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# Framing the Issues: Financial-Sector Development and Expanding Access to Credit in Myanmar

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# INTRODUCTION

With a population of 53 million people, favorable demographics, a rich history of commerce in an enviable trading location, and a democratically elected government with a mandate for change, Myanmar possesses many of the fundamental prerequisites for dynamic, private-sector-led growth. Fundamental to private-sector led growth, though, is access to credit, and fundamental to access to credit are both a resilient, well-functioning banking sector and vibrant capital markets. As such, the new government of Myanmar is trying to establish macroeconomic stability, strengthen the banking sector, develop capital markets, and improve financial inclusion in the formal sector, all of which will help the economy of Myanmar better allocate capital to those who can use it productively.

As part of this effort, on July 26, 2017, the Myanmar Development Institute partnered with the Milken Institute Center for Financial Markets to host a day-long, strategic roundtable in Yangon on developing Myanmar's financial markets. The roundtable convened senior financial-market regulators, executives from domestic commercial banks, financial-sector experts from development partners working in Myanmar, and academic and practitioner experts from throughout the Asia-Pacific region.

The discussion covered the fundamental pillars for developing a robust financial ecosystem, including the fiscal and monetary policy environment, the legal and regulatory environment, banking-sector reforms, and some of the critical steps for money market and capital market development. The fundamental goal of the discussion was to explore ways in which Myanmar can enhance the financial stability of the banking sector while also dramatically improving both the flow of credit to the SME sector and the financial inclusion of Myanmar's citizens.

This report summarizes the discussion. It reflects broad roundtable consensus around a number of fundamental ideas, clarifies areas of disagreement or differences in perspective, and highlights the many innovative ideas discussed.<sup>1</sup> Boxes highlight examples from Myanmar, as well as case studies from other jurisdictions introduced by experts.

<sup>1</sup> To encourage an open discussion, the roundtable was held under the “Chatham House rule,” and so the specific identity and affiliation of speakers are not identified in this report. A list of those participants who agreed to have their names published appears at the end of this report. Inclusion in this list does not necessarily mean these participants have committed themselves to all ideas and recommendations included in this summary of the roundtable discussion. Several participants have asked to remain unidentified.

## THE REPORT IS ORGANIZED AS FOLLOWS:

- **The importance of macroeconomic fundamentals.** Stabilization priorities, the interest rate regime, and the ways in which budget deficit dynamics impact monetary policymaking and the development of capital markets.
- **Critical reforms to increase bank lending to the SME sector.** Reforms to enable balance sheet expansion (through both retained earnings and liability increases), reforms to the interest rate environment, and the need to move from a collateral-based towards a cash-flow-based lending framework.
- **Improving the regulatory environment for banks.** Improving the information environment, improving communication, and getting the regulatory balance right.
- **Beyond the banking sector: fintech, microfinance, and specialty finance.** Cultivating the broader ecosystem for SME finance and financial inclusion.
- **Building capital markets.** Critical building blocks and reforms to develop money markets, foreign-exchange markets, and government debt markets as building blocks to broader capital-markets development.
- **Conclusions: Road mapping a way forward.** The importance addressing access-to-capital issues as an ecosystem, as well as creating a potential work plan for 2018.

# THE IMPORTANCE OF MACROECONOMIC FUNDAMENTALS

On the macroeconomic front, roundtable participants focused on two key issues: macroeconomic stability (the importance of bringing inflation rates under control) and the government budget deficit. Macroeconomic stability was seen as critical to improving both banking sector health and retail financial inclusion, and participants identified better management of the government’s fiscal position—in particular a cessation of its practice of borrowing at the Central Bank—as perhaps the most fundamental issue for improving monetary policy and enabling capital markets to develop.

<sup>2</sup> Partially as a result of the agriculture destruction caused by severe flooding.

## RECENT IMPROVEMENTS IN THE MACROECONOMIC ENVIRONMENT

Macroeconomic stability is foundational to banking-sector development and financial inclusion, and Myanmar has suffered on both accounts in the past due to historically high and volatile rates of inflation. In the decade following the Asian Financial Crisis of 1997, annual inflation in Myanmar rose above 20 percent in six separate years, as shown in Chart 1 below. Since 2009, rates have stabilized. However, in 2015, average consumer prices increased by 10 percent.<sup>2</sup>

A fundamental consequence of Myanmar’s history of high inflation is that depositors (earning a minimum of 8% on deposits, as mandated by the central bank) have often lost money in real terms over time, and, as a result, have sought to store their wealth outside of the banking system. “If you look back historically,” one roundtable participant noted, “the depositor has been dealt with very badly, and it has driven savers to purchase physical assets, not financial ones. When you have financial assets like deposit accounts,” he continued, “over time you lose out. That’s why people buy land. It is not a coincidence that this is where the investment is.”

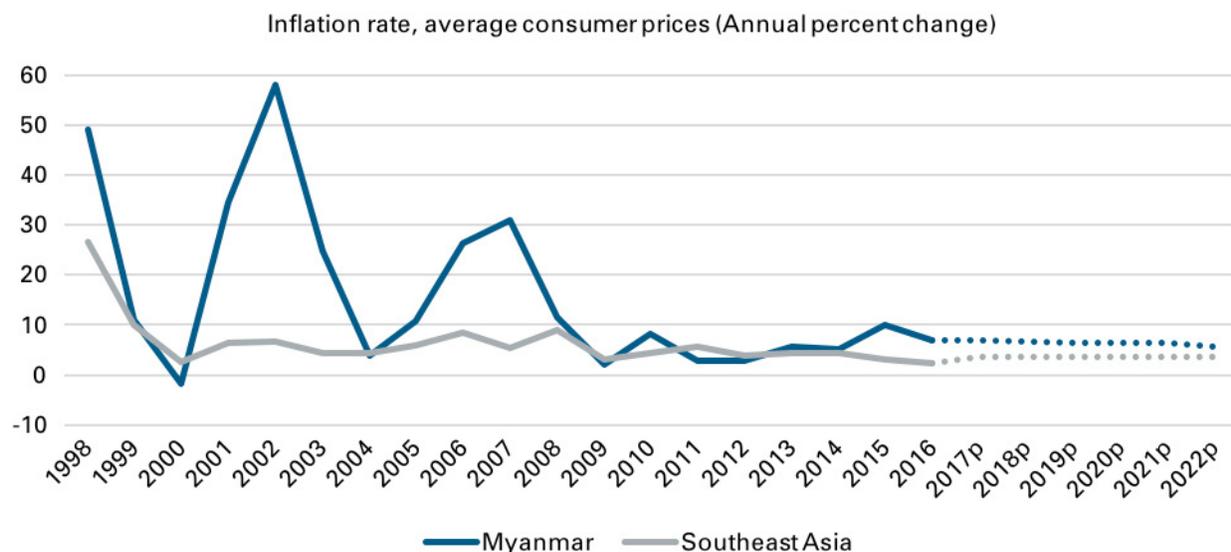
Stable inflation is also essential to developing financial markets, as

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inflation volatility makes it difficult to price long-term debt instruments (and raises concerns about the government's fiscal position). In Myanmar, holders of financial assets have sought dollar-denominated assets, and this in turn has complicated monetary policymaking as well as undermined the government's efforts to improve its balance of payments position.

According to a senior economic advisor, the outgoing military regime "pumped as much money into the economy as it could, with the idea that they could worry about the debt and inflation afterwards." The new administration inherited the effects of this "political spending cycle," and in its first year in power, the National League for Democracy's (NLD) economic and monetary policy has aimed at fundamental goals of stabilization and budgetary consolidation. Since the 2016 elections, it has had concrete success, in particular in bringing down the inflation rate. But while roundtable participants were quick to laud the government's successes in these areas, they noted that they have come at the expense of pro-growth policies. As a result, the government is not reaping political gains from these efforts. Roundtable participants seemed to agree that the NLD "is not getting sufficient credit for these efforts, nor is it doing a good job of communicating the importance of these efforts or its successes to the public at large."

**Chart 1. Historical Annual Inflation Rates in Myanmar**



*p = Projected*

Source: IMF World Economic Outlook (April 2017)

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## FISCAL PATHOLOGIES

Myanmar's fiscal position and debt burden are not egregious by regional standards. Government revenues fell short of expenditures by 4.5 percent of GDP in 2016, compared to a figure of 3.9 percent for all of emerging and developing Asia. Gross government debt was a manageable 37.3 percent of GDP at the end of 2016, lower than figures observed in Laos, Thailand, and Vietnam. Nevertheless, there are a number of structural problems limiting the government's ability to pursue pro-growth fiscal policies, most notably a low tax base and an inefficient tax administration.<sup>3</sup>

<sup>3</sup> The administration also lacks the ability to fully set spending priorities, in particular with respect to military expenditures.

**Table 1. Government Finance Indicators for Myanmar and Regional Peers**

	General Government Net Lending/Borrowing (% of GDP)			General Government Gross Debt (% of GDP)		
	2016	2017p	2018p	2016	2017p	2018p
Myanmar	-4.6	-4.5	-4.5	35.8	36.2	36.3
Cambodia	-2.9	-3.2	-3.6	33.0	33.6	34.3
Laos	-5.9	-5.3	-5.2	67.3	71.6	75
Thailand	0.5	-1.6	-1.8	42.2	41.8	42.0
Vietnam	-6.6	-5.7	-5.7	62.4	63.4	65.1
Emerging and Developing Asia	-3.9	-4	-3.7	48.4	50.3	51.9

*p = Projected*

*Source: IMF World Economic Outlook (April 2017)*

In Myanmar, tax revenue as a percentage of GDP is among the lowest in the world, significantly lower than that of its ASEAN peers. Roundtable participants noted that a sustained effort to collect taxes from individuals and organizations “that were not used to paying them” could have negative political consequences for the party in power, but they also generally agreed that reforming the tax system was foundational to advancing other priorities. Again, the new government has made progress. Tax revenue as a percentage of GDP has steadily increased, from 6.2 percent in 2012-2013 to an estimated 7.5 percent in 2015-2016, according to the International Monetary Fund (IMF). The IMF projects that this modest increase will

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continue, reaching 8.2 percent in 2018-2019.

More problematic than the size of its budget deficit, though, is the way in which the government finances it. As one participant bluntly put it, the government continues to commit one of the “great pathologies of macroeconomic policymaking”—the recourse to the central bank to finance its fiscal shortfall. During the 2015-2016 fiscal year, the government financed its deficit spending by borrowing around MMK-3.2 trillion (or about US\$3 billion), over 90 percent of which was borrowed from the Central Bank of Myanmar (CBM) at below-market rates.

As one roundtable participant explained, “What you’re seeing is a state that cannot fund itself with taxes. They have to limit the interest rate ceiling so that they can borrow and continue funding themselves. They do not want to have to pay a high interest rate, so the interest rate is administratively fixed.” One participant summarized the core issue: “This is the fundamental structural problem at the policy level: there is no demarcation between fiscal policy and monetary policy.”

## THE IMPACT OF DEBT MONETIZATION ON CAPITAL MARKETS AND MONETARY POLICY

Borrowing directly from the central bank at artificially low interest rates creates a number of problems for economic and financial market development. Most obviously, when interest rates are set artificially, markets in government securities—both money and debt markets—fail to develop. Myanmar has very limited secondary trading of government securities and only a very nascent government bond market because “no bank wants to invest in securities at which it earns a negative real rate of return.” As one participant explained, “It makes very little commercial sense to buy paper at 6.5 percent or 7 percent. The reality of the matter is that we’ll only go there if we’ve got nothing else to do.” Another participant referred to investing in treasuries as “a last resort.”

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The lack of well-functioning debt and money markets, in turn, makes it difficult for the CBM to conduct monetary policy. In Myanmar, as several participants noted, the CBM cannot implement some aspects of monetary policy because the market mechanisms through which the policy takes effect are either missing or too rudimentary to work efficiently. “Actually, Myanmar has no monetary policy at all,” one participant argued. As a result, “sometimes the central bank is blamed for things over which it actually has little or no control.” This situation is, of course, exacerbated by the level of dollarization in the economy. And, as part of a vicious cycle, the lack of effective monetary policy, along with the lack of well-functioning capital markets, further undermines the government’s ability to manage its fiscal position.

Again, the NLD has begun to implement reforms. It has set targets to steadily scale down direct CBM-financing of federal deficits to 40 percent of deficit spending in FY17, to 30 percent in FY18, and then to reduce the number by 10 percent every year thereafter, until it fully stops the practice in 2021.

# CRITICAL REFORMS TO INCREASE BANK LENDING TO THE SME SECTOR

Across various studies, Myanmar businesses have consistently ranked access to finance as their most pressing growth constraint,<sup>4</sup> and the lending environment is particularly challenging for small and medium-sized enterprises (SMEs). According to one participant, businesses that need between US\$10,000 and US\$50,000 “have a very hard time accessing capital” in Myanmar. As he noted, “It’s these small businesses that generally—not just in Southeast Asia, but the world over—generate the most jobs, and if they’re going to grow, they need access to working capital.”

<sup>4</sup> In the 2016 World Bank Enterprise Survey, access to finance was cited as the most significant challenge for Myanmar businesses. In “Myanmar Business Survey: Data Analysis and Policy Implications,” a 2015 study from the United Nations Economic and Social Commission for Asia and the Pacific, 60 percent of Myanmar businesses reported that access to finance was an obstacle, and 34 percent of respondents classified it as a “severe obstacle.”

But bank financing remains inaccessible for many of these small companies. One reason is that SMEs often do not own land, which is the most important and most commonly used form of collateral in Myanmar. Another is that analyzing the loan applications of a large number of small borrowers imposes higher operational costs on banks than focusing on a few large corporations. Consequently, as shown in Chart 2, only 28 percent of medium-sized businesses and only 7 percent of small businesses have an outstanding bank loan in Myanmar, according to the World Bank Enterprise Survey. And total bank loans to SMEs only come to about 1 percent of GDP, a figure that is much smaller than is observed in other countries in Southeast Asia.<sup>5</sup>

<sup>5</sup> In the Philippines, total SME banking lending amounts to 3 percent of GDP, and in Indonesia, the figure is 7 percent, according to the Asian Development Bank’s SME Finance Monitor 2014.

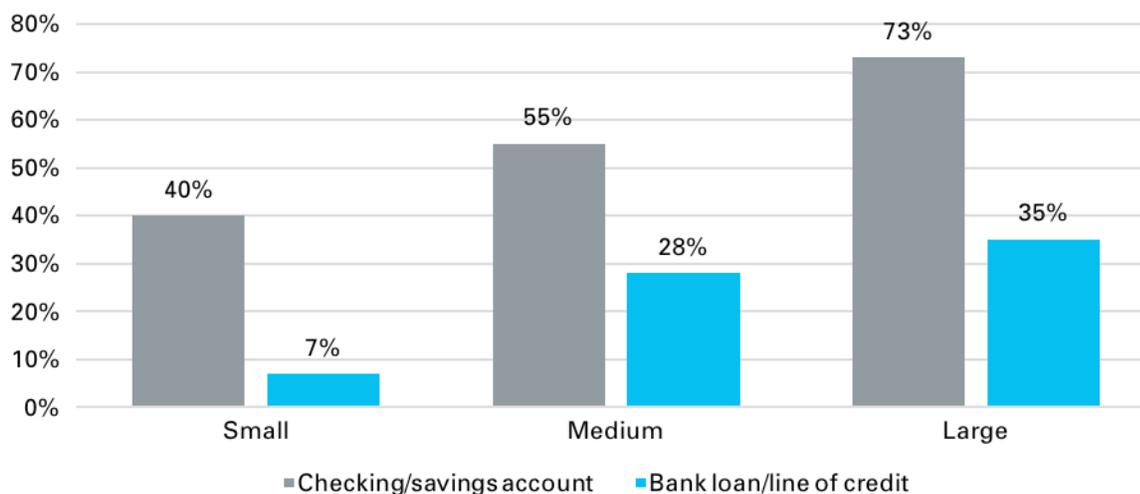
Given this context, the fundamental question asked at the roundtable was how to improve the quantity and quality of bank lending to the private sector, and in particular to SMEs, without jeopardizing banking-sector stability. While discussion ranged across a number of topics and sessions, participants honed in on three fundamental issues: the need to expand bank balance sheets for lending (through retained earnings, expanding the deposit base, and capital-markets funding); the need to move to a more risk-based lending approach (entailing, among other things, a more liberalized

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interest rate regime); and the ecosystem requirements for moving from collateral-based to cash-flow based lending models.

<sup>6</sup> "Myanmar Banking Sector 2025: The Way Forward," Roland Berger, September 2016. See especially pages 20-21.

**Chart 2. Use of Banking Services Among Myanmar Businesses**



Source: World Bank Enterprise Survey, Myanmar 2016

## BALANCE SHEET EXPANSION

Banks at the roundtable made the case that increased levels of lending would need to come primarily from balance sheet expansion. One participant pointed to a Roland Berger study that projected the domestic banking sector would require around US\$25 billion in new equity by 2025 to meet credit demands from Myanmar's rapidly growing private sector.<sup>6</sup> Roundtable participants discussed expanding bank balance sheets through increasing retained earnings, growing the deposit base, and raising funding through the capital markets.

Not surprisingly, banks argued an increase in retained earnings would significantly contribute to closing the sector's anticipated funding gap, especially in the absence of well-developed capital markets. "The total banking assets," one participant explained, "are about US\$25 to US\$30 billion, as an approximate number. A 1 percent increase in the net interest margin results in US\$200 to US\$300 million per annum net capital generation for the banking

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industry. This kind of money is not going to come from capital injection and paid-in capital on an industry-wide basis.”

<sup>7</sup> These are based on the central bank reference rate of 10 percent, with the deposit rate fixed at minus 2 percent of the reference rate and the lending rate capped at plus 3 percent.

However, in a regulated interest rate regime, the net interest margin that banks can earn on their loan books is implicitly defined. In Myanmar, the CBM mandates an 8 percent nominal rate on deposits and caps the bank lending rate at 13 percent.<sup>7</sup> Throughout the roundtable, participants from the banking sector emphasized that this spread is too narrow for capital formation. As one participant argued, “Today, the interest rate regime contributes to net capital destruction rather than net capital formation.”

Both banks and regulators present at the roundtable agreed that, in principle, an effective spread of 5 percent (typical of Asian economies), or even of 3 percent, was necessary to ensure stable, sustainable financial-sector growth in Myanmar. However, there was disagreement as to the real effective spread banks face. Banks argued that the effective spread is much narrower than the nominal spread, given both CBM reserve requirements and the fact that Myanmar is a cash-based market. “We have to hold from 5 to 15 percent in hard currency notes, and that really increases the cost of doing business,” argued one participant. Another participant added, “The net effective spread—after taking into account the reserve ratios, cash in hand, and everything else—is 1 percent or less. Depending on the bank, it ranges from 0.75 to 1.2 percent.” He emphasized, “These numbers are financial-center numbers. They are not frontier-market numbers, and therein lies the risk.”

Regulators present during the meeting, however, argued that banks underestimate their interest rate cost in a number of ways. First, the real deposit rates they pay are significantly lower than the nominal rates. “Banks really talk a lot about the 13 percent interest rate, but they don’t talk about the 8 percent rate, which is a below market rate,” argued a senior regulator. Second, “There are other ways banks get relief. Banks don’t even pay depositors for their average

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daily balance; they pay interest on the minimum balance for the quarter. Effectively, although the interest rate is 8.25 percent,” he argued, “banks don’t pay that much.”

Participants next discussed the importance of improving the deposit base in order to fund balance sheet expansion. As one participant suggested, “banks need to expand the liability side of their balance sheet in order to expand the asset side.” “Right now,” another participant said, “all the bankers are just sitting in the bank. They are waiting for the borrowers to come. Once the funds are fully available, we will have no time to wait and sit in our offices. We will have to go outside and start selling loans.”

In Myanmar, however, the depositor base remains limited, largely because banking services remain out of reach for millions of individuals. With only 3.3 commercial bank branches per 100,000 people, Myanmar has the lowest penetration rate in the region except for Laos.<sup>8</sup> One study has found that only 17 percent of Myanmar citizens have a bank account.<sup>9</sup>

One participant pointed to the experience of Malaysia as a possible model for rapidly mobilizing savings. There, she explained, the government actively worked to institutionalize a savings culture across the society, mainly targeting lower-income groups. For example, before bank branches were set up across the country, the government developed a savings culture through the network of post offices to implement point-of-sale outreach to increase financial literacy and encourage savings. Participating post offices were later transformed into National Savings Banks offering deposit and lending products throughout the country for small savers and borrowers.

Last, banks argued for the importance of developing capital markets, both for expanding bank balance sheets and for banking sector stability as a whole. One banker in particular lamented the lack of policy progress in these areas. “There is no discussion of preferred

<sup>8</sup> According to the World Bank’s World Development Indicators, the penetration rate in Laos is 2.9 per 100,000 people. Among countries with populations of over 40 million people, only four have lower bank-branch penetration rates than Myanmar. Those four are Ethiopia, Tanzania, the Democratic Republic of the Congo, and Ukraine.

<sup>9</sup> This figure is from the 2013 FinScope survey of Myanmar conducted by Finmark Trust.

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markets as a contingency funding plan.” This effectively limits banking options to paid-in equity capital to expand balance sheets.

In addition to the financing benefits, participants discussed the importance of deep capital markets for overall financial stability. As one roundtable participant said, “The sharing of financial risk becomes much better when you develop your capital market properly.” First, banks become less reliant on fleet-footed depositors. “The fact that virtually all of bank funding comes from customer deposits creates a very dangerous situation,” said one participant, noting that rumors of banking instability have nearly caused bank runs even very recently in Myanmar.<sup>10</sup>

## IMPLEMENTING A RISK-BASED LENDING FRAMEWORK

Given the current size of their balance sheets, banks at the roundtable argued that the single most significant inhibitor to lending to the SME sector was the interest rate regime itself. Since interest rates on loans are set by the CBM, the banks contended that they are unable to charge for loans based on a risk assessment of the particular borrower. One participant said, “We want to innovate. We want to introduce new products, services, and offerings to our customers and to the country, but we need to be compensated for the credit risk of lending to SMEs that may have unproven businesses, may be unable to produce adequate financial documentation, and may not own land as collateral.” Another participant argued, “Banks migrate towards the larger companies because it’s more economically feasible to analyze and serve large companies when you have a 13 percent interest rate ceiling.”

In this spirit, several participants from commercial banks requested the opportunity to receive special permission from the CBM to charge higher rates on a small, walled-off percentage of their loan portfolio as a way to experiment with risk-based pricing. The idea is to develop a proof-of-concept of how relaxed rate restrictions could impact lending to the private sector and to SMEs in particular.<sup>11</sup> One participant identified what his bank would be willing to do in order

<sup>10</sup> In August 2015, for instance, the CBM had to make televised announcements to calm depositors and prevent a wave of withdrawals. For more details, see Aye Thidar Kyaw, “Central Bank dismisses rumours of bank run,” Myanmar Times, August 19, 2015: <https://www.mmmtimes.com/business/16054-central-bank-dismisses-rumours-of-bank-run.html>.

<sup>11</sup> One commercial banker argued that it was also a matter of fairness to be charge some businesses more than 13 percent. “We want to have a risk-adjusted rate,” he said, “so that good SMEs can enjoy a better rate, and this means that for the high-risk SMEs, we have to charge a little bit more.”

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to receive permission from the CBM to expand lending at rates above 13 percent. He said, “We will do the internal alignments to ensure that our processing, our review, and our assessment of the repayment capacity and the business is sound. We will put prudent and responsible measures in place, and we will limit the exposure to those unsecured and under-secured loans to a certain portion of the portfolio for a set time limit.”

In reaction to this proposal, though, a participant with close ties to the CBM said, “My opinion is that the banks are not yet ready for interest rate liberalization. Interest rate liberalization can take years, maybe five or 10 years.” But, he added, “As a bridge to interest rate liberalization, the CBM may want to consider the categorization of products. Some products can be a little bit higher, perhaps an allowance of 15 percent or 16 percent. In this way, we can move toward full interest rate liberalization in the next five to 10 years.” At least one commercial banker signaled that this bridge proposal would be of interest.

## MOVING FROM COLLATERAL-BASED TO CASH-FLOW-BASED LENDING

A third issue that affects financial access for SMEs is the fact that banks continue to require collateral for almost all business lending in Myanmar.<sup>12</sup> As one roundtable participant said, businesses “can get access to capital only if they have property. It doesn’t matter how good a business it is. It doesn’t matter the cash generation of the business. It’s all about collateral.” Another participant added that “the tradition of collateral-based lending in Myanmar is partly due to traditions that date back at least to the 19th century, partly due to a lack of capacity in the banks to assess credit, and partly due to the dearth of financial documentation produced by Myanmar businesses.”

This has two negative impacts on financial-sector development. First, and most obviously, the collateral requirement sharply limits access to finance for SMEs, especially those that do not own land or

<sup>10</sup> In August 2015, for instance, the CBM had to make televised announcements to calm depositors and prevent a wave of withdrawals. For more details, see Aye Thidar Kyaw, “Central Bank dismisses rumours of bank run,” Myanmar Times, August 19, 2015: <https://www.mmtimes.com/business/16054-central-bank-dismisses-rumours-of-bank-run.html>.

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<sup>12</sup> In 2016, World Bank Enterprise Survey found that, on average, lenders required business borrowers to put up collateral valued at over 400 percent of the loan amount.

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other acceptable collateral. Second, a system-wide over-dependence on land-based collateral ties the stability of the banking system to the vicissitudes of the property market. As one participant noted, “If the real estate market is down, our collateral value will be half of the value. And, because we don’t have a distressed finance company in Myanmar, it will be difficult to recover from this situation if it happens.” This participant worried that Myanmar could be headed toward a mutually reinforcing real estate and banking crisis along the lines of the Japanese asset-price bubble of the early 1990s.

The fundamental issue in moving towards a cash-flow based lending regime is the ability to assess the borrower’s business. In Myanmar, this transition is hampered by the lack of reliable information on borrowers. Even if banks were prepared to move to cash-flow-based lending, they would need better information from their borrowers than is currently available.

As one participant said, “The banks don’t know the cash flow of the companies they lend to.” Another added that the reason the Yangon Stock Exchange has had a sluggish start is that, even for publicly listed companies, investors “cannot rely on financial statements to detect what is the value of the equity share.” The same problem stalls corporate bond-market development.

Modern financial markets rely heavily on third-party assessments of corporate balance sheet health, in particular from auditing and accounting firms, ratings agencies, and credit bureaus. This institutional framework is missing or lacks capacity in Myanmar, however, and this has also contributed to the inability of banks to safely move to a cash-flow-based lending model. According to some participants, many Myanmar businesses “rely on underqualified service providers who rubberstamp financial documents without reviewing the contents.” A related issue is that current regulations prevent domestic banks from using the services of major global accounting firms. One participant explained that not having these global players in the country means that Myanmar is missing out

## CRITICAL REFORMS TO INCREASE BANK LENDING

on an important avenue of skills transfer and capacity building. She said, “We are not actually getting the advice that we need as banks or the hand-holding which is needed.” Some roundtable participants called for expanding accounting and auditing capacity building through further developing the Myanmar Institute of Certified Public Accountants, as well as letting foreign firms practice in the country.

<sup>13</sup> Currently, it still has not obtained a license. According to one roundtable participant, this license should be forthcoming relatively soon; however, given numerous previous delays in this project, others were uncertain about how quickly the credit bureau would be established in reality.

In addition, Myanmar is the only country in Southeast Asia, apart from Laos, that does not have either a private or public credit bureau. Roundtable participants agreed that having a credit bureau would improve the information environment for lenders in Myanmar, including banks and microfinance institutions. One participant noted that, along with improving lending decisions in the regular operating environment, a credit bureau could mitigate some long-term effects during financial crises, as credit bureaus make it easier for banks to identify safe borrowers.

The government has now put in place the legal and regulatory framework necessary to establish a credit bureau, and a private joint venture between the Myanmar Banks Association and a Singaporean financial firm is ready to establish the country’s first credit bureau.<sup>13</sup> Some participants, however, cautioned against thinking about the credit bureau as “the be-all and end-all, ultimate solution for credit data.” These participants pointed out that the credit bureau will only cover individuals and so will not directly impact business lending at all. They also emphasized that “it usually takes two to three economic cycles before the database of a credit bureau becomes significantly relevant.” Last, several participants added that, in addition to a credit bureau, Myanmar needs a collateral or lien registry to enable lenders to ensure that a given property collateral tracks only one loan.

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## Box A. Development Case Study: Pakistan's Electronic Credit Information Bureau

As roundtable participants noted, even when the planned credit bureau comes online in Myanmar, it will only cover individual borrowers, leaving the issue of providing better information about SME borrowers unresolved. As a possible solution, one participant recommended a data-sharing approach used in Pakistan as a possible model for Myanmar. In Pakistan, which based its system on a similar platform in the United Arab Emirates, the State Bank of Pakistan (SBP) maintains an electronic Credit Information Bureau (eCIB), which collects and organizes data on both individual and corporate borrowers. The eCIB includes data from banks, MFIs, and other financial institutions. Each of these institutions can request a report for any borrower included in the database at any time. The reports assist banks and other financial institutions in assessing the credit risk of a loan applicant by detailing the borrower's current outstanding loan exposure and past repayment performance. As the same roundtable participant explained, "From the 1990s onwards, the receipt of a 'clean CIB report' became an integral part of credit approval, which forced borrowers to keep their accounts in good order with all creditors."

Given these issues, there are some interesting initiatives underway to improve the ecosystem in general. They aim to expand the set of allowable collateral, improve credit assessment tools, and provide guarantees and other credit enhancers to encourage credit provision. First, the CBM, in partnership with the International Finance Corporation (IFC), is undertaking a secured-transactions reform project that "will allow businesses, especially micro, small, and medium-sized enterprises, to access finance by offering movable assets as collateral."<sup>14</sup> The project will also establish a collateral registry within the Ministry of Planning and Finance (MOPF) or the CBM to track potential claims on underlying collateral and to determine the priority of ownership to lenders in case of default.<sup>15</sup> Although this is "a medium-term project," a draft Secured Transaction Law has been written and stakeholder consultations are beginning.

Yoma Bank and the United States Agency for International Development (USAID) are piloting a program that seeks to improve "efficient and prudent lending" by developing a model that standardizes what constitutes "a good loan." As one participant explained, the bank is implementing a credit-scoring system (CSS) to collect specific data points from loan applicants to be used over time for statistical analysis and improved credit decisions. Overall, this participant argued, by standardizing and streamlining the application approval process, banks can allocate credit more responsibly while also overcoming some of the operational costs involved in lending to a large number of smaller clients.

<sup>14</sup> For more details, see "Press release: IFC Promotes Moveable Assets-Based Lending to Expand Access to Finance in Myanmar," IFC, November 5, 2016: <https://ifcextapps.ifc.org/ifcext/pressroom/ifcpressroom.nsf/0/>.

<sup>15</sup> A roundtable participant working on the project argued it was important that the collateral registry be established "in-house" at the MOPF or CBM, not as a private enterprise with a profit motive. Her reasoning was that the registry is a public good and that government agencies have the right level of human capital required to manage the system.

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## Box B. The Credit Scoring Systems Model

The CSS model is designed to enable banks to build a large enough dataset on borrower repayment performance to statistically model the characteristics of what can be considered good loans for the particular market. Therefore, the key to preparing a statistically based CSS is to develop a good “data collection sheet.” This checklist would include such indicators as the number of years a business has been in operation; the location of the business; the sector in which it operates; and various financial ratios, such as sales-growth rate, profitability ratios, debt-to-equity ratios, and net cash flow relative to the proposed loan repayments. The CSS model assumes that banks do not have sufficient data to begin with—as they currently do not in Myanmar—so, in the meantime, the data collection sheet also serves as a basis for making judgments about the likelihood of repayment and as a training tool for loan officers. After the bank has collected data for several years, it becomes possible to statistically model which kinds of borrowers and loan amounts are most likely to be repaid and to, thereby, standardize credit decision making.

<sup>16</sup> In addition, one participant argued that “this scheme also demonstrates that borrowers are willing to pay more than they do currently in order to access finance.”

CB Bank is working with the MOPF to expand the use of credit guarantee insurance. Through this program, SMEs can borrow up to MMK-20 million (or about US\$15,000) without collateral. In this scheme, SMEs pay an effective interest rate of 16 percent (13 percent on the loan, plus 3 percent for the insurance).<sup>16</sup> Other banks are experimenting with credit guarantees and insurance products in order to expand access to credit for SMEs and other riskier borrowers. Yoma Bank, for instance, has partnered with a nongovernmental organization, Livelihood and Food-Security Trust (LIFT), to create a risk guarantee fund that enables hire-purchasing of capital-intensive machinery.

However, despite these wide-ranging efforts, banking executives cautioned that the transition to cash-flow-based lending will require a shift in mindset and significant capacity-building efforts throughout the banking-sector workforce, “from loan officers in rural branches to senior managers at headquarters.” It will likely be a number of years before this shift occurs across the industry.

# IMPROVING THE REGULATORY ENVIRONMENT FOR BANKS

Beyond a discussion of specific regulations, much of the discussion at the roundtable focused on the quality of the regulatory environment itself. In particular, participants focused on the need to improve bank reporting so that regulators have an accurate picture of bank balance-sheet health and overall banking-sector activity, as well as the need for better institutional mechanisms for ongoing communication between regulators and the banking sector, and, in particular, the need for a regulatory roadmap. Last, throughout the day and across topics, participants discussed issues concerning the right regulatory balance.

## **IMPROVING BANK REPORTING FOR REGULATORY DECISION MAKING**

Financial markets of all kinds depend on the availability of accurate, up-to-date data so that lenders and equity investors can assess the quality of investment opportunities and allocate capital to productive companies and projects. A consensus view among roundtable participants, however, was that Myanmar lacks this kind of reliable information environment. The data gaps extend from small-business bookkeeping to the figures banks report to the CBM, and there was agreement among roundtable participants that improving data collection and data sharing would be critical for developing the financial markets.

For the banking sector in particular, the poor state of Myanmar's information environment has consequences for banks' relationships with their regulators, their potential investors, and their clients. First, as several roundtable participants emphasized, the CBM needs accurate information from the banks in order to properly design regulatory policy that both mitigates systemic risks and promotes growth. The effect of poor reporting is that policy is made without a full set of information. As one regulator participating in the roundtable said to the banks, "If someone cannot see, say, 'I cannot

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see.’ If someone cannot see and he says, ‘I see A, B, and C,’ then he will not get the right prescription for his eyeglasses.”

For these reasons, CBM participants stressed the need for the banking sector to improve the accuracy and timeliness of its reporting to the central bank. Recent directives from the CBM have insisted on more extensive and more frequent data reporting from Myanmar banks, but banks have been reluctant and slow to comply with these standards, and participants cited several reasons for this. First, for banks (particularly given the low-tech processes used by many offices), data collection is time-consuming and expensive. Second, according to several roundtable participants, data collection problems are exacerbated by a widespread lack of understanding of what information banks should be reporting and how it should be reported. Third, given the current state of accounting and auditing capacity within the banks, those present also questioned whether banks, even if they were fully committed to transparency, would be able to properly categorize loans and report accurate data. Participants agreed that much of the solution relies on developing the accounting and auditing industry in Myanmar. Not all banks, for instance, are compliant with International Financial Reporting Standards (IFRS), and the sector as a whole uses a variety of different bookkeeping systems.

However, several roundtable participants also raised the issue of inherent dishonesty on the part of some banking-sector actors. As one participant said, “The problem nowadays with our local banks and the central bank is the dishonesty between ourselves. We are lying to each other. We are giving false bank statements. We are keeping multiple accounts books, and we are giving a distorted report on NPLs. Then, we are pointing out that the central bank is doing nothing. What we need is honesty. We have to be transparent.” As a result, one participant explained, it is difficult to know whether banks are actually meeting prudential standards. “It’s like putting a jigsaw puzzle together to see what the banking sector really needs,” she said.

One participant argued that banks could be incentivized to share data if the CBM offered, in return, to calculate their market share based on data collected. Another participant suggested that the CBM should “publish a banking sector ledger or balance sheet and profit and loss statement, so that the banks could benchmark themselves against the entire industry, rather than to guess who was doing well and who was not doing well.” This way, he argued, “If we see weaknesses, we can then come to the central bank and have a productive dialogue on how and where we are missing out.”

Last, though, regulators argued that the new regulatory measures, as announced in early July 2017, themselves will become an important instrument for gathering information and enabling regulators to better understand the weaknesses in the current financial system. As one participant said, “The regulations will reveal the weaknesses that have been there for a long time and that have not been addressed. Unless we see what the situation really is, we can never address it properly. The impact of the regulations will be to show the weaknesses.”

### **BETTER COMMUNICATION**

A major theme that ran throughout the roundtable was the need for better communication between the CBM and the banks it regulates. In particular, several participants noted that the CBM had not engaged with the banks in a substantive way during the drafting of the new regulations announced in July. As one commercial banker said, “Collecting people in a room, presenting a draft, and then issuing the draft is not consultation.”

Most fundamentally, perhaps, banking-sector participants repeatedly stressed the need for a regulatory roadmap to set clear expectations and a clear timetable for regulatory reform. As these participants noted, the Financial Institutions Law (FIL) was enacted in January 2016, but eighteen months later there is still uncertainty about how aspects of the law will be implemented by regulators. As one

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participant said, “There has not been a roadmap to this day that has been shared with the industry of what regulations will come out as a result of the FIL. We understand there are about 23 to 24 regulations that will come out eventually, but what period of time do we have for compliance?” Another participant said that it is impossible for banks to plan ahead, to make substantial changes internally, or to develop new products without having a roadmap.

Overall, roundtable participants believed that the current environment offers an opportunity to reboot the relationship between the regulators and the banks. One participant said, “We would expect, going forward, a more consultative, collaborative approach between the industry and the central bank. We can talk, we can debate, we can discuss so that the instructions, the directions, and the roadmap will be clearly understood and be conducive for a stronger and a healthier industry.”

## GETTING THE REGULATORY BALANCE RIGHT

Both regulators and roundtable participants from the private sector agreed on the need for higher prudential standards to reduce the fragility of the financial system. However, some participants from the private sector emphasized the importance of regulatory balance. As one argued, Myanmar’s policymakers “need to recall that, while banks can cause economic destruction, banking should be viewed fundamentally as a productive force for economic development.” “We know,” he said, “particularly in Myanmar, the long history of financial crises. But we must never forget the other side of the equation. And that is that banks don’t exist in order just to manage risk and just to meet compliance standards, but to do things. They actually create funds and allocate capital for growth.”

In addition, banking participants added, if financial stability is the goal, regulators should want to create an environment where the banking sector can be profitable. As one participant said, “Banks that can’t make money are not going to be safer. They are going to

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be less safe, and at an industry level, this makes the entire industry less safe.” Another participant made the point that, during financial crises, regulations that prevent banks from achieving profitability would actually accelerate the crisis, not only for the financial sector but also for the real economy that needs access to bank financing. While she agreed in principle with these points, another roundtable participant also cautioned against encouraging “excessive profits” in the banking sector. “Banking is a long-haul business,” she said, “and banks need to also help in the development of the economy.”

Last, the banks argued that as the CBM imposes higher standards on banks, those demands should be paired with reducing undue restrictions. As one observer put it, “In exchange for sticks, if we’re going to be talking about new prudential ratios and tightening, we should also be advancing freedoms for the banks to do the things they need to do. We all know that the banks here have long been constrained in all sorts of ways of doing proper banking business.” Another participant later echoed this point, saying that policymaking “has to take into account the importance of giving banks the freedom to do their jobs.”

### **Box C. Development Case Study: Government-Industry Engagement in the Philippines**

One participant pointed to the case of the Philippine capital markets as an example of a successful consultative planning process between policymakers and the financial industry. As he said, “The capital markets are really the ultimate public-private partnership, and they require a lot of dialogue.” In the Philippines, the private and public sides of that partnership developed an institutionalized mechanism that facilitated a constructive dialogue about the future of the markets. It is called the Capital Market Development Council. It includes multiple government agencies along with industry associations, and together these organizations have developed a legislative priority agenda for market development. The Council also has sub-committees actively working on regional capital-market integration, ideas for tax reform, and financial literacy programs for the Philippines.

This roundtable participant encouraged the development of a similar platform for dialogue in Myanmar. He believed it should include the relevant regulators, the banking association, and the insurance association, as well as any other relevant stakeholders. “By having this process institutionalized,” he said, “you can work together to actually create a blueprint of legislation, regulation, and actions that should help you transition from where you are to where you want to be.”

# BEYOND THE BANKING SECTOR

“Banks cannot do everything,” one participant said, voicing a general consensus among those present that Myanmar needed to further develop other financial institutions in order to expand access to capital, particularly to smaller SMEs. Specifically, roundtable participants discussed how FinTech solutions might compliment the development of the banking sector and the right regulatory approach for new tech-based products. Participants also discussed ways in which the current legal and regulatory environment prevents microfinance institutions from expanding SME lending, as well as the importance of new lending products and specialty lenders.

## MYANMAR'S FINTECH OPPORTUNITY

Across a number of developing countries, innovative financial products enabled by new technologies have expanded financial access for millions of people. The most well-known example is the rapid expansion of mobile money products in Kenya, where over 60 percent of the population now uses the M-Pesa platform to save and make transactions. Roundtable participants believed similar products could be transformative in Myanmar, where mobile penetration rates have grown from seven percent in 2011 to nearly 90 percent in 2017. One participant argued that the FinTech industry “will be a large vector for innovation in the economy where we can bring in foreign expertise on the use of credit scoring models, gathering information from data sources like cell phones, constructing models for lending that are not collateral-based or asset-based but are information-based. We see a huge upside for Myanmar in this area.”

In general, several roundtable participants saw FinTech companies and products as compliments, rather than competitors, to traditional banking. One FinTech representative made several arguments about how the rise of FinTech companies in Myanmar would actually

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benefit the banking sector. First, mobile money and other consumer-facing FinTech products bring more people—and more money—into the formal financial sector. As one participant said, “The evidence has actually demonstrated in most markets where mobile money has been successful that mobile money actually acts as an accelerator for the whole financial sector. By driving accounts and by driving efficiencies through the bottom of the pyramid and customer base, it results in the entire financial sector broadening.” Second, disruptions by FinTech companies across a number of product lines and particularly in the domestic remittance market would allow banks to focus on more value-added products, more closely aligned to their core competencies. Third, the expansion of FinTech companies also accelerates the widespread adoption of technologies that benefit all financial institutions. These technologies include the use of e-documents and e-signatures, the development of e-commerce platforms, and new electronic databases of credit information.

Participants also discussed the role regulators should play as the FinTech market develops. A FinTech provider wanted to see the regulators more actively involved in market development, and called for severe measures to restrict or discourage the behavior of unregistered FinTech companies, arguing that these companies are offering Myanmar citizens poor products and turning off large segments of the population to FinTech altogether. Another participant echoed this view but added that “regulators must also wear the hat of enablers. Their job is not just to catch those who do wrong, but also make it easier for people to do business. This is where collaboration with FinTech companies is very important.” Several participants urged the CBM to study the experience of “regulatory sandboxes” in other jurisdictions, where regulators allow approved companies to experiment with new products under relaxed regulations either for a limited time period or until the product scales up to a certain number of users.

The CBM has also been working to create the market infrastructure

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and the regulatory environment required to enable FinTech innovations. Most importantly, in 2011, the CBM established a national payments switch to facilitate non-cash payments and money transfers that was designed from the start for mobile interoperability. Full Fintech regulations are still pending, but the CBM has already issued directives allowing the use of mobile payments within the banking sector and in other parts of the economy.<sup>17</sup>

### Box D. The Treatment of Overdrafts in New CBM Regulations

On July 7, 2017, the CBM issued four new sets of regulations to implement the 2016 Financial Institutions Law. The regulations covered a number of issues, including capital adequacy ratios, asset classification, limits on large exposures, and liquidity ratio requirements. Overall, the intention of the new regulations is to strengthen the banking sector and reduce systemic risk by bringing the Myanmar financial system under the Basel I framework. In addition to general concerns about the timing needed for implementation, banking-sector participants raised particular worries about paragraph 11 in CBM Notification No. 17/2017, the directive that details the new asset classification and provisioning regulations. In a provision titled, "Treatment of overdraft," the regulations say, "A bank shall ensure that all overdraft loans in its books are cleared/paid in full for a period of two consecutive weeks annually."

Several banking participants expressed their fear that this regulation threatens the stability of the financial sector. As one participant said, "Overdrafts are the most prevalent form of financing offered by the banking sector," with overdrafts accounting for about three-quarters of outstanding loans. Another participant predicted that to have these loans called and, additionally, to be unable to renew them for two weeks "could be quite cumbersome and quite onerous on the industry. There could be a domino effect," as borrowers default and banks experience a liquidity crisis.<sup>18</sup> Another participant said, "We don't even know, exactly, what the motivation, what the intentions of the CBM are in terms of issuing his directive."

The regulators at the roundtable, though, were ready to answer this point. They argued that the fact that the practice was so widely prevalent in Myanmar actually increased the urgency to implement regulations in order to curtail it. One participant who works closely with the central bank said, "There are banks, several of them, giving nothing but overdraft loans." She added, "What does it tell me as a regulator? It tells me that your nonperforming loans are actually very much understated, because the overdrafts are just renewed every year." This participant urged banks to begin discussing the implications of this measure with their clients immediately. "The best way to react to the regulation is for banks to start a conversation with their clients now. They need to actually start talking to their clients and to start studying a term structure for them rather than just renewing all the time."

<sup>17</sup> It is also currently working on regulations to facilitate the use of e-documents and e-signatures.

<sup>18</sup> In a stakeholder interview with the Milken Institute outside of the roundtable, a Myanmar national working for a foreign bank in Yangon referred to the use of overdraft lending in Myanmar as "interest-only perpetual facilities" and noted that they were so widespread that the CBM directive could have catastrophic consequences. "If this rule is implemented," he said, "I guarantee the domestic banking system will collapse."

## MICROFINANCE INSTITUTIONS AND SPECIALTY LENDERS

At present, 168 microfinance institutions (MFIs) lend to around 2.7 million clients across Myanmar, according to the MOPF. A reasonable expectation is that, as this industry matures, it could grow to play a larger role in funding SMEs that find bank financing out of reach. As one participant said, "What we've seen in other markets is that microfinance institutions migrate up-market and then become small business lenders." However, he argued, the current

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legal and regulatory environment is “hardwired” to prevent this from happening in two specific ways.

<sup>19</sup> Until recently, when it was raised by the Financial Regulatory Department, the lending cap for MFIs was MMK-5 million.

First, current law prevents MFIs from taking any form of collateral. This makes expanding from established relational networks to new borrowers a riskier prospect. Removing the legal restriction on accepting collateral will require passing new legislation at the national level, a barrier that may take years to overcome. The second issue, though, is easier to address. It is a regulation that limits the maximum loan size MFIs can provide to only MMK-10 million or just over US\$7,000. This figure is too small to meet the financing needs of many SMEs, but the maximum loan limit could be raised by the MOPF’s Financial Regulatory Department.<sup>19</sup>

Ultimately, in the view of several participants, meeting the financing needs of SMEs in Myanmar will require additional lending products and new lending institutions. In particular, participants argued that Myanmar businesses need inventory and receivables financing. In addition, roundtable participants believed that the Myanmar economy would benefit from new, special-purpose finance companies, including agri-finance companies with seasonally based products and equipment-financing firms that enable hire purchasing of capital-intensive machinery. Unlike banks and MFIs, these non-depository institutions put investors’ capital, rather than the savings of depositors, at risk.

However, according to one participant, the development of these products and businesses is “impossible under the current regulatory structure.” The lack of a secured-transaction framework means that lenders are wary to accept movable collateral such as inventory, accounts receivables, equipment, and crops as the basis for a lending decision. As a result, one participant argued, the main financial product Myanmar businesses turn to for working capital is overdraft facilities from banks. He encouraged lawmakers to stop relying on the CBM to engineer a financial system and to start thinking holistically about “what kind of financial sector a country

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like Myanmar needs with an agricultural economy and a lot of small businesses.” He added that they must then ask, “How do we put in place the laws and regulations that would allow the financial sector to respond to that?”

# DEVELOPING CAPITAL MARKETS

While a full treatment of the development of capital markets was beyond the scope of the discussion, participants did discuss in some detail the importance of developing both money markets and government bond markets. Most fundamentally, as discussed above, for monetary policy to be effective, the central bank must be able to execute its policies through the money markets. In addition, interbank markets are critical for the banking system's ability to maintain reserve balances. As such, they are also critical for banks to be able to lend on a longer-term basis into the economy.

Government bond markets, for their part, serve as the anchor yield curve upon which corporate bonds are priced. As one participant described it, "The interbank markets and the government bond market are really the base of the pyramid. They are the basic capital-market infrastructure that we need to really transfer money between supply and demand, between savers and borrowers. Only later can we talk about equity or corporate bond markets."

Importantly, capital markets also reduce systemic risk throughout the financial sector. First, in the event of a banking sector crisis, capital markets can provide ongoing funding to the private sector. Second, crises in capital markets are not as systemic as those in the banking sector. And third, as several participants argued, capital markets reduce systemic risk by improving the corporate governance and financial reporting capacity of a country's large, economically important corporations—including the banks themselves—which must meet high standards in order to attract investors.

## DEVELOPING MONEY MARKETS

Several prerequisites must be in place for the interbank markets to develop. First, banks need to be able to assess the counterparty

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credit risk of other banks in order to make unsecured—that is, uncollateralized—loans. As one participant noted, “In many countries even significantly more developed than Myanmar, second- and third-tier banks usually are completely cut off from unsecured interbank markets. Nobody wants to face them.” However, extending liquidity to these second- and third-tier banks is important. In many developing countries, they are the main interface between the banking sector and essential segments of the real economy, including SMEs and the agricultural sector.

To reduce counterparty risk in the interbank markets, one participant argued that the CBM should act as a backstop for interbank markets to develop, given the risks of liquidity imbalances and banking-system contagion from failed transactions. “In practical terms, the CBM, which should be the primary source of unquestioned liquidity in the market is absent, both on the kyat side, as well as the FX forward and swap side.” The IMF has cautioned against CBM playing this role, however, and there was some debate about its merits at the roundtable.

Developing collateralized—or repo—markets requires a well-functioning government-securities market, as T-bills and bonds are the main form of repo collateral. In 2015, the CBM began issuing treasuries on behalf of the MOPF, but the legal and regulatory environment needs to develop in a number of areas, in particular around legal netting in the event of counterparty bankruptcy. As one participant explained, “Interbank markets are only able to develop to the extent that non-defaulting parties don’t have to go to court and stand in a queue with a liquidator. Most regulators agree that, in order to make this market liquid and functional, we have to give interbank market participants super-priority to liquidate collateral.” To do so, banks need to be able to hold treasuries on a full title transfer basis without payment, “and so the law needs to explicitly permit title transfers of this kind.”

In addition to the legal regime, money markets require several

infrastructure elements, and the CBM is making progress in a number of areas. For example, it has worked with development partners to invest in the payment and settlement infrastructure needed for interbank trades, and Myanmar's first real-time gross settlement (RTGS) system, CBM-Net, came online in January 2016.<sup>20</sup> These developments are fundamental to deepening the financial markets because the infrastructure of the market must be sound "so that investors can have confidence that they are not subject to fraud or undue operational risk."

## Box E. Dollarization and the Forex Market in Myanmar

"As everybody knows," one roundtable participant said, "Myanmar is a highly dollarized country." Partly, ongoing dollarization is the legacy of misguided policymaking over many decades, including the disastrous demonetization episodes in the 1960s and 1980s and the dual-exchange-rate system that persisted until 2012. The current limitation of loanable administration funds in the Myanmar banking system, one roundtable participant explained, also sustains dollarization pressures, driving many Myanmar corporations to pursue offshore financing.

Myanmar's domestic banks also receive offshore funding and participate in an active interbank forex market. This interbank market is also highly dollarized, to the degree that at least one banking-sector participant believed CBM-Net should allow transactions in dollars. A participant on the regulatory side, however, insisted that CBM-Net would not facilitate dollar payments, and a financial-sector expert from outside of Myanmar agreed with this approach. She said, "All domestic transactions must be conducted in local currency. This is to avoid more dollarization which would further complicate your ability to do monetary policy effectively."

There is also a significant informal forex market in Myanmar, often with a noticeable price difference of about 20 to 50 kyats per U.S. dollar, according to one roundtable participant. This same participant recommended that a policy priority should be to bring this informal market under the formal system. "Otherwise," she said, "it will be very hard for us to even have a proper calculation of how much currency inflow and outflow is actually going on, because some of these accounts are also settled offshore." One of the regulators present agreed that the CBM "should be better predicting the inflows and outflow instead of just monitoring and reacting to what already happened in the market." He noted that accepting this role will also require better data reporting from the industry.

Myanmar's overall economic growth strategy involves following the export-oriented growth model of other Asian countries. However, as one participant said, "Developing the foreign exchange market in a developing, export-oriented economy can be quite difficult." Some roundtable participants, though, believed that policymakers could boost kyat demand by requiring mandatory repatriation of export proceeds and, additionally, requiring those proceeds be converted into kyat within a certain timeframe.<sup>21</sup> In Malaysia, as one participant explained, regulators "require conversion within six months. The reason is that it is gross flows that make the market. If companies bring earnings in, they convert them. Then they are allowed to convert back to foreign currency to pay their imports. These gross flows create the forex market that enable liquidity on forward rates and other benefits." Some industries that do a lot of foreign transactions, she added, could be exempted so that they continue to develop without the expense of conversion.

<sup>20</sup> In July 2017, the Myanmar financial markets witnessed their first repo transactions. KBZ Bank conducted an overnight repo with Yoma Bank for MMK-1 billion as well as a one-week repo of MMK-500 million.

<sup>21</sup> Much of the current demand for kyat domestically comes from foreign banks operating in Myanmar.

## DEVELOPING GOVERNMENT DEBT MARKETS

As noted above, the development of capital markets requires macroeconomic stability, regulatory reforms, and infrastructure investments. As one debt-markets expert said, these are the “fundamental building blocks” that need to be in place for Myanmar “to achieve a fully functioning debt market.” Macroeconomic stability is critical because high and volatile inflation undermines demand for long-term bonds, as do concerns about the government’s fiscal position.

As discussed in the first section, the government has put in place a timetable to curtail monetization of the budget deficit and to begin to fund its fiscal needs through a domestic and international borrowing program. But beyond the broad requirements noted above, participants discussed a number of technical lessons for the development of a credible debt issuance program. First, as one expert argued, this plan should be “shaped first and foremost by the medium-term debt management strategy” as determined by “how the government sees its debt composition evolve over time.”

Second, he argued, “market participants don’t like surprises. A government’s mantra should be transparency and predictability.” Issuance should be based on an annual borrowing plan around a calendar of auctions that reflects “a regular dialogue with market participants.” Problems can arise, of course, when short-term, cash-management needs determine the timing of bond issuances. “Ideally,” he said, “separating cash management from the bond issuance program is a good endpoint, and this can be done effectively using the treasury bill as shorter-term instruments.”

As one roundtable participant argued, the government will eventually need to accept that it is a “price taker” in the debt markets. According to this participant, cutting off auctions due to dissatisfaction with the rates only delays the funding process, as the government will have to return to the same pool of investors in the

future. Others argued that investors bid prices based on a promised auction size, so that canceling is better than allowing partially filled auctions to move forward. In general, though, roundtable participants argued repeatedly that “not allowing market prices to prevail will ultimately inhibit the development of a secondary market.” The vision for Myanmar right now, they argued, should be developing a debt market “where there are government securities across the yield curve that are trading on a secondary market in an environment where you’re starting to see at least some private debt securities being issued.”

<sup>22</sup> One participant referred to the stock market as “this accident called the YSX.”

### Box F. Discussion Case Study: Sequencing Capital-Market Development

Myanmar has recently established a public equity market. The Yangon Stock Exchange (YSX) made its first listing in March 2016 and currently lists the shares of four companies. Several participants discussed the early experience of the YSX in terms of disappointment.<sup>22</sup> But others emphasized that the exchange was still “in its infancy,” as one participant phrased it. One defender of the YSX argued that the ambition of developing capital markets must be thought of as a long-term goal for Myanmar, not a quick fix.

However, another roundtable participant insisted that it was a mistake to establish the stock market before Myanmar had an active corporate bond market. In the frontier-market context, he argued, the financial sector “needs debt capital markets to, over time, act as a centrifugal force to identify where the bulk of the liquidity outside of the banking system resides and who are the key investors.” By extension, this argument implies that, even though the YSX already exists, policymakers would do better to spend their energy and political capital on building the bond market rather than on further developing the YSX. This same participant pointed to the example of how Chile developed its bond market alongside the development of the public pension system as a model that Myanmar may wish to emulate.

## DEVELOPING THE INVESTOR BASE

The development of capital markets depends on the deepening of a local investor base with the resources to buy long-term securities. Roundtable participants argued that, although banks may be active investors in the capital markets early on, market development in Myanmar will also require the development of local institutional and retail investors. Foreign investors, according to some participants, can also be an important source of capital as the local investor base develops.

In developing countries, the banking sector is often an early advocate of capital-market development, as banks want to both invest in long-term securities and to raise capital through issuance.

One participant observed that, as government debt markets develop, “commercial banks are almost always the dominant holder of government securities to start with.” This same participant cautioned, though, that in several countries “attempting to extend the maturity of the yield curve too far too fast where banks are pretty much the only investors” has resulted in a dangerous asset-liability mismatch on the balance sheet of the central bank. He argued that a well-functioning debt market required other local institutional investors as well as a strong base of retail investors.

While local institutional investors are, in the words of one participant, “the natural habitat for buying long-term bonds,”<sup>23</sup> the institutional investor base in Myanmar remains fairly shallow, with the pension industry in a nascent stage of development. The insurance industry, though, is more developed with eleven private insurance companies and one large state-owned insurer operating in the market. Still, according to one roundtable participant from the insurance sector, “the industry at the present time is on very shaky ground.”

Given this state of affairs, one participant encouraged policymakers in Myanmar to also consider the importance of retail investors for developing the government debt markets. He noted that, in general, these investors individually invest at small ticket sizes and “tend to favor short maturities, except in countries that have very long histories of economic stability.” For these reasons, he said, “some countries take an approach of having a particular instrument for retail investors that is tailored and non-tradable.” Due to the small ticket size, the transaction costs for issuing this kind of instrument can be higher than selling traditional securities to institutional investors. Technology, though, can bring these transaction costs down. In Kenya, for example, the government has issued a treasury bond that retail investors can buy directly from their cell phones.<sup>24</sup>

<sup>23</sup> In confirmation of this point, several roundtable participants from securities dealerships and the insurance sector expressed a desire to see the government yield curve extend outward, to five or ten years or longer. At the time of the roundtable, the CBM was holding monthly bond auctions for issuances with a two- or three-year tenor. In August 2017, for the first time in several years, the government issued a five-year treasury bond.

<sup>24</sup> Kenya issued its first M-Akiba bond in April 2017, allowing citizens to buy government debt via their phones for as little as US\$30. Despite the instrument’s initial success, however, a second issuance in August 2017 was undersubscribed by over 80 percent.

Local capital, though, may not be sufficient to meet Myanmar's investment needs. A couple of roundtable participants made the case that foreign investment will be a significant component to capital-market development in Myanmar.<sup>25</sup> As one participant explained, foreign investors have become increasingly active in emerging and frontier markets in the last decade. "An interesting observation about nonresident investors," this participant added, "is that they often will be willing to go out the yield curve and can perhaps substitute for the lack of non-bank financial institutions in the early stages. From their point of view, if they are coming into a market and taking the currency risk, they may as well have the duration as well. If they're going to buy the story, they buy it wholeheartedly." Governments have to manage how portfolio flows impact the value of the local currency, but as this participant noted, the experiences of countries around the world have allowed market experts to identify a number of best practices to mitigate shocks.

<sup>25</sup> Inviting foreign investment may also be particularly important for capitalizing the domestic banking sector, one participant said. He pointed to the strength of the banking sectors in several Central Asian countries – Mongolia, in particular – which removed most restrictions to foreign ownership in the post-Soviet era, as described in *Beyond Microfinance: Building Inclusive Rural Financial Markets in Central Asia* (ADB, 2006).

# ROAD MAPPING A WAY FORWARD

There appeared to be general agreement among roundtable participants that Myanmar needed a roadmap or master plan for market development. Such a roadmap would need to take a holistic, economy-wide view of the financial markets, as well as the credit needs of private-sector businesses. As one participant said, “Without a plan, we will only be working on a piecemeal basis, and we will end up creating issues which don’t exist today.”

Throughout the day and across topics, roundtable participants laid out the section-headings of a potential table of contents for that roadmap. That table of contents would include sections on strengthening institutions; improving the regulatory environment; and developing a more inclusive, integrated financial ecosystem. The components of this program, roundtable participants emphasized, would need to be developed through a genuine consultative process between industry and government.

In its early stages, several participants said that the roadmap should be focused on establishing strong institutions. In Malaysia, for instance, where the government successfully executed a detailed, ambitious financial-sector development plan, the first ten years of strategic planning were “focused on developing institutions, then the next ten years were focused on growth with good governance,” as one participant explained. Although it takes more work in the beginning, this participant said, establishing strong institutions makes financial sectors more resilient in the long term. For the public sector in Myanmar, those institutions include the CBM, the Securities and Exchange Commission, the MOPF, the tax authorities, and the court system, as well formal venues for engagement between the private sector and these agencies.

Next, there appeared to be a consensus that banks and other market

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participants needed a regulatory roadmap as part of a broader financial-sector development plan. This roadmap would focus initially on the implementation of the 2016 Financial Institutions Law. It would clarify when the CBM would expect compliance with the directives issued in July and would also establish a schedule for issuing new regulations to implement various parts of the law. In addition to interpreting laws currently on the books, the regulatory roadmap would articulate additional reforms needed for market development as well as the further investments Myanmar needs for its payments system and other infrastructure to support financial transactions. In addition, a regulatory roadmap would also imply a legislative agenda, including a review of investors rights, bankruptcy laws, and the Companies Act.

Finally, the roadmap would address the fact that the financial ecosystem in Myanmar is currently compartmentalized and limited, as several participants described it. Microfinance institutions lend to the poor. Domestic banks lend to large domestic corporations. Foreign banks mostly lend to foreign companies operating in the country. Significant financing gaps exist between these categories, meaning that many businesses that need financing cannot access it. A full financial-sector development agenda would include a plan to fill those gaps. It would likely include proposals to provide new products and develop new lending businesses to meet the needs of SMEs, while also laying out the steps to develop deep, liquid capital markets to finance both the government and larger corporations in the country.

The general consensus of roundtable participants was that determining the specifics of such a roadmap would require consistent, honest dialogue between policymakers and the private sector. There may be a role for the Myanmar Development Institute and the Milken Institute or other civil society organizations to act again as a neutral ground for these discussions. Whatever the venue, roundtable participants agreed that open discussions between regulators and those they regulate are essential for getting

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policy priorities right. “The one wish I have,” one participant said, “is an improved consultative process. We need to identify where there are pockets of know-how and knowledge available, bring that into the mainstream from the fringes, and then work collectively to come up with an integrated plan for a fiscal, monetary, and capital-market reform process.”

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The Myanmar Development Institute is the leading economic think tank in Myanmar. Based in the capital Naypyitaw, MDI was established to strengthen the analytical capacity of the government of Myanmar.

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