SMEs have received loans³⁸.

A credit guarantee system can also unlock extra financing for SMEs. But, although many countries in Asia established credit guarantee systems, SME access to guarantees is still being restricted, except in Japan and the Republic of Korea. While more than one-third of the total MSMEs were able to obtain guarantees for loans in Japan (36.7%) and the Republic of Korea (35.8%), it was on average 3.7% of MSMEs in other Asian countries. To have an effective credit guarantee system, first of all, SME data infrastructure should be established. Then, a comprehensive policy and regulatory framework on credit guarantees should be well-designed to avoid market distortions and to facilitate innovative products, given the industry's public nature in Asia³⁹. The main problem related to credit guarantee system regulation is that they include very strict requirements for SMEs that prevent them from applying this guarantee system. Financial institutions are also hesitant to extend credits to SMEs providing guarantees through this system in some countries because governments generally pay cash to financial institutions very late in case the credit of SMEs are in default. Therefore conditions and date of refunds paid by governments should be clearly designed in credit guarantees system regulation.

³⁷ Guidance the application of the BCPs relevant to financial inclusion issued by Bank For International Settlement, BIS, 2016

³⁸ IFC's Secured Transactions and Collateral Registries Program "Results Framework: Methods and Findings" Access to Finance, IFC, Alejandro Alvarez de la Campa Global Product Leader STCR, 2013

³⁹ ADB–OECD Study on Enhancing Financial Accessibility for SMEs Lessons from Recent Crises, ADB, 2014

3. Micro Finance Institutions

In many countries micro finance institutions are governed by regulatory and supervisory frameworks developed for banking sectors. Therefore, it does not fully take account of the special nature of micro lending. For example, many countries in the region do not have separate and explicit licensing regimes for MFIs. Furthermore, there are different types of MFIs institutions in countries that lead to inconsistencies and gaps. For example, in Indonesia, there are many kinds of MFIs with overlapping regulations, coverage, and responsibilities that make it difficult for the monetary authority and government to evaluate and control the development of microfinance in the country. Therefore many semiformal and informal institutions have an unclear legal status in the financial system. In Thailand, financial institutions in the semiformal group are also not regulated by financial authorities, such as the Bank of Thailand or Ministry of Finance, and many operate under non prudential regulations or no regulations at all.⁴⁰ However, a proportionate approach to licensing that applies less stringent licensing criteria and procedures for non-bank financial institutions including MFIs than for banking sector should include all deposit taking institutions. In addition, regulatory authorities should also regularly monitor registered but not licensed non-bank financial institutions to identify whether they are required to apply a licensing approach by considering if they pose individually or collectively risks that become material. For this reason, it can be better to create a specific regulator for MFIs institutions (non-bank institutions) that fully considers the special nature of micro lending to conduct these supervisory activities. One regulatory authority responsible for supervising the whole financial sector may lead to inefficiencies and diseconomies of scale originating from the competition for resources among the different regulatory functions, such as banking, insurance and securities, which could result in circumstances in which regulators choose to focus on the banking sector or other sectors at the expense of MFIs sectors. For example, Sri Lanka is planning to establish the Microfinance Regulatory and Supervisory Authority that will be responsible for licensing, regulating, and supervising all NGO MFIs and cooperatives engaged in microfinance. This is expected to have significant positive effects for the development of Sri Lanka's microfinance sector. It seems that more countries are considering a similar explicit licensing regime for MFIs to promote efficiency in the sector.⁴¹

4. Regulatory Frameworks for Fintech

FinTech—particularly those startups that deal in consumer lending, payments processing, and commercial lending— is seen as one of the most promising industries in recent years. Goldman Sachs has estimated that FinTech could eventually absorb as much as \$4.7 billion in annual revenue from the traditional financial services players.

The FinTech sector currently enjoys a lighter level of regulation than more traditional financial services providers. This is because the regulatory framework still is not very clear for FinTech companies. Regulators do not know how to regulate these firms and what to do with them when they cross their desks. For example, although capital requirement regulation makes sense for banks to prevent them from taking on too much risk, these requirements do not exactly make sense for FinTech. Capital of peer-to-peer providers (FinTech Company) only really exists in the form of the loans it intermediates between individual lenders and borrowers. On the other hand, these companies pose cyber and security risks which have the potential to distort financial stability. In this respect, there is not much more clarity for regulators to address whether a peer-to-peer provider is a bank or simply a platform or digital service.

While these companies can easily reach a global customer base, banks are limited by different (and in some cases, conflicting) standards between countries and jurisdictions. In this respect, many larger financial services are concerned that FinTech start-ups still are not subject to the same rules as the traditional banking sector. Therefore FinTech companies can easily beat the banks at their

⁴⁰ Overview of Financial Inclusion, Regulation, and Education, Naoyuki Yoshino and Peter Morgan, 2016

⁴¹ Ibid

own game at the moment. In this context, it is very clear that there is a need for regulation in this area that should create a level playing field between FinTech and banks.

In sum, the Asia and the Pacific regulatory landscape is behind other major Fintech regions such as the United Kingdom and European Union in certain segments. These regions already have established some Fintech regulatory policies. The banking regulatory authority of the United States (The Office of the Comptroller of the Currency-OCC) declared last year that it will start accepting applications from Fintech companies for a special charter that would formally subject them to federal banking rules. However, there are some concerns about Fintech companies being subject to bank regulations. One of the important concerns is that most of the regulatory authorities have no experience of regulating Fintech financial institutions. The “test and see” approach used in creating a new regulation can be utilized by regulatory authorities in order to not stifle innovation while maintaining financial stability.

5. Islamic Finance and Financial Inclusion

Islamic finance has the potential for further increasing financial inclusion in at least two dimensions. First, it promises to foster greater financial inclusion, especially of large underserved Muslim populations. Second, it could provide support for small and medium-sized enterprises by its asset-backed financing, including the risk-sharing feature⁴².

Many Muslim-headed households and MSMEs may voluntarily exclude themselves from formal financial markets because most conventional financial services are not fit for religiously minded Muslim individuals and firms in need of financing. On the other hand, when taking into account that about 700 million of the world’s poor live in predominantly Muslim-populated countries, strengthening the linkage of microfinance with Islamic finance would help further increase access to finance. Furthermore, the principles of risk-sharing and the strong link of credit to collateral makes Islamic banking well-suited to the financing of MSMEs and startups, thereby contributing to more inclusive growth. Also Islamic finance is inherently less prone to crisis because its principles of risk-sharing and linking finance to the real economy reduces leverage and encourages better risk management on the part of both financial institutions and their customers. The prohibition of using derivative instruments for speculation would also produce a relatively resilient and stable financial system.

However, since Islamic finance faces a number of challenges, much of the potential of the industry remains to be exploited. For example, although Islamic standard-setting bodies⁴³ have developed a wide range of technical standards and guidance notes, these standards are applied only in a limited number of countries⁴⁴. In many countries the industry is still governed by a regulatory and supervisory framework developed for conventional finance. Most of the time, the special nature of Islam is not considered by the national authorities, which creates additional uncertainty for Islamic finance customers leading to them voluntarily excluding themselves from formal financial markets. Furthermore, different regulations implemented in different jurisdictions also leads to regulatory arbitrage across borders. For example, while the chosen Basel capital framework applies to all banks including Islamic banks in Kazakhstan, the Basel capital framework is tailored according to IFSB prudential standards and guiding principles to cater to certain Islamic Banking features in Malaysia. In this respect, the dialogue between Islamic standard setters and national regulators should be enhanced to increase regulatory clarity for customers and to ensure a level playing field with other jurisdictions.

Islamic banks tend to hold high levels of liquidity due to the absence of Shari’ah-compliant deposit insurance. However, they suffer from a lack of well-developed markets for diverse Shari’ah-

⁴² Islamic Finance: Opportunities, Challenges, and Policy Options, Alfred Kammer and others, 2015

⁴³ Islamic standard-setting bodies refer to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), And the the Islamic Financial Services Board (IFSB).

⁴⁴ Ibid

compliant, high-quality liquid assets. This tends to force many Islamic banks to reduce their liquidity risks by shortening the length of maturity of their financing to match with their maturity of liabilities as well as holding a higher share of cash, which can generate a crowding-out effect on private loans, particularly to SMEs. To relieve the adverse effects of this liquidity shortage, regulatory authorities should create a liquidity coverage ratio framework at a pace that is proportionate with local systemic risks.

While the complexity of some Islamic bank contracts makes it difficult for consumers to fully understand the risks, some other contracts, such as *Ijārah Muntahia Bittamlīk* or “lease-to-purchase”, places consumers at a disadvantage. For example, clients who default before the end of the contract term could lose the equity that they have built, and they cannot take advantage of capital gains to prepay the mortgage. Therefore, national authorities should develop and implement a consumer protection framework that caters to the specific character of Islamic finance, improves financial literacy, and strengthens bankruptcy and insolvency regimes⁴⁵. However, implementation is highly uneven across countries in the region. The 2014 World Bank Global Survey shows that while not all countries have enacted consumer protection laws, among those that have enacted laws, the regulations in most cases are either not consistently applied or not enforced. For example, very few countries, such as Malaysia, provide explicit guidance for Islamic financial products in their consumer protection regulations. Some countries such as Pakistan and Bangladesh have issued guidelines on calculation of profits by Islamic banks but for many others the rules do not include such these guidelines⁴⁶. In this respect, much more progress should be made with respect to integrating consumer protection issues that are specific to Islamic finance.

6. Capital Market Financing

Capital market financing for SMEs requires more sophisticated and innovative institutional arrangements in order to respond effectively to their real needs. This is because, first, they differ by sector and by size. Second, SMEs, especially start-ups, tend to have a lower probability of survival than larger firms. This uncertain economic circumstance of SMEs leads financial institutions to regard them as being inherently riskier loan prospects than larger firms. In this respect, to meet the long term funds needs of SMEs, SME capital markets should be established. However, SME capital markets are still in the early stages of development in Asia where the financial system is dominated by banking sector.

Generally, SME capital markets are subject to the same baseline laws and regulations as general capital markets are. Under the control of uniform capital market laws and regulations, the responsible regulator (e.g., Securities Commission) provides some special rules, guidelines, and regulations on SME markets. For example, the listing criteria and the disclosure requirements for SME markets in the region are widely lighter as compared with the main board of the stock exchange⁴⁷. However, if these special rules are not created in a way that is commensurate with the funding needs and risk structures of SMEs that want to raise small funds from limited investors, they can lead to uncontrolled expansion of funding from stock or bond markets or prevention of SMEs’ access to capital markets. For example, the minimum number of shareholders in a stock offering and the maintenance of stocks implemented under the baseline laws may not fit the funding needs of SMEs⁴⁸. In this context, to develop SME capital markets in the region, separate and flexible regulatory frameworks different from baseline laws and regulations that consider financial stability is needed. The “test and see” approach seems to be the most optimal approach in creating such a regulation framework for SME capital markets.

⁴⁵ Islamic Finance: Opportunities, Challenges, and Policy Options, Alfred Kammer and Others, 2015

⁴⁶ Islamic Finance, Consumer Protection, and Financial Stability, Inutu Lukonga, IMF, 2015

⁴⁷ Capital Market Financing for SMEs: A Growing Need in Emerging Asia, Shigehiro Shinozaki, ADB, 2014

⁴⁸ Ibid

F. CONCLUSION

Financial inclusion is the key to inclusive growth with its motto of reduction of poverty and strengthening shared prosperity. Increasing credit access and account penetration also do not seem to impact financial stability adversely (Figure 1 and 4). Therefore, these services can be promoted from a financial stability perspective in accordance with appropriate regulatory framework. However, the region is home to more than half the world's unbanked adults and the total credit gap for MSMEs is the largest in Asia, particularly in East Asia, with the most number of MSMEs, when comparing to other regions. This implies that there are numerous barriers to achieve sustainable financial inclusion in the region. Most of these barriers can be overcome by a well-designed regulatory framework. But, there are some challenges for regulators to create such a regulatory framework. For example, if regulation is disproportionate in relation to its objectives that balance the development of financial inclusion and maintaining financial stability, this disproportionate regulation may generate wider costs on the economy by inhibiting financial institutions from providing finance to the real economy or leading to excessive indebtedness among low-income clients. In this respect, a proportional approach to regulation has great potential to enhance the effectiveness and efficiency of the prudential regimes that will enhance the development of financial inclusion in the region.

However, proportionate regulation calls for a cultural change on the part of financial regulators because it requires adjusting prudential norms according to the risk profile and systemic importance of particular banks or micro finance institutions, at a broader level, in the environment in which the financial institutions operate. In this context, to create and implement proportionate regulation, regulatory authorities should have operational independence, skilled staff, accountability, clear strategy and robust internal organization that ensures urgent action to be taken where necessary. For these reasons, providing capacity building programs in preparation and implementation of proportional regulations in low income countries is critical. To adapt their current culture to implementation of a proportional approach, regulatory authorities can establish within their organisations semi-autonomous "Proportionality Review Groups" accountable directly to the Chair and Chief Executive of the authority, which should be consulted at an early stage and become an integral part of the process when new regulations are being proposed, in addition to making regular reports to the Chair and Chief Executive⁴⁹.

FinTech companies have a promising role in development of financial inclusion. However, although these firms pose cyber and security risks that have potential to distort financial stability, there is not much clarity for regulators to address that whether these firms are a bank or simply a platform or digital service. In this respect, the "test and see" approach used in creating new regulations can be utilized by regulatory authorities to develop appropriate regulations for these firms.

In these contexts, establishing a high-level regional task force can promote financial inclusion in low income countries, which will serve a regional platform for sharing best practices, capacity building and advisory services on the regulatory issues within the concept of proportionality in the financial industry.

Islamic finance is well suited for financial inclusion. Many Muslim-headed households and MSMEs voluntarily still exclude themselves from formal financial markets because in many countries the industry is still governed by a regulatory and supervisory framework developed for conventional finance. This creates additional uncertainty for Islamic finance customers leading to voluntarily excluding themselves. Different regulations implemented in different jurisdictions also leads to regulatory arbitrage across borders. For example, although Islamic standard-setting bodies have developed a wide range of technical standards and guidance notes, these standards are applied only in a limited number of countries. In this respect, the dialogue between Islamic standard setters and

⁴⁹ <http://www.wsbi-esbg.org/press/latest-news/Pages/Why-proportionality-in-bank-regulation-is-needed.aspx>

national regulators should be enhanced to increase regulatory clarity for customers and to ensure a level playing field with other jurisdictions.

Last but not least, many SME capital markets are subject to the same baseline laws and regulations as general capital markets are. However, this regulatory approach can reduce chances of SMEs accessing capital markets if regulations are not created in a way that is commensurate with the funding needs and risk structures of SMEs. In this context, developing SMEs capital markets in the region requires separate and flexible regulatory framework different from baseline laws and regulations that consider financial stability. The “test and see” approach seems to be the most optimal approach in creating such a regulation framework for SME capital markets.

