# Policy Monitor

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*If you would like to send an update on any information on new legal initiatives in your country, please contact Marcin Fijałkowski (marcin@mfc.org.pl).*

CEE / NIS NEWS AND VIEWS

TAJIKISTAN

## Microfinance Law Being Developed

Kate Lauer, Independent Consultant

The National Bank of Tajikistan (NBT) is currently in the process of developing a draft law on microfinance, with technical assistance from the International Finance Corporation (IFC) and financial assistance from USAID. IFC and USAID hosted a roundtable in late March in Almaty, Kazakhstan, where various Tajik policymakers (representing the NBT, the President's Office, the Ministry of Justice, the Ministry of Finance, the Ministry of State Revenue and Taxes, the Committee on Antimonopoly and the Government's Law Department) and MFIs operating in Tajikistan discussed a preliminary version of the draft law as well as proposed changes to the Tax Code.

The draft law will most likely establish three types of MFI: a deposit-taking institution licensed by the NBT and two different types of non-depositary institution certified by the NBT – a non-commercial tax-exempt foundation and a commercial company (established either as a limited liability company or a joint stock company). The deposit-taking institution will be supervised and regulated by the NBT. It is anticipated that the non-depositary institutions will be required to submit reports to the NBT but will not be subject to NBT regulation.

It is hoped that a draft of the law will be submitted to Parliament for consideration in the second quarter of 2003. In the meantime, the MFIs are continuing to extend microloans under the Civil Code. ■

KAZAKHSTAN

## New Microcrediting Law Adopted

Marcin Fijalkowski, Legal and Regulatory Program Coordinator, MFC

On the 6th of March, the President of Kazakhstan signed a new "Law on Microcrediting Organizations", which constituted the final step in the process of enacting the first microfinance-specific legislation in Kazakhstan. The new law is the result of an almost 2-year cooperation between the National Bank of the Republic of Kazakhstan and USAID advisors.

The new law defines Microcrediting Organizations (MCOs)[1] as legal entities engaged in microcrediting activity. Two forms of MCOs, commercial (established as a economical partnership) and noncommercial (established as a public fund), are permissible. The law stipulates that a noncommercial MCO can be established

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only to provide legal persons and individuals engaged in micro and small business with the financial support for their entrepreneurial activities.

The size of each microcredit is subject to two limitations: first, MCOs can not extend credits to any one borrower in excess of 25% of the MCO's capital; second, no microcredit can exceed 1000 "monthly calculation units," which are set by the Law on the Republican Budget for the calendar year in question.

In addition to microcrediting, MCOs can carry out the following activities:

- Taking loans (except for mobilizing savings from the public as an entrepreneurial activity) and grants from residents and non-residents;
- Investing assets in government securities, corporate securities, deposits with the 2nd tier banks and other investments which are legal under Kazakhstan law;
- Performing transactions with pledged property obtained as a security for a microcredit;
- Participating in authorized capital of other legal entities;
- Disposing of its own property;
- Providing advisory services related to microcrediting;
- Leasing its own property;
- Engaging in leasing;
- Delivering training free of charge.

The law on MCOs does not empower the NBRK to license, regulate or supervise MCOs, which is in line with the NBRK's objective to minimize its interference with MCOs. This means MCOs are not subject to such prudential requirements as minimum capital, minimum liquidity, limitations on open foreign currency positions or large exposure limits.

Nevertheless, MCOs will have to comply with the general rules on accounting, reporting, document retention etc. However, there is no requirement in the law for MCOs to register with or obtain a permit from any centralized authority in order to act as an MCO, nor to file periodic reports with any centralized authority.

Although the lack of a licensing or permitting process for MCOs will facilitate establishing such organizations, it brings also some new challenges. Indeed, one side effect of not receiving a license from the NBRK is likely to be the application of VAT to credits granted by MCOs. For the same reason, MCOs might not be able to deduct loan loss provisioning expenses from taxable income. These taxation issues have already been identified by USAID advisors, who have encouraged the NBRK to try remedy this situation with the relevant tax authorities.

Another practical issue raised by the law relates to the stringent conditions imposed on credit documentation. Each microcredit requires a separate credit file, and the MCO must obtain from each borrower its registration documents (in the case of legal entities) and employment information (in the case of individual borrowers), or governmental proof of unemployment. For microcredits that are guaranteed, the microcredit file must contain both a signed agreement by the guarantor and proof of the guarantor's legal authority to provide the guarantee. Such requirements, if scrupulously observed by MCOs, will render lending to informal sector borrowers and group-guaranteed lending extremely difficult, if not impossible. ■

*The author received contributions to this article from Gauhar Serikbayeva, Bryan Stirewalt and Timothy R. Lyman.*

1 In the Russian language version, the law uses the term "microcredit organization" (mikrokreditnaia organizaciya) for MCOs, and the "credit" is used throughout, rather than the term "loan." In the available English translation, the terms "credit" and "loan" are used interchangeably. In this article, we use the term "credit," as in the Russian language version.

BOSNIA & HERZEGOVINA

# The Region's First Specialized Microlending Law Set to Undergo Changes

Timothy R. Lyman, Senior Legal Issues Advisor to MFC, President of the Day, Berry & Howard Foundation
Mihret Dizdar, Legal Advisor, Foundation for Sustainable Development

## Introduction

Bosnia & Herzegovina (B&H) – the first country in the Europe and Eurasian region to adopt specialized legislation for microlending NGOs known as "microcredit organizations" (MCOs) – is now about to see the launching of a reform initiative to affect changes to this legislation. Although some of the proposed changes are to address issues unique to B&H, many of the changes will have relevance in other countries in the region as well.

## Background

B&H consists of two constitutional entities (Entities), the Federation of Bosnia and Herzegovina (the Federation) and Republika Srpska (RS). The B&H constitution leaves to the Entities the power to adopt most kinds of economic legislation, although the constitution also contemplates a single economic zone extending throughout the territory of B&H. Accordingly, there is not one MCO Law, but two separate pieces of legislation – one adopted in the Federation in 2000 and the other adopted in RS in 2001.

The two MCO Laws are quite closely parallel, and each provides for the formation and operation of a specialized form of NGO microlender. (The NGO laws of both Entities were unreformed at the time the MCO Laws were adopted and did not offer any hospitable vehicle for carrying out microlending on a nonprofit basis.) Each of the MCO Laws recognizes MCOs created under the other law, permitting MCOs to offer their microlending products anywhere in B&H. Approximately 45 MCOs have been registered in B&H since the adoption of the first MCO Law, of which approximately 11 have been authorized to provide services in both Entities.

Besides MCOs, B&H law does not currently provide for any other form of financial

institution other than licensed commercial banks. The World Bank-financed Local Initiatives Project, which spearheaded the adoption of the MCO Laws (with assistance from USAID for the initial legislative drafting) plans in its second phase work on providing legal space for additional forms of financial institution that can be used to carry out microfinance, including a commercial finance company form, possibly a form of member-owned and governed savings and credit association and eventually possibly even a specialized form of microfinance bank (if the commercial banking laws and regulations in effect don't permit such institutions to be formed conveniently as conventional commercial banks).

## Reciprocity and Harmonization

Although they are very similar in most substantive respects, the two MCO Laws presently also differ in a few fundamental ways. Of these, perhaps the most significant is the location and nature of governmental oversight over MCOs. The Federation law provides only for a simple register, housed within the Ministry of Social Affairs, Displaced Persons and Refugees, and there is no ongoing oversight of MCOs after their initial registration. The RS law gives regulatory responsibility to the Ministry of Finance, which also has the power under the law to adopt regulations defining maximum loan amounts and annual reporting requirements for MCOs operating in RS.

With the goal of increasing the harmony between the two laws and providing for equal treatment of MCOs regardless of where they are formed and operating, the intention is to amend the Federation MCO Law to vest the Federation Ministry of Finance with powers similar or identical to those exercised by its counterpart ministry in RS. This change will also enhance transparency within the sector, by requiring annual reporting in the Federation as is already in effect in RS.

## Changes to Bolster Case for Profit Tax Exemption

Presently the relevant laws of the Federation are interpreted to provide MCOs with profit tax exemption, whereas the relevant provisions of RS law have been interpreted varyingly on this issue.[2] With a view to enhancing the chances MCOs may qualify for profit tax exemption in both Entities in the future (including after tax reforms already in the drafting stages in the Federation), it is anticipated that the MCO Laws of both Entities will be amended to avoid potential abuse of profit tax exemption. Principal among these changes will be a requirement that net assets of an MCO upon its dissolution must be contributed to one or more other MCOs, other NGOs organized for public benefit purposes or one or more B&H public bodies (whether at the State level, Entity level or a regional or local level). The anticipated changes will not permit dissolving MCOs to distribute any of their net assets outside B&H.

## Changes to Permit Commercialization

Perhaps the most significant changes contemplated, in terms of the long term development of the microfinance sector in B&H, will be aimed at facilitating transformations of MCOs into other commercial forms of financial institutions, once the way has been cleared for the creation such new forms. These changes are in recognition of the fact that donor capital is likely eventually to dry up, so many MCOs will find a need to access new sources of capital only available to commercial legal forms.[3]

For example, it is expected that the MCO Laws will be amended to permit MCOs to be founders of commercial finance companies and to transfer their microloan portfolios and other property to such organizations in return for shares. Moreover, it is expected that the law will be changed to permit MCOs that have undergone such a transformation to pursue any of three possible post-transformation courses of action: (1) dissolve and distribute the shares of the newly formed company in accordance with the restrictions upon distributions of net assets described above; (2) to continue its operations as an MCO using dividends from the commercial company (perhaps serving as a kind of entry level microlender working with poorer clients and smaller loans, as a 'training ground' for clients who will eventually 'graduate' to borrowing from the newly established commercial company) or (3) become a kind of foundation that uses dividends from the commercial company to make grants to support microenterprise development in B&H (such as grants to other MCOs or NGOs providing business development services to low income entrepreneurs).

For those MCOs in a position to meet minimum capital requirements for the formation and licensing of a commercial bank (perhaps with additional investment from other strategic investors), the anticipated changes to the MCO Laws will make this form of transformation possible as well. The post-transformation options for MCOs undergoing this kind of transformation are anticipated to be the same as for organizations transforming into a finance company legal form. ■

2 Article 14, Paragraph 2 of the RS MCO Law clearly stipulates: "An MCO's revenue surplus over its expenditures is not subject to taxation." Some have interpreted this provision to provide for profit tax exemption notwithstanding that MCOs do not appear on the list of types of organization exempt from profit tax in the profit tax law itself. Others argue the provision in the MCO Law cannot be given legal effect without a parallel change to the profit tax law.

3 Some MCOs may also choose to facilitate the development of savings and credit associations, once this legal form becomes available in B&H. However, probable limitations on incorporation of outside capital into such organizations from sources other than members can be anticipated to limit the attractiveness of this option.

AZERBAIJAN

# Legal Challenges of Microfinance

Fuad Mammadov, Legal Advisor, ACDI/VOCA
Chingiz Mammadov, Chairman, Azerbaijan Microfinance Association (AMFA)

The microfinance activities in Azerbaijan are regulated by the Civil Code and the Law on Banks and Banking Activities. The regulations oblige MFIs to register as legal entities with the Ministry of Justice and obtain a license from the National Bank. Thus, in principle, NGOs are empowered to conduct crediting activity or establish MFIs.

However, a recent amendment to the Law on Banks and Banking Activities stipulates that non-commercial organizations along with political parties, state agencies and local authorities cannot form credit organizations. In turn, the Civil Code defines NGOs as non-commercial organizations. Thus, this

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amendment has forbidden international NGOs to establish MFIs in Azerbaijan.

Currently, MFIs have only one viable option – to be registered as local limited liability companies. This means they are considered as purely commercial entities with no development or social mission. In practical terms, it results in the drastic change of legal environment in which MFIs operates. For instance, previously, MFIs, in order to get a license from the National Bank, used to pay $110, now, being registered as a limited liability company, they have to pay approximately $5400.

Another challenge faced by the microfinance sector in Azerbaijan is the different tax treatment of MFIs depending of their funding source. Azerbaijan has signed with the US a treaty on exemption of certain taxes. Thus, if an NGO is implementing a U.S. government-funded program in Azerbaijan (for example, Finca, Save the Children, ADRA, ACDI/VOCA), then they are exempt from the VAT and the corporate social tax. Together, these taxes are equal to one third of the total MFIs' revenues. Even though such programs will cease to be tax exempt as soon as the USAID funding runs out, during the life of the project respective organizations have advantage in comparison with non-USAID assisted institutions like the MFIs established by the Norwegian Refugee Council, Norwegian Humanitarian Enterprise, Danish Refugee Council and UK-based OXFAM – all AMFA members.

AMFA is trying to reach a common approach to solving taxation issues. Currently, MFIs are obliged to pay all taxes applicable to commercial companies, including profit taxes. Some MFIs operating in Azerbaijan, especially those serving internally displaced persons and refugees, argue that their non-profit profile should exempt them from paying any profit taxes even if they are registered as commercial companies. Other MFIs are ready to be taxed, but only under specific rules adjusted to microfinance activity and not based on outdated profit calculations.

When AMFA was created in December 2001 only three members were registered with the Ministry of Justice and had a license from the National Bank. However, the advocacy efforts of AMFA members have been rewarded and now only two AMFA members are not registered, one of which- Save the Children – is close to registration. ■

*You can read more on legal and regulatory issues faced by MFIs in Azerbaijan in the Policy Monitor #2 available on the MFC website www.mfc.org.pl*



MONTENEGRO

# Central Bank Regulates Microfinance Operations

Luka Djurovic, Programme Manager, Alter Modus

## Introduction

Microfinancing, or to be precise, microcrediting is still a fairly new financial service in Montenegro. The very first microcredits were issued in the summer of 1999. Today there are three NGO MFIs and one bank offering microcredits in the country. The total estimated portfolio outstanding of the three NGO MFIs is 7 million. The microcredit operations in Montenegro received financial support from number of international contributors, with USAID, UNHCR, NOVIB and CIDA being the most significant contributors.

Microfinance in Montenegro has always operated in a government-friendly environment. The government recognizes the importance and significance of microfinance and the role microfinance plays in alleviating very difficult living conditions of the population, caused in part by the transition to a market economy and the privatisation of state enterprises. The government's official position and recognition of microfinance is addressed in the National Strategy on Development of SMEs, adopted in June 2002, and through cooperation with MFIs on establishing a legal framework for microfinance operations.[4]

## History of Legislative Development

Microfinance services in Montenegro, from their start, were offered under the Government "Decree on the Way of Granting Credits by NGOs to Physical and Legal Entities in Montenegro" (Decree) adopted in September 1998. This decree was the result of an advocacy effort from Alter Modus and Mercy Corps and their work with the Deputy Prime Minister's Office. The Decree provided a good basis for starting microfinance in Montenegro but not an adequate long-term solution. In Montenegro (as in many transitional countries), new laws are constantly being adopted. There was always the threat that new legislation would "forget" the Decree and establish a new set of rules for microfinance. In November 2000, Montenegrin Parliament adopted a Law on the Central Bank (CB), promoting CB as the highest and only body to regulate all financial services on the market. With adoption of this Law, the Decree was overpowered, and the organizations engaged in microfinance continued to work in sort of a legal limbo.

This was a clear signal for action for Alter Modus and an opportunity to influence creation of a stable legal basis for the development of microfinance in Montenegro. The first contact with the CB was made shortly after the adoption of the Law on CB, but it took some time before CB was ready to discuss microfinance. Once CB officials were in a position to address the issue, an informal coalition with Agroinvest (another NGO MFI in Montenegro) was formed and the coalition approached the CB. The consultative process began and input was requested by the CB from the KPMG Consulting, which was the appointed consulting group to Montenegrin CB. The process lasted for about 12 months and the first draft regulation was produced in October, 2002. Being aware that the regulation needed the political support of the Association of Banks of Montenegro, Alter Modus undertook the lobbying process to secure a positive response from the Association. In the beginning of December, the Association of Banks signalled its support for the regulation, and the "Decision on Microfinancing Institution" was finally approved

and put in force on December 17, 2002.

## "Decision on Microfinance Institutions"

The "Decision on Microfinance Institutions" (Decision) provides the legal basis for the establishment, licensing and delicense as well as for the operations and examination of operations of microfinance institutions. The Decision states that microfinance services are:

- grant loans for specified purposes for development projects to micro companies,
- invest in short-term securities issued by the Government of the Republic of Montenegro and in other quality short-term instruments of the financial market;
- offer financial leasing services, and
- offer consulting services

and can be provided by any shareholding company, limited liability company or NGO.

The amount of €100,000 is a minimal initial capital requirement. The Decision sets maximum amounts for 1st time borrowers to €3,000 for individuals and €5,000 for registered businesses, and maximum amounts of consecutive loans to 8,000 for individuals and €20,000 for businesses.

The Decision requires for an MFI to have policy on loan loss reserves in accordance to following guidelines:

- 2 – 24% of outstanding loan balance for loans past due for up to 30 days.
- 25 – 49% of outstanding loan balance for loans past due between 31 and 90 days.
- 50 – 74% of outstanding loan balance for loans past due between 91 and 180 days.
- 75 – 99% of outstanding loan balance for loans past due between 181 and 270 days.
- 100% of outstanding loan balance for loans past due over 271 days.

MFI needs to provide periodic reports to CB. Some of the reporting requirements include Balance Sheet and Income Statement, Asset Classification, Reserves, Schedule of Assets and Liabilities Maturity, Financial Contribution Sources, etc. MFI needs to conduct an annual independent auditing which is to be done by one of CB recognized auditors.

The Decision, we believe, provides for good and friendly environment for implementation of microfinance activities in Montenegro. The Decision definitely represents the recognition of the existence and importance of microfinance services. However, we do expect new challenges to arise, primarily during the implementation of the Decision and the "collision" of traditional banking and traditional microfinancing views. ■

4 English language versions of the "National Strategy for Development of SMEs in Montenegro", governmental "Decree on Way of Granting Credits by NGOs to Physical and Legal Entities in Montenegro", and the Central Bank's "Decision on Microfinance Institutions" can be found at the Montenegrin Network's for Affirmation of Non Governmental Sector web site: www.mans.cg.yu

MONGOLIA

# NBFIs and their Legal Environment

D. Undral, Legal Advisor, XAC Bank

After the democratic revolution of 1990, the one-tier state owned banking system was dismantled and the first commercial banks were established. It was one of the earliest steps taken toward transforming the centrally planned economy into market economy and privatizing state property.

The creation of the first commercial banks in accordance with "the Standard Chapter on Establishment and Operations of Commercial Banks" approved by the Council of Ministers' of the People's Republic of Mongolia in 1990 occurred in a country with no appropriate legal environment nor any established monetary or lending policies. In addition, there had not yet been any privatization of state-owned enterprises. The first experiences were sometimes painful. As the newly created banks were conducting their lending activities without sufficient knowledge, most of them became insolvent or went bankrupt, which led to the loss of the public's faith in the banking sector.

In 1991, the State Baga Hural (lower chamber of the parliament) passed the Banking Law, which established the legal basis for a two-tier banking structure allowing individuals and entities to establish banks. The amendments

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**The Microfinance Centre (MFC)** is a membership based resource centre in CEE and the NIS. It's mission is to promote the development of a strong and sustainable microfinance sector in order to increase access to financial services for low-income people, particularly microentrepreneurs. MFC fulfills its mission by providing high quality trainings, consulting research, mutual learning and legal and policy development services.

## MFC Policy Program

The Policy Program created within the MFC has a broad goal to foster improvements to the legal and regulatory operating environments for microfinance institutions in the countries of CEE and the NIS. To achieve this goal MFC has engaged in a combination of regional activities and country specific activities.

Within the scope of the Policy Program, MFC conducts *diagnostic analysis* of the existing legal and regulatory environment for microfinance in CEE and the NIS undertaken on a country-by-country basis. These assessments have already been undertaken in Armenia, Georgia, Serbia and Tajikistan. The assessment reports are available on the MFC web site.

Another important activity within the Policy Program is maintaining a *database of legal acts* related to microfinance industry in the CEE and the NIS. The database supplies reliable updated information to practitioners, policy makers and the donor community involved in microfinance legal and regulatory reform.

Finally, MFC organizes an annual *Policy Forum* on microfinance law and regulation in CEE and NIS.

*For more information on the MFC Policy Program, please contact Marcin Fijałkowski (marcin@mfc.org.pl)*

to the Banking Law passed in 1993 prohibited non-bank entities from conducting banking activities without a license from the Central Bank.

Later in the nineties, new laws were issued to improve the security of the financial system as massive disbursement of loans by commercial banks resulted in high levels of non-performing loans and threatened the existence of many commercial banks. These laws included the Law on Deposit Taking, Settlement and Lending Activities in 1995 and amendments to the Banking Law and to the Central Bank Law, both in 1996.

Although the enactment of the new laws had significant positive impact on the banking sector's legal environment, they did not address the concerns of non-bank microlenders. Indeed, the Banking Law amendments of 1993 allowed non bank entities registered under the Company Law to conduct banking operations with a license from the Central Bank, but the lack of clear licensing procedure inhibited the establishment of microfinance organizations. The development of the microfinance sector was slowed down till 1999.

Commercial banks holding about 60% of the financial sector assets were granting relatively large credits at high interest rate with restrictive collateral policy. Consequently, banks concentrated their loan portfolio to a limited realm of clients who could match their stringent requirements. The limited access of the majority of the population to financial services created demand for financial intermediaries that were able to provide flexible financial services at a reasonable price.

The increased demand for financial services resulted in further amendments of the Banking Law in 1997 and amendments to the Civil Code in 1999, which made possible the establishment of Non-bank financial institutions (NBFIs). The amendments permitted the creation of NBFIs licensed by the Central Bank. The Central Bank was also required to prepare policies and procedures on licensing and monitoring NBFIs. As the result, the governor of the Central Bank issued in March 1999 the "Rule book on Monitoring NBFIs and Granting License for Conducting Some Banking Activities" and started the licensing procedure. According to this Rule book, NBFIs were allowed to conduct the following activities: mobilizing deposits, lending, foreign currency exchange services, financial leasing, remittance services and settlement services. The first NBFI being licensed was the X.A.C. LLC. X.A.C. LLC made a great contribution to the development of NBFIs by cooperating with governmental and other organizations in establishing proper legal environment. With the support of UNDP, X.A.C conducted lobbying and education activities among policymakers as well as among the general public. Additionally, X.A.C. participated in working groups on developing necessary laws and accounting standards for NBFIs.

Today, 64 NBFIs are conducting their activities in Mongolia as local companies followed the X.A.C. example and started establishing NBFIs. A report issued in 2003 by the Central Bank shows that the NBFIs' outstanding loan balance reached MNT 30.6 billion in the 3rd quarter of 2002 (comparing to MNT 13 billion at the end of the 2001) and an increase of NBFIs' equity.

In January 2002, the Civil Law was amended in order to clarify the legal basis for disbursing loans i.e. the borrowers' obligations, the definition of the loan contract and the interest rate etc.

A few months later, in December 2002, the parliament of Mongolia passed the Law on Non-Bank Financial Activities, which addresses supervision issues related to the growing role and number of NBFIs on the financial market. According to the new law, only legal entities registered in Mongolia and foreign legal entities benefiting from a bilateral agreement are eligible for a license from the Central Bank. Entities financed from the state budget as well as religious, political or non-governmental organizations are prohibited from conducting non-bank financial activities even if they are engaged purely in lending. The law on NBFA allows the following activities: lending, factoring, financial leasing, issuing guarrantees, issuing payment instruments, trust services, forex services, investment advisory services and investment into short term financial instruments. However, the new law prohibits NBFIs from mobilizing deposits and conducting settlement services (as opposed to the Rule book[5] issued by the governor of the Central Bank in 1999, which permitted such activities). The managment and organization issues are covered by the Company Law. Each NBFI must comply with various existing prudential standards established by the Central Bank including reserve fund, liquidity, capital adequacy, loan loss provisions, foreign currency risks and other requirements. Finally, the law regulates sanctions for nonobsevance of the law provisions.

The enactment of the law was an important step foreward in the development of microfinance as it clarified the legal status of NBFIs and the scope of activity NBFIs are allowed to conduct. It also set the necessary preconditions for the clients' rights protection. ■

5 The Rule book on Monitoring NBFIs and Granting License for Conducting Some Banking Activities from March 1999 was superceded by the "Procedures for granting NBFI license" issued in January 2003.



# Microfinance Banks and Policy Dialogue

Charlotte Gray, Senior SME Specialist, EBRD

Since late 1997, when Micro Enterprise Bank Bosnia opened its doors, the EBRD, alongside other international financial institutions (IFIs) and donors[6], has invested in ten dedicated microfinance banks (MFBs) in Southeast Europe (SEE) and the NIS[7], with an eleventh due to open shortly. Between them, they have made nearly 170,000 loans totalling $976 million. Currently, they are making 7,700 business loans per month and have an outstanding loan portfolio of over $365 million. Some but not all of these MFBs offer housing and/or consumer loans.

In addition, EBRD has been involved in downscaling programmes in several countries[8] where there are banks willing to work with micro and small enterprises (MSEs). EBRD also has a shareholding in a microfinance company, which has been lending in Moldova since 1999. Together, these programmes account for a further 140,000 loans for a total of more than $1.1 billion.

This article focuses primarily on the policy dialogue issues the microfinance banks face and what EBRD has been doing in this field. We should make it clear, however, that our

fellow shareholders are also active in policy dialogue and some of the 'partner banks' are also involved in trying to improve the legal and regulatory environment.

The MFBs are focussed first and foremost on lending to their target market: micro and small entrepreneurs. However, in order to service these clients properly and, crucially, to achieve long-term sustainability, the MFBs need to offer a range of retail banking services, both domestic and international, and therefore all have full banking licenses. Thus, many of the legal and regulatory issues facing the MFBs are shared with the rest of the banking sector. In each country, policy dialogue of the MFBs needs to be dovetailed to the extent possible with the dialogue of the banking sector as a whole. On the other hand, because of the specialised nature of MFBs, there are certain aspects of the legal and regulatory environment, which affect the MFBs differently or more acutely than larger banks with more diversified portfolios. At times therefore our policy dialogue has to be delinked from that of the rest of the banking sector.

*Ad hoc* policy dialogue in the SEE/NIS region has, since the beginning, been an integral part of the work of the microfinance banks, reflecting both the nature of their shareholders and the practical need to improve the environment in which the banks operate. Almost by definition, the countries where the MFBs have been established have under-developed and often inadequately-regulated banking sectors. Most of the countries have suffered banking crises in the last ten years and many of the existing banks are, or have until recently been, regarded as arms of the state apparatus, or are effectively 'pocket banks'[9], with the result that real financial intermediation is still at a very low level.

EBRD is now developing, together with the managers of the microfinance banks and the other shareholders, a more systematic approach to policy dialogue on access to lending. Where possible, common cause has been made with the banking sector in the country concerned, with other IFIs and donors and with other microfinance organisations, and it is our intention to develop this co-operation further. Since our policy dialogue resources are limited and the issues varied, we focus our efforts where EBRD has most chance of being listened to and on those issues, which will have the maximum benefit on improving MSE access to finance[10].

In terms of access to finance for MSEs, some issues are time and territory specific and may have little wider relevance, but many of them have a cross-border significance and enable lessons learned in one place to be transferred to others. We believe that the collective experience that has been built up by the microfinance banks and their shareholders, in identifying and addressing legal and regulatory issues across ten countries can complement the policy work that MFC, the Russian Microfinance Centre and others are undertaking. Some of these issues relate to prudential regulation by the central banks and therefore are currently of limited interest to the majority of MFIs in the region – although that could change as MFIs look for routes to long-term sustainability. Others are more generally relevant to all lending organisations.

Specific cross-border issues we are addressing at the moment include:

- movable collateral registration and enforcement systems in a number of CEE and SEE countries (Bosnia, Hungary, Kosovo, Macedonia, Serbia and Slovakia). Although collateral is not the prime criterion for lending by the MFBs (or for most microfinance organisations), a functioning registration and enforcement system is both desirable per se and should increase the willingness of conventional banks to lend to SMEs. EBRD has consistently argued for and directly or indirectly supported user-friendly, inexpensive collateral registration and enforcement systems. Countries in the region have taken a variety of approaches to this issue, with consequently widely-differing results. EBRD is currently considering a project in SEE aimed at establishing standards against which the quality and efficiency of existing registries can be determined and which can be used as guidelines for the design of registries in countries which do not yet have a registry.
- loan classification and provisioning levels. The central banks are increasingly moving their norms on loan classification and provisioning towards those advocated in the Basle Core Principles. While we support this development, the different ways in which the central banks choose to apply these norms can have a disproportionate effect on microfinance portfolios which are dependent on large numbers of small loans based on specific credit technology. This can lead to provisioning requirements that bear no relation to the real credit risk of the loan portfolio and would be prohibitively expensive for microfinance. This is one of the issues which underlines the need to continue educating central banks about the specifics of micro and small lending and how it should be regulated. As prudentially regulated microloan portfolios increase in number and volume across the region, and other MFIs contemplate possible conversion, EBRD will continue this dialogue wherever necessary.

Other issues involving more than one country where the MFBs and EBRD are actively lobbying for change are:

- restrictions on foreign currency loans in Russia, Serbia and Ukraine
- unnecessarily burdensome and therefore costly reporting requirements for banks in a number of countries
- excessive reserve requirements, particularly for foreign currency funds, in several countries
- financial and administrative obstacles to regional expansion, in Russia, Ukraine and Central Asia.

Other existing initiatives we are keen to see consolidated and extended around the region include:

- the creation of a favourable environment for leasing
- revision/reconstruction of the land registries and cadastres
- establishment of functional collateral registries for real estate and mortgages
- establishment of credit information bureaus.

There remain, of course, other over-arching policy issues, which impede the development of the MSE sector as a whole. Corruption generally places a considerable financial and administrative burden on MSEs (inspections, licenses, registration, taxation can all bring with them requests for unofficial payments). In particular, the failure to reform and revitalise the judiciary in many countries of the region has made it extremely difficult, expensive and long-winded to legally enforce collateral and loan contracts. This situation provides the perfect excuse for banks to avoid lending to what they perceive to be highly risky micro and small enterprises.

These are of course huge issues, which will take a long time and much resource to tackle.

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However, some Governments appear to have the will to do something about them and every opportunity will be taken to encourage this.

While EBRD's microfinance investments are all bank-based and most other MFIs are not, we believe that there are strong possibilities for co-operation on policy dialogue across the spectrum of microfinance providers in the SEE and NIS countries. In particular, as the question of commercialisation is becoming more and more relevant to MFIs in the region, there should be increasing opportunities for co-ordination of policy initiatives and strengthening the ability of the microfinance sector to influence how policy is made and implemented. ■

6 As well as EBRD, the 'noyau dur' of microfinance bank investors comprises International Finance Corporation (IFC), KfW, DEG, Financierungs-Maatschappij voor Ontwikkelingslanden NV (FMO), the Doen Foundation, Commerzbank and IMI.

7 These microfinance banks have been opened in Albania, Azerbaijan, Bosnia, Bulgaria, Georgia, Kosovo, Romania, Russia, Serbia and Ukraine. A bank in Macedonia is planned to open in May 2003.

8 These countries are: Armenia, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Russia, Ukraine and Uzbekistan.

9 Pocket banks are banks which are effectively controlled by and exist to serve the interests of their owner(s), usually a financial industrial group or a big kombinat. The main thing about them is that they are in no way interested in general financial intermediation, as they exist to serve only the interests of their main shareholder and are usually undercapitalised and untransparent.

10 Where possible, EBRD is also beginning to engage more proactively in issues affecting the enterprises themselves. Here too we aim to work closely with other interested parties, as our resources for this will inevitably be limited. Obvious examples include: company registration systems, taxation, inspections, property titling and registration.

# Planning for Taxes

Craig Gibian, Tax Lawyer, Shearman & Sterling
Deborah Burand, Director of Capital Markets, FINCA International

**… nothing in life is certain except death and taxes.** (Benjamin Franklin)

While policymakers and stakeholders (donors and others) in the microfinance industry have paid much attention to the prudential bank regulatory regime that may be applied to some microfinance institutions (MFIs), it is the host country's tax regulatory regime that is most likely to affect the largest number of MFIs. For while prudential banking laws and regulations are likely to be applicable to any MFI that determines that it would like to offer deposit-taking services to its customers, tax laws and regulations are likely to be triggered irrespective of the kind of business strategy or products offered by an MFI. Put differently, MFIs may choose to be subjected to bank regulation; MFIs often do not have such a choice when it comes to tax regulation. Because many MFIs start their institutional existence as part of an international NGO or as an affiliated local NGO, there is often an incorrect assumption that tax exemptions available in the sponsoring NGO's home country will also apply abroad. This means that the entire subject of taxation frequently takes both the international NGO and its local partners by surprise.

Some MFIs may be buffered from facing this issue due to tax exemptions that they currently enjoy. Even if an MFI currently qualifies for an exemption from taxes in its host country of operation, however, there are two important reasons why it must still undertake some due diligence regarding tax compliance and, possibly, begin to engage in tax planning. First, an MFI's exemption may apply only to certain taxes (such as taxes on net income or profits) and therefore the MFI may not be exempt from certain other taxes. An MFI must thus consider the scope of its tax exemption, and must consider each tax to which it may be subject, including, but not limited to, income/profits taxes, value added taxes, payroll taxes, property taxes, capital or net worth taxes, stamp taxes, transfer taxes and/or any other type of local or national tax. Further, even with a tax exemption, an MFI may still be subject to certain tax reporting and filing requirements. Second, it is possible that an MFI will lose its tax exemption at some point in the future and become a regular taxpayer at such time. In this regard, an MFI could become a victim of its own success if the MFI becomes so profitable that the taxing authority no longer views it as appropriate to grant a tax exemption.

As an MFI begins to consider taxes, it should focus on two main categories. First, and most important, are tax compliance concerns. An MFI must know the timing of any tax filing or payment obligations and satisfy such obligations in a timely manner. As stated above, an MFI may have tax reporting and filing obligations even if it does not owe any tax. A failure to satisfy these reporting obligations in a timely manner could lead to the imposition of penalties by the relevant taxing authority. Additionally, even if an MFI is not itself subject to any taxes, an MFI may have an obligation to withhold taxes on certain payments that it makes. This withholding obligation may exist because the withholding tax is simply a method of collecting tax on the recipient of the payment. An MFI will likely have such withholding obligations with respect to any cross-border payments that it makes (i.e., the recipient is outside of the country), such as interest the MFI may owe on a loan from a foreign lender – even a foreign NGO lender. Thus, an MFI must understand the withholding tax rules, including the amount to be withheld on payments that it makes and how to remit such amounts to the proper taxing authority.

Once an MFI has a full understanding of its tax compliance requirements, it should also spend time focusing on tax planning so as to minimize legitimately any taxes due. In this regard, we again stress the importance of tax compliance and emphasize that any tax planning activities must go hand in hand with satisfying all compliance requirements. In other words, while minimizing the tax liability of an MFI is a legitimate goal, tax planning activity is legitimate only if it will not cause the MFI to be in violation of any of its compliance requirements.

Tax planning activities will necessarily require a basic understanding of the relevant tax laws. With respect to a profit or income tax, as previously mentioned, NGO MFIs in some countries may be able to make a claim for tax exemption available to certain non-commercial organizations operated for public benefit purposes. In other countries, NGO MFIs will be subject to profit or income tax on the same basis as commercial legal forms. In such circumstances, it will be necessary to understand what types of expenses are

deductible from gross revenues for purposes of calculating net income. The following example illustrates how tax planning can play a role in the decision making process of an MFI as it accesses capital markets in order to raise working capital for its business. In many jurisdictions, for purposes of calculating the net income of a commercial MFI, the payment of dividends to equity holders is not deductible from gross revenue while the payment of interest to debt holders is deductible. This difference in the tax treatment of dividends and interest should play a role in the decision making process as an MFI decides whether to issue stock or debt to raise capital. Further, if the MFI is accessing capital markets outside of its country of operation, the MFI should consider whether its home country has any bilateral income tax treaties that may operate to reduce the rate of withholding taxes imposed on the cross-border payments that it will make to its equity and/or debt holders. It would be advisable for an MFI to consider the tax differences between debt and equity even while it still has a tax exemption in place because it may not be tax-efficient to make changes to the capital structure after the tax exemption has expired.

To conclude, paying taxes may be an inevitable part of any MFI's institutional maturation. Nevertheless, with appropriate forethought, planning and good tax counsel, taxes can be managed effectively. Like any business challenge that faces our growing industry, the more upfront planning that is done, the easier the transition will be. ■

Below we present the IMF Working Paper (published last year) on MFIs and public policy. Some of the positions in the paper may cause a stir among readers. Willing to start a discussion on best practices in regulating and supervising microfinance, we would be happy to post in the next issue of the Policy Monitor your opinions on the IMF Working Paper Microfinance Institutions and Public Policy and the CGAP Guiding Principles on Regulation and Supervision of Microfinance. Both papers are available on the MFC website www.mfc.org.pl.

# IMF Working Paper: Microfinance Institutions and Public Policy

Daniel C.Hardy, Paul Holden and Vassili Prokopenko , International Monetary Fund

A recent International Monetary Fund working paper addresses policy issues related to the growth of the microfinance industry. The paper, 'Microfinance Institutions and Public Policy" by Daniel C. Hardy, Paul Holden and Vassili Prokopenko, issued last September, (i) defines the main characteristics of MFIs with some indicators of their performance in different countries, (ii) sets out pros and cons for supporting MFIs and presents measures to reduce the negative side effects of such support, and (iii) considers the issues of why and how MFIs should be regulated and supervised. This summary presentation will concentrate on the last two issues, which for many readers may be the most interesting as well as the most controversial.

## Supporting the development of MFIs

### *Arguments for and against the provision of support for MFIs*

According to paper, many MFIs incur losses and earn below market returns on capital (especially when they are newly founded and small) and therefore must rely to some degree on external, especially donor, support (including initial capital, loan at preferential terms, technical assistance). The paper stresses the need (i) to justify the assistance provided to MFIs given the limited resources and other possible recipients and (ii) to demonstrate that supporting MFIs does not have large negative side effects. The paper lists the pros and cons (see below) and concludes that MFIs are worth supporting "to some degree" and cautions that the forms of support should be targeted to suit the needs of MFIs at different stages of their development.

The authors identified the following arguments for supporting MFIs:

- The provision of microservices empowers clients (in a way that lump sum transfers do not) as clients gain independence and ultimately access to formal economy.
- MFIs have an information advantage (due to local knowledge and proximity) which enables them to target their assistance well.
- A successful MFI can return some assistance to donors (which ties in well with the more recent focus on sustainability).
- An MFI can increase the total resources provided to the poor by mobilizing savings and accessing capital markets.

However the working paper also raises shortcomings of supporting MFIs:

- Funds received by MFIs might be used in alternative, more productive ways (e.g., direct income support, infrastructure projects, training and education) to help the poorest of the poor, who tend not to be helped by MFIs. Additionally, job training may be preferable to the poor, who might be averse to taking on risks associated with borrowing.
- Dependence on outside assistance can result in operational inefficiency, poor resource allocation and lack of innovation. Dependence on outside support could restrain an MFI's growth and leave it vulnerable to collapse if the support is withdrawn.
- MFIs with access to preferential loans might discourage or in some cases squeeze out from the market commercially oriented financial service providers.

### *Forms of support*

The paper discusses approaches to the provision of assistance that do not (i) create aid dependence of MFIs, (ii) weaken incentives to achieve sustainability or (iii) suppress the competition and commercially-oriented financial institutions.

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The paper suggests, as one possibility, limiting assistance to one-time start-up grants or capital injection to MFIs and commercial banks willing to extend their activity to microfinance. The paper also suggests a start-up loan with a graduated and relatively long repayment period (with the possibility of an intermediary financial institution that would bear the risk and collect repayments), enabling the MFI to cover its high initial fixed costs while being motivated to keep costs down and innovate.

Another suggestion is to provide start-up funding to several MFIs. The diversity of MFIs would create competition among MFIs and would reduce the risk (in the event of an MFI's failure) of leaving the poor without services. However, given the relatively high fixed costs, few MFIs can survive in any one market and competition may prevent all of the MFIs from minimizing their average costs.

Regarding ongoing support of MFIs, efforts to limit aid dependence and promote competition between MFIs could include the use of apex organizations providing training facilities, financing and other assistance to self-sustaining MFIs. Nevertheless the paper recognizes that there are only few examples of successful apexes, noting that it is essential that the establishment of such a facility be preceded by the establishment of functioning MFIs. Other supporting institutions worth considering are independent rating or auditing services as well as credit bureaus.

Finally, the working paper stresses the need for coordinating donors' efforts to avoid contradicting or duplicating strategies.

## Regulation and supervision of MFIs

### *Costs and benefits of regulation*

The paper notes that the scope of regulation and supervision depends on a number of objectives and the interests of different players, including:

- **Protection of depositors.**
  The authors stress that MFI mobilizing deposits from the public should be regulated and supervised as depositors can not exercise control over the MFI, especially where the institution is a local monopolist or the depositors themselves are not sophisticated enough. Additionally, where most clients save only in MFIs, the failure of the MFI might affect them very badly and discourage them from participating in the formal financial system. Finally, depositors need protection from fraudulent organizations purporting to be MFIs (e.g., a pyramid scheme).
- **Protection of borrowers.**
  Where MFIs holds a monopolistic position on the market, a tendency to maximize profits at the expense of the client might arise. The paper notes, however, that it may be difficult to establish that prices are above market, especially given the willingness of microborrowers to pay high interest rates.
- **Protection of the financial system.**
  Despite the relatively small size of most MFIs, the failure of which will likely have only a minor impact on the financial sector, the paper grants that the failure of an MFI may negatively affect the public perception of the soundness of the financial system.
- **Promotion of the MFI sector.**
  Regulated and supervised institutions might attract more deposits from the public at a lower cost; licensing and greater operational freedom might prompt MFIs to offer new products; and, finally, licensing might mitigate the risks linked to the activity of fraudulent MFIs. However, experience suggests that this promotional role for supervision is most effective for estblished MFIs.
- **Protection of public funds.**
  The protection of public funds might call for regulating and supervising MFIs in two cases: first, where public funds have been invested into microfinance; second, where an explicit or implicit deposit insurance covers MFIs' liabilities.

The above-mentioned possible benefits must be weighted against costs, including:

- **Costs to supervisors.**
  The costs of supervising MFIs may be disproportionately high in relation to their financial importance or the risks concerning the regulators. (These costs will have to be born by the MFIs, the formal financial sector or the taxpayer). In addition, there may be a scarcity of skilled supervisors and using these people to supervise MFIs might jeopardize the supervision of institutions that are more central to the soundness of the financial system.
- **Costs to supervised institutions.**
  Complying with the supervisors' requirement might be costly for an MFI. Ultimately, these costs will be passed on to the clients in the form of higher interest rates and higher fees.
- **Stifling of innovation and competition.**
  Regulation and supervision might discourage MFIs from experimenting with their products, competing with other MFIs or establishing new MFIs, which could ultimately result in the preservation of local monopolies.

### *Strategy for the prudential regulations of MFIs*

The paper underlines that there is no standard approach for regulating microfinance. The regulatory regime in a country will depend on the state of development of the microfinance sector and the services provided by the MFIs. The regulations will evolve along with the institutions that are regulated.

The authors state that the regulation should apply to the types of activities performed by MFIs (lending, deposit taking, etc.) as opposed to the legal form. A regulatory framework constructed on institutional form might – in the commercial arena -- invite regulatory arbitrage. In order to set appropriate prudential requirements, the supervisory authorities will have to know what activities an MFI engage in. The paper suggests the need for a mechanism to verify the scope of activity conducted by MFIs.

The paper acknowledges that there is no need to subject MFIs engaged only in on-lending donor funds to prudential regulations and supervision. At the other extreme, MFIs acting as a fully-fledged commercial bank should not be exempted from regulatory and supervision regime faced by commercial banks. (The paper mentions that nonprofit deposit-taking organizations may have to be subject to particularly close supervision given the limited incentives of the owners of these institutions for monitoring their activities, and their lack of financial resources to provide additional capital if needed.)

The authors stress the need for a careful supervision during the founding process. At this stage, the founders should be required to i) provide credible business plan, ii) demonstrate the board members qualifications, iii) commit themselves to keep proper data record system and internal control, iv) provide capital commensurate with the envisaged risks and v) establish a system of reporting major developments to the authorities. The paper also advocates a regulatory requirement that MFIs provide information to clients and potential clients on loan terms, deposit rates and access to funds.

Once an MFI is registered, the paper proposes that the scope of its activity be

elimited initially, and expand over time as the MFI proves that it has acquired the required skills to carry out new activities.

If an MFI is allowed to operate in a relatively free environment, the authors suggest setting some limitations (overall deposit base, loan portfolio, number of staff) that would ensure that MFIs would be too small to be a threat to the financial system. Once the MFI becomes too large to operate within these borders, it should be required to be re-registered. Developed MFIs attracting deposits or borrowing significant amounts should be subject to prudential regulations, especially on (i) the recognition of impaired loans and provisionings, (ii) minimum capital requirements, and (iii) lending to insiders. The authors also recommend normally restricting MFIs (unless they are on par with commercial banks in size and sophistication) from dealing in foreign currency, although they acknowledge that in certain countries this restriction would not be appropriate.

The resume has been prepared by Marcin Fijalkowski and edited by Kate Lauer but was reviewed by the authors.

You can read the full version of the IMF working paper on http://www.imf.org/external/pubs/ft/wp/2002/wp02159.pdf



# Interview with Ms. Gulnara Dijkanbaeva,

## Board Member, National Bank of the Kyrgyz Republic

• ***What was the incitement to create a new law specifically designed for microfinance organizations?***

**G.D.** The Kyrgyz republic is strongly committed to developing the microfinance sector. In 2001, the president signed the decree "on Measures to Develop the Microfinancing System" and in 2002, there was a national forum on poverty reduction and social mobilization. This event, called "Microcrediting – a way to reduce poverty and mobilize society", was attended by NGOs, both local and international ones. The participants of the forum agreed that a law regulating microfinance institutions' activities was needed. Besides we are implementing policies to attract foreign investment and overcome administrative barriers. The development of the law on microfinance fit very well into this context.

A working group composed of the National Bank of Kyrgyz Republic (NBKR), the government and international organizations prepared a draft. This draft was presented at a roundtable (funded by ARDC/CHECCI) attended by deputies, MFIs representatives and the NBKR officials. The roundtable helped to solve the remaining concerns, which resulted in the enactment of the law a short time later.

In September 2002, the 12th regional conference "Bank Supervision in the Caucasus and the Central Asia Countries" was held with participants from the central banks of Azerbaijan, Russia, Georgia, Armenia, Tajikistan and Kyrgyzstan. During the conference, NBRK presented the new Law on Microfinance Organizations (law on MFOs).

• ***You mentioned that you were in contact with central banks in neighboring countries. Did they influence the development of this law?***

**G.D.** We took into consideration the experience of other NIS countries but it is difficult to say that these countries have significant experience in this field. However, the regional conference helped to establish contacts with the central banks of these countries. We obtained a draft law from Kazakhstan. Also the Armenians have similar draft laws. The Microfinance Centre in Poland too responded to our request and sent us the required information. However, it is worth stressing that after the adoption of the law on MFOs, important work is needed on a more detailed regulation of microfinance activities.

• ***I understand there was no contact with other Central Banks during the elaboration of the draft. Does it mean that the whole drafting process was made from scratch?***

**G.D.** Yes, we can say that. The law was mainly produced by local experts. However, international organizations – PROUN, FINCA-Kyrgyzstan and Mercy Corps-Kyrgyzstan – initiated the drafting of the law and were consulted throughout the drafting process.

• ***When was the law on MFOs passed officially, in July or August?***

**G.D.** End of July.

• ***According to the law on MFOs, microfinance institutions (referred to in the law as microfinance organizations – MFOs) have 6 months to register. Are there any organizations that already have been registered in accordance with requirements?***

**G.D.** Not yet. We have developed regulations on the process of creation of MFOs. The charter should clearly define such points as scope of activities, which includes regions, where MFOs plan to operate, the accounting policy etc. It takes time to adjust charters to new regulations.

• ***Is NBKR ready to supervise MFOs?***

**G.D.** It depends on the type of organization. In the case of microcredit agencies or microcredit companies, the supervision is easier, as they cannot mobilize savings and the loans are disbursed either from their own capital or from credit capital. From the NBRK perspective, supervision means overview and analysis of their reporting documentation.

It is much more complicated with microfinance companies, which are allowed to take deposits and therefore pose higher risks to the financial system and consumers (that is, depositors). Consequently, in this case, NBRK will carry out more rigorous supervision

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including detailed review of the documentation, external control, analysis of submitted information etc.

***• Does it mean that NBKR will be concentrated on regulatory standards for microfinance companies leaving aside microcredit agencies and companies?***

**G.D.** No, everything will be developed simultaneously.

***• That means that only the methods of supervision will vary?***

**G.D.** Yes.

***• Do you have the intention to educate the staff responsible for regulation of microfinance? What kind of training will be organized for the staff?***

**G.D.** The overall supervision is the responsibility of Administration of the Banking supervision. The Administration has a department of supervision for non-banking institutions. They are supposed to supervise the microfinance organizations. Obviously there are number of questions that require special consideration and the help of our experts will be needed. Of course if necessary we will provide training as well.

***• Are you going to invite consultants or rather organize trainings, seminars?***

**G.D.** I think both. And if possible we will train staff as well as provide technical assistance.

***• Will you mobilize additional staff for this purpose?***

**G.D.** No, there will not be special staff for this, but we realize that additional specialists will be needed. We will discuss the question of enlarging the staff of the department of supervision for non-banking institutions.

***• What is understood under non-prudential regulation?***

**G.D.** The Department of Methodology is working on regulations for MFOs and these regulations are supposed to define the format of reports. The department will decide what format of reporting should be submitted by the MFOs, how will be organized the analysis, what database will be necessary etc.

***• Are you working with existing MFOs on developing the NBKR regulations or there is a special group for this purpose?***

**G.D.** The NBKR staff carried out the development of temporary regulations for MFOs in close cooperation with the representatives of international organizations involved in microcrediting.

***• What will be the impact of MFOs activities on commercial banks activities?***

**G.D.** The microfinance industry can operate simultaneously with the existing banking sector. MFOs have their own niche in the financial sector that they are filling. However in the long run, borders between the microfinance sector and the banking sector will be washed away, which should result in a higher competition on the financial market.

***• Do you think commercial banks clients can become clients of MFOs?***

**G.D.** Currently MFOs are concentrated on rural and remote regions, where banks are rather absent. However with the development of the microfinance industry, banks will have to face increased competition influencing the clients' choices.

***• Do you think microfinance companies will compete with banks for the population's savings?***

**G.D.** According to the law, microfinance companies can fulfill depository activities after two years of operation. Maybe in the future, microfinance companies will compete with banks both in crediting and mobilizing savings. Nevertheless, until then, we are not expecting any sudden changes.

***• Do you expect an increase of financial activities in rural areas?***

**G.D.** We hope that the population will show higher interest in MFOs – it was one of the main purposes of passing the discussed law.

***• What will be the impact of this law on credit unions?***

**G.D.** Credit unions are member-based organizations governed by a separate law on "credit unions" and will not be impacted by the law on MFOs unless a credit union wishes to transform into microfinance organizations.

***• You mentioned that some central banks were considering adopting similar law on microfinance and hoped to benefit from the Kyrgyz example. What are the countries interested by the Kyrgyz experience?***

**G.D.** Yes we exchange experiences with other countries as they have shown an interest in our results in regulating microfinance.

***• Is there any NIS country, which has adopted a similar law?***

**G.D.** To my best knowledge, we are the first NIS country who adopted such a law. However, draft laws were developed in Kazakhstan and Armenia.

***• Can you say what kind of risks a non-depository microfinance organizations pose for the economy?***

**G.D.** There are always risks connected to extending credits. However, the risk is mainly borne by the institutions itself and not by the whole financial system.

***Thank you for the interview.***

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THE INTERVIEW WAS CONDUCTED
BY BABUR TOLBAEV,
DIRECTOR OF MERCY CORPS PROGRAM, KYRGYZSTAN



**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

***If you would like to send an update on any information on new legal initiatives in your country, please contact Marcin Fijałkowski (marcin@mfc.org.pl).***