Policy Monitor

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IN THIS ISSUE:

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COUNTRY HIGHLIGHT

ROMANIA

A Coherent Legal and Regulatory Framework for The Romanian Microfinance Organizations

BY MARIA DOICIU, EDS, DEPUTY MF COALITION COMPONENT, SHOREBANK ADVISORY SERVICES

The Microfinance Market in Romania

In 2003, USAID's Enterprise Development and Strengthening Program – Microfinance Coalition Component (implemented by Shorebank Advisory Services) undertook an assessment of the microfinance sector in Romania (micro-credits being defined as up to 25,000 Euros or USD 32,500). The main findings of the assessment are the following:

A reasonable estimate of the potential demand by creditworthy borrowers who would want to borrow less than Euro 25,000 on a regular basis is approximately 113,000 clients, with an aggregate demand of about US$565 million. The regions of the greatest concentration of these borrowers are Transylvania (37,000 potential borrowers, US$ 208 million) and Bucharest- Ilfov (23,000 potential borrowers, US$ 114 million). The remaining demand is spread fairly evenly across the rest of the country, with the least demand in the South West-Oltenia Region (see map).

In 2003, there were eight significant microfinance suppliers established by various international donors and support programs including: USAID, World Vision, Open Society Foundation, CHF International, Opportunity International and the Swiss Government. At the end of 2003, the aggregate outstanding portfolio for all microfinance organizations was the equivalent of US$ 23,100,000 (i.e., 4% from the estimated demand).

Many banks – including Romanian Commercial Bank, Raiffeisen Bank, Transilvania Bank, Alpha Bank, Romanian Bank and the MIRO-Bank (renamed Pro Credit Bank) – were implementing SME lending programs funded by EBRD.

Many of these providers, however, are clustered in the Transylvania region and Bucharest, while other areas of the country are less well serviced. While it has been difficult to estimate Romanian banks' loan portfolio outstanding to the microbusiness sector, as of June 2003 it totaled approximately US$ 270 million.

Based on the initial estimates, there appears to be room for a doubling of the existing loan portfolios of lenders to the sector before any nationwide demand constraints are encountered. These constraints are likely to occur first in Transylvania, while there appears to be an adequate supply of external funding available. See Graph 1 (page 2).

Romanian MFIs
1 – Center for Economical Development (CDE); 2 – CAPA; 3 – CHF (Community Habitat Finance); 4 – Opportunity Romania (OMRO); 5 – ROMCOM; 6- LAM; 7 – FAER; 8 – INTEGRA; 9 – Centre for SMEs Development Baia Mare (CDIMM BM); 10 – SMEs Development Foundation Petrosani (FPIMM P)

Legal Framework for Microfinance Activities in Romania

The legal framework for non-bank micro-credit activities involves three laws:

- The Law for Economic Reform Strengthening provides that any person or entity can sell on credit or extend loans, if that entity does not receive deposits from the general public. This activity does not fall under the provisions of the Banking law;
- The emergency ordinance No 40/2000 provides for the licensing of credit organizations (other than banks) to administer public funds (i.e., World Bank loan guaranteed by the government) for granting micro-credits. There are specific selection criteria for the credit organizations (e.g., at least three years of activity, audited financials);
- The law on the general legal conditions of the Employees' Mutual Aid Houses (i.e., Credit Unions).

Under this legal framework, the NGOs established in Romania by various international donor organizations extend micro-credits as well as support services, training and consulting for their beneficiaries (entrepreneurs, farmers, micro and small enterprises).

Who Needs a Microfinance Law and Why?

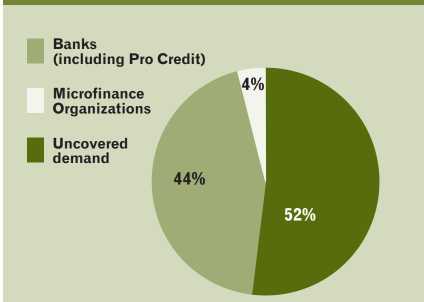
1. Romanian SME Sector

According to the "Annual Report of the SME Sector in Romania" published by the National Agency for SMEs and Cooperation ("SME Agency"), 90% (313,000) of Romanian SMEs are microenterprises (defined as fewer than 10 employees). One of the main problems encountered in their development and operation is the limited access to traditional bank loans due primarily to the following factors:

- Lack of a credit history of the micro and small companies, especially at start up;
- Lack of collateral (the guarantee funds for SMEs do not apply to loans under 25,000 Euro);
- Loan amounts that are unprofitable for banks to underwrite and service.

The draft Microfinance Companies law defines microfinance as the supply of loans and other basic financial services to individuals and companies (mainly micro-businesses)

GRAPH 1: 2003 ROMANIAN MICROCREDIT MARKET



with limited access to the formal banking system that allows them to run and develop their businesses.

2. Romanian Entrepreneurs

Entrepreneurs and micro-companies with no credit history, a lack of experience and knowledge in business management and few assets to use as collateral rarely have access to the formal financial sector. The size of loans sought by these borrowers is often too small for banks, with the administrative costs of granting and monitoring such loans outweighing the benefits for banks. These borrowers currently need to seek alternative credit sources – informal commercial and non-commercial lenders – often at very high costs.

The term "microfinance" used in the draft law includes micro-credit (up to Euro 25,000) for small businesses and micro-entrepreneurs and social programs as well as support services for the business community "for the purpose of developing an economic activity, a business or projects, of encouraging projects for community and economic development, initiatives of local communities and social programs with a view to improving the living standard of the local communities".

The draft law provides that, to develop and strengthen the micro entrepreneurs, "the microfinance institutions could develop, as secondary object of activity, and offer services for the economic development of the micro credit beneficiaries, including consulting services, information, education and specialized training".

The draft law protects the beneficiaries and ensures equal treatment of applicants by requiring "transparency of micro financing operations and of equal treatment of beneficiaries by making available to the interested parties all information regarding micro financing terms and conditions and by non-discriminatory applying the selection criteria of micro credit applicants."

3. Romanian Microfinance Organizations

Microfinance legislation would be likely to place the sector on the fast track to development, which, in turn, would serve as a driving force in combating poverty, creating jobs, educating borrowers in respect of finance and business, boosting social programs and community development projects, increasing entrepreneurship and social welfare and developing Micro, Small and Medium Enterprises.

If Romanian MFIs register as microfinance companies and start working in a regulated framework, it is probable that banks, investors and guarantee funds will be more interested in financing and partnering with MFIs' to support their development strategies.

From the fiscal point of view the law allows "microfinance companies to constitute, regulate and use specific credit risk provisions that are deductible from the profit tax, in accordance with, financing contracts and laws in force."

The role of an MFI association is specified as well:

"The MFIs' professional associations have the obligation to monitor the performance of the microfinance company and to calculate and publish performance indicators, at least on an annual basis."

The Process of Passing the Law and Its Challenges

At the round table organized in July 2003 for microfinance organizations and the stakeholders of the microfinance sector, the main area of support requested was a coherent legal framework for the microfinance activities. In addition, the MFIs and stakeholders voiced requests for technical assistance in the area of financial, human resource and marketing management, support in the assessment of MFIs' performance, development strategies and to access capital in order to increase the MFIs' micro-loan portfolio.

Based on those needs, the project's resource allocation was planned and partnerships were established with the main stakeholders of the microfinance sector in order to achieve the goals of the project.

Stages in the Development of Legal Initiative:

- **Creation of a working group for the development of the new legal framework for microfinance activities**
  The main objective of the working group was to provide specific information to the selected law firm in drafting the legal framework for the MFIs. Similar legislation from the Newly Independent States, Eastern Europe and the Balkans was reviewed, as well as trends in the evolution of the legal status of the microfinance providers.
  The working group suggested that the draft law require the registration or transformation of the existing NGOs and specify that microfinance companies would have a minimum capital requirement of Euro 200,000. (Although NGOs will be permitted to engage in microfinance activities under the draft law, they would not benefit from the advantages given to microfinance companies under the law, including the clear legal permission to engage in microfinance activities.) These suggestions were endorsed by all the MFIs that are members of the Microfinance Coalition.
- **Drafting the Microfinance Law**
  With the technical assistance provided by SALANS law firm, after studying the similar legal initiatives from different other countries and Romanian legislation related to micro-credits, the first draft of the Microfinance law was presented by the working group in the spring of 2004 to the representatives of the various parties with an interest in microfinance. The government bodies included the SME Agency, the Ministry of Public Finances, the Ministry of Labour and the National Bank of Romania. In addition, there was the Bankers' Association, SME associations and trade unions.
  Based on the suggestions and comments collected during this first presentation and debate, the lobby for the promotion of the law and education process for the policy makers on microfinance was planned.
- **Partnerships in Promoting the Microfinance Law**
  According to the Romanian constitution, a law can be promoted by the parliamentary group of a political party, Government through related Ministries or by 250,000 Romanian citizens. The selected path was through the Government in partnership with the both the SME Agency and Cooperation and Ministry of Commerce and Trade, which is currently implementing the World Bank's micro-finance credit lines for micro and small entrepreneurs in the restructured mining areas.
- **Lobbying For The Microfinance Law Promotion**
  Various presentations of the Romanian microfinance sector, trends in international microfinance, and the European Union's recommendations to promote the microfinance sector were made to National Bank

of Romania, the Romanian Bankers' Association, the Council for Social Dialogue of the SME Agency, various Ministries and Parliamentarian Commissions.

A group of experts from the Ministry of Public Finances, the SME Agency, Ministry of Economy and Ministry of Labour participated in the European microcredit conference organised in September 2004 by the European Commission, the European Microfinance Network and the Microfinance Centre and had the opportunity to meet and share information with microfinance practitioners and experts from Western European EU Countries and the EU Commission.

All Romanian MFIs participated in the promotion of the microfinance law, lobbying the parliamentarians from their own districts, professional and entrepreneurs' associations, the business community and local media.

MFC for CEE and NIS will hold its 8th Microfinance Regional Conference in Bucharest at the end of May (May 24-28 2005). This will provide a good opportunity to lobby for the microfinance Law and the microfinance sector with both the Government and the Presidential Administration as well as the business community, especially the banking and investment industries.

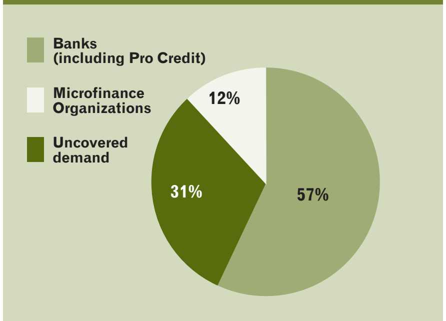
- **Challenges and Current Status**

2004 was an election year in Romania: in June – July, there were local elections for mayors and county councillors; in November – December, there were parliamentary and presidential elections. The process of endorsing the law by the Ministries was slow and difficult. Due to the change of the leading coalition of parties, the process of endorsing the law by the newly appointed ministries was repeated. Consequently, the entire process of endorsing the law took 12 months. Currently the microfinance law is being debated by the Romanian parliament.

Aims and Prospects for Microfinance Sector Development

The goal of having the microfinance companies' legal framework in force at the end of June 2005 seems to be realistic and a workshop aimed to inform and support the MFIs to comply with the new law was planned for the end of June 2005.

GRAPH 2: 2004 ROMANIAN MICROCREDIT MARKET



At the end of 2004, the MFIs had extended micro-loans exceeding 65 Million USD with an increased of market share of 8%, covering 12% of the microfinance services estimated market. Within the same period, the banks' share of the microcredit market increased from 44% to 57% mainly due to the launch of new financial products for microenterprises, such as "Credit in one hour" issued by relatively small banks (Procredit Bank and Transilvania Bank).

The banks almost reached the limit of downscaling and are interested in lending to the MFIs or in establishing strategic partnerships with them in developing new financial services for micro-entrepreneurs. Graph 2

Commercialization is the strategy of almost all large MFIs. It means (i) improvement of performance indicators, especially operational and financial sustainability, (ii) increase of the portfolio capital through borrowing from investors and banks and (iii) diversification of financial products offered to clients.

Innovative projects that combine financial services with community development support activities and training are positioning the Romanian microfinance sector as a bridge between commercial lending and social - economic development. Market access for women entrepreneurs (Integra Foundation) and private farmers and former miners or economic development of Roma communities (Center for Economic Development), micro-entrepreneurs clubs and training centres (OMRO and ROMCOM) are just a few examples.

To provide financial services for unmet demand (i.e., 31% of total demand for microcredits) means to triple the existing amount disbursed by MFIs and to reach almost 50% (USD Million 240) of the market within the next 5 years: this is a challenge for the Romanian MF sector.

By far the most challenging period for the Romanian microfinance sector as well as for the SME sector is 2005 – 2009, the preparation and accession to the European Union.

Efforts to comply with the legislative requirements of the EU are reflected in the draft microfinance law and a key role in supporting the process might be played by the Romanian Microfinance Coalition.

GEORGIA

Georgian Parliament Legislates Clear Legal Status for Non-commercial Micro-lenders

BY JEFF FERRY, CHIEF OF PARTY, GMSE

Introduction

On 25 February 2005 the Georgian Parliament voted 110-1 to amend the Georgian Civil Code (GCC) thereby clarifying the ambiguous legal status of non-commercial micro-lending institutions operating in Georgia[1]. For the first time in the history of Georgia, the term 'microfinance organizations' will appear in the Civil Code and as such these non-commercial organizations will be able to legally engage in lending activities. To fully appreciate what this means, one must understand the situation prior to the passage of the above-mentioned amendments.

Background

Ever since foundations and associations first started micro-lending in Georgia in 1997, they have been operating on questionable legal ground and have therefore been at risk of having their operations liquidated. Although registered with the Ministry of Justice as foundations, GCC regulations prohibited foundations and associations from engaging in lending or 'entrepreneurial' activities if that was their main activity[2].

Representatives of Georgia's microfinance practitioners and donors tried unsuccessfully to convince Georgia's legislators that their lending activities should not be forbidden, because the microfinance organizations were established by donors with the mission of making loans to poor people. (Associations must serve the public interest or the interest of its members; foundations must serve a socially useful purpose.) They argued that doing so would have an adverse impact on poverty reduction by impeding microfinance clients' access to financing which helps to grow businesses, create jobs, and raise household incomes.

It is important to note that Georgia's eleven main microfinance providers (Business Assistance Initiative, BBK Financial, Constanta Foundation, VisionFund Credo Foundation, Crystal Fund, FINCA-Georgia, Georgia Rural Development Fund, Small Business Development Fund, Support for Development, Society Development Association, and Union of Trust) are an important part of the financial services sector. They serve over 35,000 clients in more than 50 regions of Georgia and have a combined loans outstanding portfolio in excess of USD 13 million. Georgia's microfinance providers offer a wide range of loan products (i.e. group, individual, agricultural loans) and are evaluating possible introduction of new ones (i.e. educational loans, home improvement loans, leasing products, etc). To counter the increased competition from the formal banking sector, which has down-scaled to the microfinance market, Georgia's microfinance organizations have reduced interest rates, introduced new loan products and opened offices in new locations throughout the country. The largest impediment to rapid growth and development of the microfinance sector was their ambiguous legal status, and the reason policy reform was a key priority.

The Consensus Building Process

In August 2003, USAID began its Georgia Microfinance Stabilization and Enhancement (GMSE) activity[3]. One of GSME's main project tasks was to 'promote the establishment of an unambiguous legal status' for non-depository microfinance institutions. As a means to that end, GSME established a Legal Action Committee and a Public Information Advisory Committee to develop a public information campaign that would build consensus and raise awareness about legislative reform for microfinance.

In December 2003, the Legal Action Committee, comprised of microfinance practitioners, civil society leaders and donor representatives, was established. The purpose was two-fold: (1) to achieve consensus and conceptual agreement on the future working plans, and (2) to identify top-priority legislative amendments needed to improve the operating and regulatory environment for non-commercial, non-depository MFIs. Initially some committee members supported the drafting of a special law on microfinance, while others favored amending current legislation. After some debate, the Committee unanimously supported amendments to current legislation as the preferred short-term approach to achieving the goal of a clear legal status for non-commercial, non-depository MFIs. a document detailing the Committee's recommendations of amendments to current legislation was submitted to the Georgian Government and Parliament for comment.

Prior to the formation of the Legal Action Committee, Georgia's microfinance practitioners, viewing each other as competitors, were reluctant to work together. However, after only a few Legal Action Committee meetings, Georgia's microfinance practitioners discovered the value of working together on important matters such as legal reform for the microfinance sector. Now, more than one year later, Georgia's microfinance practitioners interact freely and openly. This bodes well for the long-term development of the sector.

In January 2004, a Public Information Advisory Committee, comprised of microfinance practitioners and representatives of civil society organizations and media, was formed to develop a public information program to promote the values and practice of sustainable microfinance. This Committee provided a forum to design a coordinated, multi-faceted public information strategy since it was quite apparent that there was a general lack of awareness and understanding about microfinance and the unique role it plays in economic development.

GMSE, together with its partners on the Public Information Advisory Committee, designed a public information campaign to raise awareness about microfinance and the role that non-depository MFIs play in alleviating poverty, creating jobs, and raising household incomes for their borrowers. The campaign used mass media channels and formal workshops and seminars, as well as face-to face contacts with key decision-makers to promote support for organized and responsible microfinance and micro-enterprise development within and among the Government of Georgia and the Georgian Parliament, Georgian NGOs, journalists, business and professional groups, and donors. Although designed to raise awareness across all elements of Georgian society, the primary focus of the campaign was targeted towards policy-makers and to support the legislative/policy reform initiative.

Some Government officials voiced their opposition to the Legal Action Committee's recommended amendments, instead preferring a specialized law on microfinance. This caused the Legal Action Committee to reexamine its proposed approach and to engage, together with GMSE, in public relations and marketing to raise awareness about microfinance and the recommended legislative amendments.

A series of meetings was organized with key policymakers in Government and Parliament as well as the National Bank of Georgia to build support across and among a broad group of stakeholders. In the course of doing so, GSME identified the person who 'championed' the amendments through Parliament. The lesson learned here is important: the consensus-building process should reach the broadest group of stakeholders in both Parliament and Government and should not stop with the first signs of opposition. This "champion", a prominent Parliamentarian, was able to secure unanimous support amongst the Cabinet of Ministers, and ultimately introduce the legislative amendments in Parliament.

Legislative Changes

In February, Georgia's parliamentarians took up discussion of the Legal Action Committee's legislative amendments, holding a committee hearing in addition to a meeting of the Cabinet of Ministers. Members of the Legal Action Committee were asked to provide statistical information about the industry, including current and projected outreach statistics (numbers of clients, regions served, etc). The two-week process concluded with the unanimous support of the Cabinet of Ministers and a presentation to the full Parliament[4].

The final version of the passed amendments legislates two major changes to the GCC[5].

First, Article 35, which provides that 'foundations and associations that engage mainly in entrepreneurial … risk having their registrations revoked,' has been amended so that such provision does not apply to microfinance organizations.

Second, there is a new article (Article 1511) which (i) defines "microfinance organization" and "micro-loan" and (ii) obliges non-commercial legal entities (i.e., foundations and associations) that are engaged in micro-lending to re-register as microfinance organizations by 1 April 2005. Newly formed non-commercial micro-lending organizations are also required to register as "microfinance organizations." Furthermore, Article 1511 obliges the National Bank of Georgia to introduce a specialized microfinance law to Parliament by 1 November 2005.

Benefits of Recent Policy Reforms

The above mentioned amendments to the GCC will have a positive impact on the long-term development of a sustainable microfinance sector in Georgia. The first and most important positive impact is the clear legal status for non-commercial microfinance organizations. No longer will Georgia's associations and foundations have to worry about their registrations being annulled by the Ministry of Justice for engaging in lending activities. As legally registered microfinance organizations, they will have the legal right to make loans to Georgia's micro- and small entrepreneurs.

A second important positive impact is that the microfinance organizations will be able to shift from short-term to long-term strategic/business planning. Prior to the adoption of the amendments, the directors of Georgia's microfinance organizations spent most of their time focused on short-term operations and worrying about the precarious legal status of their organizations. Now that their legal status has been clarified, they can spend more time planning for the long-term development of their organizations, including product diversification, geographic expansion and attracting investment.

A third positive impact is the enhanced opportunities for internal and external investors. Georgia's noncommercial microlending institutions were seen by potential internal and external investors as risky ventures largely because of their precarious legal status. With the recent amendments to the GCC, local Georgian commercial banks that have excess liquidity, as well as external investors interested in investing in the growing microfinance market in the country, may find Georgia's microfinance organizations more attractive and less risky.

Challenges

The main short-term challenge for the Georgian microfinance industry is trying to predict what the specialized microfinance law might legislate. As noted above, pursuant to the recently adopted amendments to the GCC, the National Bank of Georgia (NBG) must present a special microfinance law to Parliament by 1 November 2005. There are several models that the NBG could follow in drafting their law: Bosnia, Kazakhstan, Tajikistan, Kyrgyzstan, to name a few. Each of these laws is different and it's not clear the extent to which the Government is interested in regulation of the microfinance sector.

Another short-term challenge is the uncertainty of who will be named as Chairman of the National Bank of Georgia. The current Chairman's term expires on 25 March 2005, and one of the possible candidates for the position is the current Chairman of the Banking and Finance Committee. It should be noted that the current Bank leadership, including the Chairman, does not advocate for prudential regulation of the microfinance sector as it currently exists (i.e., non-depository institutions only). What, if any, impact the change in the Chair of the Bank will have on the staffing of the Bank and its policies vis-à-vis regulation of the microfinance sector remains unknown.

A final challenge is ensuring fair tax treatment for microfinance organizations. There are two important issues: First, according to the recently adopted Tax Code, microfinance organizations are not able to take a deduction for their loan loss reserve fund. This can be considered discriminatory tax treatment for those Georgian microfinance organizations that have loan loss reserve funds, as the formal banking sector, a source of direct competition, can take a deduction for their loan loss reserve. Second, per the current Law on Grants, grant funds that are used for 'entrepreneurial or political activities,' are not considered 'grant funds' but 'net profit' (for the recipient organization) thereby obliging the recipient organization to pay 20 percent profit tax on the funds. Since microfinance organizations engage mainly in lending or entrepreneurial activities, any grant funds that they would receive for their main activity is subject to profit tax. This places an unfair tax burden on microfinance organizations and provides a disincentive for donors to make grant funds available to microfinance organizations.

The Way Forward

Once the leadership changes at the National Bank of Georgia have been made, it will be important to establish a special working group to draft the microfinance law. Microfinance practitioners will need to continue their public information campaign to raise awareness about the impact of the industry on poverty reduction, job creation, and income generation for microfinance borrowers. The optimal end result will be a legislative environment conducive to the long-term development of a sustainable microfinance industry, part of a growing financial sector in Georgia. ■

1 Although there is no legal prohibition on commercial companies engaging in microfinance in Georgia, there are currently no Georgian commercial MFIs (excluding some local commercial banks).

2 According to the regulations in the chapter on foundations and associations in the GCC, organizations registered as such are not allowed to engage in entrepreneurial activity if that is their 'main' activity (Article 35 of the GCC).

3 The Georgia Microfinance Stabilization and Enhancement (GMSE) project is a USAID-funded activity designed to help Georgian MFIs become commercially viable and independent of donor resources through technical assistance/training, partnerships with banks, a grant facility, and by advocating for an unambiguous policy environment.

4 Between 23-25 February 2005 the Georgian parliament voted three times on the proposed amendments. It is mandatory that there are three readings/votes before any legislation can be presented to the President for signature. The final vote was 109-1 on 25 February 2005.

5 See full text of passed amendments at http://www.mfc.org.pl/doc/PassedGCCamendment_28_02_05.doc

AFGHANISTAN

Afghanistan Update

BY KATE LAUER[1]

The microfinance sector in Afghanistan – excluding the "informal" (or "traditional") financial system – consists of approximately three dozen organizations, none of which has operated for more than three years. Currently, seven of the organizations are supported – financially and institutionally – by the Microfinance Investment and Support Facility for Afghanistan (MISFA)[2]. MISFA also supports the Afghan operations of WOCCU, which has fostered the establishment of two Afghan credit unions and has agreed with MISFA to foster an additional 13 credit unions in the next four years. In addition, First Microfinance Bank – one of the eleven banks operating in Afghanistan – provides microfinance services and it is expected that in the not-too-distant future, another Afghan bank will be licensed to serve microborrowers and microsavers. The remaining organizations engaged in microfinance operate small-scale microlending programs in support of other programs and do not seek to create sustainable microfinance programs, as MISFA requires of its "partner" organizations[3].

With the exception of BRAC, which, as of December 2004, had more than 50,000 active borrowers, no MFI currently serves more than 4,000 borrowers. Primarily due to security risks, MFIs' activities are currently restricted geographically. As of March 2005, MISFA-supported MFIs were operating in 14 of Afghanistan's 30 provinces. However, the majority of their microfinance activities are in three provinces: Kabul, Herat and Balkh.

Products and Services

Lending is the primary microfinance activity. MFIs engage in both group and individual lending. Loans are predominantly business-purpose. Several MFIs provide loans to refinance business and agricultural debt, including in particular the politically sensitive debt accrued by poppy farmers that is denominated in opium and is commonly referred to as "poppy debt."

Although most MFIs do not offer voluntary savings programs, BRAC does and, in response to client demand, other MFIs plan to do so in the near future. Several MFIs require compulsory savings as a means of enforcing loan repayment. BRAC is the only MFI that has introduced an insurance product, which provides an insurance benefit to female borrowers who survive the death of a spouse.

In practice, Islamic law does not significantly constrain MFI activities, nor are MFIs providing Islamic products to any significant extent. However, MFIs' loan charges are typically labeled "a service charge" rather than interest. One MFI requires the charge be paid up-front rather than ratably over the term of the loan.

MFIs see demand for several products that are not currently offered, and many anticipate introducing new products in the near future in response to this demand. In addition to the planned introduction of voluntary savings programs, many MFIs plan to expand beyond business-purpose loans to consumer loans. Others plan to introduce insurance and leasing programs and small enterprise and home repair lending.

Legal and Regulatory Situation

The legal situation in Afghanistan is murky at best: there are few laws on the books and these are generally not helpful for the microfinance sector. Although there are no laws that prohibit NGOs and companies from engaging in microlending, the operating MFIs would prefer to operate in a legal environment that explicitly permits them to engage in microlending and the provision of other financial services to the poor and to microentrepreneurs.

There have been recent developments in the financial sector legislation: in the past two years, the President has signed laws governing the central bank and the banking sector. As of today, this legislation has no direct effect on the operating MFIs except that the banking law requires any depository institution, unless exempt, to be licensed as a bank by the central bank[4]. However, strengthening the legal and regulatory situation for regulated financial institutions is a positive step for the financial sector as a whole and for microfinance as a part of that sector.

There are also new laws on anti-money laundering and anti-terrorist financing that apply to banks and MFIs. These laws have not yet been implemented; however, they include burdensome record-keeping obligations and empower government authorities to demand copies of such records, which could ultimately be extremely taxing for MFIs.

The central bank is planning to draft and sponsor a law governing nonbank financial institutions (NBFIs) and has indicated that the passage of the law is a priority for 2005. It is hoped that the law will cover various types of financial institutions that will serve the demand for microfinance, including microlending organizations, nondepository finance companies, leasing companies and credit unions.

Currently, all of the MISFA-funded MFIs[5] operate as either branches of foreign NGOs or locally-formed NGOs and all are formed and registered under the 2000 NGO Law[6]. The NGO Law subjects NGOs to various requirements, including vague but potentially burdensome reporting requirements. The law does not specify the type of organization (e.g., a company or – if they existed under Afghan law, which they currently do not – an association or union) to be used to form the NGO, thus the MFIs are in the dark regarding governance structure and other issues that depend on the type of organization formed. The International Center for Not-for-Profit Law is providing assistance on drafting a new NGO law. However, it is hoped that the to-be-drafted NBFI law will create a "one-of-a-kind" NGO MFI that would not be formed under the NGO law.

The credit unions established by WOCCU (with MISFA support) operate without any legal status. As noted above, it is also hoped that the law on NBFIs will include credit unions.

1 Ms. Lauer is a lawyer specializing in international finance and microfinance. Ms. Lauer, together with Timothy Lyman and Lee Byrd, recently completed a diagnostic report for MISFA analyzing the legal and regulatory situation for microfinance in Afghanistan and making recommendations for reform measures.

continued on page 16

BOSNIA AND HERZEGOVINA

Legal and Regulatory Environment for Microfinance in Bosnia and Herzegovina: A Decade of Evolution and Prognosis for the Future

BY TIMOTHY R. LYMAN[1]

Introduction

The experience with microfinance in Bosnia and Herzegovina[2] and particularly the evolution of the legal and regulatory environment for microfinance over the past decade do not separate easily from the war-time and post war history of the country and the unique political and governmental structures that emerged out of the ashes of the conflict that preceded. This essay outlines: the historical background necessary to understand the legal and regulatory environment for microfinance as it has developed in post war Bosnia; the early years of microcredit (1996 – 1999) and the adoption of the microcredit organizations laws put in place to cope with the institutions that developed in the immediate post war period (2000 – 2001); developments in the broader Bosnian financial system that affected the position of the microcredit organizations (and changes in the legal and regulatory picture that accompanied these developments) (2002 – 2003); and the maturing of the microcredit sector, the emergence of the Central Bank as a likely dominant force in the future development of the Bosnian financial system and the implications of these facts for microcredit organizations, as well as the prognosis for future microfinance-related legal and regulatory reform (2004 and into the future).

Post War Historical Background

Microfinance surfaced as a topic of wide interest in Bosnia immediately after the end of the war surrounding the breakup of Yugoslavia. The reasons were clear: in the face of massive unemployment and no functioning social welfare system, self-employment and microenterprise were seen as an important means for people to earn a living and start rebuilding their lives. The early focus, therefore, was on microenterprise credit.

On January 1, 1996, the Dayton Peace Accord[3] put into effect a complicated confederation between two so-called "Entities" – Republika Srpska ("RS") in the north and east of the country, and the Federation of Bosnia and Herzegovina (the "Federation") in the south and west (which is in turn made up of numerous ostensibly self-governing Cantons) – all under a weak central government[4]. Under the Constitution, the Entity-level governments exercise all basic economic powers and have jurisdiction over substantially all matters of commercial and economic law. The most significant institution assigned under the Constitution to the weak central government (referred to as the "state level" of government) is the Central Bank (although even this institution initially had relatively little unifying effect on the situation of retail financial institutions, as in the first years of its existence it functioned exclusively as a currency board, with bank regulatory functions remaining at the Entity level).

To this already complicated picture, another institution – unique to Bosnia – must be added. While military aspects of the Peace Accord were left in the hands of a multinational stabilization force, civilian aspects of the peace were entrusted to a rather vaguely defined international body set up for this purpose known as the "Office of the High Representative" ("OHR"). Among OHR's more important responsibilities is to monitor the many legislative and political bodies called for under the Constitution to make sure they honor the spirit of the Constitution and the Peace Accord in general. Over time, OHR has used its powers increasingly to impose legislation on legislative bodies that acted in ways deemed contrary to the letter and spirit of the Constitution and Peace Accord, and particularly in situations where one or the other Entity-level government took steps (or failed to take steps) resulting in a lack of harmony between the economic and commercial law applicable in the two parts of the country. Creating a workably unified "single economic space" – at various times resisted, particularly by the many nationalist politicians who remain a feature of the Bosnian political landscape – became a primary focus of OHR's interventions.

The Early Years of Microcredit (1996 – 1999)

The two Bosnian Entities emerged from the war with a confusing morass of basic legislation, including laws "received" from the former Yugoslav Socialist Republic of Bosnia and Herzegovina, war time enactments (some of dubious legal effect following the adoption of the Peace Accord) and quickly crafted post war measures intended to move the country in the direction of a market economy. The field of NGO law, not well-developed in socialist times, presented a particularly confusing picture.

This presented a particular dilemma for would-be sponsors of microcredit in Bosnia, who wanted to use an NGO legal form to serve as the lending entity. (This was not just because NGOs had pioneered microcredit in other countries, but because war time NGOs had sprung up in Bosnia and proven their capacity to reach the targeted populations, whereas mainstream financial institutions were largely insolvent and widely mistrusted.) When the World Bank tried to agree with the Entity-level governments about the specific legal underpinnings of the nonprofit organizations that the Bank wished to propose as implementing organizations for a proposed large-scale project to introduce and fund the development of microcredit in the country (the "Local Initiatives Project"), the parties faced a large number of possible legal forms, none of which seemed sufficiently unambiguously and appropriately defined to carry out microlending as a primary purpose.

The suddenly burgeoning number of new microcredit operations being set up eventually hit upon several imperfect legal forms deemed the "least worst" vehicles for NGO microcredit: in RS, registered offices of foreign NGOs and citizens' associations; in the Federation registered offices of foreign NGOs, citizens' associations and humanitarian organizations (although some argued over whether humanitarian organizations were truly a separate legal form or perhaps simply a specialized form of citizens' association under relevant Federation law). These were also the legal forms chosen by most of the organizations receiving funding from the two newly formed apex institutions (one in each Entity)[5] charged with implementing the Local Initiatives Project. Gradually the Entity-level governments grew acquiescent with their use as vehicles for carrying out lending activities.

The banking sector in both Entities had emerged from the war with a large number of insolvent institutions with large volumes of uncollectible loans to collapsed or ailing state-owned industries and had long since stopped most normal retail lending activity with ordinary citizens and small businesses. The focus of the newly created Banking Agencies in the two Entities was appropriately focused on cleaning up the banks and closing down the insolvent ones, while building the capacity and independence of supervisors chosen for the task. They had no time for (and no interest in) monitoring the behavior of the new microlenders (whose failure, at the worst, would only waste foreign donor resources). Also, the Banking Agencies developed an early healthy respect for nonprudential monitoring being carried out by the Local Initiatives Project apexes (even though the monitoring did not extend to microlenders not participating in the Local Initiatives Project).

A credit-starved populace provided the conditions for rapid development of microcredit. Extreme mistrust of conventional financial institutions (responsible for the loss of most families' pre war savings) meant a commensurately low savings rate and little liquidity in the banking sector. During this period, the payment system remained under the control of a government-run sole provider, a separate one in each Entity, that grew directly out of the earlier similar Yugoslav state-run payment services monopoly, although commercial banks provided the main interface with the state-run system for ordinary citizens.

Besides the independent donor-funded NGO microlenders and those funded by the Local Initiatives Project, one other institution commenced operations during this period that also made smaller loans to micro and small enterprises: the Micro-Enterprise Bank ("MEB") – the first of the network of greenfield microfinance banks created by Internationale Project Consult GmbH with funding from the European Bank for Reconstruction and Development and International Finance Corporation that would grow to cover more than a dozen countries in the region[6]. MEB was formed under the Federation banking law and licensed by the newly created Federation Banking Agency.

This is the first part of the essay on Legal and Regulatory Environment for Microfinance in Bosnia and Herzegovina. This essay is part of the Essays on Regulation and Supervision series produced in conjunction with the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments. The second part will be published in the next issue of the Policy Monitor.

1 Mr. Lyman advised the World Bank in the initial legal structuring of the Local Initiatives (Microfinance) Project in 1996. Since 1997 he has served as International Legal Advisor to the twin Local Initiatives Project apex institutions in Bosnia's two constituent Entities. He is Legal Issues Advisor to the Microfinance Centre for CEE and the NIS and serves as Policy Advisor to CGAP.

2 "Bosnia and Herzegovina" is the legal name of the country that emerged from the break-up of Yugoslavia on the territory of the former Yugoslav Socialist Republic of Bosnia and Herzegovina following the implementation of the Dayton Peace Accord at the beginning of 1996. In this essay, the country is referred to simply as "Bosnia."

3 The Peace Accord encompasses the post war Bosnian Constitution and sets forth other aspects of the governmental structure of the new country.

4 The tiny District of Brcko, which has a special status, is not discussed in this essay.

5 In both Entities, the apex functions were given to specialized departments of newly formed foundations controlled by the Entity-level government, each housing a number of unrelated World Bank-funded projects. In practical terms, however, the two Local Initiatives Departments have functioned with considerable autonomy from the Entity-level governments.

6 MEB and its sister institutions in neighboring countries now operate under the name "ProCredit Bank."

CEE / NIS NEWS AND VIEWS

SERBIA

Governmental Intervention into Microfinance in Serbia with the Aim of Reducing Unemployment

BY ARMINIO ROSIC, BELGRADE MARCH 2005

At the end of February 2005, the Serbian Finance Minister announced the establishment of the Serbian Microcredit Fund (Fund). This was a sudden change of the course in policy for the Serbian government, which has vigorously opposed microcredit in the previous years. However, the entry of the Serbian government into retail microcredit is not necessarily a welcome development.

The information provided by the Ministry so far on the functioning of the Fund is relatively sparse and new information is only becoming available gradually, following the Government's initial definition of the Fund's contours. At first, all that was disclosed was that:

- the ***loan size*** is to be between 5,000 and 20,000 Euros, thus exceeding the traditional size of microloans;
- the ***maturity*** will be from 3 to 5 years, with a ***grace period*** of one year (also atypical of best practice microlending, at least for first-time borrowers); and
- the announced ***fund size*** is 8 Million Euros (a figure, in the Serbian context, potentially large enough to have a significant impact – positive or negative – on the market).

Generally speaking, the initiation of such a fund might be justified by the government's wish to boost entrepreneurship and reduce unemployment in Serbia, where an estimated 1/3 of the population is jobless. However, the announced ***interest rate*** of 1% per annum is disturbing. What will be the implications of such a fund? Is this really a microlending instrument, or really a semi-grant intended by the government to reduce unemployment? Most importantly, what will the impact of such a fund be on the prospects for ***sustainable*** microlending in Serbia?[1]

The establishment of a fund with such a structure is likely to affect the private microfinance sector in Serbia adversely, and may even **distort the broader financial market.** (The potential adverse affects of subsidized government-implemented retail microlending are well documented, and include both crowding out of sustainable private sector microlending and significant risk of political interference.)

The second question is the ***source***, that is, where will the funding for the Fund come from? Is it the tax payers' money or funds acquired from the privatization of previously state owned companies? (In either case, the money might have a greater affect on reducing unemployment if invested in sustainable private sector institutions or in policy reforms aimed at developing sustainable private sector microfinance.)

The final question is the ***sustainability*** of the Fund. It is not possible for a fund with a 1% annual interest rate to be economically sustainable in the long run (unless the government is going to cover the Fund's administrative costs and even in such case, the 1% may not be sufficient to cover loan losses). Therefore, once established, this Fund will most probably have to be recapitalized from the state budget, that is, from further tax payers' funds (as significant donor funding is generally harder and harder to find for such subsidized government retail lending schemes).

In mid March, the government announced additional conditions and prerequisites for becoming a beneficiary of the Fund: The Fund will not be open to everybody, but rather only to the **unemployed**. Unemployment will have to be proved by registering with the National Employment Service. Secondly, the beneficiaries will need to **register a company,** which takes time and money, to say nothing of the know-how needed for a successful business start-up. Thus, accessing loans from the Fund will have significant obstacles and it is questionable how well the Fund will really respond to the needs of Serbia's unemployed.

At the end of March, new information regarding the Fund again became available. Borrowers from the Fund will be required to have collateral to secure their borrowing, making it even less likely that the Fund will serve the needs of a typical unemployed person. Moreover, the Fund will be operated by the government-controlled Serbian Development Fund and the loan applications will be submitted to the National Employment Service. Following this latest current of events, it is clear the Fund is more a governmental intervention to reduce unemployment (and at that, a questionably designed one), rather than a serious microfinance intervention.

Given the history of the Serbian government to date in failing to support policies that facilitate the development of private sector financial services for Serbia's lower economic strata, the decision now to intercede with what is most likely an unsustainable government controlled retail intervention is particularly questionable. We can only hope that Serbia's policy makers, with time, come to understand that the most appropriate way for governments to assure access to financial services for all sectors of the economy, including the poor, is to create a policy framework conducive to the development of private sector retail microfinance.

For information on appropriate roles for government in microfinance, see http://www.cgap.org/direct/docs/donor_briefs/db_19_print.php.

1 Given that the Fund's minimum loan size (as currently defined) is higher than the traditional microloan in Serbia, it is probable that many microborrowers will not be able to borrow from the Fund. The result will be to lessen the potentially adverse impact of the Fund on the microfinance sector although it would not diminish the potential to distort the broader financial market.

REGIONAL OUTLOOK

Finance for the Poor: Regulatory Challenges to Private Sector Investment

BY JENS REINKE AND KATE DRUSCHEL[1]

It is widely accepted that private sector investment will be the key to mainstreaming microfinance and growing the industry to large-scale proportions. In practice, however, microfinance institutions (MFIs) at all stages of development continue to prefer donor funding, especially grants, to fund their operations.[2] For those MFIs that do prefer to access more commercial sources of capital, supply mostly stems from socially responsible investors or commercial bank loans guaranteed by international financial institutions. Whether or not this supply is sufficient to satisfy the potential capital needs of a rapidly growing microfinance sector, supply of capital is not the only obstacle to increased private capital investment. This article looks at two broad sets of regulations that hinder private sector investment in MFIs.[3] First are those regulations that limit the ability of MFIs to accept all forms of private investment, second are those that limit potential investors' ability to choose microfinance as their preferred investment destination. In both cases, poor, inappropriate, complex or unclear, or non-existent regulation and law increases the risk of investing in MFIs, thereby decreasing investor interest.

Regulations Affecting Investments in MFIs

Finding a willing investor is often assumed to be the most critical requirement to access private capital. However, many MFIs are subject to regulatory restrictions that make it difficult for them to accept private investment when it is offered or available. The types of regulations that limit private investment in MFIs are primarily concentrated in three fields: 1) company and tax laws, including bankruptcy law; 2) restrictions on foreign ownership and foreign borrowing; and 3) ownership restrictions on regulated financial institutions.[4] In addition, lack of legal clarity and transparency surrounding regulatory issues often hinders MFIs' access to commercial capital.

Company and tax law define commercial and fiscal rights, and specify obligations of companies engaged in microfinance. For the many MFIs registered as non-profit organizations, this organizational status creates a situation where commercial activity can often be restricted. In addition, tax codes often prohibit certain types of commercial transactions for tax-exempt companies, including restrictions on paying dividends on equity, interest on debt, the amount of management fees that can be paid. These restrictions can be either laid out specifically in law or implied by the organization's non-profit status. In some countries, non-equity investment in non-profit companies is restricted by the organization's inability to collect interest payment, thus making the investment unpalatable. Not all MFIs are non-profit companies, however, and generally for-profit entities are less restricted since they do not have any tax privilege to lose.[5]

In some cases, an MFI's non-profit status restricts its ability to onlend funds. This is especially true in countries with former Soviet legal traditions, where legally ambiguous permissions to on-lend funds leaves lenders and equity investors hesitant to invest in such an environment. Some regulatory amendments, such as the Georgian Civil Code Amendments passed in February 2005, attempt to legally define non-profit, credit-only MFIs, allowing the institutions to operate on a more stable footing.

Bankruptcy law has been a major issue that discourages potential investors, both foreign and domestic. If an institution has to be liquidated, non-equity investors worry about their ability to be repaid and if their investment will take precedence over other claims. If part of the liquidation process forces an institution to convert its debt into equity, the lender's investment would be trapped in the institution and therefore, more difficult to liquidate. Thus, poor bankruptcy laws and/or weak administration of these laws make investors less secure in their ability to easily extract themselves should the investment quickly become unprofitable. This concern exists for investors already wary of microfinance, where exit strategies may be particularly important for attracting non-equity investors.

Foreign investment regulations may be specific to a particular type of organization, affect all financial institutions or impact all companies. Unintended limitations may result if primary company legislation and secondary financial legislation are not well synchronized. In some countries, shareholder companies need majority local ownership, but the financial law may be silent on foreign ownership restrictions, which m ay produce severe or unintended constraints especially where an MFI wishes to transform to a private, formal banking institution. Alternatively, a country may not place any foreign ownership restrictions on companies but may require that licensed financial institutions are primarily locally owned. In another example, financial regulation may stipulate a form of company registration that limits equity investment, such as cooperatives. Restrictions on foreign investment also apply to debt financing since many countries restrict borrowing from foreign sources or in foreign currencies.

Ownership requirements in some countries can restrict investment in financial institutions. Some countries limit or exclude non-profit institutions from owning supervised financial institutions. There are some good reasons for restricting ownership, especially for ensuring controlling stakes go to well-capitalized and reputable entities. Such regulations, however, can have some unintended and adverse effects. This is especially true when inappropriate banking regulations are expanded to all financial institutions, and if avenues for institutions to graduate to another licensing tier are not available to existing, non-licensed microfinance institutions. For example, the restriction on non-profit companies owning banks may prevent a microfinance organization from acquiring a banking license.

A lack of transparency about how transformations could occur for existing financial institutions – for example, how existing loan portfolios can be legally transferred to a new, licensed entity – makes investment decisions more difficult (see textbox on Kyrgyzstan). In addition, specific regulations, such as inappropriately high minimum capital requirements or stringent loan reporting requirements, often prevent institutions from acquiring financial licenses. While these regulations are often adopted for legitimate purposes or to overcome historical imperfections in the market, they may also have unintended consequences for the microfinance industry. When no obvious route to transformation exists, some institutions, such as ACEP (Senegal), NOA (Croatia) and Nachala (Bulgaria), have chosen to register as a credit union or cooperative, which ultimately restricts their ability to access private sources of capital, particularly new equity.

Legal obstacles to NGO transformation in Kyrgyzstan.
An MFI in Kyrgyzstan prepared to transform from a local branch of an international NGO (FINCA) into a local, regulated commercial credit company with the potential of attracting more investment. In the process, there were continual problems in moving the loan portfolio from FINCA to the new company. Exchanging the loan portfolio for shares would have been illegal, because the Law on Microfinance Organizations requires that shares be purchased with cash. If the loan portfolio had been given as an in-kind gift, the commercial credit company would have had to pay a profit tax of 30 percent. If the NGO let the loan portfolio be repaid gradually, slowly turning the cash over to the company, the practical implications of re-registering the security for each transaction would have been insurmountable. In the end, however, a solution was found to overcome these obstacles and the NGO was able to transform.

Regulations Affecting Investors

Regulations that prevent a potential investor from investing in microfinance typically vary depending on whether the transaction is domestic or international. Since donor funding, which has been a critical source of capital for microfinance to date, has been largely international, the potential of domestic investment has been neglected. However, most developing countries have well-capitalized domestic investors and regulatory reform could play a critical role by removing barriers to MFI investment.

There are three primary categories of domestic private investors: social entrepreneurs, institutional investors, and other market-motivated investors. The first source of private capital for most MFIs is from social entrepreneurs, mainly non-profit companies or organizations, who often accept flexible terms and great financial risk. However, this group is unlikely to provide the volume of capital required to meet the needs of most growing MFI sectors.

Domestic institutional investors are a more likely long term source of capital for MFI growth and development. In many developing countries, institutional investors, who already may face obligations to invest a certain share of their portfolios in domestic assets, may be attracted by MFIs with favorable risk-return profiles as alternative investment opportunities. These investors, however, typically invest in assets with proven value and a reasonable level of liquidity. Many jurisdictions require that the bulk of these assets be held in negotiable instruments, while lower limits are set for investment in long-term assets, such as commercial property. Investments in microfinance would probably not meet the regulatory requirements on asset quality and liquidity.[6]

One approach to improving the attractiveness of MFIs to institutional investors would be to reduce the regulatory requirements that limit investment in non-traditional assets. Such a small change in their asset allocation could mean large changes in the absolute amounts of capital available to microfinance institutions while also allowing increased diversification of the institutional investor's portfolio. If institutional investors were allowed to invest in non-listed shares or non-negotiable debt instruments, investments in microfinance would be immediately feasible. Given the large asset base of institutional investors in some countries, even small portfolio shifts could result in large investment flows to microfinance.

Regulations can also restrict domestic debt investment in microfinance. Collateral requirements that limit lending to low-income individuals equally affect the ability of MFIs to secure debt financing. Most MFIs simply do not have the type or value of assets that collateral laws often require to secure loans from licensed banks. Financial institutions in the Philippines are having a particularly difficult time in this regard (see textbox).

In principle, **foreign investment** in microfinance is not different from domestic investment. However, since it is subject to additional regulations, foreign private investment is probably a more difficult source of capital to tap, especially when investments are sought from rich countries for MFIs in poor countries.

Filipino Collateral Laws Impede Debt Financing for Microfinance

Collateral laws in the Philippines do not support the use of intangible items, such as a loan portfolio (the traditional security offered by MFIs), and the Central Bank requires a 100% reserve requirement against any unsecured loans. Therefore, while the rural and thrift banks move forward in the microfinance market, they are unable to access loans for this business; banks assert that the MFI must offer traditional forms of collateral, such as real estate.

Institutional investors are the most likely source of foreign capital for microfinance. However, the rules that guide their investments, including country risk and accounting standards, raise a high threshold that microfinance institutions, local capital markets and domestic regulators must overcome in order to attract foreign portfolio investment. In addition most investors also require liquid capital markets and strong regulatory frameworks, another obstacle making such environments less attractive to international investors. As a result, developing country investments have little chance of being considered by all but the most specialized investment funds – and even those designated for least developed countries (LDCs) face the same regulations and economic pressures. It is important to recognize that the primary barriers to more international investment in MFIs are the local capital market and the economic and regulatory environment. Only after international investors can be certain of overcoming these barriers, does quality of individual assets become an issue. In some rare cases, however, inward investment in microfinance may be explicitly restricted by the host country (see textbox).

Restrictions on Foreign Investment

India is an example of a country which restricts inward investment in finance. Foreign investors such as Oikocredit, Deutsche Bank Community Development Fund, and Blue Orchard have been eager to tap into this diverse market for microfinance. The Indian government, ostensibly in response to fears of terrorism financing, has prohibited non-bank financial institutions from accessing foreign funding, however. Interested investors must set up Indian registered subsidiaries in order to channel funds into the country for the support of microfinance.

Overall, regulations constrain both domestic and foreign investment. Market-related factors additionally inhibit most international investment flows, mostly because of country and currency risk, market size, liquidity and information costs. Regulatory restrictions that coincidentally inhibit international investment in microfinance are unlikely to be removed simply for the benefit of the microfinance sector. Regulatory reform with respect to private investment in microfinance is more likely to be achieved in domestic markets than in international ones.

How Regulatory Implementation Impacts Private Investment

Investors make decisions based on multiple variables, not all of which are quantifiable and verifiable. While laws and regulations are written documents and usually accessible, their interpretation and implementation is more difficult to accurately capture. Changing laws, varying interpretations, and uneven implementation and enforcement make regulations unpredictable and their impact difficult to measure, which is a source of great concern to investors.

It is not only those regulations affecting their own investments directly, but also with the stability, rationality and predictability of regulatory changes affecting market conditions more broadly that concern investors. Sound regulations and processes for drafting, passing and implementing legal and regulatory changes signal a positive investment environment. Governments have an opportunity to signal their positive attitudes toward investors by consulting the private sector on policy changes, making decisions in a transparent manner and generally promoting a positive relationship with private sector stakeholders. This involves also including potential private investors in on-going microfinance policy dialogues often dominated by NGOs, experts, donors, and government officials.

Transparent and fair policy processes may harness regulation as a means to promote private sector investment in microfinance. This would require that regulators and stakeholders who discuss and implement regulation adopt these minimum standards:

- **Understand the investment market, as well as the client market**
  Policy debates around microfinance sometimes emphasize the objective of poverty reduction at the expense of understanding the needs and means of market-based capital. Emphasis on the poor tends to alienate private investors who may share the moral perspective, but are primarily interested in economic fundamentals. Regulation should be compatible with plausible business models.
- **Accept that a fair return is important**
  Private capital is more expensive than donor funding, although the reporting requirements of donors are typically more onerous and costly. Financial returns consistent with the level of risk have to be achieved reliably to attract and maintain private sector investment into the microfinance sector. Regulation that interferes with financial returns (including interest rate ceilings, collateral requirements, etc. – often promoted as misguided efforts of consumer protection) reduce the willingness of private investors to engage in microfinance.
- **Ensure Transparency and Consistency**
  Investors can only confidently make an investment decision when they have confidence in their knowledge of the legal environment and that shifts in that environment will be made for rational reasons with all stakeholders participating in the discussion. ■

1 Jens Reinke is an economist at the International Monetary Fund in Washington, DC and was formerly an Associate Director at the IRIS Center at the University of Maryland. Kate Druschel works with the IRIS Center on microfinance legal and regulatory issues. a longer version of this article was written with funding by the United States Agency for International Development as a complement to the "Financing Microfinance Institutions: Transitions to Private Capital" research project with Chemonics International and was published as microNote 7, available at http://www.microlinks.org. The authors take responsibility for all errors herein.

2 CGAP (2004). 'Foreign Investment in Microfinance: Debt and Equity from Quasi-Commercial Investors." CGAP Focus Note No. 25. Consultative Group to Assist the Poor, Washington, DC.

3 For the purpose of clarity, this paper uses the terminology of standard economics. Investment refers to the provision of capital in any form, be it equity, long or short term loans. Regulation, on the other hand, is taken to include rules, laws, decrees and supervisory action regardless of its precise legal form. |

4 Microfinance institutions, for the purpose of this discussion, are incorporated entities with or without a banking license.

5 However, tax exemption is fundamental to the viability of many microfinance institutions.

6 For a discussion on determining MFI investment asset classes, see M. de Sousa-Shields and C. Frankiewicz (2004). "Financing Microfinance Institutions: The Context for Transitions to Private Capital." MicroReport No. 8. USAID, Washington, DC. Available at http://www.microlinks.org

Microfinance in EU Countries – A Brief Discussion of Interest Rates, Banking Legislation and EU Harmonization

BY HEDWIG SIEWERTSEN, DEPUTY DIRECTOR, FACET BV

This article reflects on a few aspects of the legal framework for (micro) financial services provision in Europe. It is based on a research that analysed 6 factors necessary to make microcredit an effective tool for inclusive economic growth. The conclusion of the research is that the main barriers lie in the unfriendly business environment for micro enterprise and in the existence of a poverty trap that occurs when people move from a social benefit situation into self-employment. So although the legal framework was not the most important section, the findings are worthwhile sharing in this Policy Monitor.

Introduction

In 2000 the European Council agreed on the implementation of the Lisbon Strategy, which aims to make the European Union the most competitive economy in the world by 2010, while maintaining its social cohesion.

Economic growth with social cohesion, as defined in The Lisbon Strategy, seeks to involve and enable all European Union citizens to contribute to the realisation of growth. Policies should make participation in economic growth possible for those at risk of poverty and social exclusion. The Commission considers micro-credit as a possible effective instrument in employment and social inclusion programmes. Therefore the European Commission mandated FACET, EVERS & JUNG and nef to conduct a study on policy measures that promote the use of microcredit. MFC and the European Microfinance Network (EMN) were research partners in this study.

The research focused on six dimensions that determine the potential of micro-credit and self-employment as a tool to realise economic growth with social cohesion. They are:

- **Entrepreneurial context:**
  How entrepreneurial is the society and how

much does it support its entrepreneurs?

- **Policy environment for micro-enterprises:** Are there policy measures that promote self-employment in general, and for socially excluded in particular?
- **Welfare bridge:** How developed is the system for taking people from unemployment to employment (including self employment)?
- **Legal framework for micro-finance:** Is there a supportive legal framework for micro-finance services?
- **Financial bridge:** Are financial services available for excluded groups and the self-employed?
- **Funding and support for micro-credit providers:** Are MFIs supported through direct and sustained funding?

For the purpose of this article we will focus on the findings regarding the legal framework for microfinance, although as noted above all dimensions have implications for policy measures that could help and strengthen the microfinance sector. For the full report we would like to refer to the European Commission website: http://europa.eu.int/comm/employment_social/social_inclusion/studies_en.htm]

The research included seven EU Member States: Czech Republic, France, Germany, Poland, Spain, Sweden, United Kingdom and the EU Accession country Romania.

Country Case Findings On Legal Framework

Two important elements related to the microfinance legal framework were identified:

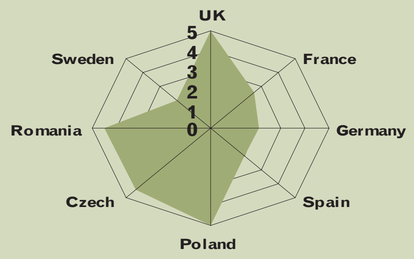
- The banking legislation and regulation
- The policies on interest rate setting.

Micro-finance is often offered by organisations that operate outside the banking sector. These institutions have the capacity and willingness to reach out, in a cost effective way, to people who are in need of micro-credit. In order to be able to cover the higher transaction costs, the micro-finance institution needs to charge higher interest and or fees. In countries where usury laws exist this might become a problem.

The scoring on each dimension is plotted in a radar diagram, for the legal framework the scoring for the 8 countries was as follows:

(The abridged explanation of the scoring is presented in the Table 1)

FIGURE 1: LEGAL FRAMEWORK



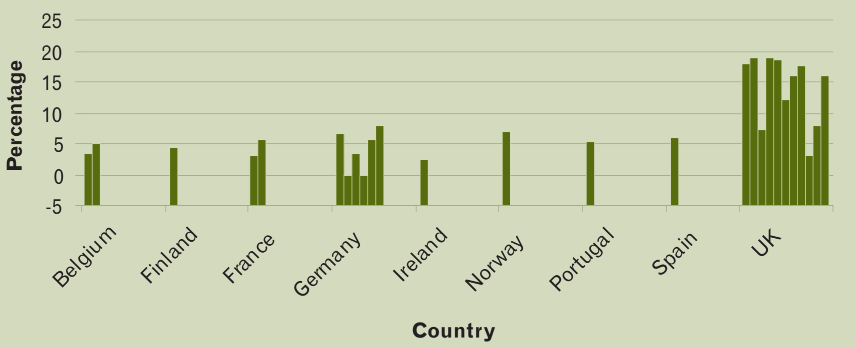
As can be seen from the figure and table, Poland and the UK are the two countries in our study with the most 'light touch' regulation for non-bank consumer lending. In both countries, non-banks can lend and neither country sets a ceiling on interest rates. However, financial lenders in the UK have to comply with the Consumer Credit Act and unfair lending is unlawful although the courts have had a difficult time interpreting what constitutes "grossly exorbitant" lending and "fair dealing". This light touch regulatory environment makes it easier for micro-credit institutions to become operational and sustainable, but it raises questions on consumer protection against predatory lending. Therefore there are discussions whether a usury law should be developed to prevent predatory lending and protect borrowers from indebtedness. Usury laws alone might not necessarily solve the problem of predatory lending because lenders can drive up the costs by rolling various fees into the loans. This underscores the importance of loan disclosure laws. The argument against usury laws is that the government may set a maximum rate that discourages legitimate lenders from entering a market that may be costly to serve. At the moment, the UK Government opposes the development of a usury law.

The UK and Polish model could be complemented with a regulation similar to the German system, which delivers consumer protection but at the same time leaves room for risk-adjusted lending and cost coverage through some interest spread. The heights of interest rates are limited by a usury law that forbids charging more than double the average interest rate in the sector (e.g. real estate, loans), or exceeding the average interest rate in the sector by 12 percentage points or more. This regulation would leave enough freedom for German MFIs to price their loans on a financially sustainable level like we see in Eastern Europe. But

Table 1: Scoring on legal framework for each country

Country	Argument
UK (5)	No usury law and non-banks are allowed to lend but they must comply with the Consumer Protection Act. While the Act is being updated, it is still fairly weak and indebtedness for some (those with debts) and predatory lending for others (politicians or "victims" of it) are major problems.
France (2.5)	The Banking Law has a regulatory window, which permits micro lenders to borrow, and on lend, which is positive but there are restrictions that apply. Usury law is different for consumer lending (20 per cent) and business lending (10 per cent). Business loans can only be given when the client has an account in name of an incorporated entity. Under the special window loans can only be given to people with minimum revenue that start up a business.
Germany (2)	The difference between cost of borrowed funds and interest rate on loaned funds is flexible and micro-lenders (i.e., public authorities) are consumer friendly. Legal bank framework is very restrictive: non-banks can't give loans, except for the public authorities. Business loans can only be given when you have a business account.
Sweden (2)	There is a usury law and no possibility for non-banks to lend other than ALMI, a government organization that supports enterprise creation.
Romania (4.5)	No usury law but in new draft law there are provisions for loan cost disclosure (i.e., effective interest rate and administrative fees). A draft MFI law has been written and is currently in the lobbying process.
Poland (5)	No usury law. Non-banks are allowed to lend. A well-known UK firm that engages in predatory lending started operations in Poland.
Czech Rep. (4.5)	No usury rate in the Czech Republic. The civil code prohibits disproportionately high rates of interest but the law does not fix the height of the interest rate. Non-banks can lend money.
Spain (2)	Usury law exists. Non-banks are not allowed to provide loans.

FIGURE 2: INTEREST RATES BY COUNTRY



for reasons unknown they don't use this freedom: in 2002/2003 the average interest rate of micro-finance providers in Germany amounted to merely 6 per cent.

Figure 2 gives an overview of the interest rates charged by 32 MFIs that participated in the EMN research in 2004. It is clear that interest rates in the UK are much higher than in other countries.

One of the most interesting issues related to the legal framework is the question whether the harmonised European banking regulation becomes micro-finance proof.

The European integration process leads to the progressive transfer of banking regulation from the national to the European level. The Member States have established two banking directives (1977 and 1989) which, together with subsequent amendments, specify two main objectives in addition to the harmonization of legislation objective:

- Protection of savers (compulsory deposit-guarantee of up to €20,000 for each European depositor).
- Creation of a level competitive playing field (that only credit institutions with bank license can take deposits).

EU banking directives do not relate to credit-only institutions and therefore do not directly affect or restrict micro lending. However, some Member States limit the lending business to licensed banks. This is the case in Germany, Portugal and Spain.[1] For organisations in these countries, the only way to operate micro-credit is to partner with mainstream banks.[2] There are two reasons that countries impose this restriction on non bank institutions. First, credit-only institutions often borrow from varying sources (and these sources may, in some cases, constitute savings of the general public or "deposits") so the risk of on-lending these non-equity sources remains. Secondly, these countries want to avoid unfair competition among different types of financial institutions because they are regulated under different laws. If, for example, a credit company does not have to comply with solvency ratios, it can offer more favourable rates to the clients. It is this type of unfair competition that the above-mentioned countries want to avoid.[3]

Another harmonization issue affecting micro-finance is usury law. France, Germany, the Netherlands, Belgium, all Scandinavian countries and Italy have introduced a legal usury ceiling for credit which, at less than 10 per cent in France, is especially low for small business credit. The rationale behind a usury law is to protect consumers and entrepreneurs from indebtedness and unfair practices.

Good And Improvable Policies And Practices

Good practice: Accommodate needs of micro-enterprise support organisations that build financial bridges without distorting the financial sector.

France

Until recently, associations could only lend from their equity; they were not allowed to borrow for on-lending. ADIE was limited in its outreach by its (limited) own resources – it was able to advance itself mainly through the development of specific agreements with various banks. In July 2003, France created a special window in the banking act permitting associations that lend to specific groups to borrow and on-lend. ADIE (l'Association pour le Droit à l'Initiative Economique) is the only organisation in France that makes use of this special window. Since the special window, ADIE is allowed to borrow for on-lending which makes the organisation much more efficient because it does not need to pass through a bank for its operations. However, the special window has restrictions on the type of end clients that can be financed in order to avoid competition with the banking sector. Only recipients of minimum welfare benefits (RMI) and the unemployed can borrow from on lent funds up to a maximum loan of €6,000 and then only during the first five years after business creation. The window is designed to allow associations to provide the first small (hence most risky and most expensive) credit to a starting entrepreneur on the basis of risk sharing with the mainstream financial sector (whereby banks only incur risk for 30% of the loan amount). This credit provision is not replacing a bank service but, on the contrary, is preparing potential clients for bank finance.

Good practice: To change unclear confusing, regulation that leads to uncertainty in the micro-finance sector into a clear, stable and comprehensive regulatory framework developed in consultation with stakeholders.

Romania

The legal framework for MFIs is murky. Romanian companies may lend and three internationally based MFIs had special permission from the Romanian Government to lend as well. However, it was unclear how long this special permission would last. For this reason, 14 MFIs formed a coalition to help draft proposed legislation to clarify the situation. The law has been agreed in principle but still needs to be signed by the Ministry of Justice and finalised with the Government. It is quite favourable for MFIs with light touch regulation, although it remains to be seen how it will work in practice. There is no usury rate in Romania. Due to central bank regulations, collateral requirements are very high (from 100 to 200 per cent) which inhibits banks to lend to micro-enterprise or start-ups.

Germany

In Germany, a banking license is required to engage in lending (excluding government entities). The conduct of banking business without a license leads to the risk of fine and imprisonment. The only possibility for non-banks to facilitate loans for micro-enterprises is to co-operate with banks. There are around five local partnerships of banks and MFIs but the numbers of loans is still small (<50). Other providers are public authorities where the legal status is somehow unclear (also true in other countries where public authorities have financing functions).

Some regional authorities implement loan schemes and call them 'repayable subsidies' to overcome legal restrictions. The best schemes, situated in the limited administrative districts of the city-states Bremen and Hamburg, reach revolving status (repayment rate >90 per cent, output >100 loans per year). They work with market-level interest rates, a target group based on the best of the unbankable people, and outsourced decision-making and monitoring of loans.

Good practice: Implement recommendations made in Reifner's study on the regulation of micro-finance in Europe.

A study of the regulation of micro-finance in Europe[4] concludes that the major issue for micro lending to be allowed is the extent to which the bank monopoly over certain financial services prevents micro lending by non-banks. EU contract law does not regulate micro enterprise lending because, unlike consumer credit, it is a credit for commercial use only.

The Ideal Legal Framework For Micro-credit And Related Services

In an ideal world the European and national regulators consider 'Access to finance for all' a goal that is as important as 'safeguarding the savers' interests through the supervision of the financial sector'. Besides mainstream commercial banks, in an ideal world there are legal possibilities for alternative financial institutions whose objectives are to create access to micro-finance for low-income groups and marginalised people. As long as microfinance institutions are providing services that are additional to the mainstream financial sector, no unfair competition takes place.[5]

Some signposts for the future to promote policy measures creating a favourable legal framework:

- The Polish and UK models of bank regulation are both very liberal and therefore provide no obstacles to micro-finance. However, we see the lack of usury regulation as being harmful in terms of consumer protection.
- This model could be completed with a regulation similar to the German one: Maximum interest rates are limited by a usury law that forbids charging more than double the average interest rate in the sector (e.g. real estate, loans), or exceeding the average interest rate in the sector by 12 percentage points or more.
- The French bank regulation has opened a special window for micro lending. The window is designed to allow micro-lenders to provide the first small (hence most risky and most expensive) credit to a starting entrepreneur on the basis of risk sharing with the mainstream financial sector. This credit provision is not replacing a bank service; on the contrary, it is preparing potential clients for bank finance.

This article was written by Hedwig Siewertsen who is deputy director of FACET BV and team leader of the research project "Policy measures to promote the use of microcredit in Europe". FACET is a consultancy company based in The Netherlands, which is specialised in small enterprise development worldwide www.facetbv.nl

1 In France, nonbanks may engage in lending provided that they are not using borrowed funds or the public's savings.
2 Guene, C., Freedom to smallness? Living with the legal framework for social and micro-finance in the EU (Appendix 2) 2000.
3 Editor's comment: We would not categorize as "unfair" the competition between a regulated depository institution and a nondepository institution that is not subject to prudential regulation. a nondepository institution is not subject to the solvency ratios (and other prudential ratios) applicable to banks precisely because the failure of a nondepository institution (i) would not jeopardize the public's savings and (ii) for related reasons, would not typically present the same risk to the financial system as the failure of a bank.
4 Micro-finance: case for regulation, U. Reifner, 2001.
5 Editor's comment: Again, MFIs can fairly compete with the mainstream financial sector even if the MFIs offer the same products and are not required to comply with certain prudential regulations with which banks must comply. Prudential regulations are generally not relevant to nondepository institutions and the fact that nonbanks don't have to comply with them is countered by other factors (i.e., nonbanks don't have the capital source of deposits).

Afghanistan Update

continued from page 7

2 MISFA operates as a project implementation unit of the Ministry for Rural Rehabilitation and Development. MISFA began operations in June 2003 with funding provided by the Afghanistan Reconstruction Trust Fund, CGAP and USAID. As mandated by various donor agreements, MISFA is to be re-established in the near future as an independent institution.
3 There are other new and exciting projects in the pipeline, including a leasing project and an initiative involving farmers' cooperatives. However, due to various problems that the sector has recently faced – including in particular severe public criticism of the NGO sector and claims of misuse of donor funds – these projects are not moving forward as quickly as hoped.
4 Exempt institutions include (i) financial institutions governed by another law, (ii) institutions specifically exempt by central bank regulation due to their nature or size of their business or the origin of their resources and (iii) entities that fund the credits they make exclusively from non-repayable capital subscriptions and the proceeds of credits received from financial institutions or debt securities issued in the capital markets. According to the IMF, which provided technical assistance in the drafting of the banking law, the exemption in clause (ii) above was intended to apply to microfinance institutions, such as BRAC.
5 The author did not have access to information on the organizations engaged in microfinance that are not supported by MISFA.
6 There is also a Law on Social Organizations which could possibly be used as a basis for establishing an MFI; however, the purpose requirement is fairly narrow and arguably would not permit microfinance as a primary activity. In addition, the Law on Social Organizations does not permit foreign founders. a foreigner may be only an honorary member and must first obtain permission from the Ministry of Justice.

If you would like to send an update on any information on new legal initiatives in your country, please contact Anna Wiśniewska (anna@mfc.org.pl).

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- United States Agency for International Development
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Microfinance Centre for CEE and the NIS
ul. Koszykowa 60/62 m. 52, 00-673 Warsaw, Poland
tel: (48-22) 622 34 65, fax: (48-22) 622 34 85
e-mail: microfinance@mfc.org.pl
http://www.mfc.org.pl